Are the U.S. Dollar’s Days Really Numbered?

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The U.S. dollar will remain the world's reserve currency because no other major currency offers such liquidity, depth of financial markets, and store of value.

Some years ago, I attended a small luncheon on the outlook for the U.S. dollar. Paul Volcker, the former Federal Reserve chairman, was the guest of honor. In response to a chorus of Cassandras who argued that the U.S. economy’s all too apparent weaknesses would lead to an inevitable dollar collapse, Volcker made a simple observation: For the dollar to depreciate, he said, it would necessarily have to depreciate against another currency. And in Volcker’s view, at that time, the U.S. economy was fundamentally no weaker than that of any competing countries.

Volcker’s logic would seem equally pertinent today in responding to the many critics who believe that the Federal Reserve’s unprecedented quantitative easing policy will lead to the dollar’s imminent demise as a reserve currency. If the dollar is to lose its reserve status, as epitomized by the fact that more than 60 percent of the world’s foreign exchange and more than 85 percent of world trade is still denominated in U.S. dollars, some other currency would need to replace it. A close examination of the world’s other major currencies reveals that a currency is yet to emerge that offers the liquidity, depth of financial markets, and store of value that the U.S. dollar does.

To be sure, when viewed in isolation, there are many reasons not to be complacent about the U.S. dollar’s long-run future. After all, the U.S. economy is only now emerging from its worst economic and financial crisis since the 1930s. At the same time, its dysfunctional
political system is yet to come to grips with the country’s long-term budget issues, while the Federal Reserve has more than quadrupled the size of its balance sheet to its present level of around $4 trillion in an effort to get the U.S. economy moving again.

Yet, despite all of its weaknesses, the U.S. economy’s recent performance has been considerably brighter than that of the other major industrialized countries. Not only has the U.S. economy recovered the most strongly from the 2008-2009 Lehman crisis, but its economic outlook for 2014 and 2015 remains the brightest of the industrialized countries, as acknowledged by the IMF’s recently published World Economic Outlook. On the basis of that recovery, the nonpartisan Congressional Budget Office is now forecasting that the U.S. budget deficit will be as low as 2.75 percent of GDP in 2014 and 2015, while by 2024 the U.S. public debt will still be comfortably below 80 percent of GDP.

Perhaps most importantly for the U.S. dollar’s future as a reserve currency, there appears to be no sign of any resurgence in U.S. inflation, despite all the dire warnings about the unprecedented expansion in the Federal Reserve’s balance sheet. Indeed, U.S. inflation is currently running at around 1 percent, or half the Federal Reserve’s desired target, while long-term U.S. inflationary expectations appear to be very firmly anchored.

The prospect for the U.S. dollar maintaining its dominant status as a reserve currency becomes all the brighter when one considers the prospects of those currencies that could conceivably challenge that status. This is most evidently the case when one considers the clouded prospects for the euro, which accounts for almost 25 percent of world international reserves and which until very recently has been touted as the currency that could seriously challenge the U.S. dollar’s dominant position.

Despite the market’s current optimism about Europe, the euro’s long-term prospects are fraught with considerable political and economic risk. At the heart of those risks is Europe’s record-high unemployment rate, which presently remains stuck at around 12 percent for the region as a whole and at as high as 27 percent for countries such as Greece and Spain. The European Central Bank itself is currently forecasting that, despite the gradual European recovery that it expects, European unemployment will not decline below 11.5 percent by 2016.

Since the onset of the European sovereign debt crisis in 2010, there has been a disturbing fragmentation of European politics. In France, Marine le Pen of the National Front is now ahead in the polls for the upcoming European parliamentary elections. Together with Geert Wilders of the Dutch far-right Freedom Party, she is campaigning on an anti-European platform. Meanwhile in Greece, the two centrist parties which commanded 70 percent of the vote in 2010 now command barely 30 percent of public support, while in Italy the populist Five-Star movement still polls 25 percent of the vote.

There is a real danger that high unemployment will continue to contribute to Europe’s political deterioration, as it has in recent years. And if that were to happen, Europe’s political commitment to the euro could be sorely tested.

The main economic risk for the euro is that Europe’s high unemployment rate is now raising the real specter of Japanese-style deflation in Europe. Over the past year, Europe’s average inflation rate has already decelerated to 0.5 percent while the countries in the European periphery are now already either experiencing outright deflation or else are on the cusp of
deflation. The trouble with deflation is that it not only constitutes a major headwind to the economic recovery but it highly complicates the task of restoring public debt sustainability in the highly indebted countries of the European economic periphery. Sadly, much like the Bank of Japan before it, the European Central Bank behaves as if it was oblivious to the deflation risk.

If the euro is unlikely to pose a serious challenge to the dollar, the Japanese yen is certainly not going to do so. After all, the Japanese government is drowning in debt and running an outsized budget deficit, while the country’s very poor demographics have led to a plunge in the domestic savings rate. There is every prospect that the Bank of Japan will have to step up its already massive quantitative easing program to avert a relapse into deflation, which will lead to a prolonged period of Japanese yen weakness. This is hardly the stuff of which a strong reserve currency is made.

In contrast to the Japanese yen, the Chinese renminbi is a currency that could eventually pose a real threat to the U.S. dollar, particularly if China were to continue to grow at anywhere near its recent rate. However, for that to happen, China would need to engage in serious financial reform aimed at making the currency convertible by lifting capital controls, developing its domestic bond market, cleaning up its shadow banking system, and making the financial system more transparent and more based on the rule of law. Judging by the experience of other countries, it would seem fanciful to think that these reforms could be successfully implemented in less than a decade.

Ever since the collapse of the Bretton Woods system in 1971, there has been no shortage of predictions that the dollar’s days as the world’s dominant reserve currency were numbered. Yet some 40 years on, the dollar’s position is yet to be seriously challenged. This is not so much because of the dollar’s inherent strengths as much as because of its rival currencies’ intrinsic weaknesses. For better or for worse, there is every reason to expect that this state of the world will continue in the decade ahead and that once again the long-run dollar pessimists will be proved wrong.

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