To What Extent Will the Global Role of the US Dollar Have Changed a Decade From Now?

By William White

In real life, what should happen often differs sharply from what does happen. The current international financial non-system, centred around the use of the US dollar, was not constructed but simply evolved out of the wreckage of Bretton Woods. Its many shortcomings imply that it should be replaced.

It has no adequate mechanisms for reducing current account imbalances. It allows disruptive spillovers of US monetary policy to an ever-growing economic periphery. It is dangerously unanchored. It has no unquestioned lender of last resort. Finally, it allows the US government to use the US dollar as a geopolitical weapon. In short, this non-system does not act in the interests of all and is increasingly prone to crisis.

Indeed, another global crisis seems likely. “Currency wars” between central banks have encouraged easy money and unprecedented debt accumulation, not least in emerging markets. Financial stability is threated by squeezed margins at financial institutions and the search for yield. Many asset prices seem unreasonably high, and corrections could be disorderly. Finally, monetary and fiscal polices are “trapped” by plausible arguments against both easing and tightening.

A small silver lining is that such a crisis might prompt a coordinated global attempt to redesign the international financial system. Unfortunately, even this is not likely to happen. The existence of a link between crises and systemic shortcomings is not universally accepted. Moreover, even if the need for reform were agreed, alternative proposals would surface. Finally, agreements at the level of theory still need active cooperation to implement. Given the growing distrust of national governments, and of globalisation, that seems highly unlikely.

Absent a cooperative agreement to fashion a new system, events on the ground will determine subsequent developments. As before, the system will evolve in response to shocks. Today, one particular shock seems likely. Similar to the last “trans Atlantic” crisis, the next one will also reveal that many non-US financial institutions face a massive shortfall in short term dollar funding. Sales of dollar assets could quickly lead to fire sale prices. Sales of domestic assets to raise dollars would further strengthen a dollar already benefitting from “safe haven” status. Either outcome could significantly worsen the crisis.

In 2009, dollar loans from the Fed to foreign banks in the US, and through swap agreements with foreign central banks, were crucial. As well, the G20 agreed to increase the allocation of Special Drawing Rights (SDR) at the IMF by $250 billion. There are various grounds for belief that the Fed might be less able or willing to respond similarly in the next crisis. This raises the tantalizing possibility that the role played by SDRs and the IMF, as a lender- of- last- resort in crises, might have to increase substantially. If this happened, attention might eventually be drawn to those other shortcomings of the dollar- based system that make such crises more likely. In this fashion, what should happen would happen, but it might take many years.