Weak dollar raises talk of alternative world currency

By David J. Lynch, USA TODAY

Just about every day seems to bring more bad news for the dollar.

Recent months have witnessed a steady erosion in the greenback's value, down 16% since March against the currencies of the top U.S. trading partners. On Wednesday, the euro broke through the symbolically important $1.50 barrier for the first time in 14 months.

Depending on whom you believe, a dollar hovering near its 52-week low represents either the market's devastating verdict on the Obama administration's profligacy or a salutary rediscovery of risk by newly emboldened investors.

Maybe it's a bit of both. But the downbeat drumbeat bangs on. Chinese officials openly worry about taking a bath on their enormous U.S. Treasury holdings. Foreign bankers talk of promoting an alternative global currency, such as the euro, yuan or a new synthetic medium of exchange cooked up by the International Monetary Fund.

In the U.S., some voices on the right, such as Rep. Michele Bachmann, R-Minn., detect an anti-American conspiracy to scuttle the dollar. But the roster of those opining on the dollar's woes includes establishmentarians such as Robert Zoellick, president of the World Bank and a former top official in Republican administrations. "Looking forward, there will increasingly be other options to the dollar," he warned last month.

As the U.S. tries to repair its crisis-battered economy, is the end of dollar supremacy about to make a tough job even tougher?

Not any time soon. There are "lots of reasons to be concerned about the dollar. … (But) a weaker dollar is a fantastic boost for the United States, and it's a problem for the rest of the world," says Kenneth Rogoff, former IMF chief economist.

A natural monopoly

Since supplanting the British pound more than 60 years ago, the dollar has reigned supreme in global markets. As of the end of June, the most recent data available, 62.8% of foreign exchange reserves worldwide were held in the form of U.S. dollars. An additional 27.5% were stockpiled in euros, according to the IMF.

The dollar's position has eroded in the past five years. In mid-2004, it made up 67.9% of world reserves. "A lot of people get excited about this. But in the 1970s and 1980s, there was even bigger volatility in the dollar share of reserves," says Stephen Jen, managing director of BlueGold Capital Management, a London-based hedge fund.

In March, Chinese Central Bank chief Zhou Xiaochuan proposed shifting global finance to a reliance on a new international reserve currency rather than the dollar or any other national unit. The aim would be to avoid the periodic crises that have characterized recent decades. But Zhou acknowledged that any such change would take "a long time."

The instability of a world economy so dependent on any single national currency is prompting even some leading American

figures to argue for a gradual move away from the dollar. Fred Bergsten, former assistant Treasury secretary in the Carter administration, says a major cause of the current crisis was the destabilizing linkage between the U.S. trade deficit, enormous capital flows from abroad that financed it and the global dominance of the U.S. dollar. He argues in a new *Foreign Affairs* article that, to avoid a repeat episode, the U.S. should promote a move to a "multi-currency system" involving the euro and the yuan.

For now, the dollar's fundamental standing remains what it's been for decades: a convenient medium of exchange for buyers and sellers around the world. Just as Chinese merchants speak the global language of English when trading with Saudi oil barons, they use the global currency to buy the oil. "The reserve currency is a natural monopoly. It's so convenient to list prices in a single currency," says Harvard University's Rogoff, co-author of *This Time Is Different*, a study of financial crises.

The U.S. benefits from the dollar's unique role, enjoying what French President Valery Giscard d'Estaing memorably labeled the "exorbitant privilege" of being able to borrow abroad in its own currency. That insulates Americans from the danger of seeing their debts skyrocket in response to a sharp decline in the dollar's value.

The dollar doesn't owe its global role to international affection for Americans. Investors relying on the cold logic of the marketplace are drawn to the greenback by specific advantages that make the rise of a dollar rival inherently difficult. "There's no equally attractive alternative," says economist Barry Eichengreen of the University of California-Berkeley.

In the short run, the only currency that could challenge the dollar is the euro. It, too, has a continental-size economy behind it, and a decade after its introduction, the European currency has established itself as a fully convertible, stable store of value.

But for all its attractions, the euro lacks some essential attributes. Although the European Union has a central bank, comparable to the Federal Reserve, there is no European treasury. Instead, there are 27 European treasuries. Investors can't easily track or influence fiscal policy on the continent.

The dollar is also buoyed by the existence of a massive government bond market. There's roughly $4 trillion worth of U.S. Treasuries floating around, and almost $100 billion changes hands each day, according to investment management firm Pimco. Trading that's carried on almost 24 hours a day, rolling east to west from Tokyo to London to New York, makes it easy to move into and out of dollar positions in a hurry.

Europe, by contrast, has no analogue to the U.S. Treasury market. Instead there is a fragmented scene with individual sovereign debt from Germany, Italy, France and other EU members. No individual market enjoys anything like Treasuries' liquidity and size.

There's another potential dollar rival on the horizon, though its day likely lies a decade or more in the future. Just as the United States overtook the British empire, China's economy one day is likely to pass the U.S.'s. When it does, the yuan would be in position to fill the dollar's global role.

But before it does, China will have to thoroughly overhaul its existing financial system. Today, the yuan isn't freely convertible into other currencies, and there are strict limits on the cross-border movement of the Chinese currency. Chinese officials publicly have committed themselves to freeing the yuan to float alongside the dollar, euro, yen and other major currencies. That change, however, won't happen overnight.

Even if foreign investors have concerns about having so much of their national wealth tied up in dollars, there is a limit to what they can do about it in the short run. The Chinese, for example, have little choice but to keep recycling into Treasury purchases their dollar surpluses from trading with the United States. Beijing wants to prevent the yuan from appreciating against the dollar, to protect employment in its export sector. Even as it worries about the long-term prospects for its dollar-denominated investments, it has to keep buying dollars to do so.

"There's a gap between what's feasible and what central banks would like to do," said Steven Englander, chief foreign exchange strategist for Barclays Capital in New York.

Further to fall

The dollar's long-run prognosis is negative. In the wake of the crisis, a retrenchment in cross-border financial flows will mean less demand for dollar-denominated assets. And with Uncle Sam's printing press running overtime to cover the government's trillion-dollar budget deficits, the currency is expected to be further cheapened, says Eichengreen.

The decline in the dollar's value in the past seven months largely reflects an unwinding of the "flight to quality" that occurred during the most panicked crisis phase. Amid unprecedented levels of uncertainty late last year, investors flocked to assets denominated in the largest, most liquid currency. That drove the dollar's value against the euro, for example, up about 13% over the three months ended in March.

Since then, the euro has regained the lost ground and then some. A euro, which settled at $1.50 Wednesday, was at $1.43 in December.

In the political realm, the dollar's weakness is interpreted as a referendum on American decline. But its steady slippage this year is in line with economic fundamentals — that is, near-zero U.S. interest rates.

That said, neither the euro nor Japanese yen have had anything to celebrate. The biggest beneficiaries of the move out of dollars since March have been currencies of countries that heavily export raw materials, such as the Australian dollar (up 33% against the greenback) and the Canadian loonie (up 21%).

U.S. officials historically repeat mantra-like that they favor a "strong dollar." That really should be interpreted as a fancy way of saying "no comment."

So far, the dollar has only retreated back to the level it was at before the Lehman Bros. bankruptcy filing in September 2008 turned an economic downturn into a global financial panic. A weak dollar would be a problem if it contributed to inflation by increasing the cost of imports, or if it got so low so fast that the Fed felt compelled to raise interest rates to attract foreign investors. Neither is the case today.

The shrinking dollar also carries important economic benefits for the U.S. economy as it tries to climb out of recession. By making U.S. goods less expensive overseas, a weaker dollar provides a welcome boost for exports. The Obama administration has said it wants to rebuild the U.S. economy to rely more on making goods here to sell to people in other countries instead of depending on buying more and more stuff made elsewhere.

"The U.S., in the new normal, is going to have to export more because U.S. households will be saving," said Eichengreen.

For that to happen, the dollar likely has further to fall.

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