
Two Dollar Fallacies

By Martin Feldstein *Thu, Mar 7, 2013*

If progress is not made in reducing the projected fiscal imbalances and limiting the growth of bank reserves, reduced demand for dollar assets could cause the dollar to fall more rapidly and the interest rate on dollar securities to rise.

The United States' current fiscal and monetary policies are unsustainable. The US government's net debt as a share of GDP has doubled in the past five years, and the ratio is projected to be higher a decade from now, even if the economy has fully recovered and interest rates are in a normal range.

An aging US population will cause social benefits to rise rapidly, pushing the debt to more than 100% of GDP and accelerating its rate of increase. Although the Federal Reserve and foreign creditors like China are now financing the increase, their willingness to do so is not unlimited.

Likewise, the Fed's policy of large-scale asset purchases has increased commercial banks' excess reserves to unprecedented levels (approaching \$2 trillion), and has driven the real interest rate on ten-year Treasury bonds to an unprecedented negative level. As the Fed acknowledges, this will have to stop and be reversed.

While the future evolution of these imbalances remains unclear, the result could eventually be a sharp rise in long-term interest rates and a substantial fall in the dollar's value, driven mainly by foreign investors' reluctance to continue expanding their holdings of US debt. American investors, fearing an unwinding of the fiscal and monetary positions, might contribute to these changes by seeking to shift their portfolios to assets of other countries.

While I share these concerns, others frequently rely on two key arguments to dismiss the fear of a run on the dollar: the dollar is a reserve currency, and it carries fewer risks than other currencies. Neither argument is persuasive.

Consider first the claim that the dollar's status as a reserve currency protects it, because governments around the world need to hold dollars as foreign exchange reserves. The problem is that foreign holdings of dollar securities are no longer primarily "foreign exchange reserves" in the traditional sense.

In earlier decades, countries held dollars because they needed to have a highly liquid and widely accepted currency to bridge the financing gap if their imports exceeded their exports. The obvious candidate for this reserve fund was US Treasury bills.

But, since the late 1990's, countries like South Korea, Taiwan, and Singapore have accumulated very large volumes of foreign reserves, reflecting both export-driven growth strategies and a desire to avoid a repeat of the speculative currency attacks that triggered the 1997-1998 Asian financial crisis. With each of these countries holding more than \$200 billion in foreign-exchange holdings - and China holding more than \$3 trillion - these are no longer funds intended to bridge trade-balance shortfalls. They are major national assets that must be invested with attention to yield and risk.

So, although dollar bonds and, increasingly, dollar equities are a large part of these countries' sovereign wealth accounts, most of the dollar securities that they hold are not needed to finance trade imbalances. Even if these countries want to continue to hold a minimum core of their portfolios in a form that can be used in the traditional foreign-exchange role, most of their portfolios will respond to their perception of different currencies' risks.

In short, the US no longer has what Valéry Giscard d'Estaing, as France's finance minister in the 1960's, accurately called the "exorbitant privilege" that stemmed from having a reserve currency as its legal tender.

But some argue that, even if the dollar is not protected by being a reserve currency, it is still safer than other currencies. If investors don't want to hold euros, pounds, or yen, where else can they go?

That argument is also false. Large portfolio investors don't put all of their funds in a single currency. They diversify their funds among different currencies and different types of financial assets. If they perceive that the dollar and dollar bonds have become riskier, they will want to change the distribution of assets in their portfolios. So, even if the dollar is still regarded as the safest of assets, the demand for dollars will decline if its relative safety is seen to have declined.

When that happens, exchange rates and interest rates can change without assets being sold and new assets bought. If foreign holders of dollar bonds become concerned that the unsustainability of America's situation will lead to higher interest rates and a weaker dollar, they will want to sell dollar bonds. If that feeling is widespread, the value of the dollar and the price of dollar bonds can both decline without any net change in the holding of these assets.

The dollar's real trade-weighted value already is more than 25% lower than it was a decade ago, notwithstanding the problems in Europe and in other countries. And, despite a more competitive exchange rate, the US continues to run a large current-account deficit. If progress is not made in reducing the projected fiscal imbalances and limiting the growth of bank reserves, reduced demand for dollar assets could cause the dollar to fall more rapidly and the interest rate on dollar securities to rise

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