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Decouple the World from the Dollar

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Until recently, some economists believed that this economic crisis would end when investors returned to the stock market and recapitalized banks. But investors lacked confidence, thinking that they would be throwing good money after bad. The dubious assets buried deep in bank balance sheets still had to be cleansed, but trying to sell them off would further decrease their market value and compound banks' losses. Thus the bottom could not be reached until the investors returned, but investors would stay on the sidelines until asset prices hit bottom.

The initial rescue package from former Treasury Secretary Paulson was aimed at addressing this dilemma by trying to provide a floor to falling asset prices. The Paulson plan failed to change investors' expectations or persuade financial markets that it could provide the bottom that the market would not, and it is doubtful that the latest Geithner-Summers Plan will do so either.

It is clear that this is no ordinary recession. While there is no consensus on how to revive banks, there appears to be considerable agreement that extreme monetary easing and a massive fiscal stimulus are necessary to prevent the current slump from getting even worse. There is, however, a panacea of sorts for the broken machinery of the global economic system.

While an emphasis on reviving banks and an injection of public spending are both important, the trouble is that neither one directly addresses the main source of global deflation, which is that global imbalances are no longer being recycled effectively. Because U.S. households and banks are now bankrupt, the United States has lost much of its capacity to absorb and recycle foreign trade surpluses. That, in a nutshell, is the driving force behind the global deflationary trend.

Substituting massive public spending for private consumption and putting banks on life support are at best stopgap measures, and it is unlikely that they will bring back the ability to recycle trade surpluses. Even in the best-case scenario, where confidence in the dollar holds up, the broken machinery that produced the world's credit supply cannot not be reassembled because too many borrowers and intermediaries are insolvent. There is no easy way to make the debt overhang go away, and neither tax cuts nor cleansing banks of toxic assets will bring about a lasting increase in private consumption.

If confidence in the dollar ebbs and a slide/rush to gold occurs, the situation will be further complicated. The 1920s and 1930s offer a lesson on the dangers posed by a potential slide/rush into gold. Following the Fed's shift to tight money in 1928, the capital flow from the United States to Europe began to reverse and the deficit countries were forced to deflate, increasing doubts about the overvalued sterling and the dollar. A destabilizing dynamic was set in motion—more confidence eroded fear of devaluation, which led countries to liquidate foreign exchange (sterling and dollar) in favor of gold in their reserves, and the devaluation risk rose further. The extinction of monetary reserves caused by the dwindling foreign exchange led to a progressive contraction of money supply and credit, making the slump worse and further undermining the confidence in the monetary system.

There are no fixed parities to defend today, whether against gold or any other currency, and the Fed is doing exactly the opposite of what it did then. However, there are also unmistakable parallels. Just like then, a process of deflation driven by the disruption of the recycling of trade surpluses is threatening global financial disintermediation. Similarly, the erosion of confidence is again liable to cause a massive monetary contraction and fragmentation of trade around the world in the following years.

This time, the stakes are higher and there is less room to maneuver, given that the share of dollars in international reserves is far larger now than it was in the late 1920s. If financial sentiment forces the United States to choose between trying to keep unemployment from rising further into double digits or defending the dollar, the United States could probably succeed in neither. Reversing its policy of extreme monetary easing and fiscal stimulus in order to defend the dollar could be as disastrous as letting its value fall. Unlike the 1930s, depreciating the dollar is much less of an option, as its deflationary impact abroad would come back to haunt the United States.

The advantage the United States enjoys in being able to issue its liabilities in its own currency can turn into a liability. The United States has been spared the worst ravages of this financial crisis because of this ability. There is a potential downside, though. Most countries that had a currency crisis in the 1990s experienced a speedy, V-shaped recovery mainly because the sharp capital account reversals they experienced provided an unambiguous market signal that asset price deflation had hit bottom and overshot, which led to a strong surge in capital inflow and a speedy end to the crisis. The trouble now is that no quick obvious market-driven bottom to asset price deflation can conceivably exist in the event of a dollar crisis because of the massive size of the dollar reserves outside the United States. Sharp dollar devaluation can cause these reserves to unravel and would result in a massive dollar overhang, causing serious damage to world trade.

The United States' current policy ignores the possibility that changes in financial sentiment might eventually force its hand on the dollar. The extreme monetary easing and a massive fiscal stimulus being implemented amounts to fighting deflation by trying to destabilize the monetary standard to induce inflation. If it fails, the current slump can turn into a great depression worse than the last, and if it works, the resulting inflation will probably make the 1970s look good. But, given the severity of the situation, what else can be done?

Given that the problem is not the global imbalances per se, but how financial deregulation and the global order absorbed and recycled them, a safer approach would target the following three objectives: first, the reassertion of public control over the credit creation process; second, preparing for the possibility that the value of the dollar dives; and third, resuming recycling trade surpluses before contraction begins to destroy them. We have to wean the world off its dependence on U.S. overspending without sticking the United States and the world economy in a depression. That requires that the global monetary standard, and by extension the integrity of monetary reserves, is safeguarded as more stimulus is implemented.

A credible plan to achieve this would involve figuring out a way to drive a wedge between the global dollars accumulated in foreign reserves and the domestic dollars that the United States will be creating at a much faster clip. That way, the world economy can reinflate at the same time, since everyone would be able to devalue in relation to a stable monetary standard.

Technically, this wouldn't be hard to do. An idea such as setting up a substitution account at the International Monetary Fund to convert unwanted dollars to special drawing rights can be considered. The idea was considered before in the late 1970s when international confidence in the dollar was ebbing, only to be shelved once the political swing to the right made it redundant. In principle, the IMF could issue as many new SDRs as demanded without being inflationary, and could even refashion itself as the asset manager of the world. The IMF could even help generalize new instruments such as the proposed Asia bond by using Chinese reserves.

The real question is whether there will be the political will to carry out these proposals. Will the United States have the wisdom to decouple the world economy from the dollar? Will the United States and China, who have the most to gain from cooperation, be able to do so? Will the G-20 be the driving force behind a new global accord? Much rests on whether the Obama Administration can move past a dollar-centric economic paradigm.

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