Currency wars

Devaluing the US dollar, and US debt

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The decline of the US dollar is a real and present issue for business. The level of decline in the real value of the dollar has been in the order of 20% (as shown in the accompanying chart).

The devaluation began in 2002 when the Bush administration ratcheted up its involvement in overseas wars. There was a short-lived rally at the time of the 2008 global financial crisis but the general declining trend is once more back with us.

How large a decline is required to allow for a meaningful adjustment in relative wages? While it is impossible to make precise estimates, a close look at real effective exchange rates, which allow for cross-border wage comparisons, indicate that something in the order of over 30% is required.

In the US, once unemployment declines far enough, say to 5% or so, wage pressures are likely to build. Eventually, wages will rise to the point that they enable households to service previously accumulated debt burdens. When that happens, sustainable growth will again be possible, although households will find that their global purchasing power and relative standard of living has declined dramatically.

This is another lesson of the stagflationary 1970s, in which the US standard of living was more or less stationary while that of the rest of the world, including Germany and Japan, improved noticeably.

Those who recall the 1970s must wonder why on earth the US federal government would want to enact policies that would in all probability lead to a similar set of stagflationary conditions.

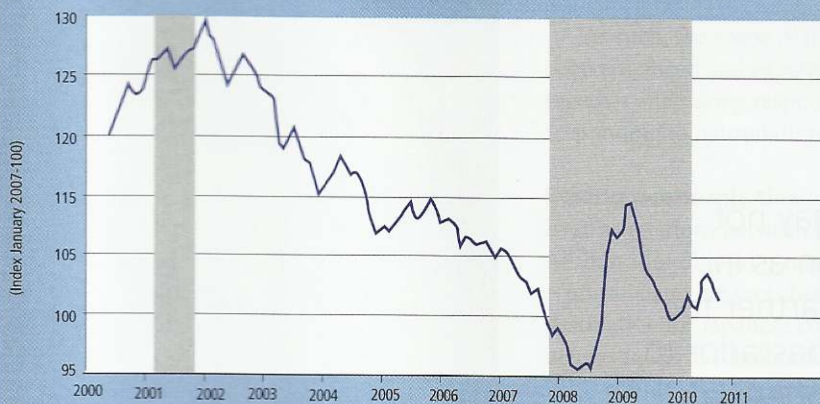
The US Federal Reserve might claim that it does not have much of a choice. Once originated, debt simply needs to be serviced. It can, however, be serviced in a strong or weak currency. A country with a solid infrastructure and industrial base and with plentiful natural resources, like Indonesia, might easily manage to service debt in a strong currency.

Had the US run up its accumulated debt in order to finance sensible investment projects over the years, it would probably be able to manage to service this without resorting to dollar devaluation, but this is not what has happened. Much of the increase in US debt has resulted from financing consumption rather than investment, with much of it unsound.

The most notable examples of poor investments occurred in the dot.com boom of the late 1990s and early 2000s, and more recently in the uncontrolled lending which went on with mortgage lending with artificially low interest rates – the Fannie and Freddie bubbles that contributed to the 2008 bank crash.

The statistics clearly show that the debt-financed consumption and housing boom is now over, but the debt remains and cannot be properly serviced by the existing productive resources of the US economy, which brings two painful choices – devaluation or default.

by William I. Gray & Scott Younger



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Devaluing debt

It has been apparent since 2003 that a declining dollar would help ease the US debt burden, lower the current account deficit and provide American manufacturers improved opportunities in global commerce.

US policymakers have clearly defined the road ahead. They want dollar devaluation to continue to ease the debt burden rather than face a more ignominious default. A debt restructuring exercise would be another possible approach, but in the current economic climate this would seem to be a very hazardous course of action, which is why policymakers reject it.

Fed Chairman Bernanke has previously weighed in on this matter. In his opinion it comes down to politics and the ability or inability to make tough choices. The solvency of banks and corporations and the implementation of significant structural change are necessary for long-run economic health.

In the short run, however, comprehensive economic reform will likely impose large costs on many, for example in the form of unemployment or bankruptcy. Consequently, politicians, economists, businesspeople and the general public have sharply disagreed about competing proposals for reform. And, in the resulting political deadlock, strong policy actions are discouraged and cooperation among policymakers is difficult to achieve.

Interestingly, when Bernanke said that he preferred "comprehensive economic reform" to zero interest rates and open-ended liquidity (e.g. quantitative easing), he was not talking about the US but about Japan. So, while he seems to imply solutions should be different between the two countries, the problems are similar, which he undoubtedly understands, but also knows that the political imperative means that the imposition of "large costs on many" would be unacceptable.

It is much easier to understand recent Fed policy actions by recognizing that they are primarily focused on short-term survival of the financial system rather than the long-term health of the US economy.

However, while global hyperinflation is most unlikely, the issue of a currency war is now being increasingly discussed, as the governments of the other main world currencies watch dollar developments and US policy with concern.

Should there be a situation of purchase and counter-purchase with a net result of no dollar devaluation but a soaring money supply then the risk of a currency war would significantly increase. Both the yuan v dollar and yen v won exchange rates are causing some heated inter-governmental discussions and open comment.

There has been an upward impact on gold, in particular, the uptrend for which started also in 2002, from which the dollar decline is traced, and other major commodities and investors have increasingly sought safety in this commodity. Any further market nervousness will only add to the value of this commodity: Gold should keep strengthening throughout 2010.

This is an interesting time, but a time to be cautious.

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