Divergent Views on the Coming Dollar Crisis

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Summary

Is the U.S. vulnerable to a full-blown dollar crisis? Why are international finance economists scared and jittery, but domestically-oriented macroeconomists much less concerned?

KEYWORDS: international finance, dollar, exchange rates, monetary economics, financial crisis

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America’s international finance economists and its domestically oriented macroeconomists have very different—indeed, opposed—views of the likely consequences of America’s huge current-account deficit. International finance economists see a financial crisis as likely, followed by a painful and perhaps prolonged recession in the United States. Domestically oriented macroeconomists, by contrast, see a forthcoming fall in the value of the dollar not as a crisis, but as an opportunity to accelerate growth.

Why the difference?

The Domestic-Macro View

Domestically oriented macroeconomists look at the situation roughly like this: at some point in the future, foreign central banks will become less willing to continue buying massive amounts of dollar-denominated securities. It looks like in 2005 China, Japan, and other Asian central banks will buy $500 billion of dollar denominated assets in order to prop up the greenback so that their exports to the U.S. continue to flow and grow. Eventually, this massive flow of foreign funds must stop (as John Quiggin has explained in the Economists’ Voice: http://www.bepress.com/ev/vol1/iss3/art2/). When they cease their large-scale dollar-purchase programs, the value of the dollar will fall—and it will probably fall hard.

But, according to the domestically oriented macroeconomists, this devaluation is not a large problem for the United States. (However, it is a very big problem for economies that export to the United States.) As the dollar’s value declines, U.S. exports will become more attractive to foreigners and American employment will rise, with labor re-allocated to the newly-vibrant export sector. It will be like what happened in Britain after it abandoned its exchange-rate peg and allowed the pound to depreciate relative to the Deutschmark, or what happened in the U.S. in the late 1980’s, when the dollar depreciated against the pound, the Deutschmark, and—most importantly—the Japanese yen.

The International Finance View

International finance economists see a far bleaker future. They see the end of large-scale dollar-purchase programs by central banks leading not only to a
decline in the dollar, but also to a spike in U.S. long-term interest rates, both nominal and real, which will curb consumption spending immediately and throttle investment spending after only a short lag.

To be sure, international finance economists also see U.S. exports benefiting as the value of the dollar declines, but the lags in demand are such that the export boost will come a year or two after the decline in consumption and investment spending. Eight to ten million workers in America will have to shift employment from services and construction into exports and import-competing goods. This cannot happen overnight. And during the time needed for this labor-market adjustment, structural unemployment will rise.

Moreover, there may be a financial panic: large financial institutions with short-term liabilities and long-term assets will have a difficult time weathering a large rise in long-term dollar-denominated interest rates. This mismatch can cause financial stress and bankruptcy just as easily as banks’ local-currency assets and dollar liabilities caused stress and bankruptcy in the Mexican and East Asian crises of the 1990’s and in the Argentinean crisis of this decade.

Can the Fed Avert a Crisis?

When international finance economists sketch this scenario, domestically oriented macroeconomists respond that it sounds like a case of incompetent monetary policy. Why should the Federal Reserve allow long-term interest rates to spike just because other central banks have ceased their dollar-purchase programs? Should not the Fed step in and replace them with its own purchases of long-term U.S. Treasury bonds, thereby keeping long-term interest rates at a level conducive to full employment?

To this, international finance economists respond that the Fed will not wish to do so. When forced to choose between full employment and price stability, the international finance economists say that the Fed will choose price stability, because its institutional memory of the 1970s, when inflation ran rampant, remains very strong. A fall in the value of the dollar raises import prices, and thus is as an inflationary shock to the supply side of the economy just as the oil shocks of the 1970s were. The Fed today puts preserving its inflation-fighting credibility as priority one. The Fed will want to raise, not lower, interest rates; to sell, not buy, bonds; and thus to reinforce rather than damp the interest rate rise coming from the shift in the exchange rate.
Moreover, the international economists say, the Fed can only influence and not control long term real interest rates. If Asian central banks stop buying $500 billion of U.S. long-term bonds each year, real interest rates will rise because the Fed cannot step in to replace them without consequence. The only way the Fed could finance large-scale purchases of U.S. Treasury bonds on a $500 billion a year scale would be to increase America’s monetary base by 60 percent per year. That would mean inflation on a scale not seen in this or the last century. Since the Fed cannot risk such inflation, it simply does not have the power to keep U.S. interest rates from rising.

I find this distressing.

Serious economists whom I respect enormously find themselves taking strong positions on opposite sides of this debate. I’m not wise enough to say which side is right, but I certainly know which side I hope is wrong.

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