
STATES
PRIVATE

US Debt, Deficit, and the Falling Greenback:

Does It Mean Currency Wars and an End to the Dollar's Reign?

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ABSTRACT

The United States' exploding debt and deficits have raised concerns about the future of the dollar. Are the days of the dollar as the world's reserve currency numbered? If this is the case, what will replace the dollar? More ominously, is the world entering a new era of "currency wars" – where each nation resorts to a "beggar-thy-neighbor" strategy of intervening in exchange rates to capture market share from competitors? The following paper argues that despite challenges to the US economy, the immediate future of the dollar is secure—in part, because there is no alternative on the horizon. However, currency manipulation and competitive devaluation is a growing problem, potentially resulting in low-level trade conflicts that could derail the global economic recovery.

INTRODUCTION

On January 6, 2011, US Treasury Secretary Timothy Geithner informed the members of Congress that America's debt stood at $13.95 trillion—$335 billion short of the limit on federal borrowing that Congress had imposed the previous year.[1] Geithner warned lawmakers that if they failed to quickly increase the debt ceiling, the US government would have no choice but to default, triggering "catastrophic economic consequences that can last for decades." Geithner stressed that "any default on the legal debt obligations of the United States is unthinkable and must be avoided," and urged Congress to "act in a timely manner to increase the limit."[2]

America's economic woes have also been of concern to its creditors, notably foreign governments. China, the world's largest holder of foreign cash reserves (roughly $3 trillion[3]) and the world's leading creditor nation, is increasingly worried that the United States (the world's largest debtor), may not be able to meet its obligations.[4] The United States finds

1 By law, the U.S. Congress sets limits on the amount the Treasury can borrow from the markets, including foreign governments. However, the skyrocketing deficits have meant that the Treasury has to regularly approach Congress to raise the debt ceiling. According to Geithner, the current limit could be reached anytime between March 31 and May 16, 2011. Also worth noting is that roughly half of the current national debt was accumulated over the past six years: from $7.6 trillion in January 2005, to $10.6 trillion on President Obama's first day in office, and to just below $14 trillion at the end of January 2011.

2 "Secretary Geithner Sends Debt Limit Letter to Congress," January 6, 2011. Washington, D.C.: U.S. Department of the Treasury http://www.treasury.gov/connect/blog/Pages/letter.aspx

3 "World-Record China Reserves Pass $3 Trillion in Policy Challenge for G20," *Bloomberg News*, April 14, 2011.

4 Nouriel Roubini, 2009. "The Almighty Renminbi," *New York Times,* May 14; Xin Wang, 2007. "China as s Net Creditor: An Indication of Strength or Weaknesses?" *China and World Economy,* vol. 15, no. 6, December, pp. 22-36; and Brad Setser, 2008. "China: Creditor to the Rich," *China Security,* vol. 14, no. 4, Autumn

Table 1 Major Foreign Holders of US Treasury Securities (As of September 2008)

China	587.0 ($ Billions)	10.1 (Percent of Debt Held by the Public)
Japan	573.2	9.8
United Kingdom	338.3	5.8
Caribbean Banking Centers*	185.3	3.2
Oil Exporters**	182.1	3.1
Brazil	141.9	2.4
All Other	852.9	14.6
Total	2,860.7	49.0

Source: US Treasury. 2009. Treasury Bulletin, Table OFS-1.

*Caribbean banking centers include the Bahamas, Bermuda, the Cayman Islands, the Netherlands Antilles, Panama, and the British Virgin Islands.
**Oil exporters include Ecuador, Venezuela, Indonesia, Bahrain, Iran, Iraq, Kuwait, Oman, Qatar, Saudi Arabia, the United Arab Emirates, Algeria, Gabon, Libya and Nigeria.

itself in this position in part because its Treasury has met its borrowing needs by purchasing debt from abroad. At the end of 1998, foreign holdings of Treasury securities totaled about $1.2 trillion (or roughly 37 percent of all debt held by the public); by 2008, the dollar value of foreign-owned debt had jumped to just over $2.9 trillion—or almost 50 percent of outstanding publicly held debt. The largest foreign holders of US debt are countries that run persistent trade surpluses with the United States. Until September 2008, Japan was the largest holder of Treasury debt, when it was conspicuously replaced by China, whose holdings of Treasury debt have skyrocketed from about $46 billion in 1998 to $587 billion by 2008 (Table 1[5]). In fact, China's actual holdings are estimated to be over $800 billion, as Beijing also purchases US debt through third countries. This debt is not recorded by the Treasury as being held by China.[6] This means that Beijing is now not only the largest foreign holder of US government debt (as it now owns $1 out of every $10 in US public debt), it is also the US government's largest creditor. Indeed, Washington has become increasingly dependent on Beijing to raise money to cover its ever-growing list of expenditures, including paying for the current stimulus and bailout programs.[7]

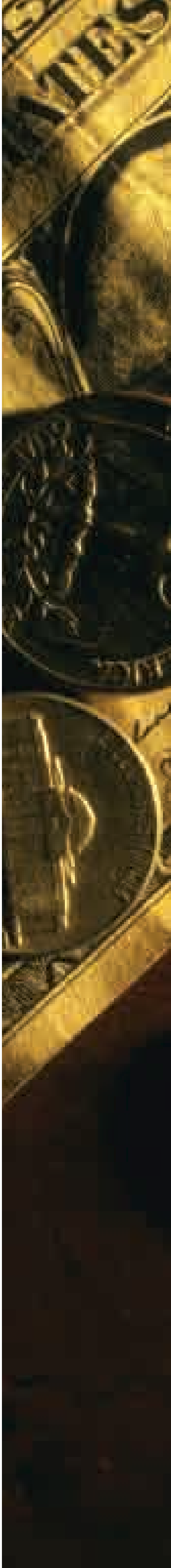
CHINA'S CONCERNS AND OPTIONS

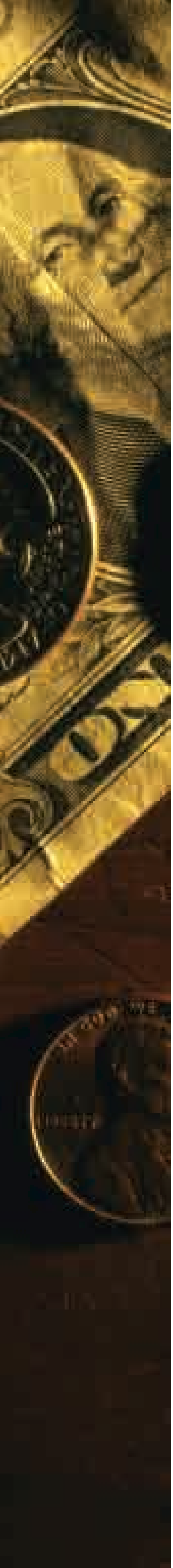
Not surprisingly, Beijing is deeply worried that exploding US government deficits have

5 Office of Management and Budget. 2008. Mid-Session Review, Budget of the U.S. Government, Fiscal Year 2009, July 2008. See, www.whitehouse.gov/omb/budget/fy2009/pdf/09msr.pdf.

6 Brad Setser, 2008. "Impact of China Investment Corporation on the Management of China's Foreign Assets," in Morris Goldstein and Nicholas Lardy, eds., *Debating China's Exchange Rate Policy,* Washington, D.C.: The Peterson Institute, pp. 201-18.

7 Also see Brad Setser and Arpana Pandey, 2009. "China's $1.5 Trillion Bet: Understanding China's External Portfolio," Working Paper, New York: Center for Geoeconomic Studies, Council on Foreign Relations, May.





potential to lead to inflation and sharply reduce the purchasing power of dollar-denominated financial assets. On March 14, 2009, Chinese premier Wen Jiabao bluntly said that he was "worried" about the safety of China's over $1 trillion in investments in American government debt, and that Beijing was watching economic developments in the United States closely. Wen expressed concern that the massive stimulus expenditures in the US could lead to soaring deficits – which, in turn, could sink the dollar's value and lower the value of China's investments. With so much at stake, Wen broke with protocol by openly lecturing Washington on financial management—urging the Obama administration to focus on important matters like providing guarantees that China's investments in the United States would maintain their value. Wen unambiguously noted: "we have lent a huge amount of money to the US. Of course we are concerned about the safety of our assets. To be honest, I am definitely a little worried… the United States must maintain its good credit, honor its promises and guarantee the safety of China's assets."[8]

On March 24, 2009, Zhou Xiaochuan, the Governor of the People's Bank of China, called for the creation of a new international reserve currency (termed a "super-sovereign reserve currency") to replace the dollar, further underscoring Beijing's fears that US budget deficits could drive down the dollar and the value of China's investments. This was because according to Zhou, "an international reserve currency that is disconnected from individual nations is able to remain stable in the long run, thus removing the inherent deficiencies caused by using credit-based national currencies."[9] On June 26, 2009, the People's Bank again renewed its call for a new global currency noting that the IMF should manage more of its members' foreign-exchange reserves. Since countries acquire portfolios of foreign exchange when they limit the appreciation of their currencies in the face of balance-of-payments surpluses, China, which holds a massive portfolio of foreign exchange in mostly dollar-denominated assets, now claims that credit-based national reserve currencies (like the dollar) not only contribute to global imbalances, but also to financial crises. To Zhou, a new reserve system controlled by the IMF would not only be more stable, but also more economically viable because it could be used for international trade, financial transactions, and commodity pricing. In essence, Zhou's proposal suggested a "gradual" replacement of the dollar with Special Drawing Rights (SDRs), as introduced by the IMF in 1969, as an international reserve to support the Bretton Woods fixed exchange rate regime. Zhou's proposal would expand the basket of currencies that currently constitutes the basis of SDR valuation to all large economies (such as Russia), and set up a settlement system between SDRs and other currencies so they could be used in international trade and financial transactions. This would mean that, first, countries would entrust a portion of their SDR reserves to the IMF to manage them collectively on their behalf, and second, that SDRs would gradually replace existing reserve currencies.

Aware that this may take some time, Beijing has been contemplating and experimenting

8 Michael Wines, 2009. "China's Leader Says He Is 'Worried' Over U.S. Treasuries" New York Times, March 14. http://www.nytimes.com/2009/03/14/business/worldbusiness/14china.html?_r=1&pagewanted=print

9 Zhou's statement is published in English and Chinese on the central bank's (The People's Bank of China's) Website. Zhou Xiaochuan. 2009. "Reform the International Monetary System" March 23. http://www.pbc.gov.cn/english/detail.asp?col=6500&id=178

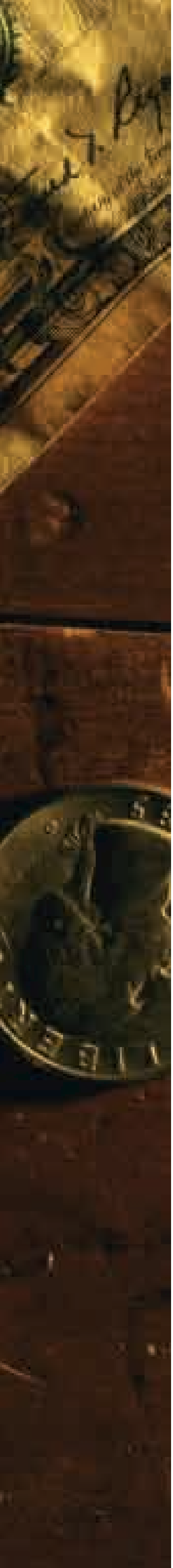
with a number of other strategies, including short-term arrangements to diversify investment portfolios away from US dollars. Put more bluntly, Beijing has been seriously examining its options regarding the cost of maintaining the dollar-based system.[10] Beginning in 2004, Beijing began experimenting with convertibility by establishing an offshore RMB market in Hong Kong—and over the following years this offshore market has expanded. In 2009, Beijing signed currency swap agreements totaling about 650 billion yuan (or about $95 billion) with Hong Kong, Argentina, Indonesia, South Korea, Malaysia, and Belarus.[11] The agreements will now allow these countries to settle accounts with China using the yuan rather than the dollar. Further, in July 2009, the People's Bank took another step towards internationalizing its currency and reducing reliance on the dollar with the announcement of new rules to allow select companies to invoice and settle in RMB through financial institutions in Shanghai, Hong Kong, and Macao. This means that importers and exporters will now be able to place their orders with approved Chinese companies and settle payment in renminbi. In addition, Hong Kong banks will now be allowed to issue yuan-denominated bonds—a step towards building an offshore yuan market, while foreign banks will be allowed to buy or borrow yuan from mainland lenders to finance such trade.[12] While the central bank has assured that this does not mean full convertibility of the RMB, and is simply to provide stability for local exporters hit by the dollar's fluctuation, it does underscore Beijing's growing concern about the future of the greenback—and is in line with its ambition to make the yuan an internationally traded currency. Yet, as the next section illustrates, Beijing still has a long way to go to achieve this goal.

For all its flaws and challenges, the US dollar and dollar denominated assets are today akin to gold during the Bretton Woods era.

10 Hongyi Chen and Wensheng Peng, 2007. "The Potential of the Renminbi as an International Currency," *China Economic Issues,* no. 7/07. Hong Kong: Hong Kong Monetary Authority. It should be noted that China is hardly alone. Both Russia and India have also called for an end to the dollar's dominance in the international monetary system. Russian President Dmitry Medvedev, on several occasions, has noted that the dollar system is "flawed" and that a new supranational currency should be created. Similarly, a senior economic adviser to Indian Prime Minister Manmohan Singh has urged the government to diversify its $264.6 billion foreign-exchange reserves (2008 figures) and hold fewer dollars. Like China, both have claimed that world currencies need to adjust to help unwind trade imbalances that have contributed to the global financial crisis.

11 The renminbi (RMB) is the name of the Chinese currency, while the "yuan" is one unit of the currency.

12 Yin-Wong Cheung, Guonan Ma, and Robert McCauley, 2011. Renminbising China's Foreign Assets," *Pacific Economic Review,* vol. 16, no. 1, pp. 1-17.; Wendy Dobson and Paul Masson. 2009. "Will the Renminbi become a World Currency?" *China Economic Review,* vol. 20, no. 1, pp. 124-35.



THE GREENBACK IS STILL KING

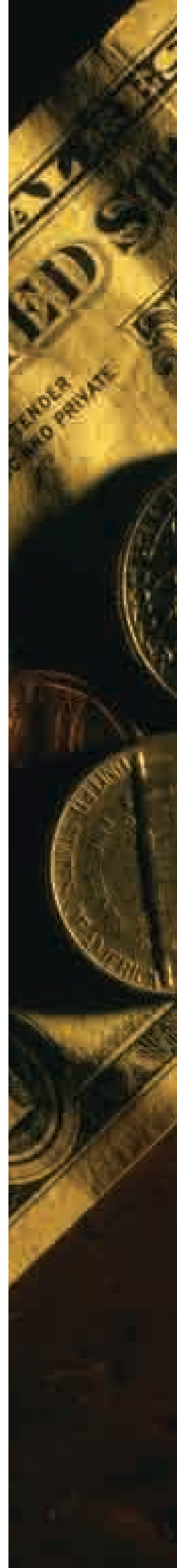
Despite Beijing's calls for the creation of a new international reserve currency (the IMF's SDR), its moves to make the renminbi an international alternative to the dollar are flatly not credible. Indeed, there is little danger that the dollar will be replaced as the world's dominant foreign exchange reserve anytime soon. For starters, the SDR is not actually a currency, but is a reserve asset and unit of account whose value ultimately depends on a basket of currencies used in global trade, including those kept as international reserves by other IMF member countries. In November 2010, the SDR basket included the US dollar (41.9 percent weight), the euro (37.4 percent), the British pound sterling (11.3 percent) and the yen (9.4 percent), but not the RMB, because its international reserve role is almost zero.[13] Moreover, although a country can convert its reserves into SDRs, this does not mean that the SDRs can automatically function as an international currency. Specifically, until the private sector adopts SDRs, countries which adopt SDRs will still need to acquire dollars or euros or some other national currency to spend their reserves. Suffice it to note, the private sector will only adopt the SDR if it provides tangible benefits – something it manifestly does not do at the moment.

Since China's integration into the global economy is mainly via international trade, and not through financial integration, this means that its financial system remains quite closed.[14] Beijing not only maintains tight controls over its currency through capital controls, it also limits the use of the RMB overseas. As a result, the volume of RMB use in the global economy is quite small when compared to the size of the Chinese economy. Thus, the yuan must first be made into a convertible currency whose value is determined by the market before it can compete with the dollar as a medium of international trade. Nevertheless, Beijing still faces fundamental constraints in allowing this to happen, as it would inevitably entail loss of control by the party over economic matters, and would also require China to lower or remove financial and trade barriers—something which the Chinese authorities are not prepared to do.

Arguably, despite the heated rhetoric and bold claims, Beijing understands this too. After all, the exponential growth of China's massive foreign-exchange reserves is the result of trying to sustain a stable exchange rate between the yuan and the dollar—even in the face of strong economic pressures for appreciation (and given China's strong productivity growth, it is natural for the yuan to appreciate). To prevent appreciation and avoid loss of export competitiveness, the People's Bank has been forced to aggressively buy dollars and sell renminbi. The hard reality is that even if a weakening dollar undermines the value of China's existing reserves, precipitating a crisis by moving out of dollar assets is detrimental to Beijing's interests. In other words, although there is nothing to prevent China from diversifying away from the dollar, such an action entails serious risks. Since

13 IMF. 2010. "IMF determines new currency weights for SDR valuation basket," Press Release, no.. 10/434. Washington, D.C.

14 For details, see Shalendra D. Sharma, 2009. *China and India in the Age of Globalization.* New York: Cambridge University Press.



China now owns so many dollars, any massive sell-off will also push the dollar down, with huge losses on China's dollar-denominated assets.[15]

This also underscores the fact that the conventional view of Beijing's ability to "punish" the United States by dumping its Treasury debt is not very compelling, as the resulting disruption would lead to higher US interest rates and a collapse of the dollar on foreign exchange markets. Indeed, the US Congressional Research Service has persuasively argued that such sudden and disruptive moves are unlikely because they will not be effective.[16] This is because even the largest foreign holdings of US government debt are smaller than the daily volume of trade in Treasury securities. If Beijing did resort to such a strategy, the resulting decline in the value of US Treasury securities would generate substantial losses to all debt holders, including those attempting to use their debt holdings as leverage.[17] It is not surprising then, that China continues to be a significant net buyer of US bonds, mainly Treasuries.

Furthermore, unlike previous hegemons, the sheer size of the United States share of the world economy (24 to 27.5 percent in 2010), as well as the world's insatiable appetite for dollar-denominated assets, suggests that the economic laws of gravity do not necessarily apply to the US. After all, the US dollar is the world's reserve currency because it is a good "store of value."[18] A very large portion of international payments are made in dol-

Table 2 Percentage of Daily Average FX Turnover Divided by Currency

	2001	2004	2007	2010
US dollar	89.9	88.0	85.6	84.9
Japanese Yen	23.5	20.8	17.2	19.0
Euro	37.9	37.4	37.0	39.1
Pound Sterling	13.0	16.5	14.9	12.9

Source: Bank of International Settlements Triennial FX Turnover Survey.

Table 3 US Dollar's Share of Official Global Foreign-Exchange Reserves (Percentage)

	2001	2004	2007	2010
	71.5	65.9	64.1	61.3

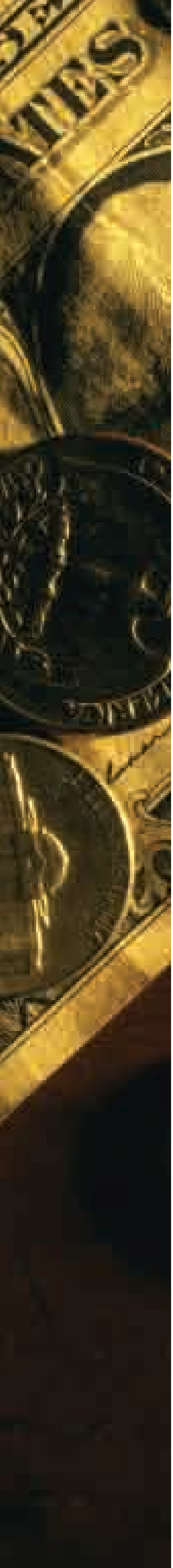
Source: Bank of International Settlements Triennial FX Turnover Survey.

15 Of course, China can buy the U.S. inflation-indexed bonds (i.e. the Treasury inflation-protected securities or TIPS), the value of which rises with inflation. Yet, the TIPS does not always fully protect against exchange-rate fluctuations.

16 Wayne M. Morrison and Marc Labonte. 2008. "China's Holdings of U.S. Securities: Implications for the U.S. Economy," Congressional Research Service, Order Code RL34314; May 19. See. www.fas.org/sgp/crs/row/RL34314.pdf.

17 Of course, for the United States, "inflating" away debt is hardly going to be painless as foreign creditors would demand higher interest rates in their attempts to get back the real valued of what is owed them.

18 For the classic statement, see Paul Krugman, 1984. "The International Role of the Dollar: Theory and Prospect," in John Bilson and Richard Marison, eds., *Exchange Rate Theory and Practice.* Chicago: University of Chicago Press., pp. 261-78.



lars and a substantial portion of international trade (even trade not directly involving the United States) is denominated in US dollars. Roughly 85 percent of foreign exchange transactions are trades of other currencies for dollars (Table 2). In addition, globally traded commodities (such as oil and grain) are priced in dollars — making it necessary for foreign banks to hold portfolios of dollar assets and liabilities. Overall, some two-thirds of the world's official foreign exchange reserves (6.7 trillion dollars) are held in dollars (Table 3). This means that central banks around the world not only hold more US dollars and dollar securities than they do assets denominated in any other foreign currency, they also know that dollar reserves are essential to stabilize the value of their own national currencies.

In fact, the once prevailing assumption that if the American economy went into a sharp downturn, foreign central banks would hesitate to invest their national savings' in dollars has so far proven incorrect. Instead, the dollar has once again been affirmed as the global reserve currency. The massive "flight to safety" into Treasuries from panicked investors after the collapse of Lehman Brothers only underscored the continuing belief that the US government is the safest investment in the world. Although trading in euro saw increases through 2008 and 2009, when the euro was seen as a "safe haven," this trend reversed sharply with the rise of European sovereign debt concerns at the end of 2009. Indeed, the prediction that the euro would inevitably challenge the dollar as the global reserve currency has failed to materialize. For all its flaws and challenges, the US dollar and dollar-denominated assets are today akin to gold during the Bretton Woods era. Of course, however, this does not mean that there are no concerns about the dollar's ultimate trajectory.

IS THERE A CURRENCY WAR?[19]

As is well known, the United States and other countries have long alleged that China deliberately maintains the yuan at an artificially weak rate to give itself an unfair trade advantage. The US claims that Beijing does this by intervening in foreign exchange markets to prevent its currency from appreciating, by selling the yuan and buying other major currencies (mostly US dollars). In the process, Beijing spends enormous amounts of money to keep its currency undervalued. To the US, Beijing's mercantilist yuan policy costs America jobs, because production moves to China to take advantage of low labor costs, while its deliberately undervalued currency helps Chinese exporters by making their products less expensive in the United States—costing even more American jobs.

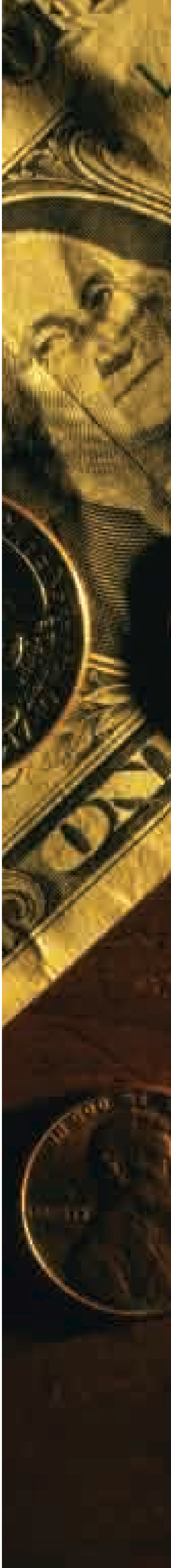
However, in November 2010, the roles were reversed when Beijing charged that the United States was itself engaging in a subtle, yet destabilizing form of currency manipulation by depreciating the dollar through the US Federal Reserve's easy-money policy. Specifically, Beijing claimed that the Fed's announcement of November 3 that it was going to phase-in a sec-

[19] The term "currency wars" was first introduced by the Brazilian finance minister in 2009.

ond round of "quantitative easing" (over an eight month period) to pump an additional $600 billion into the US economy was explicitly intended to weaken the dollar to boost American exports.[20] To Beijing, the move was an underhanded way for the United States to flood the global economy with US dollars—driving down their value, and giving American exporters a price advantage. Indeed, Beijing found some unlikely allies on this issue. Former chairman of the Federal Reserve, Alan Greenspan commented that "America is also pursuing a policy of currency weakening" which will drive-up exchange rates elsewhere. Wolfgang Schauble, Germany's Finance Minister, claimed hypocrisy, stating that "It's inconsistent for the Americans to accuse the Chinese of manipulating exchange rates and then to artificially depress the dollar exchange rate by printing money."[21]

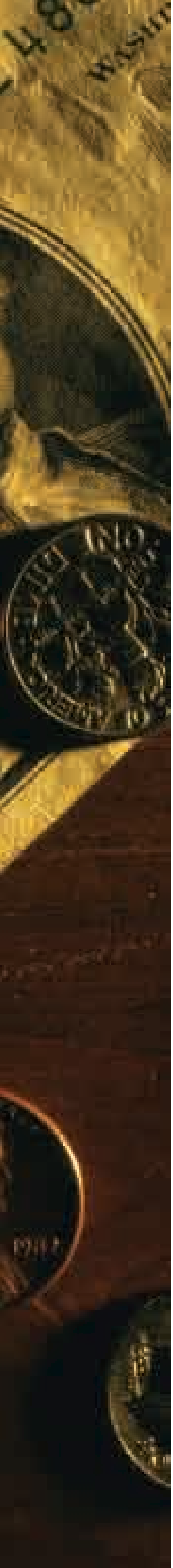
What explains the US decision to adopt more quantitative easing? Despite the Federal Reserve's multipronged strategy – including, a dramatic easing of monetary policy, official interest rates at near zero since late 2008, and the purchase of over a trillion dollars in Treasury securities and US-backed mortgage-related securities, US growth has remained anemic at best. GDP growth slowed to an annual rate of about 2 percent over June and September 2010, with unemployment persisting at over 9.5 percent. With few options, the Fed may have had little choice but to resort to other means to stimulate economic activity – including "quantitative easing." Yet, most (if not all) G20 countries saw the Fed's expansionary monetary policy, particularly its $600 billion asset purchase plan, as a greater threat to global recovery than China's trade and currency policy. Advanced economies like Germany and Japan, as well as emerging economies like China, India, and Brazil, all with healthy trade surpluses and strong currencies relative to the US dollar, seem to have concluded that the Fed's myopic bond-buying program will give US exporters an unfair advantage. Moreover, they fear further declines in dollar bonds (to at least below what markets want) given inflation concerns.

Despite the Federal Reserve's multipronged strategy, US growth has remained anemic at best.



20 "Quantitative easing" refers to a policy where the central bank infuses the banking system with excess reserves. The Federal Reserve's monetary policymaking committee or the Federal Open Market Committee (FOMC) announced that it intends to buy an additional $600 billion of longer-term Treasury securities by mid-2011. For details see, Ben S. Bernanke, "Aiding the Economy: What the Fed Did and Why," November 5, 2010 (http://www.federalreserve.gov/newsevents/other/o_bernanke20101105a.htm). In the first phase of quantitative easing, the Federal Reserve purchased medium- to long-term US Treasury and mortgage-backed securities (mostly issued by Fannie Mae and Freddie Mac). As a result its balance sheet increased in size from $800 billion in September 2008 to $2.3 trillion in October 2010. Of course, the Federal Reserve claims that its decision to buy Treasury bonds were designed to lower long-term interest rates, and thereby boost economic activity and job creation.

21 *The Economist,* "The ghost at the feast," November 12, 2010 http://www.economist.com/blogs/newsbook/2010/11/g20/print



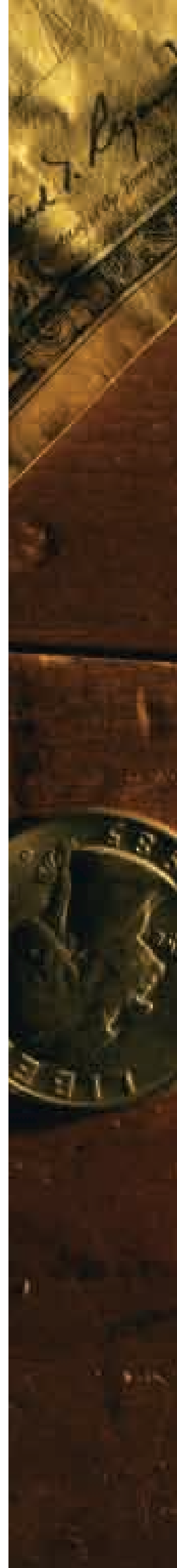
Doubtless, the G20's heavy-hitters have every reason to be concerned about rising levels of public debt in the United States.[22] They also know that the United States' aggressive easing policy, as revealed in the Obama administration's penchant for printing money to cover deficits and obscure the value of its debt, will stoke inflationary pressures both nationally and globally. On the other hand, emerging economies are also worried that the Fed's $600 billion purchase of US Treasury bonds will push Treasury interest yields so low that it could spur investors to pump massive volumes of speculative capital (or "hot money") into the capital, portfolio equity, fixed-income, and stock markets of emerging markets. If this happens on a large enough scale, it can greatly exacerbate exchange rate volatility and push up currencies in emerging economies (undermining exports), and lead to dangerous asset bubbles. Overall, emerging economies that have rebounded from the global credit crisis much faster than advanced economies prefer a tighter, rather than a looser policy in the United States. These economies remain deeply concerned about their ability to respond to such capital inflows, which will drive up their exchange rates and threaten their exports. Over time, it could also potentially trigger inflationary pressures and create bubbles (especially in real estate), while making the stability of emerging economies excessively dependent on the sentiments of foreign investors.

G20 members like South Korea and Indonesia, which experienced first-hand the debilitating effects of "hot money" during the Asian financial crisis are thus highly motivated to avoid recreating these conditions. This explains why a number of countries, including Brazil, China, India, Indonesia, South Africa, Japan, Malaysia, Taiwan, and Thailand, have put in place capital controls in their bond markets to curb currency appreciation.[23] Japan has also intervened in exchange markets to slow-down the yen's appreciation. Brazil began limiting capital inflows by taxing investors' purchase of its stocks and bonds on concern that foreign investors were pushing-up the prices of securities. Brazilian authorities are also concerned that a massive influx of foreign capital will inflate the value of its currency, the real (in fact, Brazil's exchange rate was fast rising against both the dollar and the euro), making Brazilian exports uncompetitive and dampening the country's economic growth.[24] In the meantime, the yuan continues to remain artificially undervalued to promote Chinese exports. The end result is that despite the stated commitment by key nations to maintain exchange rate flexibility and avoid disruptive swings in capital flows and exchange rates, competitive devaluation has continued unabated, albeit in

22 It is estimated that the total outstanding U.S. federal-government debt was $8.3 trillion at the end of March 2010. The overall gross national debt is over $13 trillion if obligations for government trust-funds such as Social Security and Medicare are factored in. See Jason Thomas, 2010. "Managing the Federal Debt," *National Affairs,* No. 5, Fall, pp. 20-34. Equally troubling, in their recent study, Reinhart and Rogoff conclude that when a nation's gross debt reaches 90 percent of its economy, it usually loses about one percentage point of growth a year. U.S. gross debt is close to that threshold. According to the IMF, the U.S. national debt will reach 100 percent of GDP by 2015. This means that the United States will need to reduce its deficit by the equivalent of 12 percent of GDP. On the other hand, Greece, in the midst of a financial crisis in 2008, needed to reduce its structural deficit by just 9 percent of GDP. Moreover, the high debt levels also bring high rates of inflation. See, Carmen M. Reinhart and Kenneth S. Rogoff, 2009. *This Time Is Different: Eight Centuries of Financial Folly.* Princeton: Princeton University Press. According to the U.S. Congressional Budget Office, by 2020, annual interest owed on U.S. debt will approach $1 trillion—or roughly 21 percent of projected federal revenue for that year.

23 William Cline and John Williamson, 2010. "Currency Wars," Policy Brief, no. PB10-26. Washington, D.C.: Institute for International Economics

24 Brazil's currency has appreciated nearly 50 percent on a trade-weighted basis since December 2008.



more covert forms. The danger of this, as noted by Rajan, arises from the fact that "intervention is a zero-sum game: for one country's currency to depreciate, some other countries' currencies must appreciate. Are these in fact the same kind of "beggar-thy-neighbor" currency depreciations as those of the 1930s, when many countries competed in a race to the bottom?"[25]

On November 19, 2010, Federal Reserve Chairman Ben Bernanke, at a European Central Banking Conference in Frankfurt, not only vigorously defended the Fed's policy of quantitative easing, but also overtly blamed China and other emerging markets for undervaluing their currencies—thereby causing the imbalances responsible for the global credit crisis. Bernanke noted that "currency undervaluation by surplus countries is inhibiting needed international adjustment and creating spillover effects that would not exist if exchange rates better reflected market fundamentals." Moreover, Bernanke blamed the large capital inflows to emerging economies on these countries poorly devised foreign exchange policy—as foreign investors are not only looking for "return differentials that favor emerging markets," but also the "additional returns expected from exchange rate appreciation." To Bernanke, resolving this problem requires that emerging economies allow their exchange rates to "reflect market fundamentals." [26]

Similarly, during the meeting of finance ministers and central bank governors from the G20 in Paris (February 18-19, 2011), Treasury Secretary Geithner once again criticized China by stating that the yuan was still "substantially undervalued" and that measures taken by Beijing to allow the yuan to appreciate had been insufficient.[27] Beijing remained adamant in its claims that currency reform is an internal matter. Although, Geithner correctly noted that the "real effective exchange rate" is the best measure to evaluate a currency against its trading partners, China disagreed by noting that exchange rates and current accounts should not be singled out.[28] Rather, Beijing reiterated its charge that "hot money" inflows (a reference to the US Fed's $600 billion bond purchase program) could destabilize the economies of emerging countries. At Beijing's insistence, the final G20 communiqué made no mention of the "real effective exchange rate" or foreign currency reserves.[29] Instead, the G20 referred only to broad references to "exchange rates" and the "current account" as a measure to assess economic imbalances, with emphasis on indicators like public debt, fiscal deficits, private savings and borrowings, trade balances (rather than current account imbalances), and balance of payments (including net investment flows). Again, on Beijing's insistence, the indicators were not binding tar-

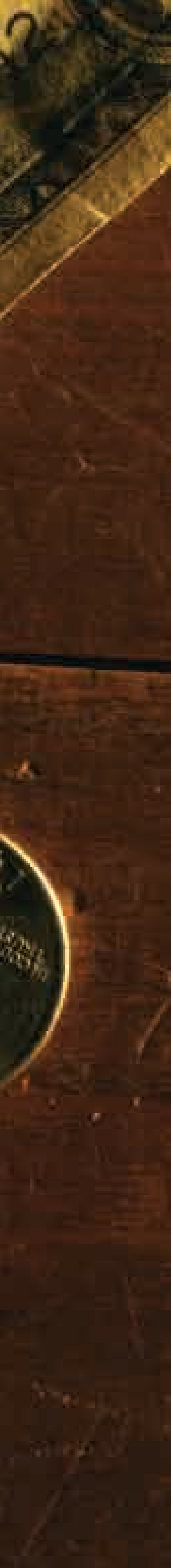
25 Raghuram Rajan, 2011. "Currencies Aren't the Problem," *Foreign Affairs,* vol. 90, no. 2, March/April, p. 104.

26 Chairman Ben S. Bernanke, "Rebalancing the Global Recovery," Speech given At the Sixth European Central Bank Central Banking Conference, Frankfurt, Germany, November 19, 2010 http://www.federalreserve.gov/newsevents/speech/bernanke20101119a.htm

27 U.S. Department of the Treasury. " G20 Statement by Treasury Secretary Timothy F. Geithner," February 19, 2011. http://www.treasury.gov/press-center/press-releases/Pages/TG1073.aspx

28 Liz Alderman, "As G20 Leaders Set Deal, Geithner Criticizes China," *New York Times,* February 19, 2011. http://www.nytimes.com/2011/02/20/business/global/20euro.html?_r=1&pagewanted=print

29 Chinese Finance Minister Xie Xuren said that "the G20 should use trade figures rather than current account balances to assess economic distortions…"We think it is not appropriate to use real effective exchange rates and reserves." Daniel Flynn and Abhijit Neogy, "Chinese stance throws G20 indicator deal into doubt," *Reuters,* February 18, 2011. http://www.reuters.com/article/2011/02/18/us-g-idUSTRE71G4FX20110218



Intervention is a zero-sum game: for one country's currency to depreciate, some other countries' currencies must appreciate.

gets, but guidelines for coordinated policies to reduce distortions, in particular, disruptive fluctuations in capital flows.[30]

During their semi-annual talks in mid-April 2011, G20 finance ministers again "chastised the United States for not doing enough to shrink its massive overspending and warned that budget strains in rich nations threaten the global recovery." Brazil's finance minister, Guido Mantega, "offered sharp words in a thinly veiled attack on the United States," stating "Ironically, some of the countries that are responsible for the deepest crisis since the Great Depression, and have yet to solve their own problems, are eager to prescribe codes of conduct to the rest of the world." Geithner replied with his own veiled criticism of China and other countries by noting that they must adopt "greater exchange rate flexibility."[31] In the meantime, despite problems with the yen in the aftermath of the Tohoku Earthquake and tsunami, as well as problems in the euro-zone (namely, the realization that Greece and Ireland may have to restructure their debt obligations), the dollar has continued its steady decline against most major currencies. While this is due in part to near-zero interest rates in the US (compared to higher rates elsewhere), other factors are also at play. On April 18, when Standard & Poor warned that the US government's coveted "AAA" status was in jeopardy on various concerns (including the failure of the US leadership to reach an agreement on deficit reduction, as well as concerns about its exploding budget deficit), the dollar experienced a sharp sell-off. Adding to the dollar's woes, Beijing has continued to put pressure on Washington, implicitly warning of a diversification away from dollars, while allowing the yuan to gradually appreciate. Of course, this creates more challenges for the dollar. On the one hand, a rising yuan means that Beijing needs fewer dollars to offset the yuan's strength; on the other hand, China's competitors, in particular other Asian exporters, are also letting their currencies gain strength against the dollar. Thus, Washington's long-held demand that Beijing allow the yuan to rise against the dollar (and other currencies), in order to boost US exports and reduce its massive trade deficit—the dollar's continued decline also poses an unanticipated challenge—further widening the divide between the United States and

30 Communiqué from the Meeting of Finance Ministers and Central Bank Governors, Paris, 18-19 February 2011. http://www.treasury.gov/resource-center/international/g7-g20/Documents/COMMUNIQUE%20-%20G20%20MGM%2018-19%20February%202011.pdf

31 Lesley Wroughton, "World finance chiefs chastise U.S. on budget gap," *Reuters,* April 16, 2011 http://www.reuters.com/article/2011/04/16/us-imf-usaidUSTRE73F1TN20110416

other G20 members. Needless to say, this continuing acrimony is threatening to resurrect destructive protectionist policies like those that prolonged the Great Depression in the 1930s. Of course, one hopes that good sense and pragmatism will eventually prevail—notwithstanding threats by influential US senators like Chuck Schumer (Democrat) and Charles Grassley (Republican) that Congress would impose anti-dumping duties on some Chinese goods and countervailing tariffs on all of them if China did not allow its currency to appreciate. Tit-for-tat retaliation is not in the long-term interest of either country, not to mention the still fragile global economy.

CONCLUSION

In his recent book, *Exorbitant Privilege,* Barry Eichengreen argues that the dollar's fate will not depend on Beijing or the EU, but rather on the decisions made by Washington. The decline in the dollar's status, if it occurs, will thus lie in a failure to correct macroeconomic distortions in the American economy that will cause it to lose its status as the world's international currency. Moreover, the US cannot perpetually rely on its "exorbitant privilege," (i.e. its ability to borrow money in its own currency), to help service its external debt. The ever expanding US deficits and worsening of the Federal Reserve's balance sheet will undermine the attractiveness of the greenback, as creditors (especially foreign governments) conclude that the dollar is not only low-yielding, but also not risk-free. Eichengreen predicts that as America's dominance in the global economy erodes over time, the dollar will gradually play a less important role, if not ceasing to be the world's standard currency (when, however, is not made clear). However, he cautions that this should not be viewed as a zero-sum game because the dollar's decline does not necessarily mean corresponding erosion in American living standards or international influence. Rather, several currencies such as the euro and the RMB can peacefully coexist – after all, there is precedent for this as several currencies have shared the role of international currency in the recent past.[32] SQ

Keywords
US Treasury securities, international reserve currency, international trade, Special Drawing Rights (SDRs), G20

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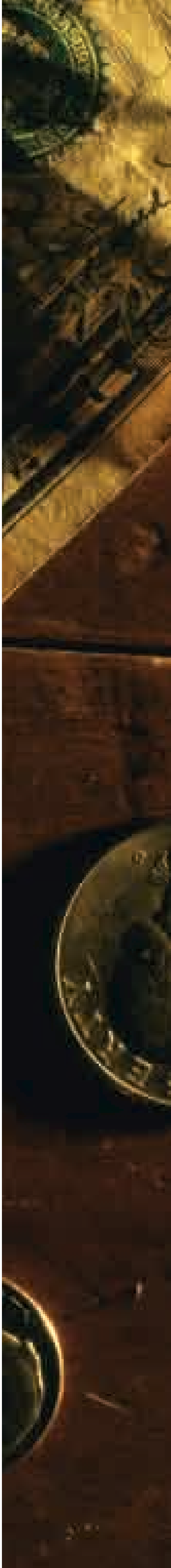

[32] Barry Eichengreen, 2010. *Exorbitant Privilege: The Rise and Fall of the Dollar and the Future of the International Monetary System.* New York: Oxford University Press.