Whither the Dollar?

The concern is that, with the Federal Reserve's recent expansionary policies — pumping trillions of new dollars into the world's money supply — the dollar will begin losing value as the long-term effects of inflation kick in. Put otherwise, the United States might choose to print money to cover its debts, discharging them in depreciated dollars.

At this week's Federal Reserve meeting, interest rates were left unchanged but a commitment was made to scale back for the first time the activities of the Term Auction Facility (TAF) and other novel Fed instruments for pumping credit and money into the economy. The view from Ben Bernanke's seat, in other words, suggests that the madcap spree of money creation that the Fed embarked upon last year is beginning to slow, because the Great Recession is bottoming out. This in turn may portend new life, at least in the short run, for the beleaguered dollar, whose trade-weighted strength has fallen by more than 25 percent since 2002.

{modulepos inner_text_ad}

The critical feature of modern currencies, the dollar included, is that they are backed by nothing but public confidence, or lack thereof. That wasn't always true, of course. In the pre-First World War international financial arena, currencies were backed by gold or silver, and relative valuations thereof amounted to sober-minded appraisals of the amount of money in circulation as against the specie actually available to back it up. These days, central bankers rely upon nothing more than sentiment as they engage in a perilous game of international brinksmanship to sustain the mostly illusory value of the currencies they manufacture at whim out of thin air (or, more accurately, out of debt). That the dollar has endured so long past the termination of all promises to redeem in gold is testament to the power of state propagandists in the Disinformation Age.

Now the dollar is teetering on a very narrow razor's edge as its apologists try to exploit the Fed's inflationary powers to defang the recession at home, all the while keeping international holders of U.S. government debt mollified.

So far this confidence game has served the United States — at least, the powerful and well-connected among us — reasonably well, enabling an unprecedented three-decade long asset bubble that has allowed Americans to party almost without respite. But cracks in the confidence façade are showing as it begins to dawn on the rest of the world that the dollar need not remain the world's reserve currency forever.

After World War I the Bank of England, trying to hold onto its status as the world's reserve currency, resorted to inflation during the Roaring Twenties, all the while reassuring holders abroad of pounds, like the French and Dutch governments, that their holdings were safe, and that the British government would honor its commitment to redeem pounds in gold. The French in particular were leery of such assurances, but were unable to dump their pound holdings lest such an action ignite an international currency run. The fiction of the pound's stability was maintained until the beginning of the 1930s, when Britain finally went off gold, repudiating its obligations to redeem the once-sterling currency.

Although the bar has been lowered since the pound debacle — investors no longer expect to redeem dollars in gold, but only that the dollar's value will be kept approximately stable — many of the same economic factors are at play. Governments like China, who hold vast sums in U.S. treasuries, are quietly looking ways to unload the debt without triggering a stampede out of the dollar that could erase the value of their holdings overnight.

Then there is the hue being raised over a new global currency, a not-so-new idea that is regaining currency, so to speak. The British delegation at the Bretton Woods financial conference in 1944, led by economist John Maynard Keynes, wanted an international reserve currency, issued by and international banking authority. The Americans wanted one, too, but in the end, Bretton Woods designated the U.S. dollar as the world's fallback currency instead. Now internationalists and political leaders are clamoring for turning the Special Drawing Rights (SDRs) used to reckon sums held at the International Monetary fund into a bona fide global currency. Such a move would amount to a true monetary world order, with the inflationary confidence game being conducted by the UN system rather than powerful central bankers like Bernanke.

The real question is not whether the fiat dollar will collapse and be utterly discredited, but how long it will take and what will replace it. At the moment, extra-financial factors like the perceived reliability of U.S. property rights laws (as compared with those of, say, Russia or China) may extend the dollar's lifespan. But the best that the Fed can do is engineer a slow collapse over a span of years or perhaps decades, while national debt continues to mount to infinity and beyond and confidence in the dollar and in the sustainability of the dollar-centric international financial system continues to ebb. When the dollar's demise does come, America will be left with only two choices, namely, whether to submit to a foreign fiat currency, like the yuan or the Euro or even the SDR, thereby losing national monetary autonomy, or to return to currency backed by gold, which would restore not only sound money but a large measure of U.S. financial independence.