Fed policies spark concerns over dollar’s global role

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Questions are beginning to be raised in financial circles about the long-term status of the US dollar as the world’s reserve currency as the Fed continues to pour money into the financial system, effectively financing the growing debt of the US government, while fuelling an asset bubble.

On Tuesday, the *Financial Times* published a major article by long-time financial commentator John Plender entitled “The demise of the dollar? Reserve currencies in the era of ‘going big’.”

Plender began with a reference to what he called an “apocalyptic warning” by the billionaire US hedge fund chief Stanley Druckenmiller that the dollar could cease to be the predominant global reserve currency within 15 years.

The warning was made in an interview with Druckenmiller on the business channel CBNC on May 11, where he elaborated on an op-ed piece he had written for the *Wall Street Journal* that day headlined “The Fed is playing with fire.”

The central criticism advanced by Druckenmiller was that, while he agreed with the Fed’s initial actions, its continuation of the ultra-low interest rate regime and asset purchases, under conditions where the US economy was undergoing a significant recovery, was now creating major risks.

“I can’t find any period in history where monetary and fiscal policy were this out of step with the economic circumstances, not one,” he stated in the CNBC interview.

Druckenmiller said in the long term the Fed’s policies and the rising government debts and deficits they support threatened the dollar’s international standing.

“If they want to do all this and risk our reserve currency status, risk an asset bubble blowing up, so be it. But I think we ought to at least have a conversation about it.

“If we are going to monetize our debt and we’re going to enable more and more of this spending, that’s why I am worried now, for the first time, that within 15 years we lose our reserve currency status and of course all the unbelievable benefits that have accrued with it,” he said.

While not fully endorsing Druckenmiller’s warnings, Plender pointed out that “even before the coronavirus pandemic and the extraordinary economic conditions it has generated, there were signs that the dollar’s dominance was slipping.”

Plender noted that in its most recent survey, covering the last quarter of 2020, the International Monetary Fund had found that dollar reserves held by central banks had fallen to 59 percent, their lowest levels in 25 years, and well below the 71 percent when the euro was launched in 1999.

Plender drew attention to the extraordinary developments that took place in the market for US Treasury bonds when the pandemic began to make its economic and financial effects felt in March 2020 which raised “important questions about the market’s liquidity.” The usual response to financial turbulence is a rush to purchase Treasury bonds as a “safe haven.”

In early March there was a typical and orderly flight to safety in US Treasuries. But from March 9 on “there was a disorderly flight from Treasury paper into cash” resulting from forced selling by hedge funds that had borrowed heavily to try to profit from differences in the yield on Treasuries and the yields in futures markets.

The plunge in the market threatened the solvency of highly leveraged funds, forcing them to sell, promoting a feedback loop in which those sales prompted further declines and further sales.

“That should not have happened in what is usually termed the world’s deepest, most liquid government bond market,” Plender wrote.

The other factor in the plunge, and the one most significant from the standpoint of the dollar’s global role, was the sell-off by international investors. While purchases of US Treasury bonds rose from $1.79 trillion in February 2020 to $2.67 trillion in March, “this was more than offset by foreign sales, which jumped from $1.79 trillion to $2.98 trillion, nearly a trillion higher than the previous peak over the decade.”

Druckenmiller also referred to this development in his *Wall Street Journal* op-ed, pointing out that, according to

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projections by the Congressional Budget Office, in 20 years almost 30 percent of all fiscal revenues, compared to the current level of 8 percent, would be needed just to meet interest payments. Thus, the pressure on the Fed to simply monetize the debt, that is to buy it up, would inevitably rise.

He said the March 2020 events had shown that the risks were no longer hypothetical. For decades US Treasuries had been regarded as the preferred asset for foreign investors.

"It was therefore shocking and unprecedented to find that in the midst of last year's stock market meltdown and while the Cares Act was being debated, foreigners aggressively sold US Treasuries. This was dismissed by the Fed as a problem in the plumbing of financial markets. Even after trillions spent to prop up the bond market, foreigners have continued to be net sellers. The Fed chooses to interpret this troubling sign as the result of technicalities rather than doubts about the soundness of current and past policies."

In his CNBC interview, Druckenmiller alluded to, but did not elaborate on, the core reason for the Fed's continuing massive intervention amounting at present to $1.4 trillion a year.

He said that without Fed intervention bond rates would reach "prohibitive" levels. He did not lay out the consequences of such a development, but they are clear. Even a relatively small increase in the bond rate threatens to collapse the speculative bubble which has enabled finance capital to rake in trillions of dollars during the pandemic.

Druckenmiller wrote that the Fed "should balance rather than fuel asset prices." But the fear in Fed circles is that even the talk of tapering its asset purchases could set off a crisis and so it is sticking, at least so far, to its insistence that monetary policy must remain "accommodative."

Other commentators are also voicing their concerns. On Tuesday, former Treasury Secretary Lawrence Summers posted another opinion piece in the *Washington Post* repeating earlier warnings about the dangers of inflation.

He said the Biden administration was correct in pointing out that some of the inflation was transitory, but not everything was likely to be temporary and policymakers "starting at the Fed, need to help contain inflation expectations and reduce the risk of a major contractionary shock by explicitly recognizing that overheating, and not excessive slack, is the predominant near-term risk for the economy."

As always, wages occupy a key place in the thinking of Summers and other such analysts. He wrote that policies towards workers should be aimed at the "the labour shortage that is our current reality" and increased unemployment benefits "should surely be allowed to run out in September" and end sooner in some parts of the country.

In a comment published in the *Financial Times* on Tuesday, financial analyst Mohamed El-Arian recalled the signs of market turbulence earlier this year, including the GameStop phenomenon, the surge in bond market yields and the collapse of the little-known family investment firm Archegos Capital in March that inflicted some $10 billion in known losses on banks.

"Disruptive spillovers" were contained, he wrote, "by luck rather than crisis prevention measures" and "the enormous risk-taking encouraged by the provision of liquidity resumed."

However, the drivers of these "near accidents" should not be ignored as they were "part of dry tinder that, if ignited, could risk a consequential financial accident."

El-Arian described the Fed as being hostage to its "new monetary framework," dictating that financial market support should continue even as inflation starts to rise. It now faced a "tricky policy pivot" that involved the twin risks of market volatility and loss of Fed credibility. Rather than just "surfing the liquidity wave," it was better to risk some short-term discomfort than "the durable damage that a bigger policy mistake would inflict on asset values, the functioning of markets, and economic and social wellbeing."

The basic problem for all the scenarios for a smooth glide-path to stability is that they ignore the fundamental cause of the Fed's massive intervention. It was a response to the freezing of the world's largest and supposedly most liquid bond market in March last year. The contradictions of the financial system, fuelled by policies going back more than a decade that led to that event, have only intensified in the period since.

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