Growth of US debt threatens dollar dominance

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A report by the Congressional Budget Office on the soaring US government debt has raised questions as to how long the dollar can continue to function as a stable base for the global monetary system.

The issue of dollar supremacy does not feature prominently in the public statements of financial authorities, but it is certainly discussed under conditions where there are moves away from dependence on the US currency for international transactions. The recent initiatives by China, Brazil and Saudi Arabia, among others, to conduct some transactions in their own currencies are an example.

Even though shifts away from the dollar are limited at this point, they are of some concern as evidenced in a speech delivered earlier this month by Christopher Waller, a member of the Federal Reserve's Board of Governor, to a conference on central banking.

The subject of his address was the dollar's primacy in global finance and the global economy "which some feel is under threat as never before."

After noting that warnings of the dollar's demise had been raised on previous occasions, and it was tempting to write them off because they "never seem to come to pass," he added, as if to cover himself, that "I don't dismiss them." However, he went on to precisely do that.

Waller outlined possible sources of dollar instability, including: moves to conduct international transactions in other currencies; the economic rise of China and the international role of its currency, the renminbi; the shift out of US assets because of fears of US sanctions such as those imposed on Russia; and the role of what has been termed "geoeconomic fragmentation"—the increasing trend towards the division of the world into blocs.

While noting these issues, Waller brushed them aside as having little effect before turning in his conclusion to "financial stability concerns" as a factor in the international use of the dollar.

That too was dismissed because whenever a crisis occurred there was a "flight to the dollar" with a heightened demand for US dollar assets.

"We saw this in 2008 and again in 2020. This is the ultimate vindication that the US dollar is the world's reserve currency and is likely to remain so—in times of global stress, the world runs to the dollar, not away from it."

It did not seem to bother Waller that there is, to say the least, something highly perverse about the claim that the "ultimate vindication" of dollar supremacy is the rush toward it every time there is a crisis emanating from the US financial system as took place in 2008 and 2020.

The issue was taken up by long-time *Financial Times* columnist John Plender in a comment published this week.

He noted that Waller had "conspicuously failed to mention the biggest reason for thinking Treasuries [US government bonds] are no longer an ultra-safe store of value."

According to Plender: "This is not the US's appallingly dysfunctional politics. Nor the weaponisation of the dollar thanks to geopolitics. Nor again the possible competitive threat from other central banks' digital currency plans. Rather, it is a spiralling public debt now exceeding 97 percent of gross domestic product, a level not seen since the second world war."

The explosive growth of US public debt was highlighted in the CBO report issued earlier this month which forecast it would grow by almost two thirds, from $1.6 trillion to $2.6 trillion over the next ten years.

In the period of ultra-low interest rates following the financial crisis of 2008, the issue of US public debt was to a great extent out of sight and out of mind. But with lifting of interest rates by the Fed from near zero to 5.5 percent since the spring of 2022, it has come into focus.

The CBO said interest payments on debt would account for around three quarters of the rise in the deficit over the next decade, taking it from 5.6 percent of GDP in 2024 to 6.1 percent in 2034, well above the average of 3.7 percent over the past 50 years.

The widening debt has already had an effect as seen in the decision last August by the credit rating agent Fitch to remove its triple A rating from the US because its debt to GDP ratio exceeded that of other countries afforded the top rating.

Plender noted that the demise of dollar dominance had been predicted in the past but had not happened “because other countries cannot match the supposed safety and liquidity of US Treasuries.”

However, he continued, that “logic may fracture in the face of a deep-seated problem” identified by former International Monetary Fund chief economist Kenneth Rogoff and two other economists in a paper published in 2021.

The paper likened the present situation to the so-called Triffin dilemma, identified by the Belgian-American economist Robert Triffin in 1960, which ultimately led to the demise of the Bretton Woods Agreement of 1944. The agreement had formed the basis of the post-war monetary order, a central foundation for the boom which lasted until the beginning of the 1970s.

Under the agreement, the dollar functioned as the global currency backed by gold at the rate of $35 per ounce, but as Triffin explained, this system required a net outflow of dollars from the US to finance trade and other financial transactions. However, as dollars piled up outside the US, it lacked sufficient gold to redeem them, leading to president Nixon’s decision to remove the gold backing on August 15, 1971.

Since then, the US dollar has functioned as a fiat currency, backed ultimately by the economic power of the US state.

According to the paper cited by Plender, the modern-day version of the Triffin dilemma “is the demand for safe dollar assets that risks eventually overwhelming the US government’s fiscal capacity to back them.” That waning capacity is revealed in the shrinking US share of global output and the rise of debt.

The US Treasury has already declared that the growth of US debt is “unsustainable”.

Pointing to this issue, Plender recalled the UK experience of September-October 2022. So-called bond market vigilantes set off a financial crisis, selling off government bonds after the Liz Truss government sought to fund tax cuts by increasing debt without making deep cuts to government spending.

“Could the fiscal disciplinarians of the global investment community not turn their disruptive talents to the US Treasury market?” he wrote.

“As well as savaging the president of the day, such a challenge would devastate the US’s role as the world’s chief provider of safe assets during global crises, while simultaneously threatening the dollar’s status as the pre-eminent reserve currency.”

Such a situation is today dismissed an “unimaginable,” but that is always the case in the lead up to a crisis when the guardians of finance capital maintain that “all is for the best in the best of all possible worlds.”

The UK crisis of 18 months ago came seemingly “out of the blue” as did the collapse of three US banks in the spring of last year.

One should recall the events leading to the global financial crisis of 2008. Warnings that the ultra-easy monetary policies of the Fed were creating the conditions for a crash were dismissed as a slander against the “maestro,” chairman Alan Greenspan, with Lawrence Summers, one of the advisors to the Biden administration, leading the charge.