

Less Bang For The Buck: U.S. "Dollar Weapon" Policy In Historical Perspective

By Brahm Eiley

Like rocket science, knowledge of monetary policy does not often get you the best seat at a dinner party. However, much of our day-to-day existence depends on the ability of America's central bank to affect exchange rates by setting interest rates and buying or selling currency in the financial markets. Every day, the U.S. Treasury Department (which issues bonds) and the federal Administration (which oversees and directs economic policy) coordinate the nation's competition within mammoth international financial markets.

Since 1971, when the Bretton Woods fixed-rate exchange system was terminated, we have lived in a world where currency movements have been floating—no longer tied to gold or to one currency. Such an arrangement has resulted in the huge growth of the financial sector of the economy, including its power to affect economic and social policy nationally and internationally. Since Nixon, then, global financial markets have been the major breadwinner of the world economy, far outpacing trade in profit and volume.

This floating "non-system" has been credited for the end of U.S. autocracy in financial relations. Although the U.S. continues to dominate the world in many ways, the past twenty years have seen the rise of other financial superpowers, while at the same time U.S. debt has grown exponentially.

In response to these shifting economic relations, the U.S. has failed to undertake long-term adjustments. Rather, since 1971 it has repeatedly turned to what I will call the "dollar weapon"—a cheap dollar intended to improve U.S. exports—in order to pull itself out of recession. The positive effects of dollar devaluation have rarely been anything more than short term. In the medium and long run, the dollar weapon has exacerbated many of the structural problems of the world's most powerful economy.

Further, the U.S. has angered both the Europeans (especially the Germans) and the Japanese because of its weak dollar and expanded money supply. This has forced both of these

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nations' currencies and inflation rates skyward—a direction to which their economies are not oriented. Because of dollar-weapon strategy, the European Economic Community's European Monetary System, and to a lesser extent the Japanese yen, have developed rapidly to counteract U.S. manipulation.

A Short History Of Bretton Woods

The U.S. emerged from World War Two virtually unscathed. It had benefitted greatly from the war, by 1945 controlling forty percent of the world's exports and over seventy percent of the world's gold reserves. It was the only international power with a trade surplus, large capital reserves, and nuclear capability. Any decision to reorient the world's money matters were therefore heavily influenced by the world's newest Great Power.

The overall objective of the 1945 Bretton Woods Agreement was to create a liberal economic structure in order to avoid the re-emergence of economic nationalism. It was generally believed that through increased international economic links and free trade, fastened to a fixed-exchange-rate system and gold convertibility, international war could be avoided. Thus, by reducing barriers to trade and capital flows, nations would have more freedom to pursue stability, growth and low unemployment.

Instead of the contending plan forwarded by British economist John Maynard Keynes, who called for massive unconditional lending and an international currency, the Bretton Woods Agreement followed U.S. objectives closely. The newly created International Monetary Fund (IMF) and World Bank were to distribute limited funding based on a high level of conditionality, with U.S. veto power over any lending proposal. Rather than create an international currency, the U.S. dollar was to become the world's central currency.

By 1947, the issue of lending came to a head when Bretton Woods capital could not meet demand. This was exacerbated by the IMF's legal inability to loan money for reconstruction purposes. As well, World Bank borrowing, mainly from large U.S. banks, was severely hampered by a restrictive lending policy.

Insufficient liquidity led to a significant decline in U.S. exports and the recession of 1948-49. Concurrently, and as importantly, Europe and Japan faced political and economic



President Nixon (1969-74): closed the "gold window" in 1971. [U.S. Embassy, Ottawa]

strife both internally and through pressure by the U.S.S.R. If the U.S. vision of a liberal economic order were to survive and the world economy improve, a new loan program was necessary.

Enter the Marshall Plan and the Truman Doctrine, which changed the face of modern relations between the U.S. and Europe. Marshall Plan aid had significant ramifications. First, it abrogated the official Bretton Woods system of multilateral aid. Second, it facilitated the entrance of American multinationals into Europe on the back of U.S. government programs. Third, it meant that the U.S. now had greater influence over its allies' economic, political, and military policy. Fourth and most critical, European and Japanese currencies became non-convertible. Only the U.S. dollar could now be exchanged in international trade and payments. Instead of the international management implicit in the Bretton Woods Agreement, the Marshall Plan and the Truman Doctrine ushered in an era in of U.S. hegemony.

The transition to non-convertibility insulated the damaged European and Japanese currencies from further speculation and helped the rebuilding of their economies. However this insulation came at a cost, since the Marshall Plan was indirectly used to devalue European currencies, especially Britain's. These devaluations, by twenty-five countries in 1949, resulted in a rapid and total flight to the U.S. dollar. In a few short years, the dollar became not only the world's safest currency, but in essence the world's only currency.

How and Why The U.S. Avoided Adjustment

From the fifties until 1971—when President Richard Nixon (1969-1974) suspended the gold-based system of Bretton Woods—the U.S. extracted perks from the world economy by its inflated dollar. As producer of the world's dominant currency, the U.S. could overspend virtually without worry. Because all international trade and finance was still carried out in dollars, foreign countries had to hold an abundant supply of dollars even as they began to lose value in the late 1960s. Moreover, the U.S. as an export market and security blanket were two further reasons to continue to use and support the dollar. Thus, in 1971 the Europeans and Japanese remained beholden to the dollar as the world's central currency.

Nixon's 1971 closing of the "gold window" introduced a new American trade policy: the "dollar weapon." Throughout Nixon's tenure the dollar was continuously devalued in order to improve the U.S. trade balance. The effect of dollar depreciation on other strong currencies was to push them up, lessening these nations' exports and creating inflationary pressures. The unsteady dollar played havoc on accounting procedures and profit for the

export-based Western European and Japanese economies. But there was little these economies could do since dumping dollars would only improve the U.S. trade balance. Besides, hurting the U.S. economy was equivalent to self-mutilation: Western Europe and Japan needed the U.S. consumer.

During Jimmy Carter's Presidency (1977-1981), the deficiencies of U.S. dollar weapon strategy became graphically visible. The Federal Reserve Board continued to exceed money-supply targets by pumping too much currency into the economy and driving up inflation. The trade balance—despite zealous but ineffective efforts by the Carter Administration to coax the West Germans and the Japanese into expanding their economies—continued to decline. Also, high fiscal spending (a bipartisan addiction) persisted unabated. By the autumn of 1978, the already much devalued dollar began a steep decline in the rapidly deregulated and growing international financial markets. Saudi Arabia and West Germany in particular were lukewarm to U.S. calls to come to the dollar's rescue.

Thus began a difficult period in the U.S. economy. For the first time in postwar history, the collapsing U.S. dollar required support in international financial markets from the Federal Reserve, now managed by Paul Volcker. Moreover, on the Treasury side, "Carter" bonds—denominated in European and Japanese currency—were also minted in an attempt to restore confidence in the falling dollar.

American expansionary monetary and fiscal policy raised the value of the German mark and other Western European currencies too high for the good health of their export-based economies. In 1979, the Western Europeans, scarred by their experience with U.S. dollars, initiated a plan for monetary union.

Dollars in the Recent Past

In the 1980s, the administration of Ronald Reagan (1981-1989) introduced the "strong" dollar weapon, thereby reversing past principles of dollar weapon strategy while retaining the arsenal itself. In order to satisfy U.S. military borrowing, the Federal Reserve—buoyed by interest rates well above the international market—overvalued the dollar and kept the money supply tight. At the same time, the Treasury began to issue bonds at twice the rate of previous years and Congress further deregulated the financial markets, creating an even larger U.S. market for financial instruments.

In response to the administration's bond and financial market promotion frenzy, the purchase of U.S. Treasury and corporate securities by foreigners, especially the Japanese, doubled between 1983 and 1986. The U.S. was thus able to draw in vast amounts of money at the expense of the U.S. borrower and investor.

Word Watch

Exchange Rate: The price at which one currency is exchanged for another.

Money Supply: The stock of liquid assets in an economy that can be freely exchanged for goods and services.

Interest Rate: The proportion of a sum of money that is paid over a specific period of time in payment for a loan.

Monetary Policy: Central government policy with respect to the control of the quantity of money in the economy, the interest rate and the exchange rate. The three variables are simultaneously determined. If money supply is increased, for example, the exchange rate will fall, unless interest rates are raised.

Fiscal Policy: The budgetary stance of the central government. Government can raise fiscal spending by lowering taxes or by increasing public expenditures. Decisions to raise taxes and lower public spending will tighten fiscal spending.

Moreover, Europe and Japan ultimately were to enjoy significant increases in their exports to the U.S., as their currencies were greatly lowered in value by U.S. policy. Instead of creating an economy based on industrial production and exports, the Reagan entourage launched a recovery built on paper.

The “strong dollar” weapon fell from grace in 1986, when the dollar’s value—having appreciated sixty percent between 1980 and 1985, and then declined by the same amount the next year—could no longer hold. The U.S., saved by global consternation over the looming financial-market crash, was able to elicit international support not just in bringing the dollar down without immediate disruption, but also in returning to the monetary and fiscal policy of Nixon and Carter’s weak dollar weapon strategy.

However, the nasty side effects of Reagan’s policies could not easily be swept under the carpet. The spring bond downturn and autumn stock market crash of 1987 came on the coattails of the U.S.’s expansionary monetary errors. Since this crisis, the Germans and Japanese have been less inclined to go along with the U.S.’s erratic economic policies.

George Bush’s tenure (1989-1993) brought further to light how far the U.S. had declined in the economic sphere. Each meeting of the world’s economic superpowers produced little agreement on international macroeconomic coordination. Meanwhile, the Europeans and Japanese continued to intensify their development of economic zones separate from the North American bloc. Domestically, Bush’s support of dollar devaluation and the traditional dollar weapon formula did little to bring the U.S. out of recession.

The dollar remains the world’s center currency. But while



President Ronald Reagan (1981-89): the “dollar weapon” with a twist, a strong dollar. [U.S. Embassy, Ottawa]



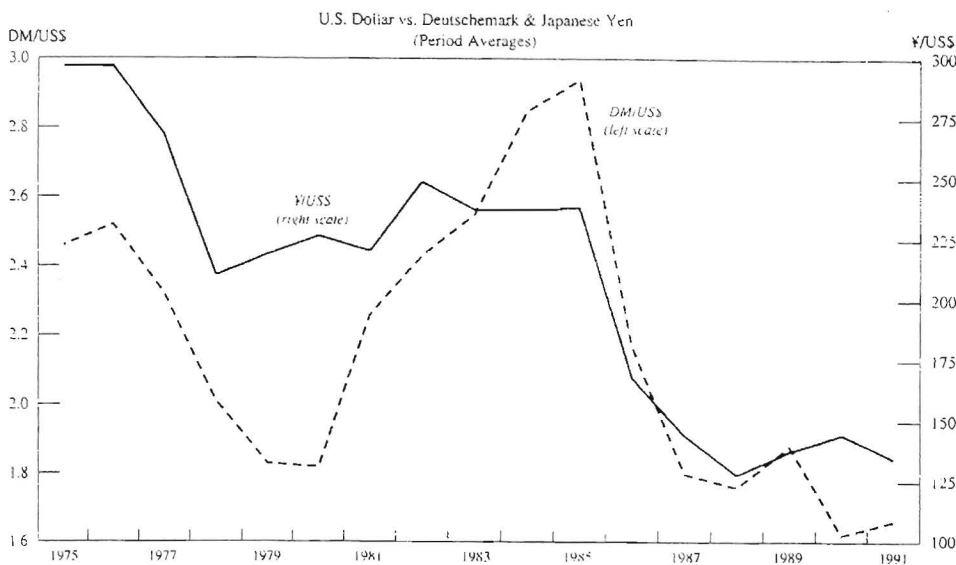
President Jimmy Carter (1977-1981): continued the cheap “dollar weapon” policy. [U.S. Embassy, Ottawa]

U.S. dollars composed 80 percent of the world’s official reserves in 1976, today they constitute just over 51 percent. At the same time, Germany and Japan’s presence in the world’s official reserves has risen from 7 and 0.7 percent respectively (in 1976), to 17 percent for the former and 10 percent for the latter.

Current Problems

Today, the U.S. dollar-weapon strategy is proving especially ineffective in the face of the simultaneous economic problems of Germany, Japan, and the United States. In Germany, there is little room for increased fiscal spending and monetary expansion without triggering more inflation. The Bundesbank’s historic July 1992 decision to increase its discount rate (the lending rate to its private banks) to the highest level in sixty years, clearly shows that the Bundesbank is committed to squelching inflationary pressures. Because German monetary policy dominates European Community monetary policy, a Germany with high interest rates, appreciating exchange rates and low money supply growth will perpetuate sluggish economic performance throughout the European Community—bad news for U.S. exports.

Historically, even when Germany has gone along with the expansionary macroeconomic platform of the U.S., its effort has been tepid at best. Disagreements between Bonn and Washington over coordinated monetary policy were one factor leading to the October 1987 stock market crash. The Western Europeans, led by the Germans, wanted to avoid the monetary manipulation of the dollar weapon strategy. The Reagan



From a cheap to a strong dollar and back again.
[I.M.F. International Financial Statistics Yearbook]

Administration saw the situation differently. They continued to favor the expansionary fiscal and monetary policies which many economists believe helped trigger the crash.

In Japan today, the credit structure is cautious and weakened. Like the U.S., Japan faces corporate and private debt crises. The recession, the stock exchange fiasco, and falling property prices have hit Japanese banks hard and subsequently led to higher lending rates. Coupled with this has been Japan's April 1993 adoption of the Bank of International Settlements' capital adequacy ratios—mandatory international agreements which increase the amount of money banks must put aside to cover each new loan. Japan's bubble economy has also been popped by the continual efforts of the Ministry of Finance and the Bank of Japan to create deregulated Western-style competitive interest rates, a task begun less than fifteen years ago.

On top of this, Japan is no longer experiencing spectacular economic growth rates. Falling asset prices have damaged the wealth base, which in turn has lowered consumer spending. The current situation has made Japan far less willing to allow the U.S. to affect its monetary and fiscal policy. Since 1989, Bank of Japan Governor Mieno has kept monetary policy tight. In terms of international macroeconomic coordination, Japan resembles independent Germany far more than it did in the past.

In the United States, the stagnating effects of government and trade deficits emphasize just how long the nation has been without real economic leadership. If the U.S. were a household, then over half of it would be in the pawn shop, while the other half digging deeper into debt. The U.S. can no longer jump-start the economy and begin recession recovery by increasing fiscal spending because total government borrowing today amounts to fifty percent of U.S. domestic savings. In 1988 and 1989, borrowing was only twelve percent. Even if consumer confidence picks up and the Federal Reserve continues to ease the money supply, the nation will remain in crisis for a long time.

Looking Forward

The Clinton Administration is handling the recession in the manner of its predecessors by relying on a weapon that has

been losing its potency for over twenty years. The American dollar weapon has been nationally and internationally disruptive. Both Republicans and Democrats have bowed to financial market power, satisfying U.S. borrowing costs and financial-sector profit at the expense of the rest of the economy. Politicians have supported the deregulation of domestic and international financial markets and given them liberty in setting exchange and interest rates in order to satisfy these prerogatives.

The U.S. has been able to avoid monetary and economic adjustment because of the sheer size of its consumer market, military capability and its vast pools of wealth. These global advantages have been augmented by the U.S.'s ability to borrow in the increasingly deregulated world of international finance.

Today, despite lower export prices and interest rates, borrowing and investment are lukewarm and there has been little change in U.S. exports. For all its extolled virtues, the dollar weapon has rarely been anything more than a short-term solution.

The current recession graphically reveals why Americans cannot flaunt the dollar weapon forever. Each use of the weapon threatens further the health of the U.S. economy. Weakening the dollar might ultimately set off a stock and bond crash on par with 1987. On the other hand, attempts by the government to bolster the dollar's value by raising interest rates will only result in depression. Yet, as the dollar continues to decline, real value ebbs away.

If the U.S. can no longer improve its economic well-being with a cheap dollar, then what can it do? Easing government debt by cutting social spending is politically infeasible, as is a complete overhaul of the U.S. economy. Most reasonably, the U.S. can stop playing the weak-dollar game and begin concentrating on real changes to its monetary policy. ●

Suggestions for Further Reading

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