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Can Trump Safeguard the US Dollar?

By Duvvuri Subbarao

SYNOPSIS

President Trump has threatened to impose tariffs on countries that try to move away from the US dollar. Why he wants to protect the US dollar hegemony is quite clear – it gives America an “exorbitant privilege”. Whether he will succeed is less clear. Quite possibly, Trump’s efforts will end up dethroning the US dollar.

COMMENTARY

“Tariff”, US President Donald J. Trump once said, is the fourth most beautiful word in the dictionary, after God, love, and religion. Although his tariffs on imports are grabbing all the headlines for now, not to be forgotten is his threat of tariffs on countries that try to move away from the US dollar.

This threat raises two questions. Why does Trump want to protect the US dollar hegemony, and will he succeed? Both are interesting questions. The first has a straightforward answer, and the second does not.

US Dollar Hegemony

Today, the US dollar reigns supreme in global economy and finance. Much of international trade, especially oil, is settled in US dollars, and a vast proportion of central bank reserves are held in US dollars. Exchange rates between pairs of currencies are set via their parity with the US dollar.

The sentiment on Wall Street and the decisions of the US Federal Reserve affect markets and economies around the world. Although SWIFT, the messaging system at the heart of the cross-border movement of money, is based in Europe, it is American banks that have overriding control over it.

America's Exorbitant Privilege

Because of this massive sway of the US dollar, America enjoys an “exorbitant privilege”, a phrase memorably coined by Valéry Giscard d'Estaing, then the finance minister of France. It is able to borrow cheap in world markets simply because the rest of the world needs US dollar assets and is therefore eager to lend to America.

The world's dependence on the US dollar also gives America enormous geopolitical clout. It is able to weaponise the US dollar by slapping sanctions on what it believes are rogue countries such as Venezuela, Iran and, most recently, Russia. Why risk “putting boots on the ground” when it is possible to force a country into submission by crippling its economy?

The reason Trump wants to safeguard the US dollar jealously is therefore straightforward. He is loath to lose these huge political and economic privileges that America derives from the US dollar.

Whether he will succeed in this endeavour is a more difficult question. It's not as if there is an international treaty anointing the US dollar as the world's preeminent currency. For sure, there was the Bretton Woods Agreement of 1944, by which the US dollar was pegged to gold, and every other currency was pegged to the US dollar.

That fixed exchange rate regime ended when President Richard Nixon abandoned the gold standard in 1971. Nixon's abrupt decision, however, did not dethrone the greenback. Its primacy prevailed because of the strength of the US economy, the depth and openness of its capital markets, and the credibility of American institutions of governance.

World's Resentment Against the US Dollar

Nevertheless, resentment has been building up against the US dollar for many reasons. The first is America's resort to weaponising its currency for political ends. America's sanctions on countries that it believed went out of line did not always have broad international endorsement. European countries, for example, did not agree with non-UN-mandated sanctions on Iran.

Emerging economies, on their part, are increasingly worried that America might use its outsized power capriciously and impair their economic security. It is this fear that has motivated many of them to briskly convert a part of their US dollar assets into gold in recent years.

The second source of resentment is the threat that US dollar dominance poses to financial stability in emerging markets. Consider the Global Financial Crisis of 2008, which was caused by reckless risk-taking in the US financial system. If that happened in an emerging economy, its currency would have collapsed. In the case of the US dollar, however, the opposite occurred; instead of losing value, it strengthened because American capital, which had been invested around the world, fled home – a manifestation of what economists call the “safe-haven effect”.

What worries emerging markets is that the sudden capital flight in the wake of the

global financial crisis was not an isolated incident. Much to their distress, there have been several instances over the last two decades when they were held hostage to US dollar volatility.

Enter Trump, even advanced economies are increasingly worried about the stability of their currencies. In past instances of market stress when US dollar liquidity in the global system dried up, the US Federal Reserve cushioned the impact by offering a swap facility for other hard currencies. European central banks have begun to wonder whether they can continue to rely on the Fed to similarly rescue them in the future.

The world also resents the exorbitant cost it has to incur to fund America's "exorbitant privilege". If you have a hundred United States dollars in your pocket, for example, you are in effect giving an interest-free loan to America of a hundred US dollars. Similarly, when countries accumulate US dollar assets for conducting their international dealings, they are effectively providing cheap financing to America, which in turn allows America to perpetually live beyond its means with no consequences.

Is There an Alternative to the United States Dollar?

For sure, the greenback can be dislodged from its perch if a strong and credible rival emerges. That has, however, not happened so far. When the euro was launched in 1999, there was an expectation that it would take some heft away from the US dollar. In the event, it failed to live up to those expectations.

Could the Chinese renminbi be an alternative to the US dollar? That has been a tantalising prospect ever since China started dominating global trade at the turn of the century, and more noticeably after the IMF included the renminbi in the Special Drawing Rights (SDR) basket of currencies in 2016, giving it a global imprimatur.

Many experts, however, believe that the renminbi cannot challenge the greenback simply because it does not meet the necessary preconditions to inspire global confidence. The renminbi's exchange rate is not market-determined; China imposes controls on capital flows, and its financial regulation standards are not transparent and predictable.

Can Trump Safeguard the United States Dollar?

However, that record is no guarantee that the US dollar will continue to reign. Money serves three purposes: a unit of account, a medium of exchange and a store of value. Already, the proportion of world trade invoiced and settled in dollars is on the decline. Central Bank Digital Currencies (CBDCs) will make it possible to set bilateral exchange rates between pairs of currencies without using the US dollar as an intermediary. Trump's threats and policies will possibly accelerate these trends.

Unpredictable policies, doubtful rule of law and erosion of institutional credibility could lead to America forfeiting the world's trust. Pushed to the wall, the world may decide that the costs of moving out of the US dollar are less than the costs of staying with it.

More than half a century ago, John Connally, then US Treasury Secretary, told the G-10 finance ministers: "The dollar is our currency, but it's your problem".

If Trump tests the limits of the world's forbearance, would the world turn back and tell America, "The dollar is your currency, and it's your problem"?

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