THE WALL STREET JOURNAL.
WSJ.com

OPINION | MAY 11, 2010

The World's Dollar Drug

Expect the greenback to remain the world's reserve currency, but that won't be a sign of U.S. strength.

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For all the talk about the problems of Greece and their implications for the euro zone, there is another currency that presents equally profound problems: the U.S. dollar. The dollar is, as everyone knows, the world's reserve currency, and it widely seen as a boon and an anchor for the emerging global economic system. It is also the only thing standing between the United States and its own moment of reckoning, and that is not a good thing.

The evolution of the dollar as the world's reserve currency tracked the emergence of the U.S. as a dominant power. The Bretton Woods agreement of 1944 designated the dollar as the currency of last resort because the U.S. accounted for a significant percentage of world manufacturing and held much of the world's gold in Fort Knox and other depositories. The British at first demurred but were forced to accept the primacy of the greenback in 1946 when faced with a choice between bowing to the dollar or defaulting on their loans because the Americans would not lend to them otherwise.

Bretton Woods obligated participating countries to determine their exchange rates and the value of their currencies in relation to the dollar, with gold as the underpinning. Then, in 1971, President Richard Nixon ushered in the era of fiat currency when he announced that the U.S. government would no longer allow foreign nations to redeem their U.S. dollars for gold.

The move came in response to rising inflation in the U.S. It also came in response to competitive pressures from Germany and Japan, which were beginning to undermine American manufacturing—a decline that has continued unabated since and can only be laid at China's door by a willful forgetting of the legacy of a host of lower-cost competitors over the past 40 years. By the early 1970s, the U.S. was importing heavily from new manufacturing centers outside America (though not yet running trade deficits) and being forced to redeem ever larger amounts of dollars for rapidly dwindling reserves of gold.

After 1971, currencies began to float against one another. This fiat system is what exists today, with notable outliers such as China, which continues to peg the value of its currency to the dollar. It does so primarily because when Beijing began to liberalize its economy in the early 1980s, the dollar was the most important avenue of access to the U.S., the world's most vital and dynamic economy.

Over the past decade, the relative position of the U.S. has shifted. It is no longer a creditor to the world but rather a large debtor. It is a net importer of manufactured goods—though its manufacturing sector remains quite large even while employing fewer workers. Its national economy is the world's largest but is surpassed by the multinational euro-zone. And China's economy, while still perhaps not much more than a third the size of the U.S., is growing three to four times as rapidly and accumulating dollars at a torrid clip.

Yet the dollar remains the linchpin of the global system. The financial crisis brought global grumblings about the U.S. currency, about the toxicity of the U.S. financial system, and about the need and desire for an alternate global currency. The Chinese were vocal in their desire to find a new anchor, and the Europeans echoed the sentiment along with others. But words are easy. Even the Chinese, who have made moves toward pegging the yuan against a basket of currencies, still find that having tethered their system to the dollar they can't simply walk away because they would rather things were different.

The dollar's dominance has clear short-term benefits for the U.S. Unlike Greece or just about any other country, when the American federal government wants to take on additional debt it has the advantage of a world that must buy dollars. Because much of global trade is conducted in dollars, especially Chinese trade, governments and institutions throughout the world have little choice but to invest in U.S. assets. The U.S. government also has the ability to print that global reserve currency when dire straits demand it. That gives the U.S. considerable latitude to spend its way out of a crisis without confronting real structural challenges.

Greece is being forced to adopt more austere government fiscal policies, as are Latvia and many other smaller countries. Having to turn to global markets with cap in hand is a bitter pill but could force reforms that will eventually leave those economies in stellar shape. The U.S. has been able to forestall deep reforms because it has the dollar.

But while the presence of the dollar keeps money flowing in and the system well-oiled, it no longer reflects the world's economic pecking order. For all the talk of currency manipulation by Beijing, it is equally true that China's peg to the dollar is currently propping up an otherwise shaky American economy. The Chinese have become the ultimate offshore bank for American capital, and there is no evidence they deploy it to less American benefit than Americans themselves do. The Chinese government invests conservatively in U.S. bonds, and spends heavily on a domestic economy that produces goods for American consumers.

The U.S. government uses its dollars—and the ability to print them and borrow them—poorly. Large amounts of debt fund consumption of goods and health care. While today's needs are important, without sufficient investment those dollars will dissipate. You'd lend someone money to open a business or invent a new energy source, but not for dinner and a movie. Yet because of the dollar, America tends to get the money it wants. And so the dollar as an anchor of the global system forestalls fiscal crisis in the U.S. while allowing for gradual decay of the American economy.

This can go on for many years. The world needs a reserve currency to reduce costs and allow market players to assess value across different countries and economies. But that need for the dollar shouldn't be confused for American strength.

India continues to use English as a lingua franca, more than 60 years after the British departed, not because Britain remains a world empire but because India needs a common tongue and English was already in place. The dollar today serves the same purpose for the world. The ubiquity of the dollar allows Americans to believe that their country will automatically retain its rightful place as global economic leader. That's a dangerous dream, an economic opiate from which we would do well to wean ourselves.

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