

# The Dollar and the World Development: A Conflict to Be Solved<sup>1</sup>

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*Abstract.* Two economic models are presently colliding in the global market: the «US locomotive» and the «EE autopoietic» growth. The first, based on the international use of the dollar, requires exogenous pushes coming permanently from the US foreign deficit and periodically from the US federal budget deficit. The second, based on the growing of the EE- (Emerging Economies) domestic demands, is feeded by foreign direct investments induced by countries' liberalizations and integrations (i.e., the globalization). The structural weakness of the dollar creates problems to the working of the EE model. Lacking a real international cooperation, there is the risk of a global currency crisis and a fall in the global growth rate with a probable impact on international relations and the related foreign policies.

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<sup>1</sup> A different version of this paper has been jointly presented with Carlo Viviani at the Third Florence Colloquium organized by Associazione Guido Carli, Cesifin Alberto Predieri and the Editors of the Journal of Financial Stability on April 23, 2005. This version is more oriented to analyze the geopolitical impact of the dollar if the US will follow the ideas of the Treasury Secretary John Snow and the former Governor of the Fed and now Chairman of the Council of Economic Advisors Ben Bernanke.

### **The three aims of the paper**

The US expansionary policies under flexible exchange rates regime and the entrance on the market of about three billions of new potential consumers and a growing number of new potential producers are structurally weakening the dollar and this is creating an incoherence between the working of the «US locomotive» and the «EE autopoietic» models.

The US GDP is still the dominant part of the GWP (Gross World Product) and the dollar is «the» international currency. These dominant factors act as engines of the locomotive of the world growth. This well-known mechanism needs a permanent deficit on US foreign current account and a transitory public (federal) budget deficit, i.e. an «exogenous» impulse to the US domestic demand and from here to the world demand.

Anyhow a new pattern of growth started to emerge as an associated wave of liberalizations and integrations of national economies and the connected growth in foreign direct investments. This new mechanism, that we call «autopoietic», does not require foreign or public deficits because it is based on an «endogenous» demand which renders the exogenous pushes coming from the «twin deficits» unnecessary.

Before August 1971, when the Bretton Woods Agreement was still in operation, the rest of the world had the possibility to control excessive foreign deficits of the US by converting dollars into gold at a fixed rate. There was therefore an instrument which allowed a certain degree of control on the dollar denominated money supply for international use by non-US countries.

After August 1971, the US unilaterally decided to break this monetary bound to their real growth, forcing the other countries to take autonomous decisions to react or not to the floating of the external value of the dollar.

This is why the former Treasury Secretary John Connolly and more recently the new Secretary John Snow said that «the dollar is our currency, but your problem». However cynical, this statement correctly recognizes that the dollar is a problem to the rest of the world which transfers its impact from the economic policy to foreign policy.

There is no doubt that the dollar is the world's fiat money, but not a monetary standard. The absence of a standard transfers the burden of the adjustment of the disequilibria from the US to other countries and the presence of floating exchange rates transfers the responsibility of monetary management from authorities to the market. Both of these effects have very serious consequences on economic and political relations.

If the current international monetary order (or disorder) were functional to the working of the locomotive model for world growth it could be still accepted, albeit it requires some institutional changes (as a permanent monitoring of domestic and international money creation at IMF level followed by political pressures on countries involved). If, instead, the autopoietic model becomes relevant in dimension and dominant in the impact on world growth, the current monetary order cannot be accepted anymore.

Leaving the currency regime as it is, the burden of the floating dollar can be reduced by accumulating dollar denominated reserves and disturbing domestic money management or by accepting the dollar floating paying a price in terms of real growth.

The first goal of this paper is to evaluate if the US locomotive model of world growth is on the way of being substituted by the EE autopoietic model, but the second is to understand whether the current co-existence of the two model can cause problems to the working of the dollar-centered international monetary system and, through this, to the world development process.

There is anyhow a third goal: to verify the relations between the current floating dollar-based international monetary order and the degree of free (or fair) competition in the global market. If the cost of dollar devaluations has a different impact on traded (competitive) and non-traded (protected) sectors, the result would be that rents are reinforced and profits penalized, worsening the trend of the real growth and the quality of social organizations.

## **The two models of world economic development and the international monetary regime**

There is a widespread consensus on the interpretation of the US locomotive model. We must say that Keynes was right in seeing a close relationship between fixed exchange rates (but multilaterally adjustable after a consultation at the IMF) and economic development, at least in the «western political» area of the Globe. However, for this scheme to work properly, he added some limitations in short-term capital movements, logically and practically as a substitute of an adequate supernational control in domestic monetary creation. This means that domestic monetary disequilibria should have been contained within the national boundaries and, should structural differences in inflation rates arise (whatever being the cause), they should have been solved by international cooperation and/or exchange rate adjustment.

The other precondition that Keynes proposed, and which was not accepted either in the 1944 Bretton Woods Agreement or in the 1968 Rio Agreement, was the creation of an international monetary standard to which every national currency including the dollar should refer, that he called «bancor» (to state that it should have been managed to be «as good as gold»). Those proposing the term «SDR-Special Drawing Rights» surely were less imaginative and efficient in communication than Keynes!

Under the pressure of the American interests, effectively supported by liberist economists, the Bretton Woods international monetary regime was abandoned with an unilateral decision by the US, switching to a flexible exchange rates regime and subsequently encouraging and supporting a growing liberalization in short-term international capital flows. In the growing currency confusion that followed and under the pressure of the market initiative, a number of financial innovations emerged, generally known as «derivatives»; with their introduction, the fundamental rule of monetary sovereignty and creation — i.e. that the market is not able to determine the optimal quantity of money and this task had to be allocated to an independent authority — was twisted in favor of the market (Savona, Maccario and Oldani, 2000). This has been implemented with different measures country by country.

In South America there was a series of failed trials of dirty floating, and a peculiar case of fixed exchange in Argentina, the «dollarization», ended in a country default and heavy losses to bond holders throughout the world. Dollarization experiments leave on the other hand open the question of the political legitimacy of surrendering the domestic monetary sovereignty to another Government, which in turn is neither interested nor disposed to discuss its monetary policy.

In Japan a dirty floating was adopted, sometimes coming very close to a fixed exchange rates regime following the well known merchantilistic approach to the Japanese economy (and society).

In the European Union, a system with the maximum possible rigidity of exchange rates, the one corresponding to a common currency, was established, with 11 of the 15 EU members entering since the beginning (one, Greece, after) and the 10 new entrants irrevocably committed to do the same within a relatively short period of time. The external value of the Euro was left to float with a huge devaluation at the beginning and an equal huge revaluation over the last two-three years. Given the perverse effects on European exports due to their high price elasticity, the result of the floating regime of the euro with respect to the dollar is that monetary and financial foreign disequilibria have been transferred to the domestic real sector.

This is the main reason why China and other Far Eastern countries with export-oriented economies adopted a peg on the dollar. Economic history of post-WW II teaches us that fixed exchange rates can be a relevant instrument of development of exports as a push to domestic growth rate. The catch here, of course, is that the real sector is isolated from external monetary shocks; there still the risk of being transferred, sooner or later, to the domestic monetary sector. This policy has been successfully only for China (if we are already authorized to such a judgement!), while for other countries like Indonesia and Thailand the mismanagement of short-term credit and derivative contracts generated perverse and disastrous effects.

The theoretical expectation on the stabilizing virtues of floating exchange rates was not fulfilled, and the US foreign deficits have grown to a disturbing share of American GDP. As we said, public budget deficit in the US has been the preferred cyclical instrument to support domestic demand, while the US being short of domestic savings and already heavily dependent

from foreign savings. This confirms the close relationship between the characteristics of the current international monetary regime and the American policy of leaving American citizens live above their domestic real supply and propensity to save.

On the other hand, the process of globalization, pushed by several tendencies synthesized in what I propose to call the «LISCA effect» (an acronym from Liberalization, Internationalization, Securitization, Computerization and Apoliticization), has the merit of exploiting in economic terms the end of the political blocks following the fall of the «iron curtain» (Savona, 1988).

Globalization also has the merit of starting a new development model, which substitutes foreign demand with domestic demand. This happens through the impulse of foreign direct investments, which provide less developed countries with an initial endowment of advanced technology, and a growing autonomous purchasing power. This kind of model, of course, does not need the American locomotive anymore.

One member of the Fed Board, Ben Bernanke, recently appointed chairman of the Bush-II's Council of Economic Advisors, expressed a different view starting from the existence of a world «saving glut» that the non-US countries are not able to absorb and the US are instead able to (Bernanke, 2005). According to this interpretation he believes that the US are giving a precious service to the rest of the world investing the unused savings.

This version of the US locomotive model — because such it remains! — still escapes to the problem that this capacity to invest lies on periodic fiscal stimulus and permanent foreign deficits, i.e. more on politics than market. Bernanke's view is an modernized interpretation of the US foreign deficit advanced in the past (Despres-Kindleberger-Salant, 1967), which is characterized by a better consideration of the IS-LM schemes. DKS interpretation assumes a different liquidity preference between the US and the rest of the world, the second being higher, which justifies the dollar creation for international uses.

*The Economist's* staff commented DKS's view under the title of «Why we disagree»: «Certainly America's deficit represents above all a provision of banking services to other financially less mature countries. Certainly the current attempts to dam up the provision of these banking services threaten constriction of world trade and investment. Certainly one can see no quick replacement for those services, least of all through new official form of international reserves (from Triffin to Cru). But that was never their intended function». DKS interpretation of the US foreign deficit convinced President Kennedy to try the «operation twist» (increasing short term interest rates and lowering the long term ones) which failed to prevent the 1971 dollar crisis.

Does the US want to follow these views and repeat this experience?

The world economic environment has deeply changed and we are still facing the same international monetary problem with a new growth model at work and less arguments in favor of the US locomotive.

### **The future of the dollar in the two conflicting growth models**

Given the current status of world economic relations, we argue that the exchange rate of the dollar will remain weak. In the best-scenario case, it will remain around the current levels waiting for the effects on the current account of the balance of payments of the US restrictive monetary and fiscal policies taken by the US authorities. In the worst-scenario, the dollar will continue to weaken because other factors are in motion.

The first is the policy of the ECB. If it will adopt a more restrictive monetary policy stance, given the recent relaxing in European fiscal policy rules (the so called «Stability or Amsterdam Pact»), the effect could be a neutralization of American decisions, strengthening the external value of the euro and keeping the dollar weak or even weaker. The difficulties on Eurozone real growth are preventing but not excluding this decision given the unique mission of preventing inflation assigned to the ECB by the Maastricht Treaty.

The second is the Chinese economic policy. If the «soft landing» of domestic demand pursued by Chinese authorities should evolve in a search for higher exports — i.e., a traditional responses known in the profession as «absorption or Alexander effect» — they would increase the foreign

surplus and the probability of further currency disturbances, which could lead to a change in the yuan exchange rate regime or, more simply, to a negotiated change in the pegged value of the yuan towards the dollar creating a vicious circle.

The third is the behavior of oil producing countries. They are becoming nervous for the external value of their dollar reserves and considering to diversify by buying euros or other strong currencies (if any!) with the possibility to strengthen the vicious circle in the international monetary system which brings to a weaker dollar.

We expect the American foreign deficit to remain close to the current (high) levels, because it depends on the American domestic demand that no government, be it Republican or Democratic, can afford to curb beyond a given limit. American citizens are highly sensitive to the GDP real growth and connected level of employment and less sensitive (since indifference) to the external value of the dollar, as the low value of the import elasticity to the exchange rate shows. However, they should not be indifferent to their foreign debt, which grows at \$1.9 billions a day <sup>2</sup>, at the same level of the daily increase of their public debt. The well-known twin deficits are largely in motion <sup>3</sup>. They should also to consider that the US public debt is largely (more than 40% according to estimates of the Treasury, the New York Fed and the Fed Board, 2004) in the hands of the central banks of China and Japan whose preference schedules on exchange rate and foreign reserves could change <sup>4</sup>.

In the long term, therefore, independently from national monetary and fiscal policies, the dollar will remain structurally weak. And even if this weakness is technically manageable, the risk of a dollar crisis will remain high either for market reactions and political reasons. It would be advisable to treat it, or much better to anticipate it, by activating some foreign policy instruments, as an international agreement involving the G8 and China to establish an international monetary standard or to fix new rules to avoid or to manage international currency crises.

This suggested agreement has two scopes.

The first is that the countries participating in the globalization process under the WTO rules recover their monetary sovereignty, wrongly left in the hands of the market, which today fix both the quantity of money and the interest rates.

The second to state the costs and benefits of cooperation, in economic policy as much as in foreign policy.

We believe that any State has its own set of preferences and that its behavior is guided by them. It would be therefore misleading to think that any State should cooperate on exchange rates — or on any foreign policy issue — purely on the basis of a superior and abstract common interest. But it would be equally misleading to ignore the benefits that can arise from a cooperative behavior, as game theory teaches us. As the history of European integration shows, cooperation can be successful if it is based on a common interest, and not successful when it proves to be too strong a limit (as in the case of the Stability and Growth Pact) for the preferences and interests of the governments.

Until now the behavior and the exchange rate strategy of US governments has been purely guided by a narrowly defined national interest. But we believe that an heavy international currency crises would damage also American interests. Therefore, it should be in the American interest to cooperate in order to anticipate and avoid it.

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<sup>2</sup> As of 31 march 2005, according to the data published by the U.S. Bureau of the Public Debt, the total public debt of the USA was \$7.78 trillions including intragovernmental holdings, or \$4.57 trillions only considering the debt held by the public. Between 31 march 2004 and 31 march 2005 the growth of the total public debt was 9.06%, or \$1.8 billions a day.

<sup>3</sup> See *The Economist* (2005), *Economic and financial indicators*, “Trade, exchange rates and budgets – Current-account balance”, April 9, pag. 89.

<sup>4</sup> Department of the Treasury, Federal Reserve Bank of New York and Board of Governors of the Federal Reserve System (2004), *Report on Foreign Portfolio Holdings of U.S. Securities as of June 30, 2003*.

## **The effects of the current international monetary order on global competition and social organization**

Monetary and currency disturbances can hamper fair competition inside the countries and among them. A stable monetary standard is a necessary requirement for any market to work in a satisfactory way, and therefore any policy curbing inflation and stabilizing exchange rates helps to establish a fair competition.

While there may be different interpretations on the causes of inflation and on the instruments to prevent or reduce it, there is a complete agreement on the fact that money supply must be managed by an independent public authority.

This agreement has solid economic foundations, but also political ones. The «no taxation without representation» principle involves inflation as much as any traditional fiscal instruments, because inflation is a hidden tax and therefore an income redistribution instrument. If not controlled, inflation violates one of the fundamentals of democracy: no income redistribution without representation.

However, the same agreement reached on the necessity of fighting inflation has not been reached in the case of an inflation deriving from exchange rates depreciations (the case of floating regime) or devaluations (the case of a fixed regime). The idea expressed by Piero Sraffa (1920) that internal monetary stability cannot be achieved without external monetary stability, has never been logically deepened and empirically tested.

This dispute has been solved in the European Monetary Union with the intention to promote a common market with fair competition: it adopted one money. The same applies to the global market if we really want one fair competitive market: it needs one money. If we think that this global money can be the dollar with floating exchange rates, we implicitly admit that we do not want a global market with a fair competition, but only a process of economic integration among countries called globalization of which benefit only the most able to speculate on its imperfections. Without a proper monetary standard and without an independent institution which manages the international money supply or as a second-best solution a fixed exchange rate regime under the control of an IMF type international organization, we will never have a «global market» with fair competition.

Even in the European Monetary Union the problem of the responsibility for the foreign value of the euro has not been solved. The EU treaties correctly say it belongs to the Head of the States Council, which has political responsibility and power to signs international agreements on external value of the euro. Apart from this institutional framework, however, the managing of the exchange rate lays de facto in the hands of the ECB, because the EU Council has never shown any will to do that.

This means that the external value of the euro is not managed at all, the only currency policy of the ECB being to control inflation through the European money base creation. It took a very long time for the ECB to admit that the falling external value of the euro would have an impact on Eurozone inflation and real growth. If we assume that the only thing that matters for the foreign currency markets are purchasing power parities, we render empty the frequent invocations of the «rules of the market» done by governments to enforce the acceptance of reforms regarding the welfare state or competition.

The alternative to the European exchange rate policy is to stabilize more or less rigidly the external value of the euro, accepting to accumulate both dollar-denominated reserves and tensions of the kind we already described in the case of China. The change in the foreign currency regime also help to mitigate the impact of the different behavior of traded (competitive) and non-traded (not competitive) sectors.

Be it for any reason, ranging from historical tradition to political influence, any economy has traded and non-traded sectors. We can roughly say that primary and tertiary sectors are on average price-makers, working shielded from external competition and with limits to internal competition too; while the industrial sector generally is a price-taker, working exposed to domestic and international competition. The weight of traded and non-traded sectors is difficult to

precisely estimate for each country: but we can say that it usually ranges respectively between 40 and 30% for the former and 60-70% for the latter.

Given their nature, traded sectors are greatly influenced by exchange rates: in case of a depreciation, they cannot transfer to the consumer the inflation due to higher cost of imports. The non-traded sectors can do it. On the other hand, in case of an appreciation, they cannot recover the lost margins, because they do not make the price. If exchange rates variations depend upon differences in inflation rates, and these differences depend in turn upon the different relative weights of traded and non-traded sectors, the logical consequence is that price-maker sectors (or non-traded) determine inflation, while traded sectors endure it, perpetuating the vicious circle of inflation-depreciation. Traded sectors can adjust prices only if and into the extent that their foreign competitors do it.

The case of Italy before the euro is a clear text-book example of the damages done on the traded sectors by the dominance of non-traded in the vicious circle created by the links between inflations and devaluation of the lira (Savona, 1993).

The logical conclusion is that — independently from their causes — exchange rates variations harm traded sectors and benefit non-traded ones. The consequences are market failures and a bad performance of the economy. Finally, the social organization itself is harmed due to the strengthening of the rents and the weakening of the profits, i.e. the protected sectors will prevail on the innovative ones.

### **Conclusion: the dollar is the American currency, but a problem for all countries, US included**

A dollar reflecting the American policy choices harms the economies of the rest of the world, especial those which growth is of export-led type.

The Eurozone is one of these economies.

Also the countries with an autaptic-led growth model are hinted by a floating dollar, either in their economies and social organizations, because growth, employment and competitive sectors are harmed and rent sectors benefited. This double impact produces directly and indirectly a worse social order. Directly, because less growth and employment mean less welfare; indirectly, because reinforcing non-traded sectors means discouraging the emergence of the benefits of free and fair competition. Societies become less meritocratic and more parasitary.

If China would be enforced to adopt flexible exchange rates accepting the outcome of the market on the value of the yuan-renmimbi, or should accept a negotiated revaluation of it, its growth rate would go down, adding new unemployment to the set of its unresolved problems. Even in the case of a successful «soft landing» of the Chinese economy, the tendency to appreciate the yuan will be strengthened by the substitution of domestic demand with exports and the system would strengthen its vicious circle. This could deteriorate political relations with the US, in an area where international relations are exposed to the unresolved problems in Taiwan, North Korea and other “non-integrated” countries.

We cannot ask to the market to manage the potential policy effects of the conflict between the two different models of world growth and the floating dollar, as it cannot pursue political or social goals, but only goals related to the rational use of scarce resources. In our opinion, the *laissez-faire* has definitely come to an end, eighty years after Keynes (1926) declared it. The «market capitalism» needs today more politics, or better said more geopolitics, than it needed before the globalization process started.

We cannot exclude either logically or practically that the dollar-denominated official reserves owned by the Chinese authorities will be sold on the market to gain a foreign policy advantage, or to regain internal political control in case it is lost by the Chinese Communist Party. We should not forget that, at the height of the oil crisis in the seventies of the last century, Saudi Arabia defined their dollar reserves as «monetary weapons» (war instruments), which could have put the US and other governments in serious difficulties.

We must also consider the effects on the dollar of oil exporting countries which announced they are considering a diversification of their reserves, pushing an appreciation of the euro and strengthening the vicious circle in the international money system.

While all countries look at economic variables on a global basis, they pay less attention to the relationship among economic, social and foreign policies. The US appear moderately interested in this perspective, while European governments are concentrated on regarding internal stability and infra-European cooperation. It is highly probable, instead, that the Chinese government is interested, given the traditional long-term view of their culture. They could be forced to react quickly to real and currency disequilibria coming from outside or to political problems coming from inside.

The leaders of the world does not show at the moment the “vision” needed by the very delicate monetary and economic situation.

The time has come instead to pass from pure domestic and international economic policies to a geopolitical approach of the effects of the modifications in the global development model and the increasing demand for democracy and social welfare.

Popular wisdom says we cannot eat the cake and have it too, meaning we cannot passively let the two models of development co-exist without a cooperative effort to minimize the potential dangers. If we let this happen, it could be the model pegged by the stronger country (or countries) to prevail, and not necessarily the better. In this case, we should continue to face, as happened many times in the past, with an international monetary regime deeply inadequate to the needs of world development and peace.

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