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OPINION | COMMENTARY

Monetary Reform Would Rebalance Trade

The dollar's status as global reserve currency is as responsible as bad agreements for the deficit.

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By Sean Rushton

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Contrary to claims coming from some trade hawks, America's large and persistent trade deficit is not caused primarily by bad trade deals. The U.S. dollar's status as the global reserve currency is at least as responsible as any free-trade agreement or unfair practices. High demand for dollars has tilted the playing field against American exporters and workers. Those arguing against tariffs—including Republicans courting blue-collar voters in the industrial Midwest—should be leading the charge for international monetary reform.

Before World War I the international gold standard amounted to an independent, relatively stable and universally accepted global currency. That system broke down during the interwar years. Then, at the Bretton Woods conference after World War II, the victorious Allies decided that the U.S. dollar, backed by gold, would be the international reserve currency to which exchange rates would be fixed. But this "gold exchange standard" was fatally flawed: The world's need for dollar reserves soon outstripped America's gold supply.

In the 1950s and '60s, the U.S. ran big trade deficits with its Cold War allies Japan and Germany, as they rebuilt their manufacturing bases and stockpiled dollars. By the early 1970s, American policy makers were fed up. They severed the dollar's link to gold and allowed the greenback's value to float relative to other currencies, in the hope that it would depreciate and smoothly reduce the trade deficit.

The opposite happened. No longer bound by fixed exchange rates and dollar convertibility, the U.S. government's fiscal discipline broke down. Federal debt as a percentage of gross domestic product, which had been falling since the end of World War II, soon began rising steadily. As a matter of national income accounting, Johns Hopkins economist Steve Hanke has explained, a rising fiscal deficit means a rising trade deficit. The nearby chart shows how the U.S. trade balance dropped sharply into negative territory.

In the bedlam of floating exchange rates, demand for dollars soared.

Many nations abhorred having their currencies—and thus their economies—jerked up and down because of decisions made by central bankers in the U.S. and other large economies. To defend against crises, especially at times of major U.S. monetary easing or depreciation, foreign governments stockpiled dollars. In 1973 the world held $500 billion in foreign-exchange reserves (in 2017 dollars); last year it was $11 trillion, a 22-fold increase. About two-thirds of total reserves are now denominated in dollars. Because of high global demand, the dollar's international position is always stronger and U.S. interest rates are lower than they would be otherwise. This, in turn, means that America's budget and trade deficits swell in tandem, while U.S. exports are costlier and imports are cheaper, regardless of trade practices.

Such a dynamic has made it difficult for American companies to add manufacturing jobs inside the U.S. Meantime, the finance industry—driven by profits from trading currencies and hedging the associated risk—has grown from about 2% of GDP to more than 9%.

Leveling the playing field will require reducing global demand for dollars, first by stabilizing the dollar and other major currencies, then by establishing a new international reserve currency. Here's how to do that:

First, to guide monetary policy, Federal Reserve appointees should commit to targeting the real-time prices of an index of commodities, plus foreign currencies and bonds. Such an approach would have prevented the Fed's biggest recent errors. Easy money in the 1970s and 2000s led to large increases in world dollar holdings, price bubbles and crashes.

Second, the U.S. should invite other major currencies—starting with the second-largest, the euro—to stay steady with the dollar. A dollar-euro stability pact, later including Japan and other democracies, would stabilize demand for dollars. A recent International Monetary Fund communiqué expressed positive sentiments on this front: "We recognize that excessive volatility or disorderly movements in exchange rates can have adverse implications for economic and financial stability. We will refrain from competitive devaluations, and will not target our exchange rates for competitive purposes."

Third and most controversial, the U.S. and other leading economies should establish a new international currency for pricing global commodities and settling trade accounts. Nations would keep their own currencies for domestic use, exchanging them for the international currency at fixed rates.

The Nobel laureate Robert Mundell suggested such an international currency, to be backed 50% by gold and 50% by the world's five leading currencies. Rep. Jack Kemp once proposed solving the "reserve currency curse" with a return to the full international gold standard. Other ideas, such as expanded use of the IMF's reserve asset, the Special Drawing Right, are also worth considering.

If the U.S. has reached the end of its rope and is unwilling to feed the world's demand for dollars through its trade deficit, then international monetary reform is the answer. It would put U.S. trade on a more level playing field, enforce fiscal discipline in Washington, and help millions of American workers.

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