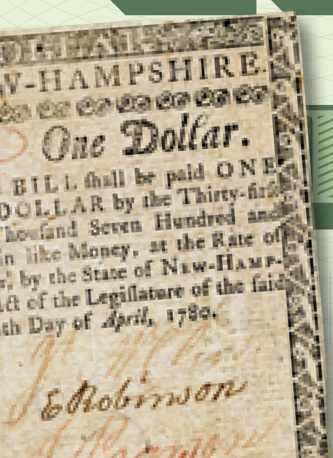
Getting to the Bottom of the Dollar



TODAY, KING DOLLAR REIGNS SUPREME OVER THE GLOBAL ECONOMIC AND FINANCIAL SYSTEM. IT IS THE WORLD'S PRINCIPAL RESERVE CURRENCY, USED IN ALMOST 90% OF FOREIGN EXCHANGE TRANSACTIONS. But might the days of dollar supremacy be numbered? To assess the dollar's future, we must first consider its past. For that, we look to the latest addition to the Ruffer collection of historic currencies – a clutch of noteworthy bills – displayed on the walls of our London office.

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COINS OF THE COLONIES

The dollar's origins can be traced back to the Joachimsthal silver mines of 16th century Bohemia. Coins minted there became known as thalers – anglicised as dollars.

The next phase in the journey to the currency we recognise today came with the Spanish colonisation of the Americas. Silver coins, like many pictured on these pages, became the default currency for trade across the vast and expanding Spanish empire. These pesos were known in English as Spanish dollars, or pieces of eight.

The success of the dollar in facilitating transatlantic trade with the Latin south throughout the 17th and 18th centuries stood in stark contrast to the North American colonies where, under British control, there was a dearth of practical means of exchange.

Successive British governments prohibited the minting of new currencies whilst failing to provide sufficient coinage to meet the fast-growing demand in the burgeoning northern economies. Eventually the colonial governments took the onus upon themselves and, in 1652, the Massachusetts Bay Colony began minting silver shillings imprinted with the emblem of a pine tree.

With no gold or silver mines of their own, the colonies sought an alternative to coinage and began issuing paper money. Between the 17th century and the onset of the American Revolution (1765-1783), each of the 13 colonial governments released their own currencies. These were not physically backed by gold or other commodities but by a simple promise. With trust as collateral, fiat currency had arrived.

A REVOLUTIONARY IDEA

In 1765 Britain sought to impose a sterling denominated sales tax on the colonies via the Stamp Act. It met fierce opposition, under the slogan 'no taxation without representation.' In 1775, the Continental Congress – which had executive function for the 13 colonies and coordinated resistance to British rule – launched the continental dollar.

Continental dollars were printed with clear intentions: to fund the revolution, pay soldiers and liberate America from British rule. From 1775 to 1779, printing totaled $200 million.[1] This was a vast issuance – too vast. A swift devaluation followed, and the phrase 'it's not worth a continental' soon entered the vernacular. In 1781 they were abandoned, signifying the official failure of America's first foray into fiat.

1 National Bureau of Economic Research
2 United States Mint
3 Federal Reserve

THE ROOM WHERE IT HAPPENED

Until Lin Manuel Miranda's hearty Broadway show, Founding Father Alexander Hamilton's legacy had faded into relative obscurity. But it was Hamilton, as innovative as he was daring, who swept in with an early experiment in central banking.

He came up with the blueprint for America's first national bank, which opened in Philadelphia in 1791. First Bank was modelled on the Bank of England and was granted a 20 year charter and a mandate to issue credit for national improvements and economic development. First Bank provided the infrastructure required for the next attempt at a single and functional currency. The US silver dollar – issued with a ratio of silver to gold fixed at 15:1 – was ratified in 1792.[2] This marked the return to commodity-backed money.

But the silver dollar was no silver bullet. By 1860 an estimated 8,000 different types of currency were still in circulation, and a unified federal monetary system remained a pipe dream.[3]

"BUT THE SILVER DOLLAR WAS NO SILVER BULLET."

CANNONS AS CATALYSTS

Wars, throughout history, have tended to catalyse industrial and economic change. The outbreak of the American Civil War in 1861 exposed the limitations of the bimetallic system. Reserves of gold and silver were insufficient to meet the demands of financing war. Congress, to advance the cause of the Union, issued a new form of paper money, which became known as 'greenbacks' because of their green reverse. They were printed at breakneck speed: $450 million worth of greenbacks were issued between 1862 and 1865, and the consequent rise of inflation quickly eroded their purchasing power.

The greenback was down, but not out.

FROM GREEN, BACK TO GOLD

The ubiquity of greenbacks made their outright removal from circulation impractical. Instead, Congress decided to cut back production and, in 1879, link the currency to gold. But what had changed that made physically backed dollars viable once again?

America emerged from the Civil War politically stronger and with a more prosperous economy. Rapid industrialisation and an accompanying boom in manufacturing brought about a Gilded Age. By 1900 the United States' share of global GDP had reached 18%.[4] As international trade boomed, the dollar became increasingly significant on the world stage. At last, Americans could be confident in a currency with clout.

Domestically, however, the absence of a federal monetary system remained problematic. The banking system was disparate and fragmented – operating as a series of cottage industries with some 20,000 individual institutions.[5] The system's instability culminated in the panic of 1907, which saw a frenzy of withdrawals. Runs on the major New York banks eventually required bailouts from private institutions and individuals led by John Pierpont Morgan.

This crisis accelerated plans to establish a central bank as the lender of last resort. The Federal Reserve System (Fed) was founded in 1913, with sole authority for the printing of paper currency. This provided the stability the dollar needed to continue its rise to global hegemony.

"WHILST IT MAY HAVE REMOVED ITS CROWN OF GOLD, THE DOLLAR'S REIGN CONTINUED THROUGH THE LATTER HALF OF THE 20TH CENTURY."

EXCEPTIONAL TO EXORBITANT

In the first half of the 20th century, US export trade boomed, with its comparative leadership accelerated by the two world wars. America supplied the allies with armaments and goods in exchange for gold, resulting in the US accumulating roughly 70% of the world's gold.[6] By contrast, Britain amassed debt of around 270% of GDP, the franc devalued by 80%, and Germany's monetary system collapsed entirely.[7] By the mid-20th century, the US had emerged as the pre-eminent global superpower.

The 1944 Bretton Woods Agreement was King Dollar's coronation. Under this system, 44 countries agreed to base their currencies on the US dollar rather than the gold standard, whilst the dollar would remain backed by gold. This created structural buyers for dollars, affording the US exceptional monetary and fiscal freedom – described by Valéry Giscard d'Estaing, then the French minister of finance, as the United States' 'exorbitant privilege'.[8]

4 Brands (2011), *Greenback Planet: How the Dollar Conquered the World and Threatened Civilization as We Know It*
5 Federal Reserve Bank of St Louis
6 International Monetary Fund
7 Office for Budget Responsibility
8 Eichengreen (2010), *Exorbitant Privilege: The Rise and Fall of the Dollar*

FAST-TRACK FIAT

But privilege never lasts in perpetuity. Successive US administrations tested the dollar's strength by adopting 'guns and butter' fiscal expansion. The butter came with President Lyndon B Johnson's 'Great Society' project in the mid-1960s, the guns with the Vietnam War, whose ballooning costs forced President Nixon to suspend gold conversion in 1971.

This severance from the gold standard was made permanent in 1973, amid concerns that US gold reserves were no longer sufficient to cover the number of dollars in circulation across the globe. Like its ancestral greenbacks, the dollar had become a pure fiat currency.

Whilst it may have removed its crown of gold, the dollar's reign continued through the latter half of the 20th century. It was supported primarily by trade agreements, like the 1973 Petrodollar Deal in which Saudia Arabia committed to price and trade oil in dollars in return for US aid. In 1975 the other OPEC members followed suit.

More recently, capital flows have provided the ballast. With dollar-based securities protected by US rule of law and backed by the US federal state, dollar capital markets have become the deepest and most liquid in the world. As a result, the dollar's role as the world's international reserve currency has thus far been guaranteed. Testament to its domination, over 65 countries today still choose to peg their currencies to the dollar.[9]

BUCK TO THE FUTURE

Clearly, a dominant dollar is not in everyone's interest. The Chinese Communist Party has made no secret of its desire to upend the dollar-based world order by positioning the renminbi as an attractive, carefully managed alternative. A growing number of countries are also seeking to use bilateral currency settlement systems, potentially aided by the advent of central bank digital currencies (CBDCs).

US sanctions on Russia after its invasion of Ukraine have increased the perceived risk of holding dollars for potential enemies of America, and this too will encourage a diversification of reserve assets. Commodity exporters, such as Saudi Arabia, may also begin accepting alternative currencies for key exports.

Capital flows are critical in the kingdom of currencies – they dwarf trade flows. Until there is a meaningful shift in investors' willingness to hold their assets in renminbi or digital currencies, we are unlikely to see an abrupt and immediate de-dollarisation of the global economy.

The dollar owes its staying power not only to the political power and economic prosperity of its issuer, but also to the flexibility of the currency itself and to a less tangible quality – the legacy of trust.

Still, there may come a time when some investors are forced to bet their bottom dollar on whether the US will remain on top. ●

9 The Brookings Institution

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