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Monetizing U.S. Debt: The Global Effects

By [Dan Steinbock](#)

U.S. Treasury Secretary Timothy F. Geithner recently said that the U.S. government "will not engage" in currency devaluation. In reality, the United States has already engaged in such devaluation, through quantitative easing — and there will be more of the same in the future. In fact, all governments are taking measures that affect exchange rates, directly or indirectly. The very concept of "currency manipulation" is flawed, argues Dan Steinbock.



The Rethink

- Since the early 1980s, the goal of U.S. economic policy has been a strong dollar. However, the U.S. Federal Reserve is contemplating another round of quantitative easing (QE) — which is essentially currency intervention by another name. It is an indirect intervention, but the net effect is the same: devaluation and a weaker dollar.

The Consequences

- Whether QE will stimulate the U.S. economy or not, its net effect will be a devalued dollar — and that, in turn, will affect foreign holders of U.S. debt. Today, half of the U.S. budget deficit is funded by foreign investors. They would be the ones to get hurt.
- In a global economy, the success of further QE depends on multilateral cooperation. Today, no central bank is an island. A second round of quantitative easing is a gamble in which the U.S. moves are funded by many of the very same nations that QE has the potential to hurt the most.



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A few weeks ago, the U.S. House of Representatives passed a controversial bill that denounced China as a “currency manipulator.” Yet, through quantitative easing (QE), the United States has also engaged in devaluation, though only indirectly. A second round of QE would raise the stakes dramatically.

In fact, if the logic of the U.S. House bill were valid, Washington should not only challenge numerous nations worldwide for currency manipulation — it would also have to challenge itself.

A disruptive decline of the dollar could prompt investors to shun U.S. debt.

In principle, every country has the option to devalue or not to devalue its currency. QE is currency intervention by another name. It is an indirect intervention, but the net effect is the same: devaluation and a weaker dollar.

In 2008, the U.S. Federal Reserve resorted to QE to overcome the grave recession by printing more currency notes, which were injected into the domestic economy.

Recently, U.S. Federal Reserve chairman Ben Bernanke made a case for [another round of QE](#) (dubbed QE2), which is likely to trigger similar actions in the United Kingdom and Japan. Other advanced and emerging economies are expected to follow in their footprints.

Indeed, the dollar has dropped more than 7% since August 27, 2010 — a mere two months — when Bernanke signaled the Fed was prepared to ease monetary policy. Inflation-protected securities are now sold at negative yields for the first time ever because traders expect the Fed to start [a new round of asset purchases](#).

The case for further QE is based on the idea that, through bidding up the price and thus lowering the yield of Treasuries and other safe debt instruments, the Fed will encourage investors to move their money to potentially high-yield investments, such as stocks.

The Fed would like to push large corporations to use their record cash piles to hire people and buy equipment. It would also like to see banks deploy their huge excess reserves to make loans to businesses. In short, the Fed would like to boost America’s confidence.

The most charitable thing that can be said about this strategy is that it is not devoid of risks.

QE encourages speculators to bet that the currency of the country where it is performed will decline in value. Yes, the large increase in the domestic money supply will lower domestic interest rates, but that prepares the conditions for a carry trade (investors borrow low-yield currencies and invest in high-yield ones).

The United States is now in a "liquidity trap," where monetary policy finds itself unable to stimulate the economy, either through lowering interest rates (read: zero is zero) or increasing the money supply (read: QE2 asset purchases). Neither is likely to increase borrowing or lending because consumer demand just is not there yet. Further, experimenting with imperfect instruments can also result in uncertain outcomes and collateral damage. Welcome to the Japanification of the U.S. economy.

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The problem is that, as increased liquidity seeks for high returns, it may not stay in the U.S. economy. QE has the potential to drive "hot money" into the high-yield emerging economies, which can further inflate dangerous asset bubbles in emerging Asia.

Since the early 1980s, the goal of U.S. economic policy has been a strong dollar. While Treasury Secretary Geithner continues to stress that the United States has a "strong dollar policy," the reality is that things are changing.

Despite the "strong dollar" rhetoric, the weak dollar has already boosted the earnings of U.S. companies and propelled the Dow Jones Industrial Average above 11,000 for the first time since May 2010. This has helped to reinforce consumer and business confidence, which is perceived as vital to jumpstart growth — especially before the 2010 midterm elections on November 2, and the important Fed meeting just a day later. The risk, however, is that a disruptive decline of the dollar could prompt investors to shun U.S. debt.

In a mild scenario, the impact of a slow and gradual shift away from dollar-denominated assets would have the least adverse impact. In a severe scenario, the withdrawal from U.S. Treasuries could prove sudden, broad and driven by panic. From the standpoint of Washington, these scenarios range from bad to very bad.

If a new round of quantitative easing is announced on November 3 (a day after the midterm protest elections), it is likely to debase the value of the U.S. dollar and thus accelerate "debt monetization" — inflating away the soaring U.S. debt.

In the past, this was primarily a U.S. problem. Today, this is no longer the case.

“Dollar issuance by the United States is ‘out of control,’” said Chen Deming, the Chinese commerce minister, recently. As a result, “China is being attacked by imported inflation.”

Historically — from World War II to Korea and Vietnam — monetizing large government deficits has prompted substantial increases in inflation.

QE encourages speculators to bet that the currency of the country where it is performed will decline in value.

In the foreseeable future, monetizing deficits is even more attractive politically. After World War II, Americans owned over 90% of U.S. debt. Today, half of the U.S. budget deficit is funded by foreign investors. They would be the ones to get hurt.

Thus, whether QE will stimulate the U.S. economy or not, its net effect will be a devalued dollar — and that, in turn, will affect foreign holders of U.S. debt.

The point is not that a new round of QE should be embraced or avoided. That decision belongs to the Fed. Rather, the point is that, in a global economy, the success of further QE depends on multilateral cooperation. Today, no central bank is an island.

In 1971, U.S. Treasury Secretary John Connally famously told a delegation of Europeans worried about currency fluctuations that the U.S. dollar is “our currency, but your problem.” Today, global imbalances, including competitive devaluations, are multilateral problems — and can only be resolved through international cooperation.

U.S.-China economic relations are deeply symbiotic. In the long term, China is committed to flexible exchange rates. However, the transition must be gradual. These are the parameters for sustainable bilateral cooperation.

QE has the potential to drive “hot money” abroad. As increased liquidity seeks for high returns, it may not stay in the U.S. economy.

A disruptive renminbi appreciation would not only hinder China’s growth, but global recovery as well. It would also undermine poverty reduction in the emerging world, which today depends more on growth in China than in the advanced G7 economies.

A second round of quantitative easing is a gamble in which the U.S. moves are funded by many of the very same nations that QE has the potential to hurt the most.

In the Bush era, unilateral security policies left America alone. In the Obama era, unilateral economic policies would not only leave America without many friends — but turn many of these friends against America.

Ultimately, the Federal Reserve must decide what is best for America. But — as with the Smoot-Hawley Tariff Act in the 1930s — in a globalizing world, no nation can any longer seek for its best alone.

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G20 ECONOMIES AND GLOBAL CORPORATIONS



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