The Travails of the US Dollar

Given the economic upheavals resulting from the pandemic and from the political instabilities faced by the country, one would expect wild fluctuations of the dollar. Indeed, looking at an historical perspective, the dollar depreciated by close to 50% against the euro in 2008 after the bankruptcy of Lehman Brothers. In 2020, the US economy has dipped by 4.5% in the first quarter, then by 31% in the second quarter and increased by 33% in the third quarter – so it is not back where it would have been. In sum, the economy is expected to fall by 3.5% over the year. In addition to the inability of the country to hold the virus back, the political atmosphere is toxic: congress was unable to agree on a new stimulus to alleviate the economic pain on the public and on business until December, the result of the election is bitterly contested by the outgoing administration without any proof of voter fraud, and the transition is fraught with nastiness like the refusal to share information with the new administration.

Given this situation, one would expect the dollar to be affected adversely. But the dollar has barely moved over the year and its volatility is minimal. The $ trade-weighted exchange rate index was 116 in January and fell to 113 in December – this is minimal compared to the $ plunge in 2008. Why is it so? First, the shock resulting from the pandemic is common to all the other world economies and is happening around the same time triggering massive fiscal responses from governments around the world, and second, the Fed has offered generous swap lines to support the dollar. Theoretically, exchange rates are affected by interest rates. But given the failure of conventional monetary policy to move interest rates, they are now hovering around 0%, just kept artificially above negative territory in the US. Likewise, quantitative easing operations by central banks, viewed as quasi-fiscal, have lost their impact as long-run interest rates have also converged down.   With inflation being so low, the major sources of uncertainty have faded away, resulting in the disappearance of the core sources of exchange-rate volatility. All these developments might explain the stunning exchange rate stability of most currencies in the industrialized world in the face of economic disaster.

What about external factors that could influence the exchange rate? The exchange rate is just the relative price of one currency in terms of another. Exchange rates are affected by trade balances, but also by capital flows. The US has suffered chronic trade deficits since the 80s. They resulted in an increasing debt owed to the rest of the world. For instance, the external debt measured as the net US international investment position went from -33 to -11,050 billion dollar in the past 30 years – this number represent the net US liabilities toward the rest of the world. On the other hand, exchange rates are also affected by flows of capital. The dollar has always been the main world reserve currency. During the worst of the pandemic, investors worldwide believed that the US was the safest place for their assets, so they bought US government and private securities. To do so, they first had to buy dollars and, in the process, bid up its value thus explaining the strength of the dollar at the peak of the pandemic. Then several vaccines were developed and approved with great fanfare resulting in a show of optimism from the part of the investors, now willing to send their capital towards other shores and causing the recent weakening of the dollar.

This article has presented a number of facts to explain the short-run stability of the dollar. But what about its future? It has also uncovered a number of concerning issues. The US economy will have shrunk in 2020; how strong will the recovery be in the next few years? In the meantime, the Chinese economy continues to grow steadily. The importance of the US as a share of the world economy will decline. In addition, the US debt toward the rest of the world shows no sign of falling. Will the dollar remain king?

Read the above article and write an essay, based on your own knowledge of economics and on issues presented in this article, discussing the following. "Currencies fluctuate a lot in the short run, but economists also detect long-run trends that are more predictable and they believe that the dollar is presently unusually strong: do you think there might be a correction in the near future and the dollar might just stabilize at some lower level or do you believe that there are serious structural issues about the US economy and that, further down the road, the dollar might weaken to such an extent that it will end up as just one of a number of other reserve currencies?" Support your predictions with conceivable economic and political developments.

The Travails of the US Dollar – What the graders are looking for

The article presents information regarding the relative stability of the U.S. dollar in spite of the economic downturn due to the pandemic. The prompt asks you to discuss whether you think the U.S. dollar will stay on as the world's reserve currency in the long run, or it will lose its place and will be one of a number of other reserve currencies.

In addressing the prompt and arguing in favor of the dollar stabilizing and staying on as the world's reserve currency in the long run, you could make several points:

- Relative to other countries' currencies, the U.S. dollar holds a special place: many international payments between countries for sale and purchase of major commodities like oil and gas are made in U.S. dollars. Barring an unlikely scenario, where the U.S. economy loses its status in the world, one would expect the U.S. dollar to continue to act as the world's reserve currency.
- The U.S. economic system has a complex institutional structure with many checks and balances, making it fundamentally a stable system. Although there may be short run political and economic upheavals, the U.S. economy recovers after a period of shock or downturn. The U.S. currency, likewise, reflects this institutional strength.
- You could also make a point about the strength of the U.S. Federal Reserve system, the Fed. This institution sets monetary policy that affects the value of the U.S. dollar. The Fed is a well-known and trusted institution around the world for proposing stabilizing and sound economic policies. This positively affects the position of the U.S. dollar in the world.

In addressing the prompt and arguing that in the long run, the dollar may lose its premier reserve currency status, you could make several points:

- The narrowing of the economic distance between U.S. and other countries, especially China may lead the U.S. to lose its economic leadership position and hence the dollar may lose its status.

- The effect of the pandemic and the relatively slow response in the U.S. to overcoming this pandemic may hurt productivity in the U.S. in the long run. Therefore, the rate of growth of U.S. economy may be lower relative to other countries, negatively affecting the status of the U.S. dollar in the world.
- The current atmosphere of political divisiveness in the U.S. may linger and stay unresolved for some years, weakening the economic status of the U.S. and negatively affecting the standing of its currency in the world.

It is very important that

1. You answer the essay question thoroughly
2. You introduce your own ideas and factual knowledge and do not regurgitate the article
3. You support your points
4. You organize your essay such that it reads well.

If all the points, facts, or ideas in your essay come directly and only from the article itself, you will not get a good score.