CHAPTER 6

The US Dollar as an International Currency Reserve and Its Value

The current account deficit (e.g., consumption exceeds production in the United States because US MNCs have transferred their production abroad) causes a capital account surplus (e.g., capital inflows in the United States) and at the same time, the scale of financing needed to support the US fiscal deficit and the private sector’s and households’ debts, along with the Federal Reserve’s policy of keeping US interest rates low to ward off deflation, stimulate the financial markets, and revive growth, which is difficult without fiscal policy, has revived concerns about a sudden and sharp depreciation of the US dollar.

Americans have lost an enormous amount of their purchasing power and wealth. This enormous liquidity by the Fed has caused many reactions from foreign nations. The wars in Iraq and Afghanistan have caused Muslim investors to turn to other currencies holdings instead of the US dollar. This chapter examines potential triggers and indicators of such a crisis and posits concrete policy options to limit US vulnerability to the possibility of a plunging dollar. It argues that the obvious long-term response to the risk of a dollar crisis is to limit buildup of the United States’ external debt (i.e., trade deficits) and domestic public and private debts, and recommends that larger reserves and well-understood mechanisms for borrowing foreign exchange reserves from major foreign central banks would help to reduce the United States’ vulnerability to such a crisis.

As a debtor, the United States is benefited from the devaluation of its currency. But the country has to increase its production domestically and reduce its imports, which will improve US employment, too.
The US dollar has shown great volatility even before 1971, when the gold exchange standard was abandoned\(^1\) by President Nixon\(^2\). This volatility has continued since 1973, when the exchange rate became flexible. Looking at the different exchange rate indexes, one can see the value of the dollar. The Trade Weighted Exchange Index (USXRI)\(^3\) has had a mean value during this period, \( \overline{USXR_I} = 98.23418 \) and a standard deviation, \( \sigma_{USXRI} = 13.91965 \). Its maximum value was 138 (1985:M03) and its minimum value was 69 (2011:M08). In 2002:M02, the index was at a value of 111 (Graph 6.1). After that date, the dollar continues to depreciate with respect to the other major currencies. The questions that arise here are: What are the causes of this depreciation? What is the cost and what are the benefits for the United States?

Graph 6.2 shows many factors that have caused the dollar’s depreciation. The causality, correlation coefficients, and F-statistics of these variables are presented in Table A6.2. The current account deficit, the capital account surplus, the huge national debt, the inflation in the country, and the tremendous uncertainty of the Middle East crises in Iraq and Afghanistan—and there are

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**Graph 6.1**  The Depreciation of the US Dollar with Respect to the Major Currencies  
*Note:* USXRI = Trade Weighted Exchange Index: Major Currencies: Index March 1973 = 100. An increase in the index, the dollar is appreciated. The peak point of the US dollar was in 1985M03 and the trough was in 2011M07.  