The Dollar Problem and Its Solution
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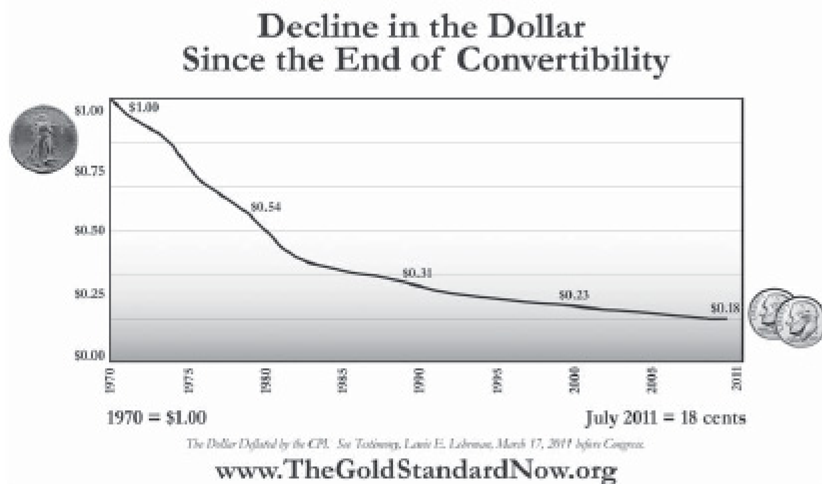
There is little new in this latest cycle of economic boom, panic, and bust. All of these cycles are linked to the life and death of the unstable post-World War II Bretton Woods monetary system. First came the crisis-ridden gold-dollar system from 1944 to 1971. Then came the rise of floating exchange rates and the world paper dollar standard from 1971 to the present — associated with regular booms, panics, and busts — bringing us down to this very day.

Between 2009 and 2011, the world experienced a major emerging market equity and economic boom—but at the very same time, sluggish growth in the United States. Foreign authorities now react to inflation by raising interest rates. Why such a sluggish sequence in the U.S.? Because the Federal Reserve's vast credit creation of 2008-2010 could not be fully absorbed by the U.S. economy, coming as it did after a wild panic and a deep recession. The unprecedented Fed credit expansion flooded into U.S. stocks, bonds, and commodities. Excess Federal Reserve credit and money also went abroad, causing not only a fall in the dollar but also the emerging market financial boom. What is the mechanism which links Fed credit expansion to the emerging market boom? It is simply this: financial authorities abroad purchase the incoming flood of excess dollars against the creation of their local currencies. There, the new local money is put to work promptly, creating a boom in all financial assets, and then a boom in the local economy as well.

In truth, the Federal Reserve is the defacto central bank of the world monetary system, because the paper dollar is the monetary standard of the world banking system. Expansive Fed credit policy—especially Federal Reserve and foreign financing of the U.S. balance of payments deficit and the government budget deficit—has been behind almost every boom and bust cycle since 1914. The cycle is engineered by the purchase of dollar-denominated securities by the Fed and foreign central banks, a process enabled by the opaque workings of the official world reserve currency system, based on the dollar.



Graph 1: The Dollar Deflated by the CPI. See Testimony, Lewis E. Lehrman, March 17, 2011, before Congress.

For example, after World War II the dollar-based Bretton Woods gold-exchange system, followed by the disorder of floating-pegged exchange rates, led to an overvalued dollar and to the diminution of our dominant manufacturing sector. Floating exchange rates cause huge upward and downward currency moves, which abruptly reprice the entire productive machinery of nations subject to floating currencies. Thus, whole national economic sectors become unprofitable, making steady long-term investment and output very difficult. Subsequent underinvestment leads unavoidably to scarcity booms, fueled from cycle to cycle by Fed-subsidized credit to the banking system and to the deficit-ridden Treasury. Thus, the natural business cycle is intensified rather than moderated. To mitigate the perverse effects of floating exchange rates, many countries have pegged their undervalued currencies to an overvalued dollar in order to subsidize and sustain their export production machines. This is an ancient practice of predatory mercantilism.