

Thanks to France, Dollar is a Mighty Hegemon

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At one level, France has achieved for now its aim in Europe – the destruction of the German monetary hegemon. Ex French politico Christine Lagarde as ECB chief for 8 years (from 31.10.19) should preserve that victory unless she stirs so much populist anger in Germany as to bring about a monetary revolution there.

At a second level, though, France has suffered defeat. The US monetary hegemon is mightier than ever before, no longer facing any serious countervailing force from Europe. It is only a distant memory that in 1977-8 and again in 1988-9 Bundesbank policy could sway the Federal Reserve, via the market reality of a crashing dollar against the Deutsche mark, into abandoning the path of rampant monetary inflation.

A previous generation of French statesmen, including President de Gaulle, had sought to topple US hegemony in the global monetary system and replace it with gold. Today, however, the dollar's dominance (whether measured in terms of currency usage or of US power over global monetary conditions) is unprecedented. Its recent advance, after some setback from 1970-2010, reflects a reversal of *relative* monetary performance between the US and Europe – from US inferiority to superiority.

In the 1970s, Europe was leading the way under its German hegemon in the application of strict monetarism. This contrasted with the US, where the breaking of the dollar's last links to gold marked the start of the greatest peacetime inflation. Paul Volcker with his two-year monetarist onslaught briefly (1981-5) re-boosted the US monetary hegemon, but his subsequent embrace of Plaza-led dollar devaluation undid that.

Fast forward to the 1st decade of the 21st century, the founders of the euro billed it as the European "Deutsche mark", pointing to the constitutional enshrinement of ECB independence and its aim of stable prices. All the chatter was about the euro challenging the dollar's place in the global financial system. President Bush's fast-tracking of a renowned neo-Keynesian advocating permanent inflation and trigger-ready money printing to the head of the Federal Reserve seemed to justify such speculation.

In the second decade we have had complete upset of these expectations. The ECB eventually applied monetary "stimulus" even more radical (including negative rates) than the Federal Reserve and has not let up. By contrast, for now the US experiment with QE (quantitative easing) is largely over (its balance sheet has shrunk considerably to a point where the market for reserves has showed some real signs of normal life recently), even if Chief Powell hopes to emulate Alan Greenspan and steer the US economy from yet another mid-cycle downturn into a super-long cyclical expansion.

In the next recession, Fed may move back to QE, but that is far from sure. Several key Fed board members today opposed QE under President Obama. Legislation to allow negative rates would not get through the Senate without a super-Democrat majority.

By contrast, further monetary wildness in Europe looms large. Yes, at some point, Washington may combat this by imposing stiff tariffs as penalty for the accompanying currency manipulation. But despite all the murmurs, the Trump Administration has been loath to follow that course so far, perhaps fearful of triggering a crash in global asset markets. Meanwhile, growing power for the US monetary hegemon goes along with a stronger dollar.

The one real threat to dollar hegemony comes from Germany. The combination of recession and growing ECB-imposed tax burdens could trigger a political earthquake there. The ruling CDU would abandon the field of eurocentrism where it competes with the Greens for votes and win a majority by shifting to the right, campaigning for a new sound money within a smaller union.

For now, this possible scenario is just faintly detectable on the horizon. If it grows in likelihood, we would first see a dramatic further descent of long-maturity Bund yields into sub-zero territory – a turn-off to global investors.