Something Had to Happen

A view of recent times.

BY BERNARD CONNOLLY

The advertised agenda of the Trump administration raises important and much-discussed questions about the plumbing of the financial system and the global monetary order. But in assessing the potential impact of that agenda on the U.S. economy and on U.S. Federal Reserve policy, one has to begin with the underlying economics.

Something had to happen. And on "Liberation Day," it looked as though it was going to happen. The U.S. economy in March of this year was in the state of fundamental disequilibrium that had characterized it for almost thirty years. The vaunted "resilience" of the economy—the strength of aggregate demand—was an illusion. The asset price and credit bubbles that sustained the illusion had extremely negative impacts via worsening inequalities of income and especially wealth in the country, and via weakening the foundations of both capitalism and democracy. The illusion also allowed successive administrations to pile on budget deficits and government debt. Full-employment budget deficits in excess of 6 percent a year, with no immediate prospect of correction, could be consistent with avoiding future default by the U.S. government only if the wealth of the country—future income streams discounted at an equilibrium real interest rate—was valued at extravagant levels. Stock prices certainly involved extravagant expectations. But more was needed: a belief, grounded in experience even after the wave of defaults by individual states—then still regarded as fully sovereign debtors—that the federal government simply never would or could default.

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Of course, that experience ignored inflationary repudiations such as that of the 1970s. True, not everyone was completely taken in. A decade ago, China, for instance, realized the risk in its holdings of Treasury bonds and began to diversify away from them. Given the political barriers to greatly increased Chinese direct investment in the United States (barriers subsequently evaded to some extent via private credit), that realization became the economic element, even if less important than the geopolitical element, in the Belt and Road strategy (see Connolly, *TIE,* Summer 2019).

Donald Trump, too, could see that the U.S. economy was on the wrong track. In the 2016 presidential election campaign, he decried "a big, fat, ugly bubble" in the stock market. That rhetoric did not translate into presidential action during Trump's first term—rather the opposite. But in the 2024 campaign and into his second term, Trump's proclaimed concern to reverse what has been the enrichment of "Davos Man"—the enrichment of increasingly self-perpetuating elites, including foreign elites, at the cost of hollowing out the middle class—correctly identified the dangerous erosion both of America's internal cohesion and of the country's position in the world.

But correct diagnosis does not always lead to correct prescription. Much of the initial financial market impact of "Liberation Day" was subsequently reversed as the scale of tariffs seems to be reduced. At the time of writing, it is still not entirely clear exactly what the prescription and its dosage will end up being. But initially pervasive uncertainty—except, according to surveys, about the likelihood of increased inflation—affecting U.S. firms and households had a sharply negative effect on "confidence." And confidence—in moderation the life force sustaining the genius of capitalism but long transformed into the collection of illusions underlying asset price and credit bubbles—has for many years been the primordial force apparently supporting the economy.

"Liberation Day" at least had the merit on initial impact of bringing these things painfully into focus. But the questions it raised are difficult analytically as well as politically. Even if there is ultimately more clarity about the scope and scale of tariffs, predicting their effect will be a very hazardous business. Economic theory is arguably of no help at all. Yes, economists tend to agree that in practice, if not necessarily in theory, tariffs will boost inflation and hurt output (or at least domestic demand) and employment in the U.S. economy. And even two justly celebrated economists who typically have difficulty agreeing with each other—Larry Summers and Paul Krugman—are as one in characterizing such effects as negative supply shocks. But Fed officials are rightly in the "definitely maybe" camp: definitely on the inflation and demand impacts, maybe on monetary policy reaction—one way or the other—given the subtly different question of whether tariffs are supply shocks that reduce the efficient level of output.

Given this background, will tariffs promote Trump's stated objectives, which include creating manufacturing jobs for the middle class, eliminating the U.S. current account deficit, and improving the net financial assets position of the country—currently at a massive negative of around 100 percent? Are these objectives the right ones?

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And how should the Fed react, assuming that it retains its independence?

These questions are very hard to answer in view of the still-uncertain landing point of U.S. tariffs and retaliatory tariffs by other countries. As long as uncertainty about the landing point persists, it will be very difficult for manufacturing firms to relocate production to the United States. And standard economic theorizing had suggested that the impact of U.S. tariffs, if unilateral, would largely be offset by an appreciating dollar. Instead, what was seen on impact was a depreciation of the dollar and, albeit with a great deal of up-and-down, an increase in long-term U.S. yields and a substantial correction of stock prices. That initial combination was often described as a "sell America" reaction. There can be little doubt that confidence in the stability of U.S. policy, the U.S. financial system, and "the full faith and credit" of federal government debt remains dented by the tariff actions and announcements and by the musing within the administration about a reordering of the global monetary system which would amount to an implicit repudiation of U.S. foreign debt.

But it is also instructive to think of a weaker dollar/higher yields reaction as a jump onto a weaker forward curve for the currency, and that is exactly what is needed for U.S. adjustment.

True, a much better outcome would have involved a beefed-up version of the Teddy Roosevelt "Square Deal" so as to reduce monopoly rents—a positive supply shock bringing lower inflation and higher efficient output than otherwise—combined with reduced regulation, and reduced taxation on effort, creativity, and entrepreneurship, all seriously antithetical to economic success and social fairness. Such a program would amount to a validation *ex post* of otherwise unjustifiable valuations of stocks and credits. It would allow long-term yields to achieve a level more consistent with long-run equilibrium than those in most of the last thirty years, and it would do so without causing a short-run crashing of the economy (to be clear, it would appropriately involve an initial widening of the current account deficit and initial appreciation of the dollar).

The Fed should not cut rates until it might become clear in the data and not just in surveys that the economy is weakening beyond any hypothetical reduction in the efficient level of output.

Certain elements of such a program can definitely be found—and are very welcome—in the Trump administration's announced intentions. But it was abundantly clear that those elements were initially swamped, in financial market, business, and household reactions, by the confidence-crashing impact of policy on tariffs and the doubts about the reliability of U.S. economic policy. To repeat, this was very far from a first-best outcome. But the jump, since somewhat moderated, onto a weaker forward curve, and the necessary correction in stock prices is likely, all else being equal, to substantially reduce the U.S. current account deficit, reducing domestic expenditure and switching expenditure towards domestic output. That would work in the direction of Trump's desire to eliminate the deficit.

But would eliminating the deficit, wholly or incompletely, be consistent with another stated objective, that of reducing interest rates (or, in U.S. Treasury Secretary Scott Bessent's elucidation, long yields)? Many financial market commentators, and even some celebrated academic ones, have stated flatly that because the balance of payments balances (absent reserve movements), eliminating or reducing the current account deficit would necessarily involve the elimination or reduction of capital inflows, with the supposed result that long yields in the United States would rocket. True enough, because the current account is "sticky" whereas the capital account can adjust instantaneously, in the short run the capital account adjusts to offset the more gradual movements in the current account. But there is nothing mechanical or purely arithmetical about this. What produces a change in the capital account is not the current account *per se* but a change in relative (U.S. versus foreign) asset prices and the exchange rate and expectations of those variables, including expectations of the policy reaction. At the time of writing, the case that has so far seemed relevant—an initial crash in "confidence" and a marked slowdown, or perhaps a significant pullback, in domestic demand—there is not an immediate reduction in the deficit. There is correspondingly no immediate reduction in capital inflows. But relative asset prices, including the exchange rate, do change. In April this year, U.S. assets had to become cheaper to induce capital inflows consistent with an initially unchanged current account deficit but an implied downgrading of expectations of future U.S. incomes and thus of the long-run equilibrium exchange rate of the dollar.

Given the lags in the effect of monetary policy, the price the administration is likely to have to pay for its criticism of the Fed is an otherwise unnecessary rise in unemployment.

How should the Fed react? In the late 1990s, then-Fed Chair Alan Greenspan shocked Federal Open Market Committee members by telling them that the Fed could no longer forecast the economy because its course depended above all else on the stock market, and the stock market could not be forecast. The Fed still attempts forecasts, but its forecasts both for inflation and for output and employment may well have changed quite radically between the end of January and the end of April.

Does that create a dilemma, given the dual mandate? The relative weights assigned by the Fed to inflation and employment should not be fixed but should depend on the driving forces. Arguably, the Fed should have been tighter over the past ten years or so, in which firms' mark-ups over costs appear to have risen dramatically. But in the present situation, inflation—or at least the *consumer* price level—will be higher because of tariffs, to the extent they are implemented, and a weakened dollar. But neither of these effects unambiguously represents an increase in mark-ups that would justify a reduction in the level of output. That argues in favor of the Fed's quite substantially reducing interest rates, and doing so soon, to offset or moderate the net negative effect of recent developments on output (since expenditure reduction is likely to be much greater than expenditure-switching unless "confidence" rebounds further).

However, the administration's fierce criticism of the Fed and its insistence on rate cuts seemingly independent of the path of output and employment alter the calculus. The argument advanced above would amount to a Fed put on the economy, accommodating an increase in the *consumer* price level. The obvious danger is that early and substantial rate cuts in response to administration pressure would be seen by markets, firms, and households as a put on the administration, thereby aggravating a loss of confidence in the U.S. economy and inducing expectations of corrosive ongoing inflation.

Thus, the best strategy for the Fed seems to be to, first, wait for greater certainty on what is actually going to happen with tariffs and on the reaction of "confidence," and, second, buttress or reinstate economic agents' belief that the Fed will, absent supply shocks such as an increase in mark-ups by import-substituting firms, operate a put on the economy—but not on administration policies. And that will probably mean that the Fed should not cut rates until it might become clear in the data and not just in surveys that the economy is weakening beyond any hypothetical reduction in the efficient level of output. That is, given the lags in the effect of monetary policy, the price the administration is likely to have to pay for its criticism of the Fed is an otherwise unnecessary rise in unemployment. ◆

credit, but investors don't necessarily have such high regard for them as they do with other euro securities.

So there's no single asset that rivals Treasuries even in a big economy like the eurozone, which is sophisticated, has rule of law, and issues a currency with most of the other features that the dollar has.

TIE: **Turning to the Chinese renminbi, U.S. Treasury Secretary Scott Bessent said in a recent TV interview that the renminbi could never become the dominant global currency because the Chinese government would manipulate it, weakening it for trade purposes, and then flood the world with cheap goods. The world economy would go to hell as a consequence. Do you agree with him?**

Blustein: I'd put it differently, while coming to a similar conclusion. China has the ability to manipulate its exchange rate in ways that other countries don't because it maintains capital controls—that is, it doesn't allow money to flow freely in and out of the country. Those controls make international investors very skittish about putting lots of money in renminbi because of the fear that the government would clamp down in a crisis and block them from taking their money out.

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Another factor that makes investors wary is the power that the Chinese Communist Party exerts over the nation's courts, which casts doubt on whether you'd get a fair shake in a legal dispute. That's how I prefer to explain why the renminbi's chances of dethroning the dollar are close to zero.

TIE: **Let's look back historically at how the Treasury market became so liquid. What led to the dollar's dominance?**

Blustein: I tell this story in some detail in the book, and as I'm sure many readers know, the dollar was the central currency of the post-war international monetary system under the Bretton Woods agreement, with all other currencies pegged to the dollar and the dollar pegged to gold.

After Bretton Woods collapsed in the early 1970s, the market for Treasury securities was exploding for a variety of reasons. For one, the United States was starting to run big budget deficits in the 1960s because of Lyndon Johnson's guns-and-butter policy of financing the Vietnam War and the Great Society at the same time without being willing to raise taxes to pay for all of it. So the U.S. Treasury was issuing a lot of securities. Along with big deficits, inflation was starting to erupt and interest rates were fluctuating. That contributed to the pressures that led to the end of Bretton Woods, but it also meant that the market for Treasuries became very active and lucrative for a lot of traders.

The United States does benefit tremendously in its foreign policy because the dollar can be weaponized and used as a sanctions tool.

Around the same time came the development of the eurodollar and petrodollar markets—that is, the offshore use of dollars by banks and other financial institutions. And when they're holding dollars for periods of time—maybe as short as a day, maybe a week, maybe a month—they want to be in Treasuries because it is safe, and they can at least get some yield on it. They're not just holding idle cash. Every big asset manager wants to make sure that they're optimizing the return that they're getting on their holdings without sacrificing safety and liquidity.

Also at that time, computerized trading was becoming much more of a thing. And for all these reasons, people in the markets developed a big, deep network for exchanging these incredibly important securities.

TIE: **What are some of the key advantages for Americans in a world where we have King Dollar?**

Blustein: The advantages are much more geopolitical than economic, in my opinion. This isn't a consensus view, but a lot of economists believe the economic benefits of dollar dominance are not that great anymore. They were in the 1960s, when French Finance Minister Valéry Giscard d'Estaing coined the phrase "exorbitant privilege." At the time, the United States was indeed gaining enormously from having a currency that everyone had to hold. The U.S. government and American companies could borrow at cheaper rates and the United States could run budget and trade deficits more freely than other countries could under the Bretton Woods system.

But there also are drawbacks, because if so many people hold dollar securities, the foreign exchange rate of the dollar will be higher than it would be otherwise. That detracts from the competitiveness of American exporters and manufacturers in import-sensitive industries—not that it's a decisive factor, but it surely has some modest effect. It's very hard to measure these things precisely, but I would argue that the economic benefits probably outweigh the economic disadvantages. I don't think it's huge in either direction.

But the United States does benefit tremendously in its foreign policy because the dollar can be weaponized and used as a sanctions tool. That is a major advantage. I don't know how much Americans appreciate the degree to which the government is able to use sanctions instead of military force. It means our men and woman in uniform don't have to go overseas and shed blood as much as they might if we used hard power instead of our economic power.

The Fed has come to play this remarkable role, akin to being central bank for the entire world.

***TIE:* Returning to the issue of catastrophic policy errors, tell us under what scenario you could see the dollar's special privilege being lost or diminished.**

Blustein: Even before the second Trump term began, it was easy for me to conjure up a few such scenarios in my book. One—which is looking ominously like it might come true—is that U.S.-China tensions boil over to the point that the world splits into separate, economically isolated blocs, one dominated by the dollar and the other by the renminbi.

Another possibility is that the president could put much more pressure on the U.S. Federal Reserve than he did in his first term, undermining the independence of our central bank, which is a very important pillar of people's confidence in the dollar. If the Fed bows to White House demands for lower interest rates and the result is high inflation, faith in the dollar would obviously be sorely tested.

Let's maintain perspective, though, about these disaster scenarios. Loss of dollar dominance would almost certainly be less awful than the other consequences.

***TIE:* The Fed has a vital role in dollar swaps—that is, swaps with other central banks, rather than the kind of private sector swaps you were referring to earlier. Tell us about that.**

Blustein: It's very important—it shows how the Fed has come to play this remarkable role, akin to being central bank for the entire world.

Here's what happened: During the 2007–2009 global financial crisis and, more recently, the covid crisis beginning in March 2020, there was huge demand for dollar assets because the dollar was the safest place to be. People were desperate to have liquid, safe assets that they could convert into cash easily. As I said before, that's crucially important in a crisis. Also, lots of companies and financial institutions had borrowed heavily in dollars, so they needed dollars to pay obligations coming due.

And there was so much demand for dollars abroad that the Fed had to provide the world with dollars by swapping dollars with other central banks. The European Central Bank, the Swiss National Bank, the Bank of England, the Bank of Japan all needed dollars to lend to big financial institutions in their areas that were desperate to get dollars. So, the Fed was willing to swap dollars for their currencies.

Now, there's a lot of speculation that maybe Trump will insist on some *quid pro quo* that is so unreasonable that it would impede the functioning of swaps. There was a worry about that during the covid crisis, during Trump's first term. As it turned out, Trump did not try to interfere. He probably wasn't paying enough attention to what the Fed was doing. He was probably just happy that the financial crisis was resolved satisfactorily.

But Trump's obviously been much more willing to behave in what are euphemistically called "transactional ways" in his second term than he was in his first term. I think we ought to be worried that confidence in the dollar may be undermined if foreign holders of money become concerned that in a crisis, the Fed won't be there to backstop everybody. That could be a catastrophic misstep.

***TIE:* Is there a scenario in which the supply of Treasuries grows so rapidly because of a burgeoning U.S. debt that there is insufficient demand?**

Blustein: There has to be some limit but I don't think we're close to it at the moment. The latest projections show deficits on the order of 6.5 percent of GDP over the next decade or so, and that's an underestimate because that assumes that the Trump tax cuts won't be extended. It's probably more like deficits under current policies might be closer to 8 percent, 9 percent, or who knows what percent of GDP. They'll be big. That means the Treasury has to borrow even huger volumes. And there has to be some point at which foreigners' willingness to extend credit to the U.S. government reaches its endpoint.

But I think the bigger thing to worry about is that markets will insist on very high interest rates for Treasuries. And when the government has to borrow at high interest rates, that means everyone else has to borrow at high interest rates, and there won't be so much productive investment, and U.S. growth and prosperity will suffer. That to me is a bigger reason to worry about massive deficits than the possibility that foreigners will say "We simply aren't gonna buy Treasuries anymore." At high rates I think they will. But if they're demanding extremely high returns on every investment, then that's going to be painful for the United States.

***TIE:* If the dollar were to stumble and collapse, what do you think would most likely replace it?**

Blustein: The one currency that's looking a little more like a possibility these days is the euro because some of those impediments that I mentioned earlier—the fragmentation of the eurozone market—may be in the process of becoming fixed because Trump signaled that he's not just an unreliable ally, but possibly an economic adversary of Europe. The Europeans are scrambling around looking for ways to spend money and to knit their economies together more tightly. The Germans have relaxed the "debt brake" that they used to limit the amount of deficits that they could run. That'll mean more bunds will be issued. So the euro is looking, at least in early April as we're speaking, a bit more credible, but I still think it's got a long way to go before it's going to rival the dollar.

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The advantages to King Dollar are much more geopolitical than economic.

***TIE:* What do you see as the role of cryptocurrency? Does it weaken or strengthen the dominance of the dollar?**

Blustein: Let's distinguish between two types of crypto. There's the kind that fluctuates up and down by the day, by the hour, by the minute, by the second, like Bitcoin does. And then there's stablecoins, which are tied mostly to the dollar or other fiat currencies or other valuable assets.

Regarding the first type of crypto, I think it's ludicrous to think that an asset like that, which has absolutely no state or institutional backing, will challenge the dollar. The great advantages that creators of crypto touted—that it's decentralized. There's no state involvement, there are no banks—all these things make crypto useless as a means of exchange. I don't see how they possibly develop network effects. They can be used in small markets where their fans congregate. There's that bitcoin city in El Salvador, Bitcoin Beach, I guess it's called. And yes, I know you can go into a bar there and order a nice frosty mug of beer with Bitcoin. Big deal.

Stablecoins are a more interesting question. I must say that at one point in the course of my work on my book, I thought that stablecoins really were a good solution to the question of how we keep dollar dominance while advancing in payments technology.

China issued a central bank digital currency in 2020 and then moved ahead with pilots on it. There was a lot of alarm that the United States had better match it or else we'd be carrying around "e-yuan" in our phones and beaming our personal data back to the Chinese Communist Party. I thought that was ridiculous. But I did think there was a good argument that the United States ought to try to be closer to the technological cutting edge in payments. We have the leading currency, and stablecoins offer, like other cryptocurrencies, rather interesting, innovative features such as smart contracts, where a transaction will only go through if certain conditions are met, with the conditions programmed into the software.

But the more I've looked at stablecoins, the more concerned I've become. I've come around to the view of the critics that they would have a lot of undesirable consequences if they're not well regulated. And at the moment, it seems like Congress is kind of rushing to produce a bill which may not properly address a lot of these concerns, particularly illicit finance, sanctions evasion, and money laundering—all the things that bad guys use stablecoins for.

The Trump administration has been making pretty clear that they see stablecoins as a great way of spreading the dollar all around the world, that people will want stablecoins backed by the U.S. dollar and because it's whizzy and innovative and cool and easy to transact.

First of all, I don't think stablecoins are necessary to promote the dollar. For the reasons I said before, I think the dollar's status will be safe as long as we don't make catastrophic policy missteps. Stablecoins aren't going to make much difference.

I think the regulation needs to be extremely strict and I don't think that having dollar stablecoins flying around the world is a good idea. People in other countries will use stablecoins instead of their own national currencies because, in some cases, their central banks are doing poor jobs of running monetary policy successfully. But they'd be much better off if the central banks just do better at monetary policy, rather than dollarizing their economies. I doubt that it's in America's interest to mess up the ability of foreign central banks to get their monetary policies under control.

If the Fed bows to White House demands for lower interest rates and the result is high inflation, faith in the dollar would obviously be sorely tested.

TIE: **Global currency markets talk about the "dollar smile," which refers to the fact that the dollar is strong when the United States is doing well but also strong when the rest of the world is doing poorly because everyone runs to get dollars, as you mentioned. What do you think will be the state of this dollar smile by the time of next year's midterm congressional elections?**

Blustein: That's hard to predict. I can certainly envision that two years from now, there could be a crisis thanks to the confrontation between the United States and China getting out of control, and that neither end of the dollar smile will necessarily be fully applicable. In other words, it won't be that the United States is doing well, and it won't be that foreigners are doing worse. That could mean that the dollar smile would be a really big frown.

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TIE: **As you know, economic forecasting is a very hazardous profession: economists predicted nine of the last five recessions. With that caveat, if we were sitting here in 2050, would you still say with confidence that the dollar is still king?**

Blustein: Not with overwhelming confidence, but I think it will be very hard to dislodge it, again barring really catastrophic missteps.

One big worry is that the rule of law is being eroded on an almost daily basis. Fresh horror stories come out all the time about people being kicked out of government jobs that Congress funded, about people being snatched off the street and sent to prison camps in El Salvador without due process. The list goes on. I don't have to enumerate them, but will that mean that big international investors feel that they can't get an impartial shake in the U.S. judicial system? We're not quite there yet, but that's a very important concern.

Will the U.S. economy be ruined by protectionism and irresponsible fiscal policy and erosion of Fed independence, and, my God, by the complete wreckage of the whole scientific and technological government apparatus that we've seen in just the short time since Trump came to office? Will that end America's economic supremacy? Will people lose faith in dollar assets to some extent? Yes.

But what can replace the dollar in international commerce? Not the renminbi, unless China is able to overcome the problems that cause investors to regard Chinese markets as unsafe, where there's dubious rule of law and