Businessweek
Remarks

The Debt-Ceiling Standoffs Threaten American Prestige

Recurring struggles over the borrowing limit undermine the status of the US as an economic superpower.

Photo Illustration: Daniel Zender for Bloomberg Businessweek; Photo: Getty Images

By Saleha Mohsin and Enda Curran
May 18, 2023 at 4:00 AM EDT

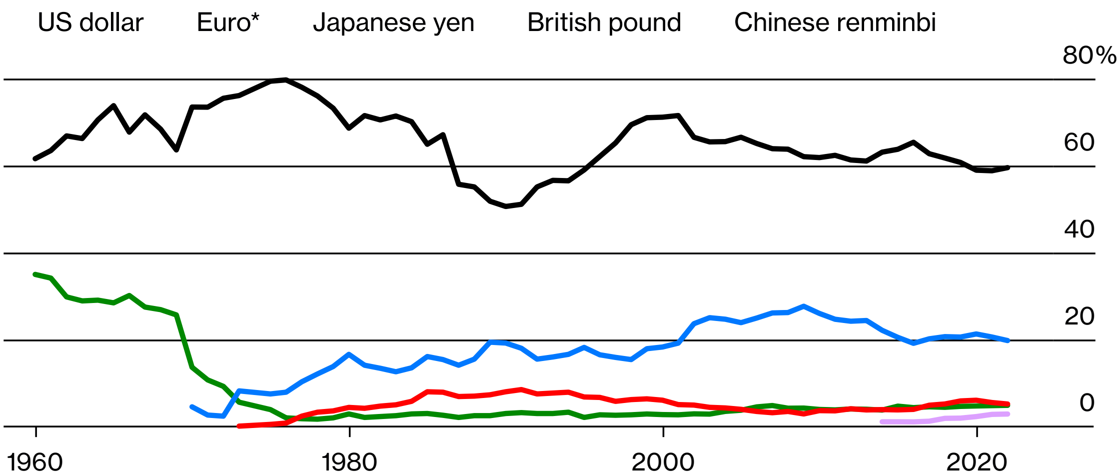
America's sway over the world economy is being eroded by self-inflicted policy wounds, with a dangerous standoff over the debt ceiling putting renewed scrutiny on the dollar's preeminent status in global trade and finance.

A behind-the-curve Federal Reserve struggling to corral inflation, a string of bank failures and now a political deadlock over the government's ability to borrow are chipping away at US authority. At the same time, geopolitical fault lines are hardening, with the US assisting Ukraine in its war against Russia and locked in competition with China, two adversaries poised to exploit any misstep by policymakers in Washington—such as a first-ever US debt default.

Warnings about the decline of American prestige are everywhere. "Anything that moves us away from being viewed as the world's reserve currency, of being the safest, most liquid asset in the world, is bad for the American people, bad for the dollar and bad for the US government," Beth Hammack, co-head of the global financing group at Goldman Sachs Group Inc., told Bloomberg Television on May 9.

The dollar is the most widely used currency in trade and financial transactions. It also accounts for just under 60% of central banks' official currency reserves, though that's a quarter-century low—a sign that its dominance is slipping.

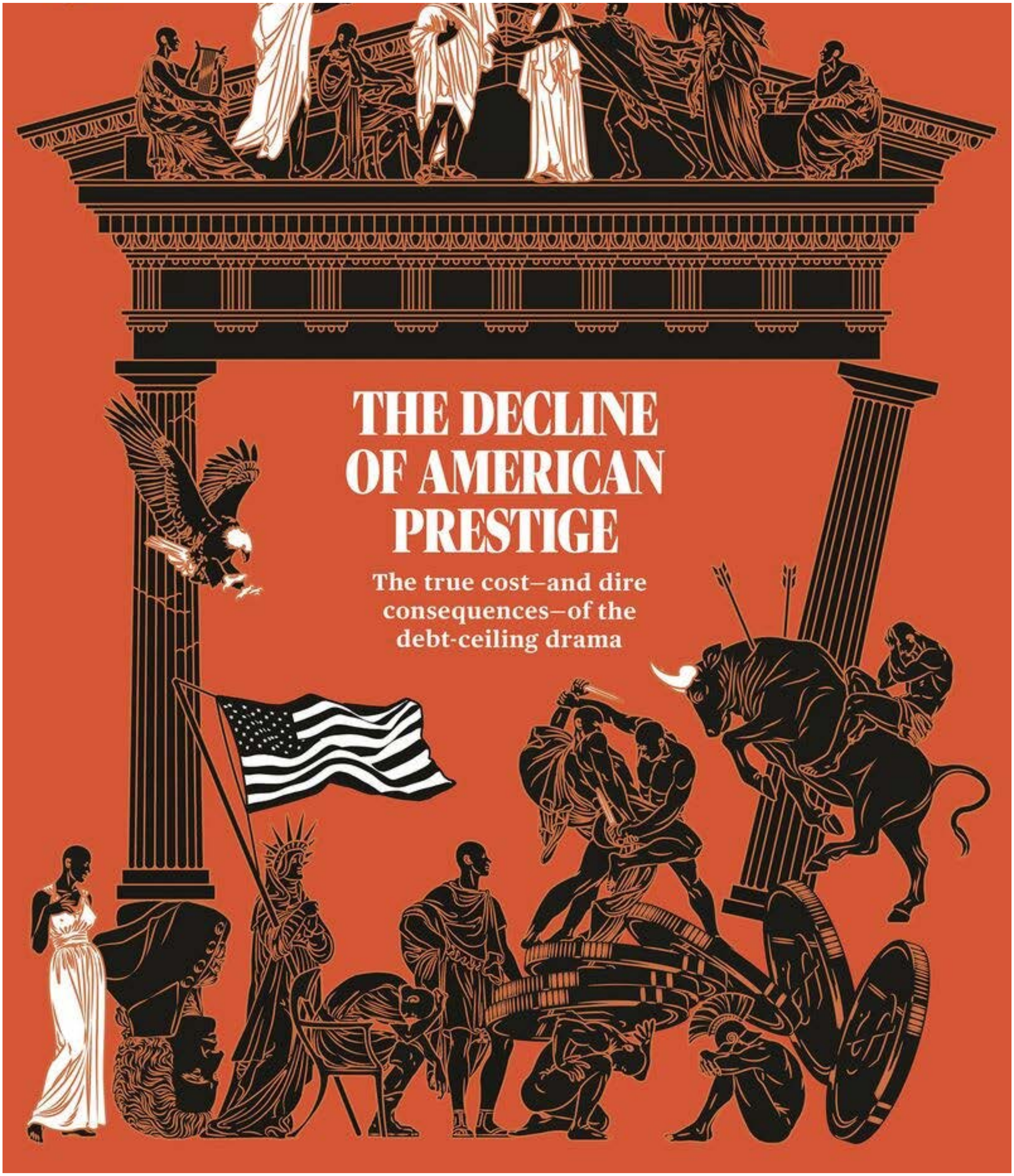
Share of Foreign Exchange Reserves in Global Central Banks



Source: Compiled by the Congressional Budget Office
*Euro data before 1999 show the sum of the French franc and German mark

In these uncertain times, hardly a day passes without some country announcing an incremental move to promote the use of its own currency. China, India and Russia, among other nations, have rekindled a long-running conversation around de-dollarization as a way to assert their own hegemony—but also as insurance against US sanctions such as the ones used to punish President Vladimir Putin for invading Ukraine and to isolate Iran after it restarted its nuclear weapons program.

It's not just a matter of geopolitics. As Eswar Prasad, author of *The Future of Money*, tells it, the pillars that support the greenback are starting to show cracks. "It is becoming harder to view the US as a well-functioning, dynamic economy with a deep and sound financial system, backed up by a robust policymaking process with checks and balances," says the Cornell University professor.



Featured in *Bloomberg Businessweek*, May 22, 2023. Subscribe now. *Illustration: Berke Yazicioglu for Bloomberg Businessweek*

Investors may not pay much heed when Brazil's president, Luiz Inácio Lula da Silva, calls for an end to the greenback's reign, as he did during a state visit to China in April. More alarming is the political jousting in Washington over the debt limit, a spectacle that to the dismay of many has become routine over the past quarter century, repeatedly bringing the nation to the brink of a manufactured crisis.

Jamie Dimon, who as chief executive officer of JPMorgan Chase & Co. presides over the world's most valuable bank, has set up a war room to prepare for what would be a "catastrophic" default—an event that according to Treasury Secretary Janet Yellen could come as early as June 1. It's a good bet that competitors as near as Wall Street and as far as Shanghai are carrying on their own D-Day simulations.

After three face-to-face meetings, US President Joe Biden and House Speaker Kevin McCarthy have expressed optimism that it's possible to raise the limit by Yellen's deadline.

McCarthy (left) and Biden in the Oval Office for a debt limit meeting on May 9. *Photographer: Evan Vucci/AP Photo*

As many economists, including Sarah House of Wells Fargo, have argued, "you don't even need to actually default on the debt for there to be real damage in the economy." At Bloomberg Economics, a team led by Chief US Economist Anna Wong modeled a scenario where a protracted standoff leads to elevated market stress, and Treasury is forced to cut social spending to prioritize funds to repay the debt. They estimate, conservatively, that gross domestic product could contract at an annualized rate of 8% in the second half as a result.

Through wars, recessions and the pandemic, Americans have benefited from the US Treasury bond being the closest thing there is to a risk-free asset, allowing the federal government to fund itself often at lower costs than its peers. Demand for those securities supports a $24 trillion market that is the world's deepest and most liquid. US Treasury bonds also anchor a world-spanning network of financial transactions.

Even if a last-minute deal averts a default, America's reputation as a country that honors its debts could take a hit, with the effects lingering for months or even years. Consider that at a recent auction of four-week T-bills—the shortest-maturity Treasury benchmark—buyers demanded a record yield of 5.84%, the highest for any Treasury bill since 2000.

A less pronounced rise in borrowing costs would still increase the burden of servicing existing debt and force the White House and a polarized Congress to make tough decisions about where to cut spending. There'd be less money to invest in infrastructure, in cleaner energy and the massive subsidies the government has rolled out to boost high-tech manufacturing to compete with China.

The potential of Congress failing to act in time isn't the only act of self-sabotage that's stoking doubts on whether the US should remain at the center of the global financial system. The Fed's failure to address the obvious risks that rising interest rates present to the balance sheets of regional banks, laid out in its own postmortem on the failures of Silicon Valley Bank and Signature Bank, raises questions about its oversight capabilities. While financial crises are a staple of history, repeated "supervisory and regulatory failings will undermine the world's trust in the Fed and diminish the dollar's longer-term attractiveness," says Mark Sobel, who previously oversaw US currency policy at Treasury.

That trust flows in part from the high standard of ethics in America's independent institutions, where insulation from political meddling and adherence to a strict code of ethics is prized. Recent revelations of active stock trading by Fed officials on the central bank's rate-setting committee—which led to two resignations—and of Supreme Court Justice Clarence Thomas accepting gifts and travel without disclosing them are another black eye for the US.

The US isn't the only advanced economy making trouble for itself. The UK's exit from the European Union is blamed by some for denting the nation's appeal as a place for foreign investors to do business. The country has struggled to regain political stability since the 2016 referendum.

The high-stakes battle over the borrowing limit could also have implications for US security. Director of National Intelligence Avril Haines warned on May 4 that a default would have geopolitical implications, with "almost a certainty" that Russia and China would seek to exploit the moment to push propaganda through "information operations." She added that a default would create "global uncertainty" about the value of the dollar, US leadership and American institutions.

Yellen during a Bloomberg Television interview on the sidelines of the G-7 finance ministers' meeting in Niigata, Japan, on May 12. *Photographer: Kiyoshi Ota/Bloomberg*

Marcus Noland, executive vice president of the Peterson Institute for International Economics, writes that China would jump at the chance to cast itself as a "benign, reliable leader" in contrast to an "unreliable hegemon" in order to expand its influence. "For a Congress that is obsessed with America's standing vis-a-vis China, the notion that it would commit an own goal and hand China such an opportunity seems incomprehensible," he concludes.

Biden is already showing how the debt limit drama is forcing the US to recede from the world stage: The president has scrapped planned stops in Australia and Papua New Guinea following this week's trip to Japan for the Group of Seven meeting to rush back to Washington to negotiate with Republicans. The change in schedule means Biden will miss a key opportunity to meet with Pacific island leaders in Port Moresby, a decision that threatens to undermine efforts by the administration to strengthen ties in the Pacific in a bid to counter Chinese influence.

It's not just US rivals who bristle at Washington's apparent disregard for the collateral damage US policies inflict. Friends even more than foes have borne the brunt of the Fed's interest-rate hikes, which by driving up the value of the dollar against their own currencies have forced their central banks to respond in kind.

During a seminar at the spring meetings of the International Monetary Fund in April, Felipe Medalla, governor of the Philippines central bank, noted that in the aftermath of World War II the US leveraged its influence and economic might to design the global financial system in its image, and countries like his pay the price. "We wish that Keynes had won the debate in Bretton Woods instead of Mr. White, that the global system was a basket of all the important currencies," said Medalla, referring to the faceoff between British economist John Maynard Keynes and his US counterpart, Harry Dexter White, which set the foundations for the postwar monetary order. "But if I was an American, I would like what happened."

The dollar's enduring preeminence is not guaranteed, however. As Daniel Fried, an economist at the Congressional Budget Office, noted in a working paper published in April, a war or financial crisis can be enough to dethrone one world-dominant currency in favor of another once the second's economy has overtaken the other in size. This was how the Dutch florin eventually gave way to the British pound, which rose to dominance in the 19th century, while the latter yielded to the dollar in the years after World War II.

A March 2022 report by economists at Goldman Sachs enumerated several parallels between the pound in the early 20th century and the dollar at present, including a small share of global trade volumes relative to the currency's dominance in international payments; a deteriorating net foreign assets position, largely the consequence of a growing debt pile; and potentially adverse geopolitics. "The bottom line is that whether the dollar retains its dominant reserve currency status depends, first and foremost, on US's own policies," they wrote.

US Treasury Cash Balance

Source: US Treasury

One could debate forever whether America is a diminished superpower. But it still boasts an economy that was around $7 trillion larger than China's at the end of 2022. Moreover, as Yellen and many others have noted, there is no obvious substitute for the dollar. (Underscoring the lack of alternatives, a survey of Bloomberg News readers showed that US Treasuries were the second most popular asset to buy–after gold–in the event of default.)

As recently as the early 1990s, some believed the Japanese yen was on course to supplant the greenback, while some saw the euro as a potential usurper. Both bets proved wrong. Barriers to the yuan replacing the greenback are numerous, starting with Beijing's reliance on capital controls to guard against sudden exchange rate movements.

“The dominance of the dollar seems unassailable despite fluctuations in its value or the quality of US government,” according to Catherine Schenk, a professor of economic and social history at the University of Oxford.

So, in short, the debt-ceiling drama may not be the precipitating event that robs the dollar of its mantle. But that’s no reason for complacency. “Dollar primacy is a national treasure,” former Biden administration economic adviser Daleep Singh said on Bloomberg Television on May 8. “It allows us to fund our government at 20 to 50 basis points cheaper than it would otherwise. It allows us to absorb a shock like the 2011 downgrade of our credit rating. All of that is put at risk in terms of the long-term scarring effects of this type of debate.”

Read next: One Neat Trick to Raise the Debt Limit