Is Taxation the Source of the US Dollar's Strength?

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By Peter C. Earle
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Commentary

Last summer I gave a talk on dedollarization, and as customarily occurs a question and answer session followed. Most of the queries and comments focused on the outlook for the dollar, prospects for gold and Bitcoin, and the comparative advantages of the growing BRICS union versus those of Western (U.S. dollar, British pound, Euro, etc.) nations.

One audience member expressed deep doubt over most of the assertions regarding growing diversification away from dollar dependence. Skepticism is generally scholarly and typically a source of improved inquiry, but the foundation of this gentleman's reservations were truly unorthodox. In a friendly exchange, he asserted that the strength of the U.S. dollar comes first, foremost, and mostly from the taxing power. Washington DC's ability to extract copiously from America's $29 trillion economy, he held, is why greenbacks are sought and exchanged globally.

The belief that the U.S. dollar's strength stems primarily from the government's taxation power overlooks several critical factors. While taxation contributes to fiscal stability, the dollar's demand and resilience are driven by a complex interplay of trade practices, and financial markets, and confidence. (Where dollar 'strength' or 'demand' are referenced, it is in *relative* terms: the strength of the U.S. dollar in comparison to other, competing currencies as illustrated by the DXY index.)

The primary reason for the dollar's historically coveted status is its central position as the global reserve currency. Countries around the world hold vast quantities of dollars due to its widespread acceptance and unparalleled liquidity. As a major importer and exporter, the United States creates a substantial need for dollars worldwide—which is why waning demand for dollars in settling oil transactions are a cause for some concern. These trade practices mean that the dollar's value is buoyed by international economic relationships rather than domestic taxing capacity.

The fundamental demand for our currency originates far outside the tax system, anchored by ubiquity in global trade and settlement practices.

A closely-related component of dollar robustness is global appetite for U.S. financial assets. The size, depth, and diversity of those markets, but particularly U.S. Treasury securities and U.S. equities, make them a singular destination for investors seeking safety and returns. Financial institutions around the world purchase those and other U.S. assets using dollars, which underscores the appeal of U.S. investments, from U.S. Treasury bills to the S&P 500, in bolstering the dollar far beyond the activities of the Internal Revenue Service.

DXY Index: Economic Growth and Tax Relief Reconciliation Act (June 7, 2001) & Jobs and Growth Tax Relief Reconciliation Act (May 28, 2003). Source: Bloomberg Finance, LP

Investor and public confidence in the U.S. economy and its political stability fundamentally support the dollar's value. The trust that the dollar will retain its worth over time encourages its acceptance and widespread use. This confidence can persist independently of the government's taxing power. Even with fluctuations in tax policy, as long as the global community believes in the U.S. economic system, the dollar maintains its strength.

Lastly, the existence of foreign debt and liabilities denominated in dollars creates an inherent international demand for the currency. Countries and institutions need dollars to service their debts, ensuring sustained demand regardless of U.S. tax policies. This debt-driven requirement emphasizes that the dollar's strength is intertwined with global financial systems beyond the reach of domestic taxation.

In conclusion, while the U.S. government's taxing power contributes to fiscal health, the dollar's strength is a multifaceted phenomenon. It is shaped by its reserve currency status, the attractiveness of U.S. financial markets, global trade practices, prudent monetary policy, and overarching international confidence in the U.S. economy. Simplifying its strength to taxing power alone overlooks the complex interplay of global factors that uphold the dollar's dominant position.

DXY Index: The Tax Cuts and Jobs Act (Dec. 22, 2017). Source: Bloomberg Finance, LP

If none of that is convincing, consider two thought experiments.

First, if state revenue collection translated to currency strength, any country could bolster its medium of exchange by simply increasing taxes. Two counterexamples illustrate the point.

Argentina has, for a long period of time, had extremely high taxes while the Argentinian peso has wasted away to nothing. On the other hand, Switzerland has among the lowest tax rates in the world with the Swiss Franc perhaps the second most popular safe haven on earth. The discrepancies illustrated here, in addition to numerous others, indicate that economic stability, investor confidence, and widespread demand are far more essential for a strong currency than internal revenue policies.

Second, if the United States were to implement significant tax cuts, under the taxing power theory the dollar should weaken substantially. In fact, the dollar rose so substantially following Reagan's 1981 tax cuts that a concerted international effort—the Plaza Accord—was joined with the Reagan Treasury Department's blessing to drive the dollar back down. (The dollar traded sideways after a later tax easing.) The two Bush administration tax cuts saw the dollar decline substantially, but the terror attacks of September 11, 2001, and the consequent Global War on Terror were far more relevant factors. The Trump tax cuts in late 2017 were also not accompanied by a weakening dollar.

The notion that the U.S. dollar's crucial standing stems, even partially, from fiscal extraction is untenable. While such views are coherent and understandable from the perspective of individuals paying an ever-increasing share of their earnings to the government, they misapprehend the fundamentals of currency competition. Understanding these dynamics is crucial for appreciating why the dollar remains strong, what threatens that standing, and how complex global interactions, rather than a single domestic factor, factor into global currency markets.

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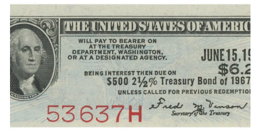

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