

The Future of Reserve Currencies

Benjamin J. Cohen

For nearly a century, the U.S. dollar has reigned supreme, but are those days over?

THE global economic crisis has again raised the question of the future of reserve currencies. For nearly a century, the U.S. dollar has reigned supreme as the world's top international money. In recent decades, however, confidence in the greenback has been undermined by the United States' persistent current account deficits and growing foreign debt. Increasingly, observers have predicted an end to the dollar's dominance. For many, the dollar's fate seemed sealed following the collapse of the U.S. housing market in mid-2007, which triggered the greatest upheaval in U.S. financial markets since the Great Depression.

As it turned out, the crisis proved to be anything but fatal for the dollar. Not even the troubles of the U.S. financial sector, which required massive government interventions, sufficed to tip preferences decisively. Instead, ironically, the crisis temporarily reinforced the greenback's global standing, as investors fled to the dollar for safety. Late last year, global demand for U.S. treasury bills was so intense that yields fell to zero or below. Nonetheless, the dollar's future continues to be hotly debated (Helleiner and Kirshner, 2009). Over the longer term, it is widely held, the decline of the greenback will undoubtedly resume, ending the currency's reign once and for all.

But that begs a critical question: What would replace the dollar? Some say it will be the euro; others, perhaps the Japanese yen or China's renminbi. And some call for a new world reserve currency, possibly based on the IMF's Special Drawing Right or SDR, a reserve asset. None of these candidates, however, is without flaws. In fact there is no obvious alternative to the dollar lurking in the wings, just waiting to take center stage. To paraphrase Winston Churchill's famous remark about democracy, the dollar may turn out to be the worst choice—except for all the others.

The most probable outcome is apt to be more ambiguous—more like the interregnum between the two World Wars, when

Britain's pound sterling was in decline and the dollar on the rise but neither was dominant. Coming years, I submit, will see the emergence of something similar, with several monies in contention and none as clearly in the lead as in the recent past. The economic and political impacts of a more fragmented currency system could be considerable.

When economics and politics intersect

In the absence of a world currency backed by an effective global government, foreign trade and investment must rely on acceptable national currencies to play international roles. A disconnect therefore exists between the jurisdictions that are the source of international monies and the domains of the markets in which they operate, which introduces a political dimension that is often overlooked in purely economic analyses.

The conventional framework for the study of international currencies separates out the three standard functions of money—medium of exchange, unit of account, and store of value—at two levels of analysis: the private market and government policy. In markets, an international currency plays a role in foreign exchange trading, trade invoicing, and financial investments. For governments, the functions of international money are as an exchange rate anchor and as a reserve currency. At the market level, economic considerations typically dominate in determining preferences. At the government level, the additional ingredient of politics is unavoidable.

Politics enters because an international currency offers unique advantages for the nation that issues it—political as well as economic. Economists naturally tend to focus on the economic benefits involved, such as international seigniorage—the gain of real resources that results when a country's currency is acquired and held abroad. Economic benefits also include the increased flexibility of macroeconomic policy that is afforded by the ability to finance deficits in one's own currency—what



Charles de Gaulle had in mind back in the 1960s when he complained about America's "exorbitant privilege." But there are political benefits as well. The government of a country with an international currency is given more room to pursue diplomatic or military initiatives outside its borders, a manifestation of what political scientists call "hard" power. The issuing country gains geopolitical influence. Nor can we discount the enhanced prestige and status that is associated with international money—"soft" power, according to political scientists. As Nobel laureate Robert Mundell (1993) once wrote, "Great powers have great currencies."

There may also be disadvantages for the issuer, of course, especially once a substantial overhang of its currency accumulates in foreign hands. Interest rates might have to be raised to sustain the money's value in exchange markets. Ultimately, policy autonomy may be seriously compromised by the need to avert a flight to other assets. As Britain's long ordeal after World War II testifies, the defense of a great currency—once in decline—can be very costly indeed. Both at home and abroad, significant sacrifices and concessions may be required.

All these matters are at issue when governments choose what money to use as a reserve currency. The preferences of market actors, based essentially on economic calculus, also play a role; no government will opt for a currency that is not already widely used by the private sector. Central bankers are clearly sensitive to issues of liquidity, exchange convenience, and comparative rates of return. But when choices are made from the small pool of alternatives favored at the market level, political factors are sure to intervene, too. Key considerations include both the quality of governance in a currency's home economy and the nature of relationships between states. Is the issuer of a currency capable of ensuring political stability at home? Can it

project power abroad? Does it enjoy strong intergovernmental ties—perhaps a traditional patron-client linkage or a formal military alliance? The future of reserve currencies is a matter of *political economy*, not economics alone.

Runner-up

Consider the euro, for instance, widely considered to be the most natural rival to the dollar. The euro began life a decade ago with many of the attributes essential to international acceptance, including a large economic base, political stability, and an enviably low rate of inflation, all backed by a joint monetary authority, the European Central Bank, which is fully committed to preserving confidence in the money's future value. Europe is the equal of the United States in output and trade. Why, many ask, should it not be America's equal in currency matters, too?

But the question overlooks the fact that, for all its strengths, the euro is also handicapped by several critical shortcomings. Among these is a strong antigrowth bias built into the euro area's provisions for monetary and fiscal policy, compounding other factors that tend to weaken Europe's output potential (for instance, aging populations, rigid labor markets, and strict government regulations). A sluggish European economy can hardly be expected to make the euro attractive for trading or investment purposes. And the familiar ambiguities of the euro area's governance structure are bound to give outsiders pause. Everyone knows that the euro is an artificial construct, the complex product of an international treaty, which can be only as good as the multilateral agreement underlying it.

Not surprisingly, therefore, the euro's international reception has been relatively muted. In private market activity,

adjusting for the elimination of intra-euro area transactions, the euro has managed to do little more than hold its own compared with the past shares of its several “legacy” currencies. Given that Germany’s old deutsche mark had already attained a number-two ranking on the global stage, anything less for the euro would have been a real shock. After a fast start, market use of the euro has broadly stabilized for the past half-decade. Moreover, growth of usage has been uneven across sectors—greatest in issuance of debt securities but scarcely noticeable in such areas as foreign exchange trading. Activity has also been concentrated in economies with close geographical and/or institutional links to the euro area—what might be considered the euro’s natural hinterland in Europe, the Mediterranean, and parts of Africa.

Yet many continue to predict a bright future for the euro at the government level, as a reserve currency. Although Europe’s money today accounts for no more than a quarter of global reserves, compared with a nearly two-thirds share for the dollar, the euro could nonetheless surpass the greenback within as few as 10 years, according to one well-publicized econometric forecast (Chinn and Frankel, 2008). But is that realistic? A statistical study highlighting no more than three causal variables, all economic in nature, can hardly be considered definitive. Where are the diplomatic and military considerations that are bound to play a major role in shaping government choices? To ignore the political side in this context is like trying to mount a performance of Hamlet without the prince.

Japan, for instance, has long relied on a formal security umbrella provided by the United States to protect it against external threats; and the same, less formally, may be said of most of the major Gulf oil exporters as well. Can we really imagine any of these nations, all very large dollar holders, casually jeopardizing their established ties to Washington for the sake of a few basis points of return on their reserves? The euro area, as we know, is composed of a gaggle of sovereign states with interests that only partly coincide in practice. It defies the imagination to believe that Europe could substitute effectively for the political or military influence of the United States in the Middle East or beyond. Scenarios based on parsimonious econometric models surely have their uses, but they are almost certainly incomplete and misleading, if not downright wrong.

Also-rans and other possibilities

Are there any other possibilities? Japan’s yen was once thought to be the dollar’s heir apparent but now looks more like a sad, faded also-ran. During the 1970s and 1980s, when the fast-growing Japanese economy seemed destined for superpower status, international use of the yen accelerated swiftly, particularly in global bond markets. But, at the end of the 1980s, the bursting of Japan’s “bubble economy” abruptly halted the currency’s upward trajectory. Today, after years of domestic stagnation, the yen appears to face a gradual erosion of market standing not unlike sterling’s long decline in an earlier era.

As the yen declines, could China’s yuan rise? The currency of one of the world’s largest economies, the renminbi (“people’s money”) certainly has much going for it. International use, however, remains rudimentary despite recent efforts by Beijing

to broaden the currency’s appeal. Acceptance is discouraged by obstacles far more severe even than anything blocking the euro or yen, including a full panoply of capital controls and a severely underdeveloped financial system. In time, these handicaps may be surmounted—but not anytime soon.

Dark horse

Most recently, debate has turned to the possibility of a new world reserve currency, most likely building on the already existing SDR. Stimulated in particular by comments from Chinese and Russian officials, the idea has been endorsed by a United Nations commission headed by former World Bank chief economist Joseph Stiglitz. Some see a start in the new bonds to be issued by the IMF, which China and Russia aim to use to diversify a portion of their reserves away from the dollar. But here too the obstacles are daunting. Even with the new \$250 billion allocation of SDRs just implemented by the IMF, total SDRs in existence will amount to less than 5 percent of global reserves. Can enough be created to make a significant difference? Can supply be provided more flexibly? And most critically, who would have the authority to manage it? Without an effective government to back it, a world reserve currency of any kind—whether based on the SDR or invented *de novo*—would have difficulty attaining even a minimal level of credibility. The ambiguities of the euro area’s governance structure would seem trivial by comparison.

In fact, nothing better illustrates the politics inherent in the choice of reserve currencies. Large dollar holders like China and Russia are understandably frustrated by the lack of satisfactory alternatives to the greenback and fearful of what might happen to the value of their hoards should there be a run on the U.S. currency. But, more to the point, both also are aspiring powers that make no secret of their resentment of what they call Washington’s global “hegemony.” Each is well aware of the role played by the dollar in underwriting U.S. geopolitical privileges. In their appeals for a substitute for the greenback, therefore, it is hard not to see an implicit campaign to clip the American eagle’s wings. The idea has symbolic value as a threat to U.S. hard and soft power. Whether it has any practical plausibility is of distinctly secondary importance.

Fragmented system

In short, while prospects for the dollar may not be as bright as they once were, the outlook for its main rivals appears little better. Some movement away from the greenback can be expected as the center of gravity in the world economy shifts toward China, India, and other emerging markets, which now account for the largest share of global reserves. Not many of these countries are as close to the United States as America’s traditional allies in Europe and Japan. But the scope of any turn away from the dollar is sure to be limited by the lack of a clearly attractive alternative.

A more fragmented currency system thus seems in the offing, with much competition and no money clearly dominant. The economic and political impacts could be considerable, despite the shock absorbers provided by floating exchange

rates. Movements of currency values cannot always compensate for inconsistencies of policy behavior and may themselves become a source of stress if manipulated by governments or amplified by speculative market behavior. Without some form of leadership to assure a minimal degree of compatibility among national policies, global monetary relations will be at constant risk of instability or worse.

To be sure, a more fragmented system would not necessarily be a bad thing. Indeed, it might even turn out to be an improvement. For many, the greatest threat to monetary stability over the long term is to be found in the United States' mammoth current account deficits. As the supplier of the world's most popular currency, the United States is in the position of a monopolist that has grown complacent abusing its "exorbitant privilege." But once the dollar's supremacy is eroded by emergent challengers, goes the argument, the United States would finally be forced to curb its appetite for foreign savings, lowering the risk of future crises. Much depends, however, on the kind of relationship that develops among the system's leaders. The last time the world was obliged to live with a fragmented currency system, during the interwar period, the outcome was—to say the least—dismal. A lack of cooperation between the British, with their weakened pound, and a self-consciously isolationist United States was a critical cause of the financial calamities that followed the stock market crash of 1929. Can we expect better this time around?

Optimists emphasize how much conditions have changed since the interwar years. In contrast to the years after World

War I, an array of multilateral organizations and forums have developed to institutionalize cooperative practices, from the IMF to the Group of 20. Past experience has provided some pointed lessons about the costs of unbridled competition among states. Governments have a much better sense of where their enlightened self-interest lies. Pessimists, by contrast, stress the enduring imperatives of national sovereignty that persistently compel governments to elevate parochial interests over what might be conceived as the common good, particularly at times of crisis. Despite the lessons of the past, monetary cooperation tends to be episodic at best and, at worst, not worth the paper that joint communiqués are written on. Time will tell whether the optimists or the pessimists have it right. ■

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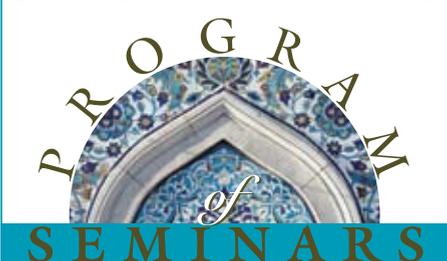
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