Revue de la régulation

Capitalisme, institutions, pouvoirs

Maison des Sciences de l'Homme - Paris Nord

18 | 2e semestre / Autumn 2015 :
Contestations monétaires. Une économie politique de la monnaie

Contestations monétaires. Une économie politique de la monnaie

The Demise of the Dollar?

Plus ça change, plus c'est pareil...

La mort du dollar ? Plus ca change, plus c'est pareil...

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p. 1-19

Résumés

English Français

The aim of this article is to explain why, despite decades of doubts, the US dollar remains the world's top currency, and more importantly, why it is likely to remain on top for years more to come. I argue that the dollar is the indispensable currency: the one money that the world cannot do without. The dollar offers unique advantages that are unmatched by any other currency. The essay begins with a review of the attributes that are most essential to the international status of a currency. Only the dollar embodies the full list of attributes that make a currency internationally competitive. The euro and renminbi, by contrast, are seriously lacking in one or more respects. For the foreseeable future the greenback will remain dominant, as it has done for decades.

L'objet de cet article est d'expliquer pourquoi, en dépit de nombreuses remises en question, le dollar américain reste la monnaie internationale dominante, et risque de conserver ce statut pour de nombreuses années. Je montre que le dollar est l'unique devise indispensable, c'est-à-dire la seule monnaie internationale dont les agents ne peuvent se passer. Aucune autre devise n'est en mesure d'offrir tous ces avantages. L'article débute avec une caractérisation des critères conférant le statut de monnaie internationale à une devise. Il établit ensuite dans quelle mesure aucune autre devise, ni même l'euro ou le renminbi, n'est en mesure pour l'instant de concentrer tous les attributs d'une monnaie internationale concurrente. Dans un futur proche, le dollar restera la monnaie internationale dominante, comme c'est le cas depuis plusieurs décennies.

Entrées d'index

Mots-clés : dollar, monnaie internationale, hégémonie monétaire
Keywords : US dollar, international currency, currency dominance
Codes JEL : E42 - Monetary Systems; Standards; Regimes; Government and the Monetary System, F33 - International Monetary Arrangements and Institutions, N22 - U.S.; Canada: 1913-

Texte intégral

The dollar is finished as international money

Charles Kindleberger (1976)

The reports of my death have been greatly exaggerated

Mark Twain (1835-1910)

1. Introduction

1 The demise of the dollar has been forecast for decades. More than half a century ago, the celebrated economist Robert Triffin was already warning about of "the imminent threat to the once mighty US dollar" (1960: 230). After Washington ended the dollar's gold convertibility in 1971, Charles Kindleberger was convinced that the currency was "finished." And even today advance obituaries continue to appear, anticipating the fall of America's greenback. In the words of Barry Eichengreen (2011: 121), "doubts are pervasive about whether the dollar will retain its international role." Dollar pessimists abound.

2 Until recently, I was one of them. In an essay published in 2009 (Cohen, 2009), I agreed that the greenback's global position was weakening. We were heading, I suggested, toward a "leaderless currency system," with several currencies in contention and none clearly in the lead. Today, however, I am persuaded otherwise. A careful look at the empirical evidence (Cohen and Benney, 2014) shows that America's money prevails as much as ever, pervasive doubts notwithstanding. The greenback remains the only truly global currency, the one major pole in the monetary system. Not even the gale-force winds of the crisis of 2008-2009 seemed able to topple the dollar from its perch at the peak of the currency hierarchy. Observes Canadian political scientist Eric Helleiner (2014: 9-10):

> In the wake of the crisis, the dollar quickly faced new challenges... [Yet] the dollar's status as the world's dominant currency emerged remarkably unscathed. (Helleiner, 2014: 9-10)

3 Forecasts about the greenback's perils, like reports of Mark Twain's death, are still greatly exaggerated. The dominance of the dollar remains undiminished. *Plus*

ça change, plus c'est la même chose.

4 Should we care? In fact, the stakes are enormous. This is not just a simple financial matter of whose money happens to be chosen to invoice trade, denominate lending, or fill central bank reserves. At its most basic, currency dominance is profoundly political, going to the heart of what we mean by the global balance of power. Long ago, France coined the term "exorbitant privilege" to describe the great benefits enjoyed by the United States as a result of the popularity of its greenback. Most of all, the constraint of the balance of payments is relaxed, since Americans can spend abroad simply by using their own domestic currency. The country can run "deficits without tears," as Jacques Rueff used to say. Policy makers in Washington are free to pursue ambitious foreign policy goals – whether diplomatic, economic, or even military – without worrying much about where the money is coming from.

5 What explains the dollar's endurance? The aim of this essay is to explain why, despite decades of doubts, the greenback remains the world's top currency – and more importantly, why it is likely to remain on top for years more to come. Back when she was Bill Clinton's Secretary of State, Madeleine Albright liked to describe the United States as the "indispensable nation." This essay argues, similarly, that there is cause to believe that the dollar is the *indispensable currency*: the one money that the world cannot do without. This is not a matter of chauvinism or misguided American hubris. The hard reality is that the greenback offers unique advantages that are unmatched by any other currency.

6 I will begin with a review of the attributes that are most essential to the international status of a currency – what may be regarded as the prerequisites of currency internationalization. In the absence of a truly global money issued by a supranational central bank, the world economy has no choice but to rely on selected national currencies to play vital international roles. But at any given time just a few currencies are able to gain widespread acceptance outside their country of issue – to become *internationalized*. Currency internationalization is produced by a sort of Darwinian process of natural selection, driven above all by the forces of market competition. Only the fittest survive.

7 With the prerequisites of currency internationalization in mind, I will then evaluate the competitive credentials of the dollar and its principal rivals – Europe's euro and, prospectively, the Chinese yuan, also known as the renminbi (RMB, people's currency). Many observers remain convinced that both the euro and the RMB are destined to challenge the dominance of the dollar (Eichengreen 2011). The world, we are told, is rapidly moving away from unipolarity toward something more like tripolarity. As the World Bank puts it:

> The most likely scenario for the international monetary system is a multicurrency system centered around the U.S. dollar, the euro, and the renminbi. (World Bank, 2011: 125-126)

8 The evidence, however, suggests otherwise. Only the dollar embodies the full list of attributes that make a currency internationally competitive. The euro and RMB, by contrast, are seriously lacking in one or more respects. For the foreseeable future the greenback will remain dominant, as it has done for decades, continuing to defy exaggerated reports of its demise.

1.1 Prerequisites

9 What makes a currency competitive? Over the years, a vast scholarly literature has developed to help understand the process of currency internationalization. By now, as I summarize elsewhere (Cohen 2015), the basic prerequisites required for competitive success are familiar and hardly controversial. Overall, five attributes stand out as particularly salient. These are economic size, financial development, foreign policy ties, military reach, and effective governance. The first two of these are emphasized by economists; the remaining three, by political scientists. The more a country can lay claim to any or all of these five attributes, the greater will be the appeal of its currency.

10 First is the factor of *economic size* – the magnitude of an issuer's gross domestic product (GDP) and importance in world trade. An economy that is big and well integrated into world markets creates a naturally ample constituency for a currency, which in turn generates a potential for what monetary theorists describe as "network externalities" or, simply, the network value of a money. Network externalities may be understood as a form of interdependence in which the practices of any one actor depend strategically on the practices adopted by others. The broader the transactional network offered by a currency, the more likely it is to be adopted elsewhere, since nothing enhances a currency's acceptability more than the prospect of acceptability by others. As economist Jeffrey Frankel (1995: 13) has suggested, "the currency of a country that bulks large in the world economy has a natural advantage." No money has ever risen to a position of international pre-eminence that was not initially backed by a leading economy. The greater the issuer's weight in global commerce, the stronger will be the "gravitational pull" of its currency.

11 Second is the factor of *financial development* – the sophistication and openness of the issuer's banking and capital markets. To appeal to outside investors or central banks, a currency must offer the qualities of *exchange convenience* and *capital certainty* – a high degree of transactional liquidity and reasonable predictability of asset value. The key to both is a set of well-developed financial markets, sufficiently open to ensure access by outsiders. Markets must not be encumbered by high transactions costs or formal or informal barriers to entry. They must also offer considerable depth, breadth, and resiliency – the three most fundamental characteristics of an efficient financial sector. Depth means the ability to sustain relatively large market orders without impacting significantly on an individual asset's price. Breadth means trading volumes and enough market competition to ensure that the spread between ask (sell) and bid (buy) prices is small. And resilience means the ability of market prices to recover quickly from unusually large sell or buy orders. Secondary markets must be fully operational for most if not all financial claims.

12 Third are *foreign policy ties*, which are particularly likely to influence the currency preferences of governments. In an uncertain world, geopolitical leadership also exercises a form of gravitational pull, encouraging use of the leader's currency as an exchange-rate peg, intervention medium, or reserve asset. Ties to a geopolitical leader may take many forms – traditional patron-client linkages, informal security guarantees, or formal defense alliances – and may be more or less institutionalized. The closer the relationship, the more likely it is that friends and allies will feel comfortable using the leader's money. Empirical studies

find, for example, that formal alliances have a distinct impact on a country's choice of anchor currency (Li, 2003, Posen, 2008).

13 Fourth is the factor of *military reach* – the security dimension of international relations. For nervous investors or central banks, a militarily powerful nation can provide an appealing "safe haven." A strong defense ensures a more benign investment climate. A nation's ability to project power abroad will exercise yet more gravitational pull – though only so long as the issuer is seen as a guardian of peace and stability. The opposite effect is much more likely if the issuer is seen as a destabilizer or aggressor. As Adam Posen has commented:

> military misadventures will erode the willingness of other countries to rely on [a currency], and thus create a negative feedback loop between economic and security capacities. (Posen, 2008: 96)

14 Finally, last but not least, is *effective governance*. In narrow terms this means a proven track record of successful macroeconomic management, a policy regime capable of sustaining relatively low inflation and inflation variability over time. No currency is apt to come into widespread use for cross-border purposes if its purchasing power cannot be forecast with some degree of assurance. More broadly, effective governance means political stability, adequate protection of property rights, and genuine respect for the rule of law. Why would anyone willingly adopt a currency whose issuing government cannot be counted upon to faithfully enforce contractual obligations? As Andrew Sobel (2012) points out in an important historical study, effective governance was essential to the success of all major international currencies in the modern era, from sterling and the dollar to more recent contenders such as Germany's old Deutsche mark, Japan's yen, and the euro. In the absence of relative price stability and accountable government, it is hard to imagine that any of those currencies would have gained much traction in international markets.

15 Together, these five factors determine the fate of currencies. The question is: Viewed in terms of these prerequisites, what are the competitive credentials today of the dollar and its two main rivals, the euro and yuan? The answer, I suggest, is that prevailing conditions greatly favor the greenback and will continue to do so for years to come.

2. The dollar

16 Dollar pessimism is not without foundation. The United States has been running deficits without tears for decades, gradually accumulating the largest foreign debt in history. The situation is clearly unprecedented. For the first time ever the world's greatest monetary power is also the world's biggest debtor. Washington, pessimists declare, has abused its exorbitant privilege, putting at risk the value and ultimately the usability of its currency. Sooner or later, a tipping point will be reached triggering a flight from dollar-denominated assets. As one commentator asks:

> How much more debt can the US accrue without undermining [...] the very confidence in the dollar that makes those securities so appealing in the first place? (Wheatley, 2013: 13)

17 In effect, America has long lived beyond its means, relying too heavily on the borrowing capacity afforded by the greenback's worldwide acceptability. After decades of dollar supremacy, pessimists suggest, the United States has come to take its exorbitant privilege for granted. Seemingly, policy autonomy is now assumed to be something of a birthright. Only rarely do US politicians or voters ever pay attention to the external accounts when thinking about domestic or foreign policy. As another source ruefully comments:

> Americans, it appears, have grown deeply habituated to our exorbitant postwar privileges [...] Instead of consuming less and exporting more, we prefer exporting more dollars. (Calleo, 2009: 186-187)

18 Old habits are hard to break. But why, then, does the greenback continue to prevail? Why, despite America's ever-growing debt, do outsiders continue to invest in the dollar? The answer lies, above all, in the greenback's unique advantages as an international store of value. There may be risk, but there is also great reward. The United States offers an extraordinarily well developed set of financial markets, promising unparalleled liquidity and safety. And that advantage, in turn, receives additional support from America's still broad network externalities in trade, wide range of political ties, vast military reach, and unquestioned respect for the rule of law. Alone among currencies, the dollar embodies all the essential prerequisites for global success.

2.1 Financial markets

19 The attractions of America's financial sector are unmistakable. Institutionalized exchanges are available not only for conventional stocks and bonds but also for swaps, options, forward and futures contracts, derivatives, and all sorts of other exotic financial instruments. Markets are broad, deep, and resilient and open to all. The range of services is wide, transactions costs are low, and property rights are well protected. Outsiders, whether private investors or public agencies, know that they can count on an exceptionally high degree of exchange convenience and capital certainty when they do business in dollar-denominated claims.

20 Some other economies also offer many of these same attractions, but by no means on the same scale. The euro zone, combining the financial sectors of all its members, was initially expected to pose a serious competitive challenge to the dollar. But its early promise has remained largely unrealized, and after a fast early start has even regressed under the pressure of Europe's sovereign debt crisis. Since the global crisis exploded in 2008, European banking and capital markets have actually fragmented, with many sectors retreating once again behind national frontiers. Any claim to breadth or depth has been lost. Elsewhere, such as in London or Switzerland, markets are efficient but in no way able to offer the range of investment opportunities available in the United States. Neither the British nor the Swiss can provide financial assets in the volumes required by the global system. Japan's capital market is large but remains uncompetitive with America or Europe. And China, of course, is still only at the earliest stage of financial development.

21 In reality, the US financial sector stands alone, at the strategic center of the global network of currency and capital markets. As one source puts it (Rajendran,

2013: 92), America "has come to function as a sort of central processing core through which funds are routed." A recent analysis of links in the international financial system (Oatley *et al.* 2013) finds that while most countries are strongly connected to the United States, direct ties to monetary centers elsewhere are much weaker. The structure is clearly hierarchical and, in the absence of suitable alternatives, unavoidably dependent on US markets.

22 Whatever the risks of America's looming debt, therefore, there are compensating advantages for outsiders to sustain the greenback's appeal. The evidence can be easily seen in the ample seigniorage that the United States is still able to enjoy at the expense of the rest of the world. Multiple studies show that foreign accumulations of dollar-denominated claims generate a substantial interest-rate subsidy for Americans, whether measured by the saving on borrowing costs (Kaminska and Zinna, 2014) or by the difference between net rates of return on inward and outward investments (Gourinchas and Rey, 2007). In effect, outsiders collectively seem prepared to pay a considerable price for their right to make use of the greenback. One source (Jeanne, 2012: 3) refers to this as a kind of "saver's curse" in international finance.

23 Is it rational for outsiders to tolerate the saver's curse? On balance, the calculus does not seem unreasonable. In effect, the price reflects an implicit trade-off – a "liquidity premium" paid in return for the dollar's promise of operational and valuation efficiency. Particularly relevant is the market for US government debt, which includes everything from three-month Treasury bills to much longer-term notes and bonds along with so-called agency securities – bonds issued by various quasi-governmental agencies. Federal debt is a popular investment medium for private actors around the globe; it is also the principal form in which central banks hold their dollar reserves. Overall, Treasury obligations and agency securities in general circulation exceed $ 8 trillion. With a turnover of as much as $ 500 billion or more daily, the public debt market offers a degree of liquidity that is difficult to match. Nothing in the world comes close to the US Treasury bill – commonly known as the T-bill -- for transactional ease or assurance of value.

24 In political terms, an additional consideration is safety – a trade-off for the promise of a safe haven for investments or reserves; what may be called a "security premium." For many analysts today, the single most important role that an international currency can play is that of a safe haven: providing a range of assets that is as free of risk as possible. Properly understood, insists one commentary (Fields and Vernengo, 2013: 746), the essential feature of a dominant money is that it "delivers a secure financial asset that facilitates the functioning of financial markets." Much has been written lately about the danger of a growing shortage of high-quality claims around the world, relative to demand (Chen and Imam, 2012). Since the start of the global financial crisis, a consensus has developed that the United States is presently the only source capable of supplying safe and liquid assets on anything like the scale required. "There are now few genuinely safe assets," declares a prominent British journalist (Tett, 2014). In the absence of alternatives, she says, the greenback "has become ultra-attractive because of bountiful supply". More bluntly, in the words of a New York investment strategist, "When people are worried, all roads lead to Treasuries" (as quoted in *The New York Times*, 13 May 2012).

25 Some decision makers greatly resent the saver's curse. Representative is the oft-cited diatribe by Luo Ping, a senior Chinese official, when asked back in 2009

whether China would continue to buy US Treasury bonds.

> We hate you guys, [he said]. Except for Treasuries, what can you hold? US Treasuries are the safe haven. For everyone, including China, it is the only option... Once you start issuing $ 1 trillion-$ 2 trillion... we know the dollar is going to depreciate, so we hate you guys but there is nothing much we can do. (as quoted in *Financial Times*, 12 February 2009)

26 The attractions of the dollar-based system are appreciated, but that does not mean that the arrangement must be liked. The late Ronald McKinnon (2013) was not far off when he called it the "unloved dollar standard." Yet in the end, the advantages offered by the greenback are understood.

27 Nothing better illustrates the point than the global response to the bursting of the US real-estate bubble in 2007 and the grinding financial crisis that ensued. America could be fairly blamed for a near-collapse of the global economy. Yet remarkably, as events unfolded, a tidal wave of capital flowed into US markets, not outward as might have been expected. In the last three months of 2008 alone, at the height of the crisis, net purchases of US assets topped half a trillion dollars – three times what had come in during the preceding nine months. The greenback appreciated rather than depreciated, and the T-bill market stood out as one of the few financial sectors anywhere to remain liquid and continue operating smoothly. Even when Standard and Poor's, a leading credit rating agency, downgraded its rating of Treasury securities in mid-summer 2011 following a brief shut-down of the government in Washington, outsiders continued to acquire dollars.

28 Some of the buildup of dollar claims, we know, reflected the fact that many foreign banks and institutional investors needed greenbacks to cover their funding needs at a time when interbank and other wholesale short-term markets had suddenly frozen tight. Here the Federal Reserve played a vital role, from December 2007 onward, by authorizing new temporary dollar swaps with key central banks elsewhere. Ultimately, fourteen agreements were signed. In return for reciprocal currency pledges, the Fed provided greenbacks that could then be lent onward by each central bank to its dollar-hungry constituents. At their peak, in December 2008, swaps outstanding under these arrangements totaled $ 580 billion, which one source (Irwin, 2014) has described as "the biggest United States government bailout that most people do not know anything about." There is little doubt that the global crisis would have been a lot worse had the Fed not risen to the occasion.

29 But funding need was hardly the only reason why outsiders piled into the dollar on such a large scale. It was also evident that much of the demand for greenbacks could be attributed to fear. Who knew how bad things might get? As Helleiner (2014: 8) summarizes, "investors also perceived the dollar to be a safe haven currency because it was backed by the world's dominant power."

2.2 Trade

30 Reinforcing the attractions of America's financial sector are the US economy's still broad network externalities in trade. Admittedly, the United States is no longer quite the export powerhouse that it once was. For much of the twentieth century, America was by far the world's leading exporter. Even as late as the 1990s, one eighth of all traded goods came from the United States. But since the

start of the new millennium America's share of global exports has dropped by nearly a third, from above 12 percent to under 8.5 percent. Much of the decline appears to be related to the falling share of the United States in total world output (Mandell, 2012). In nominal terms, US GDP has trended downward from a peak above 32 percent of world output in 2001 to under 24 percent more recently. Recalculated on a purchasing power parity basis, the drop has been from 23 percent to 19 percent. The biggest gainer has of course been China, which is now the world's top exporter with a global share above 12 percent. Many expect China's GDP to surpass America's within the next decade.

31 Yet for all that, the gravitational pull of the US economy remains exceptionally strong. Most informed observers agree that America's longer-term growth prospects are still bright, powered *inter alia* by a dynamic high-tech sector, favorable demographics, a sophisticated financial sector, and flexible labor markets. Particularly influential is the energy revolution that has spread across the country as a result of the development of new methods for extracting oil and natural gas from previously inaccessible sites (hydraulic fracturing – for short, "fracking"). In just a few years, the United States has emerged as the world's largest energy producer – bigger even than Russia or Saudi Arabia -- producing massive amounts of dependable and low-cost fuel to US industry. By 2020 the economy is expected to be fully energy independent. Joel Kurtzman, a former *New York Times* business editor (2014), lists the energy revolution as one of four major "forces" that can be counted upon to sustain American economic leadership for a long time to come. The others are high levels of creativity, "gigantic" amounts of capital, and unrivaled manufacturing depth. Decades ago, US publisher Henry Luce dubbed the twentieth century the "American Century." Kurtzman is by no means alone in predicting that the present era could be remembered as the "Second American Century".

32 In fact, the evidence of America's staying power is impressive. The share of global output originating within the borders of the United States may have declined. But that fails to take into account many other critical vital signs, such as the share of output accounted for by US multinational corporations *outside* America's frontiers. The scale of penetration abroad is, to say the least, considerable. In effect, US enterprises sit at the center of a global transactional network defined by complex supply chains and direct investment flows. According to one recent study (Starrs, 2013), American companies dominate in as many as 18 of 25 broad sectors of the world economy.

> We live in an age of globalization [the author declares]. But we also continue to live in an age of American economic dominance [...] American economic power has not declined – it has globalized. (Starrs, 2013: 828).

33 So long as that remains true, the dollar will retain its worldwide constituency.

2.3 Political factors

34 Finally, it is hard to deny America's unparalleled political advantages. Ever since World War II, the United States has stood tall as the world's most powerful nation. During the Cold War, America was the "leader of the Free World." After the breakup of the Soviet Union, the country was relabeled "the world's last

superpower." French commentators spoke of US *hyperpuissance*. Madeleine Albright came up with the term "indispensable nation." Even today the United States has far more formal or informal alliance relationships around the globe than any other nation. The US military has as many as 900 bases or installations in some 130 countries. Washington's defense budget accounts for close to half of all arms spending in the world.

35 Among scholars of international relations, a lively debate rages over whether American geopolitical supremacy is in decline. For some, the rise of China and other regional powers, as well as the revival of Vladimir Putin's Russia, inevitably spells the end of US primacy. Typical is the foreign policy specialist Leslie Gelb (2009: 56), who concludes that "the United States is declining as a nation and a world power." But others disagree, insisting that "declinists" are simply too gloomy. Declinists, it is said, discount America's deep underlying strengths, both economic and political. Representative is Robert Lieber, who stresses above all America's remarkable ability to change and innovate, especially in response to crisis:

> A fundamental characteristic of the United States," he writes, is "its unique flexibility and adaptability [...] It is this capacity that provides a basis for optimism in assessing America's future. (Lieber, 2012)

36 At some point, of course, the declinists will undoubtedly be vindicated. No superpower has remained on top forever. In the long run US geopolitical dominance is bound to fade. The system built on America's extensive alliance networks and capacity for power projection will be replaced by something else and history will move on. But as John Maynard Keynes famously reminded us, in the long run we are all dead. Over a shorter time horizon more relevant to decision makers, measured in years rather than generations, it is a good bet that US primacy will endure, if only because the margin of superiority is still so great. As two American political scientists, Stephen Brooks and Willam Wohlforth (2008: 1), observe: "No system of sovereign states has ever contained one state with comparable material preponderance." For the foreseeable future, we can safely assume that the United States will remain number one in geopolitical terms.

37 In turn, that suggests a still bright future for the dollar as well. Preservation of America's widespread political ties around the globe will certainly encourage continued allegiance to the greenback by allies and other friendly governments. This will be especially so for smaller states with more clientilistic relations with Washington. Likewise, preservation of America's extensive military reach should help sustain the dollar's appeal as a safe haven. And certainly no one doubts the strength of the country's commitment to the protection of property rights. These factors can all be counted on to support the greenback's elevated standing for years to come.

3. The euro

38 What about the euro? Could Europe's money pose a serious challenge to the dollar? Many have thought so. Typical was Nobel laureate Robert Mundell, who at the time of the euro's birth confidently declared that the newborn currency would "challenge the status of the dollar and alter the power configuration of the system"

(Mundell, 2000: 57). Polls taken in late 2008, just ahead of the euro's tenth birthday, indicated that a majority of Europeans expected their money to overtake the dollar within as few as five years. A destiny of shared currency leadership with America's greenback – perhaps even global dominance – seemed imminent, shimmering brightly on the horizon.

39 Such expectations were by no means unjustified. In fact, the euro began life with many of the attributes needed for competitive success as an international currency. These included a large economic base, unquestioned political stability, and an enviably low rate of inflation, all backed by one of the world's most powerful (and conservative) monetary authorities, the European Central Bank. The euro's credentials were excellent; its future value and usability appeared secure. Seemingly there was every reason to believe in the glowing promise of Europe's Economic and Monetary Union (EMU).

40 But that was before the great crisis that struck the world economy in 2008. Since then, a rash of sovereign debt problems around the euro zone's periphery, from Portugal and Spain to Greece and Cyprus, has shaken confidence severely. The bright shimmer on the horizon turned out to be something of a mirage. After a steep takeoff, euro internationalization quickly reached a ceiling. By the mid-2000s, cross-border use had already leveled off and, most recently, has even slipped back considerably. Moreover, it is well known that while the greenback continues to circulate virtually everywhere, the euro's domain remains confined mostly to a limited number of economies with close geographical and/or institutional links to the European Union. In reality, the euro's challenge to the dollar has fizzled. In the words of *The Economist* (25 May 2013): "Bombastic talk of the euro rivaling the dollar is gone. The aim now is simply to arrest the decline."

41 What went wrong? First and foremost, the problem begins with the design of EMU's governance mechanisms. As an incomplete merger of sovereign states, the project was flawed from the start, doomed to operate in a messy netherworld of considerable inefficiency and uncertainty. And that flaw, in turn, exacerbates other weaknesses that constrain the currency's competitiveness. The gravitational pull of the European economy is diluted; Europe's financial institutions are unable to match the liquidity and safety of the global dollar market; and European governments cannot compete with the United States in projecting political or military power. The wonder is that these crippling liabilities were not anticipated from the start.

3.1 An imperfect construct

42 Governance, at its most fundamental, is about the formulation, implementation, and enforcement of rules for behavior. The basic question is: Who is in charge? For the euro, regrettably, the answer has never been clear. From the start, uncertainty reigned concerning the delegation of authority within EMU among national governments and EU institutions. At the heart of the monetary union are ambiguities that do little to enhance either managerial efficiency or user trust.

43 The issue is straightforward. The euro is a currency without a country. Its members are a club of sovereign states. Unlike the dollar or most other currencies, which are created and managed by a single sovereign power, Europe's money is the product of a multi-state agreement – the Maastricht Treaty, EMU's founding

document. Hence a fundamental mismatch prevails between the domain of the euro zone and the legal jurisdictions of its participating governments, making decision-making problematic at best. The challenges of monetary management must be resolved by diplomatic negotiation, which is notorious for its tendency toward obfuscation and ambiguity to resolve knotty questions. In lieu of efficient governance, backed by an unquestioned political authority, EMU is condemned to operate in what *The Economist* (2011) has referred to as a vague "spirit of shoddy compromise." Equivocal and messy trade-offs are the norm.

44 For some commentators the implication is that, sooner or later, EMU will collapse. Representative is the economist Martin Feldstein (2012: 105), who calls the monetary union "an experiment that failed.... [The euro] is the little currency that couldn't." For others, conversely, the implication is the reverse – that EMU will learn from its mistakes and become ever stronger. "Europe is well on its way to completing the original concept of a comprehensive economic and monetary union," declare Fred Bergsten and Jacob Kirkegaard (Bergsten and Kirkegaard, 2012: 1-2). Europe will "rewrite the euro area rule book and complete the half-built euro house."

45 Reality, however, is most likely to remain somewhere in between – in the grey area between abject failure and glowing success. Radical predictions, whether for failure or success, are simply not persuasive, and for the same reason. Their logic suffers from what in philosophy is known as the Fallacy of the Excluded Middle – a sense that outcomes must be black or white, one extreme or the other. The assumption is that a half-built house cannot stand. Either it must be completed, or it will collapse. But in reality nothing could be further from the truth. In the real world shades of grey predominate, and even if they are distinctly sub-optimal they may prove to be remarkably hardy. The euro house, for all its rickety defects, has proved durable through years of stormy weather, relying on one messy trade-off after another. The house may sag in places, the floor boards may be warped, and the roof may leak. But for all that, there is no reason to believe that it cannot long remain habitable. It just will not be very comfortable – a sadly imperfect construct.

46 Is it any wonder, then, that hopes for the euro remain unrealized? A construct as imperfect as EMU is hardly likely to engender confidence in the currency's future value and usability. For outsiders, the euro can be considered only as good as the political agreement underlying it. The experience of recent years has demonstrated that the requisite cohesion is tenuous at best. Rather than the clarity of a single sovereign power, we find discord and a spirit of shoddy compromise. How could user trust not be damaged? As one source summarizes:

> In the absence of a central authority, eurozone countries' cooperative management of the crisis has been clumsy, damaging the credibility of eurozone governance and accordingly market confidence in the euro. (Chey, 2012: 64)

3.2 Trade

47 In turn, other weaknesses are exacerbated that further limit the euro's appeal. Begin with size, which might have been expected to encourage use of Europe's money for invoicing and settlement of trade. Collectively, the 28 members of the

European Union (EU), most of whom are committed to adopt the euro one day, constitute an economy roughly equivalent to that of the United States, with a per-capita income above $ 28,000 for its 500 million consumers. The EU is also the biggest trading bloc in the world, with a 16 percent share of global exports (excluding intra-EU trade), nearly twice America's share. Germany alone sells as much around the globe as does the United States. Given Europe's considerable weight in international commerce, it is not surprising that outsiders might feel a considerable gravitational pull.

48 But can that gravitational pull be sustained? Prospects are not bright. The EU's share of world output has been shrinking for some time, from as much as 25 percent in the 1990s (calculated on a purchasing power parity basis) to little more than 18 percent recently; and projections into the future suggest a continuation, if not an acceleration, of the same grim trend. Observers point to three critical issues. One is the frailty of the region's demographics – a rapidly aging population with an overall growth rate under 0.2 percent – that will soon translate into a significant decline in the available labor force. A second is the low rate of productivity growth in Europe due to a paucity of investment in research and development. And a third is an expected erosion of human capital due to the prolonged unemployment since 2008. All three suggest a significantly reduced growth potential. In the words of one recent study, projecting Europe's outlook out to the year 2030:

> The combination of such factors will deliver a weak GDP growth in Europe.... The weakness of European growth does not allow a sufficient rate of job creation to ensure a rapid decrease in the unemployment rate. (Gros and Alcidi, 2013: *v*)

49 From a pace of some 2.6 % during the decade before the crisis, annual growth in the EU is expected to average no more than 1.5 % at best in coming years.

50 In such unpromising circumstances, is it reasonable to look for the euro to be more widely adopted for trade purposes? The currency does already play a substantial role in economies with close geographical and/or institutional links to the EU. But that was only to be expected. "These are EMU's traditional hinterland – the euro's turf," as economist Charles Wyplosz (1999 : 89) once put it. For countries within the EU's orbit, the euro's gravitational pull naturally remains strong. But beyond that limited domain the currency's appeal is weak. Outside of what the ECB has referred to as the "European time zone," use of the euro remains limited; in transactions between third countries, where neither counterparty is an EMU member, it is practically non-existent. Europe's shrinking role in the world economy is most apt to be matched by a gradual atrophy of the euro's function as a medium of exchange as well. Wider use in global trade does not seem to be in the cards.

3.3 Finance

51 What about the euro's store-of-value function, as an investment currency or reserve asset? Back when EMU started, it certainly seemed reasonable to look for expansion of the euro's role in financial markets. The anticipated process of monetary integration promised to create the largest single-currency capital market in the world, with a huge pool of savings and a high degree of liquidity. Savings

previously lodged outside the EU, it seemed likely, would naturally be attracted by the financial sector's new depth, enhancing the euro's global standing.

52 True to form, expansion was immediately evident. In short order there was a dramatic increase in the use of Europe's new money in capital markets, particularly for international bond sales. Indeed, the euro soon actually surpassed the greenback as the world's most important currency of issue. But the effect did not last. After peaking in 2005 at some 34 percent of global bond inventory, the euro's share dwindled, falling to little more than a quarter in more recent years. That compares with a dollar share above 50 percent. Moreover, here too it is clear that the euro's domain, in terms of both borrowers and investors, has tended to remain confined more or less to the EU and its hinterland. On the supply side, where the euro performs a financing function (a medium for borrowing), most new issues tend to come from neighboring countries like Britain, Denmark, and Sweden. Borrowers farther afield, in Latin America or Asia, continue to contract more in dollars. Likewise, on the demand side, where the euro performs a store-of-value function (an investment medium), the largest part of new euro-denominated issues tends to be taken up by investors within EMU itself, making them effectively "domestic," while much of the rest goes to the nearby European region. Elsewhere, available data indicate that the greenback still dominates in holdings of bonds as foreign assets.

53 A major reason for the dollar's continued dominance is the absence of a universal financial instrument in Europe to rival the US T-bill for liquidity and convenience. This is a deficiency that will remain difficult, if not impossible, to rectify so long as EMU, with its separate sovereign members, lacks a counterpart to the Federal government in Washington. There is no single market for public debt in EMU as there is in the United States. Rather, there are separate and distinct markets for the national issues of each individual participant – German "bunds," French "bons du Trésor" and so on. Full consolidation of the euro-zone's government debt market is stymied by the persistence of differential credit and liquidity risk premiums among member countries as well as by variations in legal traditions, procedures, issuance calendars, and primary dealer systems.

54 Worse, once Europe's sovereign debt problems erupted, EU capital markets actually began to fragment, reversing the anticipated process of integration. The retreat behind national frontiers has reduced both exchange convenience and capital certainty. In effect, Europe's financial sector has become balkanized, discouraging wider use of the euro as an investment medium or reserve asset. The currency's appeal as a store of value has not lived up to expectations.

3.4 Political factors

55 Nor, lastly, can Europe match America's unparalleled advantages in terms of foreign policy ties or military reach. The dollar benefits greatly from the central position of the United States in the geopolitical order. By contrast, no one has ever described EMU as the "indispensable nation."

56 Admittedly, Europe is not without political resources. Two of the EU's members, Britain and France, are nuclear states with militaries capable of projecting power well beyond their own borders. Each, however, acts largely on its own in pursuit of its own national interests. Apart from a very small "rapid reaction force," which

exists mainly on paper, the EU as a whole has been unable to put together any kind of unified armed units. Defense remains primarily the domain of individual sovereign states.

57 Some effort has been made to achieve more cohesion in foreign policy. In 2009, the position of High Representative for Foreign Affairs and Security Policy was created – in effect, an EU foreign minister – with responsibility for coordinating Europe's external diplomatic and political relations. In principle, the idea was to elevate the profile of the EU as an international actor. In practice, the effect has been mainly cosmetic, since the High Representative can speak for Europe only when all 28 members agree. As might be imagined, consensus in such a diverse group is difficult to achieve on any kind of consistent basis.

58 In reality, Europe is a long way from being able to challenge America's advantages in the security realm. Quite the reverse, in fact. Since World War II Europeans have tended to rely on the military prowess of the United States for most of their defense needs; and that in turn further dims the appeal of the euro. In the words of one source:

> The EU's dependence on the United States for its security precludes the EU from having the kind of political leverage to support the euro that the United States has with the dollar. (Brooks *et al.*, 2013: 140)

59 More bluntly, a senior official of the European Commission concedes, speaking anonymously: "We're a political dwarf." Given a choice, few governments outside the European time zone would opt for the EU as a patron in preference to the United States; few investors would see EMU as a safer haven than the greenback. As a practical matter, Europe's political capabilities are simply too limited. Hence here too weakness limits the competitiveness of Europe's currency. Concludes Adam Posen (2008: 88), "foreign policy and national security ties [...] continue to favor the dollar's global use."

4. The renminbi

60 If not the euro, why not the renminbi? For many it is the yuan, not the euro, that is truly the currency of tomorrow – the challenger that will finally topple the dollar. Internationalization, it is said, is the RMB's manifest destiny, an unstoppable by-product of China's remarkable economic success. Time and again, the word "inevitable" is heard. Many agree with economist Arvind Subramanian, who confidently predicts that:

> China's growing size and economic dominance are likely to translate into currency dominance [...]. The renminbi could surpass the dollar as the premier reserve currency well before the middle of the next decade. (Subramanian, 2011: 5)

61 What makes the rise of the yuan seem so unstoppable? We know that China has emerged as an industrial dynamo. Few doubt that, as a result, the country will have a major impact on the international monetary order in the years ahead (Helleiner and Kirshner, 2014). Expected soon to be the world's largest economy, the proverbial Middle Kingdom offers the foundation of a broad transactional network – a key prerequisite for currency internationalization. To all appearances,

the stage would seem to be set for widespread adoption of the RMB.

62 Appearances, however, can be misleading. In reality, prospects for the Chinese currency are less promising than believed, for two reasons. In the first place, the foundation of the yuan's appeal – China's economic size – is shaky at best and, most recently, has begun to look increasingly fragile. And second, the RMB offers few attractions other than a large transactional network. Most of the other sources of success in the Darwinian struggle are conspicuous largely by their absence.

4.1 A shaky foundation

63 Economic size stands out as the RMB's trump card: the principal factor that promotes interest in China's currency. The Chinese economy is a giant among nations – the world's leader in exports and second biggest market for imports, creating a considerable potential for network externalities. More than a hundred nations now count China as their largest trading partner. There can be no doubt about the Middle Kingdom's gravitational pull in today's global commerce.

64 But will the trump card hold for long? Until lately, the prevailing view was glowing. China's success over the last thirty years was only the beginning. The giant would continue to grow, in time emerging as the world's dominant power. The new century would belong to China in the same way that the nineteenth century was said to belong to Britain or the twentieth century to the United States. As Subramanian put it:

> The economic dominance of China [...] is more imminent (it may already have begun), will be more broad-based (covering wealth, trade, external finance, and currency), and could be as large in magnitude in the next 20 years as that of the United Kingdom in the halcyon days of empire or the United States in the aftermath of World War II. (Subramanian, 2011: 4)

There would be no "Second American Century." Like it or not, the "Chinese Century" had begun.

65 More recently, however, doubts have begun to multiply. As successful as China has been until now, its shadow in future years may not loom as large as Subramanian and others expect. In 2015 it became clear that the economy's phenomenal growth was slowing down sharply; starting at mid-year, a stock-market "correction" began that by the end of the summer had erased as much as a third of the value of Chinese equities. Moreover, while China's GDP may soon be the largest in the world, on a per-capita basis the Middle Kingdom is still no better than a lower middle-income country. As the saying goes, China is big but poor.

66 Furthermore, as numerous observers point out, it is important not to conflate size with power. By many measures China's economy still suffers badly by comparison with the United States. Its exports are mostly low-end consumer products with poor brand presence, and its knowledge-intensive industries and financial services fall well below world standards. In the World Economic Forum's latest survey of global competitiveness (Schwab, 2014), China ranked no better than 28th, far behind the United States, which was in third place surpassed only by Switzerland and Singapore. In the words of political scientist Michael Beckley:

> The United States has not declined; in fact, it is now wealthier, more innovative, and more militarily powerful compared to China than it was in 1991 [...] China is rising, but it is not catching up. (Beckley, 2011/2012:

43-44)

67 In fact, prospects for the Middle Kingdom look increasingly clouded. Grave problems have accumulated that could significantly suppress economic expansion in the years ahead. These include an excessive reliance on investment and exports to generate growth, a rising level of debt in relation to GDP, widening income inequalities, rampant corruption, severe pollution, and a swiftly aging population. Economists at the International Monetary Fund (Das and N'Diaye, 2013) suggest that China is now approaching the so-called "Lewis Turning Point" (named after Nobel Prize winning economist Arthur Lewis, a development specialist), where the country will move from a vast supply of low-cost workers to conditions of labor shortage, restraining growth potential. Many observers now foresee a sharp slowdown over the longer term (Lardy, 2012; Gurtov 2013; Hoffman and Polk, 2014). The days of double-digit growth are definitely over.

4.2 Absent attributes

68 Of course, even with a possible slowdown, China's gravitational pull is bound to remain substantial. The economy will still be big and will still offer a broad transactional network. Beijing will continue to hold a strong trump card. But that is all the only prerequisite in evidence. In other respects Beijing's hand is considerably weaker.

69 In finance, for example, China offers little appeal. For all the vaunted success of the Chinese economy, financial institutions remain rudimentary at best and the sector is still essentially closed to the outside world. Starting as early as 2002, a few international investors were granted direct access under so-called Qualified Foreign Institutional Investor (QFII) scheme, permitting a small number of outsiders to acquire claims in the domestic capital market. And in 2014 a new initiative was announced, the Shanghai-Hong Kong Stock Connect, allowing indirect purchases of shares on the Shanghai stock exchange through the Hong Kong market. But all investments are subject to strict quotas and administrative controls and remain very limited in total. In 2015 the Chinese government succeeded in persuading the International Monetary Fund to add the yuan to the basket of currencies that determines the value of the Fund's Special Drawing Rights, alongside the dollar, British pound, euro, and yen. But as the Fund staff suggested in a critical review (IMF, 2015), the RMB is still a long way from truly achieving the status of a "freely usable" currency. Overall, the yuan is still largely inconvertible for residents and non-residents alike.

70 In fact, most of the growth in foreign use of the yuan for investment purposes has occurred offshore in the special administrative region (SAR) of Hong Kong. The former crown colony is useful to Beijing as a testing ground. In recent years, Hong Kong markets have grown both for RMB bank deposits and for yuan-denominated ("dim sum") bonds. But it is clear that the SAR is too small to carry the load on its own. A global role for the yuan will require much greater scale than can be provided by Hong Kong alone. Moreover, until now the bulk of activity in Hong Kong has been effectively local rather than truly international. Most trades of RMB deposits do little more than shuffle cash between mainland enterprises and their own offshore subsidiaries; few transactions involve genuinely foreign companies (Cookson 2011). Likewise, more than three-quarters

of dim sum bond issues are sourced by mainland and Hong Kong firms rather than enterprises farther afield. Even including Hong Kong, China remains something of a financial pygmy as compared with more traditional centers. As one observer has written: China's economic influence "derives primarily from its role in the international trading system, rather than its financial might" (Kelly, 2009: 6).

71 Nor, for all of China's success in restoring its great-power status, does the Middle Kingdom offer much appeal in political terms. Certainly much effort has been put into cultivating foreign-policy ties around the globe, using strategic investments and bilateral aid programs as well as a variety of regional and multilateral forums. Beijing has gone to great lengths to persuade the world that its rise is "peaceful." Typical were the remarks of President Xi Jinping (2014) during a 2014 tour of Latin America:

> The Chinese people are peace-loving, and we do not carry in our blood the gene of invaders and imperialists, inasmuch as China rejects antiquated logic that equates being great with being hegemonic. Persisting in the road of peaceful development, China actively strives for a peaceful international environment.(President Xi Jinping, 2004)

72 Actions, however, speak louder than words. Offsetting such soothing homilies has been the scale of China's vast military buildup, which is clearly designed to project power well beyond the country's immediate borders. In practice, as China specialist David Shambaugh (2013) has reminded us, the Middle Kingdom has done remarkably little to help address major international security challenges or global governance issues. Instead, Beijing has increasingly chosen to act like a bully, aggressively asserting what it regards as its core national interests. That has been most notable in the East China Sea and South China Sea, where territorial claims have embroiled the country in disputes with a number of its neighbors. For many in the East Asian region, the expansion of Beijing's military reach is seen as anything but reassuring. China's historical sense of entitlement is deeply resented.

73 Finally, we must note the authoritarian nature of China's domestic political regime, which is so different from the forms of governance that prevailed in all previous cases of currency internationalization in the modern era. Beijing's political economy model does not inspire a high level of confidence, despite the government's record of success in terms of macroeconomic management. Policy makers have shown little regard for property rights or faithful enforcement of contractual obligations. Quite the reverse, in fact. In reaction to the collapse of equity prices in the summer of 2015, for instance, the authorities did not hesitate to make use of the state's heavy-handed security apparatus to discourage liquidations by institutional investors.

74 To this day, the ruling Communist Party remains dictatorial in nature and often arbitrary in behavior. In its survey of global governance indicators, the World Bank (2014) ranks China in the 40th percentile for the rule of law, while Transparency International (2013) places China no higher than 80th among 177 nations in its latest corruption index. Indeed, over the medium term, it is not even clear whether political stability can be assured. Only the most sanguine of investors or central banks would see today's China as a safe haven for their assets. In the understated words of one critical commentary (Lo, 2013: 162), "China faces a credibility problem".

Conclusion

75 Overall, then, the greenback's primacy seems secure, refuting long-standing doubts. Dollar pessimists, it turns out, are like members of one of those religious cults that predict the end of the world at noon tomorrow. How do we explain, the day after, why we are all still here?

76 The explanation, it appears, lies in the five prerequisites for successful currency internationalization. With good reason many resent America's exorbitant privilege, which has long tipped the global balance of power in Washington's direction. But the Darwinian process of natural selection, where only the fittest survive, is cruel. Today, only the dollar embodies the full list of attributes that make a currency internationally competitive. If the greenback's dominance is to be eroded, it can only result from the emergence of more effective rivals – currencies that offer more than do either the euro or the yuan at present. For Europe's money, that means, at a minimum, improved governance structures and a reintegration of EMU's balkanized financial sector. For China's RMB, it means much more financial development and a fundamental reassessment of Beijing's foreign policy and domestic political economy model. In neither case would such change be easy – which is precisely why the dollar appears likely to remain dominant for many years to come.

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Pour citer cet article

Référence papier
Benjamin J. Cohen, « The Demise of the Dollar? », *Revue de la régulation*, 18 | -1, 1-19.

Référence électronique
Benjamin J. Cohen, « The Demise of the Dollar? », *Revue de la régulation* [En ligne], 18 | 2e semestre / Autumn 2015, mis en ligne le 20 décembre 2015, consulté le 04 janvier 2016. URL : http://regulation.revues.org/11501

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Droits d'auteur