

7

**TOWARD A LEADERLESS
CURRENCY SYSTEM**

Benjamin J. Cohen

The dollar presently reigns supreme as an international currency. Can its dominance be challenged? Many observers foresee the rise of significant rivals for global currency leadership—the euro; possibly a revived yen; perhaps, in the longer run, even the Chinese yuan. My aim in this essay is to assess the prospects of the greenback’s main competitors and implications for the broader monetary system.

Do any of the dollar’s potential rivals represent a truly serious challenge? Like other contributors to this book (Calleo, de Cecco, Kirshner), I accept that the global position of the dollar is weakening. Essential to the greenback’s dominance until now has been a widespread and remarkably durable faith in the currency’s value and usefulness. Sooner or later, confidence in the dollar is bound to be undermined by the chronic payments deficits of the United States, which add persistently to the country’s looming foreign debt. But that by itself will not ensure the success of some alternative. The decline of one currency does not automatically guarantee the ascendancy of another. In fact, potential challengers have considerable deficiencies of their own, which are likely to limit their appeal, too. There is no obvious new leader lurking in the wings, an understudy just waiting to take center stage.

Author’s note: I am indebted to William Grimes, Eric Helleiner, and Jonathan Kirshner for helpful comments. The research assistance of Heather Arnold is also gratefully acknowledged.

So what, then, should we expect? We should anticipate something like the interregnum of the period 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 a similarly fragmented monetary system, with several currencies in contention and none clearly in the lead—an increasingly *leaderless* mix of currency relationships. We know that the absence of firm monetary leadership during the interwar period was a contributing factor to the financial crisis and Great Depression of the 1930s. The economic and political impacts of a leaderless monetary system in the twenty-first century could also be considerable.

I begin with a brief review of prospects for the dollar, setting the stage for the analysis to follow. Contrary to the more sanguine views of observers such as Harold James (chapter 2) or Ronald McKinnon (chapter 3), I do not consider the persistent buildup of America’s foreign debt as sustainable for long. Unless reversed by significant policy reform in Washington, the U.S. economy’s dependence on foreign capital must be expected in time to erode the advantages historically enjoyed by the greenback, creating an opportunity for possible challengers.

Three currencies are most frequently mentioned as potential contenders for the dollar’s crown—the euro, yen, and yuan. Prospects for each are considered. Overall, my assessment is skeptical. None of the three candidates appears capable of mounting a serious challenge to the dollar; certainly none is likely to surpass the greenback in the foreseeable future. Rather, the more plausible outcome is one in which the dollar’s supremacy is eroded but no other single money emerges to replace it. In Jonathan Kirshner’s terms (chapter 9), the dollar will become one of several “peer competitors” in a fragmented currency system, with no dominant leader.

I then turn, in conclusion, to the implications of a fragmented currency system for international monetary stability. A heightened struggle for leadership seems probable, threatening an increase of tension in currency affairs. Much will depend, however, on how aggressive policymakers choose to be in promoting their respective monies. The most likely battlegrounds are the Middle East, where the dollar and euro will contend for supremacy, and Asia, where the greenback can expect determined efforts on behalf of both the yen and the yuan. In both locales, the most likely outcome is intensified rivalry but not outright conflict.

Assumptions

I focus on the *market* role of the dollar and its potential challengers—that is, the extent to which alternative currencies are used by market actors as a medium of exchange, unit of account, or store of value in international transactions. Hence the competition for monetary leadership is treated here as primarily a function of economic constraints and incentives. Politics in this context enters only through what Eric Helleiner (chapter 4) calls the “indirect” channel of political influence: the role that public policy may play in shaping economic constraints and incentives, thus helping to determine the relative attractiveness of alternative currencies for private market use. Only in the final section do I bring in what Helleiner calls the “direct” channel of political influence—the part that politics may play in seeking to sway the behavior of *state* actors in the currency system.

Underlying my analysis are four working assumptions, all well documented in practice. First, echoing Helleiner, is the assumption that for market actors international currency choice is shaped, above all, by a trio of essential attributes. First, at least during the initial stages of a money’s cross-border adoption, is widespread confidence in its future value backed by political stability in the economy of origin. No one is apt to be attracted to a currency that does not offer a reasonable promise of stable purchasing power. Second are the qualities of “exchange convenience” and “capital certainty”—a high degree of liquidity and predictability of asset prices—each of which is essential to minimizing transactions costs. The key to both qualities is a set of broad and efficient financial markets, exhibiting depth and resiliency. Third, a money must promise a wide transactional network, since nothing enhances a currency’s acceptability more than the prospect of acceptability by others. Historically, this factor has usually meant an economy that is large in absolute size and well integrated into world markets. The greater the volume of transactions conducted in or with an economy, the greater will be the economies of scale to be derived from the use of its currency.

Second is the assumption that currencies in the global economy tend to be distributed hierarchically in what I have elsewhere called the Currency Pyramid.¹ At issue is the geography of money—the spatial organization of currency relations. Driving the geography of money is the force of competition—the constraints and incentives that shape market demand for currencies for either foreign or domestic use. Under the force of competition, the monetary universe becomes stratified, assuming the appearance of a vast

pyramid: narrow at the top, where the strongest currencies dominate, and increasingly broad below, reflecting various degrees of competitive inferiority. In the nineteenth century, sterling stood at the peak of the Currency Pyramid. Today, of course, the top currency is the dollar.

Third is the assumption that monetary preferences are “sticky,” characterized above all by path dependence and a noticeable tendency toward inertia. Currencies derive their popularity, in part, from scale economies in use—what specialists call network externalities. Network externalities may be understood as a form of interdependence in which the choices of any one actor depend strategically on the practices adopted by others in the same network of interactions. The same scale economies that encourage use of a currency in the first place are also responsible for “hysteresis” or “ratchet effects”—a marked resistance to change reflecting the high cost of switching from one money to another. Stickiness of preferences gives leading currencies a natural advantage of incumbency. This does not mean that change in the hierarchy is impossible. But it implies that when change does occur, it most likely will come relatively slowly. It took decades for the dollar to supplant sterling atop the Currency Pyramid.

Fourth—and following directly from the third—is the assumption that at any given moment, more than one currency may be widely used for international purposes. There is a common view, as one recent commentary put it, that “at any one point in time, there tends to be a single dominant currency in the financial world, not two or more. . . . In the currency markets the spoils go to the victor, alone; they are not shared.”² But that scenario is patently inaccurate. It was certainly not the case during the interwar period, as the dollar gradually eclipsed the pound. Typically, it has not even been the case when one currency was clearly dominant, as during the decades before World War I. Though sterling was then the world’s leading money, both the French franc and German mark also enjoyed widespread popularity, particularly on the European continent. Likewise, even as the dollar has dominated in more recent times, a considerable share of market activity has been accounted for by the deutsche mark (now the euro) and Japanese yen. Competition tends to be as keen at the peak of the Currency Pyramid as it is below. As Barry Eichengreen writes, the “argument that competition for reserve-currency status is a winner-take-all game holds little water either analytically or historically.”³

¹ Cohen 1998, 2004.

² Persaud 2004, 1.

³ Eichengreen 2006, 145.

The Dollar

No one questions that the dollar today still enjoys top rank in the Currency Pyramid. In most categories of international market use, the greenback continues to dominate. In currency trading, the dollar remains the most favored vehicle, appearing on one side or the other of some 86 percent of all foreign-exchange transactions.⁴ The dollar is also the most favored vehicle for the invoicing of world trade, used for just over half of all exports, and still accounts for some two-fifths of the international bond market, roughly one half of the international banking market, and two-thirds of central-bank reserves. No other currency today comes close to matching the greenback's global reach.

The threat to the greenback's dominant status is obvious. In the short term it comes from the great financial crisis that started in America's subprime mortgage market in 2007, which has thrown the security of the entire U.S. financial structure into question. Over the longer term, the threat comes from America's chronic balance-of-payments deficits, which are unprecedented by historical standards. As measured by the current account of the balance of payments, the gap in recent years has widened markedly; in 2006 it surpassed \$850 billion, equivalent to some 6.5 percent of gross domestic product (GDP). Every year, the United States spends considerably more than its income, relying on foreign capital to make up the difference. In effect, Americans have outsourced their saving to the rest of the world. Although now shrinking a bit, the shortfall continues to add to America's foreign debt, absorbing as much as two-thirds of the world's surplus savings. On a gross basis, external liabilities now exceed \$20 trillion. Net of America's own assets abroad, the debt reached \$2.5 trillion at the end of 2007, equal to nearly a fifth of GDP.

Can the process be sustained? Many, optimistically, have tried to make a case for sustainability. One popular argument points to the attractiveness of the U.S. economy as a market for goods of all kinds. America's deficits, it is said, are the direct result of export-led development strategies promoted by governments in East Asia and elsewhere, which are unlikely to be abandoned any time soon. A second argument stresses the attractiveness of the U.S. economy as a haven for investments. The growth of debt is said to be the direct result of a growing "global savings glut" seeking high returns in a secure environment—a long-term trend that the *Economist* has labeled the "great thrift shift."⁵ Either way, America's deficits are seen as a sign not of disequilibrium

⁴ Bank for International Settlements 2007a.

⁵ *Economist* 2005.

but rather as a form of equilibrium that we might expect to be sustained for a long time to come. James (chapter 2) goes even further, suggesting that in these patterns can be found the conditions for a new preeminence of the dollar in global affairs.

Such optimism, however, hardly seems justified. James discounts the importance of market confidence as a factor underlying America's ability to persistently live beyond its means—what Charles de Gaulle had in mind years ago when he referred to America's "exorbitant privilege." For how long can the United States go on building up a mountain of debt before doubts finally begin to take over? Some amelioration is possible, of course. The rate of growth of net liabilities already appears to have slowed somewhat since 2006, as a result of exchange-rate shifts that have stimulated exports and discouraged imports; and further adjustments are no doubt possible given the celebrated flexibility of the U.S. economy. But not even the most sanguine observers expect to see America's deficits disappear completely under the influence of market forces alone. In the absence of significant policy reforms to raise the domestic savings rate, spending will continue to exceed income, sooner or later eroding the world's trust in the dollar. The exorbitant privilege obviously cannot endure forever.

The case for sustainability, in short, is not nearly as persuasive as optimists such as James would have us believe. In fact, the probability that the dollar can long avoid a significant loss of confidence is sadly low. A fall from grace is unlikely to happen suddenly, as Kirshner (chapter 9) suggests; Kirshner seriously underestimates the stickiness of monetary preferences. Much more probable is a gradual, cumulative erosion of the greenback's appeal, opening the door to a possible challenge by others. Is any other currency capable of seizing the opportunity?

The Euro

The most obvious candidate is of course the euro, the joint currency created in 1999 by Europe's Economic and Monetary Union (EMU). Many have predicted a bright future for the euro as an international currency. Europe is the equal of the United States in output and trade. Why should it not be America's equal in monetary matters, too? Typical is the cheerful enthusiasm of de Cecco (chapter 6), who suggests that we are at a turning point in world monetary history. Europe's new currency, he avers, is a "rising star" that is destined to play a role in the twenty-first century comparable to that of gold in the nineteenth century.

In reality, however, such enthusiasm seems misplaced. De Cecco asserts that Europe's new currency will be attractive—especially as a store of value—because, like gold, it is not an expression of national sovereignty. But that is simply wrong. Europe's governments have not *renounced* monetary sovereignty, as de Cecco puts it. Rather, monetary sovereignty has been *pooled*—an important distinction. The euro is the expression of the *joint* sovereignty of a group of governments and therefore can be considered only as good as the political agreement underlying it—an example of what one scholar calls a “sovereignty bargain.”⁶ Because the euro zone lacks the clean lines of authority traditionally associated with the management of money by individual states, it will always be at a structural disadvantage in global markets. James (chapter 2) is right when he contends that there are more uncertainties about the future of the euro than of the dollar.

Briefly updating a previous analysis,⁷ I argue that only in the immediate neighborhood of the European Union (EU), where trade and financial ties are especially close, does the euro enjoy any special advantages. That is EMU's natural hinterland—“the euro's turf,” as Charles Wyplosz calls it.⁸ Elsewhere, the joint currency's star lacks luster.

Critical Shortcomings

Admittedly, the euro is blessed with many attributes necessary for competitive success, 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, that is fully committed to preserving confidence in the money's future value. Much room, therefore, does indeed exist for the euro's star to rise. But because of its base in a sovereignty bargain, the euro is also handicapped by several critical shortcomings, all structural in character, that limit the currency's attractiveness as a rival to the greenback. These include relatively high transactions costs; a serious antigrowth bias; and, most important, ambiguities at the heart of the monetary union's governance structure.

Transactions Costs First is the cost of doing business in euros. Transactions costs directly affect a currency's attractiveness as a vehicle for exchange transactions or international trade. From the start, it was clear that the dollar would be favored by the natural advantage of incumbency unless euro trans-

⁶ Litfin 1997.

⁷ Cohen 2003.

⁸ Wyplosz 1999, 89.

actions costs, which began high relative to the widely traded greenback, could be lowered to a more competitive level. That, in turn, would depend directly on what could be done to improve the structural efficiency of Europe's financial markets. In practical terms, much has been accomplished to knit together previously segmented national markets. Efficiency gains have been substantial. Yet for all that effort the dollar's cost advantage has persisted, discouraging wider use of the euro.

The core problem is evident. The euro is condemned to remain at a disadvantage vis-à-vis the dollar so long as the EMU is unable to offer a universal financial instrument that can match the U.S. Treasury bill for international investor liquidity and convenience. This is a deficiency that will be impossible to rectify so long as the euro zone, with its separate national governments, lacks a counterpart to the federal government in Washington. The best the Europeans could hope to do was encourage establishment of selected benchmark securities for the public debt market. Gradually three euro benchmarks have emerged: the German Bund at ten years, the French bond at five years, and the Italian bond at two years. But such a piecemeal approach falls far short of creating a single market as large and liquid as that for U.S. government securities. The greater depth and convenience of the U.S. Treasury bill market continues to give an advantage to the greenback.

Antigrowth Bias Second is a serious antigrowth bias that appears to be built in to the institutional structure of the EMU. By impacting negatively on yields on euro-denominated assets, this bias directly affects the euro's appeal as a long-term investment medium.

When the EMU first came into existence, eliminating exchange risk within the European region, a massive shift was predicted in the allocation of global savings as compared with holdings of European assets in the past. But as the ECB has ruefully noted, international portfolio managers have in fact been quite slow to commit to Europe's new money, despite some cyclical uptick of euro-zone growth in 2007.⁹ Liquid funds have been attracted when there was a prospect of short-term exchange-rate appreciation. But underlying investor preferences have barely budged, in good part because doubts persist about the longer term growth prospects in EMU countries, which have been trending downward for decades. Many factors, as we know, contribute to the slowing of Europe's trend rate of expansion—aging populations, which limit manpower increases and stress old-age pension systems; rigid labor markets, which hinder economic adaptability; and extensive government regulation,

⁹ ECB 2008.

which can constrain innovation and entrepreneurship. The EMU, regrettably, adds yet one more brake on growth.

The core problem here, as is well known, lies in the EMU's institutional provisions governing monetary and fiscal policy, two key determinants of macroeconomic performance. In neither policy domain is priority attached to promoting output. Rather, in each, the main emphasis is on other considerations that tend to tilt policy toward restraint, producing a distinct anti-growth bias for the euro zone as a whole. On the monetary policy side, the European Central Bank is mandated to focus exclusively on fighting inflation, even if over time this might be at the cost of stunting growth. Similarly, on the fiscal policy side, euro-zone governments have formally tied their hands with their controversial Stability and Growth Pact, which sets a strict cap on national budget deficits at 3 percent of GDP, inhibiting contra-cyclical stimulation. Though the pact is by no means airtight, empirical evidence suggests that overall it has in fact exercised a significant discipline, particularly on some of the EMU's smaller members.¹⁰ Is it any wonder, then, that the anticipated shift of global savings has turned out to be illusory?

Governance Finally, there is the governance structure of the EMU, which for the euro's prospects as an international currency may be the biggest handicap of all. The basic question is: Who is in charge? The answer, regrettably, has never been obvious. From the start, as is well known, uncertainty has reigned concerning the delegation of monetary authority among governments and EU institutions.

Who, for example, controls monetary policy? Practical operational control lies in the hands of the ECB's Executive Board, made up of the president, vice-president, and four other members. Overall managerial authority, however, is formally lodged in the Governing Council, which in addition to the six-member Executive Board includes the heads of the central banks of all the member states, each participating fully in discussions and sharing voting rights. The large size and mixed representation of the Governing Council are clearly inconsistent with efficient or transparent governance. No one really knows how critical decisions are arrived at.

Or consider the question of financial stability. Who, ultimately, is responsible for crisis prevention or the management of financial shocks? Under the Maastricht Treaty, the EMU's founding document, no specific tasks are assigned to the ECB to help forestall crises. Though linkages have grown among national financial markets, increasing the risk of contagion should troubles

hit, the ruling principle remains decentralization, otherwise known as subsidiarity—the notion that the lowest level of government that can efficiently carry out a function should do so. Formal authority for prudential supervision and regulation continues to reside at the national level, as it did before the EMU. Each central bank is charged with responsibility for the financial institutions based within its own national borders. No one can be sure that such a decentralized arrangement can be counted on to assure the smooth operation of the overall system. The possibility that central banks might work at cross-purposes, provoking or aggravating a crisis, is certainly not outside the realm of possibility.

Finally, there is the issue of external representation. Who is to speak for the euro zone on broader macroeconomic issues such as policy coordination, crisis management, or reform of the international financial architecture? Here the Maastricht Treaty has no answer at all, leaving a vacuum at the heart of the EMU. At a minimum, the treaty's silence compounds confusion about who is in charge. At worst, it condemns the euro zone to lasting second-class status, since it limits the group's ability to project power on monetary matters.

A Regional Destiny

For all these reasons, it should be no surprise to find that the euro's experience as an international currency to date has been underwhelming (even allowing for the characteristic stickiness of monetary preferences). In most categories of international market use, adjusting for the elimination of intra-EMU transactions, the euro has managed roughly to hold its own as compared with the past aggregate shares of the EMU's "legacy" currencies. This means that Europe's joint money has smoothly taken its place as the successor to Germany's old deutsche mark, which among international currencies had already attained a rank second only to the dollar. But that is about all. Evidence from the ECB indicates that after an initial spurt of enthusiasm for the new currency, use in most market segments has leveled off or even declined in recent years.¹¹ Moreover, since its birth the euro's only enduring gains have been in the EMU's natural hinterland, including the EU's newest members before they joined as well as other actual or potential candidate countries. In the ECB's words, analysis "confirms the largely regional character of the euro."¹² Beyond the European region, the euro remains very much in the dollar's shadow.

¹¹ ECB 2008.

¹² *Ibid.*, 7.

¹⁰ Annett 2006.

None of this, therefore, adds up to a serious challenge to the greenback. The dollar's appeal may be eroded by America's persistent payments deficits. But that by itself does not ensure success for the euro so long as the new currency's own deficiencies remain uncorrected. The euro clearly does have a future as an international currency. But its appeal is not unqualified and, worse, seems limited mainly to the EU's own backyard. The currency's destiny appears to be regional, not global.

The Yen

Less need be said about Japan's yen—once thought to be the dollar's heir apparent, now looking 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 significantly. But then at the end of the 1980s came the bursting of Japan's "bubble economy," which abruptly halted the currency's upward trajectory. Years of domestic stagnation dampened foreign interest in the yen, despite some highly visible attempts by the government in Tokyo to promote internationalization. Today the yen appears to face a gradual erosion of market standing not unlike sterling's long decline in an earlier era.

The appeal of the yen in its heyday was obvious. Postwar recovery had transformed Japan into the second largest economy in the world, an exporting powerhouse with extensive trade ties in just about every corner of the globe. The potential for network externalities was considerable. Moreover, the country suffered from neither political instability nor high inflation; and its financial markets had come to rank among the largest anywhere. Most of the ingredients for success were present.

Yet even at the peak of its popularity, enthusiasm for the currency was limited. Internationalization was strongest in the banking and securities markets, where a record of seemingly endless exchange-rate appreciation made yen-denominated claims especially attractive to investors. But the yen never came close to surpassing the dollar, or even the deutsche mark, in trade invoicing or as a vehicle for exchange transactions. The central problem could be found in the Japanese financial system, which long lagged behind the American and even many European markets in terms of openness or efficiency. Until the 1990s, Japan's capital markets remained the most tightly regulated and protected in the industrial world, preventing wider use of the yen. Strict controls were maintained on both inward and outward movements of funds; the development of a domestic securities industry was retarded by the historic re-

liance of Japanese enterprise on bank lending for capital investment; and financial institutions were rigidly segmented. Neither exchange convenience nor reasonable capital certainty could be assured.

Worse, since the end of the "bubble economy," foreign use of the yen has in relative terms actually decreased rather than increased. The currency's appeal has clearly waned, mirroring Japan's broader economic troubles. Challenges include not only anemic growth and a rapidly aging population but also a fragile banking system and a level of public debt, scaled to GDP, that is now the highest of any industrial nation. Japanese government bonds are scorned by rating agencies, discouraging investors and inhibiting the use of the yen in lending markets. In exchange markets, the percentage of transactions involving the yen has shrunk from a high of 27 percent of global turnover in 1989 to barely 20 percent in 2004. Overall, the yen's position near the peak of the Currency Pyramid has slipped dramatically vis-à-vis both the euro and the dollar.

Can the yen's appeal be revived? Belated efforts by the Japanese government to promote greater internationalization of the yen have largely proved futile. Today, even the most ardent of the currency's supporters appear to have lost their enthusiasm for the struggle. Like the euro, the yen might still realistically aspire to something of a regional destiny. But outside Asia, it poses no serious threat to the dollar.

Ironically, a determined government interest in internationalization did not even emerge until the yen's popularity had already begun to wane. Intermittent discussions started as early as the mid-1970s, but for many years widespread foreign use was resisted on the grounds that it might destabilize the yen's exchange rate or compromise domestic monetary management. Official policy, as C. H. Kwan puts it, could best be described as "neutral if not passive."¹³ It was only after the economy nose-dived that the authorities started to focus more on the potential advantages of an international currency. A greater role for the yen could help jump-start stalled growth. It might also enhance Japan's political standing in the global pecking order. In the words of one informed source: "Success at internationalizing the yen would be tantamount to achieving greater political prominence. . . . [It is] a bid to expand Japan's global political influence."¹⁴ Policy shifted from passive to active.

In substantive terms, most effort has been put into modernizing Japan's financial system, accelerating a modest program of liberalization that, under

¹³ Kwan 2001, 110.

¹⁴ Castellano 1999, 5.

pressure from the United States, was initiated as long ago as the 1970s. Capital controls have been loosened, new instruments and markets have been developed, and institutional segmentation has been relaxed. Most dramatic was a multiyear program announced in 1996, dubbed the Big Bang in imitation of the swift deregulation of financial markets that had taken place a decade earlier in Britain. Under the Big Bang, all remaining capital controls were eliminated and a variety of other ambitious measures were set in motion to enhance the general attractiveness of the yen as a vehicle for exchange transactions or international investment. Further reforms were initiated in 1998–99.

In geographic terms, policy has taken on a distinctly regional cast. Any pretense that Japan's currency might challenge the dollar on a global scale has plainly been abandoned. But, officials hope, it might still be possible to cultivate Japan's neighbors in East Asia—what could be thought of as the yen's natural turf. The EU is bound to dominate financial relations in the European hinterland. So why not counter with an Asian strategy for the yen, to consolidate a region of its own? Particular impetus came from East Asia's financial crisis of 1997–98, which seemed to create an opportunity for broadening the yen's role in the area. Internationalization of the yen, comments one source, "became a national cause célèbre for Japanese elites after the financial crisis."¹⁵ Most notable was Tokyo's proposal for a new Asian Monetary Fund (AMF), a regional financial facility that would have done much to institutionalize Japanese dominance in Asian currency relations. When the AMF initiative got shot down, owing mainly to opposition from Washington, the Japanese soon followed up with ideas for other regional schemes, culminating in creation of a network of swap arrangements dubbed the Chiang Mai Initiative after the town in Thailand where negotiations took place.

In practice, however, results have been discouraging. Asian governments prefer to hedge their bets as they watch China emerge as a rival to Japan for regional economic and political dominance. As Saori Katada observes, "Asian countries still try to avoid any attempts by Japan that might result in locking those countries into power relations."¹⁶ These days, even Japan's own policy elites now seem resigned to a diminished future for the yen. Japanese aspirations today seem limited to little more than holding onto a piece of regional leadership.

¹⁵ Green 2001, 260.

¹⁶ Katada 2002, 105.

The Yuan

As the yen declines, could China's yuan rise? The notion that the yuan could one day become the key currency of Asia—or beyond—is widely shared. But is it justified? The renminbi (the "people's money" or RMB) certainly has much going for it and has already begun to step out onto the world stage. International use, however, remains rudimentary at best and is retarded by obstacles far more severe even than anything blocking the euro or yen. In time, the currency's handicaps might well be surmounted. But the time required is likely to be measured not in years but decades, if not generations. For the foreseeable future, the yuan poses no threat to the dollar.

The potential is there, of course. Years of double-digit growth have already made China's economy, in purchasing-power terms, the second largest in the world after the United States; as an exporter, China now ranks ahead of both the United States and Germany. With such a huge and well-connected economic base, the opportunity for network externalities is obvious. Few observers seem to doubt that international use of the yuan will eventually follow. As the *Financial Times* puts it, "The emergence of the RMB as an international currency will be . . . a natural result of China's booming economy."¹⁷

But that reckons without the other attributes essential to cross-border adoption—in particular, the qualities of exchange convenience and capital certainty that are so critical to the usability of a currency. China's financial sector is still at the very earliest stage of development, offering limited investment opportunities. The level of transparency and efficiency lags far behind all of the more established financial powers; markets are thin and liquid assets are few. Worse, the yuan itself remains tightly regulated, not easily accessible for international transactions. Convertibility for trade in goods and services was introduced only in 1996. Cumbersome capital controls are still nearly universal.

Not surprisingly, therefore, yuan internationalization to date has been negligible. A certain amount of Chinese paper currency has begun to show up in neighboring economies as a result of growing cross-border trade and tourism by Chinese citizens. But the totals remain small—no more than \$2–3 billion at the end of 2004 according to one recent estimate, equivalent to roughly 1 percent of China's overall cash circulation.¹⁸ By comparison, as much as two-thirds of Federal Reserve notes are in permanent circulation outside the

¹⁷ *Financial Times*, June 2, 2003, 2.

¹⁸ Zhang 2007.

United States. Beyond the borders of China the RMB is rarely used for trade invoicing or as an investment vehicle.

To its credit, China's government acknowledges its currency's limitations and seems determined to do something about them. Unlike the Japanese prior to the 1990s, the Chinese have long welcomed prospective internationalization as a logical corollary to their country's reemergence as an economic superpower. As one prominent academic in the authoritative *People's Daily* declared, "China has become a world economic power and the RMB has to be internationalized."¹⁹ But for reasons as much political as economic, nothing like Japan's Big Bang has ever been mooted. In their typically cautious manner, the authorities prefer to move only gradually to widen use of the yuan.

In 2005, for example, multilateral agencies such as the Asian Development Bank and International Finance Corporation (a subsidiary of the World Bank) were authorized for the first time to issue yuan-denominated bonds inside China. The so-called Panda bonds, it was hoped, would encourage greater use of the RMB as a borrowing vehicle. Two years later, domestic borrowers were given permission to issue RMB bonds in Hong Kong, with the aim of broadening the range of potential buyers as well. Steps like these are essential if the yuan is ever to attract significant international interest. At the present pace, however, it clearly will be many years before any kind of serious challenge to the dollar can be mounted.

Fragmentation

In short, prospects for the dollar may be discouraging (barring significant policy reforms in the United States), but the outlook for any of the greenback's main competitors appears little better. Neither the euro in Europe nor the yen or yuan in Asia seem ready to seize the dollar's mantle. Rather, a much more fragmented system appears in the offing, with much competition and no money clearly dominant. For years to come, the world will have to learn to live with a leadership vacuum at the peak of the Currency Pyramid.

Cooperation?

The dangers of fragmentation are clear. Without some form of leadership to assure a minimal degree of compatibility among national policies, the global

¹⁹ Li Daokui, "Internationalization of the RMB to Be Accelerated" *People's Daily Online*, 2006, <http://english.people.com.cn/other/archive.html>.

monetary system will be at constant risk of instability or worse. Among public agencies there is no "invisible hand" to assure mutually beneficial outcomes. Decentralized decision making among sovereign governments without some manner of coordination is potentially a recipe for disaster.

To be sure, a leaderless currency system would not necessarily be a bad thing. Some have argued it could even turn out to be an improvement. Few knowledgeable observers doubt that the greatest threat to monetary stability today is to be found in America's mammoth payments 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, America would finally be forced to curb its appetite for foreign savings, lowering the risk of crisis. As C. H. Kwan puts it, "The emergence of international currencies that compete with the dollar may help impose discipline on the economic policy of the United States by rendering the international environment less forgiving of its mistakes."²⁰

Much depends, however, on the kind of relationship that develops among the competitors. The last time that the world was obliged to live with a leaderless 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. As Charles Kindleberger wrote in his classic *The World in Depression*, "The international economic system was rendered unstable by British inability and United States unwillingness to assume responsibility for stabilizing it."²¹ Can we expect better this time around?

Optimists might emphasize how much conditions have changed since the interwar period. In contrast to the years after World War I, an array of multilateral organizations and forums have developed to institutionalize cooperative practices, from the International Monetary Fund to the Group of Seven. Past experience has provided some pointed lessons about the costs of unbridled competition. Governments have a much better sense of where their enlightened self-interest lies. A system lacking a single dominant leader, therefore, might not lack for effective leadership if the principal players can learn to work together for the common good.

Monetary cooperation, however, is notoriously difficult to sustain, as I have suggested previously.²² The issue is monetary autonomy, which govern-

²⁰ Kwan 2001, 7.

²¹ Kindleberger 1973, 292.

²² Cohen 1993.

ments greatly prize for its importance to domestic economic management. In times of crisis, when the benefits of coordination take precedence, governments may for a time be willing to enter into significant policy compromises. But once a sense of threat subsides, the desire to maintain control over domestic monetary conditions tends to reassert itself, encouraging defection. Despite the lessons of the past, cooperation among sovereign states tends to be episodic at best, with commitments ebbing and flowing like the tides.

Moreover, this time there are not just two major players involved, as there were after World War I, but as many as four. Worse, one of the four, the EMU, has still not resolved the issue of external representation; while two others, Japan and China, are in open contention for monetary influence in their regional neighborhood. In these circumstances, the probability that effective joint leadership could be successfully cultivated seems decidedly low.

Leadership Struggle

Much more likely is a heightened struggle for leadership. Rational policymakers understand the benefits of widespread international use of a currency. The United States may be expected to resist any compromise of the greenback's historical dominance. The contenders in Europe and Asia may be expected to make every effort to defend or enhance the status of their own monies. Life at the peak of the Currency Pyramid will undoubtedly be tense.

But will it be dangerous? That depends on how aggressive policymakers choose to be in promoting their respective monies. As I have noted elsewhere, a critical distinction must be drawn between two different kinds of leadership aspirations: *informal* and *formal*. Much rides on the difference.²³

Informal leadership refers to dominance among *market* actors—the scope of a currency's use for private market purposes. At this level, a competitive struggle may be said already to exist, operating through what Helleiner (chapter 4) calls the “indirect” channel of political influence. In the EMU as well as in the two Asian contenders, public policy is already actively engaged in trying to improve the appeal of the dollar's rivals, particularly via financial market reform; in defensive reaction, the United States will do what it can to sustain the popularity of the greenback. The consequences of an informal leadership struggle, however, are apt to be largely benign, since governments take this sort of contestation very much in stride. Rivalry to promote or sustain each currency's competitiveness can be regarded as a natural feature of a decentralized monetary system based largely on market principles. The global

community might even benefit if the result is lower transactions costs and more efficient capital markets.

But what if the players elect to go a step further, to seek to alter the behavior of *state* actors—what I term formal leadership? This option corresponds more closely to what Helleiner describes as the “direct” channel of influence. The aim here is alter currency choices at the official level: to induce governments to switch to a different reserve currency or perhaps even to adopt the foreign currency domestically in place of their own national money (“dollarization”). The result, ultimately, would be the formation of organized currency blocs, not unlike the old sterling area that coalesced around Britain's pound in the interwar period. The world would face the “new geopolitical reality” of a “variety of regional systems” that David Calleo (chapter 8) predicts.

As in interstate relations generally, tactics in a formal leadership struggle in monetary affairs may involve either coercion or persuasion, depending on circumstances. Currencies might be directly imposed on client states in a manner similar to what Susan Strange meant by a “Master Currency.”²⁴ In the language of Jonathan Kirshner, countries could be threatened with *enforcement* or *expulsion* if they do not align themselves monetarily—a threat of sanctions, say, or a withdrawal of past commercial or financial privileges. Alternatively, attractive inducements of an economic or political nature might be offered to reshape policy preferences in manner analogous to Strange's notion of a “Negotiated Currency”—what Kirshner describes as *entrapment*.²⁵

Whatever the tactics used, the consequences for the global monetary system could indeed be dangerous. In a formal leadership struggle, by definition, competition becomes more overtly politicized and hence less easy to contain. Economically, increasingly antagonistic relations could develop between mutually exclusive groupings, reversing decades of multilateral liberalization in trade and financial markets. Politically, currency rivalry could become transformed into serious geopolitical conflict.

Many observers discount the probability of a formal leadership struggle, pointing to the evident perils involved. Any efforts to alter currency choices at the state level would imply a cutback of dollar accumulations, which in turn could lead to a sharp depreciation of the greenback, causing massive losses on existing reserve holdings. Would governments truly risk such self-inflicted wounds? To avert a doomsday scenario, it makes more sense for state actors to support the greenback—or, at least, not undermine it—whether they like it or not. Optimists see this as nothing more than enlightened self-interest.

²⁴ Strange 1971b.

²⁵ Kirshner 1995.

²³ Cohen 2004.

Others, however, see it as more like the notorious balance of terror that existed between the nuclear powers during the cold war—a “balance of financial terror,” as former treasury secretary Larry Summers has described it.²⁶ A fear of mutually assured destruction is surely a powerful deterrent to overtly destabilizing behavior. But fear cannot rule out the possibility of miscalculation or even mischief by critical players. As Kirshner (chapter 9) points out, today’s challengers for currency supremacy, unlike in earlier years, are not all political allies of the United States bonded together by the glue of the cold war; indeed, one of them, China, is deemed America’s greatest potential adversary. In fact, the balance of financial terror is inherently unstable and could conceivably break down at any time.

Battlegrounds?

Will the balance break down? Prediction is hazardous, of course (particularly, as the joke goes, when the future is involved), and a doomsday scenario can hardly be excluded. But I am less persuaded than some observers, such as Kirshner, that the wolf is actually at the door, ready to wreak systemic havoc. Certainly the foundations for a confrontation over formal leadership are in place, suggesting that a threat somewhere, at sometime is possible. There seems little reason to worry in the Western Hemisphere, where a dollar bloc has effectively existed for some time; there, the greenback remains largely unchallenged. Nor do many question the euro’s increasing dominance in the EMU’s European hinterland as well as in much of Africa. But elsewhere room does indeed exist for serious clashes, though my expectation is that in the end most risks will be held in check by broader geopolitical considerations. The greatest dangers are to be found in the Middle East and East Asia.

Middle East In the Middle East, where the greenback has long reigned supreme, Europe could be understandably tempted to seek a greater role for the euro.²⁷ With its concentration of wealthy oil exporters, the region would seem a prize well worth fighting for. At the moment, the U.S. dollar is not only the standard for invoicing and payments in world energy markets; it also accounts for the vast majority of central bank reserves and government-held investments in Middle Eastern countries. Overall, however, the region’s commercial ties are far more oriented toward Europe—a disjunction that many Europeans find anomalous, even irrational. Repeatedly, the question is asked:

Would it not make more sense for the area to do business with its largest trading partner, Europe, in Europe’s own currency rather than the greenback? And if so, would it not then make sense to switch to the euro as a reserve currency as well? Europe is well placed to make the Middle East a currency battleground.

Certainly, the possibility of a switch to the euro is tempting from a European perspective. Displacement of the dollar might go far to restore a measure of Europe’s historically privileged position in the region. Arguably, the prospect might be tempting from the perspective of Middle Eastern governments, too, for sound economic reasons as well as to curb the presently overweening strategic influence of the United States. It is well known that from time to time oil exporting states have actively explored alternatives to the dollar, only to be discouraged by the lack of a suitable substitute. Now, with the arrival of the euro, they see the possibility of a truly competitive rival for their affections. Talk of a switch to the euro (or to a currency basket heavily weighted toward the euro) has been particularly intense lately as a result of the greenback’s most recent bout of weakness. Should Europe seek to capitalize on the dollar’s travails, directly promoting use of the euro by regional governments, it might find itself pushing against an open door.

Any effort along these lines, however, would surely provoke determined opposition from the United States, which has long linked the region’s use of the dollar to broader security concerns. For Washington, there is no higher politics than the Great Game being played out today in the energy-rich Middle East. America needs both the region’s oil and continued support for the greenback; regional governments, in turn, need protection against enemies both within and without, which Washington has promised under a series of unwritten understandings dating back to the first oil shock in the 1970s. With so much at stake, the level of U.S. tolerance for a formal currency challenge from Europe would be correspondingly low, making geopolitical conflict a virtual certainty.

Indeed, for some observers, the conflict has already begun. Theories abound that America’s 2003 attack on Iraq, following as it did shortly after Saddam Hussein’s decision to demand payment in euros for Iraqi oil exports, was motivated above all by a desire to sustain the dollar’s role in the region. Though the idea is wholly unsubstantiated by plausible evidence, as Kirshner (chapter 9) notes, one need not be a sensationalist to recognize the seeds of truth that it contains. A battle of currencies in the Middle East could get nasty.

Would Europe risk it? In the end, however strongly tempted, the Europeans are more likely to keep their aspirations in check, averting direct confrontation with Washington. Even after the Bush administration’s decision to pro-

²⁶ Summers 2004.

²⁷ Cohen 2006.

mote "regime change" in Iraq, there is no consensus among Europeans to risk the broader political and security relationship that they have long enjoyed with the United States. Beyond their currency's natural home in Europe's immediate neighborhood, therefore, they will most probably act with restraint. Maneuvering for advantage in the Middle Eastern region will undoubtedly persist. But the euro's challenge to the dollar is unlikely to be allowed to get out control.

East Asia In East Asia, where both Japan and China continue to aspire to regional leadership, it is easy to imagine a three-way contest developing between the greenback, still dominant for now, and its two regional counterparts, the yen and yuan. Here also the U.S. dollar still accounts for the vast majority of central bank reserves and government-held investments. Hence here also there is much room for a vigorous campaign by either Tokyo or Beijing to promote a greater role for its currency at the greenback's expense. Japan, despite recent disappointments, has by no means given up on its Asian strategy for the yen, while China, taking the long view, clearly has committed itself to a policy of gradual internationalization of the RMB. These countries are well placed to make their neighborhood a currency battleground, too.

Determined opposition from the United States must be expected here as well, given America's long-standing security interests in the region. Much is at stake here, too. Washington has long enjoyed an impressive ability to project power in East Asia, based on an extensive network of military bases and alliances as well as deep commercial and financial ties. For decades America has in effect played the role of sheriff in the area, preserving a degree of stability among unfriendly, even hostile neighbors. More recently, Washington has also aimed to contain the rise of China as a potential global rival. To a significant degree, all this has been made possible by the unquestioned acceptability of the dollar, which allows the United States to spend whatever it feels it needs to promote its policy ambitions. Washington is hardly likely to take any challenge from the yen or yuan lying down.

In the case of the yen the risk is actually quite modest. That is because of America's decades-old defense alliance with Japan, which neither Washington nor Tokyo would wish to jeopardize. Like the Europeans, the Japanese are most likely to keep their aspirations in check rather than confront the United States directly. Ever since World War II, Japan's foreign policy has involved a delicate balancing act, seeking to play a leadership role in East Asia while also keeping the United States engaged in the region as a counterweight to China. Tokyo has no interest in seriously alienating its most powerful ally for the sake of a putative yen bloc.

In the case of the yuan, by contrast, the risk is greater. That is because of China's evident superpower aspirations, which color every dimension of Beijing's relationship with Washington. China has already gained a great deal of clout throughout East Asia as a result of its rapid economic growth and shows every sign of intending to reclaim what it regards as its rightful place as the dominant power in the region—a strategy that we know includes a wider role for the RMB. Given its limitations, the yuan is clearly unready to replace the dollar as yet. On the other hand, with Beijing's enormous dollar accumulations that could be diversified at any time, the Chinese do have the means to undermine the greenback should they so desire. The question is: Would they so desire, knowing that they could themselves suffer massive losses in the process? The answer ultimately will depend on broader trends in Sino-American relations, which cannot be predicted in advance.

Prospects

Prospects for the future, therefore, are clouded at best. A weakening dollar is unlikely to be replaced by any other single currency. The outlook, rather, is for a more fragmented currency system, with three or four monies in direct competition in different parts of the world. Sustained cooperation among the major players is unlikely, except in the event of a serious crisis. Much more probable is a prolonged leadership struggle, particularly in such contested regions as the Middle East and East Asia, though for the most part there seems little risk of an escalation into outright geopolitical conflict. Once again, as during the long interregnum following the start of sterling's decline, it could be decades before the final outcome becomes clear.