

The Hegemony of the US Dollar

Written by Luke Springthorpe

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LUKE SPRINGTHORPE, APR 8 2013

Over recent years, the debate surrounding dollar hegemony has faced a renewed revival in a manner that ties in with broader speculation about the future of the USA's global role. Not since Robert Keohane's "After Hegemony" (1983) has the debate been quite as lively academically.

Of late, the spotlight has increasingly focused on the continued role of the dollar in global finance. There are those, such as Barry Eichengreen, who have speculated the dollar's "reign is near an end". The case for why this may actually be beneficial has gained traction since a UN report which sought to make the case for an overhaul to the global reserve system.[1] They are by no means in a minority. I argue, however, that there is reason to believe that there are important considerations relating to both governance and the strength of US institutions- both governmental and financial- that mean the end of the dollar's crucial role in the global financial system may not be as imminent as some are forecasting.

This is, of course, a discussion that is intertwined with considerations regarding the future of broader US influence. In this article, I shall consider the key conditions that have maintained dollar hegemony, and criteria to be met by any challengers who may seek for their own domestic currency to enjoy what is coined the "exorbitant privilege"[2] of reserve currency status.

There is little doubt that the outcome of any transition from dollar dominance would be significant, and would represent a wider shift in the balance of power. With international goods and commodities priced in the dominant reserve currency, the US dollar, the movements of other currencies relative to the reserve currency have a very real impact. The 2008 decline in sterling against the dollar[3] highlights exactly this. A bout of inflation followed, putting upward pressure on a whole range of commodities, the most important being food and petrol. If the value of the domestic currency isn't what concerns the majority of citizens, you can bet that the cost of a basket of commonly purchased goods is.

So, what makes a currency 'dominant' as a reserve currency and what exactly is it used for? In the reserve sense, we only consider how much of a given currency (or denominated assets) sits in the vaults of central banks. In a wider respect, however, it would also include the currency which international companies predominantly use to price their exports, and the currency which the majority of commodities are priced in. In each of the aforementioned, the US dollar is still very much the most significant currency and accounts for approximately 62% of official foreign exchange reserves- up from 59% in 1995.[4] What is also striking is that although the US only accounts for approximately 15% of global trade[5], the dollar accounts for 84.9% of daily foreign exchange transactions.[6] The reason being that almost all intra-state trade for goods be it oil from OPEC states, or wine exports from Chile sold to Japanese buyers, the transaction is likely to be completed in dollars. All this is despite over a decade of forecasts over its demise; it was previously hypothesised the Euro would replace the dollar- or at least achieve equal status, for example.

The reasons for the dollar's continued dominance, despite a financial crisis in 2008 and a ballooning deficit are a textbook case study of political economy.

First and foremost, there are the economic factors that contribute to continued dollar hegemony. Perhaps most significant is the fact that the USA has by far the largest and most liquid market for the assets denominated in its

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currency. The debt issuance by the US Treasury is substantial, meaning there are plenty of Treasury Bills and other 'risk free' assets which can be held by foreign central banks (thus solving the so-called Triffin Dilemma[7]). Whilst the Eurozone has a similarly large economy, it has no asset that is similar in its nature to US Treasury stock; that is, mutually guaranteed by the entity as a whole, rather than just a single member state. While Euro denominated assets are plentiful, their quality varies from one member state to another.

The dollar is also complemented by the sheer size of the US economy. The USA remains the world's largest economy and imports vast quantities of goods. As such, those wishing to sell their goods to the USA will have to do so on the terms of US companies, part of which is likely to mean invoicing in dollars. The US also has the benefit of better growth prospects over most of Europe, and a more open economy than China in a number of important regards. Both of these factors combined ensure the USA is still seen as the most attractive large economy for investors. It also means US assets are easily tradable and have lower bid-ask price spreads.

Politically, the comparative stability of the USA is also a contributing factor. Even in the face of a recent downgrade, US Treasury Stock still commands a large degree of confidence in the market given its long and unblemished track record. Those investing in other dollar assets can also be assured that any US assets are unlikely to be unfairly seized by the state or affected by uneven enforcement of the law.

Historic events were also significant in establishing the dollar as a global currency. The security guarantees and reconstruction aid the US offered to Europe & Japan in the post-war period were pivotal in ensuring these nations played ball when it came to financing the US deficit further down the line. The dollar was also effectively enshrined as the reserve currency in the post-war Bretton Woods agreement. Although of little significance today, it was of importance in formally recognising the dollar's supremacy and formally bringing an end to sterling's international role.

One also shouldn't underplay the role of strong US financial institutions. This doesn't just mean banks. The well regulated commodities & futures exchanges and clearing houses ensure that large chunks of global financial flows will still pass through the US, regardless of its origin and final destination. They will also allow investors in US assets to hedge their exposure for a vast array of transactions.

So, what of the challengers to the dollar's status? We can largely discount the possibility of the Euro replacing the dollar as a reserve currency held by central banks, unless it was to expand further to include new member states and to centralise its powers further, particularly with regards to fiscal policy. Recent events offer little encouragement that either is likely- at least in time for the Eurozone to mount a timely challenge to its other challenger, the renminbi.

So that leaves China's renminbi as a challenger. How likely then is it that the renminbi will replace the dollar in the future, and when might it occur?

For China, it is not simply a case that the moment it becomes the world's largest economy its currency will become the reserve currency of choice. It will still have a few crucial hurdles if it has ambitions to surpass the dollar in this regard.

Most importantly, China will actually need the desire to hold reserve currency status and properly internationalize its economy. This moment will come when it transforms from a mercantile economy that artificially manages its currency and exercises certain capital controls to a more open consumer society. It must also be prepared to tolerate the financial inflows that will create upward pressure on the value of its currency without resisting the appreciation by trying to induce inflation. Most importantly, it must also become a debtor to allow its highest grade and most liquid debt to be widely held internationally.

Politically, China must also make difficult decisions that would open up its economy, lifting restrictions on foreign investment and move to full capital account convertibility. This would effectively entail lifting capital controls and restrictions on foreign asset purchases – moves that will have an impact on Chinese society and cause friction domestically in the short term. It's hard to see China's Communist Party hitting the constituents that would be affected (such as manufacturers) at the risk of losing its iron grip on power. Such moves will therefore either be very

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gradual, or require a democratic mandate. In a similar vein, it would also need to allow its currency to become fully convertible and freely traded.

Beyond this, China must take advantage of events that unfold, similar to how the US did in the post-war upheaval. This will involve flexing its muscles and increasingly intervening across the globe. Just as the US rebuilt Europe and Japan with dollars, China must aid development in the developing economies in renminbi, embedding its currency in the relevant financial sectors in the process. Such moves will no doubt arouse suspicion and competition is likely – not least from other emerging powers such as Brazil & India.

The date of 2050 has been bandied about by market commentators about for the renminbi to replace the dollar. In reality, there is little point placing a hard and fast date to such a change. It is more a case of certain criteria being met once China does become the world's largest economy – something it will achieve this decade. Econometrics aside, political events are likely to be of far greater significance in determining the pace at which renminbi internationalises.

As already alluded to, it isn't just a single characteristic that makes a currency a "Reserve Currency" with central bank holdings just one part of the picture. Changing the currencies in which major commodities are traded is likely to be a more significant process that would be fraught with tension given its symbolism. Such a move would also have significance for US multinationals, which would increasingly have to spend resources hedging against currency volatility.

When and how these events unfold remains to be seen. Political developments may well lag the economic developments, which could affect the pace of change. One thing we can say is that just as other international currencies have faced their curtain call throughout history, time will also be called on the dollar's reserve status. It only remains to be seen how graceful its bow will be.

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[1] United Nations Conference on Trade and Development, "Trade & Development Report: Reform of the International Monetary & Financial System, Chapter IV", 2010

[2] Barry Eichengreen, "Exorbitant Privilege: The Rise and Fall of the Dollar and the Future of the International Monetary System", 2010.

[3] The Telegraph, "Value of pound falls to 28-year low", December 2008, <http://www.telegraph.co.uk/finance/financialcrisis/3703632/Value-of-pound-falls-to-28-year-low.html>

[4] International Monetary Fund, "Currency Composition of Official Foreign Exchange Reserves", 2011. <http://www.imf.org/external/np/sta/cofer/eng/cofer.pdf>

[5] The CIA World Fact Book 2012, based on total exports and imports. <https://www.cia.gov/library/publications/the-world-factbook/rankorder/rankorderguide.html>

[6] The Bank for International Settlements "Triennial Central Bank Survey: Report on global foreign exchange market activity in 2010", 2010 Page 12, <http://www.bis.org/publ/rpfx10t.pdf>

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[7] Robert Triffin, "Gold and the Dollar Crisis: The future of convertibility", 1960

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