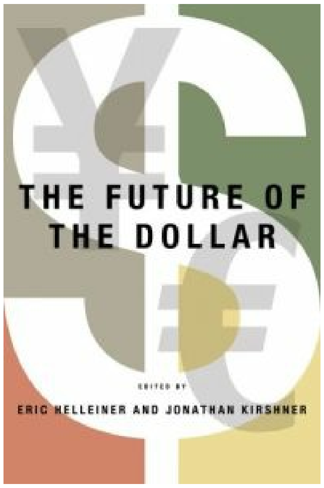

Book The Future of the Dollar

Eric Helleiner and Jonathan Kirshner (Eds.)
Cornell UP, 2009
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Recommendation

The dollar is dead; long live the dollar. That's the message from this insightful look at the greenback's future as the world's reserve currency. Edited by Eric Helleiner and Jonathan Kirshner and including essays by half a dozen other academics, this overview plays out as a polite debate among professors. They offer useful historical and economic perspectives that will help readers understand the forces that make one currency a winner and another a loser. With a variety of contributors, however, the study suffers from a good deal of repetition of background material from one essay to the next, and an unevenness in writing styles that veer from clear to cloudy. While the book promises a spirited debate between "dollar optimists" and "dollar pessimists," a close reading reveals that most of the contributors tend to fall into both camps simultaneously. *BooksInShort* recommends this book to readers seeking an erudite review of the US dollar's past, present and future in world currency markets.

Take-Aways

- The 2008 financial crisis has renewed a decades-old debate about the US dollar's role as the world's dominant currency.
- The US's huge economy, vibrant capital markets, robust growth and political stability have ensured the dollar's prime position.
- The greenback still acts as "a medium of exchange" for most international trade.
- International investors consider the dollar "a store of value" for investment purposes.
- Nations that link their own currencies to the dollar use it as "a unit of account."
- The euro, the dollar's most obvious rival, presents a qualified test to dollar hegemony.
- The Japanese yen and the Chinese renminbi may battle for regional dominance in Asia.
- Intriguingly, the dollar gained against most other currencies during the financial crisis.
- No single currency is likely to replace the dollar entirely, which will coexist alongside other major currencies.
- This "leadership vacuum" could lead to currencies battling for financial supremacy.

Summary

Another Day, the Same Dollar

Is the US dollar on the verge of a permanent decline? Will the euro or another currency surpass the almighty dollar to become the world's reserve currency? Those questions gained particular urgency after the 2008-2009 US-led global recession. While no clear answer yet has emerged about its staying power, predictions of the dollar's demise are nothing new. Since the 1960s, skeptics have anticipated the greenback's tumble from the top, but the dollar hasn't given up its pole position among global currencies quite yet. Consider that it serves on one side of 86% of all foreign exchange transactions, compared to the euro's 37% and the yen's almost 17%.

> "The greenback has provided the monetary foundation for the international economy and its worldwide role has both reflected and reinforced America's

global pre-eminence."

The dollar's popularity arose for a number of reasons: The US is the world's largest economy, and its traditionally vibrant capital markets, robust growth and political stability have made the dollar an easy choice for most favored currency. The greenback acts as "a medium of exchange" for transacting international business, as "a store of value" for investment purposes and as "a unit of account" to which other nations can link the values of their own currencies.

> "The primary attraction of the United States as a destination for capital movement is the unique depth of its markets...and the political and security position of the country."

The US government gains from issuing the world's most viable money. Foreigners who own dollars, either as Federal Reserve notes or US Treasury securities, essentially offer the US an interest-free or low-interest loan. For private sector firms in the US, the dollar's stability reduces exchange rate risks. In the public sector, the dollar's prominence helps the US finance its deficits. The dollar's key role becomes self-perpetuating: Investors and traders find it easy to use dollars because everyone else uses them, too.

> "The US dollar will be the major international currency as long as the United States remains the world's largest concentration of political and military might as well as of economic potential."

Intriguingly, even the global financial panic of 2008 couldn't displace the dollar. Demand for US Treasury securities was so strong then that yields fell to nearly zero. Evidently the dollar remains the ultimate "safe haven": During the crisis, the dollar gained against most major currencies, climbing 25% against the euro; only the yen rose compared to the dollar.

Thumbs Up, Down and Sideways

Experts pontificating on the future of the dollar fall into three schools of thought: the "dollar optimists," the "uncertain" and the "dollar pessimists." The currency's fans say it will continue its dominance because American economic power will stay strong while inflation remains in check. For the dollar to sustain itself, it must remain attractive, based on "confidence and liquidity," compared to other currencies. While few predict a sudden collapse of the US currency, most dollar pessimists anticipate a fairly steady decline. They forecast that US debts and deficits will affect monetary stability; growing inflation and depreciation of the US economy could lead traders and investors increasingly to turn from the dollar as the markets' main exchange mechanism. Those who remain uncertain take a middle-of-the-road stance, weighing both sides of the argument. Yet all three schools agree that the dollar's place at the summit could be under threat.

> "If the dollar was not playing this invaluable role in today's international economy, the markets would have chosen some other national money to be the world's key currency."

With the dollar's role so prominent, critics in other nations long have targeted what they see as US irresponsibility and profligacy. More than 40 years ago, French president Charles de Gaulle called the US government's deficit spending "poor management"; he chastised the US's "exorbitant privilege." And while popular opinion holds that Americans' "conspicuous consumption" causes the US's current account imbalance, in fact more spending goes primarily to cover rising costs for education and health care than to big cars and luxury items. Recent concerns about the dollar have centered on America's growing reliance on China both as a trading partner and an investor. China has emerged as the US's largest creditor, with unbalanced trade between the two nations. Worries over US deficits and mounting debt lead the world to consider which currency might take on the dollar's current role.

A Replacement for the Dollar?

If the dollar were to slide out of the spotlight, which currency would replace it? The euro has emerged as a credible competitor, thanks to Europe's cautious management of its currency. The Maastricht Treaty constitutionally mandates the region's conservative monetary approach. The relatively new euro-denominated government securities also have the potential to compete with US Treasury bonds as reliable storehouses of capital.

> "China is the largest creditor of the United States, nervously holding huge stocks of dollar claims."

The euro faces challenges, however, including a rocky relationship between the European Union (EU) and the European Central Bank (ECB), and a patchwork of country-by-country financial regulation. Strict labor laws, rigid rules and a quickly graying populace all conspire against growth in European economies, while the ECB's charge is to fight inflation, not to stimulate growth in employment and business. Euro securities – a hodgepodge marked against "the German Bund at ten years, the French bond at five years and the Italian bond at two years" – still are weak competitors to the handily liquid US Treasury bill. The Maastricht Treaty's failure to specify exactly how the EU should respond to financial crises strikes another blow against the euro.

> "As amazingly robust as the dollar standard under stress seems to be, the United States has been gravely weakened in its ability to mount a countercyclical policy to offset the global recession."

Although finance experts consider it a long shot, the yen could be in contention to usurp the dollar, because Japan enjoys political stability, low inflation and a large economy. Financial reforms, which began in the 1990s, opened up the Japanese financial system, but the nation's low growth, aging population and huge public debt have tempered the yen's chances to serve as the world's reserve currency. Its usage in foreign exchange transactions dwindled from 27% in 1989 to less than 20% in 2004, reflecting the yen's tapering influence. At best, the yen could work as an Asian regional currency.

> "Housing turbocharged the US economy and in turn bolstered the dollar's position."

Despite China's soaring economic power, the renminbi (which means the "people's money") is not in the running to become a global currency for at least the next few decades. The country's embryonic economic infrastructure, its limited protections for creditors and its strictly regulated currency flows all impede the renminbi's acceptance in global money markets.

The Housing Market and the Dollar

The price of a US home, on the surface at least, seems irrelevant to the fluctuations of the world's dominant currency. After all, money is "universal, abstract, [and] delocalized," while a house is "local, material and specific." But the US housing market has been an important factor in the dollar's value for almost two decades. From 1991 to 2005, low interest rates allowed the US mortgage market to create an above-average rate of economic activity. That engine of growth propelled the US dollar to even greater prominence as more investors and traders clamored for dollars and dollar-denominated assets. The more-restrained mortgage markets in Japan and Europe, on the other hand, generated less robust growth than the US.

> "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."

If Europe and Japan's economies could advance faster than the US's, the euro or the yen might take a run at displacing the dollar from its top spot. But in 2008 and 2009, Europe and Japan saw even weaker growth than the US did, and Europe didn't escape the effects of the mortgage meltdown and bank failures. As long as the US performs relatively better than Europe or Japan, the dollar probably will "muddle through" the aftereffects of the housing crash.

A Currency Oligopoly?

The recent global currency environment bears some resemblance to that of the pre-World War I era, in which Great Britain – then the world's dominant economic power – faced challenges from the US and Germany. The pound sterling gradually ceded its position – first to gold and then to the US dollar. But for many years, the greenback and the pound coexisted as the top currencies. Indeed, as late as 1965, the pound still accounted for 20% of global monetary reserves; that share now has dwindled to 5%.

> "With the rise of China and the growth of the euro, we may now be moving toward a competitive oligopoly."

The US's abrupt burst of economic activity prior to the 1930s, fueled by machine and worker productivity, parallels that of the latter-day emergence of the BRIC nations, Brazil, Russia, India and China. These nations pursue a largely mercantile agenda, placing them as major trading counterparties to the US and thus contributing to the dollar's continued importance. None of the BRIC currencies pose an imminent threat to the US dollar.

> "Nothing enhances a currency's acceptability more than the prospect of acceptability by others."

An oligopoly consisting of the euro and the dollar is most likely to unfold in foreign exchange markets over the next several decades. Because the US buys 15% of the world's imports but sends out only 7% of the globe's exports, the dollar will continue to play a major part. It still makes up two-thirds of all the world's currency reserves, followed by the euro, which accounts for less than one-third. China remains a key player to watch: Its foreign currency reserves include $1 trillion. China began switching out of dollars into euros in 2002, a course it ended in 2004.

"A Leaderless Currency System"

Dollar pessimists, who posit that the dollar's position clearly is weakening, recognize that even if the dollar is toppled from its summit, another currency is unlikely to eclipse it wholly. Just because the dollar is lagging doesn't mean that another currency is poised to take its place.

> "In effect, Americans have outsourced their saving to the rest of the world."

Legal tender that aims to become a global reserve currency must maintain its purchasing power and have at its back a nation that is politically and economically stable. The currency must be liquid, convenient and widely used. All these factors create "stickiness": Once a currency becomes the top choice, inertia works to keep it in place. The dollar's dominant position in so many areas – trade, capital markets, bank reserves – illustrates that stickiness. So the dollar is unlikely to drop off the currency map suddenly; it's more apt to enter a long, gradual decline.

> "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."

In that scenario, a "fragmented" scheme occurs, in which the dollar loses some of its luster and the euro gains momentum. The absence of a single hegemonic currency could create a "leadership vacuum," resulting in financial uncertainty and economic struggle. The Middle East is one obvious battleground: Countries there conduct oil transactions almost entirely in dollars, even though the region maintains closer commercial links with Europe. Leaning on Middle Eastern countries to use euros in place of dollars in Europe-directed trade would give the EU currency a huge boost but would invite US resistance. And geopolitics could creep into the currency wars, if it hasn't already done so. For example, in 2003, Saddam Hussein insisted on receiving payment in euros for Iraqi oil exports. Some say the US's subsequent invasion of Iraq had much to do with retaining US dollar hegemony in the region.

> "Dollar diminution would significantly affect international power politics...by presenting new and underappreciated restraints upon American political and military predominance."

In East Asia, meanwhile, the dollar, the yen and the renminbi are likely to fight for top billing in the region. No matter how these battles play out, decades will pass before a clear winner emerges. Japan's interest in furthering the yen comes up against its need for American military protection, particularly against China. Meanwhile, China could force out the dollar if it chose to do so, but it risks damaging its own American investments should the dollar decline precipitously.

Dollar Power

Since the 1960s, the US military's pursuit of geopolitical goals gave the rest of the world an incentive to keep the dollar strong. Amid Cold War threats, nations under the US umbrella believed buying dollar assets was a small price to pay for US protection. With this fiscal wind at its back, the country's politicians became "addicted to managing the world." With the fall of the Soviet Union, however, the US turned away from large-scale military incursions and used its "peace dividend" to promote productive investment in technology, driving down its deficits. But post-September 11, 2001 military expenditures soon outpaced those of the Cold War, and armed forays, along with spending on social services, again drove the US into massive deficits.

The standard prescription for what ails the US would be more saving and less borrowing, but that medicine would come at the expense of robust growth and military might. Europe's more disciplined approach to monetary policy could serve as an example for the US. Europe is less likely to become engaged in military conflicts because it lacks the resources to do so. US spending is nothing new, but now the dollar's support has weakened: The fall of the Soviet Union and the up-and-coming euro may have paved the way for the dollar's decline.

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