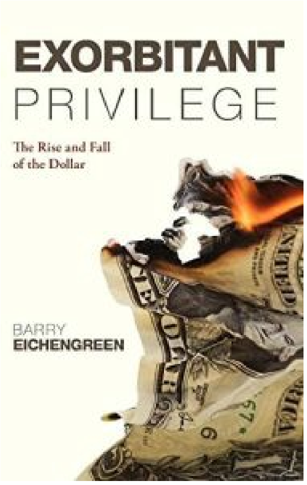

Book Exorbitant Privilege

The Rise and Fall of the Dollar

Barry Eichengreen
Oxford UP, 2011

Recommendation

Professor Barry Eichengreen's exploration of the dollar's reserve currency role could be merely an interesting history of currencies and repositories of value – from wampum and whelk shells to credit default swaps – all mapped out from Bretton Woods to the Maastricht Treaty to China's looming role and beyond. But Eichengreen accounts for more than history as he expertly guides readers through the maze of the international monetary system. *BooksInShort* finds that unresolved issues in world markets give this exposition considerable contemporary bite. Eichengreen argues solidly that the threats to the dollar's international reserve status are real enough, but says all signs are that the dollar will endure as the first among rivals, even if other regional kingpins arise. He seems to believe that, despite its various crises and challenges, the dollar will remain dominant – but, in the end, he ducks a definitive judgment and concludes that its fate is in American hands and not in those of the Chinese or other international competitors.

Take-Aways

- The dollar's world reserve currency status is an "exorbitant privilege" for the US.
- Everything could change. The 2008 financial crash damaged America's reputation for rectitude, economic stability and safe investment.
- Rivals who would like to take over the dollar's international reserve role are becoming more plausible as their growth rates outpace that of the US.
- The euro zone's GDP exceeds the US's, so the euro could emerge after the fiscal crisis.
- Yet as a currency with no country, the euro lacks stable central government control.
- China wants its renminbi to become an international currency by 2020, though it is doing little to act on that ambition.
- The proportion of the world economy in dollars unexpectedly kept rising after 2008.
- The mighty greenback will have to co-exist in future with regional rivals, but these rivals' flaws protect the dollar's role.
- A dollar crash with catastrophic results for the US and other countries is still possible.
- The US will need higher taxes, lower deficits and some belt-tightening to protect the dollar's supremacy, but at least its fate remains in US hands.

Summary

Advantage: US

In a scene in *The Counterfeiters*, a German film set just after World War II, the main character turns up at a casino with a suitcase of money. It contains neither French francs nor German marks, but dollars. Move forward 50 years to the thriller *City of Ghosts*, which features another hero carrying a ransom payoff in a suitcase. The scene is set in Cambodia, but the money is not in Chinese renminbi; once again, the suitcase is full of dollars. This neatly illustrates how enduring the dollar has been as the international reserve currency, not just in demand by Somali pirates and kidnappers everywhere, but also foremost in the hearts of the world's respectable financial leaders. So far at least, the 2008 financial crisis has not dented the dollar's status, though it tainted many US financial assets.

> "Jeremiads about American declinism notwithstanding, the United States remains the largest economy in the world...This may not be true forever, but [it] remains true now."

Many Americans may take the dollar's international role and importance for granted, not realizing that serving as the world's reserve currency is an "exorbitant privilege." Former French President Valery Giscard d'Estaing coined the phrase as finance minister when he became all too aware of the economic advantage this status gives the US.

> "A world of multiple international currencies is coming because the world economy is growing more multipolar, eroding the traditional basis for the dollar's monopoly."

Every trading country and company must use the international reserve currency: That is its potency. The arithmetic is very simple – almost magical. America's Bureau of Engraving spends practically nothing to print a $100 bill, but other nations have to provide $100 in goods and services to buy one. The process involves a massive transfer of value to the US. Foreigners hold around $500 billion in value, circulating outside the US. The Chinese surplus, held largely in dollars, is so great that it amounts to $1,000 for every person in the world's most populous nation.

> "The defeated [World War II] powers Germany and Japan were the most successful at exporting and acquiring dollars. Denied foreign policy ambitions, they focused on growing their economies."

Having the dollar as the international reserve currency has other advantages for the US, apart from being able to print $100 bills. Most commodities, notably oil and trade goods, are priced in dollars. The fact that other nations buy and sell in dollars, want dollars, and will pay for them, in effect saves the US money on its debt. That may be easier to understand if you note how the privilege works even for individuals: US tourists almost anywhere can simply pay for their purchases in dollars and avoid currency transaction costs. Pretty much everyone takes dollars.

Rival Currencies Remain at Bay

The dollar began to come to the fore in the 1920s on the back of an expanding economy and growing commerce. After a time, it gained the advantage of being the incumbent currency in widest use in international trade. Once a nation has the exorbitant privilege, it has a good chance of keeping it unless its financial authorities do something unpredictably stupid. Of course, the money has to perform. The UK's pound sterling lost its former international status and its role as a partial reserve currency due not only to the devastation of World War II but also due to its poor economic performance after the war.

> "The cheap finance that other countries provided the US...to obtain the dollars needed to back an expanding volume of international transactions underwrote the practices that culminated in the [2008] crisis."

Military power helps, of course, but an expanding economy, increasing exports and the output of an affluent population are the main factors that protect a currency's reserve status. So where is the US dollar's reserve status today? Once dominant, the US now accounts for only 13% of all the world's exports; China and Germany both now have higher export tallies. That is one reason that some commentators portray the dollar as being in a "death race" with its many rivals.

> "The United States is the source of less than 20% of foreign direct investment, down from nearly 85% between 1945 and 1980."

The possible replacement reserve currencies range from the euro and the renminbi to the International Monetary Fund's "special drawing rights," or SDRs (the IMF's reserve of supplemental international exchange assets). Other currencies in line include the pound sterling and the Swiss franc, while some experts still argue nostalgically for a return to gold as the standard of value. But as you examine these contenders one by one, they fall by the wayside.

> "The world for which we need to prepare is thus one in which several international currencies coexist. It is with this in mind that the euro was created."

Chinese authorities say they would like to see the renminbi become an international currency by 2020, but their behavior gives no sign that they are actually pursuing world reserve status. The renminbi will gain as a regional reserve currency because China's Asian trading partners will increasingly include it in their local transactions.

> "For the euro to rival the dollar as a global currency...attitudes toward sovereignty would have to change. Europe would have to move toward deeper political integration."

Despite its current headline-catching troubles, the euro has sufficient scale to rival the dollar. It accounts for around 37% of foreign exchange deals. However, the euro has a primary flaw: It is a currency without a country and therefore lacks stable central government control. As commentators often note, the nine countries that signed the initial euro treaty are not at the same stages of either development or indebtedness, as the current problems facing Greece, Portugal, Ireland and even Spain demonstrate vividly. In reality, the dollar will probably eventually have to share some of its primacy with the euro and the renminbi, but that is not unusual. The absolute dominance of a single currency is a phenomenon that began only in the mid-20th century.

> "The euro is fundamentally a political project."

Other potential rivals are less likely to challenge the dollar. The pound sterling and the Swiss franc do not have the scale to punch with enough weight in today's expanding global markets, particularly given the increasing number of nations starting to play a part in the international economy. And, at present, SDRs are just bit players in international finance, and that position is likely to continue. Nations can use SDRs to settle debts with the IMF and even to pay intergovernmental obligations, but since SDRs are not traded in commercial markets, their range is limited. Meanwhile, a return to gold as the world standard seems unlikely; governments have been heading in the opposite direction for more than 50 years.

> "This is its weakness since it explains how...the euro was created before all the economic perquisites needed for its smooth operation were in place."

The absence of an overwhelmingly plausible rival to the US dollar is important, but the US also has other powerful weapons in its currency armory, among which superior liquidity is the most notable. The market in US Treasury securities is unrivaled worldwide, and such liquidity attracts investors.

How the Financial Crisis Affected the Dollar's Reserve Status

The magic of being the reserve currency is profound. Because of that status, the US can turn bad economic news into good news. The dollar's market drop of around

8% in 2007 looked like an unfortunate development at the time. Yet US debts suffered no negative impact because they were in dollars. Americans' foreign investments generated more dollars in interest as offshore investors converted interest and dividends back into dollars at lower rates. Doing the math shows that the 2007 fall in the dollar actually improved the US's overall foreign financial standing by almost $450 billion. Even during the 2008 financial crisis, first marked by the collapse of Lehman Brothers, the dollar did not suffer a significant run.

> "But it is also its strength, since it explains...why the euro is likely to emerge from its crisis stronger than before."

The mighty greenback came through and still remains the preferred choice for international trade transactions. To state the dollar's dominance simply, about 85% of foreign exchange transactions include the dollar, and "it accounts for nearly half of the global stock of international debt securities." The dollar's current remaining advantages make the reserve currency death race look somewhat less than lethal. Yet those who have a high regard for reserve currency's status also value stability, and analysts have asked just how solid the US is after the 2008-2009 financial crisis. And, if it is sufficiently stable, how could such a crisis have happened in the first place?

> "As of mid-2009, 54 countries pegged to the US dollar, compared to just 27 to the euro."

During a period when marketing – and boasting about – US financial instruments as examples of integrity and reliability drew derision, some nations surely felt tempted to migrate to the dollar's competitors, no matter how flawed. Instead, something extraordinary happened: Despite everything, the dollar strengthened, not just against the euro but against other currencies as well. Optimists said that if the dollar could survive that crisis, it could survive anything. However, the risk was higher than it might have seemed because inadequate regulation was the real problem at the heart of this systemic failure, a problem that is hard to solve in a politicized environment.

> "The speed with which this world of multiple international currencies arrives will depend on the advantages of incumbency."

Credit ratings agencies, notably Standard & Poor's and Moody's, also have to accept their share of responsibility for the financial disaster. For example, by law, US pension funds can buy only investment-grade securities. The ratings agencies evaluated collateralized debt obligations (CDOs) before pension plans bought them to be sure they qualified as investment grade. But simultaneously, other parts of the same ratings agencies were earning good fees advising CDO originators how to structure the instruments to hit the investment-grade target. Was that a conflict of interest? The theory was that investors would assess their own comfort levels in terms of the degree of risk they took on, but the reality was that some buyers did not understand what they were getting. As long as the money flowed, markets enjoyed a riot of optimism. Few participants could imagine the worst or see what could go wrong. The system offers no incentives for caution.

> "In the black market, the dollar still rules." (*The Wall Street Journal*)

Another flaw emerged: The information investors and ratings agencies used to judge the risks of investments came from a time when housing prices were rising. These experts did not know what would happen when home prices started to fall. Perhaps someone with a sense of history could have realized that the optimists of the 1920s also believed that the Federal Reserve Board had control of the financial cycle, yet they were no longer around in 2008 and financial history teaches that what goes up must come down. Once the 2008-2009 crisis hit, market predictors turned on the dollar. They issued pessimistic currency forecasts, offering deep doom mongering that turned out to badly mistaken. The dollar emerged, not unscathed, but still the world's foundational reserve currency.

What Could Go Wrong?

The mighty dollar may have escaped this time, but circumstances loom when it could suffer a full-blown collapse – and so the question is, what would happen if there really were a collapse? Could overseas investors decide to get rid of their dollar holdings?

> "Forecasts are risky, especially when they involve the future."

For instance, serious political trouble between China and America could lead to the dollar's downfall. After all, Great Britain's Suez crisis destroyed the stable $2.80 exchange rate between the dollar and the pound sterling. However, such an outcome between the US and China is unlikely because the Chinese have too much to lose. China will not allow any crisis to reach a precipice because of the damage China itself would incur if it trashed the value of its vast dollar-denominated reserves and investments. China's self-interest protects the dollar.

If international politics don't lead to a dollar debacle, could market beliefs, high unemployment or protectionist policies do the trick? Could the dollar slide to a tipping point that would trigger a sudden collapse? The problem with this is the underlying assumption that the Federal Reserve wouldn't act in the face of potential disaster.

If calamity loomed, the Fed would actively buy dollars in the currency markets. Not even the most hard-nosed speculators would be that keen to take on the Fed. American budgetary policies also would greatly influence the health of the dollar. The US deficit reached its peacetime peak in 2009, and deficits that grow much larger could pull down the dollar just as they have undermined the economy of Greece and other nations.

Unless the US acts, federal spending could hit 40% of total national output within the next 25 years. The baby boom generation's retirement can worsen the outlook for the economy, unless the government acts quickly with tax increases and spending cuts. If foreign banks decided that they no longer wanted to hold the dollar as their reserve currency, Americans would face lower wages, and a greater demand for efficiency and tight budgets.

Constructing endless scare stories is easy. The reality will probably be very different. Eventually sharing the role of international reserve currency should only marginally affect America's geopolitical status, particularly if the US economy rallies to support that status. The dollar will crumble only if Americans do that degree of harm to themselves. Whether the US retains the exorbitant privilege is firmly in the control of the US, not China.

About the Author

Barry Eichengreen is a professor of economics and political science at the University of California, Berkeley, and the author of *Financial Crises and What To Do About Them* and *The European Economy Since 1945*.