Book reviews on global economy and geopolitical readings

ESADEgeo, under the supervision of Professor Javier Solana and Professor Javier Santiso.
Exorbitant Privilege: The Rise and Fall of the Dollar and the Future of the International Monetary System

Eichengreen, Barry (2011), New York: Oxford University Press

“It is not obvious why the dollar, the currency of an economy that no longer accounts for a majority of the world’s industrial production, should be used to invoice and settle a majority of the world’s international transactions. (...) Nor is it clear why the dollar should still constitute a majority of the reserves of central banks and governments. As the world economy becomes more multipolar, its monetary system, logic suggests, should similarly become more multipolar.”

Basic Idea and Opinion

This “fascinating and readable tale” (The Economist) charts the history of the Dollar as a world currency. The book is both intellectually rigorous and pleasant to read and is a rare blend of sound scholarship and narrative skill. The work examines the various stages in this story, from the Dollar’s birth and rise until the latest financial crisis, which has cast doubt on the greenback’s role as an international currency. Eichengreen clearly sets out the reasons behind each chapter in the Dollar’s history. Towards the end of the book, the author speculates on the monetary system’s medium and long-term futures. He begins this exercise by analysing possible rivals to the Dollar as a world currency—the Euro, China’s Renminbi and the IMF’s SDR [Special Drawing Rights]—explaining the world monetary system’s likely evolution from the current hegemony of the Dollar to a multi-polar model in which the Dollar may continue to play a leading role. Eichengreen concludes by analysing the risks that might arise if the current economic crisis pushes the Dollar off centre stage.

The author

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**The role of international currency: an exorbitant privilege?**

The Dollar has enjoyed unchallenged domination of the international monetary system since the end of The Second World War. It is by far and away the most heavily-used currency for international trade and finance transactions—including those covering imports and exports that do not involve the U.S. Furthermore, it is the currency in which all raw materials are traded, representing close on half of the world’s international obligations. Over 60% of central banks’ currency reserves are in Dollars.

This hegemony gives the American economy considerable advantages: Americans gain from the two to three per cent gap between the interest rate the U.S. pays on its trade debt and the yield for foreign investors holding Dollars. This allows the U.S. to run a trade deficit or buy foreign companies for the value of this difference without having to increase its debt with the rest of the world. In the years before the crisis, the U.S. benefited from a deficit of close on 6% of its GDP, which meant the country consumed or invested $1 trillion more than it consumed “simply because central banks and other foreign investors have a voracious appetite for dollars that require no real resources to supply”. This U.S. advantage is what De Gaulle criticised back in 1960 as an “exorbitant privilege”.

This privilege was logical back in the 1950s when the U.S. represented over 50% of the GDP of the world’s great powers. Yet it makes little sense today, when America only accounts for 13% of world trade and under 20% of direct foreign investment. This differs from the situation between 1945 and 1980 when U.S. foreign investment made up over 85% of the world total. America’s falling share of world transactions contrasts starkly with the Dollar’s persistent role as the world’s currency. However, the financial crisis appears to have shaken the world’s faith in the Dollar. Could the currency suddenly be toppled from its throne and lose its corresponding privileges? “A currency is attractive”—states the author—“because the country issuing it is large, rich and growing, (...) powerful and secure”. In other words, it is not the international role a currency plays that makes a country rich but rather a nation’s economic strength that turns its money into a world currency.
From the birth of the Dollar to the present financial crisis

Eichengreen begins his book with a detailed study of the four key stages in the contemporary international monetary system: (1) the birth of the Dollar and its steady rise as an international currency; (2) its overwhelming hegemony as a world currency following the Bretton Woods agreement, first through the Dollar parity and then through the end of the system of fixed exchange rates; (3) the evolution of the European monetary system until the creation of the Euro; (4) the financial crisis, stemming from “perverse financial practices and lax regulation”, based on unfounded confidence that it “had become possible, using modern mathematical tools, to more effectively price and manage risk”.

One of the factors that worsened the crisis was precisely the Dollar’s role as a world currency. Asian countries built up huge Dollar reserves to protect themselves from financial volatility following the 1997 crisis and to defend their exchange rates, which were of key importance to their export-led growth. They chose the Dollar given the remarkable liquidity of the U.S. bond market. This liquidity grew as more central banks began operating in the market, creating a strong feedback loop. The liquidity ‘virtuous cycle’ is yet another manifestation of the hegemonic Dollar’s ‘exorbitant privilege’. Nevertheless, this huge injection of foreign capital boosted the prices of U.S. assets and only made the ‘bubble’ grow even larger.

Furthermore, the hegemonic role of the Dollar carried another risk: given that the bonds of most American banks were held by foreigners, it must have seemed an irresistible temptation to reduce the value of those debts through inflation. To avoid a repetition of the crisis and protect savings, the Dollar would have to lose its mantle as the world’s reserve currency and thus stop “fueling the excesses that drove the global financial system to the brink”. The day following the outbreak of the crisis, there was general agreement that the international monetary system “should entail a more limited role for the dollar”. Indeed, most of the world doubted that the Dollar could maintain its current role as the world’s currency.

New rivals

Even so, so far there has been no run on the Dollar and its role as an international currency has not waned. It is currently being used in 85% of the world’s exchange transactions, 45% of the world’s international obligations are denominated in Dollars, as are 61% of the world’s stated currency reserves. In the wake of the crisis, central banks have continued to amass American bonds. Why should this be? The reason is that “jeremiads about American declinism notwithstanding, the United States remains the largest economy in the world”. Furthermore, for exporters, the Dollar is already
king of the heap and it is best to conduct business in the world’s leading trade currency. For international financiers, it is best to denominate accounts in the currency that is most used by their competitors. For central banks, it makes sense to have their accounts in the currency used for exports so that they can intervene in exchange markets to stabilise their own currency. Therefore, “the status quo is self-reinforcing”.

However, the main reason why the Dollar still plays this role is that no rival is strong enough to push it off its pedestal. “All the other candidates (...) have serious shortcomings of their own.” Sterling, the Swiss Franc and the Canadian Dollar are the currencies of nations with economies that are just too small. Japan does its utmost to discourage international use of the Yen in order to keep its exports competitive. The Euro is the only serious contender, with a sufficiently large economy, large trade flows, a well-respected central bank that “aspires to provide reserve assets”, has a large stock of public bonds and bond markets that are open to foreign investors. However, for the Euro to be a contender, Eichengreen believes the currency area needs extending. Right now, boosting growth in EU Member States is the best way of turning the Euro into a world heavyweight. However, Europe is suffering from structural problems, low growth rates and an aging population - “a stagnant population will mean a stagnant economy”.

Even so, the Euro’s basic problem is that it is “a currency without a State”. “The European Commission is the proto-executive not of the euro area but of the European Union” and its fiscal and financial powers are limited. The Euro Zone’s decision-making system is slow and unreliable and has shown itself unequal to the task of dealing with “unpredictable financial fallout. This in turn creates reluctance on the part of central banks in other parts of the world to put their eggs in the euro basket.” Europe will not get to grips with these problems without “closer coordination of fiscal [and budgetary] policies” and “a proper emergency funding mechanism”—both of which entail surrendering yet more national sovereignty to Brussels. However, the Euro will not be seen as a substitute for the Dollar until Europe draws up a common foreign policy that props up the Euro and creates a European bond market comparable with the U.S. one. Meanwhile, it may become merely a regional reserve currency, strengthening its role in neighbouring zones—in particular Russia and The Mediterranean.

**SDR** (international reserve assets created by the IMF and based on the Dollar, the Euro, Sterling and the Yen) cannot replace the Dollar as the world’s currency, even though China has proposed just this. **That is because SDR cannot be used to intervene in private markets.** “Making the SDR attractive would require building deep and liquid markets on which SDR claims can be bought and sold”. Furthermore, “for the SDR to become more like a global currency, (...) the IMF would have to become more like a global central bank and provider of emergency liquidity.” “But as a practical matter, so long as there is no global government to hold it accountable for its actions, there will
be no global central bank. No global government, which means no global central bank, means no global currency. Full stop.”

Although China wants to turn the Renminbi into a world currency (its target date is 2020), it still has a long way to go. The Renminbi will continue as a non-convertible currency for a long time to come, making it impossible for foreigners to use it to buy goods from China or for central banks to take Renminbi positions in currency markets. In other words, the Chinese Government’s tight control over the country’s financial system clearly limits the international use of the currency. China can only give its currency a world role by “developing liquid securities markets and liberalizing access to them”, allowing the exchange rate to float freely. Achieving this will take a long time and many reforms before “financial stability and full freedom to buy and sell domestic and foreign assets” become compatible. Meanwhile, the Renminbi—as is the case with the Euro—may become a regional reserve currency, with the former becoming increasingly attractive to Asian countries.

The future of the world monetary system—the crash of the Dollar?

In the future—writes Eichengreen—we may have various international currencies. “A world of multiple international currencies is coming because the world economy is becoming more multipolar, eroding the traditional basis for the dollar’s monopoly.” The crisis underscored the financial weaknesses of the U.S. and the strengths of emerging markets but it had been clear for some time that the tension between a multi-polar world economy and a uni-polar monetary system would have to be resolved sooner or later. Information technology made it possible to follow exchange rates in real time, cutting down the cost of switching from one currency to another. The technological development that facilitated greater international financial competition also affected currency markets. Furthermore, the size of the 21st-Century world economy allowed more than one bond market with sufficient liquidity to ensure low transaction costs, opening the door to dealings in other currencies.

“Forecasts are risky, especially when they involve the future” says the author, tongue in cheek. Even so, one can identify tomorrow’s players. The dollar will remain one of the world’s biggest and most liquid markets and the currency will remain ‘first among equals’. The Euro, with an economy of comparable size to the U.S. one, will become more attractive, particularly on Europe’s fringes as the currency’s problems are gradually ironed out. In the not-too-distant future, the Renminbi will become an attractive currency for international investors and central banks, particularly in Asia. Even so, there may be room for more than three international currencies. The Indian Rupee and the Brazilian Real are the main candidates to join the big three in an international monetary system, albeit in more limited roles.
Given this scenario, can we rule out a Dollar crash and the currency losing its world role overnight? In fact, China already holds 13% of U.S. Treasury bonds. If it were to sell these off in one fell swoop for either geo-political reasons or in order to dethrone the Dollar, this “would send the [American] bond market into a tizzy” and there would be a stampede to sell. U.S. interest rates would soar and “the dollar would crater”. However, this particular scenario can be ruled out because were China to do this, it “would be inflicting significant financial damage on itself, since it would be pushing down the value of its dollar assets”. The fall of the dollar would greatly harm China’s exports, which currently account for 40% of the country’s GDP.

A sudden financial panic would not end the Dollar’s hegemony either, given that U.S. reserves are more than sufficient to stop a run on the dollar. The real threat to the Dollar’s position comes from an inability to bring the U.S. budget deficit under control. U.S. wars in Iraq and Afghanistan, Bush’s tax breaks for the rich, the impact of ageing baby boomers and soaring pension costs are what wrought the damage. When the budget deficit runs out of control, it is tempting to reduce the Dollar’s real value through inflation. However, foreign investors would jump ship before this happened and U.S. interest rates would rise as a result. History shows that it is more likely that a crisis like this would hit suddenly.

If the Dollar were to lose its status as a world currency, the U.S. would no longer enjoy its “exorbitant privilege” and would have to slash its trade deficit to 6% of GDP and export more. There would be three options for pulling this off: (1) raise industrial productivity; (2) let the dollar devalue; (3) let exchange markets shape trade flows. Eichengreen concludes that the Dollar’s fate depends on America’s ability to manage its own economy, slash the public deficit and boost productivity and not on what its geopolitical and economic rivals do.