

Summary: It is commonplace to speak of the U.S. dollar's demise as the world's reserve currency. Along these lines, the U.S.-led financial crisis of 2008 is widely considered a tipping point and the death kneel of the greenback's global supremacy. The general consensus today is that a tri-polar currency world is in the making, with the dollar, the renminbi, and euro set to emerge as the world's most dominant currencies. According to this narrative, the era of a uni-polar currency world is over. This shift is inevitable, but the dollar-centric global monetary order of the past half century will not be upended any time soon. In the years ahead, the dollar is likely to remain first among equals in a more multicurrency world. Therefore, the most significant question is this: at what speed will the global economy shift away from the dollar-centric world of today and move towards a more multilateral currency world? The answer to this question depends on a number of factors. Ultimately, however, the more the financial health of America declines, the faster the world will shift away from the dollar-centric global economy of the past 60 years. These transformations pose new policy challenges for the G20.

The G20's Coming Currency Challenge: Do We Need Heirs to the U.S. Dollar — and Are There Any?

by Joe Quinlan

Introduction

*"The dollar's singular status is in doubt"*¹

—Barry Eichengreen, *Exorbitant Privilege*

It is commonplace to speak of the U.S. dollar's demise as the world's reserve currency. The U.S.-led financial crisis of 2008 is widely considered a tipping point and the death kneel of the greenback's global supremacy. The crisis not only severely damaged the economic credibility of the United States but also shattered the confidence in the dollar-centric global economy. In the years since the crisis, a debate has ensued about the need for a new international monetary system, one not resting squarely on the shoulders of the U.S. dollar.

The general consensus today is that a tri-polar currency world is in the making, with the greenback, the redback (the renminbi), and euro set to emerge as the world's most dominant currencies. The era of a uni-polar currency world is over, according to this narrative, with the United States

no longer deserving of its "exorbitant privilege." The latter term, of course, comes from the French who were critical of the Bretton Wood system for allowing the United States to print money to pay for imports and to fund U.S. military ventures overseas. Today, many believe the United States is undeserving of this privilege. Rather, America's battered fiscal position and Europe's simmering sovereign debt crisis juxtaposed against the capital-rich Chinese economy has set the world on the path towards a tri-polar currency order. Or has it?

Not for the first time, the general consensus about the future of the U.S. dollar could be wide of the mark. It is far too early to write the dollar's obituary. Granted, countries in the West — namely the United States, developed Europe, and Japan — are severely in debt and in the midst of a multi-year period of austerity. The developing nations, meanwhile, are flush with capital and desire changes to the existing global monetary order. But the dollar-centric global monetary order of the past half century will not be upended anytime soon. The dollar is likely to remain first among equals in a more multicurrency world.

¹Barry Eichengreen, *Exorbitant Privilege: The Rise and Fall of the Dollar and the Future of the International Monetary System*, New York: Oxford University Press, 2011, page 6.

The Buck's Staying Power

A number of factors will underpin the dollar's world reserve currency status over the medium-term. One such factor is America's capital markets, among the deepest, largest, and most innovative in the world. This gives the dollar a built-in competitive advantage relative to other currencies — or as some say, the power of incumbency.

Notwithstanding the “Made in America” financial crisis, the United States remains at the core of the global capital markets. America is not only a global titan when it comes to total bank deposits, government debt securities, corporate debt, and equities, but is also at the forefront of financial innovation and expanding financial services.

Another support of the dollar: global trade remains predominantly denominated in U.S. dollars, with more than 80 percent of world trade estimated to be invoiced in U.S.

Table 1: Key Dollar Supports

- Largest, most productive economy in the world
- Large, deep capital markets
- Top exporter in the world
- Number one destination for foreign direct investment
- Top-ranked manufacturer
- Global technology leader
- Top global brands (soft power)
- Sole military superpower (hard power)
- Global trade invoiced in dollars
- Few alternatives to dollar

dollars. This is despite America's declining share of global trade over the half century. As noted by Barry Eichengreen, more than 80 percent of South Korea's and Thailand's trade are priced in dollars — notwithstanding the fact that only 20 percent of their exports are destined for the United States.² In the aggregate, the U.S. dollar is used in 85 percent of all foreign exchange transactions.

It is the widespread global use of the dollar that gives the greenback more staying power than most observers

recognized. To this point, key commodities like petroleum continue to be invoiced in dollars despite grumblings from some Middle East states over the steady decline in the value of their petrodollars. There has been increasing talk of creating petroeuros, but just talk. The status quo in the Middle East pivots around oil being priced in dollars and dollar-pegged currencies — a decades-old arrangement in the Middle East that continues in exchange for U.S. military protection.

In addition to the above, there are a host of other variables that continue to underwrite the global supremacy of the U.S. dollar. Notably, the dollar's dominance reflects the fact the U.S. economy is the largest, most productive, and resilient economy in the world. While much has been made of the rise of China in recent years, total U.S. economic output (\$14.7 trillion) was more than twice China's \$5.8 trillion. Granted, based on purchasing power parity metrics, the gap is not that wide. But this still does not subtract from the fact that the U.S. economy remains one of the most dynamic in the world.

The dollar's supremacy mirrors other unappreciated attributes of the U.S. economy. For instance, the United States remains among the top manufacturers of goods in the world, with a global share of roughly 17-18 percent in 2010.³ The United States is the world's largest exporter of goods and services, and reins as the world's most favored destination for foreign direct investment (FDI) and portfolio flows. The United States is a magnet for foreign portfolio thanks to its large and transparent capital markets; meanwhile, America's wealthy consumer base, skilled labor pool, world-class technology capabilities, and protection of intellectual property rights support the United States as a prime destination of FDI. Last decade, for every \$1 China attracted in foreign direct investment, the United States attracted \$3. The more trade and FDI conducted with the United States, the more the demand and stature of the U.S. dollar.

The buck is also supported by the fact that when it comes to technological innovation, the United States ranks number one in the world. The United States is also home to nine out of the top ten consumer brands in the world (soft power)

² Ibid, page 2.

³ Data on global manufacturing comes from the United Nations

and the number one military power in the world (hard power).

Considering all of the above, it is little wonder the U.S. dollar remains the world's primary reserve currency, the world's only true international currency. This does not preclude other currencies from gaining importance in the years ahead, but at worse, the dollar will remain first among equals for the next decade or so. A snapshot of the holdings of central banks speaks to the staying power of the U.S. dollar.

The Future Has Yet to Arrive

The U.S. dollar remains the currency of choice among central banks. Based on data from the IMF, of allocated global reserve holdings of central banks in the fourth quarter of 2010 — approximately \$5 trillion — 61.4 percent were held in dollars. That share was roughly unchanged from the prior quarter, although down from 62.1 percent in Q4 2009 and 64.1 percent in Q4 2008.⁴

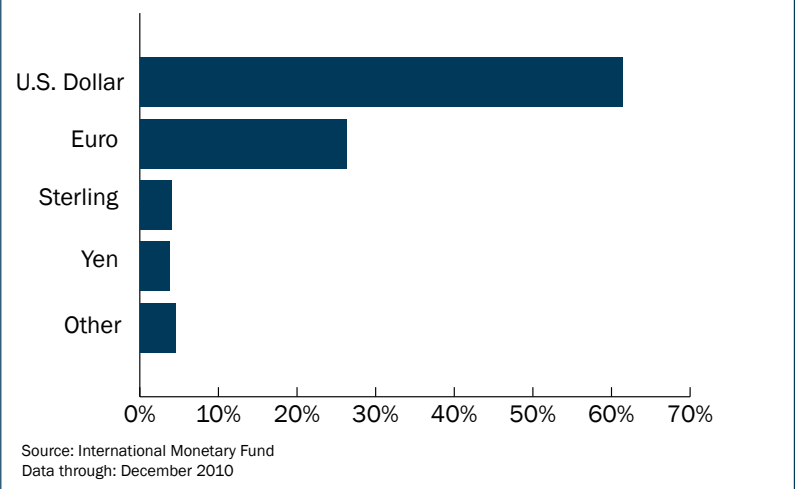
Since the third quarter of 2008 — or the onset of the global financial crisis — central bank holdings of U.S. dollars have increased on an absolute basis from \$2.7 trillion at the end of 2008, to \$2.8 trillion at the end of 2009, to over \$3.1 trillion at the end of 2010. That said, however, the dollar's share of central bank holdings on a relative basis has dropped by over three percentage points since late 2008 and by more than 10 percentage points since 2000.

Which currency has gained at the dollar's expense over the past decade? Answer: the euro, whose share of total central bank holdings rose from 18.3 percent at the end of 2000 to roughly 26 percent in the fourth quarter of 2010. That represents a sizable jump and supports the claim that the euro is a credible challenger to the U.S. dollar. Yet there still exists a sizable gap between the U.S. dollar and its next closest rival.

As for the yen and pound, the former's share of central bank reserves declined from 6 percent in 2000 to 3.8 percent in the fourth quarter of 2010. The pound's share

⁴ The figures are sourced from the IMF's Currency Composition of Official Foreign Exchange Reserves, which shows central bank holdings by major currency.

Figure 1: World's Apart: Central Bank Holdings of Dollar vs. Others (For Q4 2010; Percent of Allocated Holdings)



of total reserves has averaged roughly 3-4 percent over the past decade, a far cry from the time when sterling was the world's premier currency.

All told, world central banks have made it a strategic point to diversify their holdings over the past decade. Yet the evidence still points to a world that is still dollar-centric, reflecting 1) the underlying attributes of the U.S. economy and 2) the fact that there are few legitimate alternatives to the greenback.

Alternatives to the Dollar?

Substitutes for the U.S. dollar are few. Yes, the euro has grown in importance during the past decade, and yes, the European Union rivals the United States in terms of economic output and global trade.

But while Europe has a single currency, it structurally lacks a pan-European capital market that would pool and allocate capital more efficiently and effectively. Europe has one currency, but not one single capital market, and the region's financial sectors are small, fragmented, and lacking economies of scale. In addition, the region's simmering sovereign debt crisis — and the muddled way Europe's policy elites have handled the crisis — has done little to engender confidence in neither the near-term nor long-term future of the

euro. As Eichengreen notes, the euro is a currency without a state; there is no euro-government backing the currency, rather 17 different national governments with different goals and objectives.⁵ If nothing else, the Greek debt crisis has been a perfect example of Europe lacking an effective cross-border policy mechanism for handling acute periods of intra-Europe financial stress.

As for the pound and the yen, the sun has already set on these two currencies. Japan has neither the interest nor the economic means to nurture a true global currency. While the U.K. pines for a strong pound, the sterling is an obvious has-been when it comes to being a world currency. Switzerland has little interest in seeing the Swiss franc become a world reserve currency.

China: Not Ready for Prime Time

What about the renminbi — or the prospect of China emerging with the world's number-one currency? The short answer: although Beijing has accelerated the pace by which its currency is used in international transactions, it is going to be some time before the Middle Kingdom's currency challenges the greenback.

During President Hu Jintao's visit to the United States in January 2011, the Chinese leader proclaimed that "the current international currency system is a product of the past." That was code for the following: that China, fast becoming a global economic power in its own right, was not comfortable with dollar-centric world of today; the status quo was unacceptable and that China's own currency, renminbi, was primed to become more globalized.

To this end, Beijing has set up an offshore market for renminbi transactions in Hong Kong, with sales of renminbi-denominated bonds in Hong Kong climbing to 40 billion renminbi thus far this year, versus 36 billion last year. In March 2011, renminbi deposits in Hong Kong rose to a record 451 billion and are expected to approach 1 trillion by year-end. In promoting greater use of the renminbi, Beijing regulators broadened the scope of trading in Hong Kong in late 2010 by increasing the number of exporters

that can use renminbi to trade their goods. Meanwhile, China has entered into a number of currency swaps with a number of nations and has agreed to price bilateral trade with Brazil and Argentina in local currency, moves that will further underpin the globalization of the renminbi. Finally, in a historic first, McDonald's and Caterpillar became the first U.S. nonfinancial corporations to sell debt priced in renminbi last year.

Looking forward, in order for China's currency to remotely challenge the rein of the greenback, China has to first modernize and open its financial sector, allowing for the build-out of efficient money and capital markets. At the moment, China's banking sector is more closed than opened. While the Chinese financial sector weathered the financial crisis rather well, that was due less to any inherent strength of Chinese banks and more to the fact that China's banks remain relatively walled off from the rest of the world — circumstances that hardly auger well for the convertibility of the renminbi.

China remains financially underdeveloped at the moment, a suitable strategy for a government that believes control of one's financial system remains paramount for growth and stability. The financial crisis of 2008 only confirmed in the minds of Chinese policymakers that it is best to go slow when opening its capital markets. Against this backdrop, China's banking sector basically begins and ends with four large banks; in 2009, state-controlled banks held over \$11 trillion in assets, with the big four controlling 43 percent of China's total financial assets.⁶

Not until the mainland fortifies and opens its capital account, strengthens its financial sector, resists currency intervention, and establishes full convertibility of the renminbi will the Chinese currency even have the slightest chance of being a world reserve currency. China is not ready for prime time — full-fledged financial reform will be an evolutionary process, not revolutionary.

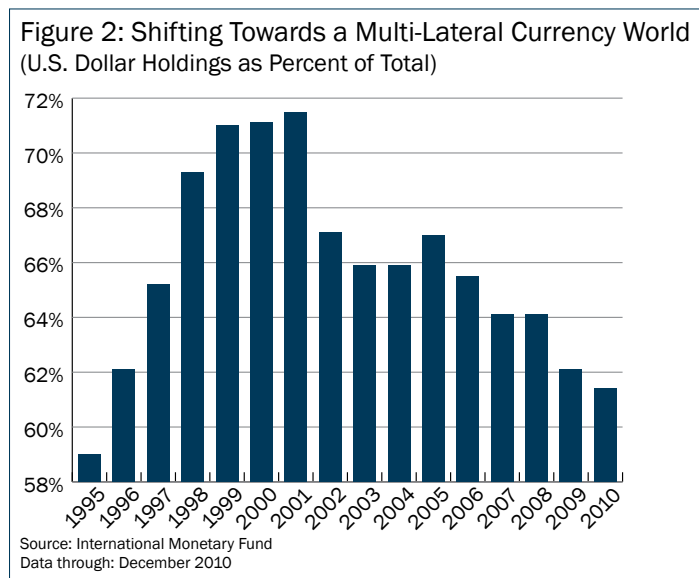
⁵ Barry Eichengreen, *Exorbitant Privilege: The Rise and Fall of the Dollar and the Future of the International Monetary System*, New York: Oxford University Press, Page 7.

⁶ See Carl E. Walter and Fraser J. T. Howie, *Red Capitalism: The Fragile Financial Foundation of China's Extraordinary Rise*, Singapore: John Wiley & Sons, 2011.

SDR's Rise?

What about the attraction of special drawing rights (SDRs) as a world's reserve currency — a prospect bandied about by some policymakers, notably the Chinese? Answer: the odds of SDRs becoming a reserve currency are slim given that very few SDRs are in circulation and that very few countries, notably the United States, are likely to agree to an SDR-driven world of global finance.

Might the gold standard return? While widely discussed of late among policymakers, a return to the gold standard is an unrealistic option in a world economy that is greased by some \$4 trillion in daily global foreign exchange transactions. Pegging a currency to the fixed stock of a real asset would dramatically slow the volume and velocity of global capital flows, and result in a much slower speed limit of the global economy. Gold is just too illiquid to be considered a world reserve currency.



The Road Ahead

The dollar's reign is set to continue over the next decade, although beyond the medium-term, the world is moving toward a multilateral currency system, with the dollar at the head of the pack. The euro and renminbi will follow, while hard assets like gold, timber, and oil are expected to

remain viable alternatives to the dollar as a store of value. The Russian ruble and Brazilian real could also emerge as significant regional currencies in the decades ahead. A more multi-polar world entails a more multilateral currency regime, a scenario that will gradually erode the dollar's global monopoly.

The most significant known unknown is this: at what speed will the global economy shift away from the dollar-centric world of today and move towards a more multilateral currency world? Another unknown: will the shift be orderly or disorderly?

The answers depend on events overseas and in the United States, and on the ability of the G20 and its key members to adjust to the shifting sands of the global monetary order. To ensure an orderly transition towards a multilateral currency architect, the G20 must avoid "currency wars" and the toxic temptations of trade and investment protectionism. The latter could become a more attractive option if unemployment remains stubbornly high in the developed nations, notably the United States.

A less dollar-centric world entails a weaker dollar relative to other currencies, a transition that needs to be handled with care since the stronger currencies of the developing nations will impinge on their export-led growth strategies. It is critical for the G20 to champion a more multilateral currency world in the content of global rebalancing, whereby saving-short nations like the United States consume less and export more, while capital-rich nations like Russia, China, and Brazil opt for more spending and less savings. Adjustments in currencies can facilitate such a shift, and needs to be a stated policy objective of the G20.

G20 members should also avert using and excusing capital controls and avoid blatant investment protectionism. The latter is key since a more multicurrency world entails China and other surplus developing nations diversifying out of dollar-based securities for hard assets like plants, equipment, and companies. However, emerging market acquisitions of developed nations corporations and physical assets remains a sensitive topic and one that needs to be managed very carefully by the G20. The G20 should also work to ensure that as a new multicurrency world takes shape,

financial deglobalization — or the risk of over-regulated global capital markets — is avoided at all costs.

At the regional level, the speed at which the world becomes less dollar-centric will depend on how the eurozone debt crisis is resolved. The euro could still emerge stronger from the crisis if the nations of the eurozone band together and successfully navigate the treacherous waters of today.

Meanwhile, the pace at which China allows its currency to become more global will also determine the pace at which the world moves towards a more multicurrency world. The process is expected to be gradual as China slowly shifts from export-led growth to more consumption-led growth. With the leadership of the Communist Party slated to be changed next year, moves on the currency front will be nominal at best over the near term. It is in China's own interests not to see the dollar dethrone in a sudden and unexpected fashion, since the Middle Kingdom is one of the largest holders of U.S. dollars. A sharp decline in the dollar would cost the Chinese dearly.

Finally, no other variable will influence the future of the U.S. dollar, and its role as the world's reserve currency, more than policies in the United States. The cost of two wars, and the tab associated with one of the largest financial crises in U.S. history and soaring entitlements threaten to turn the United States into a financial cripple. Uncle Sam still enjoys a triple A credit rating — although America's pristine credit rating is increasingly being called into question given the inexorable rise in U.S. debt.

Against this backdrop, the more the financial health of America declines, the faster the world will shift away from the dollar-centric global economy of the past 60 years. This shift is inevitable, but expected to play out over years and decades. An orderly passage to a multilateral currency

world would help sustain global growth, promote global rebalancing, and further integrate the global economy. Conversely, a sudden and disorderly turn away from the dollar-based global economy would be hugely disruptive and benefit no one, notably the United States. For the G20, managing the tectonic shift towards a multi-currency world is one of the most important and pressing challenges before the young organization.

About the Author

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