Special Feature B

The Dollar's Future as an International Currency

by Barry Eichengreen [1]

One of the surprising features of the global credit crisis, which spread from the US to other regions with the failure of Lehman Brothers in September 2008, is how this episode of financial turbulence benefited the dollar, which strengthened against virtually every currency but the Japanese yen. A number of factors were cited to explain the dollar's rise. Some suggested that US investors were faster than foreigners to deleverage and bring their foreign investments home in order to repair damaged balance sheets. Others posited that volatility was causing carry trades to be unwound; thus the currencies of countries with low interest rates, notably the dollar and the yen which investors had borrowed to engage in carry trades, benefited as those borrowings were repaid. Still others suggested that markets had already discounted the economic slowdown in the US and that the new information in September was that the slowdown had infected other countries, causing their currencies to weaken. Finally, there was the possibility that investors rushed into the dollar on the traditional grounds that it was the safe-haven currency.

Some of these explanations implied that the dollar's strength would be temporary, while others suggested that it might be more long-lived. But taken together they rekindled interest in long-standing questions about whether the dollar would continue to function as a leading international currency: as a store of value for central banks and of payment for countries engaged in foreign trade, and as a unit of account for oil exporters and others pricing their goods in international markets.[2] Now that central banks had incurred losses on their holdings of US securities, it was suggested, they might accelerate the diversification of their portfolios away from the dollar. Similarly, now that other investors no longer saw the US as a supplier of high quality financial assets, they might respond in like fashion. At some stage in this adjustment, there might be movement away from the dollar to another currency such as the euro, as the dominant international unit. Insofar as international currency status is characterised by network externalities – where it pays to use the same international currency used by others, since that is the currency with the most liquid markets and greatest convenience factor – there might occur a "tipping point" marked by a sudden and discontinuous shift away from the dollar.[3]

One view, then, was that notwithstanding the dollar's temporary strength, the crisis made it likely this shift would come sooner rather than later. But the opposite view was also heard: because so many market participants use dollars, the advantages to doing so are considerable. Incumbency is an advantage in the competition for international currency status, a fact which lends inertia to prevailing arrangements. Because network effects are strong, the argument goes,

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[2] These questions were posed in a special feature in the April 2008 issue of the *Review*, "The Fall in the US Dollar and its Status as a Reserve Currency".

[3] See Chinn, M and Frankel, J (2008), "The Euro May Over the Next 15 Years Surpass the Dollar as the Leading International Currency", *International Finance* (forthcoming).

there is only room in the world for one international currency. And for historical reasons as much as anything, that one international currency remains the dollar. A very profound shock would be needed to alter this status quo.

Evidence of network effects is indirect. It is based on the observation that the dollar was far-and-away the leading international currency in the second half of the 20th century, accounting for the vast majority of other countries' foreign exchange reserves. Before that, it is asserted, the pound sterling was the dominant reserve currency. The power of network effects is also reflected, it is argued, in the extent of inertia – in the fact that the dollar only supplanted the pound sterling after World War II, more than half a century after the US had surpassed Britain in economic size and influence.[4]

Or so goes the conventional wisdom. In fact the historical evidence, when considered directly, paints a different picture. In work with Marc Flandreau of the Graduate Institute of International and Development Studies in Geneva, I have constructed new estimates of the currency composition of international reserves in the 1920s and 1930s.[5] By the middle of the 1920s, the dollar had already surpassed sterling as the leading reserve currency, about two decades earlier than suggested in much of the literature. Evidently the inertia associated with international currency status is not as powerful as suggested previously.

The other striking fact that emerges from our estimates is that international currency status in the late 1920s was not the exclusive preserve of one country. In fact it was shared between Britain and the US. Financial markets in both London and New York were sufficiently deep and liquid to be attractive to foreign central banks and governments in search of places to hold their reserves. Evidence for previous historical periods is further consistent with this view: Lindert's estimates for 1900 and 1913 similarly suggest that reserve currency status in this earlier epoch was shared, in this case between sterling, the French franc and the German mark.[6] Network externalities do not appear to have been as overwhelmingly important as sometimes suggested. They do not preclude several currencies from sharing reserve-currency status at any one point in time.

This suggests that the truly anomalous period was the second half of the 20th century, when the dollar disproportionately dominated international reserves. The US emerged from World War II as the major industrial power: its share of global industrial production approached 50 per cent in 1945. Under these circumstances it made sense for other countries to hold the bulk of their reserves in dollars. But there was no reason why the US should remain so preponderant indefinitely. As Europe and Japan recovered from wartime devastation and economic development and convergence proceeded in other parts of the world, that preponderance was bound to diminish.

Moreover, following World War II, only the US had deep and liquid financial markets open to the rest of the world. Japan discouraged the internationalisation of the yen to avoid disrupting the conduct of industrial policy. Germany maintained capital controls to prevent capital inflows from complicating its pursuit of low inflation. More generally, Europe retained capital controls to facilitate the maintenance of pegged exchange rates, first under the Bretton Woods System and then, until the early 1990s, under the European Monetary System.

Now, in contrast, both Europe and Japan have removed capital controls. Both have deep and liquid financial markets. Doubts about the ability of the European Central Bank to match the track record of the Fed that may have understandably existed in 1999 are now less pervasive. Given all

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4 The US had surpassed Britain in economic size by the 1870s, as an exporter in 1915, and as an international creditor in 1917. See Frankel, J (2008), "The Euro could Surpass the Dollar within Ten Years," *Vox EU*, 18 March.

5 Eichengreen, B and Flandreau, M (2008), "The Rise and Fall of the Dollar, or When Did the Dollar Replace Sterling as the Leading Reserve Currency?" *NBER Working Paper* No.14154 (July).

6 Lindert, P (1969), "Key Currencies and Gold, 1900-1913," *Princeton Studies in International Finance* No. 24, International Finance Section, Department of Economics, Princeton University.

this it makes sense that reserve currency status should be increasingly shared.

What are the implications for the future? Now that the anomalous period, the second half of the 20th century, has passed, one should expect to see the continued diversification of central bank reserve portfolios. One should also expect to see reserve currency status shared once again, between the dollar, the euro and conceivably sterling and the yen. Other popular candidates, such as the Chinese renminbi, may play a greater role when the countries issuing them similarly have deep and liquid financial markets.

None of this tells us, of course, exactly what the reserve shares of the dollar, the euro and other reserve currencies will be a few years from now. Central banks that have taken losses on their dollar balances and have been alarmed by the prospect of very large budget deficits in the US may seek to diversify faster as a result. But, barring serious economic mismanagement, there is no reason to anticipate a tipping point and mass flight from the dollar.

The remaining question is whether what is true of reserve currency status is also true of other dimensions of international currency status. In other words, whether the dollar's status as the invoicing currency for international trade, the currency of denomination for oil and other commodity prices, and the base currency for foreign-exchange-market transactions has and will again come to be shared. Professor Flandreau and I hope to answer this question in future work.