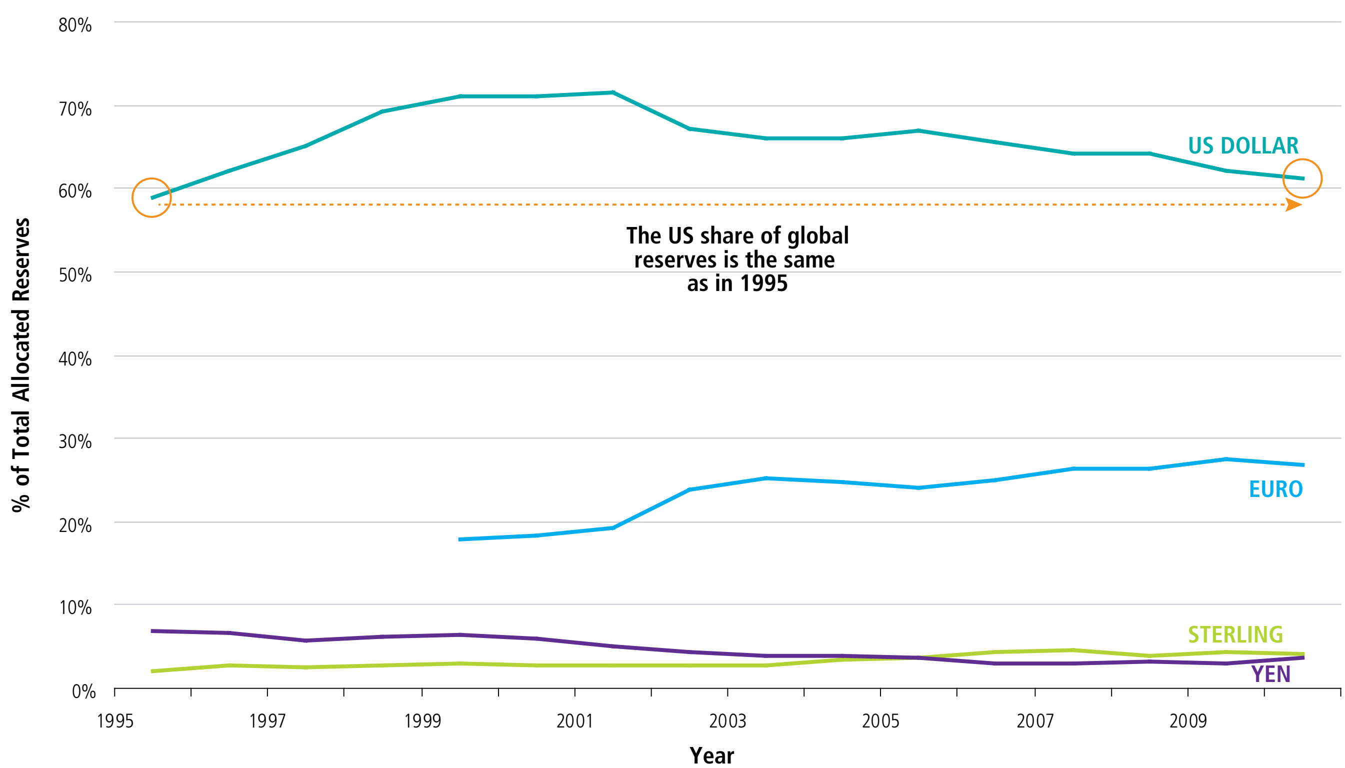
Reports of the US Dollar's Death Have been Greatly Exaggerated

Relative to its major trading peers, the real value of the US dollar has declined about 20% in the last two years. Together with growing US government debt and a shifting of the balance of world economic power away from developed nations, this depreciation has prompted speculation about the US dollar's imminent demise as the world's reserve currency. Among the rivals jockeying to supplant the dollar, China is often mentioned. While we acknowledge that the global reserve currency system must evolve to better reflect the world's underlying economic structure, the process will take time. Inertia combined with a lack of viable alternatives make any proclamation of the dollar's demise premature at best.

WHAT IS A "RESERVE CURRENCY"?

A "reserve currency" is one that is held in large quantities by many nations other than the issuing country and serves as a global currency in that many international transactions and commodity prices are denominated in it. For nearly 70 years, the US dollar has played this role almost exclusively. Since World War II (WWII), the US dollar has held the enviable position as the world's "most popular" currency, Today, it accounts for 65% of all global reserves (See Figure 1).

fig. 1 THE US HAS NOT LOST ITS THRONE YET



SOURCE: International Monetary Fund

WHY ALL THE FUSS? ADVANTAGES OF BEING A RESERVE CURRENCY COUNTRY

Being a reserve currency country offers five important advantages. First, exchanging currency is costly, so having the majority of international transactions conducted in your home currency reduces your transaction costs.

Second, interest rates are lower for the reserve currency country. Central banks around the world hold reserves in the form of government debt. For example, Japan holds its US dollar reserves in the form of US Treasury bonds. The high demand for government bonds pushes government interest rates down, which also decreases rates for all debt in that country. Lower interest rates mean cheaper financing costs and therefore higher investment and economic growth.

Third, these same low interest rates create revenue for the government in the form of seigniorage, or the difference between the cost of printing the money and what the money can buy. The US, for example, is able to purchase assets with dollars that it simply prints, with the only 'price' arising from a bigger money supply. A 2009 McKinsey study found that seigniorage creates between $10-20 billion for the United States annually.

Fourth, the prevalence of dollar-denominated assets creates a liquidity discount, as investors require very little compensation for liquidity risk (the risk that they will not be able to find a buyer). People feel more comfortable (and will therefore accept a lower yield) with a security that is denominated in a widely-used currency than for an identical security denominated in Zambian kwatcha, for instance. The same McKinsey study found that this liquidity discount results in $90 billion in savings from lower interest rates each year.

Finally, the reserve country becomes a large net lender, which permits it greater flexibility in the trade balance for goods and services. In the case of the dollar, this has allowed the United States to run a huge trade deficit, boosting the American standard of living beyond what would otherwise be possible.

> **"THE MOST LIKELY OUTCOME IS A TRIPOLAR SYSTEM OF DOLLAR, RENMINBI AND EURO THAT REFLECTS THE UNDERLYING ECONOMIC STRUCTURE."**

CALLS FOR CHANGE

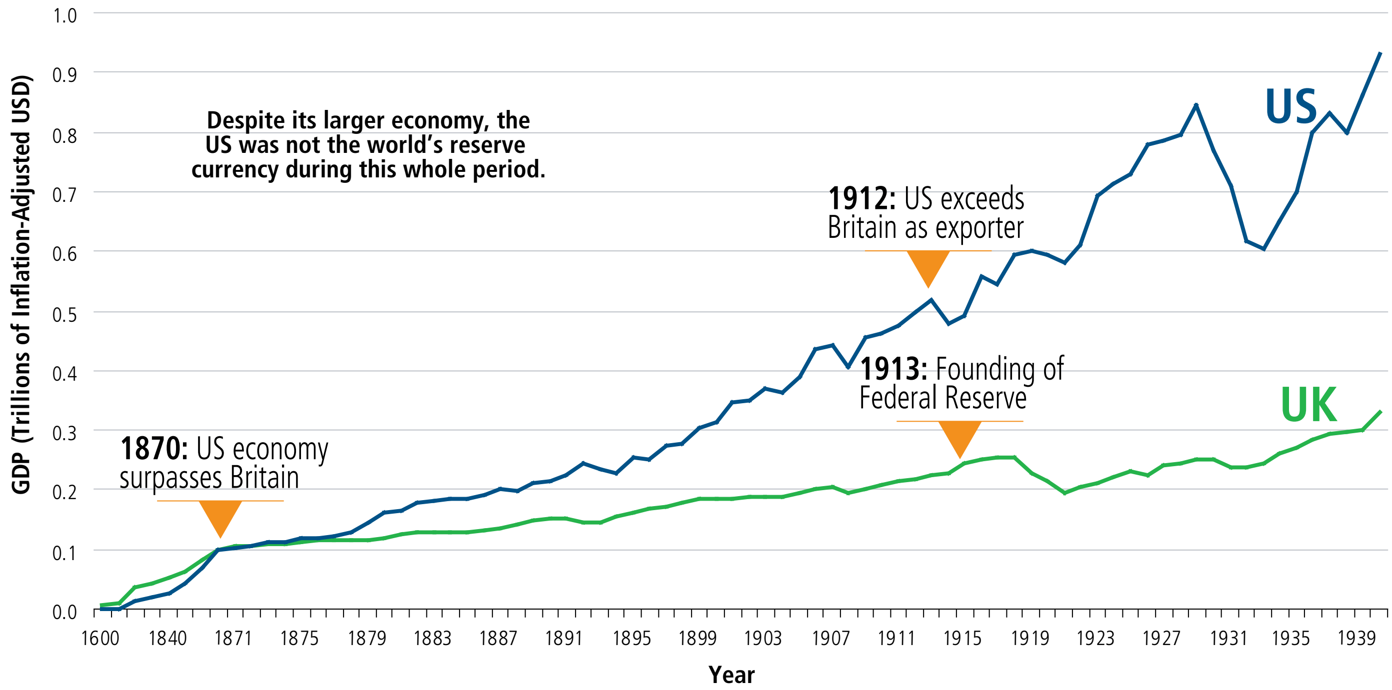
These "advantages" were termed "exorbitant privilege" by the French Minister of Finance Valéry Giscard d'Estaing in the 1960's. For much of the past half-century, the United States was the uncontested world superpower with a healthy budget surplus and a booming economy, and few begrudged the US dollar its position as the world's currency. More recently, however, a towering debt load and shrinking (though still dominant) share of the global economy have prompted some doubts as to whether the position is still merited.

In some cases, the United States has been accused of abusing its privilege and neglecting the global responsibilities of a reserve currency country. For example, critics have charged the Federal Reserve with contributing to the Great Recession by holding interest rates artificially low for the past decade. Many emerging market (EM) countries have complained that the Fed's quantitative easing policies, while helpful to the United States, are unfairly depreciating the US dollar, making it harder to export to the huge US market and prompting capital inflows from investors searching for higher yields, thereby aggravating EM inflation problems. In fact, the Governor of the People's Bank of China, Zhou Xiaochuan, complained of an overreliance on the dollar

DID YOU KNOW?

The Chinese currency is known officially as the renminbi and informally as the yuan. What is the difference? Technically, the "renminbi" is the name of the currency system in general, while "yuan" refers to the bills themselves. The US equivalent would be the "dollar" as the primary unit of "US legal tender," which would indicate all types of money, including quarters and dimes.

fig. 2 LEARNING FROM HISTORY: GROSS DOMESTIC PRODUCT FOR THE UK AND US: 1600–1940



SOURCE: Angus Maddison

and advocated a move toward a more balanced system, while the International Monetary Fund (IMF) released a detailed report advocating the adoption of a global reserve currency based on Special Drawing Rights (SDRs), comprised of a weighted basket of the euro, the dollar, the pound and the yen.

WHY IS THE DOLLAR STILL DOMINANT?

US Treasury Secretary Timothy Geithner responded to critics in his testimony to Congress that "the SDR is not a currency, it is a unit of account and it can't provide the role than many people aspire to it." Indeed, an SDR cannot provide the liquidity of a US Treasury bill. However, it is clear that the US dollar will not be able to maintain its "exorbitant privilege" forever.

This is not the first time the dollar has been declared doomed. Commentators predicted the imminent fall of the dollar after the Bretton Woods system was dissolved in 1971, following Japan's rise in the 1980's, and after the adoption of the euro in 2000. Yet, the dollar remains on top. Why has it shown such resilience? The reality is that, despite the dollar's real challenges, competition is scarce. The US dollar will remain the primary reserve currency for the foreseeable future because there is simply no good alternative.

Moreover, the dollar benefits from pure path-dependency. Pulitzer Prize winning author Liaquat Ahamed has compared the dollar's dominance to the use of the English language as the world's lingua franca. The idiosyncratic offspring of German, Latin and French is not particularly well-suited to the position. Nevertheless, people choose to learn English because it is what everyone else already uses. This same path-dependency is evident with the use of the US dollar as well.[1] Foreign central banks hold close to $5 trillion in US Treasury and Agency-backed debt. The dollar acts as a currency peg for 89 nations, accounts for the largest share of the world's debt securities (39%), and is employed in 85% of foreign exchange transactions. A full 70% of US $100 bills are held abroad.[2] All of this translates to unrivalled liquidity worldwide, and provides significant entry barriers to any aspiring rival currency.

SO YOU WANT TO BE A RESERVE CURRENCY COUNTRY?

The pool of potential reserve candidates is so small because it takes a lot to qualify. The eight Criteria of Reserve Currencies are seen as follows:

1. ***Economic size*** – The domestic economy must be large enough to back the issuance of a sufficient supply of government bonds to meet global demand. The

economies of Switzerland and the United Kingdom, for example, are too small.

2. ***Confidence in the currency as a store of value*** – Holders of the currency must be confident that it will not lose significant value. Inflation, therefore, must not be too high, as higher prices erode the buying power of a currency.

3. ***Free-floating exchange rate*** – The currency must be allowed to float freely. It cannot be pegged to any other currency. No one wants to borrow in a currency that will only appreciate in the long run, just as no one wants to lend in an overvalued currency.

4. ***Currency used in many international transactions*** – The currency must actually be used in economic transactions. Usage in a large share of transactions provides scale benefits. (SDRs, for example, are not.)

5. ***Open economy with few (if any) capital controls*** – For the market in reserves to operate correctly, money must be allowed to flow freely into and out of the issuing country.

6. ***Strong banking system with a lender of last resort*** – There must be a strong banking system and a lender of last resort (like the US Federal Reserve) to help prevent bank runs and bolster confidence in financial institutions and markets.

7. ***International banking presence*** – A banking presence abroad helps facilitate relationships and borrowing/lending transactions in the domestic currency. In fact, one of the great inhibitors to the US dollar's initial ascent as a world currency in the 19th century was the lack of international banking presence, even after it became the largest economy on earth (see Figure 2).[3]

8. ***Deep and liquid securities market*** – Debt markets denominated in the currency must be large, diverse and liquid to provide easily-tradable market investing reserves.

EVALUATING THE CONTENDERS – ARE THERE ANY?

Proponents of the Chinese renminbi as a reserve currency point to parallels between China's current ascendency and the US dollar's rise in the 1800's. Prior to WWII, the British pound sterling was the world's reserve currency, despite the fact that the US was by far the larger economy (see Figure 2). The tipping point was WWII, which placed a heavy debt burden on Britain. At the same time, the United States was the world's *de facto* lender of last resort and the dollar was anointed as the world's reserve currency at Bretton Woods. It was only then that the US dollar became the dominant reserve currency. Today, the tables have turned: China is growing at a double-digit clip and the United States is struggling with debt. Many have looked at these similarities and seen the imminent replacement of the dollar.[2] However, as is clear from the dollar's experience versus the sterling, the process takes a long time and all of the criteria must be satisfied. In the case of China, these preconditions have yet to be met.

While China has announced that it aims to become a major reserve currency, this process is likely to take until 2040.[2] Currently the renminbi meets only the first two criteria of reserve currencies: China is the world's largest exporter and is the second-largest economy. However, the renminbi is not used at all as a reserve currency and very little in international exchanges. Furthermore, China needs to rein in inflation, allow the renminbi to float freely versus the dollar, and build a deeper and more liquid bond market. At present, very few fixed-income securities are denominated in yuan. China also needs to command a larger share of international transactions, though this is likely to happen naturally as China continues to grow. Finally, China needs institutional reform to increase central bank independence and decrease intervention in its capital markets. Given recent progress, it will likely take 20 years for China to clear these hurdles, and another ten to become established as a major reserve currency.[3]

TOWARD A MORE PERFECT (EUROPEAN) UNION

A more realistic competitor to the dollar may actually be the beleaguered euro (see Table 1). While this may come as a surprise to some, the shared currency possesses all of the requisite criteria but one: "a strong banking system." Fully one quarter of all global reserves are already held in euro, and the eurozone economy as a whole is open and even larger than the United States. Euro-denomi-

table 1 Who is in the Running?

Criteria	US Dollar	Euro	Chinese Renminbi
Large, robust economy	Yes	Yes	Yes
Significant goods exporter	Yes	Yes	Yes
Free-floating currency	Yes	Yes	No
Currency used in many international transactions	Yes	Yes	No
Open economy, few capital controls	Yes	Yes	No
Strong banking system with lender of last resort	Yes	No	No
International bank branches	Yes	Yes	No
Deep, liquid securities markets	Yes	Yes	No

nated bond markets are deep and liquid, if a bit fragmented. We believe that the cause of Europe's current malaise is a unified monetary system without any corresponding fiscal union to support it and that the only solution will be greater fiscal consolidation. When this happens, the banking system will eventually right itself.

GAZING INTO THE CLOUDY CRYSTAL BALL

There is little doubt that as the world economy transforms, so too will the international monetary system. The most likely outcome in our view is a tripolar system of the dollar, the renminbi and the euro that better reflects the world's underlying economic structure. However, this shift will only occur slowly, as the dollar has an inertia advantage that will slow the transition process. This co-currency arrangement will develop more easily if we continue to see development of financial innovations that make it easier to convert currencies as well as further regionalization of world trade into European, American, and Asian blocs. In any event, the US dollar will play a major role for a long time to come. To paraphrase Mark Twain, reports of the US dollar's death have been greatly exaggerated.

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