Is the Dollar About to Lose its International Role
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It is impossible to pick up a financial newspaper these days without finding a story on how the dollar is about to lose its international role. One can't help but feel that too much is being made of this prospect. To paraphrase Mark Twain, reports of the dollar's death have been greatly exaggerated. The dollar is still the dominant reserve currency for central banks. The share of central bank reserves held in dollars has actually been rising, not falling. The market in US treasury securities is still the single most liquid financial market in the world. The dollar is still the dominant invoicing and vehicle currency in international trade. Petroleum and other commodities are still invoiced in dollars.

There are, of course, good reasons to ask whether this is about to change. The dollar has fallen by 16 per cent on a trade-weighted basis from its peak at the beginning of the decade. More importantly, never before have we seen the extraordinary situation where the country issuing the international currency is running a current account deficit of 6 per cent of GDP. Never before have we seen the reserve currency country so deeply in debt to the rest of the world. The prospect that the dollar might have to fall further to prevent America's external indebtedness from spiraling out of control creates the specter of rising inflation and of a rush out of dollars in favor of another more stable currency, perhaps the euro, the yen, or the yuan.

Fears of a rush out of dollars are fanned by the belief that there is room in the market for only one international currency. Once it was the pound sterling, now it is the dollar, and in the future it will be something else. Once a few central banks begin shifting into another currency, in this view, the others will follow en masse. The idea is that, as with computer operating systems, there are strong incentives to conform to the choice that dominates the marketplace. In this case, it pays to hold reserves in the currency with the most liquid market, which is necessarily the currency in which everyone else holds them. This makes competition for international currency status a winner-takes-all game.

But today there actually exist several economies with liquid financial markets, not just one. Japanese financial markets are deep and liquid. The growth of financial market liquidity in Europe has of course been one of the main effects of the advent of the euro. That these markets coexist means that there are several forms for central banks to hold their reserves and for other market participants to hold their working balances. Those markets have also grown more efficient, reducing the costs of exchanging currencies. This makes it attractive to hold balances in a variety of different currencies. There are a number of attractive candidates for international currency status, in other words. In turn this means that there is reason to doubt that there is room in the world economy for only one international currency.

In fact, the dominance of the dollar in international transactions in the second half of the 20th century reflected not that there intrinsically is room for only one international currency but that countries like Germany and Japan maintained capital controls and actively discouraged international use of their currencies. The only country with open financial markets that encouraged international use of its currency was the United States. In effect, other countries conceded to the US its status as the issuer of the international currency. Participants in international markets held dollars because they were given no alternative. Now, of course, none of this is the case.

Hence, in the future several currencies will share this international role. But which currencies? My candidates, whether we are thinking of 2020 or 2040, are the dollar and the euro. Europe and the US both have strong institutions and respect for property rights. They have stable political systems. Their economies are likely to be of roughly equal size, to engage in similar levels of external trade and financial transactions, and to have comparably liquid securities markets. How much ground the dollar loses to the euro will depend on whether the US avoids policies leading to unsustainable deficits and chronic weakness of its currency.

The other popular candidates are unlikely to be major rivals. Japan is a smaller country with serious demographic problems and a hostility to the obvious solution, immigration. The currently fashionable heir to the throne, China, will have to address some serious issues before its currency becomes attractive as a repository for other countries' reserves. Removing capital controls is the least of its problems. Its financial markets are not liquid or transparent. The security of property rights is uncertain. Making investors feel secure will require a transition to democracy, the creation of credible political checks and balances, and the development of a creditor class with political sway. While the yuan is everyone's favorite candidate for the new reserve currency champion four or five decades from now, such hopes are, in my opinion, premature.

Thus, the euro and the dollar will likely share the role of international currency for the foreseeable future. At the same time, mistaken policies, like those leading to chronic external deficits, can still knock a currency out of contention. Time will tell whether this fate befalls the dollar.

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