Paper

The Dollar and US Power

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Today the US dollar is undoubtedly the top international currency. This is true by any of the conventional measures, for its public or private international roles, whether it is measured as unit of account, medium of exchange, or store of value (the three traditional roles of money). The first part of the paper is devoted to justifying this assertion. The second part of the paper then goes on to ask whether this is likely to continue in the medium term, and concludes that it is. The third part of the paper asks whether this widespread use of the dollar confers great privileges in terms of US power in the world, and concludes that the main source of advantage stems from private rather than public use of the dollar.

The Present Position of the Dollar

Consider first official use of the dollar. The dollar is the currency most commonly used by countries to express their exchange rate objectives: at least 37 of the 146[1] currencies of International Monetary Fund (IMF) members express their objectives in terms of pegging to the dollar,[2] as opposed to at least 21 (mainly but not exclusively advanced countries) which claim to float and at least 20 which are pegged to some other single currency (mainly the euro) or the Special Drawing Right (SDR). (It was not possible to infer the exchange-rate objective of the remaining currencies from the information given in *International Financial Statistics* (IFS).)

The US dollar is absolutely dominant as the intervention currency: Most countries intervene in nothing except dollars. It is the major unit in which about 60 percent of official foreign exchange reserves are held ($3,548 billion of the total reserve holding of $10,422 billion are in identified dollar holdings, with some part of the $4,718 billion also held in dollars by central banks that for some reason are unwilling to declare even to the IMF the composition of their holdings).

[1] There are 188 members of the Fund, but many of them share currencies: the euro, the East Caribbean dollar, the CFA franc, or Ecuador uses the US dollar.

[2] The IMF no longer publishes a table showing the exchange rate regime of each member, so I examined the country pages in IFS. Countries counted as pegging to the dollar were those which showed a constant official rate in terms of the dollar throughout the period; countries with minimal variation; and countries with a constant one-way movement (e.g., consistent with a dollar peg combined with a policy of offsetting inflation by a regular crawl).

Similarly, the US dollar dominates private use, although official estimates of these private magnitudes are notable by their sparcity. It was estimated in the past that close to a half of all international trade was invoiced in dollars (Hartmann 1998), as opposed to under 12 percent of world trade that involved the United States in 2011. So far as foreign exchange trading is concerned, most takes place against the dollar, resulting in a share of foreign exchange trading of about 85 percent (the sum of the two sides adding to 200 percent, since a trade is necessarily of one currency against another). Although the euro had more bond issues than the dollar for a time, most international transactions involve the dollar. And most private international holdings of liquid assets are denominated in terms of dollars (if, unlike equity, they are denominated in anything at all): There are no good statistical estimates of the size of this portfolio, but it is usually reckoned to be a lot larger than the holdings of official reserves.

It is thus undeniable that the US dollar presently constitutes the most important component, indeed the vast bulk, of international money. For a time it looked as though the euro might constitute a serious competitor, but the recent difficulties in the euro area have resulted in it ceasing to be a threat to the pre-eminence of the dollar. The Chinese are still taking the first steps to establishing the renminbi as an international currency. The use of the yen has shrunk, along with the Japanese economy. The same is true of the pound sterling. For the moment, the dollar is quite unrivalled.

If there is no plausible competitor to the dollar among national currencies, what of the international level? In 1970 the IMF created the SDR, which was not named as an international currency because of a simmering dispute as to whether the SDR was really money or credit. But the Committee of Twenty which was created in 1972 to design a successor to the Bretton Woods system wanted to see the SDR as the "central reserve asset of the system," and since reserves are normally thought of as international money this would seem to have settled the dispute. However much the C-20 may have dreamed of making the SDR the center of the system, it clearly has not come to pass in the past 40 years. The SDR has no private international role at all. On the official level, a single currency (Myanmar's kyat) is pegged against the SDR. Central banks cannot intervene in SDRs because intervention involves transactions with the private sector. In terms of reserves, less than 3 percent of the total was last year held in SDRs. The dollar continues to reign.

The Future of the Dollar

Cohen (2004, 10–11) lists the factors that determine demand to hold a currency internationally. He argues that demand is shaped by three attributes. The first is widespread confidence in the future value of a currency, backed by political stability in the country of origin. Without such confidence, it is impossible to imagine people voluntarily choosing to hold a particular money, given that they have any choice. The second is the qualities of "exchange convenience" and "capital certainty"—a high degree of transactional liquidity and reasonable stability of asset value, the key to both being the existence of well-developed financial markets which are open to nonresidents. The final factor is a money that promises access to an extensive transactional network, which seems to give a strong advantage to a large country. (Notice that his list does not include "backing" for the currency, which is often held up by lesser thinkers as a key attribute. What matters to give a money "moneyness" is not assurance that one can get repaid by the issuer, but certainty of being able to find someone else who will be only too pleased to accept the money. Holders of money do not want the trouble of being repaid.)

Consider which currencies are likely in the future to satisfy these conditions. One needs to consider all the currencies that were mentioned in the previous section, and possibly in addition the rupee, which may emerge as a contender for reserve currency status at some time in the future. Cohen is right to argue that widespread confidence in the future value of money depends on both political stability and being able to trust the country's authorities not to tolerate inflation. It is in the dimension of political stability that recent travails in the euro area have been particularly damaging, since all the members of the euro area, and certainly their collectivity, can no longer be regarded as politically stable. The secondary reserve currencies—sterling, the yen, and the Swiss franc—score quite well on the political stability criterion, but there are perhaps lingering doubts about the depth of the United Kingdom's attachment to anti-inflationary policy and abut Japan's political stability. China is also generally judged as politically stable, although some of us worry that one of the things that people generally want as they become richer is a stake in how they are governed, and China still has to make the transition to democratic governance (which has often proved stormy). India does not face that particular concern, but has concerns of its own. So far as attachment to price stability is concerned, China's record since the hyperinflation was stabilized in 1951 looks pretty impressive, but India's much less so: It seems that price stability is regarded as inflation of under 10 percent, which is unlikely to impress international investors.

The most widely satisfied criterion is presently the second one, possession of well-developed capital markets that are open to all: not only the United States and the euro area satisfy this condition, but also all the secondary reserve currencies. On the other hand, China and India clearly do not satisfy this condition at the present time. However, China has been moving in this direction and one would expect that it will be able to fulfill this criterion relatively quickly, say within 10 or 20 years. It is often held up as a stumbling block preventing China from acquiring a reserve role, but it is likely to prove a temporary block. The same is true of India: if anything, India seems overanxious to liberalize its international currency dealings.

But the final factor is the most important one. It is this which distinguished the United States and the euro area from the secondary reserve currencies: The fact that they each had an enormous home market seems to have been the decisive factor in establishing their international roles. However, if it is right that the euro area is now out of the running because of the political doubts about its future, the key question becomes how long the US supremacy will persist. After all, China is already by some measures the largest economy on earth (Subramanian 2011), and it will certainly become the largest by all measures within the next few years. Moreover, it is this factor that is likely to propel India's claim to reserve currency status, since the large size of its population guarantees that it will become the third largest economy in the world unless its growth rate falls far more than is currently anticipated. However, while Cohen is correct in diagnosing the importance of an extensive transactional network in causing a currency to become internationalized, he does not mention a second critically important factor: the role of the existing network of transactors in this market. Those who wish to transact in this market are not greatly interested in the fact that the good citizens of Idaho overwhelmingly use the dollar, but they are vitally interested in the fact that the dollar is already used extensively in London, Frankfurt, Dubai, Singapore, Hong Kong, and wherever else international trades are executed. This factor gives a great deal of inertia to the international role of currencies. Because of inertia, I see the dollar having a great advantage over any other national currency for the next quarter of a century. (However, I would hesitate to forecast for as long as 50 years.)

Rather than an alternative national currency, could the SDR supplant the role of the dollar? Eichengreen (2009) has argued that it would be necessary to transform the SDR into a private asset if its attractiveness to official holders is to be materially increased, since any use of the SDR as intervention currency would be possible only once the official sector is able to transact with the private sector. I have replied that this is mistaken, since an important potential role of the SDR is that of providing precautionary reserves which do not derive their utility from an expectation that they will be used in intervention (Williamson 2009). But even on this less demanding criterion, there is no sign of the international community showing that enthusiasm for holding the bulk of their reserves in SDRs which would be indispensable for an SDR solution to come to pass. Accordingly (with sadness) I conclude that an international solution is unlikely. The dollar is likely to remain the top international currency.

The Dollar's Role and US Power

The central question that has been posed to me is to reflect on the extent to which the US gains additional leverage by virtue of the international role of the dollar. Economists have typically given a partial answer to this question.

The standard economic analysis holds that the United States gains by international use of the dollar because of the collection of seigniorage. Historically the term seigniorage meant the ability of the sovereign to make a profit when it minted metal into money. In our context the term is used to signify the ability to make a profit from international holding of the currency. There are generally reckoned to be two sources of profit from foreign holdings of the dollar. One arises from holdings of dollar bills (in practice, $100 bills) by foreigners (in practice, mainly drug dealers): In effect, the US gains an interest-free loan to the extent that foreigners hold dollar bills. The other arises from the fact that many foreigners wish to hold dollar assets. The preferred form of assets are US Treasury bills, and therefore the interest rate on US Treasury bills is somewhat lower than it otherwise would be; and the saving is regarded as a part of seigniorage. In reality the demand for many dollar assets is higher as a result of the international role of the dollar, and therefore their price is somewhat higher than it otherwise would be. But because they bear interest the profit the United States makes is merely given by the few basis points by which the interest rate the United States pays is lower than it otherwise would be. This may be even less than the profit yielded by the foreign holdings of dollar bills: Although the base is vastly larger (perhaps of the order of $20 trillion as opposed to $414 billion to $672 billion (Truman 2012)), the saving is in terms of basis points[3] as opposed to the whole interest rate in the case of additional holdings of dollar bills.

It can be objected that the real US gain lies in the ability to finance payments deficits without thought and without stockpiling previous reserves. It can be replied that same is true of other developed countries that are able to borrow in their own currencies: The fact that many of them have not run deficits is due to the fact that they have maintained their currencies at reasonable levels, rather than because of an inability to finance a deficit. And insofar as the United States is unable to manage its exchange rate as a quid pro quo of the seigniorage benefit, the United States loses from the dollar's role.

Economists typically evaluate the reserve role of a currency as a case of trading off the benefits of being able to finance payments deficits more cheaply against the costs of losing full freedom to manage their own exchange-rate policy. In the case of the United States, the Dollar Standard involves a bargain whereby the United States gains cheap finance, in return for other countries having full freedom to manage their exchange rates; but in consequence the exchange rate of the dollar adjusts as a residual. The dollar acts as the so-called nth currency. In the case of the United Kingdom, in the later days of the sterling balances the holders of sterling made it clear that they expected the United Kingdom to avoid devaluing in return for their continuing to hold sterling. In both cases the advisability of maintaining a reserve role of the currency is determined by one's view of the trade-off between the benefits in terms of financing and the costs in terms of freedom to manage the exchange rate. It is not surprising that many economists have therefore concluded that a reserve currency role is not a good bargain.

It has often been argued that the large indebtedness of the United States makes it vulnerable to threats to move holdings out of dollars on the part of foreign governments. But it is a moot point as to whether the United States should fear such a threat. In a floating exchange rate world, the effect of such a shift would be a dollar depreciation of whatever size were needed to persuade private holders to hold an equivalent volume of dollars. The fact that private holdings of dollars are so much larger than official holdings suggests that this might not be a large depreciation. In any event, there is a countervailing factor: the fear of a large foreign holder of dollars that it would induce a reduction in its own wealth if it were to initiate a shift from dollars. As Keynes once observed, when I owe my bank a thousand dollars, I have reason to fear my banker; if I owe it a million, he fears me. In the case of the United States, it owes several trillion dollars to China, and there is nowhere else with financial markets that are large enough to give China a realistic possibility of moving more than a small fraction of its holdings. Any Chinese threat to move the bulk of these balances would certainly result in dollar depreciation, so a threat to shift the balances is not credible. Far more credible is the notion that the balances act as a restraining influence on any Chinese inclination to engage in acts that would be regarded as hostile by the United States. This is not to say that China will accept orders from the United States in order to defend its dollar holdings; Chinese leaders have made perfectly clear that they cannot be blackmailed in this way, and that what they regard as vital national interests (like Taiwan) are not negotiable. Nor indeed does the

[3] McKinsey (2009) has suggested a figure of between 30 and 200 basis points, but even the lower figure strikes me as on the high side.

United States not value continued dollar holdings by China sufficiently highly to be hesitant about words that might suggest that it would contemplate actions that could place the dollars in jeopardy. The Chinese leadership is nevertheless bound to be circumspect about threatening to shift out of dollars.

It is only China, and possibly Japan, which holds dollar balances sufficiently large to face major difficulties in redeploying them should occasion be perceived to demand their removal. No other countries need to take account of the danger of forfeiting a large part of national wealth should they shift out of the dollar.

But note that this traditional analysis is mainly concerned with the official role of the dollar. It is only via the foreign holdings of dollar bills and assets that private actions are deemed relevant. One needs to ask whether it is really true that having the overwhelming majority of international assets denominated in dollars has no impact on the power of the United States.

It is difficult to see how US power in many dimensions is enhanced by virtue of the widespread private international use of the dollar. For example, the US ability to wage war in Iraq and Afghanistan was in no way dependent upon private international use of the dollar. This would seem to be generally true of the use of armed force. Nor is US influence on Pakistan (for example) influenced by the holdings of many private foreigners in dollars. (However, official Pakistan benefited from the US-led clampdown on terrorist financing after 9/11, since this induced many rich Pakistanis to repatriate their holdings of financial wealth.)

There seems to be one large exception: the ability of a country to enforce a financial blockade, such as that currently directed against specified Iranian entities. (It would be possible to expand this into a total financial blockade, but this has not yet occurred.) The United States can order its own companies not to do business with Iran, but this power is present in any sovereign government and is in no way dependent on the role of the dollar. But because third countries generally pay Iran in dollars, the United States government does have additional leverage. Any payment in dollars ultimately involves a transfer on the books of the Federal Reserve banks (neglecting the trivial case in which both the recipient of funds and the payer have accounts at the same bank, which hardly seems likely for international payments). The Fed can require that any institution for which it does business has to certify that it either has no prohibited connection with Iran or is in receipt of a waiver. They can similarly require that an institution that contracts with the Fed impose similar requirements on the institutions on behalf of which they are acting. (Of course, the Fed does not inspect each transaction, but depends upon financial institutions to do the screening, with stiff penalties possible if prohibited transactions slip through. A recent example occurred when Standard Chartered Bank was accused by the New York state Department of Financial Services of having hidden some $250 billion of financial transactions with Iran.) Thus the United States has the ability to stop transactions in terms of dollars. Insofar as foreign institutions insist on paying out of their dollar holdings, and/or Iran insists on receiving dollars, Iran is going to be vulnerable to US pressure.

Is it possible to conceive of a way of side-stepping such pressures? Clearly this would be possible by mutual agreement to stop using the dollar. The most likely country to contemplate this is China: instead of China paying Iran in dollars, it would be possible for China to pay Iran in renminbi, which could be used by Iran to import from China. (Even here there is a caveat: The particular Chinese institution that issued the renminbis could be penalized by the United States if it was also involved in trade with the United States, since the US government has the power to prohibit US companies doing business with it.) Unless Iran wished to import from some third country which had in turn agreed to accept payments in renminbi, presumably because it had obtained a guarantee that it could spend the renminbi in China, it would be restricted to using its renminbi balances to import directly from China. But since China has a good range of products available, the thought of its balances being limited in this way would not be particularly devastating.

It would be difficult to conceive of many other countries being able to persuade Iran to accept payment in their own currency. India seems to be the next most promising candidate, though India probably has more compelling reasons for wanting to maintain good relations with America than China. The rupee also promises to be usable for a wide range of goods, even if not as extensive as those accessible in China.

Are there many other countries which the United States might wish to blockade in the same sort of way that it has sought to do to Iran? I am unable to name any. But it would be wrong to read a great deal into this: In international relations the unexpected is liable to occur. The fact is that having the international financial markets operate in terms of dollars gives the United States a power which other countries do not have. It is a power that could be used against any country at a particular point in time, and it is impossible to foresee exactly under what circumstances the power might be used. That does not mean that it should be ignored.

It is natural to consider the relationship between this position and the typical economist's view outlined at the beginning of this section. The "economist's view" is one about the public sector role, whereas the preceding argument is that it is the role of the private sector that gives the United States extra influence. It follows that the two would be incompatible only if it were true that the private role of the dollar was dependent upon the dollar continuing to play a major role as a reserve currency, which seems very doubtful. The economic skepticism is compatible with private international use of the currency giving a potent additional power to the government.

The question has been raised of the relationship of this analysis to QE3 (the third round of easing of monetary policy announced by the Federal Reserve since hitting the liquidity trap). This easing was motivated by the continued weakness of the US economy and the hope of contributing to its revival. It will have as a side effect a depreciation of the dollar against any other currency which permits it (the remainder will accumulate additional reserves). The Fed has promised to leave this policy in place until there are clear signs of economic revival in the United States. It is perhaps unfortunate that the actions of the Fed are solely motivated by the perceived needs of the US economy and that it takes no account of spillover effects on the rest of the world, but this is one of the effects of that institution called national sovereignty. It is therefore unlikely to change unless and until the world adopts some alternative form of governance.

Conclusion

I have argued in his paper that the US dollar is well-established in its role as the dominant international money. The one currency that looked as though it might offer serious short-run competition, the euro, has for political reasons ceased to be a rival. Nor does there seem any prospect of an international currency becoming a threat to US dominance. Moreover, I do not think the dollar is likely to be seriously challenged in this role in the next quarter century.

The extent to which this gives the United States additional power in the world economy is subject to more serious debate. I identify two ways in which the international role of the dollar contributes to US power in the world: by making China more hesitant to jeopardize its relations with Washington (though only China, apart from possibly Japan, is a large enough holder to be subject to such considerations); and by contributing to the ability of the United States to impose a blockade on other countries.

I have the impression that the additional national power which stems from commanding an international currency tends to be exaggerated by strategic thinkers. One needs to designate the specific mechanisms which would be involved rather than assuming the result.

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