

# Is the US dollar on the way out?

## No, but...

Over a period of about 40 years (1910-50), the British pound went from being the world's leading currency to a struggling minor player. It took another generation to wind down its use as a reserve asset across its former empire, but its reputation and its role in the global financial system had evaporated along with Britain's power.

As the rise of new economies in the 21st century rapidly shrinks the US share of world trade, it's natural to extrapolate history and speculate about the decline of another empire. When Asia's economies outrank North America a decade from now, will the US dollar cease to be the world's money, as newly wealthy countries hold their foreign currency reserves in euros and renminbi?

The short answer is that the US is not Britain, and that there's more to being the world's top currency than simply being the biggest economy. Certainly, as an ever larger proportion of world economic activity is unrelated to the US, less and less will be measured and transacted in dollars. But the liquidity and reliability of the US dollar will probably remain preeminent for several decades.

## History

The transition from sterling to the dollar as the world's leading reserve currency is the only case study in history. All previous arrangements involved stores of intrinsic value – you might choose to hold Spanish or Dutch gold and silver coins, but what you were relying on was the contents of your vault, not promises to redeem bonds.

### Shares of Currencies in Known Foreign Exchange Assets, 1899-1913

	1899	1913
<b>Sterling</b>	64	48
<b>Francs</b>	16	31
<b>Marks</b>	15	15
<b>Other Currencies</b>	6	6

Source: Lindert (1969) quoted by Eichengreen (2005)

The dominance of sterling in the 19thC reflected Britain's dominance in world trade, as it absorbed 30% of the rest of the world's exports in 1860 and still 20% in 1890 (Imlah, 1958). Not surprisingly, it's estimated that 60% of world trade in this period was invoiced and settled in sterling. "Network externalities" (the convenience of using the same unit of account as everyone else) tend to a winner-takes-all solution. The pound was used overwhelmingly for transactions, and accounts were held in London to clear them.

Now it is the dollar that benefits from the network externalities, and from the inertia of dollar-denominated financial practices worldwide and accumulated balances of dollar assets. Switching from the dollar would be like switching from Windows – possibly desirable, but costly and hard to coordinate.

However, the choice of currency for holding a nation's foreign exchange reserves is different, and does not necessarily imply a single winner. What's important is liquidity, especially in a crisis. Therefore, the key criteria are the depth of a country's bond market, the creditworthiness of its government, and the absence of capital controls. A critical factor in the dominance of sterling was that the British government never interfered with the right of foreigners to export gold bullion, in other words to cash in their chips. If other governments had chosen to be similarly trustworthy, their currencies would have been similarly viable as foreign-exchange reserves.

## Composition of Foreign Exchange Reserves

	1973	1987	1995	2000	2005	2Q 2010
<b>% of total allocated reserves</b>						
<b>U.S. dollars</b>	85	66	59	71	67	62
<b>Pounds sterling</b>	6	2	2	3	4	4
<b>Deutsche mark</b>	7	13	16			
<b>French franc</b>	1	1	2			
<b>Japanese yen</b>		7	7	6	4	3
<b>Swiss franc</b>	1.4	1.5	0.3	0.3	0.1	0.1
<b>Netherlands guilder</b>			0.3			
<b>ECU</b>		6	9			
<b>Euro</b>				18	24	26
<b>Other currencies</b>		3	5	1	2	4
<b>Unallocated as % of total*</b>			26	22	34	44

\*Reserves not identified by currency  
Source: Lindert (1969) quoted by Eichengreen (2005)

For the dollar's dominant role to continue, it's not necessary that everyone agree with U.S. fiscal and monetary policies, but they do need to have faith that the government will not interfere with their assets for political reasons. Sound and fury in Congress are tolerable, but the independence of the Federal Reserve is vital. Historically, nobody used the dollar for reserves until the Fed was created, despite the substantial weight of the U.S. economy. The outlook for the dollar as the world's top reserve currency thus depends on the pre-eminence of its bond markets, the creditworthiness of its government, and broadly trustworthy monetary management. Looking out a couple of decades into the future, these may persist, but they cannot be taken for granted.

### **Outlook: what will the world of trade and fx reserves look like in 2030?**

The eurozone is now comparable to the US in terms of GDP and trade, but its bond markets are more fragmented, less liquid, and involve untested sovereign default risk. Nonetheless, its institutions are probably about equally attractive in terms of legal rights and the absence of capital controls, so Asia and OPEC will increasingly diversify their reserves into euros. If Britain ever joins, there could be another quantum leap, but it will probably remain a second-best choice given the absence of a deep, liquid market in ECB-backed bonds.

The Chinese renminbi has much further to go, but if its economic growth continues until it matches western per capita incomes it will be a clear contender for primacy. For transactions, China is tentatively encouraging trade denominated in its own currency. But renminbi balances are otherwise not obviously useful, since to be a viable store of value there needs to be a deep bond market, with ample liquidity, and totally reliable free withdrawal of capital when it's most needed – in a crisis.

Given the transformations in China over the last 30 years, we should expect radical progress over the next 30. But to build the necessary reputation will take major reforms, as well as the unfettered movement of capital in and out during a minimum of one big international crisis.

In any case, it's not clear for now that China aspires to the role of top reserve currency. Since it has barely started down the road to convertibility, it seems on balance unlikely that such a historic shift will happen within the next decade. Nonetheless, it would contribute to the nation's pride and confidence as the dominant force in a new century, so it may well be a longer-term goal.

### **Would China benefit from dethroning the dollar?**

The right to issue money, known as seignorage, confers some real benefits. The French long complained that the US enjoyed the "exorbitant privilege" of issuing the world's money – the rest of the world absorbs virtually unlimited quantities of dollars regardless of investment returns and bears all the risk of currency fluctuations. The nation's cost of capital is lower than it would otherwise be, though it's probably somewhat more vulnerable to swings in global bond markets.

Equally important to China, though, are the monetary and political responsibilities of a dominant international reserve currency: to be willing to act as everyone else's benchmark, to allow its exchange rate to move around unpredictably in response to other countries' policy moves, and to allow capital to flow in and out at all times in unlimited quantities.

Ultimately, there are both tangible and intangible benefits to being on top of the world economy. Whether that position will naturally shift to China as its GDP comes to outrank all others will depend on how safe its financial markets are perceived to be. Today it still seems natural to assume that the US will remain the safe haven for the world’s investors in a financial storm. But given China’s achievements in recent decades, and the long-run issues hanging over the US, it would be rash indeed to rule out a transition much sooner than seems plausible today.

Sheer size is a key issue, and probably points in the direction of multiple “major” reserve currencies. Even when China achieves the world’s largest GDP, it won’t be as pre-eminent as the post-WWII US, and its bond markets won’t be able to handle the whole world’s needs for reserve assets. We should look forward to a world more like 1913, when even the leading reserve currency (sterling) accounted for less than 50% of known reserves.

**Emerging Asia is already important in the world economy and equity markets, but still lags far behind in the depth of its bond markets**

Shares of World Aggregates, 2009

	GDP	Stock Market Capitalization	Debt Securities Total
<b>Euro area</b>	22%	14%	30%
<b>United States</b>	24%	32%	34%
<b>Japan</b>	9%	7%	13%
<b>Emerging Asia</b>	14%	12%	4%
<b>All Other</b>	32%	35%	19%

Source: IMF

**What could go wrong for the dollar?**

The wild card is the US current account deficit. Without constructive policies to limit the escalating international debt, there will be serious dollar depreciation and/or inflation. As the perceived likelihood of a crisis increases, the attractiveness of the dollar for reserves will erode, and no country will want to be the last one out of the door as its value shrinks. A cooperative solution would benefit everybody, but there is no world government to impose one, and self-interest could generate a brutal crisis.

The arithmetic of US debt is simple. The ratio of net foreign debt to GDP stabilizes when the current account deficit is equal to the debt times the growth rate of nominal GDP. Mathematically, therefore, a 5% deficit and a 5% nominal growth trend imply that Debt/GDP will stabilize at 100%. Unfortunately, foreign investors may not tolerate such a level of debt without much higher interest rates – which will themselves contribute to a larger current account deficit. This exponential trend leads rapidly to either a draconian policy shift, with sharp fiscal tightening and recession, or a crash in the dollar exchange rate and a spike in interest rates and inflation.

These possibilities are bad news for the US dollar’s reserve currency role. The only reason to hold an asset that is obviously on a track towards rapid depreciation is a shortage of alternatives, and that shortage will not last as other countries gain ground and expand their financial markets.

The good news is that the stability and attractiveness of the dollar depend on America’s own efforts to reduce the current account deficit. In general, the need is for a sharp increase in exports and a substantial rise in national saving. Policies to balance the federal budget and to discourage consumer spending would be required in order to reduce the gap between what we produce and what we spend. Of course, such efforts are generally unpopular and have not so far been forthcoming from the US political system. The hope must be that the danger is now obvious enough to spur action.

## Conclusions

The US dollar's role as the world's money will diminish with the declining US share of world GDP and world trade, just like sterling 100 years ago. But for the moment it remains the dominant medium of exchange, and there is a lot of inertia inhibiting a switch.

The dollar's role as a store of value, however, can erode gradually, since there is no special benefit from having the same reserve currency mix as your neighbor. For now, the euro is the only serious competitor, and although its role is increasing it is hampered by the lack of a central government – the market for each individual country's bonds is far less liquid than that for US Treasuries.

Meanwhile, the Chinese renminbi is not ready for prime time. Despite tentative steps towards clearing bilateral trade in renminbi, even the most basic prerequisites for a reserve currency are absent. However, if growth and institutional development continue at a pace similar to the last 30 years, it's impossible to rule out a well-developed bond market and a convertible currency within a decade, and a solid reputation as a reserve asset within two.

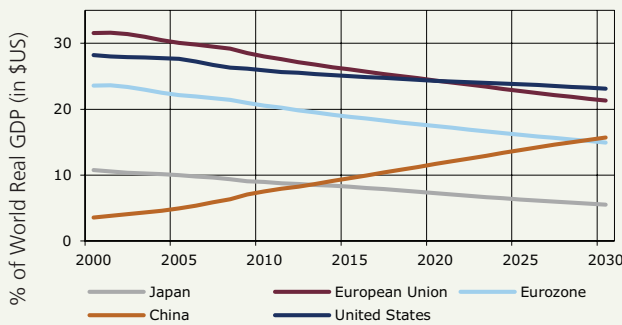
The bottom line is that the decline of the dollar and the rise of the renminbi will be driven by policy decisions within each country. If the Chinese government makes a priority of full convertibility with free capital flows and a deep and efficient bond market, and if the US government allows its international debt to escalate unsustainably, then the tectonic plates of international finance could shift within a decade.

However, it still seems more likely that the Chinese will not be willing to give up control of their currency and markets so soon, and it is at least reasonably plausible that the US government will not ultimately drive its economy off a looming cliff. In this scenario, while the dollar's share of surplus countries' reserves will decline, it will be competing primarily with the euro, and is likely to remain the biggest single reserve asset. The US will therefore continue to enjoy the benefits of the "exorbitant privilege" of issuing the world's money for another generation.

**Global Economic Standings – the basis of power**

We normally trust “real” measures of economic output, and in these terms the US seems set to remain dominant for decades. However, what counts is not the raw quantity of GDP but the world’s current valuation of it. In nominal dollars, using projected exchange rates and inflation, we get a very different story. In other words, we expect the rest of the world to pay a lot less for a dollar in the future, reducing sharply our relative global purchasing power and influence.

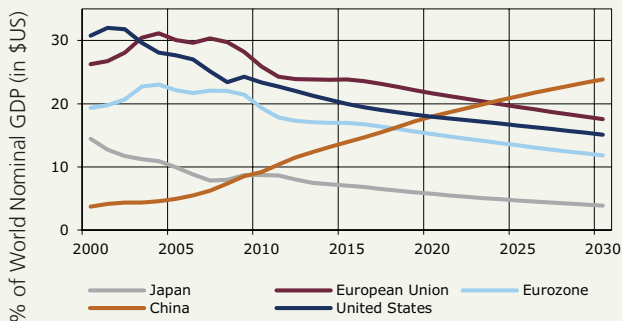
**Shares of World Real GDP**



Source: IHS Global Insight

China’s expected somewhat higher inflation and stronger currency will combine to dramatically increase its weight in the world, outranking the US around 2020 and the E.U. within a few more years.

**Shares of World Nominal GDP**



Source: IHS Global Insight

**Top currency or top nation? – the link between economics and power**

For much of the 19thC Britain was the undisputed leader in trade and finance, and its military reach mirrored its economic status. But times change, and by the end of the century it was in steep relative decline. The Naval Defense Act (1889) called for the Royal Navy to have at least as many main battleships as the next two largest navies combined (France and Russia). It didn’t work, and promoted an arms race that Britain couldn’t afford, as France and Russia more than matched the British shipbuilding program while Germany and the US also built up their strength.

The symbolic end of Britain’s power came with the Suez crisis of 1957, when Britain and France were humbled into backing down not by military force but by the orders of their chief creditor, the US. Massive debt does not support global power.

Given today’s trends in relative economic weight, historical analogies are alarming. The current U.S. strategic assumption that its military should be able to win two wars at once can easily be extrapolated in the direction of bankruptcy.

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