How Global Currencies End

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June 26, 2024

Many people assert

- That the dollar is about to lose its global role.
- Or at least its global dominance.
- (Notice the date at right. This reminds us that “many people” can be accused of crying wolf.)

The risks are rising that the dollar could lose its special global standing

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James McCormack, Fitch Ratings

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KEY POINTS

- There are a number of factors suggesting that, over time, the US dollar may be at risk of surrendering its position as the world's global reserve currency, argues Fitch Ratings analyst James MacCormack.
- Economic sanctions and protectionist trade initiatives are two of the leading causes.
- China and the euro zone have been actively touting their currencies as reserve and transaction substitutes.

A trader shows U.S. dollar notes at a currency exchange booth.

Akhtar Soomro | Reuters

But may it now be about to happen?

- Russia has reason to hope, given how it has been shut out of the US banking system.
- China evidently thinks that there is a possibility, given its investment in internationalizing the RMB.
- President Lula has called for the BRICS to create an alternative to the dollar, reflecting the rising power of emerging markets. So he evidently sees an opening.
- (Notice the headline, however.)

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The U.S. Dollar? 'A Very Far-Fetched Notion,' Expert Says

(Left to right) Brazilian President Luiz Inacio Lula da Silva, Chinese President Xi Jinping, South African President Cyril Ramaphosa, Indian Prime Minister Narendra Modi, and Russian Foreign Minister Sergei Lavrov pose for a family photo during the BRICS summit in Johannesburg, South Africa,

Factors for us to consider

- US geopolitical dominance in decline?
- US commercial/manufacturing dominance in decline?
- Cloudy US financial prospects (indebtedness).
- Whether or not US policymakers prioritize the dollar's international currency status.
  - Or instead weaponize the dollar.
  - Or instead prioritize other economic goals.
    - As with Trump's mooted capital inflow tax to weaken the dollar exchange rate and boost US manufacturing.

There is a geopolitical story for the end of dollar dominance

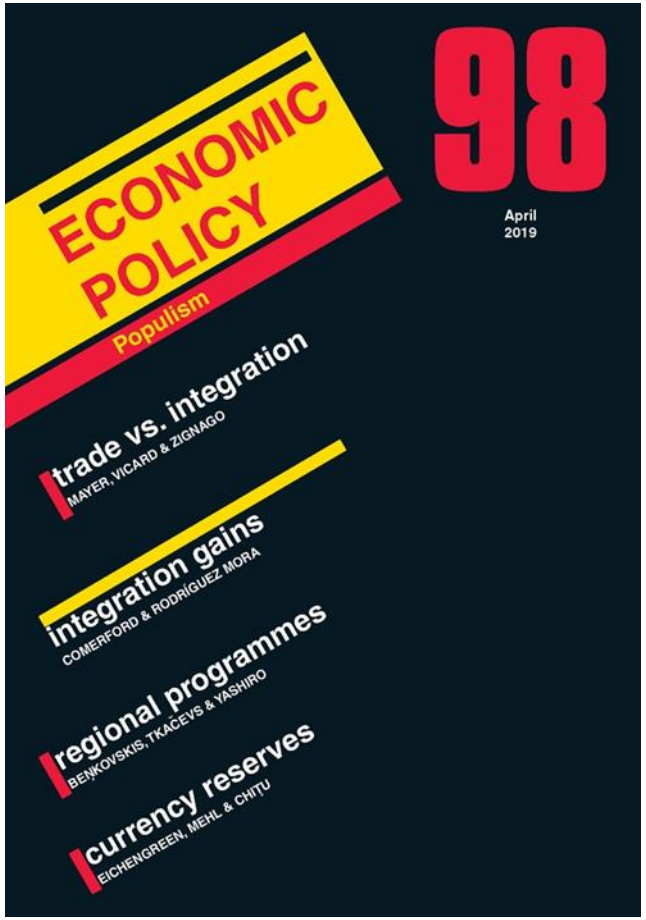
- International currency status depends on the ability of an issuer to project geopolitical power.
- It can compel other governments and central banks to favor its currency.
- Other central banks and governments will agree to do so as a gesture of good faith.
- And the issuer of a leading international currency has to be able to protect its economy, financial system and reserves from external threats.
- So does the putative decline in US geopolitical dominance presage a decline in dollar dominance?

The leading international currencies in history having been:

- The Greek “Alexander”
- The Roman silver denarius
- The Byzantine solidus
  - “The dollar of the Middle Ages.”
- The Spanish silver dollar
- The British pound
- And now the US dollar.

- Each the currency of the leading geopolitical power of its day.


World War One Alliances 1914
Triple Entente
Triple Alliance
Norway
Sweden
Denmark
Great Britain
The Netherlands
Belgium
German Empire
Russia
France
Switz
Austria Hungary
Romania
Portugal
Spain
Italy
Serbia
Bulgaria
Albania
Greece


ECONOMIC POLICY
98
April 2019
Populism
trade vs. integration
MAYER, VICARD & ZIGNAGO
integration gains
COMERFORD & RODRÍGUEZ MORA
regional programmes
BEŇKOVSKIS, TKAČEVS & YASHIRO
currency reserves
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But there are also the cases of:

- The Florentine florin
  - The Florentines lacked the vast hinterland and natural resources of a major power.
- The Dutch guilder
  - The Dutch similarly lacked resources and were unable to decisively defeat the Spanish in the Eighty Years War (1568-1648).
- These were commercial and financial, but not so much geopolitical, powers.
- In each case international currency status rested instead on commercial and financial preeminence
- Until the latter was lost.

Also important is whether leaders prioritize international currency status

- The contrasting fate of sterling after WWI and WWII illustrates this point.
- (This case also illustrates that for a dominant currency to lose its international preeminence there must exist an alternative.)

Sterling, as noted, was the leading 19th century international currency

- But Britain then emerged from WWI economically and financially weakened.
  - It had a public debt on the order of 130% of GDP, 6 times the prewar ratio.
  - It struggled to maintain export competitiveness, full employment and price stability.
- Questions were asked about whether it might inflate away or repudiate its debt, as Germany, France and Italy all essentially did.

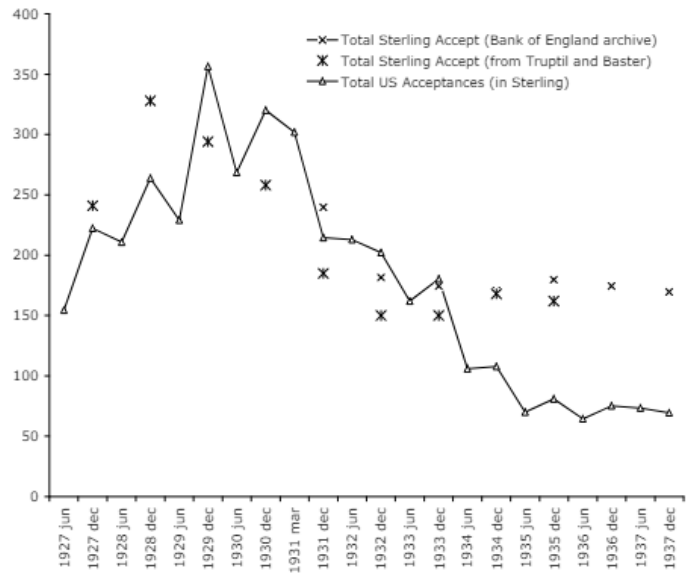
Yet sterling's international status was successfully maintained

- Because Britain prioritized its maintenance.
  - Churchill privileged the interests of the City.
  - Prices were pushed down to prewar levels. Painful budget balancing measures were taken.
- These policies came at a cost to British competitiveness and hence to output and employment.
  - But this sacrifice was accepted in the interest of reestablishing sterling's role in the global economy.
  - Financial interests saw the goal as in their self-interest, while imperialists saw it as necessary for maintaining Britain's geopolitical reach.
- As a result, the currency's international role survived even the turbulent 1930s, when it remained the pivot of the Sterling Area. It was the leading currency in payments, denomination of international bonds, international reserves etc.

Yet sterling's international status was successfully maintained

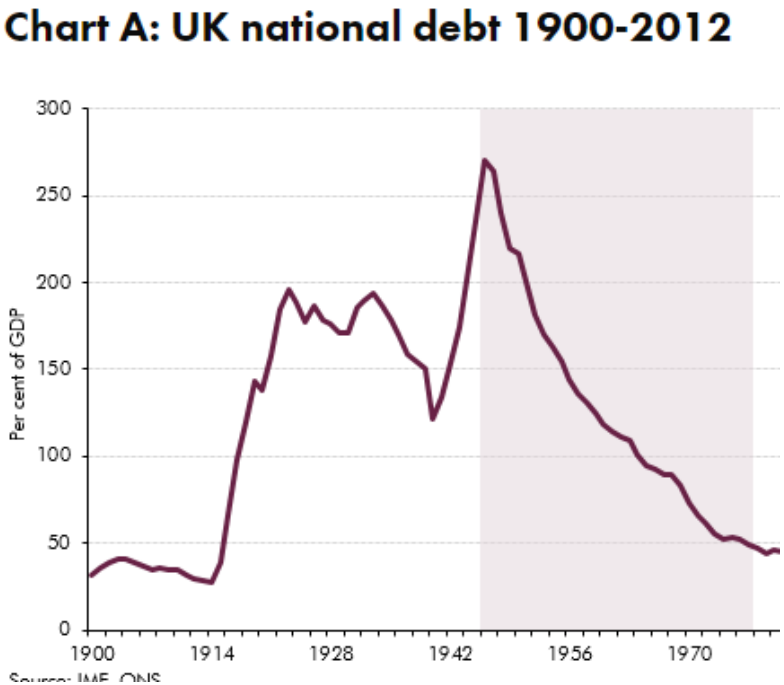
- And because the US, while attempting to mount a challenge, was unsuccessful.
  - Paul Warburg et al. tried.
  - But it took more than a decade or two to build the requisite financial infrastructure (accepting banks, bill brokers, reputable underwriting banks, and a central bank that everyone confidently expected would backstop the market).
  - Dollar had dominated sterling on multiple dimensions in the 1920s, but this collapsed in the 1930s.
  - Sterling maintained its dominance in the 1930s because there as yet existed no viable alternative.

Figure 5. Dollar and Sterling Acceptances 1927-1937 (millions of £)



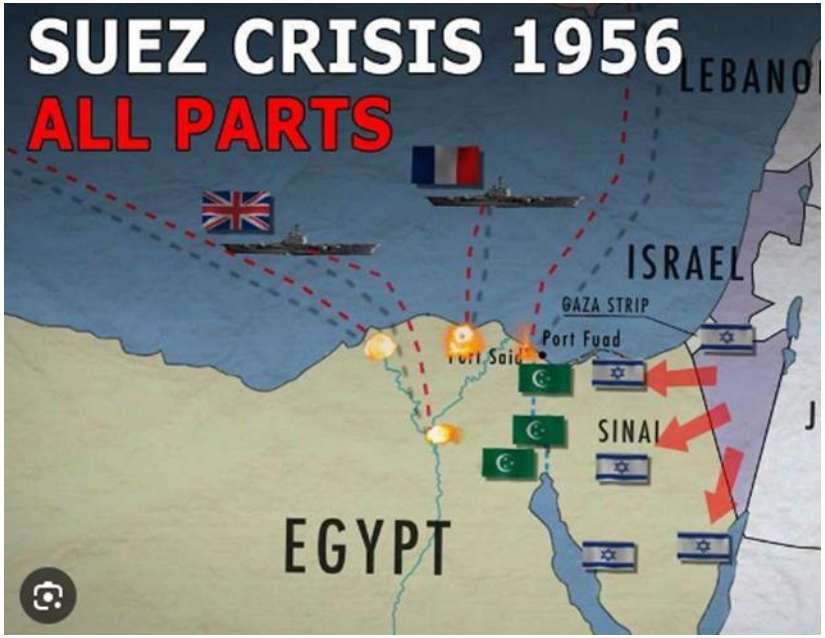
Britain's economic and financial position was again weak post-WWII

- Financial fragility
  - Debt-to-GDP ratio of more than 250%.
  - Overhang of blocked sterling balances.
- Lack of competitiveness.
  - Sick man of Europe."
- In addition, in contrast to the earlier episode, maintenance of international currency status was no longer a political priority.



Geopolitics were then the last nail in the coffin

- When in 1956 the UK participated in the invasion of Suez, sterling crashed.
  - Given how the adverse fiscal implications of this adventure were now superimposed on an already weak financial position.
- The Eisenhower Admin, opposed to the invasion, refused to help (or let Britain draw from the IMF) until the country withdrew its forces.
- This confirmed both Britain's diminished geopolitical stature and sterling's weakness.
- And, importantly, there now existed a viable alternative, in the form of the dollar (U.S. economic and financial dominance of the West being unquestioned, and the institutional deficiencies of the interwar period now having been overcome).



I draw the lesson that…

- …that both geopolitics and commercial competitiveness/financial strength matter for the maintenance of international currency status.
- In addition, a country's policy makers need to value and preserve (prioritize) their currency's international status.
- One can raise questions about how well US efforts to repel geopolitical challenges, enhance the international competitiveness of American manufacturing, and bring its public finances under control are working. These are of course the questions that feed dollar doubts.
- But history is also a reminder that for a currency to lose its international status rapidly, there has to exist an alternative.

The question being whether today there exist viable alternatives to the dollar

Not obviously the euro

- Notice how the dark blue line has, if anything, been falling.

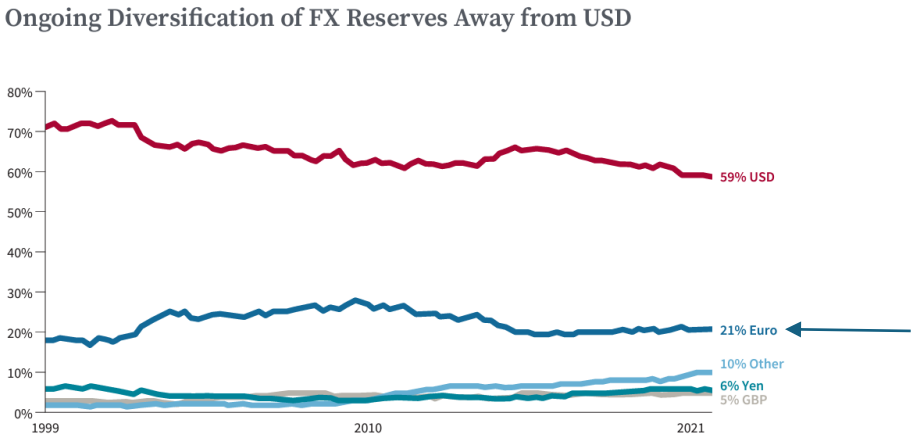
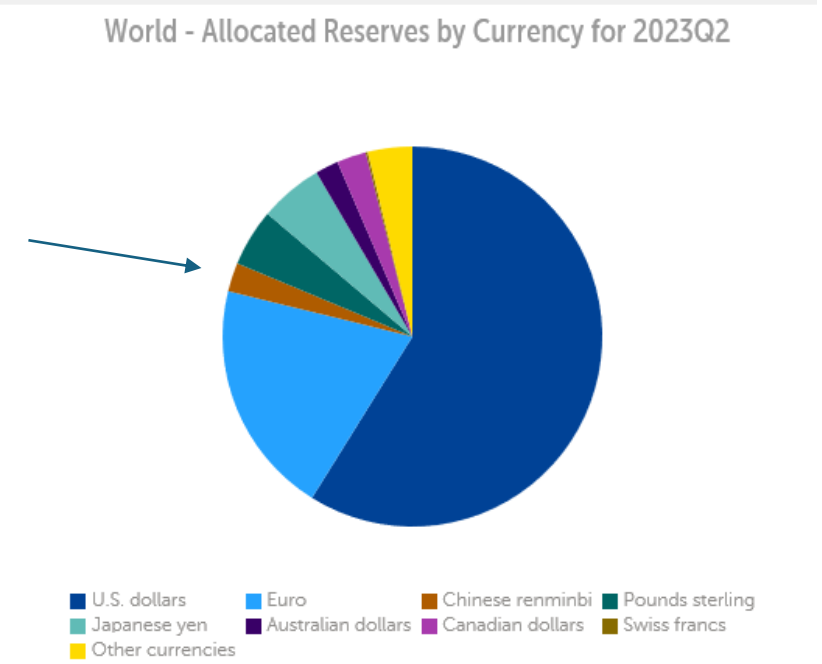


Figure: IMF Currency Composition of Official Foreign Exchange Reserves (COFER). The "other" category includes RMB, at 2.7% in Q42022. See, also, Arslanalp, Eichengreen, and Simpson-Bell (2022). https://data.imf.org/regular.aspx?key=41175

Not obviously the RMB

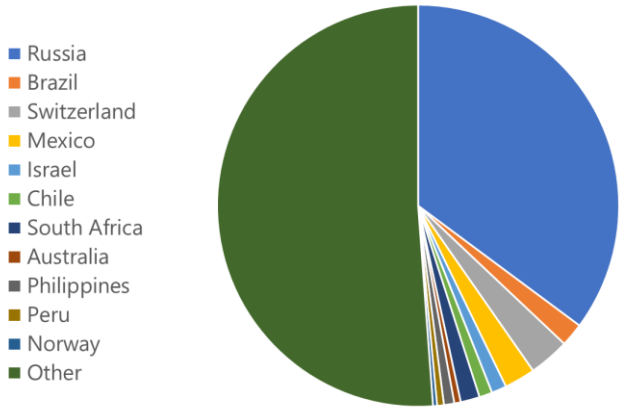
- Notice the very small renminbi slice of the pie (in brown).
- Latest COFER data suggest that efforts at RMB internationalization are stalling out.



More on the renminbi: who holds and uses it exactly?

- You can see here my effort to reconstruct the global renminbi portfolio here.
- Evidently, the renminbi is attractive mainly for Russia (which holds more than a third of all identified renminbi foreign exchange reserves).
  - It's motives will be obvious

Figure 2. Countries Holding Chinese Renminbi in Reserves
(as a share of total RMB holdings, end-2022)



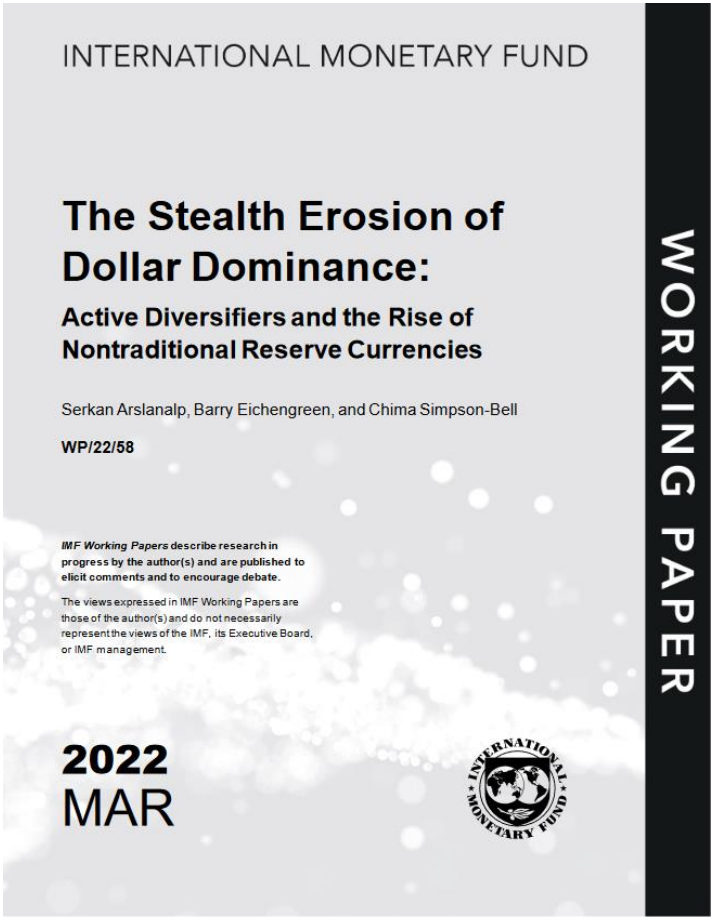
Sources: IMF COFER, IMF Reserve Data Template, and central bank annual reports.
Note: The chart shows identified countries that hold US$1 billion or more of RMB in reserve assets. Data for the Philippines, Russia, and South Africa are for Dec 2021, Dec 2021, and Mar 2022, respectively.

More generally, the RMB is gaining ground only very slowly

- Admittedly, China now settles a quarter of its own trade in renminbi, as shown here.
- But, contrary to widespread chatter, there is little evidence of renminbi-denominated trade settlement that doesn't directly involve China.
  - Again, special cases such as Russia (which settles 20 percent of its trade in renminbi) notwithstanding.
  - Overall, just 5 percent of trade credit and invoicing worldwide is in renminbi at latest report.

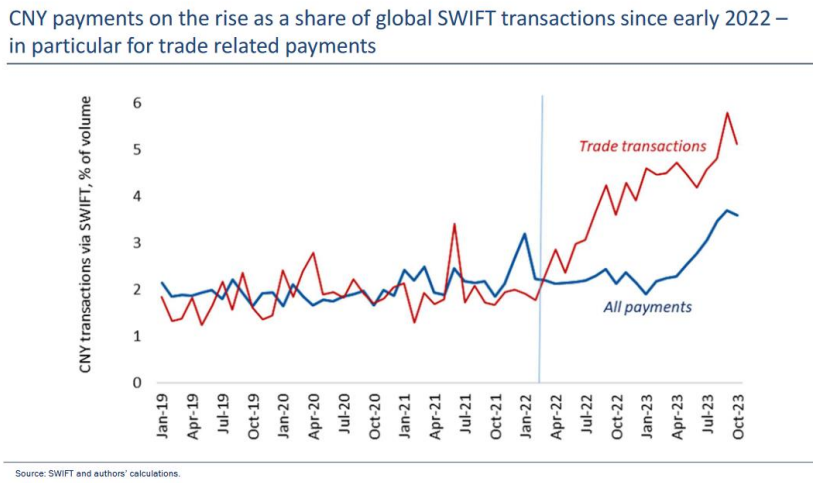
What about so-called weaponization of the dollar?

- Much angst about this at the moment. But while the danger of undermining the global dominance of the dollar exists in the long run, there is little evidence of an effect as of yet.
- We found little evidence of movement from the dollar to other currencies as a result of past U.S. sanctions.
- There was some movement by the directly sanctioned countries (again, think Russia), but not more generally.
- Moreover, where to go? (Issuers of most of the obvious alternatives, other than China, are on board with U.S. sanctions).



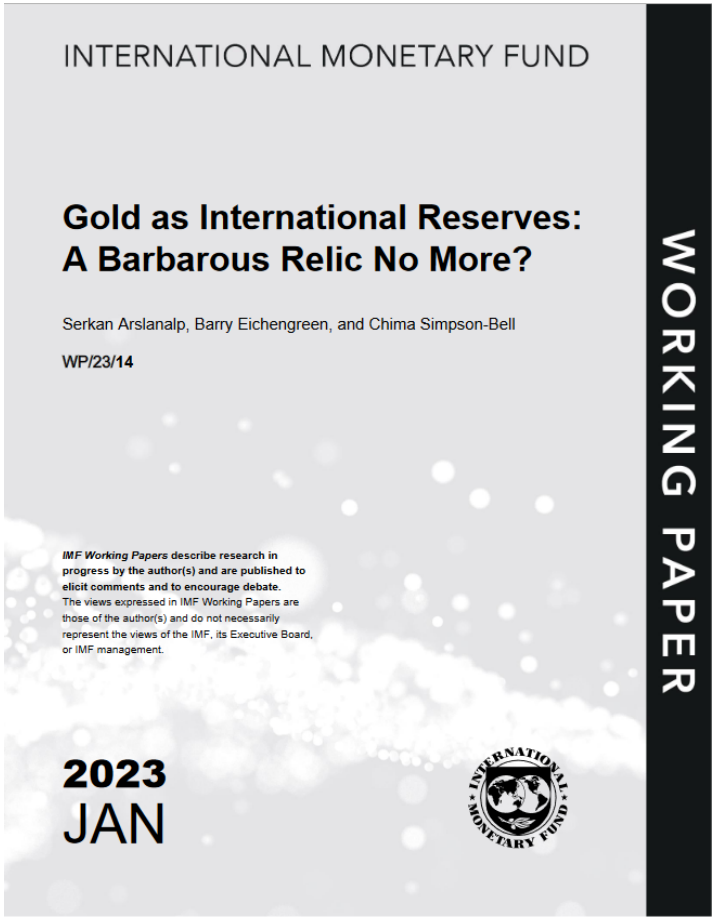
Impact of sanctions on RMB use in trade is definitely there

- As you can see from this figure.
  - Notice the timing.
  - Might we now be about to see more of the same?
- But the effect so far is small.
  - Notice the axis.

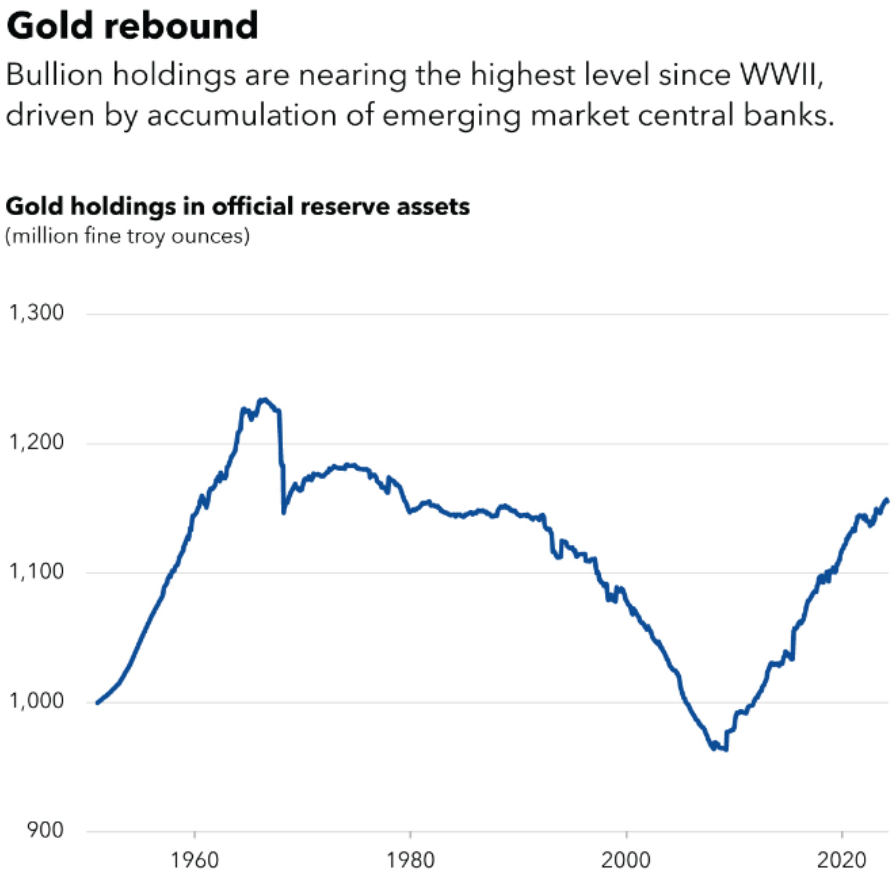


What about so-called weaponization of the dollar?

- However, we did find evidence of movement from currencies to gold here.
- Because gold vaulted at home is insulated from seizure/freezing (though it doesn't have much utility for transactions).
- But the effect is relatively small, reflecting the other costs of holding reserves in gold (inability to use it in payments and financial transactions).



I don’t need to remind this audience



What is going on?

- Euro held back by a shortage of safe and liquid AAA-rated public-label safe assets.
- China held back by capital controls and lack of political checks and balances.
- 21st century digital technology reduces the advantages of a large platform, so that much of the movement away from the dollar has been movement into "nontraditional" or "subsidiary" international and reserve currencies.

Table 5. Nontraditional Currencies in Global Foreign Exchange Reserves, end-2020

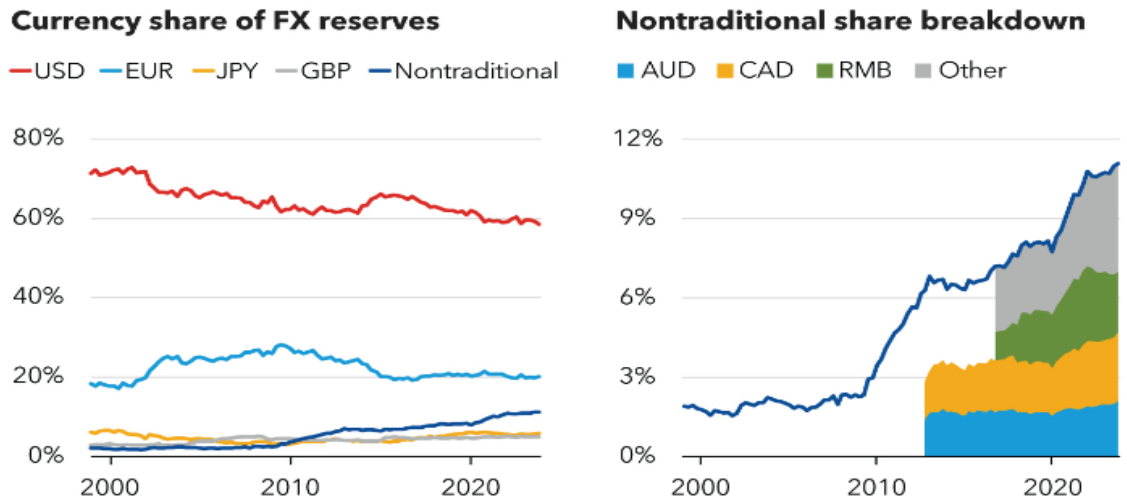
	in bil US$	as % of Total
Total	1070	100%
Australian dollar	217	20%
Canadian dollar	247	23%
Chinese renminbi	272	25%
Swiss franc	21	2%
Other	315	29%
Korean won	81	8%
Swedish krona	63	6%
Singapore dollar	51	5%
Norwegian krone	49	5%
Danish krone	47	4%
New Zealand dollar	12	1%
Hong Kong dollar	11	1%

Sources: IMF, COFER and CPIS.
Note: The size of "other" currencies is estimated based on Arslanalp and Tsuda (2014).

Digital technology makes non-traditional alternatives more practical

Nontraditional currencies rise

Falling share of "big four" currencies mirrored by increasing holdings of nontraditional reserve currencies.



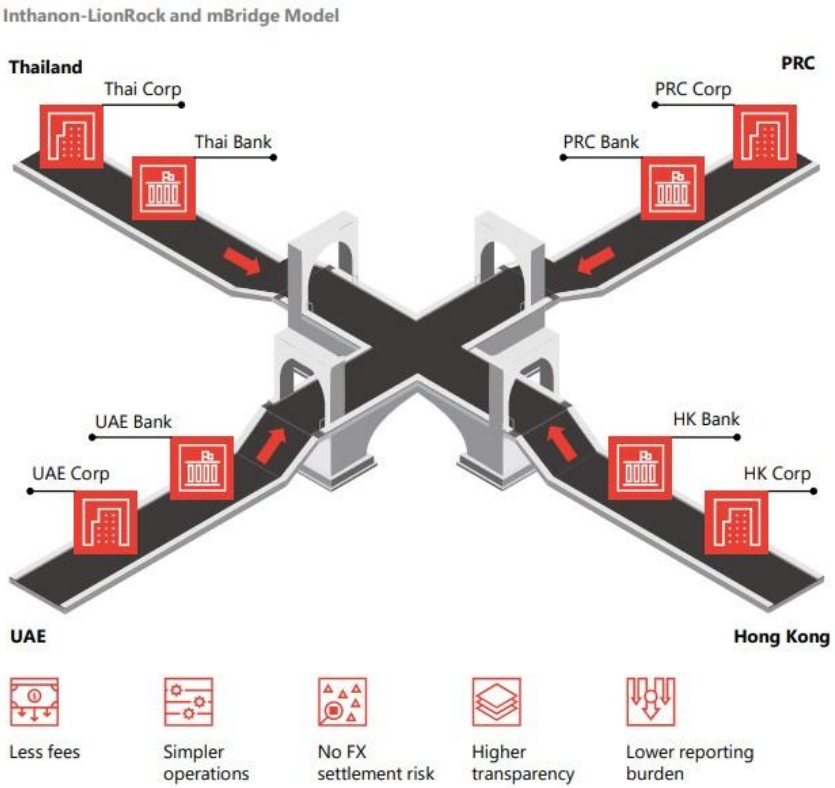
Sources: IMF COFER; Arslanalp, Eichengreen, and Simpson-Bell (2022, updated).
Note: The "big four" currencies are the US dollar, euro, Japanese yen, and British pound. Nontraditional are all other currencies. AUD = Australian dollar. CAD = Canadian dollar. RMB = Chinese renminbi. China became a COFER reporter between 2015 and 2018.

What about CBDCs?

- Currently, CBDCs can't be used cross-border.
- To use China's, for example, you must be resident in China.
- Allowing foreigners to hold significant amounts of eCNY would undermine China's capital controls.
- For other countries, especially in the developing world, cross-border use would create problems of dollarization/currency substitution.
- So it is not clear they will allow this to happen.

What about mBridges?

- In principle, multiple central banks could agree on a dedicated corridor (mBridge).
- Experiments are underway along these lines.
- Or multiple CBDCs could run on a single blockchain.
- No strictly technical obstacle to this. But consider the governance problems.
- An order of magnitude more serious than World Trade Organization Governance.



Conclusions

- We are moving toward a more multipolar international monetary system that better matches our more multipolar global economy, but slowly, slowly.
- More aggressive/widespread use of sanctions could conceivably accelerate this transition. So could reckless, counterproductive U.S. economic policies.
- But, to repeat, we haven't seen much evidence of reserve diversification away from the dollar yet.
  - China may have trimmed its holdings of U.S. Treasuries, but it has mainly substituted U.S. agencies, which are attractive for their higher yields.
- Movement away from the dollar implies movement toward a viable alternative. (Contrast sterling after WWI and WWII.) And the prospective alternatives all face challenges.

- Thank you.