CENTRO STUDI LUCA D'AGLIANO

Seventh Luca d'Agliano Lecture in Development Economics

THE DOLLAR IN DOUBT

Barry Eichengreen

George C. Pardee and Helen N. Pardee
Professor of Economics and Professor of Political Science,
University of California, Berkeley

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Fondazione Luigi Einaudi
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Via Principe Amedeo, 34
10123 Torino

Reports of the Dollar's Death are Exaggerated

Barry Eichengreen

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It is a pleasure to be here to deliver the Luca D'Agliano Lecture. In preparing for the event I couldn't help but notice that Luca D'Agliano did his post-graduate work at St. Antony's College in Oxford. Part of my own graduate education was there as well. St. Antony's had a significant impact on my intellectual development by encouraging a historical sensibility that you don't find in most leading American graduate schools, by emphasizing the synergies between theory and policy, and by its focus on the developing world, especially those parts that we now refer to as emerging markets. In reflecting on the history of this series, I see that all these features – the historical sensibility, the emphasis on practical policy, and the preoccupation with the developing world – feature prominently in previous lectures. None of this, I am sure, is a coincidence.

On to my topic. The blogosphere is abuzz with reports of the demise of the dollar. The greenback has fallen against the euro by nearly 15 per cent since the beginning of the summer. Central banks have slowed their accumulation of dollars in favor of other currencies. One sensational if undocumented story has the Gulf States conspiring with China, Russia, Japan and France – now there's an odd coalition – to shift the pricing of oil away from dollars.

Economists have no trouble explaining the dollar's weakness ex post. With American households saving more in order to rebuild their retirement accounts, the country has to export more. A weaker dollar is needed to make U.S. goods more attractive to foreign consumers. Disenchantment with the sophisticated instruments that U.S. financial institutions specialize in originating and distributing means more limited foreign capital flows into the United States. Fewer foreign purchases of U.S. assets again imply a weaker dollar. Extrapolating the past into the future, forecasters predict that the dollar will decline further.

The first thing to say about this is that one should be skeptical about economic forecasts, especially when they involve the future. Our models are, to put it bluntly, useless for predicting currency movements over a few weeks or months.

I should know. When the subprime crisis erupted in early September 2007, I published an article entitled "Why Now is a Good Time to Sell the Dollar" in a prominent financial publication. (I shouldn't mention it by name, but its initials are FT.) What happened next, of course, was that the dollar strengthened sharply, as investors desperate for liquidity fled into U.S. treasury securities. Subsequently the dollar did decline. But then it shot up again following the failure of Bear Stearns and problems with AIG.

Thus, when all the forecasters line up on one side of the market, recommending that investors sell the dollar, you have a reliable signal that it's time to buy.

It is true that over periods of several years, our models do better. Over those horizons the emphasis on the need for the U.S. to export more and on the greater difficulty the country will have in attracting foreign capital are on the mark. These factors give good grounds for expecting further dollar weakness.

The question is weakness against what? Not against the yen, which is the currency of an economy that refuses to grow and which is already very dear. Not against the euro, which is also already dear and the currency of an economy with banking and structural problems at least as serious as those of the United States.

Thus, for the dollar to depreciate further, it will have to depreciate against the currencies of China and other emerging markets. Intervention by the central banks of several emerging markets in recent weeks shows a reluctance to let this happen. But the choice boils down to buying U.S. dollars or buying U.S. goods. I would submit that they increasingly understand that the first option is a losing proposition.

China for one signaled last month that it appreciates this logic. A report from its central bank suggested that it intends to follow a contingent currency strategy. With exports still down 30 per cent year over year and the prospects for a durable global recovery unclear, it is understandably reluctant to see its currency appreciate now. But once it sees evidence that a durable recovery is underway, it will allow the renminbi to strengthen. The growth of exports to the West will be matched by the growth of its own imports, which will be rendered cheaper by that appreciation. This should limit the return of global imbalances. This is another reason why, in the longer run, we should expect to see the dollar decline.

All this will have implications for the dollar's status as an international currency. For example, it is all but certain that OPEC will eventually shift to pricing petroleum in a basket of currencies. It sells its oil to the U.S., Europe, Japan and emerging markets alike. It hardly makes sense for it to denominate oil prices in the currency of only one of these customers. And central banks, when deciding what to hold as reserves, will surely want to put fewer of their eggs in the dollar basket.

But, beyond this, the dollar isn't going anywhere. With both Europe and Japan having economic problems of their own, the dollar is not about to be replaced by the euro or the yen. The renminbi is coming, but not before 2020 when Shanghai becomes a first-class international financial center. And, even then, the renminbi will presumably share the international stage with the dollar, not replace it.

Let me say a few words about the challenge that China faces in turning the renminbi into an international currency to rival the dollar. I actually think that the renminbi can become a major international currency in as few as ten years. This, in fact, is the time frame on which the United States completed the same transition. In 1914, the dollar played no international role. For trade credit U.S. exporters borrowed not in New York in dollars but in London in sterling. The U.S. was entirely dependent on the UK for trade finance. Similarly, countries around the world relied on London for trade credit, denominated their bonds in sterling, used the services of London banks to underwrite them, and held their reserves mainly in sterling (and in French francs and German marks). No one held reserves in dollars, floated foreign bonds in New York, or used U.S. banks to obtain trade credits. This reflected Britain's head start as an early industrializer, as the leading trading nation, and as banker to the world but also the absence of the relevant financial markets and institutions in the United States.

Indeed, remedying this problem was one of the principal motivations for creating the Federal Reserve System in 1913. And virtually the first initiative of the new central bank was to develop a market in acceptances, the main instrument used for financing trade. By 1924, beginning from a standing start, New York had surpassed London as a source of trade credit, and the dollar had overtaken sterling as a form of international reserves.

My point, then, is that it can be done in as few as ten years. Admittedly, the success of the United States in doing so reflected not just aggressive policies on the part of the newly created Federal Reserve but also the fact that London's position as a financial center was damaged by the suspension of normal business during World War I. Similarly, one might say that whether the renminbi succeeds in rivaling the dollar as an international currency will depend both on Chinese policy and whether the U.S. suffers reputational damage in the meantime. I will return to this.

At the same time it is important not to understate the challenges that China faces in attempting to elevate the renminbi to international currency status. At the moment the currency is used in cross border trade only with Mongolia, Vietnam, Cambodia, Nepal and North Korea (and the special administrative regions of Hong Kong and Macau). Brazil and China recently announced their intention of exploring ways of using their own currencies in their bilateral trade, and Malaysia has indicated that it may follow. But this agreement is useful mainly for advertizing the fact of Chinese-Brazilian trade. What use would the typical Brazilian firm have for renminbi given that the Chinese currency cannot be converted into real? A Brazilian firm will take renminbi in payment for its exports only insofar as it imports from or invests in China – not your typical case. Brazil and Argentina reached a similar agreement to conduct their bilateral trade in their own currencies in September 2008 but, revealingly, continue to use mainly the dollar.

Similarly, China's recently concluded swap agreements with Argentina, Belarus, Hong Kong, Indonesia, South Korea and Malaysia are more a way for China to signal its desire to be an international player than of practical importance. The central banks of these countries can't use renminbi to intervene in foreign exchange markets. They can't use it to import merchandise from third countries or to pay foreign banks and bondholders. Contrast the $30 billion dollar swap that the Bank of Korea received from the Federal Reserve last November, which it used to intervene in foreign exchange markets. China could become a more consequential as a supplier of emergency credits if it made its swap lines available in dollars. But so much then for swaps as a device for enhancing the renminbi's international role.

In time China can strengthen the international role of the renminbi by developing liquid securities markets and liberalizing foreign access. In time it can make its currency convertible for financial as well as merchandise transactions. The question is: *how much time*? China has been feeling its way toward capital account convertibility for more than a decade and even now it is only part of the way. Reconciling financial stability with full freedom for residents to buy and sell foreign assets and for foreigners to buy and sell domestic assets has formidable prerequisites, as other Asian countries have learned to their chagrin. Markets must first become more transparent. Banks must be commercialized. Supervision and regulation must be strengthened. Monetary and fiscal policies must be sound and stable, and the exchange rate must be rendered more flexible to accommodate a larger volume of capital flows.

China, in other words, must first move away from a growth model in which bank lending and a pegged currency have been two of the main instruments of development policy. This is easier said than done. Witness how the Chinese authorities' reaction to the crisis was to move in the other direction, relying more on directed lending to boost investment and hardening the renminbi's peg to the dollar to sustain exports.

Until now, renminbi-denominated bonds have been sold only by Chinese banks along with multilateral banks such as the Asian Development Bank and International Finance Corporation, and the bonds have been sold only in China. The Chinese government has been reluctant to allow bond issuance by foreign corporations, since this would interfere with its ability to channel savings to Chinese industry. (Shades of Japan in the 1970s…) This is now beginning to change, if slowly. Thus, in May HSBC Holdings and the Bank of East Asia said they would become the first foreign banks to be authorized to sell renminbi-denominated bonds in Hong Kong.

Hong Kong, with its open markets, is one thing. The China Development Bank and the Bank of China are already permitted to issue renminbi-denominated bonds to individuals there. But Shanghai would be another. On a visit to the U.S. in June, Guo Shuqing, chairman of the China Construction Bank, suggested that the U.S. government should consider issuing renminbi-denominated "panda bonds" in Shanghai as well as Hong Kong. Allowing the U.S. to issue bonds there on a small scale might further the authorities' efforts to develop Shanghai into an international financial center. But allowing it to do so freely would destroy the ability of the Chinese authorities to channel savings to domestic industry. Households would presumably regard these bonds, with their returns guaranteed in domestic currency, an attractive alternative to the captive bank deposits which are funneled into industrial development. (Note that the IFC's panda bonds, issued in 2005, were in fact raised on behalf of three Chinese companies requiring local-currency finance.) Thus, the entire Chinese development model would be placed at risk.

All this said, China's efforts to internationalize the renminbi should not be underestimated. That, as I have said, is the lesson of my country's own history. Chinese policy makers are serious about turning Shanghai into an international financial center by 2020. Doing so will require building deeper and more liquid financial markets in renminbi-denominated assets. It will require liberalizing the access to those markets of foreign investors; it will require capital account convertibility, in other words. And that in turn will imply a host of other policy changes that amount to moving away from the country's tried and true growth model. That, in a nutshell, is what China must contemplate if it is serious about turning the renminbi into an international currency to rival the dollar.

The other serious emerging-market candidates for reserve currency status are the Indian rupiah and the Brazilian real. (I disregard Russia as lacking the requisite political stability and transparency, as being demographically stagnant, and for the fact that a petro-state has never been the issuer of an international currency). Both the Indian and Brazilian economies are smaller than China's, creating a smaller platform from which their currencies can launch their international careers. But they already are market economies. They already have floating exchange rates. They have well-regulated banking systems and well-developed financial markets by the standards of China. (Of course, they also have barriers to foreign investment in their debt securities – in India's case quantitative restrictions, in Brazil's newly imposed taxes. These would have to go in order for the rupiah or real to become important reserve currencies – not, to be clear, that I am necessarily advocating this.) Still, whether Brazil or India on the one hand, or China on the other becomes a reserve-currency country first will shed light on the disputed question of what is more important for the acquisition of this status: sheer economic size or financial development and the quality of regulation.

I should also say something about the proposal of People's Bank of China Governor Zhao to replace the dollar with a synthetic unit – an updated version of the IMF's Special Drawing Rights, since this idea has been echoed by spokesmen for the Brazilian, Indian and Russian governments and by a United Nations commission chaired by Joe Stiglitz. The idea here is that the IMF would issue SDRs on a regular basis in amounts equal to the increase in global reserve demand. The problem here is that SDRs can be used only for transactions with the IMF and among consenting governments. Unlike national currencies they cannot be used for foreign exchange market intervention and other transactions with market participants. For central banks and governments that see reserves as insurance – that anticipate actually having to use them – this illiquidity renders SDRs unattractive. If there is one lesson of history relevant to this issue, it is that only currencies that market participants regard as attractive for private international use are attractive to governments and central banks as a form of reserves. There have been many previous attempts to create a reserve unit that has not previously been attractive in private use, with names like bancor, veritas, ecu, and of course, in the 1960s and 1970s, Special Drawing Rights. None of these have succeeded.

Thus, making SDRs attractive would require making them liquid. This would mean developing private markets on which SDR claims can be bought and sold. It would be necessary to build broad and liquid markets on which governments and, for that matter, financial and nonfinancial firms can issue SDR bonds at competitive cost. Banks would have to find it attractive to accept SDR-denominated deposits and extend SDR-denominated loans. The pension funds and insurance companies that are the dominant sources of private demand for bonds would have to be attracted to holding bonds denominated in a basket of currencies despite the fact that their liabilities tend to be dominated in a single national currency. It would be necessary to restructure foreign exchange markets so that traders seeking to buy, say, Korean won for Thai baht first sold baht for SDRs (before buying won) rather than first selling baht for dollars. While all this is possible, it would not be easy. It is worth recalling that there was a previous attempt to commercialize the SDR in the 1970s that never really got off the ground. Succeeding this time would take decades rather than years.

As part of this effort, the IMF would have to be authorized to issue additional SDRs in periods of shortage, much as the Fed provided dollar swaps to provide dollar liquidity in the second half of 2008. At the moment countries holding 85 per cent of IMF voting power must agree before SDRs can be issued, which is not exactly a recipe for quick action. IMF management would have to be empowered to decide on emergency SDR issuance just as the Federal Reserve can decide to offer emergency currency swaps. For the SDR to become a true international currency, in other words, the IMF would have to become more like an independent global central bank. The idea of an independent IMF has its advocates,, but it is not clear that China, Russia, Brazil and other advocates of replacing the dollar with the SDR are aware that this is the implication of their proposal.

There may be a limited role for additional SDR issuance in supplementing existing holdings of national currencies in the reserve portfolios of central banks. Because the SDR is defined as a basket of currencies, accumulating SDR claims will be another way for central banks to modestly diversify their reserve portfolios in the direction of fewer dollars. Issuing SDRs has the attraction that it is cheap. Since the SDR is simply a paper claim, it costs no real resources to produce. Countries seeking additional reserves do not have to forgo consumption and run external surpluses in order to acquire them. It is also a way of limiting the exorbitant privilege that will be shared by the future reserve currency countries. But central banks will willingly hold only a limited fraction of their reserves in this form, since SDRs are not liquid and not readily used in market intervention. The SDR will not replace national currencies in central bank reserves because it will not replace national currencies in other functions. Moreover, a decision to create large numbers of SDRs on a regular basis to meet the global demand for additional reserves would have to confront the intractable question of how to distribute them. Would they be distributed in proportion to existing reserves? Mainly or even exclusively to the poorest countries? In the absence of a consensus as to the answer, the likely result is SDR issuance that is more token than real.

Governor Zhou being aware of these facts, one might ask what motivated him to make the case for the SDR. One answer is that his SDR proposal was intended as a stalking horse for a "Substitution Account" through which, in conjunction with issuing SDRs, the international community will take China's dollars off its hands. The idea of an account at the IMF through which SDRs would be substituted for dollars already on the books of central banks was first raised in the late 1970s, an earlier period of angst over the prospects for the greenback. It foundered then over the question of who would bear the losses on the dollars deposited in the Substitution Account. The U.S. government was not prepared to do so, and if the risk therefore remained in the hands of other countries – the same countries that had previously had those dollars on their own books – the operation would be purposeless. Recently the idea of a Substitution Account has been raised again, this time by academics but not yet officials. But again, it seems pretty obvious that the proposal will founder over the insolvable problem of who takes the losses on the dollars in the account. If it is present reserve holders like China, then the operation accomplishes nothing. If it is the United States, this would be tantamount to the U.S. offering to guarantee the value, in foreign currency terms, of its dollar liabilities, which is not something it is willing to do. Governor Zhou is savvy enough to understand this.

The more compelling explanation is that he was engaged in symbolic politics. Zhou wanted to signal China's unhappiness with prevailing arrangements. By publishing his essay on the eve of a high-profile G20 economic summit in London, he wanted to remind other countries that China expected to actively participate in discussions of international monetary reform and that its views were to be reckoned with. By suggesting an enhanced role for the SDR, he was positioning China as an advocate of a rules-based multilateral system. But he was also playing to his domestic audience. He was seeking to deflect criticism that the Chinese authorities, by failing to more actively seek out alternatives to the dollar, had not been careful stewards of their country's international reserves.

While this is supposed to be a lecture on developing countries, I can't resist saying a few words – given the locale – about the euro. The euro is clearly gaining market share. But, in my view, the euro will rival the dollar as a reserve currency only when it possesses equally deep and liquid markets. Recall how the market in U.S. treasury debt remains far and away the most liquid in the world. Europe's problem is that the stock of government debt securities is not homogeneous. Different government bonds differ in their risk, returns and liquidity. German bunds have a reputation for stability but, since they tend to be held to maturity by institutional investors, the market in them lacks liquidity. Certain other euro area countries with plenty of bonds have deep financial problems as a result of past policies and the crisis. Italian government bonds, as this audience will know, are in fact the most important euro area debt securities in value, but these problems mean that they are hardly attractive as reserve assets. Recent events in Greece only serve to underscore the point. The crisis has encouraged talk of issuing euro area bonds and putting the full faith and credit of the entire set of members, starting with Germany, behind them. Were this done on a significant scale and were such debt to replace the national debt securities of the member states, the euro area would possess something more closely resembling the U.S. treasury market. But this kind of radical fiscal federalism is not something to which the German government is likely to agree anytime soon.

So I conclude that the dollar is here to say, as the leading international currency, for the foreseeable future, simply because there are no viable alternatives for the time being.

The one thing that could precipitate the demise of the dollar would be reckless economic mismanagement in the United States. One popular scenario is chronic inflation. This is not my baseline scenario. More plausible in my view is that once the episode of zero interest rates ends, the Fed will be anxious to reassert its commitment to price stability. There may be a temptation to inflate away debt held by foreigners, but the fact is that the majority of U.S. debt is held by Americans, who would constitute a strong constituency opposing the policy.

The other scenario is that U.S. budget deficits continue to run out of control. Predictions of outright default are far-fetched. But heavy debts will mean high taxes. The combination of loose fiscal policy and tight monetary policy will mean high interest rates, sluggish investment, and slow growth. The United States will come to look more like Italy, not just fiscally and financially but in terms of economic growth as well. And, as Italian observers can attest, foreigners – and residents – might well grow disenchanted with the currency of an economy with these characteristics.

Mark Twain, the 19th century American author and humorist, once responded to accounts of his ill health by writing that "reports of my death are exaggerated." He might have been speaking about the dollar. For the moment, the patient is stable, external signs notwithstanding. But there will be grounds for worry if he doesn't commit to a healthier regimen.