

The dollar standard: (only the) beginning of the end

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One of the joys of being a seasoned observer of foreign-exchange markets is watching the interplay of exchange rates with politics, policy and psychology across a couple of cycles. Whenever the dollar is strong and the euro weak, there is unbridled talk of "euro sclerosis" and the triumph of American capitalism; and whenever the dollar is weak and the euro strong [1], there is fervent discussion of the spiralling costs of United States healthcare [1] and how the rest of the world is unceremoniously ditching the dollar standard. What keeps these cycles repeating themselves is that there is an element of truth in every story.

Today, around 65%-70% of central-bank reserves are held in US dollars, and a similar proportion of international trade, banking and investment flows are invoiced in dollars. The euro has made strong advances [2] in a number of areas, especially in corporate bonds, without breaching the dollar-standard fortress. I believe this will change: not overnight, as some of the more breathless commentary [3] suggests, though it is likely to occur within the lifetime of the average currency trader. That said, traders with daily, monthly or quarterly investment horizons will lose a lot of money if they focus too closely on this generational trend to the exclusion of the many peaks and troughs along the way. By the time the dollar has lost its status [4], somewhere around 2035, the Chinese *renminbi* (RMB [5]) or even the Indian *rupee* - not the euro [6] - will be best placed to take over its mantle.

Owners of reserve currencies down the centuries would blush and say that their role is a Kipling-esque burden [9] they did not choose. In fact, issuing the world's reserve currency brings substantial benefit. It is analogous to paying for things by writing cheques that no one cashes. Between 2000 and 2007, American consumers behaving this way have spent 30% more than they have earned.

The benefit of reserve status is well illustrated by the symmetrical costs of losing it, when the cheques written over the years are called in to be cashed. The so-called "balance of payments" constraint on United Kingdom growth from 1945 to 1979 which led to a deterioration in Britain's relative economic position was due in no small part to what was then described as the "sterling balances" problem: returning sterling reserves that owners wanted to cash in for dollars.

The sense of an ending

The trick to paying for things with cheques that nobody cashes is to practice restraint. However, insufficient restraint brings benefits within a timeframe that matters to politicians and costs within a time-frame that does not. It is no surprise, therefore, that while there have been around twelve international currencies over the past 2,000 years - among them the (Roman) *denar*, (Greek)

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drachma, (Ottoman [10]) *dinar* and (Venetian) *ducat* - the limited historical evidence suggests that they ended their reign in a blaze of inflation through debasement. Reserve currencies seduce their issuers into economic and military "over-reach" that decades later leads to a messy end (the British chancellor Denis Healey [11]'s sudden recall from Heathrow airport to deal with the 1976 sterling crisis is one such moment).

This very messiness means that the loss of reserve status is resisted by those who have enjoyed it for so long. The British used military and political influence to extend the reach and period of sterling's reserve-currency status. In the 1900s, for instance, over 60% of central-bank reserves were still held in sterling even though the US economy had become the largest economy some twenty years before. However, the principal owners of sterling reserves were not the then great powers (the US, France, Germany and Japan), but the great treasuries of the British empire: India, Canada and Ireland.

In light of such precedents, the expectation must be that the United States will seek to use its military, economic and political might to prolong the dominant [12] position of the dollar. Iraq is a case in point: irrespective of what is in Iraq's best interests, I suspect that under the US protectorate, the Iraqi central bank will not be one of the first central banks in the middle east to diversify its reserves from dollars, loosen its currency link to the dollar [13] or invoice its oil in euros. Indeed, the reversal of Saddam Hussein's decision in November 2000 to start invoicing oil sales in euros has probably cost Iraq \$25 billion between 2003 and 2007, equivalent to 30% of its GDP.

Indeed, gunboat diplomacy in the currency field is not new. In 1944, the British negotiating team led by John Maynard Keynes [14] expected friendly terms when they began negotiating with the US over the repayment of debts London had built up during the war. Instead, the US insisted on strict conditions that were designed to undermine the sterling area.

An open contest

The history [15] of international currencies suggests that a key factor in their evolution is the absolute amount of international trade that a country conducts. The Roman and Ottoman empires were the largest trading blocs when the *denari* and *dinar* were international currencies. In the 19th century, Britain was the largest trader and sterling was the reserve currency. In the 20th century, the US was the world's largest trader. By the middle of the 21st century, the largest trader is likely to be China. If the euro-area were set for an aggressive eastward expansion (encompassing Turkey, Ukraine, Russia, Kazakhstan and their neighbours) then the euro would be a good contender to replace the dollar. Today that seems unlikely.

Some argue that the next reserve currency will be a basket of currencies. True, there is a greater choice of liquid, freely trading currencies today than in the past. Yet I do not think this will be the case because when market participants seek a reserve currency they are looking for something that will rise in value when all else is falling, and if one of the basket is expected to rise more than others it will soon become "the" reserve currency.

The idea that the world's next reserve currency [16] might be China's *renminbi* can provoke scorn. China, after all, does not even have a convertible exchange rate today. However, it does

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have a central bank, which is more than the United States had in 1910. China also thinks consistently about such grand issues in a way that is not always the case in the US where policy influence flitters between "Wall Street" (which favours a reserve currency) and "Texas" (which favours a competitive dollar [17]). Currently the Texans are in charge.

The biggest risk to a RMB-standard by the mid-21st century is that between 2007 and 2035, there is likely to be major political change [17] in China. This may be as smooth as the "velvet revolution" in the former Czechoslovakia in 1989 or it may be as tumultuous as China's own cultural revolution of the 1960s. However, if China is delayed or diverted by politics, it is not clear that this provides an opportunity for Euroland in 2035. India's economic and political path, by contrast, appears well set. China's one-child policy makes it all the more likely that India will end up with the largest population and, one day, the largest economy in the world.

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