The dollar reigns supreme -- by default

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The dollar has been the pre-eminent global reserve currency for most of the past century. But its dominance appears under threat. The global financial crisis, which had its epicenter in the U.S., has heightened speculation about the currency’s looming, if not imminent, displacement.

The U.S. is beset by a high and rising level of public debt -- gross debt now equals the nation’s annual gross domestic product. The Federal Reserve’s aggressive use of unconventional monetary policies has increased the supply of dollars. Bitter political partisanship has made U.S. policymaking ineffectual, hindering the economic recovery and making it harder to tackle long-term fiscal problems related to rising health care and social security expenditures. Meanwhile, short-term fiscal tightening has constrained government spending on education and infrastructure, hurting long-term productivity. All of this should set off an economic decline and hasten an erosion of the dollar’s importance.

U.S. bond binge

This logic is compelling, but the reality is starkly different. The dollar’s position as the dominant reserve currency has become stronger since the global financial crisis. Foreign investors have purchased $3.5 trillion in U.S. government securities since 2007 and now hold $5.7 trillion worth. The dollar’s share of foreign currency reserves has held steady at 62% despite the crisis.

How did this happen, and is the situation tenable? Financial globalization is part of the explanation. Given their increasing financial openness, emerging market economies are keen to accumulate massive hoards of foreign exchange reserves to insulate themselves from volatile capital flows. Additionally, many of these countries intervene in foreign exchange markets to limit appreciation of their currencies. The same is true of some advanced economies, such as Japan and Switzerland, that have also been intervening in foreign exchange markets to prevent their currencies from appreciating. Reserves acquired through such intervention need to be parked in safe and liquid assets.

This has led to rising demand for safe financial assets. Regulatory reforms that require banks and other financial institutions to hold such assets as a buffer against financial shocks are adding to this demand. Under the new Basel III banking regulations, it is estimated that global banks will have to add about $2.5 trillion to $3 trillion in safe assets, mostly government bonds from advanced economies, to their balance sheets.

The supply of safe assets has fallen even as demand has surged. After the crisis, few private-sector securities can be considered safe assets. Government bonds issued by the eurozone and Japan look shaky because these economies are contending with unfavorable demographic trends and weak growth prospects. With its deep financial markets and rising public debt, the U.S. government has thus become the primary global provider of safe assets.

Sense of security

Are these assets really safe? It is a tempting proposition for the U.S. to reduce its debt through higher inflation, as this would disproportionately hurt foreign investors. But higher inflation would also hurt the U.S. economy. Domestic holders of U.S. debt include retirees, pension funds, financial institutions and insurance companies. These groups are politically powerful and would inflict damage on the incumbent government if inflation were to rise sharply. This gives foreign investors some reassurance that the value of their U.S. investments will be protected from inflation.

The dollar’s dominance as a store of value does not necessarily translate into continued prominence in other aspects. Its importance as a medium of exchange and unit of account is likely to decline. Financial-market and technological development are making it easier to conduct cross-border financial transactions using other currencies, reducing the need for the dollar. There is no good reason why contracts for certain commodities like oil should continue to be denominated and settled only in dollars.

By contrast, financial assets denominated in U.S. dollars, especially U.S. government securities, remain the preferred destination for investors interested in keeping their investments safe.
The dollar's position as the dominant reserve currency has become stronger since the global financial crisis.

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The reason the U.S. appears so special in global finance is not just its economic size but also because it has fostered a set of institutions -- democratic government, public institutions, financial markets, legal framework -- that, for all their flaws, still set the standard for the world.

There has been a great deal of discussion about the prospects for China's currency, the yuan, also known as the renminbi, to challenge the dollar as the dominant reserve currency. If it stays on its present growth trajectory, the Chinese economy could soon match that of the U.S. in size. Due to the rising importance of China in global GDP and trade, the renminbi has already become a significant international currency -- one that is used widely in international trade and finance transactions.

For the renminbi to become a reserve currency, China will need to free up its capital account, make its currency freely convertible, and have better-developed financial markets. These reforms are underway, albeit at a gradual pace. Hence, it is likely that the renminbi will become a reserve currency in the next one to two decades.

However, the Chinese currency is unlikely to become one that foreign investors turn to for safety. With its present political and legal frameworks, China is not generally perceived by foreign investors as a safe haven for their money. The leadership in Beijing has made it clear it is focused on economic and financial market reforms, and has no intention of undertaking broader political, legal and institutional reforms. Thus, the renminbi will erode, but not challenge, the dollar's dominance as the global reserve currency.

**Boosted by dysfunction**

The dominance of the dollar is not necessarily a reflection of strong American policies. Rather, it is a consequence of weaknesses in other countries' policies and financial markets, and a dysfunctional international monetary system.

These factors also imply that, despite the high level of Japanese government debt, the yen will remain a major safe-haven currency. Japan's strong institutions and deep financial markets mean that whenever there is turmoil in global financial markets, investors will continue to look to the country as a safe haven that allows them to diversify their holdings away from dollars. These safe-haven inflows will likely make it harder for the Bank of Japan to push down the value of the yen in order to stimulate exports.

Is the dollar-centric system fragile and likely to end in a disorderly manner, with a sharp fall in the value of the U.S. currency? The present situation can be characterized as a suboptimal but stable, self-reinforcing equilibrium. Foreign investors, including central banks, now hold about $5.7 trillion in U.S. Treasury securities, in addition to trillions of dollars of other dollar-denominated assets. Thus, the rest of the world has a strong incentive to support the currency. A plunge in the dollar's value would mean that the value of those assets would decline in terms of other countries' currencies, causing a huge capital loss for foreign investors on their dollar assets. The world has therefore become stuck in a dollar trap.

Ultimately, escaping from this trap will require significant financial, institutional and political reforms in other countries that want their currencies to rival the dollar's dominance. Also, to save countries from having to resort to accumulating reserves as a form of insurance, global governance needs to be reformed so that better financial safety nets are in place to reduce demand for safe assets.

The dollar will remain the dominant reserve currency for a long time to come, mostly for want of better alternatives.

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