

IS THE US DOLLAR IN DANGER OF LOSING ITS RESERVE CURRENCY STATUS?

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by

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Introduction

Since the collapse of the Bretton Woods system of exchange rates fixed (with only occasional discrete adjustments) to the US dollar in the early 1970s, episodes of sustained weakness in the US dollar (such as those of 1977-78, 1985-89 and 1993-95) have prompted doubts about the status of the US dollar as the world's principal reserve currency.

Such doubts were largely hypothetical in the absence of any plausible alternative to the dollar. But with the advent of the euro in 1999, the speculation about the dollar's reserve currency status which has re-emerged during the most recent period of sustained dollar weakness (during which the dollar has declined by an average of some 30% from its most recent peak in February 2002) has acquired a sharper edge. Even before the onset of the current financial crisis, the euro had been seen by some as having the potential to rival, if not replace, the dollar as a medium of international exchange, a repository for official reserve assets and as a unit of account – the traditional functions of a reserve currency¹.

Questioning of the dollar's reserve currency status has intensified since the onset of the global financial crisis in mid-2007. In March 2009 the Governor of the People's Bank of China, Zhou Xiaochuan, proposed giving the IMF's Special Drawing Right (SDR) a 'greater role' as a step towards the creation of a 'super-sovereign reserve currency managed by a global institution (Zhou, 2009), an idea which has gained support from Russia. Nouriel Roubini (2009), among others, has suggested that the yuan may eventually supplant the dollar's role.

This paper looks at this debate initially from an historical perspective; examines the criteria necessary for a currency to acquire 'reserve status'; asks whether current US macro-economic policy settings undermine the dollar's claim to that status; and, finally, considers the practicality of alternatives to the US dollar over various time horizons.

The current status of the US dollar as a reserve currency

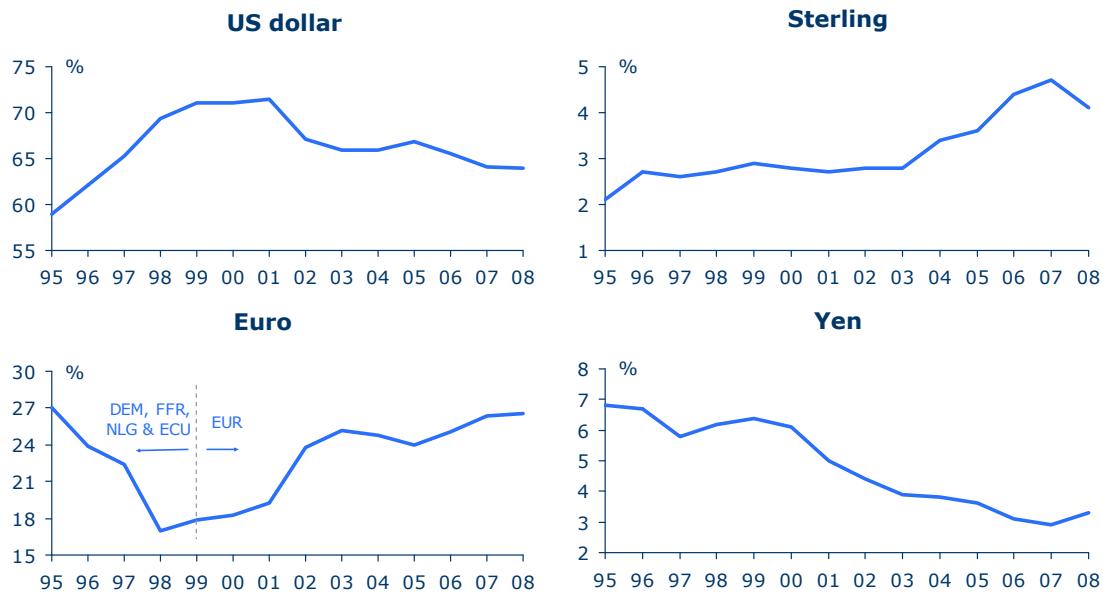
Amidst this heightened debate about the likely future reserve currency status of the US dollar it is perhaps worth noting, if only in passing, *how little*, in several key respects, that status has actually changed thus far.

First, as Figure 1 (on page 2) suggests, there does not appear to have been any significant diversification away from the US dollar in central bank reserve asset portfolios over the past decade. Of the (currently 140) central bank foreign exchange reserve portfolios whose composition is reported to the IMF's Currency Composition of Official Reserves (COFER) database, the US dollar accounted for 64.0% at the end of 2008, down from a peak of 71.5% at the end of 2001 (just before the US dollar peaked against other major currencies) but well above the level of 59.0% at the end of 1995 (when this series commenced), and (on the basis of earlier IMF surveys) higher than at any time since 1979².

¹ See, for example, Bergsten (1997), Mundell (1998) and, more recently, Eichengreen (2005), Chinn and Frankel (2005), and Galati & Wooldridge (2006).

² The share of total foreign exchange reserves whose currency composition is included in the COFER database has declined from 78% to 63% since 2000, a trend which appears to result largely from the suspected omission of China (whose foreign exchange reserves have risen rapidly during this period) from the reporting countries (Galati & Wooldridge (2006, p. 5)). If, as some unofficial estimates (eg Setser (2007)) suggest, around 70% of China's reserves are in US dollars, the proportion of total central bank reserves held in dollars would almost certainly be higher than that of the central bank reserves included in the COFER database.

Figure 1: Currency composition of central bank foreign exchange reserves



*Source: International Monetary Fund, *Currency Composition of Foreign Exchange Reserves*.*

Another interesting trend suggested by chart 1, in the light of suggestions that one of the factors contributing to concerns about the sustainability of the US dollar's position as the principal reserve currency is the persistence of large US current account deficits, is the increase in the proportion of central bank reserves held in sterling, the currency of a country which has also run large current account deficits in recent years, and the parallel decline in the share of reserves held in yen, the currency of a country which has persistently run large current account surpluses over the same period.

Second, the US dollar actually *appreciated* by a trade-weighted average of nearly 13% against other major currencies between the weekend of 13-14 September when Lehman collapsed and the point when global sharemarkets bottomed in early March 2009 (see the charts in Figure 2 on page 3) – the period during which risk aversion reached its most extreme levels and in which concerns about the stability of the US financial system (in particular) were most deeply and widely held. Similarly, from the Lehman collapse until the end of 2009, when global government bond yields reached their trough, US ten-year Treasury bond yields fell by 164 basis points, compared with a decline of 83 basis points in a GDP-weighted average of other G7 ten-year government bond yields. These trends together suggest that the US dollar, and US Treasuries, retained their 'safe haven' status through an especially trying period.

Third, countries running large current account surpluses have continued to accumulate large quantities of US dollars despite their professed concerns about the 'safety' of their assets held in this form³. Data from the US Treasury International Capital (TIC) system show that China purchased US\$14.8bn of US Treasury securities in March, the second largest monthly amount ever, and a further \$8.3bn in April, after several months in which they had either been net sellers or only modest net buyers. China has been a significant net seller of agency (Fannie Mae and Freddie Mac) securities since July last year (having previously been a major purchaser), and its earlier appetite for corporate bonds has much diminished.

³ See, for example, '[Chinese Premier] Wen Voices Concern over China's US Treasurys', *The Wall Street Journal*, 13 March 2009.

Figure 2: The US dollar and US Treasury bonds during the financial crisis



Sources: Bloomberg; Thomson Reuters.

Federal Reserve holdings of US Treasury securities on behalf of foreign central banks and other official institutions rose by US\$69bn in May this year, the third largest monthly increase on record, again suggesting that the resumption of a downward trend in the US dollar has yet to have any material impact on its reserve currency status.

However it would be a mistake to infer from the fact that the US dollar has not been dislodged from its reserve currency perch during the latest financial crisis that its status remains immutable.

Some historical perspectives

History suggests that 'reserve currency status' is something which evolves over time through combination of international economic and political power and convenience to the greatest number of users, rather than abruptly as the result of conscious decisions by a single country.

According to Eichengreen (1996: 8-9 and 2005:3), prior to about 1870 most international transactions between countries were settled in gold or silver. The rapid growth in international trade after about 1870, facilitated more by technological developments affecting transport costs than by favourable changes in trade policies⁴, made settling international transactions through exchanges of bullion less convenient.

Several factors combined to make sterling the obvious candidate to serve as a medium of international trade and financial transactions, and as a repository for international reserves. Although Britain was no longer, by then, the world's largest economy, having according to Madison (2003) been surpassed by the United States in 1872, and would be overtaken by Germany by 1909, it remained the world's pre-eminent trading nation, absorbing between 20 and 30% of the world's exports during the final decades of the nineteenth century.

⁴ O'Rourke and Williamson (2000), pp. 28-55.

Britain was also the most important single participant in capital account transactions. As Eichengreen (2005: 5-6) explains,

'Foreign governments seeking to borrow abroad came to London, making sterling a logical unit of account for debt securities, since ... there was a limited appetite for bonds denominated in their own currencies. When funds became available, it was natural to park them temporarily in deposit accounts in London ... Lenders encouraged the practice on the view that the maintenance of deposits in London was a bonding device that might promote good behaviour on the part of the borrower ... Because the [London] market was deep and liquid, official foreign holdings of sterling could augment and deplete their positions without disturbing prices or revealing facts about their balance sheets'.

Finally, Britain's commitment to the gold standard since 1717, a much longer period of time than any other country⁵, and its stable political and legal systems, were seen as underpinning confidence in sterling as a store of value.

Notwithstanding these advantages, sterling did not achieve the same degree of preponderance in international use as was later attained by the US dollar. Sterling was certainly the principal currency used in international trade; Williams (1968: 268) estimates that about 60% of world trade between 1860 and 1914 was invoiced in sterling. However by the eve of World War I, only 38% of official foreign exchange reserves whose currency composition was known were held in sterling, only marginally more than were held in either French francs (25%) or German marks (12%)⁶.

World War I dealt a substantial, though not immediately fatal, blow to sterling's reserve currency status and facilitated the emergence of the US dollar as an increasingly credible alternative to the British currency. Britain suspended international convertibility of sterling into gold in 1917 (as Germany had done at the beginning of the war and France in 1915), while the United States maintained convertibility after it entered the war in 1917. The US now had a central bank⁷. The US emerged from World War I as a net creditor, and in that capacity played a growing role in the settlement of reparations among European nations, as well as debts incurred to it by its wartime allies. The US ran large current account surpluses throughout the 1920s, and re-cycled them back through dollar-denominated loans to foreign (and especially European) governments.

Despite the growing importance of the US dollar in trade and investment transactions, sterling and the French franc continued to be widely held as reserve currencies during the inter-war period. One estimate⁸ suggests that just under 20% of global foreign exchange reserves were held in dollars in 1928, with the rest split 70-30 between sterling and francs; by 1933, after the collapse of the gold exchange standard, the dollar's share of global reserves had fallen back to 5%.

⁵ Portugal, the second country formally to adopt the gold standard, did not do so until 1854. Germany adopted the gold standard after the Franco-Prussian War of 1871, prompting most other European countries apart from Austria-Hungary, Spain and Italy to follow in short order. The United States demonetized silver in 1873 and effectively went on to a gold standard in 1879; Russia, Japan, India and most Latin American countries had done so by 1900 (Eichengreen (1996), pp. 17-18).

⁶ Eichengreen (1996: 24), drawn from Lindert (1969), p. 22.

⁷ And Broz (1997) suggests that one of the motives for the establishment of the Federal Reserve System in 1914 was to strengthen the position of New York as an international financial centre.

⁸ Triffin (1964), cited by Eichengreen (2005), p. 9.

The immediate assumption of reserve currency status by the US dollar in the post-World War II international financial system established at Bretton Woods in 1944, and the much greater preponderance it subsequently assumed in international trade and financial transactions and as a repository for foreign exchange reserves than was ever attained by sterling, was of course largely dictated by the United States' unprecedented global economic and political hegemony at the end of World War II and for a considerable period afterwards.

Britain, whose remaining international financial assets had effectively been stripped by the United States as a pre-condition of the Lend-Lease program, and to whose continuing imperial pretensions Franklin Delano Roosevelt had long been particularly hostile⁹, was in no position to contest American aims. Hence the United States was able to dictate to Britain that it restore the current account convertibility of sterling in 1947, as a means of countering the British Commonwealth's system of 'imperial preference'¹⁰, a decision which led inexorably to the 30% devaluation of sterling in September 1949. Britain received a further reminder of its vulnerability to American financial pressure during the Suez Crisis of 1956¹¹. (Commonwealth countries continued to hold significant proportions of their reserves in sterling, and to peg their currencies to the pound, until well into the 1960s, mainly out of a sense of loyalty).

But the pre-eminence of the US dollar was not entirely the result of the United States' ability to impose its own choices. It also stemmed from the continued reluctance of other countries to allow their currencies to be used for any of the main purposes of a reserve currency. The Soviet Union – the only other country with sufficient economic and political muscle at the end of World War II to have sought a role for its currency in the post-war international financial system – chose not to, for ideological reasons¹². France, Germany and Japan all, for different reasons, resisted the internationalization of their currencies, and maintained capital controls until (in the case of France) the end of the 1980s.

The dollar's reserve currency status first came into serious question in the 1960s, after Western European countries restored convertibility of their currencies for current account transactions and began to accumulate US dollars as a result of the transactions required to maintain their exchange rate parities to the dollar whilst running current account surpluses with the United States (note the parallel with China's experience during the current decade).

The problem was foreshadowed by Triffin (1960), who argued that once foreign holdings of dollars exceeded the value of the US' holdings of gold, the credibility of the US commitment to convert dollars into gold at the fixed price of US\$35 per ounce would be eroded; and that the US would eventually be forced to adopt deflationary policies in order to preserve the dollar's value, which would in turn reduce global liquidity. This tension between the objectives of domestic monetary policy and the requirements for global liquidity has since become known as the 'Triffin dilemma' and, interestingly, was explicitly referred to in PBoC Governor Zhou's March 2009 paper.

The Kennedy and Johnson Administrations resorted to an increasing array of controls on US capital outflows to counter downward pressure on the US dollar and upward pressure on the gold price.

⁹ See Skidelsky (2000), p. 91-133 for a fuller account.

¹⁰ Eichengreen (1996, p. 103).

¹¹ Almog (2003), p. 102-3.

¹² Even though the Soviets were well aware of the US intentions for the post-war international financial order, courtesy of the information passed to them by Keynes' American interlocutor Harry Dexter White: see Skidelsky (2000), pp. 241-2 and 256-63.

The creation of the Special Drawing Right (SDR) in 1967 – though the first allocation was not actually made until 1970 – represented an attempt to solve the ‘Triffin dilemma’ by creating a new source of international liquidity. But by then, the Nixon Administration had arrived at an alternative solution to the ‘Triffin dilemma’ – that it would in fact not seek to defend the dollar’s value against gold, a position encapsulated in the then US Treasury Secretary’s remark to his European counterparts in 1971 that the dollar was ‘our currency but your problem’. This indifference to the dollar’s value led soon afterwards to the collapse of the Bretton Woods system in 1973.

And although, as noted at the beginning of this paper, the US dollar’s reserve currency status has come into question during each of the episodes of sustained downward pressure on the dollar which has occurred since then, and as a result of the persistent current account deficits which the US has run since the early 1980s, the lack of any obvious credible alternative prevented such questioning from moving beyond the realms of speculation.

Current US policy settings and the risk of sustained US\$ depreciation

Discussion of alternatives to the US dollar as a reserve currency has acquired additional gravity from concern over the possible consequences of the large budget deficits which the US is expected to incur over the next few years, and of the policy of ‘quantitative easing’ which the US Federal Reserve has adopted in response to the financial crisis, one aspect of which is the outright purchase by the Fed of up to US\$1,550 bn of ‘high-quality securities’, including up to US\$300bn of longer-term Treasury securities. Some influential critics, including Chinese Premier Wen Jiabao, German Chancellor Angela Merkel, Pimco founder Bill Gross, Quantum Fund co-founder Jim Rogers and *Gloom, Boom and Doom Report* author Marc Faber¹³, have asserted that these policies may or will lead to higher inflation and to a sustained erosion in the dollar’s value.

The idea that ‘printing money’ inevitably leads to high, if not hyper-inflation, has both intuitive appeal and (to many) empirical support in the historical experiences of Weimar Germany, post-war Hungary or Japan, any number of Latin American countries or former Soviet bloc countries in the aftermath of the collapse of the Berlin Wall, and contemporary Zimbabwe.

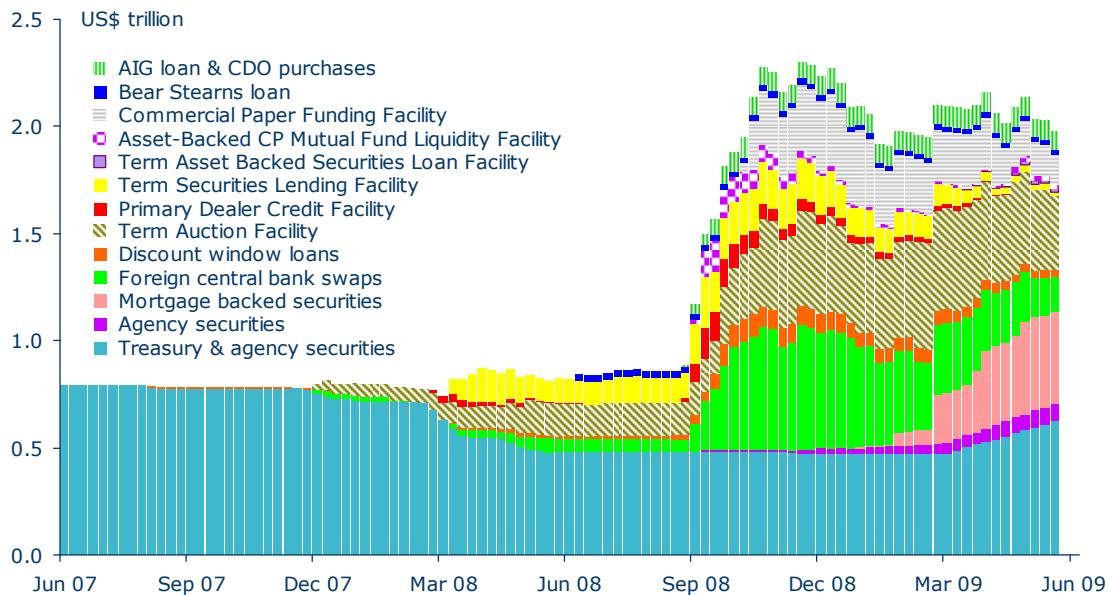
However all of those historical examples involved attempts by government-controlled central banks to use the printing presses to maintain demand in the face of a collapse in the ‘supply potential’ of their economies, resulting from foreign occupation of their most productive industrial facilities (Weimar Germany), enormous war-time losses of human and physical capital (countries defeated in World War II), institutional collapse (former Soviet bloc countries), or wanton looting and destruction of productive capacity (Zimbabwe).

None of these situations applies to the US economy in 2009, nor is it likely to in 2010. The US is experiencing a substantial shortfall of aggregate demand, not of aggregate supply: as of May, 9.4% of the labour force were unemployed and a further 7.0% were ‘under-employed’ or discouraged from seeking work; as of April, nearly 31% of industrial capacity lay unutilized; the IMF forecasts that the US will have an ‘output gap’ of 4.1% of potential GDP this year and 5.6% of GDP in 2010. It is difficult to conceive how the US could experience a significant acceleration of inflation in these circumstances.

¹³ See footnote 3 on p. 2 above; ‘Germany Blasts Powers of the Fed’, *The Wall Street Journal*, 3 June 2009; ‘Gross Says Diversify from Dollar as Deficits Surge’, *Bloomberg*, 3 June 2009; ‘US Inflation to Approach Zimbabwe Level, Faber Says’, *Forbes*, 2 June 2009.

Moreover, if and when the Fed fulfils its stated intention to purchase outright US\$300bn of Treasury securities (having acquired nearly US\$150bn up until mid-June), it would still hold a slightly smaller volume of Treasury securities than it did prior to the onset of the financial crisis in mid-2007 (Figure 3). The proposition that the Fed has embarked on a ‘dangerously inflationary monetization’ of the US Government’s budget deficit is simply not supported by fact.

Figure 3: Assets on the US Federal Reserve balance sheet



Source: US Federal Reserve Board.

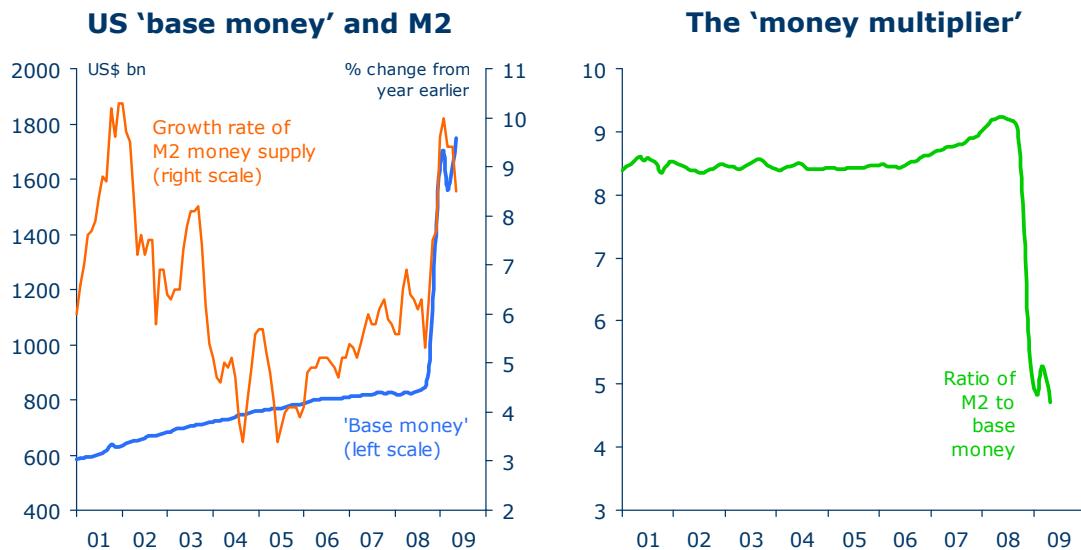
It is true that the dramatic expansion in the Fed’s balance sheet – from just over US\$900bn prior to the collapse of Lehman Brothers to an average of nearly US\$2.1trn so far this year – has resulted in a near-doubling of the quantity of ‘base money’.

However it has *not* led to a marked acceleration in any of the broader monetary aggregates (see the first chart in Figure 4 on page 8). That is because the capacity of the financial system to create credit from a given amount of base money supplied by the Federal Reserve has been impaired by the erosion of its capital base and the uncertainty as to how much capital it needs resulting from the financial crisis. Banks have left the bulk of the ‘excess reserves’ created by the Fed’s balance sheet expansion on deposit with the Fed, rather than using them to expand credit. This is encapsulated in the near-halving of the ‘money multiplier’ depicted in the second chart in Figure 4.

In other words, the Fed has expanded its balance sheet in order to offset the contraction in the money supply that would have otherwise occurred. By way of illustration, if one supposes that the Fed had instead elected to maintain the growth rate of its balance sheet at around 1/4% per month (as it had been doing prior to the Lehman Brothers collapse), and that the ‘money multiplier’ declined as it has done since then, the M2 money supply would have declined by around 45%.

This is, of course, what the Fed allowed to occur in the early 1930s, and which Ben Bernanke promised Milton Friedman on his 90th birthday that it ‘wont do ... again’ (Bernanke (2002)).

Figure 4: US monetary aggregates and the 'money multiplier'



Source: US Federal Reserve Board.

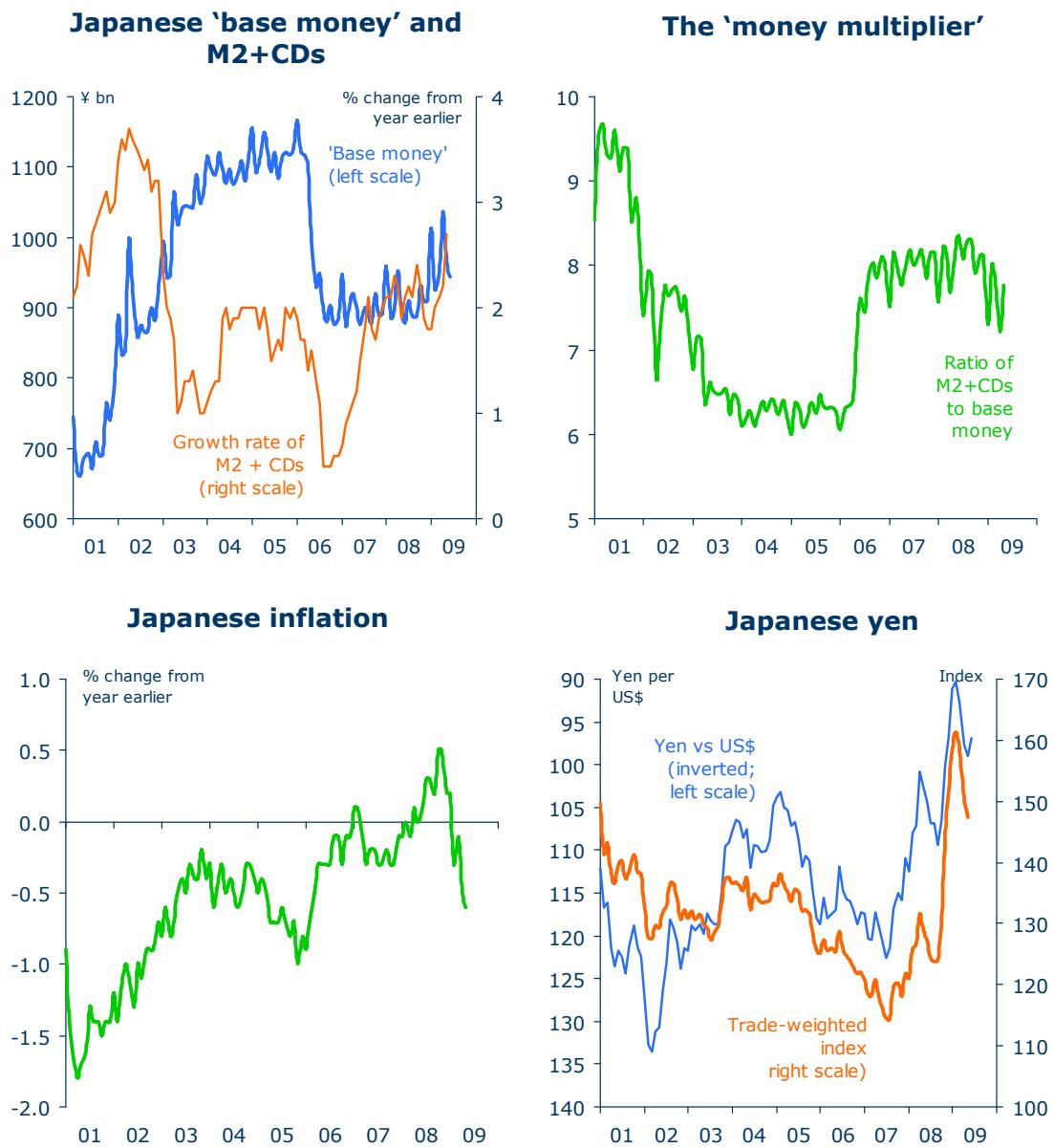
The expansion in the Fed's balance sheet *would* result in a heightened risk of accelerating inflation if it persisted beyond the time when credit markets have begun to function normally and economic recovery was under way, a risk of which Ben Bernanke (2009) and other Fed officials have repeatedly indicated they are fully aware.

As Fed Vice-Chairman Donald Kohn (2009) has noted, '[the Fed's] expanded liquidity facilities has been explicitly designed to wind down as conditions in financial markets return to normal'; while a proportion of the securities acquired under the Fed's asset purchase programs 'will run off on their own' while others can be 'actively manage[d] ... down by selling the assets outright or on a temporary basis through reverse-repurchase transactions'. Kohn also drew attention to the Administration's commitment to work with the Federal Reserve and Congress to devise an additional tool for absorbing excess reserves. It is not clear why these commitments should be seen as lacking credibility.

Critics who suggest that the Fed's 'quantitative easing' will inevitably lead to accelerating inflation conspicuously ignore the recent example of Japan. The Bank of Japan explicitly pursued a policy of 'quantitative easing' between 19 March 2001 and 9 March 2006. During this period the Bank of Japan's assets expanded by 30% and base money by 70% (at their greatest extent); however, as in the more recent US episode, banks kept the bulk of excess reserves thereby created in their current accounts at the Bank of Japan, and the 'money multiplier' declined from over 9 to a little over 6, so that there was almost no sustained acceleration in the growth rate of broader monetary aggregates (see the first two charts in Figure 5 on page 9).

Deflation persisted (albeit at a declining rate) throughout the period during which the BoJ was pursuing 'quantitative easing', and there has not been any sustained acceleration in inflation since then (third chart in Figure 5). The Japanese yen depreciated by just under 9% in trade-weighted terms during the period of 'quantitative easing', although this largely reflects the appreciation of other Asian currencies (particularly the Korean won and, towards the end of this period, the Chinese yuan); the yen actually appreciated against the US\$ throughout the period of 'quantitative easing' (fourth chart in Figure 5).

Figure 5: Effects of 'quantitative easing by the Bank of Japan, 2001-2006

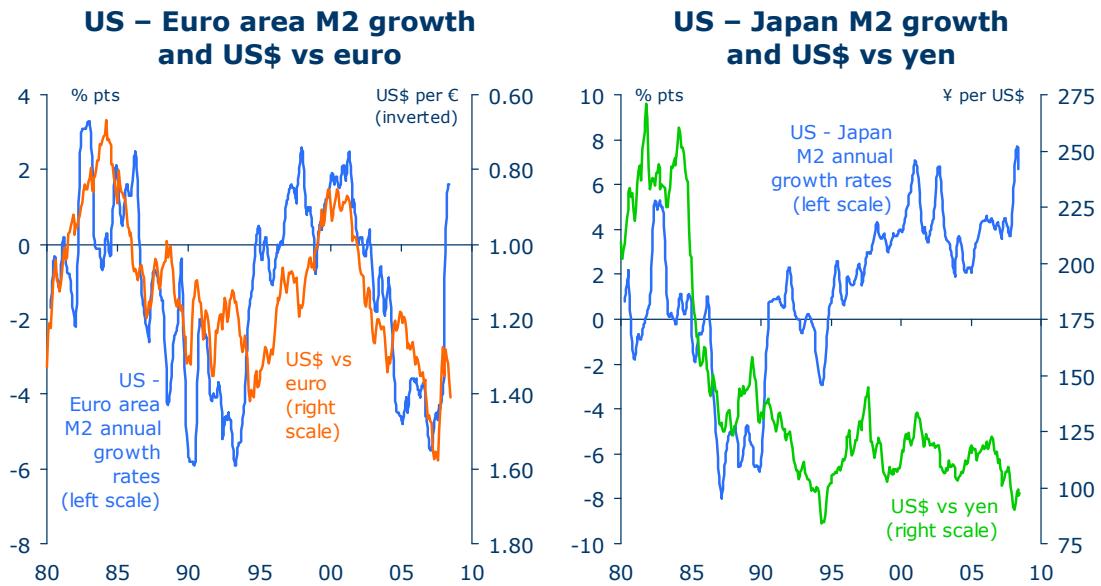


Sources: Bank of Japan; Home Ministry.

More generally, there is no historical evidence that trends in US money supply growth relative to money supply growth elsewhere has any systematic or consistent influence on the external value of the US dollar – or at least, certainly not one which suggests that faster money supply growth in the United States leads to a decline in the dollar.

If anything, as suggested in Figure 6 on page 10, the US dollar has tended to appreciate against the euro during periods when the US M2 money supply has been growing at a faster rate than its euro zone counterpart, which is the opposite of what one would expect if concerns that current Federal Reserve policies were likely to lead to dollar depreciation had any historical foundation. (There is no clear relationship between relative US and Japanese money supply growth and the US\$-yen exchange rate).

Figure 6: Relative money supply growth rates and US\$ exchange rates



Note: money supply growth rates expressed as 3-month moving averages
Sources: US Federal Reserve; European Central Bank; Bank of Japan; ANZ.

The other aspect of current US policy settings which gives rise to concerns in some quarters about the stability of the US dollar and its status as a reserve currency relates to the dramatic increase in the US government borrowings since the onset of the financial crisis and the prospect, in the absence of decisive corrective action, of large budget deficits continuing throughout the next decade and (given the inevitable impact of demographic change on government spending and revenues) beyond.

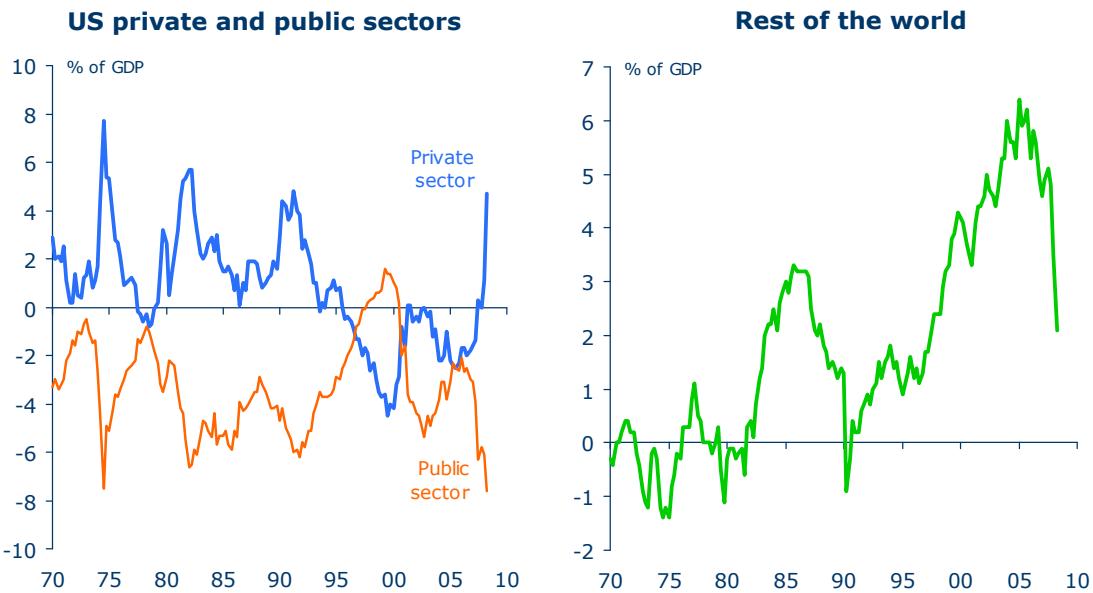
Nobody, to the best of this author's knowledge, asserts that current US fiscal policy settings are sustainable, or that at some point in the not-too-distant future some combination of tax increases and expenditure reductions will not be required to render them sustainable (on this point see IMF (2009)).

The point at issue here is whether running persistently large budget deficits implies that the US dollar must inevitably depreciate against other currencies. Both history and economic theory suggest that this need not necessarily be the case, especially if the Federal Reserve tightens monetary policy sufficiently to quell concerns that competition between the public and private sectors for resources (once economic recovery is firmly under way) might generate inflationary pressures (as was the case in the mid-1980s).

Moreover, the US is hardly alone at present in incurring unsustainable budget deficits, which raises the question as to against which currencies (at least among industrialized countries) the US dollar might actually depreciate, even if it were accepted that there is some correlation between budget deficits and exchange rates. It is not at all obvious that any 'fundamental' factors warrant a sustained appreciation of any of the euro, the yen or sterling against the US dollar.

For the time being at least, the US budget deficit is being financed largely out of the increased net saving of the US private sector. The US private sector's net lending has swung around from a most recent low of -2.5% of GDP (ie private sector gross investment exceeded gross saving) in the second quarter of 2006 to +4.7% of GDP in the first quarter of 2009, the highest since 1983 (see Figure 7).

Figure 7: net lending by the US private, government and external sectors



Sources: US Bureau of Economic Analysis; ANZ. Net lending is the difference between gross saving and gross investment.

Even though government sector net borrowing has blown out to a post-war record 7.6% of GDP in the first quarter of 2009, net borrowing from the rest of the world has declined to its lowest level in over a decade.

Hence the United States has, thus far, been able to finance its extraordinarily large budget deficit *without* putting significant upward pressure on Treasury yields (most of the rise in which since the end of last year is attributable to the return of implied inflationary expectations from close to zero to around 2%, in line with the Fed's *de facto* inflation target) or significant downward pressure on the US dollar.

Of course should the deficit not begin to narrow commensurately as private sector economic activity recovers and private sector net lending declines, then the US external borrowing requirement will widen again, and (depending on what is happening to net borrowing requirements in other countries) that could result in upward pressure on US government bond yields and downward pressure on the US dollar.

However to the extent that any widening in the US current account deficit is mirrored by an increase in China's current account surplus, China will have little choice but to finance that part of the widening in the US deficit if it remain unwilling to allow increased private capital outflows or an appreciation of its exchange rate against the dollar.

This inescapable reality is almost certainly a factor in China's recent steps towards allowing international borrowing in yuan, and in the People's Bank of China's proposals for an alternative to the US dollar as a reserve currency, to which this paper now turns in more detail.

China's proposed alternative to the US dollar as a reserve currency

PBoC Governor Zhou Xiaochuan (2009) poses the question, 'what kind of international currency do we need to secure global financial stability and facilitate world economic growth?'.

Significantly, he does not seek to assert a role for the Chinese yuan as an alternative reserve currency. On the contrary, Zhou argues that the use of 'credit-based national currencies' has 'inherent deficiencies' arising from the inconsistency between the domestic monetary policy objectives of the authorities in the issuing country and the requirement to provide adequate liquidity to the global economy (the 'Triffin dilemma'), and that 'crisis ... is an inevitable outcome of the institutional flaws' in current arrangements.

Instead, Zhou proposes the establishment of 'a super-sovereign reserve currency managed by a global institution'¹⁴. Acknowledging that 'the re-establishment of a new and widely accepted reserve currency with a stable valuation benchmark may take a long time', Zhou advocates a greater role for the SDR, including its use in 'international trade, commodities pricing, investment and corporate book-keeping', and the 'introduction of SDR-denominated securities'.

He also proposes that 'the basket of currencies forming the basis of the SDR should be expanded to include currencies of all major economies', possibly using 'GDP ... as a weight', and that the allocation of SDRs be backed by 'real assets ... such as a reserve pool', which would in turn be managed by 'a trustworthy international institution' such as the IMF, offering 'a reasonable return to encourage participation' by member central banks.

These are serious, considered proposals, which among other things indicate an intention on China's part to play a significant and constructive role in discussions about international financial arrangements. They are also consistent with China's entirely legitimate aspirations for a greater role, consistent with its growing importance in the global economy, in international institutions such as the IMF.

Nonetheless it seems unlikely that Zhou's specific proposals will gain much traction in the short- to medium-term.

The history of reserve currencies, as summarized earlier in this paper, strongly suggests that the widespread acceptance of a particular currency in international trade and financial transactions is as much a matter of convenience as it is the result of economic or political power. There are powerful 'network effects' in this context¹⁵ which mean that any change in the use of a particular currency in international trade or finance has to overcome a considerable amount of inertia. This was possible in the peculiar circumstances immediately following World War II; it seems less likely to be feasible in the second decade of the 21st century.

¹⁴ Zhou regards it as 'unfortunate' that the proposal originally formulated by Keynes in 1941 for an international currency unit (which he later called 'bancor') based on the value of 30 representative commodities had been rejected at the 1944 Bretton Woods conference. This is an interesting position for the PBoC Governor to have taken, given that Keynes' plan envisaged international payments imbalances being resolved through obligations imposed on both deficit *and* surplus countries. In particular, a country running persistent surpluses would, under Keynes' plan, be required to revalue its currency by 5% per annum, to pay 5 or 10% interest on 'credits' (created by its surpluses and deposited at the International Clearing Bank) running above 25% or 50%, respectively, of its quota to the Bank's Reserve Fund, and to have confiscated any credit balances in excess of its quota at the end of the year: see Skidelsky (2000), pp. 206-7.

¹⁵ See, for example, Chinn and Frankel (2008), pp. 10-11, or Persaud (2004), p. 2.

Moreover, the SDR is not a currency, and the IMF is not a bank. It does not have the capacity to issue SDRs in the way that a national central bank can issue its currency. Not being the agency of any national government, there would be no implicit 'power to tax' to stand behind the risk attached to liabilities of the IMF. The only backing for the SDR as envisaged in the PBoC's proposal would be the reserves deposited with the IMF by member countries.

And while China and its fellow BRICs have indicated a willingness to do subscribe to IMF bond issues, it seems unlikely that many other countries would have either the capacity or the inclination to do so in a volume sufficient to allow the SDR to be widely used, or indeed at all. Most countries, in particular most advanced economies with floating exchange rates (other than Japan) do not regard it as necessary to hold foreign exchange reserves of the order of magnitude (relative to their GDPs) that China, some other Asian economies, Russia and some oil-exporting nations have done in recent years. And some countries, in particular the United States, are likely to regard any requirement to surrender the management of a proportion of their foreign exchange reserves to an international agency as an unacceptable transgression on their sovereignty.

Conclusion

Having one's currency regarded as an international reserve currency has been described, most famously by Charles de Gaulle, as 'an exorbitant privilege'¹⁶. Apart from the additional seigniorage accruing to a country whose notes and coin are widely held by foreigners, a country whose currency is also a reserve currency enjoys lower transaction costs and reduced risk in conducting its international trade; and can borrow from abroad in its own currency thereby transferring the currency risk to its creditors, which in turn allows it to borrow more than would be the case otherwise.

It is thus in an important sense unsurprising that the United States, having enjoyed this 'privilege' to a much greater extent and for longer than Britain did, has no desire to lose it; or that other countries would like to share in it.

This paper has argued that although the United States is no longer the unchallenged global economic power which it was at the time when the dollar became the world's principal reserve currency and for a long time thereafter, this does not mean the US dollar is in imminent danger of losing its reserve currency status, any more than sterling lost its reserve currency status immediately or even soon after Britain ceased to be the world's largest economy (in 1872) or ceased to be the world's pre-eminent political and military power (after World War I).

Nor is it at all obvious that the substantial challenges currently confronting the US economy, or the way in which US economic policy makers have sought to respond to those challenges, necessarily imply that the dollar must inevitably decline, let alone sharply, against any other currencies (the 'fundamentals' for which are not, in general, significantly stronger than those for the US dollar) that could conceivably play the role of a reserve currency.

¹⁶ The description has also been credited to Valéry Giscard d'Estaing, who was Finance Minister under de Gaulle as President, and to Jacques Rueff, a sometime economic advisor to de Gaulle.

It is perhaps conceivable that, at some point in the future, China could use the financial claims it has accumulated against the United States to undermine the US dollar in the same way that the United States used its financial claims against Britain to undermine sterling. However it is hard to see how China would regard such a step as being in its interests any time soon, even if China were to move more quickly than presently seems probable to make the yuan freely convertible and to satisfy the other commonly-accepted criteria for a reserve currency.

In this context it is perhaps also worth noting that the euro area – which has no significant net financial claims against the United States – could not ‘do’ to the United States what the United States ‘did’ to Britain in order to enhance the role of the euro as a reserve currency.

What is more likely to occur is that both the euro and, in time, the yuan will slowly become more widely used in international transactions, especially in their respective regions, and in international securities transactions – as has been occurring with the euro for the past decade, and much as occurred with currencies other than sterling in the inter-war period. The pace at which this occurs will be determined largely by the convenience of users, rather than by government policy, although Chinese government policies will have a key influence on the speed at which the yuan becomes more widely used in transactions with China and outside China itself.

It is also plausible that, over time, a growing proportion of central banks’ foreign exchange reserves will be held in currencies other than US dollars. The extent to which this happens, and the speed at which it does, will be determined largely by central bank and government policy choices. Particularly significant in that regard will be the choices made by countries such as China and Russia regarding their exchange rate regimes. For so long as they elect to keep their exchange rates closely pegged to the US dollar, they will need to hold most of their reserves in dollars. If they choose to peg to some other currency, they will need to hold more of their reserves in that other currency. And if they choose to allow their currencies to float, their need to hold foreign exchange reserves (in any currency) will be greatly diminished.

Assuming that the world order evolves into one in which there are multiple centres of economic and political power, and that this occurs peacefully, it seems sensible to expect that a number of currencies will come to fulfil the roles currently discharged predominantly by the US dollar. But the key lesson of history is that, in the absence of a major military conflict, this will be a gradual process rather than an abrupt one.

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