# The Dollar Rules

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The U.S. dollar has been the preeminent global reserve currency for most of the past century, backed up by the dominance of the U.S. economy and its financial markets. Over the past two decades, many developments and events have threatened the primacy of the dollar. First, the advent of the euro, representing the monetary unification of an economic area matching that of the U.S. economy in terms of GDP, created a viable rival to the dollar. Then came the global financial crisis of 2008–09, which had its origins in the United States and should have dealt another blow to the dollar by exposing the fragility of the U.S. financial system. Meanwhile, China has grown into an economic and military superpower, with its economy now the second largest of any country in the world. China's leadership has actively promoted its currency, the renminbi (RMB), as a major international currency.



But reality has diverged quite dramatically from what this script once suggested. Paradoxically, the global financial crisis strengthened rather than weakened the dollar's position as a reserve currency. With the euro faltering after the eurozone debt crisis and the renminbi's development restrained by the deep-seated fragilities of the Chinese economy, the dollar has now become even more central to international financial markets and has solidified its position as the dominant global reserve currency.

The question of whether this "dollar trap," wherein global finance remains

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in the clutches of the dollar, is a recipe for stability or future financial mayhem is back on the table now that the new U.S. administration appears to be fomenting economic uncertainty and is looking to unravel traditional economic alliances and arrangements.[1] How have we reached the point where the dollar has fortified its position in global finance, even as the U.S. economy's share of global GDP continues to decline?

## The Euro Stumbles

The introduction of the euro was expected to shift the balance of power away from the dollar by unifying the economic power of the eurozone bloc, which in terms of GDP now rivals the United States.[2] Until the euro came into being, there had been no serious competitor to the dollar, as other currencies—such as the British pound, German deutsche mark, and Japanese yen—all came a distant second at best. The euro was created in 1999, and euro coins and notes started circulating in 2002, replacing the national currencies of the 17 member countries of the eurozone. Monetary union was seen as an essential step in the unification of Europe so that its economic power and influence in the world economy could be resurrected to the continent's former glory.[3]



Things went according to plan in the early years of the euro, with the U.S. dollar losing ground to the new currency. The European Union's (EU) expanding trade, both among countries within the union and across the union's borders, led to the euro becoming increasingly important in settling international trade transactions. The share of global foreign exchange reserves held in dollars—an important indicator of the dollar's prominence as a global reserve currency—fell by nearly 10 percentage points in just a four-year period from 2000 to 2004. The euro's share went up by a corresponding amount. Then the euro's path to dominance stalled, with the euro's share of global foreign exchange reserves unable to break beyond 30 percent.[4]

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The eurozone debt crisis dealt a sharp blow to the euro's ascendance. It has become clear that monetary union, in the absence of other aspects of a true economic union, does not work well. The eurozone has taken some steps toward fiscal and banking union, but the monetary union still faces existential threats, eroding investors' confidence in the common currency. The share of foreign exchange reserves held in euros has fallen back to slightly above 21 percent, and there is little prospect of the euro being considered a serious rival to the dollar.[5]

## The Financial Crisis Leaves the Dollar Stronger

The 2008–09 financial crisis, whose aftershocks continue to reverberate, stirred speculation about the dollar's displacement as the world's leading currency. By all reasonable logic, the dollar's status should have come under threat. The aggressive use of unconventional monetary policies by the Federal Reserve—the U.S. central bank—in the immediate aftermath of the crisis increased the supply of dollars and created risks in the financial system. Consequently, the United States is today beset by a high and rising level of public debt. Gross public (federal government) debt has risen to $20 trillion, more than the nation's annual output of goods and services.[6] Now, with a new administration in Washington, there are prospects of larger government budget deficits, financed by the issuance of even more federal government borrowing. All of these factors should have, in principle, hastened an erosion of the dollar's importance. Instead, the dollar's status as a haven of safety to protect the value of investments during times of financial turmoil has reinforced its dominance in international finance.



Rising openness to cross-border flows of financial capital and the consequent exposure to capital flow volatility have increased foreign central banks' demand for safe financial assets—investments that at least protect investors' principal and are relatively liquid (i.e., easy to trade). The central banks of emerging economies have a stronger incentive than ever to accumulate massive war chests of foreign exchange reserves to insulate themselves from the consequences of volatile capital flows. The global financial crisis shattered conventional views about the level of reserves that is adequate to protect an economy from the spillover effects of global crises. Even countries that had large stockpiles found that their reserves shrank rapidly in a short period during the crisis, as they sought to protect their currencies from collapse.

Additionally, many of these countries, as well as some advanced economies such as Japan and Switzerland, have been intervening heavily in foreign exchange markets—buying foreign currencies to limit appreciation of their own currencies, thereby protecting their export competitiveness. Exchange market intervention also results in accumulation of reserves. These reserves need to be parked in safe and liquid assets, generally government bonds, leading to a rise in demand for safe assets. Additionally, regulatory reforms that require financial institutions to hold safe and liquid assets as a buffer against adverse financial shocks are increasing this demand. Moreover, private investors worldwide clamor for such assets during times of global financial turmoil.

Thus, global economic developments and investor behavior have led to an imbalance: the supply of safe assets has fallen, even as the demand for them has surged. The crisis has dealt a blow to the notion of private sector securities, even those issued by rock-solid corporations or financial institutions, being considered safe assets. At the same time, government bonds of many major economies—such as those in the eurozone, Japan, and the United Kingdom—look shakier in the aftermath of the financial crisis as they contend with weak growth prospects and sharply rising debt burdens. Paradoxically, the same factors do not seem to have dented the dollar's safe haven status, as investors seem to regard it as the least worst of the available alternatives. With its deep financial markets (i.e., availability of a large volume of financial assets and easy tradability of those assets) and rising public debt, the U.S. government has thus become the primary global provider of safe assets.

## Paradoxes



Global investors seeking a safe haven in times of global financial turmoil automatically turn to U.S. Treasury securities. Foreign investors now hold $6 trillion of these low-yielding securities, not to mention large quantities of other dollar assets. And the dollar's share in global foreign-exchange reserves has held steady since the crisis.[7]

Why do other countries buy increasing amounts of U.S. public debt and regard them as safe assets when the amount of that debt is ballooning rapidly and could threaten U.S. fiscal solvency in the long run? This phenomenon can be explained partly by the fact that the United States boasts the world's deepest and most liquid financial markets. But the most important factor supporting America's currency dominance is the institutionalized system of checks and balances that operates among the executive, legislative, and judicial branches of its government.

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Trust in U.S. public institutions is rooted in the open and transparent democratic process that underpins them. While one could argue that there has been an erosion of trust in U.S. institutions among the American public, investors seem to have maintained their confidence. Freedom of expression and an unfettered media bolster this confidence, not by highlighting the system's strengths but by exposing its weaknesses, which can subsequently be corrected through responsive, rules-based mechanisms.

Forced to answer to its citizens, the U.S. government is unlikely to resort to inflationary debt financing. In fact, more than $5 trillion of U.S. federal debt is held by domestic investors, including retirees, pension funds, financial institutions, and insurance companies—groups whose considerable political clout ensures that no administration would risk allowing inflation to spin out of control.[8]

The U.S. legal system—independent from the executive and legislative branches of government—further supports the dollar's global role. While one might quibble about the complexity of U.S. laws and regulations, they are applied relatively consistently to domestic and foreign investors alike. Foreign investors have full recourse to the U.S. legal system, and the U.S. government must fulfill its contractual obligations, including repayment of its debt, to all investors.

The high share of foreign ownership of U.S. public debt should make it a tempting proposition for the United States to cut its debt obligations to foreign investors—in a manner that would not run afoul of legal considerations—simply by printing more dollars, thereby reducing the value of that debt and implicitly reneging on part of the obligations to its foreign investors. Of course, such an action is unappealing, as it would drive up inflation and affect U.S. investors and the U.S. economy. This delicate domestic political equilibrium makes it rational for foreign investors to retain faith that the United States will not inflate away the value of their holdings of Treasury debt.



Still, emerging market countries are frustrated that they have no place other than dollar assets to park most of their reserves, especially since interest rates on Treasury securities have remained low for an extended period, barely keeping up with inflation. This frustration is heightened by the disconcerting prospect that, despite its strength as the dominant reserve currency, the dollar is likely to fall in value over the long term. China and other key emerging markets are expected to continue registering higher productivity growth than the United States. Consequently, in the long run—once global financial markets settle down—the dollar could depreciate in value, especially if safe haven demand for the currency were to dry up. In other words, foreign investors stand to get a smaller payout in terms of their domestic currencies when they eventually sell their dollar investments. Thus, foreign investors seem willing to pay a high price—investing in low-yielding U.S. Treasury securities rather than higher-return investments—to hold these assets that are otherwise seen as safe and liquid.

The search for alternatives to the dollar has sparked interest in the prospects of the renminbi, now the currency of one of the most powerful economies in the world.

## The Renminbi Gets Off the Ground, then Stalls

China's economy is now the second largest in the world. In 2016, its GDP was $11.5 trillion, accounting for 15 percent of the world GDP, placing it second only to the United States, with a GDP of $18.5 trillion. China is also an important player in international trade, accounting for 12 percent of global trade in goods. China's impact on the world economy is even greater when measured along other dimensions: the country holds about 30 percent of global foreign exchange reserves and has accounted for one-third of global GDP growth since the financial crisis of 2008-09.[9]

Despite China's economic might, the international stature of its currency, the renminbi, does not quite match that of its economy. Among the currencies of the world's six largest economies, the renminbi is only now beginning to emerge as a significant player in the global economy. The others—the U.S. dollar, the euro (which covers two of the six largest economies, Germany and France), the Japanese yen, and the British pound sterling—all have well-established roles in global finance.

In recent years, the Chinese government has taken several steps to elevate the renminbi into this group of elite currencies by encouraging its use internationally. The currency's adoption in global markets is constrained, however, since the Chinese government is unwilling to condone a fully market-determined exchange rate and an open capital account that allows for free cross-border capital flows.[10] China has therefore adopted a unique playbook for promoting the renminbi while trying to only gradually free up capital flows and the exchange rate. Given China's sheer size and its rising shares of global GDP and trade, the government's steps are rapidly gaining traction.

The government has started removing restrictions on capital inflows and outflows, but in a controlled and gradual manner.[11] For instance, the government has set up a number of schemes to allow foreign investors to invest in China's stock and bond markets. At the same time, there are now many channels available for Chinese households, corporations, and institutional investors to allocate some portion of their portfolios to foreign markets. But the government continues to maintain a tight grip on each of these channels.[12] Consider the Shanghai–Hong Kong Stock Connect and Mutual Fund Connect schemes that allow retail investors—households—as well as mutual funds in the two cities to invest in each other's stock markets. These two schemes have created channels for two-way investment flows, but the government—through its control of the stock exchanges—limits the amount of investment flows each day and also the amount of overall investment allowed under each of the schemes.[13]

China has also promoted the renminbi's availability outside its borders, including sanctioning 15 offshore trading centers where transactions between renminbi and other currencies can be conducted.[14] The government has even set up a payment system, the Cross-Border International Payment System, to facilitate commercial transactions between domestic and foreign companies using renminbi rather than more widely used currencies such as the dollar and the euro.

These measures have led to the rising internationalization of the renminbi. This term signifies the renminbi's greater role as the currency in which cross-border trade and financial transactions are denominated and settled—that is, its use as an international medium of exchange. By the latter half of 2014, about one-third of China's international trade was being denominated and settled in renminbi. Furthermore, the renminbi accounted for about 2 percent of cross-border payments around the world, a low share, but one that already ranked the renminbi as among the top six payment currencies in the world.[15]



But then the currency's progress stalled, amid concerns about a growth slowdown, a sharp boom and bust cycle in the stock market, rising debt levels, and the risk of financial instability. Since mid-2014, the renminbi's progress as an international medium of exchange has reversed. The quantitative indicators of its use in international finance, including its use as a payment and settlement currency for trade transactions, point to signs of a retreat.[16]

Still, it is important to keep both the upswings and downswings in proper perspective. Despite the constraints on capital flowing in and out of China, the renminbi has begun playing a larger, although still modest, role in international finance within a relatively short period. While the renminbi's initial progress in this dimension has been impressive, these developments are still in their nascent stages and should not be blown out of proportion.

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A different aspect of a currency's role in international finance is its status as a reserve currency, one that is held by foreign central banks as protection against balance of payments crises. This topic might seem premature given that

China has neither a flexible exchange rate nor an open capital account—two features once considered absolute prerequisites for a reserve currency. However, in October 2016, the International Monetary Fund (IMF) took an action that was symbolically momentous in the annals of international finance.[17] The IMF anointed the renminbi as an elite global reserve currency by including it in the select basket of currencies (previously comprising the dollar, the euro, the Japanese yen, and the British pound sterling) that constitute the IMF's artificial currency unit, the Special Drawing Rights.

Even though the IMF has officially anointed the renminbi as a reserve currency, financial market participants' views are ultimately more important than the IMF's imprimatur in determining a currency's status. Remarkably, the renminbi has already become a de facto reserve currency even though China does not meet some of the traditional prerequisites. China's sheer economic size and the strength of its trade and financial linkages with economies around the world seem to have overridden other limitations. Central banks of economies with such linkages to the Chinese economy have an incentive to hold renminbi-denominated assets to avoid any disruptions in trade or financial flows due to lack of foreign currency.

Many central banks around the world are gradually acquiring at least a modest amount of renminbi assets for their foreign exchange reserve portfolios. The list of such countries is geographically and economically diverse, including Australia, Austria, Chile, Nigeria, South Africa, Korea, Malaysia, and Japan. Per IMF estimates, about 2 percent of global foreign exchange reserves are now held in renminbi-denominated financial assets.[18] Some 35 central banks around the world have signed bilateral local currency swap arrangements with China's central bank. These arrangements give them access to renminbi liquidity that they can draw upon to defend their currencies or maintain stable imports even if foreign capital inflows into their economies were to dry up.[19]

Although the renminbi has managed to attain reserve currency status, its progress along this dimension is likely to be limited by its lack of well-developed financial markets. Foreign official investors, such as central banks and sovereign wealth funds, typically seek to invest in highly liquid and relatively safe fixed-income debt securities, even if such securities have a relatively low rate of return. China's government and corporate debt securities markets are quite large, but they are still seen as having limited trading volume and weak regulatory frameworks, reducing their appeal to foreign investors.

The renminbi has come a long way in a short time. The currency is making an impressively rapid ascent into the upper echelons of international finance.

The renminbi's growing prominence as an international currency could, over time, conceivably diminish the roles of the major currencies—even that of the dollar—as units of account and media of exchange in intermediating international trade and financial transactions. However, the renminbi is now facing constraints that result from the structure of its domestic economy, which will limit its progress as a reserve currency (i.e., a store of value). Moreover, given the nature of China's political framework, which lacks either the rule of law or an institutionalized system of checks and balances on the government, it is unlikely the renminbi will attain the status of a safe haven currency. Thus, although it is likely to continue its ascent, the notion that the renminbi will become a dominant global reserve currency that rivals the dollar is far-fetched.

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The Chinese leadership's stated commitment to financial sector and other market-oriented reforms—if implemented effectively and with careful management of transitional risks—sets the renminbi on course to becoming a significant reserve currency in the long run. All is not well, however, with the reform process. Liberalization of the financial sector and capital markets has been carried out unevenly and without a clearly articulated strategy, which, in addition to imbalances across several areas of needed reforms, has created its own set of risks. Reforms on the real side of the economy have not kept pace with financial liberalization. China's economy and the renminbi's rise have also been impeded by the lack of a robust institutional framework—including good public and corporate governance, a transparent policymaking process, and effective regulatory institutions—that ought to supplement financial and other market-oriented reforms. China's leaders will eventually have to go beyond modest financial sector and economic reforms to more fundamental ones without which a market-oriented system cannot work well.



The Chinese leadership's endorsement of financial sector and capital account liberalization—coupled with unambiguous repudiation of fundamental political, legal, and institutional reforms—sets the renminbi on a clear course. Despite becoming a reserve currency, the renminbi will have essentially given up on any prospects of being considered a safe haven currency. In the absence of these fundamental reforms, especially the rule of law and a democratic system of government, the rise of the renminbi will erode but not seriously challenge the dollar's status as the dominant global reserve currency.

Even if the renminbi fails to become a safe haven currency, however, China's positioning on the global stage will allow it to exercise considerable influence on the global monetary system. The economy's rapidly growing size and dynamism will help promote the international use of its currency, especially within Asia.

## Does it Matter that the Dollar is so Dominant?

There are tangible and intangible benefits for a country whose currency serves as a reserve currency. In addition to the prestige conferred by this status, a country can also access cheap financing in its own domestic currency and enjoy the additional benefit of seigniorage revenue—the difference between the purchasing power of money and the cost of producing it—that can be extracted from both domestic and foreign holders of the currency. However, reserve currency status also makes it harder to manage a currency's value. Some decades ago, when their currencies were poised to become reserve currencies, the governments of Germany and Japan actively resisted the broad international use of their currencies.[20] Their fear was that greater demand for their currencies would lead to exchange rate appreciation—an increase in the international value of their currencies that would in turn make their exports less competitive in international markets. Thus, reserve currency status is a mixed blessing.

The dollar's status as the dominant world currency has been cemented by the global perception of international investors, including foreign central banks, that U.S. financial markets are a safe haven. That perception has ostensibly driven a significant portion of U.S. capital inflows, which have surged in the last two decades. Many believe this dollar dominance has allowed the United States to live beyond its means, running sizable current account deficits financed by borrowing from the rest of the world at cheap interest rates. Some other countries have chafed at this "exorbitant privilege" enjoyed by the United States.[21]

Moreover, the fact that a rich country such as the United States has been a net importer of capital from middle-income countries, including China, has come to be seen as a prime example of global current account imbalances. Such "uphill" flows of capital—contrary to the prediction of standard economic models that capital should flow from richer to poorer countries—have led to calls for a restructuring of global finance and a reconsideration of the roles and relative importance of various reserve currencies.[22] For now, however, the dollar's centrality to global finance appears to have trumped other considerations of imbalances in global financial flows.

If one were starting with a clean slate, an international monetary system that is dominated by one currency would seem prone to instability and, therefore, undesirable. A multiple reserve currency system, wherein the policies of each reserve currency–issuing economy are disciplined by competitive forces, would in principle be a preferred outcome. But the world in which we live is fraught with weak economic structures and policies in practically every major economy. In this imperfect world, having a dominant anchor currency may in fact provide a curious kind of stable anchor for coping with turbulent times, even if that turbulence is perpetrated by the anchor economy itself. Thus, the equilibrium in which the dollar remains the dominant global reserve currency is suboptimal but stable and self-reinforcing.

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## What Lies Ahead

Official and private investors around the world have become dependent on financial assets denominated in U.S. dollars, especially because there are no alternatives that offer the scale and depth of U.S. financial markets. U.S. Treasury securities, representing borrowing by the U.S. government, are still seen as the safest financial assets in global markets. Now that foreign investors, including foreign central banks, have accumulated enormous investments in these securities as well as other dollar assets, they have a strong incentive to keep the dollar from crashing in value. Moreover, there are no alternative currencies or investments that provide a similar degree of safety and liquidity in the quantities demanded by investors. Therein lies the genesis of the dollar trap.

The reason the United States appears so special in global finance is not just the size of its economy, but also its institutions—i.e., democratic government, an independent central bank, deep financial markets, and a reliable legal framework—that, for all their flaws, still set the standard for the world. For instance, despite the U.S. Federal Reserve's aggressive and protracted use of unconventional monetary policies, investors worldwide still seem to trust that the Fed will not allow inflation to get out of hand and erode the value of the dollar.

Other major advanced economies either have much smaller financial markets or, as in the cases of Europe and Japan, have relatively weak long-term growth prospects and already-high levels of public debt. Thus, these currencies are unlikely to return to their former glory anytime soon. But because of the benefits that the dollar has accrued from its reserve currency status, there should, in principle, be new competitors.

The renminbi is well on its way to becoming a significant international currency. If China plays its cards right, with suitable financial sector and other market-oriented reforms, the renminbi will become an important reserve currency, perhaps eventually accounting for as much as 10 percent of global foreign exchange reserves. For comparison, the U.S. dollar and the euro now account for 64 percent and 21 percent of global foreign exchange reserves, respectively.[23] For the renminbi to become a safe haven currency, however, China will have to undertake broader reforms of its institutional framework that would ultimately alter its political, legal, and public institutions. Such changes are currently not in the cards. At best, the renminbi will erode but not significantly challenge the dollar's preeminent status. No other emerging countries are likely to have their currencies ascend to reserve currency status, let alone challenge the dollar.

Of course, the dollar's dominance as a store of value does not necessarily translate into its continued dominance in other areas. The dollar's roles as a medium of exchange and unit of account are likely to erode over time. Financial market and technological developments that make it easier to conduct cross-border financial transactions using other currencies are reducing the need for the dollar. China has signed bilateral agreements with some of its major trading partners to settle trade transactions in their own currencies. Similarly, there is no good reason why contracts for certain commodities such as oil should continue to be denominated and settled only in dollars.

By contrast, because financial assets denominated in U.S. dollars, especially U.S. government securities, are still the preferred destination for investors interested in the safekeeping of their investments, the dollar's position as the predominant store of value in the world is secure for the foreseeable future. Ultimately, getting away from the dollar trap will require significant financial and institutional reforms in other countries that aspire to have their currencies erode the dollar's dominance. It will also take major reforms of global governance to reduce official demand for safe assets by providing better financial safety nets for other countries. That would remove the need for them to resort to accumulating foreign exchange reserves as self-insurance against currency or financial crises.

The dollar's continued prominence is ultimately less a parable about American exceptionalism than about weaknesses in the rest of the world and deep problems in the structure of the global monetary system. In international finance, it turns out, everything is relative. For all their weaknesses, the U.S. economy, its financial markets, and its institutional framework still set the standards for the rest of the world. The dollar will remain the dominant reserve currency for a long time to come, mainly for want of better alternatives.

## Notes

1. In 2009, Paul Krugman referred to "China's Dollar Trap," see: Paul Krugman, "China's Dollar Trap," *New York Times*, April 2, 2009. The use of this term in a broader sense first appeared in my book, see: Eswar Prasad, *The Dollar Trap: How the Dollar Tightened Its Grip on Global Finance* (Princeton: Princeton University Press, 2014).

2. Menzie Chinn and Jeffrey Frankel, "Will the Euro Eventually Surpass the Dollar as Leading International Reserve Curency?," in *G7 Current Account Imbalances: Sustainability and Adjustment,* ed. Richard Clarida (Chicago: University of Chicago Press, 2007).

3. For a nice, recent book on the genesis and flaws of the eurozone, see: Harold James, Jean-Pierre Landau, and Markus K. Brunnermeier, *The Euro and the Battle of Ideas* (Princeton: Princeton University Press, 2016).

4. Prasad, *The Dollar Trap,* 35–36.

5. For data, see: "Currency Composition of Foreign Exchange Reserves," IMF, www.imf.org/external/data.htm.

6. For data on the U.S. federal government debt and its composition, see: "The Treasury Bulletin," U.S. Department of the Treasury, https://www.fiscal.treasury.gov/fsreports/rpt/treasBulletin/treasBulletin_home.htm.

7. For data, see: "Major Foreign Holders of Treasury Securities," U.S. Treasury Department, http://ticdata.treasury.gov/Publish/mfh.txt.

8. For data on the U.S. federal government debt and its composition, see: "The Treasury Bulletin," U.S. Department of the Treasury.



9. Eswar Prasad, *China's Efforts to Expand the International Use of the Renminbi* (Washington, D.C.: Brookings Institution Report, 2016).

10. Ibid.

11. Ibid.

12. Ibid.

13. Ibid.

14. Ibid.

15. Ibid.

16. Ibid.

17. "IMF Launches New SDR Basket Including Chinese Renminbi, Determines New Currency Amounts," International Monetary fund, September 30, 2016, http://www.imf.org/en/News/Articles/2016/09/30/AM16-PR16440-IMF-Launches-New-SDR-Basket-Including-Chinese-Renminbi.

18. Prasad, "China's Efforts to Expand."

19. Ibid.

20. Eswar Prasad, *Gaining Currency: The Rise of the Renminbi* (New York: Oxford University Press, 2016), 124–5.

21. For more on this point, see: Barry Eichengreen, *Exorbitant Privilege: The Rise and Fall of the Dollar and the Future of the International Monetary System* (New York: Oxford University Press, 2011).

22. Eswar Prasad, Raghuram Rajan, and Arvind Subramanian, "Foreign Capital and Economic Growth," *Brookings Papers on Economic Activity*, no. 2 (2007).

23. Prasad, *Gaining Currency*, xvii–xviii.