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Will the Dollar be Dethroned as the Main Reserve Currency?

Robert J. Carbaugh*

David W. Hedrick†

*Central Washington University, carbaugh@cwu.edu

†Central Washington University, dhedrick@cwu.edu

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Robert J. Carbaugh and David W. Hedrick

Abstract

The U.S. dollar was in the line of fire as leaders from the largest developed and developing countries participated in the G8 meeting in July, 2009. China and other emerging market heavy-weights such as Russia and Brazil are pushing for debate on an eventual shift away from the dollar to a new global reserve currency. These countries are particularly concerned about the heavy debt burden of the United States and fear inflation will further debase the dollar which has lost 33 percent in value against other major currencies since 2002. Will the dollar continue as the main reserve currency of the world? What are the other currencies to watch as challengers to the throne? This paper addresses these questions.

KEYWORDS: international policy, open economy macroeconomics

Since the 1940s, the U.S. dollar has served as the main reserve currency of the world. Dollars are used throughout the world as a medium of exchange and unit of account, and many nations store wealth in dollar-denominated assets such as Treasury securities. The dollar's attractiveness has been supported by a strong and sophisticated U.S. economy and its safe-haven status for international investors. The world has depended on the dollar, and world trade in many products is priced in dollars. However, the widening current-account deficits and expanding foreign debt which the United States has incurred have caused some to question the dominance of the dollar. Can it continue as the world's premier currency?

For most of this decade, the United States has struggled to maintain the dollar's value. Against major currencies, the dollar depreciated by about 33 percent during 2002-2009. Also, the economic crisis of 2007-2009 revealed structural weaknesses in the U.S. financial system. And with the economic crisis prompting the United States to commit trillions of dollars to rescue its economy, the fear is that inflation will further debase the dollar. China, which holds about 70 percent of its \$1.9 trillion foreign-exchange reserves in dollars, is especially vulnerable. China would like to diversify out of dollars, as seen in its decreased purchases of U.S. Treasury securities in 2009. However, any effort to dump its stock of dollar assets would risk causing a collapse in the dollar's exchange value.

In March 2009, officials at the People's Bank of China (China's central bank) declared that the weak dollar was a root cause of the global economic crisis and that the dollar should eventually be replaced by Special Drawing Rights (SDRs) as the world's reserve currency. This view has been supported by other emerging market heavyweights including Russia, Brazil, and India. In July 2009, Russia announced that the dollar was not its basic reserve currency anymore. Instead, the euro-based share of its reserve assets exceeded its investments in dollar assets.

The purpose of this paper is to examine the role of the dollar as the main reserve currency and the question of whether or not it can continue in this capacity. The paper concludes that structural problems in the U.S. economy, unless addressed, will continue to weaken the dollar's standing as the premier reserve currency. Although the dollar is not likely to be replaced as a reserve currency by the SDR, yuan, or euro in the near future, there is a good possibility that the dollar will share this role with some other currency or currencies in the decades ahead.

THE DOLLAR AS A RESERVE CURRENCY

A reserve currency is a currency that is held in significant quantities by many governments and institutions as part of their foreign exchange reserves. About 64

percent of the world's official foreign exchange reserves are held in dollars, and about 86 percent of daily foreign exchange trades involve dollars (Bank for International Settlements, 2007). The euro, the second most important reserve currency, lags far behind the dollar, followed by the British pound, Japanese yen, and Swiss franc. For this reason, the dollar is said to have dominant "reserve currency status."

Like any standard currency, a reserve currency serves as a medium of exchange, unit of account, and store of value. As a medium of exchange, a reserve currency facilitates trade and finance by decreasing the number of bilateral exchange markets that need to be created, thus reducing transaction costs. Therefore, central banks prefer to use a reserve currency when conducting foreign exchange intervention; this offsets undesirable fluctuations in the value of their currencies caused by private inflows and outflows of capital.

As more and more people have used dollars in international transactions in the post- World-War-II era, the efficiencies in using dollars have increased, thus solidifying the dollar's place as the world's premier currency. Some have compared the dollar to that of the Microsoft Windows operating system. Computer users may feel that substitute software is easier to use, but the convenience of being able to transfer files around the world to anyone using Microsoft enhances the system's popularity. In the dollar's case, its widespread use makes dealing in the currency easier and less expensive than in any other: The more countries that transact in dollars, the cheaper it is for them all to transact in dollars. Therefore, a country would hesitate to stop dealing in dollars, even if it desired to use a different currency, unless it knew that other countries would do the same. This is a key reason that the dollar is so difficult to displace as the world's main reserve currency (Karmin, 2008).

A reserve currency also serves as a unit of account for invoicing transactions in trade and finance. Countries such as Ecuador and Argentina have pegged their currencies to the U.S. dollar, the currency of their major trading partner. Moreover, an effective reserve currency serves as a store of value. If a reserve currency maintains its future purchasing power, countries can accumulate reserves as a hedge against international currency crises and as a public demonstration of intent to promote exchange rate stability. To serve as a reliable store of value, the reserve currency must be backed by sound macroeconomic policies aimed at preserving its value vis-a-vis other currencies.

Several factors affect the decision of central banks to hold a particular currency as a reserve currency. First, the larger a country's share of world output and trade, the more likely it is that other countries will use it as a monetary anchor or in external transactions. Second, macroeconomic and political stability (especially price stability) are essential for maintaining confidence in the currency's value. Without this confidence, the ability of a currency to serve as a

store of value and unit of account is undermined. Third, a high degree of financial market development, in terms of large size and high liquidity, makes it more likely that a country's currency will be used by foreign central banks as the medium of exchange for currency intervention. Finally, network externalities create a self-generating demand for a dominant currency: The more a currency is used as a medium of exchange, the more liquid it becomes and the lower are the costs of transacting in it, leading, in turn, to its becoming even more attractive to new users. None of these influences on the choice of a reserve currency is likely to change quickly. Thus, any change in the status of a dominant reserve currency would likely occur at a slow pace, with substantial changes most often taking decades (Eichengreen and Mathieson, 2000).

It is easy to see why the U.S. dollar became the world's dominant reserve currency. Throughout the last century, the dollar served as a reserve currency better than any other currency. The United States has been the most stable capitalist economy in the world. After World War II, it realized the benefits of rapid growth due to technological innovation, a solid manufacturing base, abundant natural resources, and a stable political system. Also, the United States is the world's largest economy, producing about a fifth of the world's gross domestic product. Furthermore, capital markets in the United States are deep and liquid, and they account for about one third of the world's financial assets. Twenty-four-hour-a-day sales of short-term Treasury bills provide a highly liquid and risk-free haven that allows foreign central banks to convert their currencies into interest-bearing, dollar-denominated assets. The advantages of the United States have included the promise of a good return, safety, secure political institutions, liquidity and an enormous depth of financial expertise (Carbaugh and Hedrick, 2008).

The United States realizes substantial benefits from the dollar's serving as the main reserve currency of the world. Americans can purchase products at a marginally cheaper rate than other nations, which must exchange their currency with each purchase and pay a transaction cost. As participants in the reserve-currency country, the U.S. government and American businesses can issue debt denominated in dollars, and those assets are attractive to central bankers and foreign investors as ways to hold their portfolio of international reserves. These features allow Americans access to a vast supply of credit and permit the public to borrow at lower interest rates for homes and automobiles and the government to finance larger deficits longer and at lower interest rates. Moreover, the United States can issue debt (securities) in its own currency, thus pushing exchange rate risk onto foreign lenders. This means that foreigners face the possibility that a fall in the dollar's exchange value could wipe out not only the value of the reserve currency that they hold but also the value of the U.S. assets that they hold in their international reserve portfolio. For example, if a Chinese investor realized a

return of 5 percent on her holdings of U.S. Treasury securities, and if the dollar depreciated 5 percent against the yuan, she would realize no gain. With holdings of dollar-denominated assets of about \$1.4 trillion in 2009, China has been especially concerned about the possibility of loss of purchasing power in the event of substantial dollar depreciation.

Moreover, officials at the Peoples Bank of China have cited the “Triffin Dilemma” as a cause of concern surrounding the dollar’s present and future role as a reserve currency (Xiaochuan, 2009). Named after the economist Robert Triffin, the dilemma is that the United States, as the reserve currency nation, must run a current-account deficit to provide liquidity for the international monetary system; however, it needs to practice financial discipline and run a current-account surplus to maintain confidence in the dollar. The United States faces a dilemma because it cannot run a current-account deficit and a current-account surplus at the same time (Triffin, 1960). Under a system of largely floating exchange rates, an important barometer of how the United States is handling the dilemma is reflected in how well the dollar is performing in foreign exchange markets. If concerns arise over excessive U.S. trade deficits and the amount of U.S. borrowing, traders in the foreign exchange market will likely initiate actions that result in a depreciation of the dollar.

To help safeguard the status of its reserve currency, the United States must defend the value of the dollar by controlling its domestic money supply and thus its payments deficits. By doing so, the United States effectively determines the amount of official international liquidity, because each new deficit will inject an equivalent amount of reserve currency and assets suitable for international reserves into the global economy. To achieve this result, however, the United States has needed the cooperation of other nations. They must realize trade surpluses and thus lend to the United States to finance its trade deficits. Since the United States is an important supplier of both reserve currency and assets for international reserves, it must issue monetary liabilities that are sufficiently attractive for acquisition by other nations. Therefore, the U.S. supply of liquidity to the world must be matched by comparable demand on the part of foreign investors (Stiglitz, 2006).

However, the dollar does not currently fulfill all of the requirements of a reserve currency, especially because the United States suffers from a huge debt burden. Banks have made it possible, through credit cards, personal loans, and mortgage loans, for Americans to live beyond their means, as seen in the economic crisis of 2007-2009. Also, members of Congress “buy votes” through excessive government spending in congressional districts, resulting in large budget deficits. Moreover, the debt of the U.S. government has skyrocketed as a result of recent fiscal stimulus programs. Americans have become the world’s dominant consumers, snapping up far more than the United States produces by

importing from countries that produce far more stuff than they can digest at home. What is clear is that America's habits are inappropriate for the guardian of the world's main reserve currency.

In spite of the widespread appeal of the dollar, there is increasing concern about its continuing role as the world's key currency. Countries such as China and Russia fear that the United States is digging a hole with an economy based on huge deficits and massive borrowing that cloud the dollar's future. They worry about the volatility of the dollar and the destabilizing effect that it can have on international trade and finance. Critics claim that a credit-based reserve currency such as the dollar is inherently risky, facilitates global imbalances, and promotes the spread of financial crises. As a result, they argue that the dollar should no longer serve as the world's reserve currency. Before the dollar is displaced as a reserve currency, however, there must be a contender for the throne. Which are the other currencies to watch?

WILL THE EURO BE THE NEXT RESERVE CURRENCY?

Introduced in 1999, the European Monetary Union's (EMU) euro appears to be the dollar's first real contender as a reserve currency since the yen in the 1980s. In the last ten years, the euro has made major inroads in satisfying the three primary functions of a reserve currency.

The euro area, which includes the European countries who use or peg or coordinate exchange rates with the euro, is comprised of 27 countries whose combined GDP was about \$15 trillion in 2008, making it approximately equal in size to the U.S. economy. By its sheer economic size, the euro area has created a currency that rivals the dollar for carrying out and acting as a unit of account for international transactions.

The euro is the most actively traded currency after the dollar, and the corresponding market for euro-denominated bonds is approaching the depth and liquidity of dollar-denominated bonds (Galati and Wooldridge, 2009). This makes it possible to buy and sell euro-denominated debt without disrupting the market for those securities. Since its introduction in 1999, the euro's share of global foreign exchange reserves has increased from 18.1 percent to 25.9 percent in 2009. Moreover, in December of 2006, the number of euro notes in circulation surpassed the number of dollars in circulation. The increased use of the euro for international transactions, combined with the increasing liquidity and depth of euro financial markets, have resulted in the euro's capturing some of the advantages that have historically supported the status of the dollar as the world's key currency. These factors clearly strengthen the incentive for monetary authorities to reconsider the currency composition of their reserves.

In spite of predictions by some enthusiasts that the euro would rival the dollar's share of world reserves ten years after its introduction, the euro has not soared to the status of a major reserve currency. The euro's current share of world reserves is still below that previously held by the former currencies of EMU member nations in the 1980s and early 1990s (Galati and Wooldridge, 2009). It appears that a large part of the growth of the euro as a reserve currency is attributable to the sheer size of the economies of the nations comprising the EMU. For example, in 2008 the euro area's share of world output stood at about 21 percent, only slightly below the euro's share of international reserves (Central Intelligence Agency, 2009).

There are several reasons that the euro has not captured a greater share of international reserves. First and most importantly, the dollar enjoys the power of incumbency. As the existing reserve currency, it possesses considerable inertia conveyed by the strong network economies described earlier in this paper. In order for the euro to develop the level of network economies enjoyed by the dollar, its use must grow beyond providing a medium of exchange for its member nations.

Secondly, dollar financial markets still have a significant advantage over euro financial markets in terms of size, credit quality, and liquidity. How quickly these euro markets will expand in the future is unclear; however, it appears certain that considerable growth in euro financial markets is still needed. Some have argued that a necessary condition for the euro to overtake the dollar in the near term is for the United Kingdom, with its vast financial markets, to join the EMU.

Thirdly, while there are concerns about how well the dollar will perform as a standard of value in the years ahead, given the large foreign debt burden of the United States, it is not clear that the euro will fulfill this function as well as the dollar has. Although the euro has appreciated significantly against the dollar in recent years, it is clear that international investors still harbor concerns about the stability of the euro. In 2008, the euro reached historic highs against the dollar, trading almost \$1.60 per euro; by mid 2009, however, it had dropped to about \$1.30 per euro. Most analysts attribute these fluctuations to the weakness of the euro rather than the strength of the dollar. Aggregate statistics on the economic activity of the euro area tend to mask some significant differences in the international trade positions of its members. While Germany is running large trade surpluses, countries such as Spain, Italy, and Greece are running enormous trade deficits. How the EMU plans to resolve the tensions created by these imbalances is unclear, particularly since one of the key provisions of the pact that established the euro prohibits the EMU from bailing out member countries that experience such deficits. Exactly how these internal disparities in trade balances will affect the value of the euro, and consequently its role as an emerging reserve currency, is uncertain.

Fourthly, it is not clear that all members of the EMU desire to spread the use of the euro throughout the world. Although Germany and France are the driving forces behind the development of the euro, they have held opposing views on the benefits of its use abroad. Germans tend to frown on a global role for the euro because it complicates the ability of the EMU to manage its own monetary policy. They are cautious about taking on the challenges of Triffin's dilemma and have been hesitant to allow their economy to experience large current account deficits that a reserve currency may require. Their concerns are compounded by fears that existing euro-area members with large trade deficits, as well as the Eastern European nations in a queue for entry, will use the euro's reserve currency status to avoid the fiscal discipline needed to move toward trade surpluses. The French, however, envision a widely used currency as a means of establishing greater global influence. Thus, the European Central Bank has not promoted the euro as a reserve currency, since doing so would increase demand from central banks and cause its exchange value to appreciate against the dollar. A strong euro could hamper euro area economic growth.

Lastly, the growth in the euro's share of international reserves appears to require not only the strengthening of the euro but also the weakening of the dollar. If the United States is successful at unwinding its current expansionary monetary and fiscal policies as economic conditions improve, it will be difficult to unseat the dollar as the primary reserve currency. If, however, political pressures make it difficult for U.S. policymakers to address their current macroeconomic imbalances, inflation will lead to further weakening of the dollar and undermine its position as the world's main reserve currency.

WILL SPECIAL DRAWING RIGHTS BE THE NEXT RESERVE CURRENCY?

In March 2009, Zhou Xiaochuan, a governor at the People's Bank of China, proposed an overhaul of the international monetary system in which the Special Drawing Right (SDR) would eventually replace the dollar as the world's main reserve currency (Xiaochuan, 2009). His goal was to adopt a reserve currency that is disconnected from a single country (the United States) and would remain stable in the long run, therefore lessening the financial risks caused by the volatility of the reserve currency (Humpage, 2009). To explain the SDR proposal of Mr. Zhou, we will first summarize the characteristics of the SDR.

The SDR was created by the International Monetary Fund (IMF) in 1969 to support the Bretton Woods system of fixed exchange rates. The IMF's objective was to introduce into the payments mechanism a new type of international money, in addition to the dollar and gold, that could be transferred among participating nations in settlement of payments deficits. It was felt that

neither dollars nor gold, by themselves, could provide ample liquidity for the world. With the IMF managing the stock of SDRs, world reserves presumably would grow in line with global commerce (International Monetary Fund, 2009).

Although the SDR was designed as a reserve currency, it never took off. SDRs today add up to less than 1 percent of total reserves. The SDR has only limited use as a reserve asset, and its main purpose is to serve as the unit of account of the IMF and some other international organizations. Rather than being an international currency, the SDR is a potential claim on the freely usable currencies of IMF members. Holders of SDRs can obtain these currencies in exchange for their SDRs in two ways: (1) through the arrangement of voluntary exchanges between members; and (2) by the IMF's designating members with strong external positions to buy SDRs from members with weak external positions.

The value of the SDR is defined as a basket of currencies which include the U.S. dollar, Japanese yen, UK pound, and the euro. The SDR is calculated as the sum of specific amounts of the four currencies valued in U.S. dollars, on the basis of exchange rates quoted at noon each day in the London market. The weights of the currencies reflect the level of exports and imports of these four countries during the previous five years. These weights currently are U.S. dollar = 44 percent, euro = 34 percent, yen = 11 percent, and pound = 11 percent. The SDR's basket composition is reviewed every five years to ensure that it reflects the relative importance of currencies in the world's trading and financial systems.

The SDR's interest provides the basis for calculating the interest charged to members on IMF loans, the interest paid and charged to members on SDR holdings, and the interest paid to members on a portion of their quota subscriptions. The SDR interest rate is determined weekly and is based on a weighted average of representative interest rates on short-term debt in the money markets of the SDR basket currencies (Ekpenyong, 2007).

If the SDR is to become a global reserve currency, several steps would have to be taken to broaden its use. A settlement system between the SDR and other currencies would have to be established so the SDR would be widely accepted in world trade and financial transactions. Currently, the SDR is used only as a unit of account by the IMF and other international organizations. Also, the SDR would have to be actively promoted for use in trade, investment, and corporate bookkeeping. Moreover, financial assets (securities) denominated in SDRs would have to be created to increase the attractiveness of the SDR.

Another step to bolster the SDR's status would be to make its currency composition more neutral to global cycles and more representative of the shift in economic power that has occurred in recent decades. This suggests an increase in the commodity content of the SDR and the inclusion of major emerging-market currencies into the SDR basket, such as the Canadian dollar, Australian dollar,

Chilean peso, and Norwegian krone. This would provide the SDR a tie to raw material cycles, as these currencies reflect price movements of oil, gold, copper, and iron ore. Also, major emerging-country currencies would be included in the SDR basket as soon as they attained a predefined level of convertibility (Reisen, 2009).

Proponents maintain that allowing the SDR to serve as the world's reserve currency would provide several benefits. For the Chinese, it would cushion any depreciation in the dollar's exchange value because the dollar would be only a portion of a basket of several currencies. This would help stabilize the value of China's holdings of U.S. Treasury securities. Also, a basket reserve currency would help support aggregate demand in the world by decreasing the fear of currency volatility. Such fear has served as a motivation for countries like China to save large amounts of reserves to guard against losses due to the volatility of the dollar's exchange value. Moreover, the economic welfare of the world would not depend on the behavior of a single currency, namely the dollar. Currency risk would be diversified through a basket reserve unit. Finally, there is the issue of equity. Because the dollar is the main reserve currency, where investors flee to safety during economic strife, the United States can attract the savings of other countries even when the interest rates it pays are very low.

However, there are potential pitfalls of using the SDR as a reserve currency. One problem is that the SDR is backed by nothing other than the good faith and credit of the IMF; that is, the IMF produces nothing to support the value of the SDR. In contrast, the dollar is backed by the goods and services produced by Americans and their willingness to exchange those goods and services for dollars. Also, who would determine the "right price" of the SDR-- the IMF? Would the IMF succumb to political pressure to change the SDR's currency weightings in favor of particular nations? Moreover, the use of the SDR would add another step to each international transaction, as buyers and sellers would have to convert their local currency into SDRs. This would increase the cost of doing business for companies, investors, and so on.

Adopting the SDR as a reserve currency might be technically possible and it could occur if the United States followed persistently bad economic policy in the form of deficit spending, high inflation, and currency depreciation. If foreigners expect that the costs of holding dollars (in terms of lost purchasing power) exceed the benefits of transacting in dollars, they might opt for an alternative reserve currency. To generate such an expectation, the Federal Reserve would have to induce a substantially higher rate of inflation than the rest of the world for a prolonged period of time. However, replacing the dollar with the SDR as the reserve currency will likely not occur soon because people still realize sizable efficiencies from conducting international transactions in dollars. Until the SDR matches these benefits, it will not replace the dollar as the world's

premier currency. It would take years to develop SDR money markets that are liquid enough to serve as a reserve asset. Although the IMF approved the first issuance of SDR-denominated bonds on July 1, 2009, as it attempts to increase its resources, the bonds can be purchased and sold only by central banks, not private investors.

WILL THE YUAN BE THE NEXT RESERVE CURRENCY?

Although China's proposal for the SDR to rival the dollar has merit, it is widely seen as serving two goals. The first is to warn the United States to avoid policies that would result in a substantial depreciation of the dollar and thus promote sizable valuation losses on the dollar component of China's huge foreign exchange reserves. The second goal is political. By proposing an increased role for the SDR at the expense of the dollar, China desires to decrease the financial and political power of the United States. For this reason, China's proposal has been supported by Russia, India, Brazil, and other developing countries that have long been skeptical of the dollar as the world's key currency. However, China is aware that the creation of a totally new and powerful international currency would be an undertaking that would take many years. This is because the dollar's dominance will decrease only when some other country emerges with a large enough GDP and tax capacity to compete with the United States in providing a reserve currency. China is the country that best fits this description.

China is currently a developing country, but in perhaps another decade or two it will become a high-income country, and its GDP will begin approaching that of the United States. Regarding fiscal management, China has outperformed both Europe and the United States in recent years. As China evolves to become wealthier, its economic emphasis will shift from exports to domestic consumption. At some point, China may find it more advantageous to stop micro-managing its exchange rate and instead float its currency as have other major economic powers.

Historically, countries have evolved from having "soft" currencies to "hard" (internationally traded) currencies after realizing current-account surpluses for a sustained period, and therefore emerging as net creditor countries. Great Britain achieved net creditor status in the 1800s and the United States in the early 1900s, and the markets recognized them with hard-currency status. China has now achieved net creditor status and is moving toward a hard currency. China wants to make Shanghai an international financial center, it has entered into yuan swap arrangements with Brazil and Argentina, and it desires to create a regional Asian pool of swappable foreign exchange reserves. All of these actions put China on the path of becoming a hard currency nation.

If history of the last switch in reserve currency status, from the British pound to the U.S. dollar, is any guide, the yuan could share the role of a reserve currency with the dollar around 2050. Great Britain lost its position to the United States as the world's largest economy in the 1870s and the largest exporter following World War I. After that, Great Britain became a net debtor country and the United States became a net creditor country. By 1945, the dollar replaced the pound as the main reserve currency of the world. Today, the United States is a net debtor country similar to Great Britain after World War I, and China is the world's largest creditor. Also, China is on its way to becoming the world's largest exporter. On the basis of these historic parallels, the addition of the yuan as a reserve currency is not inconceivable.

However, the yuan is not ready to become a reserve currency in the near future. To achieve this status, China's capital markets would have to mature and open up to foreign investment as the capital markets of the United States and Europe have done. This would require China to decrease restrictions on money entering and leaving the country, make its currency fully convertible for such transactions, continue its domestic financial reforms, and make its bond markets more liquid. China also would have to move from closely managing the yuan's exchange value to greater market flexibility.

To enhance the status of the yuan, China currently is promoting its use in international trade and finance. As of July 2009, selected companies in five Chinese cities can use yuan to settle transactions with companies in Hong Kong, Macau, and ASEAN countries. Foreign banks can purchase or borrow yuan from mainland lenders to finance such trade. In addition, China and Russia have agreed to increase the use of their currencies in bilateral trade. Moreover, China has entered into currency-swap agreements with Malaysia, South Korea, Indonesia, and Hong Kong that allow the People's Bank of China to make yuan available to pay for imports from China if these countries have inadequate holdings of foreign exchange. Finally, Hong Kong banks can now issue yuan-denominated bonds, a first step in establishing an offshore yuan market. Change is underway in China, although the amount of time it might take for the yuan to achieve the status of a reserve currency is uncertain.

So what can China, which has acquired huge holdings of dollar-denominated assets, do to reduce foreign exchange-valuation risk in the near future? It can permit its yuan to appreciate. China has acquired dollar reserves by restricting the extent to which the yuan appreciates against the dollar in the face of persistent trade surpluses with the United States; that is, China sells yuan and buys dollars on the foreign exchange market. If China did not purchase dollars at the existing pegged value, the strong inflow of dollars into China would cause the yuan to appreciate against the dollar. Moreover, a yuan appreciation would tend to decrease China's exports to the United States, increase Chinese imports from

the United States, and reduce the dollar inflows. Indeed, China has preferred to manage its exchange rate against the dollar to prevent an appreciation of the yuan, thus promoting export-led growth. In doing so, however, China encounters foreign-exchange valuation exposure on its holdings of dollar-denominated assets.

CONCLUSIONS

Although the dollar has been the world's main reserve currency since the 1940s, its dominant role can no longer be taken for granted. As the world economy and international trade have expanded, the demand for the reserve currency has also soared, increasing by about 150 percent in the last decade. The dollar's share of world foreign-exchange reserves has declined from 80 percent in the 1970s to about 65 percent today. The growing demand for international reserves notwithstanding, if the United States continues to spend and borrow at its present pace, and the Federal Reserve maintains an easy monetary policy with low interest rates, the dollar's status as a reserve currency likely will continue to erode. When the world's growing demand for liquidity subsides as economic conditions return to normal, the United States could eventually lose the privilege of being able to have the world's main reserve currency.

To retain the dollar's reserve status, the Federal Reserve must be prepared to tighten its monetary reins. Doing so will not be easy, particularly since large federal deficits probably will force lawmakers to increase taxes, thus slowing future investment and growth. The Federal Reserve's dilemma is not unique. The European Union also must work hard to encourage growth among its new eastern European members and to remedy trade imbalances in countries such as Spain and Italy. These pressures may force the European Central Bank to favor lower interest rates, and thus a weaker euro. Therefore, rather than a cataclysmic collapse of the dollar occurring, it is more likely that a gradual downward drift will occur, and Americans will pay more and more of a cost. Unfortunately, there is no scientific basis with which to ascertain when and how fast this adjustment might be, and how wrenching the experience will be.

In spite of these uncertainties, there is a shortage of currencies that could replace the dollar as the main reserve currency. Although the Japanese yen, Swiss franc, and British pound have some qualities of a reserve currency, in today's world they are not viable alternatives. The yen's appeal has deteriorated in response to the Japanese deflation in the 1990s and a high government-sector debt burden in the 2000s. The safe-haven status of the Swiss franc has become less important since the collapse of the Soviet Union in the late 1980s and due to Switzerland's relatively small financial markets with limited liquidity. As for the pound sterling, its financial markets are relatively small, and they can absorb only a fraction of the large volume of investments by central banks worldwide.

Moreover, the euro zone does not appear ready yet to assume the responsibilities of having the dominant reserve currency. However, the euro will gain market share, particularly in and around Europe.

Even though there is no currency currently poised to dethrone the dollar, that does not mean that the euro, the yuan, or a basket of currencies such as the SDR could not eventually join the dollar as a reserve currency. The U.S. government might attempt to slow this erosion with policies intended to increase American savings and decrease its current-account deficit. But it is likely that slippage in the dollar's status will continue. There is no reason that, in twenty or thirty years, two or three currencies could not share the status of reserve currencies, similar to the situation before World War I, when the pound was waning and the demand for dollars was increasing.

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