



THE BRICS AND ASIA, CURRENCY INTERNATIONALIZATION AND INTERNATIONAL MONETARY REFORM

PAPER NO. 6 — JULY 2013

Reluctant Monetary Leaders? The New Politics of International Currencies

Eric Helleiner



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ABOUT THE PROJECT AND PAPER SERIES

The BRICS and Asia, Currency Internationalization and International Monetary Reform

The disjuncture between global markets and an international monetary system (IMS) based on national currencies generates instability for global trade and finance. As the BRICS (Brazil, the Russian Federation, India, the People's Republic of China [PRC], South Africa) and Asian countries have become more integrated into the world economy, their governments have become increasingly aware of fundamental problems or challenges in the current IMS.

In December 2012, the Asian Development Bank (ADB), The Centre for International Governance Innovation (CIGI) and the Hong Kong Institute for Monetary Research (HKIMR) co-hosted a conference in Hong Kong. The conference examined: a range of views on the fundamental systemic problems that are a catalyst for international monetary reforms; views from the BRICS and Asian countries, as well as regional considerations regarding the measures that key countries are already taking to respond to the challenges of the IMS, including currency internationalization; and options and preferences for orderly adjustment of the IMS.

The 10 papers in this series, authored by esteemed academic and policy experts, were presented at the conference in Hong Kong, China and were subsequently revised. These working papers are being published simultaneously by all three partners.

ABOUT THE AUTHOR

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He is the author or co-editor of numerous books, including most recently *The Future of the Dollar* (Cornell, 2009), *Global Finance in Crisis* (Routledge, 2010) and *Forgotten Foundations of Bretton Woods* (Cornell, forthcoming 2014). Eric has also published many journal articles and book chapters on other issues relating to international political economy (IPE), and has been a member of the Warwick Commission on International Financial Reform and the High Level Panel on the Governance of the Financial Stability Board. He has won the Trudeau Foundation Fellows Prize, the Donner Book Prize, Marvin Gelber Essay Prize in International Relations, and the Symons Award for Excellence in Teaching. He has been a Canada Research Chair, CIGI Chair, and was founding Director of the M.A. and Ph.D. programs in global governance at the BSIA. He is presently co-editor of the book series Cornell Studies in Money, and has served as co-editor of the journal *Review of International Political Economy* and associate editor of the journal *Policy Sciences*.

Eric has taught courses on topics such as IPE, globalization, global governance, politics of global finance, the state and economic life, and North American integration. His current research interests include global financial crises and regulation, shifting power in the international monetary system, the origins of international development and the history of IPE thought.

ACRONYMS

ADB	Asian Development Bank
BRICS	Brazil, the Russian Federation, India, the People's Republic of China and South Africa
CIGI	The Centre for International Governance Innovation
HKIMR	Hong Kong Institute for Monetary Research
IMF	International Monetary Fund
IMS	international monetary system
KC	key currency
PRC	People's Republic of China
RMB	renminbi
SDRs	Special Drawing Rights

EXECUTIVE SUMMARY

What is the future of the US dollar's role as the world's key currency (KC)? The future of international money will be determined not only by markets but also by public policy choices, in particular the choices of the United States and other leading economic powers to encourage or discourage an international role for their respective currencies. The preferences of leading economic powers are difficult to predict in the abstract, both because the implications of issuing a KC are much more ambiguous than is often assumed and because KC policy making can be influenced by a variety of political pressures. Looking to the future, there are reasons to expect that policy makers in the major powers may all be less than fully enthusiastic about supporting a KC role for their respective currencies in the coming years. If those preferences were in place, the world would drift towards a "leaderless currency system," one characterized more by a widespread reluctance to lead than growing competitive rivalries between the major powers. The consequence may be an enduring KC role for the dollar, supplemented by a modest internationalization of some other currencies and some strengthening of the International Monetary Fund's (IMF) Special Drawing Rights (SDRs).

INTRODUCTION

The severity of the US financial crisis of 2007–2008 has generated new interest in the future of the US dollar as the world's KC. Many commentators have predicted that the greenback's dominant global position will be undermined by the economic difficulties of the United States. These predictions have been reinforced by developments in the political realm, where the crisis experience has prompted foreign policy makers to openly question whether the world is well served by the current dollar-centred international monetary system. Policy makers in some countries, notably the PRC, have matched their words with actions designed to begin promoting the internationalization of their country's currency (the renminbi [RMB] in the case of the PRC). Is the dollar's international dominance thus doomed to fade away, just as sterling's did over the course of the twentieth century?

Some analysts, such as Arvind Subramanian in his 2011 book *Eclipse*, argue that the dollar's dominant role is destined to be quickly replaced by the RMB within the next decade or so. Others, such as Barry Eichengreen and Benjamin Cohen, argue that the dollar's KC role is more likely to give way to "a world of several international currencies" (Eichengreen, 2011: 8), of which the dollar, the euro and RMB will be the most important. Under this scenario, the dollar's dominant international position will be replaced by the emergence of a "leaderless currency system" (Cohen, 2010: 148) characterized by competitive rivalries between the leading monetary powers.

To adjudicate between these predictions, several core analytical issues must be addressed. The first is whether the rise and fall of KCs is best analyzed primarily as a market-led process, as many economists assume. This assumption is weakened by the fact that KC outcomes can also be influenced both directly and indirectly by public policy choices.

Particularly important are leading economic powers' decisions to support or curtail a KC role for their country's money.

If the decisions of leading states are significant, we need to understand how they are made. For this task, it is useful to first establish the full range of implications of a KC for the issuing country. There is a widespread assumption in existing literature — captured in the title of Eichengreen's recent book — that issuing a KC is an “exorbitant privilege” that confers many benefits on the issuing country. This assumption stems from too narrow a reading of the implications of issuing a KC. When we step back to look at the full range of implications, they relate to eight distinct issues: seigniorage, transaction costs, denomination rents, macroeconomic flexibility, international prestige and power, exchange rates, domestic financial systems and international responsibilities. An evaluation of these implications as a whole reveals that the overall costs and benefits of a KC for the issuing country are much more difficult to assess than is often acknowledged.

How, then, do national policy makers prioritize among the various implications in deciding whether to support or curtail a KC role for their currency? This issue is not well theorized in existing literature. It is commonly assumed that policy makers will seek, wherever possible, to maximize the international status of their currency. Historical evidence, however, calls this assumption into question. National policy makers have, in fact, often been reluctant to support a KC status for their currency because they — or the powerful domestic actors that influence them — see it more as a burden to be avoided than a privilege to be sought.

Looking to the future, this reluctance may characterize policy making in the leading economic powers — the PRC, Japan, the euro zone and the United States — over the coming years. If those

preferences were in place, the world would indeed drift towards a “leaderless currency system,” but one characterized more by a widespread reluctance to lead than by increasing competitive rivalries between the major powers. The consequence may be an enduring KC role for the dollar, supplemented by a modest internationalization of some other currencies and some strengthening of the SDRs issued by the IMF.

IS THE RISE AND FALL OF KCs JUST A MARKET-LED PROCESS?

The international role of a currency can take many different forms.¹ It can serve as a medium of exchange, either for private actors settling international economic transactions or for governments intervening in foreign exchange markets. As a unit of account, a currency might be used to invoice international trade or denominate international investments, as well as being used by foreign governments as a peg for the value of their national currencies. A currency can also act as an international store of value by foreign private investors or by governments holding foreign exchange reserves. Why do some currencies assume these international roles and not others?

As Cohen (2010) notes, economists have identified three economic determinants of KC status. First, currencies are more likely to be used internationally if foreigners have *confidence* in their stable value, a confidence usually cultivated by a record of low and stable inflation as well as a steady external value. Second, KCs are usually characterized by “exchange convenience” and “capital certainty” because they can be held in *liquid* financial markets that are broad, deep, resilient and open to foreigners. Third, KCs are

1 See Benjamin Cohen (1971), *The Future of Sterling as an International Currency*, London and Basingstoke: Macmillan.

often supported by broad transactional networks, stemming from the issuing country's prominent *size* in the world economy.

During its heyday as a KC during the 19th century, sterling's global role was bolstered by all three of these economic factors: confidence in its value, the unique liquidity of London's financial markets and Britain's dominant size in the world economy. Sterling's longevity as a KC well into the twentieth century has prompted Cohen and others to suggest how economic *inertia* is a fourth factor that can sustain the KC role of a currency. When a well-established transactional network already exists, the switching of currencies can be economically costly. Cohen (2010) argues that inertia may also be a product of conservative and risk-averse behaviour among economic actors when faced with uncertainties involved in choosing an alternative currency.

Many economists assume that the rise and fall of KCs is largely a market-led process influenced by these various economic factors. They disagree, however, about the relative importance of each of the factors. Subramanian's analysis provides the most recent contribution to this debate. Drawing on historical data, he calls attention to an important statistical correlation between a country's size in the world economy and the international reserve role of its currency. Specifically, he argues that three indicators of country size — gross national product, trade and net creditor status — explain “about 70 percent of the variation in reserve currency status of the major currencies over the last 110 years” (Subramanian, 2011: 7). For this reason, he concludes that size — more than confidence and liquidity — is “the

fundamental determinant of reserve currency status” (ibid.).²

Building on this historical correlation, Subramanian predicts that the RMB is destined to soon take over from the dollar as the leading reserve currency, because the PRC's global economic significance is growing rapidly vis-à-vis the United States. According to his calculations, the PRC's dominance of the world economy by 2030 will be similar to that of the United Kingdom in 1870 and the United States after World War II. He notes that in 2010, the PRC had already surpassed the United States in his index of economic dominance, suggesting that the dollar's share of reserve holdings is now “substantially greater than it ought to be” (ibid.: 66). To explain this anomaly, Subramanian incorporates economic inertia into his model, arguing that a close study of the interwar transition of currency leadership from the United Kingdom to the United States suggests the need to allow for a lag of roughly five to 10 years.³ He anticipates, thus, that the RMB should overtake the dollar as the primary reserve currency by the early 2020s.

Subramanian's predictive model raises many fascinating questions. For the purposes of this paper, one limitation is that it does not allow any role for public policy to influence outcomes. Interestingly,

2 Although Subramanian focusses his quantitative testing on the official reserve role of a currency, his discussion of the costs and benefits of an international currency includes assessments of the significance of the wider international roles that a currency can assume. He uses the phrase “reserve currency” in a wider sense to include a currency's use not just by governments, but also by “the private sector for trade and financial transactions” (ibid.: 53).

3 Subramanian argues that the United States eclipsed Britain in his economic dominance index near the end of World War I, while the dollar eclipsed sterling in international private use around the mid-1920s.

however, his quantitative testing does bring out this role indirectly. To achieve his correlations, Subramanian excludes the interesting case of sterling's enduring reserve role after 1945, a role that he notes persisted because of political support from members of the sterling area (ibid.: 108). Rather than try to incorporate a role for politics into his model, he justifies the exclusion of the British case with the argument that sterling "was artificially propped up by special policy measures" and its decline "would have been even quicker (relative to fundamentals) had politics and history not intervened" (ibid.: 64, 114).

The language here is very much that of an economist. Why are public policy measures more "artificial" and less "fundamental" than economic ones? Could politics "intervene" once again to determine the future of the dollar's international role? Subramanian seems to think not, arguing that public policies are much less important in determining KC standing today than during the period of the UK-US transition. In his words, "the scale of private flows today so overwhelms official flows that transitions are likely to be endogenous and market-driven, with governments, individually or collectively, less able to exert control or influence" (ibid.: 111).⁴

But Subramanian's own analysis elsewhere in the book belies this case. In discussing the prospects for RMB internationalization, he argues that "many policy changes will need to occur before these [economic] fundamentals can prevail." (ibid.). In particular, he acknowledges that his projection

4 Subramanian echoes this point elsewhere: "In some ways, one could argue that private-sector actions are indeed the deep determinants of reserve currency status" (ibid.: 54). In addition to the critiques of this argument developed below, it is also worth noting that key actors in international financial markets today include sovereign wealth funds whose investment decisions are subject to the choices of public authorities.

for the RMB's international role is "conditional" on the Chinese government launching "far-reaching" financial reforms to allow the currency to be held in more liquid markets. He continues: "[the People's Republic of] China will need to eliminate restrictions on foreigners' access to the renminbi for the entire range of financial and trade transactions, and deepen its financial markets so that investors gain confidence in their liquidity and depth" (ibid.: 9). At a deeper political level, Subramanian notes, "there is also the bigger question of whether a nondemocratic country can inspire the basic trust in the rule of law that might be necessary for spreading internationalization of a currency" (ibid.: 110).

Subramanian himself thus seems not fully convinced by his model's economic determinism. As noted below, he develops some important analyses of politics of KCs elsewhere in his book. His comments about the importance of Chinese financial reforms and the rule of law also suggest that he is not entirely persuaded by his statistical conclusion that size is the fundamental determinant of reserve currency status. If these issues relating to liquidity and confidence are not resolved, his comments imply that the PRC's growing size in the world might not be accompanied by a significant internationalization of the RMB after all. His justification for excluding measures of liquidity and confidence from his model is largely that the indicators of size explain past historical trends so well on their own.⁵ As he acknowledges, however, these indicators do not explain the dollar's share of reserve holdings today. Subramanian chooses to explain this anomaly by incorporating inertia into his model, but an equally plausible strategy would have been to try to bring in indicators of confidence and liquidity. If he had pursued this latter strategy, his

5 The choice to exclude liquidity is also explained on the grounds that Subramanian was unable find available historical data (ibid.: 64).

projections for the RMB's internationalization might have looked quite different.

While many economists assume that the rise and fall of KCs is largely a market-driven process, analysts working in a political economy tradition have long highlighted the central role that public policy plays in shaping KC outcomes. As Cohen (2010: 129) puts it, "to ignore the political side in a context like this is like trying to put on a production of Hamlet without the prince." In this literature, public policy is shown to influence KC outcomes in two ways: indirect and direct (Helleiner, 2008).

The indirect mechanism is that governments can encourage or discourage KC status via their impact on the three core economic determinants of KC standing emphasized in market-based analyses: confidence, liquidity and size. Subramanian's discussions of how Chinese financial reforms would enhance the RMB's liquidity and political reform could boost foreign confidence in the currency provide two examples of this indirect influence. Another example comes from Eichengreen's argument that the euro's ability to challenge the dollar has been hindered by the failure of European authorities to create an integrated market for European public debt that could rival the US Treasury bill market in depth and sophistication. As Eichengreen (2011: 7) puts it, if the RMB is a "currency with too much state," the euro's problem is it is a "currency without a state."

Public policy can also influence the KC standing of a currency in a much more *direct* manner, which economists often ignore. This point was at the core of one of the pioneering works in the political economy of international currencies: Susan Strange's 1971 book *Sterling and British Policy*. Strange argued that economists focus most of their analytical attention on the study of "top currencies" whose widespread international role stems from their inherent economic attractiveness, for the

market-related reasons discussed above. But she urged economists to recognize that currencies could also achieve an international standing because their issuing governments imposed the currency's use on subordinate countries or colonies over which they exerted political domination. In addition to these "master currencies," Strange also highlighted a third category of "negotiated currencies," whose international role was supported by foreign governments *voluntarily* because they have been offered various inducements — either explicit or implicit — by the issuing government.⁶ Rather than seeing master and negotiated currencies as anomalies to be ignored (as Subramanian suggests), Strange argued that they were a pervasive feature of the international monetary landscape and thus deserving of scholarly scrutiny equal to that given to top currencies. Her study of the politics of sterling — which she argued was simultaneously a top, negotiated and master currency to varying degrees for most of its history as a KC — was an attempt to fill this gap in the literature.

Catherine Schenk's (2010) study of sterling's decline as a KC during the post-1945 years reinforces Strange's overall analytical point in some fascinating ways. Schenk is critical of those who argue that sterling's slow decline resulted from economic inertia linked to network externalities or other "invisible hand" processes. Her analysis demonstrates that the timing and dynamics of the process were instead largely determined by political processes, in particular those involving negotiations among states. Some of the key negotiations involved bilateral bargains between Britain and sterling reserve holders under which the latter's support for sterling was linked to security relationships with

6 Strange also discussed "neutral currencies," which were similar to top currencies except that they were issued by countries (for example, Switzerland) that were not dominant powers.

Britain, access to British export and capital markets, and even explicit official British guarantees of the value of their sterling reserves. Equally important were multilateral negotiations within the IMF and Bank for International Settlements, which resulted in the extension of foreign financial support to Britain in return for various British commitments, including negotiations with sterling reserve holders.

Schenk's analysis provides a striking proof of the phenomenon of a negotiated currency. But sterling's post-1945 history is not the only example. Historians have highlighted how, during the 1960s, West Germany maintained dollar reserves as an explicit quid pro quo for US security protection (Zimmermann, 2002). Other analysts have linked subsequent foreign support for the dollar — not just in terms of reserve holdings but also the currency denomination of oil exports, exchange rate pegs and the investment patterns of governments — from close US allies such as Japan, Saudi Arabia and the Gulf States to their security dependence on the United States.⁷ During the past decade, some scholars have also explained the very large accumulation of dollar reserves by the PRC as an implicit arrangement under which the United States accepted Chinese financial support in return for offering market access

for Chinese exports.⁸ These various analyses suggest that the dollar's future as a KC depends not only on factors such as confidence, liquidity and size, but also on the US government's continued ability and willingness to maintain foreign official support through various explicit or implicit inducements.

The prospects for other currencies to challenge the dollar's KC role may also depend on their ability to cultivate official support abroad in these direct ways. Although Strange assumed that a negotiated currency was always one in decline, Cohen notes that a rising power seeking to promote the internationalization of its currency could also offer inducements to foreign states to make greater use its currency. For this reason, he argues that assessments of any potential challenger to the dollar's global role must address political questions such as the following: "Can it project power abroad? Does it enjoy strong foreign-policy ties with other countries — perhaps a traditional patron-client linkage or a formal military alliance?" (Cohen, 2010: 128). A recent example of how rising powers can promote their currency's internationalization through diplomatic negotiation comes from the PRC's efforts to promote the RMB's international role by signing a number of bilateral swap arrangements as well as bilateral agreements that encourage the signatory governments to use each other's currencies in bilateral trade. Historically, the dollar's international role was also boosted by extensive "dollarization diplomacy" of the US government during the early decades of the twentieth century (Helleiner, 2003).

7 See Bessma Momani (2008), "Gulf Cooperation Council Oil Exporters and the Future of the Dollar," *New Political Economy* 13, no. 3: 293–314; R. Taggart Murphy (2006), "East Asia's Dollars," *New Left Review* 40: 39–64; Adam Posen (2008), "Why the Euro Will Not Rival the Dollar," *International Finance* 11, no. 1: 75–100; David Spiro (1999), *The Hidden Hand of American Hegemony*, Ithaca: Cornell University Press; and Miguel Otero-Iglesias and Federico Steinberg (2013), "Is the Dollar Becoming a Negotiated Currency? Evidence from the Emerging Markets," *New Political Economy* 18, no. 3: 309–336.

8 See Michael Dooley and Peter Garber (2005), "Is it 1958 or 1968? Three Notes on the Longevity of the Revised Bretton Woods System," *Brookings Papers on Economic Activity* 1: 147–187.

IS THE ISSUING OF A KEY CURRENCY AN EXORBITANT PRIVILEGE?

What explains whether leading states seek to promote a KC role of their currencies in these indirect and/or direct ways? To answer this question, it is useful to first establish the implications of a KC for the issuing country. It is commonly assumed that the issuing of a KC is a kind of “exorbitant privilege,” to use the famous phrase of Valéry Giscard d’Estaing, then French finance minister, in the 1960s. There is no question that the issuing of a KC does bring some benefits to the issuing country. But detailed analyses of KCs also highlight a number of costs. When the benefits and costs are weighed against each other, it becomes clear that the overall implications of a KC are much more ambiguous than the conventional wisdom suggests.⁹

The task of evaluating the implications of a KC for the issuing country is complicated by the fact that there is a remarkable lack of consistency in the description of the costs and benefits within existing literature.¹⁰ Eight sets of implications emerge from the existing literature.¹¹ To begin with, almost all writing on this topic mentions the seigniorage benefits that accrue to the issuing state. It is also commonly argued that the issuing of a KC will reduce exchange rate risks and other currency-

related transaction costs for the country’s citizens. While seigniorage revenue provides a clear benefit to the country, there may be some citizens who see the reduction of these transaction costs in a less positive light. Schenk (2010) notes, for example, how some British analysts complained during the postwar years that sterling’s international role encouraged an excessive export of capital that was detrimental to the country’s economy. In Japan, more recently, Saori Katada (2008: 409) has highlighted resistance to greater international use of the yen among Japanese firms that earned considerable profits from foreign exchange transactions.

Another oft-cited benefit of KC status is the earning of “denomination rents” from the higher foreign demand for the issuing country’s financial services, such as trade finance, foreign exchange business, bank loans and the buying and selling of securities.¹² Once again, however, the benefit of denomination rents should not be overstated. In the British experience, for example, London’s international orientation was often the subject of domestic criticism from those who questioned whether the business it earned from sterling’s international role led it to neglect domestic needs.¹³

A KC may also benefit the issuing country by enhancing what Cohen (2012) calls its “macroeconomic flexibility.” Not only can external

9 See also Cohen (2012).

10 In some instances, as Cohen (2012) notes, this reflects a focus on the implications of different specific international roles of a currency (for example, official reserve currency role vs. private international unit of account).

11 See also Eric Helleiner and Anton Malkin (2012), “Sectoral Interests and Global Money: Renminbi, Dollars and the Domestic Foundations of International Currency Policy,” *Open Economies Review* 23, no. 1: 33–55.

12 The phrase comes from Alexander Swodoba (1968), *The Euro-dollar Market: An Interpretation*, Essays in International Finance, no. 64, International Finance Section, Department of Economics, Princeton University. It is assumed that the issuing country’s financial markets and financial firms will be able to attract a disproportionate share of business in the KC because of factors such as their greater familiarity with the currency, the fact that these markets and firms can be supported by the monetary authority of the issuing country, and the unique breadth and depth of home-country financial markets in the currency.

13 See Strange (1971a).

deficits be financed with one's own currency, but the costs of adjustment to external deficits can also be more easily deflected onto foreigners.¹⁴ In addition, monetary authorities issuing a KC need not be so concerned about how exchange rate movements might affect domestic balance sheets, because very little of the country's public and private debt is denominated in foreign currencies.¹⁵ During international political and economic crises, countries issuing KCs may also benefit from a "flight to quality" by investors in ways that boost their macroeconomic room to manoeuvre.¹⁶ While macroeconomic flexibility can be enhanced in these various ways, it is by no means clear whether these implications are entirely beneficial to the issuing country. For example, in the wake of the subprime financial bubble, prominent US analysts have lamented how the dollar's international role allowed the United States to live recklessly beyond its means by providing cheap financing.¹⁷ Some domestic actors whose interests are aligned with low inflation may also see the lack of discipline in a negative light.¹⁸

Further complicating the cost-benefit analysis in this area is the fact that KC status may not only enhance macroeconomic flexibility but also undermine it.

14 See Benjamin Cohen (2006), "The Macrofoundations of Monetary Power," in *International Monetary Power*, edited by David Andrews, Ithaca: Cornell University Press; and C. Randall Henning (2006), "The Exchange Rate Weapon and Macroeconomic Conflict," in *International Monetary Power*, edited by David Andrews, Ithaca: Cornell University Press.

15 See Eichengreen (2011).

16 See Jonathan Kirshner (2009), "After the (Relative) Fall," in *The Future of the Dollar*, edited by Eric Helleiner and Jonathan Kirshner, page 13, Ithaca: Cornell University Press.

17 See Bergsten (2009).

18 See Cohen (2012).

Because sterling's KC role left it vulnerable to considerable speculative financial pressures, postwar British policy makers found their macroeconomic policy choices constrained by the need to maintain the confidence of private speculators as well as of foreign official holders of sterling.¹⁹ Monetary officials in postwar West Germany also worried about how the internationalization of their currency could complicate their efforts to contain inflation by making the demand for money less stable. Because of the dollar's KC role, US monetary authorities have also felt compelled to take the wider world's needs into consideration in setting monetary policy at moments such as the 1982 international debt crisis and the 1997-1998 East Asian financial crisis.²⁰ As far as back as the 1960s, US policy makers have also complained about the constraints on macroeconomic policy autonomy stemming from the link between the world's growing demand for reserves and US payments deficits.

Another commonly mentioned benefit of a KC is its contribution to the issuing country's international prestige and power. In addition to its role as a status symbol, a KC may provide the issuing country with concrete international power, even beyond that associated with some of the macroeconomic issues noted above. For example, the dependence of foreigners on dollar liquidity during international financial crises has given US monetary authorities an enormous influence at those moments. The US government has also used its ability to restrict the access of foreigners to all-important US-based dollar clearing networks as a highly effective tool of economic statecraft. At a more structural level, the dependence of foreigners on a KC may also

19 See Schenk (2010).

20 See Subramanian (2011).

encourage them to increasingly associate their interests with those of the issuing country.²¹

The significance of a KC for prestige and power is not universally accepted, however. Schenk (2010: 423) notes that sterling's international role during the 1950s "became a source of friction" among members of the Commonwealth, thereby "undermining British international prestige." Subramanian (2011: 39), too, notes reserve currency's power implications are in fact a "double-edged sword" because the issuing of a KC can "create vulnerabilities" to external actors who hold the country's currency. As far back as the 1960s, US analysts have complained about how the "accumulation of dollar holdings by others enhances their ability to apply pressure on the United States" (Aubrey, 1969: 8-9).

Many of the "benefits" of a KC are, thus, rather ambiguous in their impact on the issuing country. Interestingly, the same is true of some further "costs" that analysts often identify. One cost frequently mentioned is that greater demand for a KC may put upward pressure on the issuing country's exchange rate. While currency appreciation will undoubtedly be a cost for some domestic groups such as exporters, it may be a benefit to others such as importers, thereby rendering an assessment of its overall impact on the "national interest" very difficult. Moreover, the KC role of a currency will not always be associated with an overvalued currency. KCs can be subject to strong downward pressures when foreign confidence erodes, as the United Kingdom found at various moments in the postwar period and the United States discovered in the late 1970s. At these moments, policy makers may lament their currency's

KC status not because of its high value, but because of the risk of a rapid destabilizing depreciation.

A further cost identified by Subramanian (2011: 57) is the implication of a KC for the issuing country's domestic financial system. He highlights how a "costly" prerequisite for the PRC to internationalize the RMB will be the creation of a more market-based financial system, which will undermine the system of directed credit that has been central to the Chinese export-oriented, state-led development model. Postwar Japanese policy makers had a similar concern when considering whether to promote the yen's internationalization.²² More generally, Strange (1971b: 225) cautioned that top currency countries were more likely "to suffer financial scares and crises" because their "financial markets are larger and more developed than those of other countries." These arguments are important, but not everyone agrees that the creation of more open, deep and broad financial markets is a "cost." Indeed, some may see this kind of financial reform as a benefit of currency internationalization. For example, in an analysis of KC politics a decade ago, Lawrence Broz (1997: 84) classified the creation of a financial system capable of generating a top currency as a development that had "a positive complementary effect on the provision of financial stability — a public good."

One final cost identified by Subramanian (2011: 56) for issuers of a KC is that they may come to feel a "burden of responsibility" for maintaining a well-functioning international economy. As Cohen (2012: 20) puts it, "the issuer may find itself called upon to accommodate systemic needs or fragilities should conditions warrant. Monetary policy may have to be modified to contain a crisis, or subsidized loans may have to be provided to rescue some country in distress." Strange (1971a: 323; 1971b: 229) also

21 See Jonathan Kirshner (1995), *Currency and Coercion*, Princeton: Princeton University Press; Eric Helleiner (2006), "Below the State: Micro-Level Power," in *International Monetary Power*, edited by David Andrews, Ithaca: Cornell University Press; and Cohen (2012).

22 See Eichengreen (2011: 44-45).

argued that issuing states may experience a “Top Currency Syndrome” in which policy becomes increasingly preoccupied with stabilizing the international economic system at the expense of national interests. With Britain’s postwar experience in mind, Strange also highlighted how a negotiated currency may lead the issuing state to become entangled in commitments to foreign countries that support its currency, such as guarantees of market access, defence and financial assistance. These commitments may be not only financially costly, but also distort the country’s broader foreign policy goals.

Once again, however, these costs should not be overstated. It is not clear how strongly KC issuers feel a burden of responsibility. Some analysts argue that states issuing KCs may instead be more tempted to exploit their central position in the IMS to maximize national gains at the expense of system stability.²³ The entanglements created by negotiated currencies may also create some unexpected benefits for issuing states. For example, Schenk (2010) highlights how sterling’s embeddedness within many wider international political and economy relationships during the postwar years actually provided British policy makers with a key source of leverage for mobilizing international financial support for their country.

Summing up, when examined more closely, it becomes clear that many widely cited “benefits” and “costs” of a KC are rather ambiguous in their impact on the issuing country. The difficulties of assessing the significance of a KC for the “national interest”

²³ See David Calleo (1982), *The Imperious Economy*, Cambridge: Harvard University Press; and Jonathan Kirshner (2006), “Currency and Coercion in the Twenty-First Century,” in *International Monetary Power*, edited by David Andrews, Ithaca: Cornell University Press.

only mount further if one attempts to aggregate together the implications across the eight distinct issues mentioned above. As Cohen (2012) notes, the costs and benefits may also change over time, with the former being larger for a KC on the rise and the latter becoming more significant for a KC in decline. When all these complications are weighed together, it may well be that the issuing of a KC is still judged, at any given moment, to be an overall “privilege” for a specific country concerned. But it seems just as plausible that the implications of a KC might be seen in a more negative light. Subramanian (2011: 115), for example, suggests that a KC might well be a “poisoned chalice” because its actual costs can outweigh its widely publicized benefits. After highlighting the overall costs to the United States of the dollar’s international role, Michael Pettis (2011) has gone further to urge that the phrase “exorbitant privilege” be eliminated altogether from KC analyses.

WILL LEADING POWERS WANT TO HAVE A KC?

Given the ambiguities surrounding the overall costs and benefits of a KC, how do policy makers decide whether to support a KC or not? The political determinants of KC policy making in issuing states has received much less scholarly attention than other aspects of foreign economic policy making, such as trade or exchange rate policy making. But this subject is crucially important if we are to evaluate arguments about the future of the dollar’s dominant KC status. Those arguments rely on assumptions — not always explicit — about how policy makers in leading states will weigh the costs and benefits of issuing a KC. The assumption that KC status will be highly valued by national policy makers has been particularly prominent.

For example, many of the predictions of RMB internationalization assume that Chinese policy makers have a strong preference for a KC and will,

thus, support the necessary domestic financial reforms to make this happen. But does this assumption make sense? It is useful to consider historical analogies in trying to answer this question. When arguing that RMB internationalization needs to be taken seriously, Eichengreen (2011) reminds us of the domestic financial reforms that US policy makers undertook in the early twentieth century to promote the dollar's international role at a time when the United States was rapidly emerging as a major power in the world economy. As Broz (1997) has shown, these reforms were driven by an "international currency coalition" within US domestic politics that was comprised of leading New York financial firms seeking denomination rents and exporters hoping to reduce currency-related transaction costs. Could a similar domestic coalition of financial interests and exporters be emerging in the PRC to back the financial reforms needed to support the RMB's internationalization?

There are some reasons to be skeptical. As Eichengreen points out, the kinds of financial reforms needed for RMB internationalization will undermine the Chinese state's ability to channel cheap domestic savings to industry via Chinese banks as well as its capacity to support an undervalued currency via capital controls. In other words, RMB internationalization risks undermining "the very foundations of the Chinese development model" (Eichengreen, 2011: 146). For this reason, exporters are likely to be wary, as are many of the PRC's banks that are closely tied to the export sector.

This political context suggests the possible relevance of a different historical analogy. The views of Chinese exporters towards RMB internationalization may be more similar to those of their counterparts in Japan and West Germany during the 1960s and 1970s, who opposed the internationalization of their respective countries' currencies because they

feared it would generate currency appreciation and domestic financial reform, which would undermine the basis of their export competitiveness. Because of their close ties to domestic export industries, Japanese and West German banks often shared these concerns, prioritizing them over any motivation to expand denomination rents through currency internationalization.²⁴

Subramanian (2011: 115) acknowledges these domestic political constraints in the way of RMB internationalization, but he remains optimistic about the political prospects for financial reform to support RMB internationalization. Instead of drawing on a Broz-style domestic sectoral analysis, he argues that Chinese elite policy makers will be attracted to benefits such as the international prestige that comes with issuing a KC. Using his analogy of KC status as a "poisoned chalice," he argues that the PRC will "drink and sooner than most think." He also argues that the prioritization of the prestige benefits of KC status is likely to resonate with broader Chinese public opinion, helping state elites to override the opposition of exporters to RMB internationalization. He even suggests that the domestic popularity of RMB internationalization could allow currency reform to be used as a political tool by state elites seeking to transform the PRC's growth model away from the export-led mercantilist model. In his words, "'Renmibi rules' (and not the dollar) could be the slogan that [the People's Republic of] China's policymakers use as they navigate their fraught exit from mercantilism" (ibid.: 158).

24 See C. Randall Henning (1994), *Currencies and Politics in the United States, Germany, and Japan*, Washington: Institute for International Economics; William Grimes (2003), "Internationalization of the Yen and the New Politics of Monetary Insulation," in *Monetary Orders*, edited by Jonathan Kirshner, pages 176–180, Ithaca: Cornell University Press; Eichengreen 2011: 44–45, 67; Katada, 2008: 410; Helleiner and Malkin, 2012.

There is evidence to support Subramanian's argument that prestige concerns — both at the state and domestic popular level — are encouraging Chinese official backing for RMB internationalization.²⁵ This situation highlights how the PRC's position as a potential strategic rival to the United States creates somewhat different dynamics in its KC policy making than in the earlier Japanese and West German cases. While many Chinese welcome initiatives to reduce their dependence on the United States, the unwillingness of Japanese and West German officials to alienate their US ally only strengthened their reluctance to internationalize their currencies. The contrast shows how KC policy making can be influenced not only by the priorities of state officials and domestic sectoral groups, but also by a country's position within the global security order.²⁶

Still, it is not at all clear whether the quest for prestige will be enough to offset domestic sectoral opposition to RMB internationalization. Even Subramanian (*ibid.*: 158; emphasis added) hedges his bets: "The trumpeting of symbolic and nationalist gains *could* serve to drown out the protests of those who might suffer substantial losses." Leaving aside the question of domestic sectoral opposition, Chinese leaders concerned with their country's power in the world and domestic political stability have many reasons

to conclude that the maintenance of their successful development model is more important than the prestige earned through a KC. In other words, it seems just as plausible that Chinese policy makers may ultimately conclude that the costs of KC status outweigh the benefits rather than the other way around. At the very least, the fact that Chinese officials have, so far, steered much international RMB business to the enclave of Hong Kong rather than the mainland suggests they have concerns about the implications of full-scale currency internationalization.

What about the KC politics in other leading states? In predicting the emergence of a "leaderless currency system," Cohen suggests that challenges to the dollar could emanate not just from the PRC, but also Japan and Europe. He argues that national policy makers from these jurisdictions — as well as those from the United States — may be increasingly tempted to promote their respective currencies through not only indirect means but also more direct inducements, particularly in some regional "currency battlegrounds" where rivalries could become particularly intense such as the Middle East (the euro vs. the dollar) and East Asia (the RMB vs. the yen vs. the dollar) (Cohen, 2010: 165). Their motivation, he suggests, may be the various benefits that KC status provides, such as macroeconomic policy flexibility, seigniorage, and power and prestige.

At the same time, Cohen (2010) usefully highlights that policy makers in these various jurisdictions will not always fight for KC status. As he notes, the European Central Bank declared in 1999 that euro internationalization was not its policy objective (*ibid.*: 22). Although Cohen believes that assertion may have understated its initial actual ambitions, the crisis in the euro zone since 2008 has left European policy makers preoccupied with preserving the very existence of the euro rather than promoting its

25 See Greg Chin and Wang Yong (2010), "Debating the International Currency System: What's in a Speech?" *China Security* 16: 3–20.

26 See William Grimes (2009), *Currency and Contest in East Asia: The Great Power Politics of Financial Regionalism*, Ithaca: Cornell University Press; and Strange, 1971a: 18. In the period of US policy making that Broz analyzes, concerns about prestige and power also played a role in determining US policy making towards the dollar's international role. See Emily Rosenberg (1999), *Financial Missionaries to the World*, Cambridge: Harvard University Press; Helleiner, 2003.

international use. In explaining why the yen does not presently pose much of a challenge to the dollar, Cohen also notes that “even the most ardent of the currency’s supporters [in Japan] appear to have lost their enthusiasm for the struggle” (ibid.: 157). After the East Asian financial crisis of 1997–1998, the Japanese government had become more supportive of the yen’s internationalization than in the past. But the yen’s international use has continued to be held back by enduring regulatory barriers, problems in the Japanese financial system, resistance from some Japanese firms and foreign wariness of Japanese monetary leadership in the East Asian region.²⁷ The eagerness of Japanese authorities to give the yen a more prominent international role by addressing these various issues has not always been apparent.

What about the United States itself? The British postwar experience highlights that a declining currency leader will not always attempt to preserve its monetary dominance. Although it is often assumed that British officials fought tooth and nail to maintain sterling’s KC role throughout the 1950s and 1960s, Schenk shows that many key British Treasury officials and politicians were hostile to sterling’s KC status throughout this period because it imposed considerable costs on the country, such as the export of capital, constraints on national macroeconomic policy and burdens associated with maintaining support of foreign official reserve holders. These policy makers pursued a number of initiatives designed to shed the currency leadership role rather than maintain it, such as: the tightening of foreign exchange controls on the international commercial role of sterling; negotiations with foreign countries aimed at reducing official holdings abroad; and supporting the creation and strengthening of the SDR as an alternative reserve asset. The British case is particularly interesting because Schenk argues that

the objective of reducing sterling’s KC role stemmed from these policy makers’ rational assessments of the country’s interests rather than international or domestic political pressures.

Might US policy makers follow the British example of encouraging rather than defending the de-internationalization of their country’s currency? The question is worth asking because a number of prominent US analysts are now arguing that the dollar’s global dominance is no longer in the national interest of the United States, and they have urged the US government to explore ways of “downsizing” the dollar’s international role (Bergsten, 2009).²⁸ They have highlighted how the availability of cheap foreign finance encouraged the country to live beyond its means and helped to fuel the subprime financial bubble. They have also expressed concerns about how the dollar’s international role undermines US export competitiveness, contributes to the country’s payments deficits and increases the country’s vulnerability to overseas official dollar holders. Echoing Strange, some politicians, such as Ron Paul (2006), have also argued that the US government is increasingly defending the dollar’s international role through diplomatic and military means that are costly and entangle the United States in overseas commitments that distort the country’s foreign policy goals.

If the United States did seek to reduce the dollar’s global role, we would certainly be facing a kind of “leaderless currency system,” but one resulting from a widespread reluctance to lead among the major economic powers rather than from growing rivalries. In this scenario, Schenk’s analysis of the decline of sterling contains a second interesting lesson: a

²⁷ See Katada (2008); Grimes (2009).

²⁸ See also Kenneth Austin (2011), “Communist China’s Capitalism: The Highest Stage of Capital Imperialism,” *World Economics* 12, no. 1: 79–95; Pettis (2011).

US objective to downsize the international role of the dollar would not necessarily be easily realized. Despite British government preferences, sterling's decline as a KC was a long and cumbersome process that stretched well into the 1970s. Schenk argues sterling's longevity in these years reflected enduring foreign political support for the currency's international role rather than being a product of British intransigence or even market inertia. For many countries, the holding of sterling reserves was linked to benefits they sought to preserve, such as export relationships with the United Kingdom or British security ties. Countries holding large sterling reserves also worried that their efforts to diversify might trigger sterling's devaluation, thus undermining the value of their remaining reserves. In addition, support for sterling came from other industrial countries that supported bilateral and multilateral lending to Britain largely out of fear that sterling's weakness might undermine international monetary stability.

These kinds of motivations could also play a role in slowing the decline of the dollar's international standing. As noted above, many foreign governments are already holding large dollar reserves for some similar reasons. One further motivation that has driven the accumulation of dollar reserves over the past decade has been the demand for "self-insurance," a demand that shows few signs of diminishing in the wake of the global financial crisis. Fears of the risks to the global economy as a whole stemming from the dollar's weakness could also mobilize broader international support for the dollar. Indeed, that kind of support may be even more forthcoming if policy makers in the euro zone, the PRC and Japan continued to be reluctant to promote a significant internationalization of their currencies. In the absence of attractive alternatives, foreign governments might well conclude that the dollar's KC role — despite all its problems — served

important international functions that were worth supporting. As Herman Schwartz (2009) has argued, their willingness to provide this support may also be reinforced by powerful domestic lobbies with a stake in the existing dollar-based international economy.

It is not only foreign governments that may continue to support the dollar. Private economic actors may too. During the decline of sterling, private actors had an attractive alternative commercial currency to embrace: the dollar. In the contemporary context, given the euro's troubles and the issues identified above relating to the RMB and yen, the dollar may well remain the most appealing show in town for private economic actors for some time. As Eichengreen (2011: 7) puts it, "the dollar has its problems, but so do its rivals." When market actors fled to dollar investments during the global financial crisis, they were signalling their judgement that the former was less serious than the latter. This preference function of private actors could well endure for many years.

Does this mean we are facing a status quo future of the dollar's pre-eminence? Not necessarily. As Eichengreen notes, US policy makers themselves could undermine the dollar's dominant international role unilaterally through serious domestic economic and financial mismanagement. Alternatively, and more deliberately, the US government could actively restrict foreign purchasing of US financial assets, as some critics of the dollar's international role have suggested.²⁹ These scenarios could certainly come to pass, although the latter would likely meet strong resistance from domestic sectoral groups, just as US capital controls during the 1960s did.

In the wake of the 2008 financial crisis, a number of governments in emerging market countries — particularly in Latin America and East Asia — have

29 See Austin (2011).

also begun to promote greater use of local currencies in trade settlements. One of their key goals has been to reduce the vulnerability of local firms to the dollar's fluctuations and to the kinds of dollar liquidity shortages experienced at the height of the 2008 crisis. At their March 2012 summit, the BRICS countries also endorsed a cooperation agreement among their development banks to extend credit facilities to each other in their respective local currencies in order "to reduce the demand for fully convertible currencies for transactions among BRICS nations, and thereby help reduce the transaction costs of intra-BRICS trade" (BRICS Information Centre, 2012).

These initiatives may encourage some modest internationalization of local currencies. But their limited nature will do little to challenge the dollar's dominant KC role. Indeed, many of these same governments have been introducing capital account restrictions since 2009, highlighting that they value the protection of their domestic monetary and financial autonomy more highly than a significant internationalization of their own currencies. The set of preferences may well endure for some time. As an IMF staff discussion paper recently pointed out, currency internationalization in an emerging market context "involves a number of potential risks to monetary and financial stability; including complicating monetary management...and straining the financial system's ability to adequately absorb capital flows (due to increased volatility of capital flow and susceptibility to surges and sudden stops)" (Maziad et al., 2011).

In addition to a modest internationalization of some local currencies, the dollar's pre-eminence may be increasingly supplemented by some strengthening of the SDR's role in the IMS. Like many other analysts, Subramanian (2011) dismisses the prospects for a strengthened SDR, arguing that no major power will be willing to promote an alternative international

currency to their own: "It is like asking Coke to also tout the virtues of Pepsi in its ad campaign" (ibid.: 162–163). This argument rests once again on the assumption that national policy makers want to see their currencies take on a KC role. If, instead, those officials seek to avoid currency leadership, the politics look different. Indeed, the SDR was first created at a moment in 1969 when all the major economic powers — not only the United States and Britain, but also Japan and West Germany — were reluctant to see their currencies play a larger international role.

We may be entering this kind of moment again. In 2009, the G20 backed the first new SDR allocation in almost three decades, a move that boosted the SDR's share of the world's non-gold reserves overnight from 0.5 percent to roughly five percent. The BRICS and other countries have also highlighted their desire to see the SDR's role expanded further as a means of addressing some of the instabilities associated with the dollar-based IMS. In addition, Chinese authorities have called for the creation of an SDR-based substitution account — similar to that discussed at high level in the late 1970s — that could enable governments to exchange dollar reserves for SDRs.³⁰ Echoing these calls, US critics of the dollar's international role have also backed an expanded role for the SDR, arguing that this reform would enable foreign demand for reserves to be met in a manner that does not involve growing US payment deficits. These critics have also argued that an SDR-based substitution account could be a useful tool to reduce US vulnerability to the dollar overhang. Although some may be skeptical that US policy makers would back an enhancement of the SDR's role, it is worth recalling the precedent of not only the

30 See Xiaochuan Zhou (2009), "Reform the International Monetary System," March 24, People's Bank of China, Beijing; and Eric Helleiner (2010), "The New Politics of Global Reserve Reform," *Journal of Globalization and Development* 1, no. 2: 1–12.

British experience but also US official support — for similar reasons and with little domestic opposition — of the SDR’s creation in the 1960s, as well as its strengthening in the late 1970s.³¹

Few supporters of the SDR see it as serving anything more than just a supplementary role to the dollar over the short to medium term. Even to play this relatively small role more effectively, the SDR would need to be reformed in significant ways. But its attractiveness could be boosted through a number of cooperative initiatives described by Eichengreen and others.³² In the post-crisis world, this is one form of international cooperation that reluctant monetary leaders could well be willing to embrace. A leaderless currency system need not, thus, represent a return to the currency rivalries and international economic breakdown of the 1930s. It could, instead, create the political conditions enabling some advancement — however small it may be — towards the goal expressed by John Maynard Keynes during the Bretton Woods negotiations of building a significant supranational currency.³³

CONCLUSION

This paper has advanced three core arguments. To begin with, it has questioned the assumption that the rise and fall of KCs is simply a market-led process. Public policy choices have played, and will continue to play, a significant role — both direct and indirect — in determining KC status. In particular, the

choices of leading economic powers to encourage or discourage an international role for their respective currencies have been, and will continue to be, important in this respect.

Second, the preferences of leading economic powers in this area are difficult to predict in the abstract. Although KC status is often assumed to be an exorbitant privilege for the issuing country, its implications for the “national interest” are in fact much more ambiguous because it has complicated impacts across a wide range of areas. In addition, national authorities working on KC policy do not make policy in a political vacuum; domestic and international pressures may force them to prioritize some implications of KC status over others. For these reasons, it should not be assumed that national policy makers will seek, whenever possible, to maximize the international status of their country’s currency. Indeed, there are a number of important historical examples in which leading economic powers have made quite different choices. In some cases, such as Japan and West Germany in the 1960s and 1970s, policy makers refused to endorse the internationalization of their currencies. In other cases, such as postwar Britain, national officials worked actively to try to de-internationalize their currencies. In these cases, a KC has been judged by policy makers to be more of a burden than a privilege.

Third, there are some reasons to anticipate that, rather than fighting for currency leadership, today’s leading economic powers — the PRC, Japan, the euro zone and the United States — may be somewhat reluctant to support a KC role for their respective currencies in the coming years. With those preferences in place, the world would drift towards a “leaderless currency system,” one characterized less by growing rivalry than by a widespread reticence to lead. This scenario could well result in an enduring dominant KC role for the dollar for the reasons

31 See Joanne Gowa (1984), “Hegemons, IOs, and Markets: The Case of the Substitution Account,” *International Organization* 38, no. 4: 661–683; and John Odell (1982), *US International Monetary Policy: Markets, Power, and Ideas as Sources of Changes*, Princeton: Princeton University Press.

32 See Eichengreen (2011).

33 See Michael Bordo and Harold James (2011), “Reserves and Baskets,” *Open Economies Review* 23, no. 1: 113–127.

noted above. But in those conditions, the dollar's KC role may also be supplemented by a modest internationalization of some other currencies, as well as by some strengthening of the SDR's significance within the IMS.

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