Reluctant Monetary Leaders?

The New Politics of International Currencies

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Abstract

What is the future of the US dollar's role as the world's leading international currency (IC)? Public policy choices will play a decisive role in determining the future of international money, particularly 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 an IC are much more ambiguous than is often assumed, and because IC 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 quite reluctant — rather than enthusiastic — about supporting an international 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 dominant role for the dollar, supplemented by a modest 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 leading international currency. 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 China, have matched their words with actions designed to promote the internationalization of their country's currency, the renminbi (RMB). Is the US dollar's international dominance thus doomed to fade away, just as British pound sterling's did over the course of the twentieth century?

Some analysts, such as Arvind Subramanian in his book Eclipse, argue that the dollar's dominant role is destined to quickly be replaced by the RMB within the next decade or so.[1] Others, such as Barry Eichengreen and Benjamin Cohen, argue that the dollar's monopoly is more likely to give way to "a world of several international currencies," of which the dollar, the euro and the 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" characterized by competitive rivalries between the leading monetary powers.[2]

To adjudicate between these predictions, several core analytical issues must be addressed. The first is whether the rise and fall of ICs is best analyzed primarily as a market-led process, as many economists suggest. Subramanian's prediction rests primarily on this assumption. But this assumption is weakened by the fact that IC outcomes can be influenced both directly and indirectly by public policy choices. Indeed, public policy choices have often historically played a decisive role in determining the future of international money. Particularly important are the decisions of leading economic powers to support or curtail an international role for their country's currency.

If the decisions of leading states are significant, we need an understanding of how they are made. For this task, it is useful first to establish the full range of implications of an IC for the issuing country. There is a widespread assumption in existing literature — captured in the title of Eichengreen's recent book — that an IC is an "exorbitant privilege" that confers many

[1] Subramanian 2011.
[2] Quotes from Eichengreen (2011: 8) and Cohen (2010: 148)

benefits on the issuing country. But this assumption stems from too narrow a reading of the implications of issuing an IC. When we step back to look at the full range of implications, they relate to eight distinct issues: seigniorage, transaction costs, denomination rents, macroeconomic policy autonomy, 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 an IC are much more difficult to assess for the issuing country than is often acknowledged.

How then do national policy makers prioritize among the various implications in deciding whether to support or curtail an international 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 into question this assumption. National policy makers have in fact often been very reluctant to support an IC status for their currency because they — or 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 — China, Japan, the euro zone and the United States — during 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 growing competitive rivalries between the major powers. The consequence may be an outcome quite different than that predicted by many analysts today: an enduring international role for the dollar supplemented by a modest strengthening of the Special Drawing Rights (SDR) issued by the IMF.

Is the Rise and Fall of International Currencies a Market-led Process?

The international role of a currency can take many different forms.[3] 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 by foreign governments as a peg for their 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?

[3] Cohen 1971.

As Cohen notes, economists have identified three economic determinants of IC status.[4] 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, ICs 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, ICs are often supported by broad transactional networks stemming from the issuing country's prominent size in the world economy.

During its heyday as an IC during the nineteenth 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. But sterling's longevity as an IC well into the twentieth century has prompted Cohen and others to suggest how economic inertia is also a fourth factor that can sustain the international role of a currency. When a well-established transactional network already exists, the switching of currencies can be economically costly. Cohen argues that inertia may also be a product of conservative and risk adverse behaviour among economic actors when faced with uncertainties involved in choosing an alternative currency.[5]

Many economists assume that the rise and fall of ICs is largely a market-led process influenced by these various economic factors. They disagree, however, about the relative importance 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 three indicators of country size – GNP, 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". For this reason, he concludes that size – more than confidence and liquidity - is "the fundamental determinant of reserve currency status".[6]

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 China's global economic significance is growing rapidly vis-à-vis the US. According to his calculations, China's dominance of the world economy by 2030 will be similar to that of the UK in 1870 and the US after World

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[4] Cohen 2010.
[5] Cohen 2010.
[6] Quotes from Subramanian 2011: 7. Although Subramanain focuses 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" (p.53).

War Two. Already, he notes that China surpassed the US in 2010 in his index of economic dominance, suggesting that the dollar's share of reserve holdings is now "substantially greater than it ought to be".[7] To explain this anomaly, he incorporates economic inertia into his model, arguing that a close study of the interwar transition of currency leadership from the UK to the US suggests the need to allow for a lag of roughly 5-10 years.[8] 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 questions. For the purposes of this essay, its greatest limitation is that it does not allow any role for public policy to influence outcomes. If Subramanian's economic indicators explained historical trends very effectively, this neglect might be more justifiable. But a close examination of his statistical testing process reveals that his correlations are achieved only by removing data that highlight the role of public policy. Specifically, he excludes the interesting case of sterling's enduring international role after 1945 from the regression. As Subramanian notes, sterling remained a significant reserve currency after World World Two and he correctly identifies the reason for sterling's status in this period: British policy makers succeeded in attracting political support for their currency's international role from members of the sterling area. In Subramanian words, "these politically driven developments played a role in prolonging sterling's international use".[9] Rather than try to incorporate a role for politics into his model, however, he assumes the case away and justifies that decision 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".[10]

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 today? Subramanian seems to think not, arguing that public policies are much less important in determining IC 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".[11]

[7] Ibid, 66.
[8] He argues that the US eclipsed Britain in his economic dominance index near the end of World War One, while the dollar eclipsed sterling in international private use around the mid-1920s.
[9] Ibid, 108.
[10] Ibid, 64, 114
[11] Ibid, 111. He echoes this point elsewhere: "in some ways, one could argue that private-sector actions are indeed the deep determinants of reserve currency status" (p.54). In addition to the critiques developed below of this argument, 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.

But his own analysis elsewhere in the book belies this case. In discussing the prospects for the RMB internationalization, he argues that “many policy changes will need to occur before these [economic] fundamentals can prevail”. In particular, he acknowledges that his projection 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: “China will need to eliminate restrictions on foreigners access to the remnimbi for the entire range of financial and trade transactions, and deepen its financial markets so that investors gain confidence in their liquidity and depth”.[12] 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”.[13]

Subramanian himself thus seems not fully convinced by his model’s economic determinism. Indeed, as noted below, he develops some important analyses of politics of ICs elsewhere in his book. His comments about the importance of Chinese financial reforms and the rule of law also suggests 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 China’s growing size in the world might not be accompanied by an 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.[14] 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 had pursued this latter strategy, his projections for the RMB’s internationalization might have looked quite different.

While many economists assume that the rise and fall of ICs is largely a market-driven process, analysts working in a political economy have long highlighted the central role that public policy plays in shaping IC outcomes. As Cohen 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.”[15] In this literature, public policy is shown to influence IC outcomes in two ways: indirect and direct.[16]

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[12] Ibid, 9
[13] Ibid, 110.
[14] The choice to exclude liquidity is also explained on the grounds that Subramanian was unable find available historical data (p.64).
[15] Cohen 2010: 129.
[16] Helleiner 2008.

The indirect mechanism is that governments can encourage or discourage IC status via their impact on the three core economic determinants of IC standing emphasised 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 analysis of how 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 international standing of a currency in a much more direct manner that 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 Sterling and British Policy.[17] 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", she 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.[18] 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 equal scholarly scrutiny as 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 an IC - was an attempt to fill this gap in the literature.

Catherine Schenk's new study of sterling's decline as an IC during the post-1945 years reinforces Strange's overall analytical point in some fascinating ways.[19] She 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, particularly

[17] Strange 1971a.
[18] Strange also discussed "Neutral currencies" that were similar to Top Currencies except that they were issued by countries (e.g. Switzerland) that were not dominant powers.
[19] Schenk 2010.

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 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 BIS, 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.[20] 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 US.[21] During the past decade, some scholars have also explained the very large accumulation of dollar reserves by China as an implicit arrangement under which the US accepted Chinese financial support in return for offering market access for Chinese exports.[22] These various analyses suggest that dollar's future as an IC depends not just on factors such as confidence, liquidity and size but also on 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 international 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?"[23] A recent example of how rising powers can promote their currency's internationalization through diplomatic negotiation comes from China'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.

[20] Zimmerman 2002.
[21] Momani 2008, Murphy 2006, Posen 2008, Spiro 1999.
[22] Dooley and Garber 2005.
[23] Cohen 2010: 128.

Is the Issuing of an International Currency an Exorbitant Privilege?

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

The task of evaluating the implications of an IC 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.[24] Eight sets of implications emerge from the existing literature.[25] To begin with, almost all writing on this topic mentions the seigniorage benefits that accrue to the issuing state. In a narrow sense, the state issuing an IC earns an interest-free loan from the wider circulation of its physical notes and coins abroad. In a broader sense, foreign holdings of the issuing government's debt securities also lower the latter's borrowing costs.

It is also commonly argued that the issuing of an IC 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 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.[26] In Japan more recently, Saori Katada had highlighted resistance to greater international use of the yen among Japanese firms that earned considerable profits from foreign exchange transactions.[27]

Another oft-cited benefit of IC 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.[28] Once again, however,

[24] In some instances, this reflects a focus on the implications of different specific international roles of a currency (e.g. official reserve currency role vs. private international unit of account).
[25] See also Helleiner and Malkin 2012.
[26] Schenk 2010.
[27] Katada 2008: 409.
[28] The phrase comes from Swodoba 1968. 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 IC because of factors such as their greater

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.[29]

An IC may also benefit the issuing country by enhancing its national macroeconomic policy autonomy. Not only can external deficits be financed with one's own currency, but the costs of adjustment to external deficits can also be more easily deflected onto foreigners.[30] In addition, monetary authorities issuing an IC 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.[31] During international political and economic crises, countries issuing ICs may also benefit from a "flight to quality" by investors in ways that boost their macroeconomic room to manoeuvre.[32] While macroeconomic policy autonomy 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 analysis have lamented how the dollar's international role allowed the US to live recklessly beyond its means by provided cheap financing.[33]

Further complicating the cost-benefit analysis in this area is the fact that IC status may not just enhance macroeconomic policy autonomy but also undermine it. Because sterling's international 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 (Schenk 2010). 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 international 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 1997-98 East Asian financial crisis.[34] As far as back as the 1960s, US policy makers have also complained about the constraints on macroeconomic policy stemming from the link between the world's growing demand for reserves and US payments deficits.

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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.

[29] Strange 1971a.
[30] Cohen 2006, Henning 2006.
[31] Eichengreen 2011.
[32] Kirshner 2009: 213.
[33] Bergsten 2009.
[34] Subramanian 2011.

Another commonly mentioned benefit of an IC is its contribution to the issuing country's international prestige and power. In addition to its role as a status symbol, an IC 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 an IC may also encourage them to increasingly associate their interests with those of the issuing country.[35]

The significance of an IC for prestige and power is not universally accepted, however. Schenk notes that sterling's international role during the 1950s "became a source of friction" among members of the Commonwealth, thereby "undermining British international prestige".[36] Subramanain, too, notes reserve currency's power implications are in fact a "double-edged sword" because the issuing of IC can "create vulnerabilities" to external actors who hold the country's currency.[37] Indeed, 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".[38]

Many of the "benefits" of an IC 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 an IC 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 international role of a currency will not always be associated with an over-valued currency. ICs can be subject to strong downward pressures when foreign confidence erodes, as the UK found at various moments in the postwar period and the US discovered in the late 1970s. At these moments, policy makers may lament their currency's international status not because of its high value but because of the risk of a rapid destabilizing depreciation.

[35] Kirshner 1995, Helleiner 2006.
[36] Schenk 2010: 423.
[37] Subramanain 2011: 39.
[38] Aubrey 1969: 8-9.

A further cost identified by Subramanian is the implication of an IC for the issuing country's domestic financial system. He highlights how "costly prerequisite" for China 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 core to the Chinese export-oriented, state-led development model.[39] Postwar Japanese policy makers had a similar concern when considering whether to promote the yen's internationalization.[40] More generally, Strange 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".[41] These arguments are important, but not everyone agrees that 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. In an important analysis of IC politics a decade ago, Lawrence Broz, for example, classified the creation of 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".[42]

One final cost identified by Subramanian for issuers of an IC is that they may come to feel a "burden of responsibility" for maintaining a well-functioning international economy.[43] His argument is similar to Strange's case that issuing states experience a "Top Currency Syndrome" in which policy becomes increasingly preoccupied with stabilizing the international economic system at the expense of national interests.[44] 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 just financially costly but also distorting of the country's broader foreign policy goals.

Once again, however, these costs should not be overstated. It is not clear how strongly IC issuers feel a burden of responsibility. Some analysts argue that states issuing ICs may instead be more tempted exploit their central position in the international monetary system to maximize national gains at the expense of system stability.[45] The entanglements created by Negotiated currencies may also create some unexpected benefits for issuing states. For example, Schenk highlights how sterling's embeddedness within many wider international political and economy relationships during the postwar years actually provided British policy

[39] Subramanian 2011: 57.
[40] Eichengreen 2011: 44-5.
[41] Strange 1971b: 225.
[42] Broz 1997: 84.
[43] Subramanian 2011: 56.
[44] Strange's 1971a: 323; 1971b: 229.
[45] Calleo 1987, Kirshner 2006.

makers with a key source of leverage for mobilizing international financial support for their country.[46]

Summing up, when examined more closely, it becomes clear that many widely cited "benefits" and "costs" of an IC are rather ambiguous in their impact on the issuing country. The difficulties of assessing the significance of an IC for the "national interest" only mount further if one attempts to aggregate together the implications across the eight distinct issues mentioned above. When these factors are all weighed together, it may well be that the issuing of an IC is still judged to be an overall "privilege" for a specific country concerned. But it seems just as plausible that the implications of an IC might be seen in a more negative light. Subramanian, for example, suggests that an IC might well be a "poisoned chalice" because its actual costs can outweigh its widely publicized benefits.[47] After highlighting the overall costs to the US of the dollar's international role, Michael Pettis has gone further to urge that the phrase "exorbitant privilege" be eliminated altogether from IC analyses.[48]

Will Leading Powers Want to Have an International Currency?

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

For example, many of the predictions of RMB internationalization assume that Chinese policy makers have a strong preference for an IC 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 reminds us of the domestic financial reforms that US policy makers undertook in the early 20th century to promote the dollar's international role at a time when the US was rapidly emerging as a major power in the world economy. As Lawrence Broz has shown, these reforms were driven by an "international currency coalition" within US domestic politics that was composed of leading New York

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[46] Schenk 2010.
[47] Subramanian 2011: 115.
[48] Pettis 2011.

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 China to back the financial reforms needed to support the RMB's internationalization?

There are some reasons to be sceptical. 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".[49] For this reason, exporters are likely to be wary, as are China's banks, which 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.[50]

Subramanian 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 an IC. Using his analogy of IC status as a "poisoned chalice" he argues that Chinese policy makers will tempted to "drink and sooner than most think".[51] He also argues that the prioritization of the prestige benefits of IC status is likely to resonate with broader Chinese public opinion, helping state elites to override the opposition of exporters to RMB internationalization. Indeed, 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 China's growth model away from the export-led mercantilist model. In his words, "'Renmibi rules' (and not the dollar) could be the slogan that China's policy makers use as they navigate their fraught exit from mercantilism".[52]

[49] Eichengreen 2011: 146.
[50] Henning 1994, Grimes 2003: 176-80; Eichengreen 44-5, 67, Katada 2008: 410, Helleiner and Malkin 2012.
[51] Subramanian 2011: 115.
[52] Subramanian 2011: 158.

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.[53] This situation highlights how China's position as a potential strategic rival to the US creates somewhat different dynamics in its IC policymaking than the earlier Japanese and West German cases. While many Chinese welcome initiatives to reduce their dependence on the US, 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 IC policymaking can be influenced not just by the priorities of state officials and domestic sectoral groups but also by a country's position within the global security order.[54]

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 hedges his bets: "the trumpeting of symbolic and nationalist gains could serve to drown out the protests of those who might suffer substantial losses".[55] 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 an IC. In other words, it seems just as plausible that Chinese policy makers may ultimately conclude that the costs of IC status outweigh the benefits rather than the other way around. At the very least, the fact that Chinese officials have so far steered international RMB business to the enclave of Hong Kong rather than the mainland certainly suggests they have concerns about the implications of full-scale currency internationalization.

What about the IC politics in other leading states? In The Future of Global Currency, Cohen provides a useful overview. In predicting the emergence of a "leaderless currency system", Cohen anticipates challenges to the dollar emanating not just from China, but also Japan and especially Europe. He argues that national policy makers from these jurisdictions – as well as those from the US – may be increasingly tempted to promote their respective currencies through not just 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).[56] Their

[53] Chin and Wang 2010.
[54] See Grimes 2009, Strange 1971a, 18. In the period of US policymaking that Broz analyzes, concerns about prestige and power also played a role in determining US policymaking towards the dollar's international role (Rosenberg 1999).
[55] Subramanian 2011: 158. Emphasis added.
[56] Cohen 2010: 165.

motivation, he suggests, may be the various benefits that IC status provides such as macroeconomic policy flexibility, seigniorage, and power and prestige.

At the same time, Cohen also usefully highlights that policy makers in these various jurisdictions will not always fight for IC status. In explaining why the yen's does not presently pose much a challenge to the dollar, he notes that "even the most ardent of the currency's supporters [in Japan] appear to have lost their enthusiasm for the struggle."[57] Similarly, one reason that he is sceptical about the prospects for RMB internationalization in the near future is that Chinese officials have been unwilling to embrace much-needed dramatic financial reforms "for reasons as much political as economic."[58] In the European context, too, Cohen notes that ECB has declared that euro internationalization is not its policy objective. Although he believes that statement may have understated its initial actual ambitions[59], it seems that the crisis in the Eurozone since 2008 has left European policy makers preoccupied with preserving the very existence of the euro rather than promoting its international use. It appears, then, that policy makers in these different jurisdictions face various political circumstances that may inhibit initiatives to challenge the dollar's global role.

What about the United States itself? The British postwar experience highlights that a declining currency leader will not always attempt preserve their monetary dominance. Although it is often assumed that British officials fought tooth and nail to maintain sterling's international role throughout the 1950s and 1960s, Schenk shows that many key Treasury officials and politicians were hostile to sterling's international role 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 international 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

[57] Ibid, 157.
[58] Ibid, 159.
[59] Cohen 2010: 22.

number of US prominent analysts are now arguing that dollar's global dominance is no longer in the US national interest and they have urged the US government to explore ways of "downsizing" the dollar's international role.[60] 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 also have 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 have also argued that the US government is increasingly defending the dollar's international role through diplomatic and military means, which are costly and entangle the US in overseas commitments that distort US foreign policy goals.[61]

If the United States was to seek to reduce the dollar's global role, we would indeed be facing a kind of "leaderless currency system", but one resulting from a widespread reluctance to lead among the major economic powers rather than growing rivalries. In this scenario, Schenk's analysis of the decline of sterling contains a second interesting lesson: a US objective to downsize the international role of the dollar would not necessarily be easily realised. Despite British government preferences, sterling's decline as an IC was a long and cumbersome process that stretched well into the 1970s. Rather than being a product of British intransigence or even market inertia, Schenk argues sterling's longevity in these years reflected enduring foreign political support for the currency's international role. For many countries, the holding of sterling reserves was linked to benefits they sought to preserve such as export relationships with the UK or the preservation of 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 Eurozone, China and Japan were to continue to be

[60] Quote from Bergsten 2009. See also Austin 2009, Pettis 2011.
[61] Paul 2006.

reluctant to promote the internationalization of their currencies. In the absence of attractive alternatives, foreign governments might well conclude that the dollar's international role – despite all its problems – served important international functions that were worth supporting. As Herman Schwartz 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.[62]

It is not just 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 reluctance of authorities in China and Japan to encourage the internationalization of their currencies, the dollar may well remain the most appealing show in town for private economic actors for some time. As Eichengreen puts it, "the dollar has its problems, but so do its rivals".[63] 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 dollar's preeminence? 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.[64] 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. But there is a further scenario that deserves more attention than it has received: one in which the dollar's pre-eminence was increasingly supplemented by a modest strengthening of the SDR's role in the international monetary system.

Like many other analysts, Subramanian 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".[65] This argument rests once again on the assumption that national policy makers want to see their currencies take on an international 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

[62] Schwartz 2009.
[63] Eichengreen 2011: 7.
[64] Austin 2009.
[65] Subramanian 2011: 162-3.

major economic powers – not just the United Sates 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 almost three decades, a move that boosted the SDR's share of world's non-gold reserves overnight from 0.5 to 5%. China, Brazil and Russia also purchased $70 billion of SDR bonds from the IMF soon thereafter, and they and other countries have made public their desire to see the SDR's role expanded further as a means of addressing some of the instabilities associated with the dollar-based international monetary system. Chinese authorities have also called for the creation of a 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.[66]

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 through in a manner that does not involve growing US payments deficits. They have also noted that a SDR-based substitution account could be a useful tool to reduce US vulnerability to the dollar overhang. Although some may be sceptical that US policy makers would back an enhancement of the SDR's role, it is worth recalling the precedent of not just the 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.[67]

Few supporters of the SDR see it as serving anything more than just supplementary role to the dollar over the short-to-medium term future. Even to play this relatively small role more effectively, the SDR would need to be reformed in significant ways. Until there is a deep and liquid private market for SDR claims, its usefulness to governments and the private sector is limited. But its attractiveness could be boosted through a number of cooperative initiatives that Eichengreen has described.[68] In the post-crisis world, this is one form of international cooperation that reluctant monetary leaders could well be willing to embrace.

Conclusion

This paper has advanced three core arguments. To begin with, it has highlighted the limitations of analyses that assume the rise and fall of ICs to be largely just a market-led process. Public policy choices play a decisive role – both direct and indirect - in determining the content of international money. The choices of leading economic powers to encourage or discourage an

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[66] Zhou 2009, Helleiner 2010.
[67] Gowa 1984, Odell 1982.
[68] Eichengreen 2011.

international role for their respective currencies have been, and will continue to be, particularly important in this respect.

Second, the preferences of leading economic powers in this area are difficult to predict in the abstract. Although IC 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. National authorities working on IC policy also do not make policy in a political vacuum; domestic and international pressures may force them to prioritize some implications of IC 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, an IC has been judged by policy makers to be more a burden than a privilege.

Third, rather than fighting for currency leadership, today's leading economic powers – China, Japan, the Eurozone and the US - may be reluctant to support an international 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. That scenario could well result in an enduring dominant international role for the dollar for the reasons noted above. But in those conditions, policy makers in many countries – including the US – may also see reasons to supplement the dollar's role by the strengthening of the SDR's significance within the international monetary system. 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.[69]

[69] Bordo and James 2011.

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