

MARCH 2, 2011

Why the Dollar's Reign Is Near an End

For decades the dollar has served as the world's main reserve currency, but, argues Barry Eichengreen, it will soon have to share that role. Here's why—and what it will mean for international markets and companies.

By **BARRY EICHENGREEN**

The single most astonishing fact about foreign exchange is not the high volume of transactions, as incredible as that growth has been. Nor is it the volatility of currency rates, as wild as the markets are these days.

Instead, it's the extent to which the market remains dollar-centric.

Consider this: When a South Korean wine wholesaler wants to import Chilean cabernet, the Korean importer buys U.S. dollars, not pesos, with which to pay the Chilean exporter. Indeed, the dollar is virtually the exclusive vehicle for foreign-exchange transactions between Chile and Korea, despite the fact that less than 20% of the merchandise trade of both countries is with the U.S.

Chile and Korea are hardly an anomaly: Fully 85% of foreign-exchange transactions world-wide are trades of other currencies for dollars. What's more, what is true of foreign-exchange transactions is true of other international business. The Organization of Petroleum Exporting Countries sets the price of oil in dollars. The dollar is the currency of denomination of half of all international debt securities. More than 60% of the foreign reserves of central banks and governments are in dollars.

The greenback, in other words, is not just America's currency. It's the world's.

But as astonishing as that is, what may be even more astonishing is this: The dollar's reign is coming to an end.

I believe that over the next 10 years, we're going to see a profound shift toward a world in which several currencies compete for dominance.

The impact of such a shift will be equally profound, with implications for, among other things, the stability of exchange rates, the stability of financial markets, the ease with which the U.S. will be able to finance budget and current-account deficits, and whether the Fed can follow a policy of benign neglect toward the dollar.

The Three Pillars

How could this be? How could the dollar's longtime most-favored-currency status be in jeopardy?

To understand the dollar's future, it's important to understand the dollar's past—why the dollar became so dominant in the first place. Let me offer three reasons.

First, its allure reflects the singular depth of markets in dollar-denominated debt securities. The sheer scale of those markets allows dealers to offer low bid-ask spreads. The availability of derivative instruments with which to hedge dollar exchange-rate risk is unsurpassed. This makes the dollar the most convenient currency in which to do business for corporations, central banks and governments alike.

Second, there is the fact that the dollar is the world's safe haven. In crises, investors instinctively flock to it, as they did following the 2008 failure of Lehman Brothers. This tendency reflects the exceptional liquidity of markets in dollar instruments, liquidity being the most precious of all commodities in a crisis. It is a product of the fact that U.S. Treasury securities, the single most important asset bought and sold by international investors, have long had a reputation for stability.

Finally, the dollar benefits from a dearth of alternatives. Other countries that have long enjoyed a reputation for stability, such as Switzerland, or that have recently acquired one, like Australia, are too small for their currencies to account for more than a tiny fraction of international financial transactions.

What's Changing

But just because this has been true in the past doesn't guarantee that it will be true in the future. In fact, all three pillars supporting the dollar's international dominance are eroding.

First, changes in technology are undermining the dollar's monopoly. Not so long ago, there may have been room in the world for only one true international currency. Given the difficulty of comparing prices in different currencies, it made sense for exporters, importers and bond issuers all to quote their prices and invoice their transactions in dollars, if only to avoid confusing their customers.

Now, however, nearly everyone carries hand-held devices that can be used to compare prices in different currencies in real time. Just as we have learned that in a world of open networks there is room for more than one operating system for personal computers, there is room in the global economic and financial system for more than one international currency.

Second, the dollar is about to have real rivals in the international sphere for the first time in 50 years. There will soon be two viable alternatives, in the form of the euro and China's yuan.

Americans especially tend to discount the staying power of the euro, but it isn't going anywhere. Contrary to some predictions, European governments have not abandoned it. Nor will they. They will proceed with long-term deficit reduction, something about which they have shown more resolve than the U.S. And they will issue "e-bonds"—bonds backed by the full faith and credit of euro-area governments as a group—as a step in solving their crisis. This will lay the groundwork for the kind of integrated European bond market needed to create an alternative to U.S. Treasuries as a form in which to hold central-bank reserves.

China, meanwhile, is moving rapidly to internationalize the yuan, also known as the renminbi. The last year has seen a quadrupling of the share of bank deposits in Hong Kong denominated in yuan. Seventy thousand Chinese companies are now doing their cross-border settlements in yuan. Dozens of foreign companies have issued

yuan-denominated "dim sum" bonds in Hong Kong. In January the Bank of China began offering yuan-deposit accounts in New York insured by the Federal Deposit Insurance Corp.

Allowing Chinese companies to do cross-border settlements in yuan will free them from having to undertake costly foreign-exchange transactions. They will no longer have to bear the exchange-rate risk created by the fact that their revenues are in dollars but many of their costs are in yuan. Allowing Chinese banks, for their part, to do international transactions in yuan will allow them to grab a bigger slice of the global financial pie.

Admittedly, China has a long way to go in building liquid markets and making its financial instruments attractive to international investors. But doing so is central to Beijing's economic strategy. Chinese officials have set 2020 as the deadline for transforming Shanghai into a first-class international financial center. We Westerners have underestimated China before. We should not make the same mistake again.

Finally, there is the danger that the dollar's safe-haven status will be lost. Foreign investors—private and official alike—hold dollars not simply because they are liquid but because they are secure. The U.S. government has a history of honoring its obligations, and it has always had the fiscal capacity to do so.

But now, mainly as a result of the financial crisis, federal debt is approaching 75% of U.S. gross domestic product. Trillion-dollar deficits stretch as far as the eye can see. And as the burden of debt service grows heavier, questions will be asked about whether the U.S. intends to maintain the value of its debts or might resort to inflating them away. Foreign investors will be reluctant to put all their eggs in the dollar basket. At a minimum, the dollar will have to share its safe-haven status with other currencies.

A World More Complicated

How much difference will all this make—to markets, to companies, to households, to governments?

Money Leaders

Currencies' shares of global foreign-exchange transactions, 2010



Note: Because two currencies are involved in each transaction, currencies' shares total 200% instead of 100%. Figures are based on average daily turnover in April.

Source: Bank for International Settlements

One obvious change will be to the foreign-exchange markets. There will no longer be an automatic jump up in the value of the dollar, and corresponding decline in the value of other major currencies, when financial volatility surges. With the dollar, euro and yuan all trading in liquid markets and all seen as safe havens, there will be movement into all three of them in periods of financial distress. No one currency will rise as strongly as did the dollar following the failure of Lehman Bros. There will be no reason for the rates between them to move sharply, something that would potentially upend investors.

But the impact will extend well beyond the markets. Clearly, the change will make life more complicated for U.S. companies. Until now they have had the convenience of using the same currency—dollars—whether they are paying their workers, importing parts and components, or selling their products to foreign customers. They don't have to incur the cost of changing foreign-currency earnings into dollars. They don't have to purchase forward contracts and options to protect against financial losses due to changes in the exchange rate. This will all change in the brave new world that is coming. American companies will have to cope with some of the same exchange-rate risks and exposures as their foreign competitors.

Conversely, life will become easier for European and Chinese banks and companies, which will be able to do more of their international business in their own currencies. The same will be true of companies in other countries that do most of their business

with China or Europe. It will be a considerable convenience—and competitive advantage—for them to be able to do that business in yuan or euros rather than having to go through the dollar.

U.S. Impact

In this new monetary world, moreover, the U.S. government will not be able to finance its budget deficits so cheaply, since there will no longer be as big an appetite for U.S. Treasury securities on the part of foreign central banks.

Nor will the U.S. be able to run such large trade and current-account deficits, since financing them will become more expensive. Narrowing the current-account deficit will require exporting more, which will mean making U.S. goods more competitive on foreign markets. That in turn means that the dollar will have to fall on foreign-exchange markets—helping U.S. exporters and hurting those companies that export to the U.S.

My calculations suggest that the dollar will have to fall by roughly 20%. Because the prices of imported goods will rise in the U.S., living standards will be reduced by about 1.5% of GDP—\$225 billion in today's dollars. That is the equivalent to a half-year of normal economic growth. While this is not an economic disaster, Americans will definitely feel it in the wallet.

On the other hand, the next time the U.S. has a real-estate bubble, we won't have the Chinese helping us blow it.

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