EconoFact Chats: The Continuing Dominance of the Dollar

Megan Greene, Harvard Kennedy School

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Michael Klein:

I'm Michael Klein, executive editor of Econofact, a nonpartisan web-based publication of the Fletcher school at Tufts university. At Econofact we bring key facts and incisive analysis to the national debate on economic and social policies, publishing work from leading economists across the country. You can learn more about us and see our work at www.econfact.org.

Michael Klein:

The Mount Washington hotel is one of the last surviving grand hotels from the turn of the 20th century in the white mountains of New Hampshire. If you visit the hotel, you'll see a small room off the main lobby that is cordoned off. This is the gold room, where in 1944, the post-world war II monetary system was designed. The Mount Washington hotel is in Bretton Woods, New Hampshire, and the international monetary system that was created there takes its name from that town. The Bretton Woods system established the US dollar as a central world currency. In this system, the dollar was as good as gold until it wasn't, when the system broke down in the early 1970s. But nonetheless, the dollar retains a dominant role in world trade and finance. Lately, however, there have been predictions that the dollar will lose its hegemonic role as a world's reserve currency.

Michael Klein:

What advantages does the United States enjoy because of the role of the dollar? What could replace it? The Euro, Renminbi, Bitcoin? And how likely is it that these alternatives would take over the role of the dollar? To offer context and to answer these questions, I'm very pleased to welcome to Econofact Chats, Megan Greene. Megan is a Senior Fellow at the Mossavar-Rahmani Center for Business and Government at Harvard Kennedy School, and is also the first Dame DeAnne Julius Senior Fellow in International Economics at Chatham House in England. She writes a bi-weekly column for the Financial Times on global macroeconomic issues. Megan, thanks for joining me today on Econofact Chats.

Megan Greene:

Thanks for having me. I'm ashamed to say that I'm based in Boston, but I've never been to Bretton Woods, which I obviously must fix as soon as we're done with this podcast.

Michael Klein:

It's a really beautiful hotel. I really recommend going there. And when you go there, you have to stick your head into the gold room and look around. In fact, the gold room is gold colored, but the name also comes from the fact that both gold and the dollar served as a centerpiece of the Bretton Woods system when it was designed in 1944. Can you describe how that system worked?

Megan Greene:

Yeah, sure. After the interwar period, people look back to the gold standard, which lasted from around the 1870s to World War I, as a time when there was a lot of stability, international integration worked really well and that broke down totally during the interwar period. We had hyperinflation in Germany, in the 1920s, the great depression of the 1930s, followed by the rise of both fascism and communism. There was a real nostalgic desire to return to a more stable system like that which existed under the gold standard era. But this time around the dollar was also included to underpin the global financial system as well.

Michael Klein:

Megan, what were the advantages to the United States of having its dollar as a centerpiece of the international monetary system under the Bretton Woods system?

Megan Greene:

So the dollar was really the world's global reserve currency, as it is now. And I'd say the biggest advantage really was that the US central bank, the Federal Reserve could set its own monetary policy totally independently of what was going on in the world. Whereas a lot of other countries had fixed exchange rates to the dollar. So they had a peg and that meant whenever The Fed made a move, other central banks effectively had to mimic it in order to preserve this peg. And De Gaulle's finance minister Valéry Giscard D'estaing called this the US' exorbitant privilege because it had this independence in managing its own monetary policy for its own economy, and everybody else kind of had to play along. Also, the US could print a lot of money and other countries would hold it largely offering the US something for free because they would need the US dollar in order to manage their own exchange rates and also in order to transact.

Michael Klein:

So this sounds like a pretty good deal for the United States. Why did it break apart?

Megan Greene:

So it was a good deal, but it was a dual system, unlike what we have today. So other currencies were tied to the US dollar and the US dollar was tied to go old. President Kennedy closed the gold window in 1962 because there was a lot of pressure for the dollar to depreciate in value against gold. But the biggest factor that really brought down this system was the expansionary monetary policy in the US in the 1960s. The Fed was printing a lot of money to pay for big stimulus programs and also for the war in Vietnam, and other countries didn't want to mimic the fed in this way. And so ultimately that led to the breakdown of the Bretton Woods system and this whole system of fixed exchange rates to the dollar.

Michael Klein:

So as there is no longer a system of worldwide fixed exchange rates, technically the dollar is no longer a reserve currency. But the dollar still has a dominant role in the world, right?

Megan Greene:

It absolutely does. So it's no longer officially the reserve currency, but it really is still the global reserve currency. It's used for transactions in goods and services. It underpins the entire global financial system. Most of the world trade is actually transacted in dollars. We know that commodities are often invoiced in dollars, but it goes well beyond just commodities to other goods and services as well. So trade between countries like the UK and Germany is often done in US dollars. And then the dollar has a special role in financial transactions underpinning way more financial transactions than you would expect, given how much of the world's finance involves the US.

Michael Klein:

So we had talked about the advantages to the United States under the Bretton Woods system. Are there still advantages when the world's dominant currency is the dollar, even though it's not a reserve currency at the center of a system of fixed exchange rates?

Megan Greene:

There absolutely are. I would say that The Federal Reserve is the world's central bank, really. When The Fed hikes rates borrowing costs across the globe rise. And so the US central bank is still incredibly dominant in the global financial system. Most other countries don't peg to the dollar, but other countries still want to hold dollars in order to manage their own currency valuation at certain times. And so we've seen a great example of this with the sanctions imposed on Russia's central bank. Russia's central bank held a lot of dollars for years. They started to whittle down their US dollar foreign exchange holdings after the invasion of Crimea in 2014, but they still held a number. And now they've been effectively frozen, which means that about half of the Russian central bank's dollar holdings have been held abroad and have been seized, not just dollars, but euros, any other currency that one of the allies holds. So we've seen this weaponization of finance that is now a new tool that we can use, particularly the US given the dollars role in global finance.

Michael Klein:

And Russia wanted to hold dollars in order to help preserve the value of the ruble. And then when these dollar assets abroad were frozen, it was harder for them to affect the value of the ruble so what they did is they put in place capital controls in order to do that.

Megan Greene:

That's right. But the reality is that the dollar forms the largest percentage of every global central bank's foreign reserves. And so is a particularly strong tool in terms of sanctions and the weaponization of finance.

Michael Klein:

In the early part of this century, China held a lot of dollar reserves and many people thought that was an effort to keep the renminbi from rising in value too much to help support the export engine of China.

Megan Greene:

Yep. That's right. And you might say that China's looking at the sanctions that the US has imposed on Russia and feeling really uncomfortable about the US dollar assets that it holds. Not only in terms of its central banks foreign exchange holding, but also the US treasuries. And so the theory goes that maybe China might want to diversify. China and other countries. I just don't think there's really any alternative.

Michael Klein:

Even though the dollar is no longer as good as gold as it was during the Bretton Woods period, at least before President Kennedy shut the gold window, dollar assets like treasury bills and bonds still have a special role, don't they, Megan?

Megan Greene:

They absolutely do. They're one of the world's remaining safe assets. So whenever there's uncertainty or volatility, and there's a flight to safety, often that's into US treasury bills and longer term treasury bonds. So that's still considered a very safe and stable investment despite the political volatility we've had in the US over the past number of years. Even so there's still this flight to safety for dollar assets. And so it means that our government has a seemingly endless pool of funding, of borrowing that they can do because there's insatiable appetite for US paper.

Michael Klein:

And so the US treasury can offer a lower interest rate because these assets are so attractive, right?

Megan Greene:

Yeah, that's right. And so when people look at the US' debt burden and think, well, how are we going to manage this going forward? Certainly investors will worry one day, the US won't be good for it. The US has more room than any other country because of it its currency's status as the global reserve currency. So it can run up a much higher debt burden without worrying about debt sustainability than any other economy in the world.

Michael Klein:

So Megan, let's go to the question that I raised in the introduction. There's a view now that the dollars dominant role might be coming to an end and it could be replaced by another currency. What's your view of that possibility?

Megan Greene:

So we've seen that the dollar has had a smaller share in global foreign exchange reserves over the past couple of decades. It's share has decreased from roughly 71%, two decades ago to around 59% of global foreign exchange reserves now. So it's been on a downward slope, for a while. That's a long term trend. That being said it is so far ahead of any other currency, I don't think there's really any alternative. So the Euro for is in second place. It comprises about 20% of global reserve currencies. Many are worried about the renminbi, it still comprises less than 3% of global reserve currencies. And I should say that even though the dollar share has decreased, some of that has gone to the renminbi. So the renminbi share has increased to still low levels. The majority of that share though has gone into other small Western economies' currencies.

Megan Greene:

So for example, Canada or Korea are two examples. And the thing about those currencies is that they're all backed by US dollar swap lines. So effectively in an emergency they're as good as the dollar, which means they're not really an alternative. They're sort of more of the same. It's also, if we look at the sanctions today in Russia and consider that some countries might want to diversify away from US dollars, it's hard to imagine what they could diversify to, because the second place Euro, the Eurozone has backed up all of our sanctions. So has Canada, so has Japan. So, there's no obvious bolt hole for any economy that's looking to diversify away from US dollars.

Michael Klein:

There's a lot of talk about the renminbi, but as you mentioned, that's only a small amount. And moreover there are a lot of capital controls in China that is, money flowing in or out of the country. And I imagine that would also really prevent the renminbi from becoming a reserve currency.

Megan Greene:

Yeah, the renminbi doesn't have full convertibility. And so I just don't think it could possibly become a substitute for the US dollar. Also, if you're worried about having too much exposure to the dollar because the US imposes sanctions, well, for starters, China also imposes sanctions, just ask Lithuania, which has experienced that recently. And you don't know what president Xi will do. So if the concern is that the US has taken a really bold step in terms of geopolitics, well, president XI is equally capable of taking a bold step and also one that can't be easily forecasted or foreseen. So that's an issue as well. Also, there's just the network effect, right? So businesses want to do business in dollars because other businesses want to do business in dollars. And so it takes a lot to really unwind that kind of network effect. And the renminbi is just so far away from being there. I don't think it's a real alternative.

Michael Klein:

So what about cyber currencies, Bitcoins and such. There's a to talk about those possibly replacing the dollar. Do you see that as a possibility?

Megan Greene:

So cryptocurrencies right now are roughly 15% of foreign exchange reserves. You could argue the size of 15% of foreign exchange reserves today. Who knows what their value will be tomorrow. Cryptocurrencies have been unbelievably unstable as a store of value. They've appreciated significantly, they've depreciated significantly. And so I think just the lack of stability is a factor. Also, if you branch out from cryptocurrencies and look at stable coins, which are fundamentally backed by a fiat currency, the vast majority of stable coins are actually backed by US dollars. So in a way, stable coins could reinforce the US dollars status as the global reserve currency.

Michael Klein:

So the US has opened capital markets, even though inflation is high, it's relatively stable, the currency is stable. And then there are these self reinforcing network effects. So it seems like the dollar is pretty well ensconced as the world's dominant currency. Megan, we all know that forecasting is hard, as Yogi Berra said, predictions are difficult, especially about the future. Nevertheless, what do you see as the role of the dollar in the coming years?

Megan Greene:

Look, I don't think there's really any alternative to the dollar as a global reserve currency, but you can't ignore the fact that there has been this slow pivot away from US dollars as dollars have comprised a smaller share of global reserve currencies. And that will probably continue. There are two kind of main theories for alternatives that have come out of the ally sanctions against Russia for what it's worth. One is that China is going to go and buy up all of the Russian commodities on the cheap. And they'll deploy those along with Chinese commodities as a commodity backed renminbi. And that could be a new global reserve currency. We've talked about why that's unlikely mainly because the renminbi doesn't have full convertibility. So I think that's not likely to happen.

Megan Greene:

Another alternative is something that Keynes actually suggested back in Bretton Woods, which is that we should have a basket of currencies be the global reserve currency. And so there's also this idea that for example, SDRs at the IMF could become the new global reserve currency, which is a basket of currencies, including the dollar, the Euro, the yen and the renminbi. The thing about SDRs is you can't really use them to buy groceries or a tanker full of oil. It's really difficult to use SDRs and there's no market for them.

Megan Greene:

So one of the reasons the dollar has managed to be such an effective global reserve currency is that we also have the biggest, most liquid asset class in the world, the US treasury market. There is no market for SDRs. So this idea keeps coming up throughout history. It's coming up again now, I just don't see it happening. So my prediction for the next 50 years is that the US dollar will continue to be the global reserve currency. And that some countries might diversify a bit into some of these smaller currencies that are backed by US dollar swap lines. So we might look at some alternatives also creeping up, but I think the dollar will remain dominant.

Michael Klein:

So you think sort of paraphrasing Mark Twain that the talk of the dollar's demise is greatly exaggerated.

Megan Greene:

Yep. I think so. And it comes up roughly every five years or so. Every time there's volatility in the US, when the US was downgraded for example. When we had President Trump changing the US' role on the global stage. Now, when the US has weaponized finance, this issue comes up again and again, but I just think there is no good alternative. Every other currency is so far behind the dollar and that there are such strong network effects. The dollar has deep liquid capital markets it's fully convertible and no other currency really rivals the dollar in any of these senses.

Michael Klein:

So, because this comes up every five years, Megan, I'll talk to you on Econofact Chats five years from now and we can just more or less repeat the same conversation.

Megan Greene:

That sounds good. We can rule out the same arguments. I think they'll be just as true then as they are now.

Michael Klein:

Well, Megan, thanks very much for discussing this with me today. It's a very technical topic in a way, but it's also really important for the United States and other countries. So it's been very valuable to have an expert like you lay out the facts.

Megan Greene:

Yeah. Thanks for having me. It's always a pleasure, Michael.

Michael Klein:

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