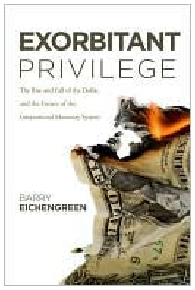
Exorbitant Privilege: The Rise and Fall of the Dollar and the Future of the International Monetary System

Public Affairs Program

Barry Eichengreen, **Joanne J. Myers**

January 13, 2011



Exorbitant Privilege: The Rise and Fall of the Dollar and the Future of the International Monetary System

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Introduction

JOANNE MYERS: I'm Joanne Myers, director of Public Affairs Programs, and on behalf of the Carnegie Council I would like to wish you all a very Happy New Year.

This morning we are delighted to begin the year by welcoming to our breakfast program a preeminent economist who is also one of the world's leading monetary historians, Barry Eichengreen. Professor Eichengreen is currently professor of economics and political science at Berkeley.

For half of the last century and beyond, the United States has garnered substantial political and economic benefits as a result of the dollar's *de facto* role as the world's currency. This position has created a great deal of envy, even inciting one French critic to declare that the international dependence on the dollar affords America an "exorbitant privilege."

Yet, in recent years the dollar's preponderant position in world markets has come under siege. With the recent financial crisis, sparked by the collapse of the U.S. mortgage market, financial bailouts, huge deficits, low economic growth, and low interest rates, many throughout the world are concerned that the dollar may no longer be able to play the role of the main reserve currency for much longer.

While it's true that the dollar has become more volatile than ever against foreign currencies—so much so that various nations have switched to no-dollar instruments in their transactions—you may conclude that confidence in the dollar as a global reserve currency is sinking and will soon be replaced by the euro or the Chinese renminbi.

But not so fast. In *Exorbitant Privilege* Professor Eichengreen counters this argument, challenging the presumption that there is room for only one truly preeminent global currency.

While there may be many factors which would support against the future of the dollar as a global reserve currency, our speaker posits that the dollar will lose its preeminent status in international currency if, and only if, the United States continues to repeat the mistakes that led to the financial crisis in the first place and fails to put its fiscal house in order.

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In other words, the fate of the dollar hinges not on the actions of the Chinese government or the European Union, but on economic policy decisions made right here in the United States.

While some may continue to believe that the dollar is doomed, others will regard its continuing dominance as inevitable. No matter what view you may hold, Professor Eichengreen admonishes that in the end what matters for now is that with exorbitant privilege comes exorbitant responsibility to prevent the international monetary and financial system from descending into chaos.

To give us his perspective on the future of our currency, please join me in welcoming our guest today, Barry Eichengreen.

Remarks

BARRY EICHENGREEN: Thank you, Joanne. You not only laid the foundation for the talk, but you summarized the book better than I probably can.

And thank you to the Carnegie Council. Books at breakfast is a very nice idea, although 5:15 AM California time is a bit ambitious for some of us.

My book is an attempt to use economic history and the dollar's past to try to draw some insights about the dollar's future.

Books go off to the publisher somewhat in advance of their appearance. When you write a book that reflects on the possible future of financial markets, you wonder what the state of the world will be at the point in time when the book appears. It was formally published last Friday. Thankfully, the dollar is still in the news, and not all that news is good.

Since the book went off to the publisher there has been the Fed's decision to engage in a second round of quantitative easing. This has led to complaints, mainly on the part of policymakers in emerging markets, that this was an overt attempt to debase or devalue the greenback. There is still the specter of trillion-dollar budget deficits extending into the future as far as the eye can see. There is the soaring price of gold, which, among other things, reflects less than full confidence in the prospects for the dollar.

But there is good news as well: other currencies have even more severe problems—the euro at the moment—and the dollar has the exorbitant privilege, the phrase coined by Charles de Gaulle's then-finance minister Valéry Giscard d'Estaing, that it's not only America's currency, but the world's.

It's the world's currency to quite a remarkable extent. The dollar, we learned last week from the Bank for International Settlements, which conducts a survey of foreign exchange trading every three years, is involved and currently used in 85 percent of foreign exchange transactions worldwide. It still accounts for 61 percent of the foreign currency reserves of central banks and governments worldwide.

Countries like South Korea and Thailand set the prices of 80 percent of their exports in dollars, despite the fact that only 20 percent of the goods they ship abroad actually go to the United States. When Somali pirates hijack a ship, they demand that the ransom money be parachuted to them in dollars. When Mr. Karzai's people get bags full of money, the money in question of course is in dollars.

The fact that the dollar is the world's currency is of considerable convenience to Americans. We can pay our taxi drivers in dollar bills in many cities around the world. It makes doing international business easier for American corporations.

But it's not entirely an unmixed blessing. Since foreigners want dollars to finance their international transactions, and they want dollars to hold as insurance against the possibility that something might go wrong in financial markets, they are willing to lend to us at low interest rates in order to acquire those dollars. If we in the United States are prone to excesses—for example, if we engage in frenzied real estate speculation—foreigners willingly give us more rope by purchasing not only U.S. Treasury securities but the securities of Freddie Mac and Fannie Mae.

After the financial crisis, we have learned the error of our ways. American households are spending less and saving more. That is a fact. The household savings rate has risen to 6 or 7 percent of household income. The fact that American households are spending less means that we have to export more of what we produce, and part of doing that will involve making our goods more competitive and more attractive to foreign purchasers.

We need a somewhat weaker dollar as part of this adjustment, but we find it difficult to impossible to obtain that weaker dollar because, given the dollar's singular role in the global system, other countries are accustomed to pegging their own currencies to the dollar. That frustrates America's effort to engineer a somewhat weaker dollar and get on with this adjustment. This is a flashpoint in relations between the United States and China, and it will come up next week when the Chinese president visits Mr. Obama. But the point is more general.

How did we get into this situation? The dollar achieved its position of dominance after World War II, when the United States was the only economy standing. The U.S. was the dominant industrial power and the world's largest exporter. We were the only country with deep and liquid financial markets open to foreign governments, foreign central banks, and private investors of other countries. It made perfect sense for people who wanted to hold foreign financial assets to hold dollars, and for other transactions in international markets to go through the U.S. dollar.

There was no intrinsic reason why Europe, Japan, and emerging markets should remain so far behind the United States. The subsequent half-century saw a process of convergence or catch-up where other parts of the world have begun to close the economic gap vis-à-vis the United States. We now live in a more multipolar economic world, but we still have a dollar-dominated international monetary and financial system.

If you want a very encapsulated description of how to understand the recent financial crisis and the continuing financial volatility we experience, it is that there is this imbalance or this tension between what is now a multipolar global economy, but still a disproportionately dollar-dominated global monetary and financial system.

Why is the monetary and financial system so dollar dominated? The traditional answer is the advantages of incumbency—the dollar is the incumbent global currency. Incumbency is an advantage for politicians seeking to hold on to office. It's an advantage for currencies seeking to hold on to their international status.

The argument goes that if everybody else is using dollars for their international transactions at a point in time, it will be convenient for them, and therefore convenient for you, to do the same thing. If you're a company exporting a particular commodity and your competitors price their goods in dollars, it will probably pay for you to do the same thing in order to make it easy for your customers to compare prices. That's what your customer base will be used to.

Economists have a name for this situation. They call it a market characterized by network externalities, where it pays to do the same thing everybody else in your network does.

That's the story of why the dollar is still the world's currency, and it has an implication that the dollar will remain the world's currency because of the advantages of incumbency.

This is wrong. It may have been a convincing story once upon a time, but it's no longer convincing. It may have been true that only sophisticated traders and investors could compare the prices of different goods or financial assets denominated in different currencies, but now everybody carries in his or her pocket a smartphone. Now a currency converter is one of the top ten downloaded apps at the Apple iStore.

Looking around the room, everybody can remember the day when you bought your first personal computer and you didn't have a choice of operating systems. You had to use the one everybody else used, unless you were a computer hobbyist. If you had an interest in exchanging data with coworkers, you had to use Microsoft's product. But now there is a proliferation of operating systems and switching is easier; what is true of computer operating systems is increasingly true of international finance.

We're moving to a world of multiple international and reserve currencies and away from the world in which there was only the dollar. We can get there in as soon as ten years. If we succeed in navigating that transition, the world will be a safer financial place. There will be a better balance between the multipolar real economy and what will then be a multipolar monetary and financial system.

Because alternatives will exist, the market discipline felt by countries like the United States that issue one of these reserve currencies will be stronger. If we do things that alarm international investors, they will have alternatives. That kind of market discipline, which we have learned from in recent experience, can come in handy.

What currencies am I talking about specifically? If you ask me what will the important international currencies be ten years from now, I would answer the dollar, the euro, and the Chinese renminbi.

People around the room will pause at this point and say, "One of those currencies is clearly not ready for prime time and it won't be still ten years from now."

The problem is that people at different tables will object to different ones of my three candidates. So let me say a few words about each of them.

Pessimism is greatest at the moment about the euro. It's not clear that the crisis countries in the euro area being forced now to impose draconian budget cuts can recover without reintroducing their own currencies, or so it is argued. Keeping them in the euro area would require massive fiscal transfers to the crisis countries from Germany, and German voters would rather abandon the euro and reintroduce the deutschmark than go for that, or so it is argued.

You will anticipate, given what I've already said, that this euro doom and gloom is overdone. Some historical processes are very hard to reverse, and the movement to create a currency union is one of them.

I'm not ruling out that there could be more serious financial problems in the euro area, and I personally attach quite a high likelihood to the possibility that Greece or Ireland or another euro-area country will have to restructure its government debt, and engage in what people offhandedly refer to as a debt default. But just like a default by Nassau County would not mean the end of the dollar, a Greek default would not mean the end of the euro.

I would argue quite strongly—I'll leave it for the questions and answers period—that for a country like Greece to at the same time reintroduce its own currency would only be making its problems worse, doing even more damage to its banking system and to investor confidence.

Germany is the one country that could, in principle, abandon the euro without precipitating a very grave financial crisis. But there are compelling political and economic reasons why it would never do that. Germany has too much invested in the European project.

This talk about a new generation of German leaders having a very different attitude about the European project is overdone. Germany's economic success in the last ten years can be summarized in one word: export. It would be very difficult to export with a deutschmark that would go through the roof against the rump euro. The German business community is still very pro-euro because they understand which side their bread is buttered.

The euro is here to stay. It is clear that Europe has a lot of work to do to complete its monetary union and put the crisis behind it. The crisis has now come to the point where European policymakers now understand exactly what needs to be done and they have to forge the political consensus to do it between now and their summit at the beginning of February.

Jean Monnet, the father of European integration, said that Europe is forged in crises. More recently, Jacques Delors, the father of the single market, said Europe has to rediscover its soul. The crisis will make Europe realize it has to go forward or it will go back, and, as it has at each similar juncture before, it will go forward.

One of the things it will have to do is issue limited amounts of bonds backed by the full faith and credit of the entire collection of euro-area countries. That will be a first step toward creating the deep and liquid treasury bond market in Europe that will ultimately be similar to the deep and liquid treasury bond market that we have in the United States.

Let me say a few words about the dollar, which may be what brought you out this morning.

The challenges facing the dollar, as Joanne said, are fundamentally fiscal. What alarms international investors is the prospects that we will let our sovereign government debt run out of control. When they look deeper, they are worried, just like many Americans are worried, about political polarization, dysfunctional politics, and the inability of the parties to work together to bring this problem under control.

Our federal government debt is approaching 75 percent of national income, for a federal government that only raises 19 percent of national income in taxes in a good year—the tax take goes down in recessions. Servicing the kind of debt load that we already have is a formidable task, or at least it will be when interest rates go back up to normal levels, as they eventually will.

Solving this problem will require the parties to acknowledge that there is no single solution to the budget deficit problem. It can't be fixed simply by cutting spending. There will have to be what we might euphemistically call revenue enhancement. There will have to be more taxes of one sort or another. There will have to be completion of the process of ending the health care cost curve because these expenses will make the budget deficit really explode going forward.

If foreigners don't see progress along these lines, they will conclude that the United States will end up having to resort to expedience. We will inflate away the real value of the debt. We will withhold payment of interest on government bonds or resort to some similar expedient rather than cutting essential public services. Foreigners can solve this problem forward, and they would try to get out of the way before the worst occurred.

That's the scenario in which there could be a dollar collapse, crash, or crisis, which would mean mass flight by international investors, public and private, away from the greenback, which would be costly obviously to the United States.

That's not my baseline scenario. The United States has faced and dealt with formidable challenges before. But this is something to worry about, and a scenario that serious people ought to ponder.

In the book I wrote something to the effect that the United States has maybe five years to get its fiscal and financial house in order. I must admit that I've grown more pessimistic since then.

Economic history tells us that financial crises occur around the time of elections. Lehman Brothers occurred right before a presidential election, when it wasn't entirely clear who held the reins of policy and who could move, and uncertainty about what would be next was pervasive.

I don't know that I've grown so worried now that I think that the end of 2012/beginning of 2013 is when it's possible that the worst scenario could occur, but serious people should think about this.

Finally, there is the third of my three candidates, China's yuan or renminbi. China has a lot of work to do in order to complete the process of internationalizing its currency. China understands that and it is working very hard. It is moving now very fast to complete that process.

Chinese policymakers understand that it would work to the advantage of Chinese firms if they could do business in their own currency and they didn't have to incur the expense of having to buy dollars when they wanted to export or import. Chinese banks would benefit from having a slice of international financial business, and they could do that more easily if their own currency was freely traded.

Yesterday the Chinese authorized the Bank of China to begin to provide foreign exchange trading services to Americans—to open up renminbi-denominated bank accounts in New York.

The share of bank accounts in Hong Kong that are not in Hong Kong dollars but in Chinese renminbi quadrupled in the last year.

China went in the last 12 months from a position where basically none of its companies did their import and export business in China's own currency to a point now where 70,000 Chinese companies are doing that.

There are now something on the order of 50 "dim sum bonds"—bonds denominated in China's own currency—issued by companies like McDonalds and Caterpillar and a variety of others.

Basically all of this business is still being done in Hong Kong, right over the border from China. But Hong Kong is their petri dish for cultivating these practices and testing them out. What is happening in Hong Kong now will be done in Shanghai five or ten years.

The Chinese have to do lots of things. They have to strengthen confidence in their financial system and strengthen rule of law. If they open their markets to financial inflows and outflows, they will need a more flexible exchange rate as a buffer or a cushion against capital flow volatility. They are serious about doing that.

They have set a deadline of 2020 as the date by which they will have transformed Shanghai into a true international financial center. A corollary of that would be greater international use of China's currency.

History also suggests that this kind of rapid transition is possible. The United States went from a position where the dollar was not used in international transactions at all in 1914, to a point where the dollar had overtaken the pound sterling as the leading currency for trade invoicing, for the issuance of international bonds, and as a form of central bank reserves, already in 1924.

Other things intervened between 1914 and 1924 to weaken the position of the dominant international currency, the pound sterling. People like Senator Nelson Aldrich from Rhode Island and Paul Warburg, the New York banker, were expressly interested in enhancing the international use of the dollar in order to advantage American corporations and banks. That was one of their motivations for supporting the establishment of a central bank. The Fed was founded in 1914. The Fed then set out to create a market in trade credits and other foreign investments in dollars.

It had succeeded in ten short years. I wouldn't disregard the possibility that the Chinese, who are intent on achieving the same by 2020, will succeed.

The dollar, the euro, the renminbi all face challenges, either to hold onto or to acquire international currency status. The fact that there are questions about all three suggests that none of them will necessarily be dominant and that there is room on the international stage for all three of them.

What will this mean for Americans and what will it mean for the international system?

There are some calculations in the book about the implications for American living standards and what American incomes would be if the dollar lost its exorbitant privilege entirely. It would cost us $225 billion or 3 percent of U.S. GNP, which is one year of normal economic growth. So it's not a catastrophe, but one would feel it.

We would feel it in the form of higher borrowing and funding costs for the government because foreigners would no longer be absorbing the majority of the treasury bills and bonds that we issue. If the government had to compete at higher interest rates for funding, others, such as corporations and home buyers, would face higher interest rates. The dollar would be somewhat weaker. You would see higher prices for flat-screen televisions at Best Buy.

Again, it's not a disaster from the point of U.S. living standards, but 3 percent of U.S. GNP is one year of economic growth. We've had a recent reminder of how much better people feel when the economy is growing than when it isn't. That kind of change would be felt.

On the other hand, moving toward a system where there are multiple international currencies would help us in terms of dealing with some of the sources of financial volatility that we've seen recently. There would be more discipline felt by the reserve currency-issuing countries.

Other people object that the kind of system I've described could be dangerously unstable. With the dollar, the euro, and the renminbi all being important reserve currencies, if central banks and governments perceive that the existence of problems with one of those countries could easily switch into the others, the problem currency would collapse, the others would go through the roof, and exchange rates would become dangerously volatile.

I don't believe it. Central bank reserve managers don't act the same way as hedge fund managers. They don't have the same high-powered incentives. They're not compensated on a 2+20 basis; they don't have to exceed the previous high-water mark in order to draw a paycheck. They have social responsibilities, and they know it.

I have by this point talked to a lot of them. They have patience. They're investors. Their principles are more patient than those of hedge fund managers. Central bank reserve managers have guaranteed funding. They find it easier to act as contrarians—when everybody else is panicking and selling a currency, they can step in and buy it and stabilize the otherwise unstable exchange rates. That seems to be what the data shows.

If you want a recent example, in the third quarter of last year the dollar was relatively weak, and central banks around the world bought more than $100 billion worth of dollar bonds that same quarter, acting in effect as stabilizing speculators and rebalancing their portfolios.

I am ending, if you will, on a high note. I'm not entirely a messenger of doom and gloom. If you buy my argument, then you should see our current difficulties as a reflection of the existing imbalance between our increasingly multipolar international economy and our still-dollar-dominated international monetary and financial system.

The good news is that this is a problem that should solve itself over a period of ten years if we can safely get from here to there. The bad news of course is that history teaches us that financial crises of one sort or another occur about every three years.

I'm happy to take some questions.

Questions and Answers

QUESTION: Don Simmons is my name. I enjoyed your talk, Professor Eichengreen.

For decades, New York state has sent more tax dollars to our national government than we have received in benefits. Mississippi has experienced the opposite flow. Every few years there's an article in the newspaper where this is all laid out for us to read. New Yorkers' reaction to that is nothing more than a shrug. We don't really resent Mississippians. We feel lucky that we have a higher income.

It seems to me that Germans would have to have that feeling about Greece, to pick those two countries, in order for them to be prepared to take on what is an indefinite responsibility of subsidizing the residents of that country. Would you agree with that, and do you think that would be likely to happen?

BARRY EICHENGREEN: I would agree that the extension of those kinds of transfers or subsidies indefinitely is implausible, partly because of that sense of identification as Europeans—we are all Americans, whether we live in Mississippi or New York. The same sense of identification at the European level doesn't exist.

It however increasingly does exist among the young as a result of airline deregulation and the fact that everybody is using Ryan Air and the like to go to secondary cities around Europe on weekends.

But I take your point. These transfers will not continue indefinitely. Greece is really getting tough love at the moment, and any transfers that will occur now will be predicated and conditioned on cleaning up the mess in such a way that there is a clear terminal date to the assistance.

You clearly read about the debate in Germany, and I'm sure you will have read that Mrs. Merkel and other German politicians have said in no uncertain terms that any assistance will be conditioned on real reform. That is true of the existing limited IMF-EU packages for Greece and Ireland. They are doing the kind of fiscal reform that we in the United States have not yet begun to talk about.

QUESTION: I'm Jim Robbins.

Last year in this room we heard Rogoff and Reinhart speak about *This Time Is Different*, which you might like to comment about. They speculated that the amount of debt that had accumulated both privately and in the public domain was irrevocably large and that the only solution for it was to be an inevitable crash of some kind. They claimed also to have studied economic history and they developed their theories of finding, particularly, data that supported their ideas about the frequency of crises.

Since you have just mentioned the same thing, I'd be interested to hear your reactions to their ideas.

BARRY EICHENGREEN: I'm an admirer of the Reinhart and Rogoff work. You are quite right to bring it up. The two books and the three minds are not entirely independent of one another. Their data set draws on earlier research that I did with a co-author on the incidence and frequency of banking and currency crises. My book, which is mainly words rather than tables—that may be one of the main contrasts with theirs—in turn is influenced by their ideas.

The notion that we will inevitably experience a fiscally driven crisis in the United States is too strong. It's entirely within our economic capacity to draw back from the brink. There's no reason why we have to deal with the debt that we have already incurred in a disorderly, opportunistic way. It's entirely within our economic capacity to do it. The problem, as with almost all financial crises, has a political dimension as well.

QUESTION: I'm John Hirsch. First of all, thank you very much for your remarks and your rather upbeat assessment of the prospects for the future.

I was struck by the phrase you used about the United States early on in your remarks. You said we have learned the errors of our ways, and you referred specifically to consumers saving more than previously.

But what about more broadly, Congress and the administration, Wall Street as it's called, the banking system? There are a lot of comments that suggest that people have not learned the errors of their ways, that there is still an inclination in Wall Street to go into unreasonable speculation, to risk, in other words, the economy of people here. Could you comment on that?

BARRY EICHENGREEN: When I am being sardonic I should raise my eyebrows more visibly. The recent financial crisis, as all financial crises, had multiple causes. One of them was the credit boom that led to both the real estate bubble and the fact that households stopped saving.

There has been a de-leveraging, a drawing down, of household debt and a rise in household savings that data and economic analysis suggest are permanent. Those are good things.

But there are plenty of other problems that we haven't solved and plenty of other errors that we haven't corrected.

Financial reform is at the top of that list. What we succeeded in doing in the form of the Frank-Dodd bill was better than nothing, but not a whole lot better than nothing, for a variety of reasons.

The fact that we still have a set of very large, highly leveraged banks that remain too big to fail continues to create all kinds of problems of skewed incentives in financial markets that can come back to haunt us again in ways that are not so similar to what happened last time.

The fact that there are still lots of derivative securities that are traded hand to hand, traded over the counter, rather than through clearing houses, means that the problems of counterparty risk are still there. If Bank A fails, it topples the whole set of dominoes.

I'm worried about all this. Problems in financial markets could be another precipitant for doubts about the dollar.

QUESTION: John Richardson.

My question touches on the point of view of economic history. When you look around the world, it seems to me that the tendency is for mature economies to just run lousy public finance and they're in debt. Japan is probably the worst example in the public debt level. France is terrible. The United States is catching up to France.

Is it possible that this can go on? Is this going to lead to where we just disappear in a whimper, or is it going to produce a right-wing reaction? Is there a historical precedent or some sort of guidance that you can suggest?

BARRY EICHENGREEN: Herbert Stein, who was one of Nixon's economic advisors, famously said that things that can't go on forever, generally do not. It can't go on forever in that sense. There has to be a relationship between the rate of growth of the debt and the rate of growth of the economy for the debt load not to just explode out of control.

The rate of growth of mature economies tends to slow down. That makes it important to bring those financial problems under control.

The United States has had the exorbitant privilege that foreigners would buy our debt and demand interest rates that were lower than what we could earn on our own foreign investments. That enables us to issue more debt than we would have had to otherwise. I'm suggesting that that privilege will, at least in part, now go away.

So I can answer that first part of your question. The second part, which is how will it play out if the government finds itself in a position where it can't both maintain interest payments on the debt and provide essential public services, which contract do you think our leaders will opt to honor and which one will they abrogate? I can't yet give you what the movie screenplay would look like, but there is a general class of dark scenarios there that could develop.

QUESTION: Richard Valcourt.

Going back to Mr. Simmons' question at the beginning, both the United States and Chinese currencies are based upon the individual performance of those countries, whereas the euro is a currency that is superimposed on various nations.

To what extent can the euro be stabilized short of the integration of those countries into a united Europe? There is nothing that essentially balances it, like we do with the individual states in this country, to make one nation.

BARRY EICHENGREEN: The euro is a currency without a state, the renminbi is a currency with too much state. So there are problems of both kinds.

I wouldn't embrace the language that the euro is imposed on a group of countries. It was voluntarily adopted by a group of countries that are still wedded to it.

There is real substance to your question about how can Europe complete its monetary union in the absence of a unitary or federal state. Europe has shiny coins, beautiful banknotes, and a more than adequate central bank, but it doesn't have the other elements of a functioning monetary union. For the project to succeed, Europe needs to move now to put those other elements in place. What are they?

Number one, the crisis in Europe and the problems of the euro are fundamentally a banking crisis. The fact that bank regulation is being done at the state level rather than at the euro-area level is part of the problem. So they need to fix that.

They need an honest broker to call things as it sees it in terms of which banks are weak or strong, and which need to be recapitalized or closed down. The European Commission or another independent agency at the level of the euro area needs to do the supervision and regulation of the banking and financial system. With the banks strong, they can get around to the debt restructuring that they need.

They need a proper emergency financing facility. Emergencies happen, as we learned in the United States in 2008, and Europe didn't have a proper mechanism for providing those temporary financial transfers that I was talking about before. There is now agreement to create a permanent European stability mechanism in 2013, but it isn't yet adequately in place. The bridge facility in place now is under-capitalized.

Those are the essential things that are all Europe needs to do to secure its monetary union, and it would be possible to do those things in relatively short order.

I don't think Europe needs to become a federation in order for the euro to work. But the kind of experiment on which Europe has embarked, a single currency for a set of sizable sovereign states, is unprecedented.

QUESTION: Robert Shaw.

You've said that if the dollar ceases to be the only international reserve currency, the competition among, say, three reserve currencies would impose more fiscal discipline on us. Do you think it would have any benefit in the area of major trading countries not using their currencies and exchange rates as a means of controlling trade flows? Or do you not see an advantage of having more than one main reserve currency?

BARRY EICHENGREEN: Problems are created by large, chronic surplus countries continuing to peg their currencies rather than allowing them to adjust. I do not think that moving to a multiple international currency world will automatically eliminate or solve that problem.

But insofar as what I'm really talking about here is China. If China is serious about internationalizing its currency and making it attractive as an international and reserve currency, and it therefore opens its financial markets as a necessary prerequisite for doing so, it will have to let its currency fluctuate more freely. So at least one manifestation of the problem you're describing will go away in the course of this transition.

Will the more general problem, that a bunch of countries around the world are reluctant to see their currencies rise against the dollar, go away? I don't think so.

QUESTION: I'm Jean Ergas. Thank you for an excellent presentation.

I have a very simple question. You talk about the end of the dominance of the dollar and what could happen in that event. What is the number? I mean at what point? How do we measure the end of the dominance of the dollar? You mentioned that 85 percent of world trade transactions are in dollars. A lot of that is going into crude oil. I have worked in energy for many years. What is the trigger point? When do we say the dollar is no longer dominant?

This can happen. Is it a question of the amount of trade flows denominated in dollars? Is it a question of a critical interest rate level in the ten-year treasury bond which brooks a crisis, like it has been rumored in Europe about certain yield levels? How do we actually get our hands around this?

I'm an economic advisor. I work with an asset manager. This is very important for me to have an idea of how this works.

BARRY EICHENGREEN: I wish I could make your life simple. [Laughter] The problem being that international currency status has multiple dimensions.

We will see over time the share of international reserves held in the form of dollars go down. We will see the share of trade that is exports and imports that are invoiced and settled in dollars go down. We are seeing the share of foreign bonds that are denominated in dollars go down. But some of these things can move more quickly than others.

China's currency is taking over from the dollar more quickly in the realm of trade invoicing and settlements than in these others. That comes first.

China is moving next, but more slowly, to encourage foreign central banks to hold some of their foreign reserves in its currency. The Central Bank of Malaysia has already moved in that direction and others will follow.

Private finance will be the caboose on the train.

There isn't a tipping point where one morning you should wake up and say, "Sell, sell," or at least the kind of economics and economic history that I do doesn't point to a particular day.

QUESTION: Susan Gitelson.

Thank you for your very clear exposition of very complex issues. I think that must explain why you've won so many distinguished teaching awards.

As an international business person, there's something about going away from the dollar that's very difficult. That is for most deals one has to quote a price at the beginning of the year and live with it for the whole year. It can be very confusing to have to have the exchange differences. How do you guarantee your margins?

But the major question is that you haven't had a chance to deal much with the internal Chinese economy. We are reading so much about it. How is China going to satisfy the consumers of its enormous population? And it's now concerned with inflation. So what kind of stability can the Chinese currency have?

BARRY EICHENGREEN: We could have a very long and rich conversation about the challenges facing China. They obviously need, and they understand that need, to rebalance their economy toward domestic consumption spending. They understand that as Chinese people begin to spend more on Chinese goods, the price of those Chinese goods will have to rise relative to the goods produced by other countries. That change in relative prices can occur in only three ways:

- Inflation in China. The Chinese understand that inflation can be socially corrosive because some people's incomes keep up with the rising prices and other people's don't.
- It could occur through deflation abroad, like in the United States. The Fed will do what it takes to avoid going there.
- Or it could occur through strengthening of China's currency relative to the dollar.

That's why I'm confident that we will see that as China's currency grows stronger, it will be in the common perceived interest of more people to open renminbi-denominated accounts at the Bank of China. It will be another step toward enhancing the appeal of China's currency globally.

There could be potholes on this road. There could be financial problems in China emanating from the property market lurking in the loans of the banks to Chinese construction companies or in other places. That could throw this process off-course. So nothing is guaranteed.

QUESTION: Thank you very much, Professor Eichengreen. I'm Karthik Sankaran.

One of the arguments against Chinese renminbi reserve status has been that it's not convertible on capital accounts. Now, historically, until 1971, capital accounts were not freely convertible. They kind of became gradually convertible.

Since then you've seen a massive increase in capital flows relative to trade flows and the capital account tail wag the current account dog in some sense, according to some arguments at least.

With IMF acceptance of capital controls for some countries, particularly emerging markets, do you think the process of capital account convertibility, free capital flows, just continues, or do we actually see a reversal in some sense where things become less convertible on the capital accounts and we go back to a more current-account-driven world?

BARRY EICHENGREEN: The growth of capital flows has created severe discomfort for a variety of countries. Most recently, with very low interest rates in the United States, it has become profitable for financial operators to borrow here and invest abroad where yields are potentially higher. That has driven up exchange rates, driven up stock markets, driven up property markets, in a variety of emerging markets.

They have responded in a variety of ways. They have let their currencies rise to make investments there more costly for us. Some of them have tightened fiscal policy a bit to prevent their economies from overheating. Most recently, the Brazilians have tightened up on the regulation of their banks. If all the aforementioned doesn't work and they still have the problem, they resort to taxes or controls on capital inflows.

Do I expect to see more of that? Yes, I do. Do I think that that will roll back the process of financial globalization that we have experienced in recent decades that you have described? No.

What the Brazilians have done is to put basically a 6 percent tax on foreigners who want to buy financial assets there, and they have limited the ability of the banks to access some sources of foreign currency funding. But if you still want to buy financial assets in Brazil, you still can. My guess is that will be true five years or ten years from now.

JOANNE MYERS: Thank you. It certainly was an exorbitant privilege to have you speak to us this morning. Thank you very much.
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