How the dollar might lose its status as the world's main reserve currency

Once a decade or so, economists ask whether the dollar's reign as the world's number one reserve currency might be at the start of a slow decline. These musings usually coincide with a fall in the dollar's value. In the past 30 years, the dollar has had four bouts of marked depreciation. During the most recent, which began in 2002, it has fallen by 28% against the euro and by 14% against a broad basket of currencies. Even so, 66% of the world's official foreign-exchange holdings are still in dollars, compared with 25% in euros, 4% in yen and 3% in pounds, according to figures published last week by the IMF.

And yet dollar sceptics note that this time the dollar's crown is, if not wobbly, at least skewed. America's current-account deficit, at 6% of GDP, is its highest on record; its net foreign liabilities, at 22% of GDP, are also close to an all-time high. Foreign central banks seem to have reduced their purchases of American Treasuries: official holdings of these rose by only $2 billion in the first seven months of 2005, against $295 billion in (the whole of) 2004 and $175 billion in 2003. If this trend continues, other currencies could one day challenge the dollar's dominance.

History offers perhaps only one true example of a reserve-currency shift, from the British pound to the dollar. The pound was king during the era of the gold standard. But in the years after 1914, Britain switched from net creditor to net debtor, and by the 1920s the dollar was the only currency convertible to gold (although the pound returned to gold in 1925). Two costly wars and two episodes of currency devaluation in Britain later, the dollar was unchallenged as the world's chief reserve currency.

The likeliest pretender to the dollar's crown is the euro. Reserve currencies need to have a home economy with a large share of global output, trade and finance. America's economy still dominates, but the euro area is not much smaller. The euro area's total trade with the rest of the world is about as big as America's; about half of this trade is invoiced in euros. The financial market of the reserve currency country must also be deep, open and well developed. America leads the euro area by most measures, but the creation of the single currency has helped to integrate Europe's financial markets.

Confidence in the value of the currency is also an important requirement, and this is where critics of the dollar have mostly taken aim. Barry Eichengreen, of the University of California at Berkeley, argues in a recent paper* that whether the dollar retains its reserve-currency role depends mostly on America's own policies. If America allows its large current-account deficit to persist and its net
foreign liabilities to rise, foreigners will become less willing to hold more dollars. The dollar would depreciate, creating inflationary pressure in America and making dollar reserves less attractive still—perhaps even if the Federal Reserve raised interest rates.

In another recent study†, Menzie Chinn, of the University of Wisconsin, and Jeffrey Frankel, of Harvard, estimate the importance of these factors in determining the shares of different currencies in the world's total reserves. They also take “network externalities” into account: the tendency of each monetary authority to favour the dominant currency because all others do. They use these estimates to predict whether the euro could overtake the dollar as the world's main reserve currency.

It could, but not soon. Suppose, say the authors, that the dollar loses 3.6% a year against a basket of other currencies, while the euro gains 4.6% a year—the same rates as in 2001-04. Then, they reckon, the euro could become the top currency by 2024. If in addition Britain, Sweden, Denmark and all the central and eastern European countries that joined the European Union last year adopted the euro, it would supersede the dollar by 2019.

Of course, it is impossible to forecast such a change with any precision. The dollar, after all, took decades to displace the British pound. And the euro zone has obvious economic weaknesses. Moreover, with the stability and growth pact in a shambles and the EU constitution rejected by France and the Netherlands, some even wonder whether the single currency will be around in 20 years, let alone compete with the dollar.

Sharing the crown

Another view, offered by Mr Eichengreen, is that the world might eventually have more than one main reserve currency. The dollar could share its status if other currencies become more attractive. The preference to stick with the dominant currency might secure the greenback's position for a long time. However, as financial markets in other countries become more liquid, this effect is weakened and other currencies become more trusted as a store of value. Reserve-currency competition will then cease to be a game in which the winner takes all.

This process, thinks Mr Eichengreen, favours the euro. He is doubtful about other candidates, notably the yuan. He argues that both Europe and America “have strong institutions, respect for property rights, and sound macroeconomic policies relative to the rest of the world.” In China, by contrast, capital controls, financial markets that are neither very liquid nor transparent, and uncertainty about property rights make the yuan an unlikely contender for decades to come.

Whether the dollar ever loses or is forced to share its pre-eminence among reserve currencies depends mostly on whether America continues to run the economic policies that will eventually undermine its position. But even if America changes course, the crown may slip a bit.


† ”Will the Euro Eventually Surpass the Dollar as Leading International Reserve Currency?” NBER Working Paper No. 11510: www.nber.org/papers/w11510