SPECIAL FX

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Déjà vu All over Again

The Economist Magazine ran a story and leader noting that the U.S. dollar's dominance is waning. There are numerous press articles about oil being denominated in something other than dollars and, more broadly, there is much discussion about the diversification of central bank reserves. That was in the first quarter of 1995.

From February 1994 when Treasury Secretary Lloyd Bentsen threatened Japan with dollar devaluation unless it made some trade concessions, until May 1995 and the first articulation of the "strong dollar policy", the U.S. dollar lost around a fifth of its value. Over the next several years, the beleaguered greenback appreciated by 50%.

The dollar's recovery was fueled by the cumulative impact of rate hikes by the Federal Reserve beginning in early 1994. By early 1995, the Fed funds target was twice the 3% level that prevailed at the start of 1994. There was repeated coordinated intervention. There was also a shift in U.S. rhetoric that remains in place today.

Some think that the strong dollar policy is vacuous. The dollar has declined and the Federal Reserve and the U.S. Treasury have not objected. Proof positive of benign neglect many say. This misses an important nuance that has not been lost on the likes of the head of the European Central Bank and other senior officials.

The strong dollar policy has nothing to say about the short-term price swings that capture the imagination of the media and many speculators. To appreciate the value of the strong dollar declaratory policy is to appreciate that previously Treasury Secretaries had used the threat of driving the dollar down to force recalcitrant trading partners to capitulate to U.S. demands. Bentsen was not the first, but he was the last. Some accounts attribute the equity market crash 22 years ago this month to, at least in part, then-Treasury Secretary James Baker threatening Germany with a weaker dollar if it did not do more to stimulate its economy.

The strong dollar policy signals the forswearing of using the currency as policy tool or weapon. This is important for the creditors of the world's largest debtor. The strong dollar policy does not prevent the dollar from falling as a consequence of the pursuit of other policies, such as a broadly accommodative monetary policy to help reflate the economy.

Triffin Dilemma Revisited

Robert Triffin, a Belgian-American economist predicted the demise of Bretton Woods in 1960 and the dilemma he identified continues to haunt the dollar, so much so that the governor of the People's Bank of China explicitly cited it in his now famous speech earlier this year, when he called for reform of the international monetary regime and in particular the eventual replacement of the dollar as a reserve currency.

The dilemma for the country whose national currency is also the main reserve asset resides in conflicting impulses. On one hand, if it does not provide a sufficient quantity of the reserve asset, its currency would appreciate markedly. In the early years of Bretton Woods, European officials feared they would not have access to a sufficient amount of dollars.

Now it is the other horn of the dilemma that is problematic. Through its current account deficit and capital exports, the U.S. has provided the world with enough dollars to allow the vast accumulation of reserves. Due to the increase of trade and capital flows, countries have required large supplies of the reserve asset. The provision of it by the US in the form of dollars has, in turn, undermined confidence in it (from time to time)..

Moving from the dollar to the euro, for example, as many observers once believed was likely, does not overcome the Triffin Dilemma. It is noteworthy that in the chatter about international monetary reform, and abandoning the dollar, the euro was not embraced as the key alternative. This seems to sit well with European policy makers. Most recently at ECB President Trichet's press conference on 8 October, Trichet clearly stated that the central bank has no plan or strategy to increase the international use of the euro.

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Many people believe that the uni-polar world of the immediate post-Cold War period is evolving into a multi-polar world. Perhaps, then several currencies can provide the reserve asset. While that might minimize the Triffin dilemma in the short-run (but regardless of what it is denominated in oil exporters will still be accumulating a surplus, for example, and other global imbalances would persist), it will pose other problems that might just be less preferable.

Some economists have argued that a multicurrency system would be less stable than an international monetary regime dominated by a single currency. It harkens back to hegemonic stability theory, which essentially holds that international order is best preserved when there is a single country (hegemon) that has the capability and will to set and enforce the rules of the engagement (trade, finance, etc) for the other major countries.

Of course, not everyone subscribes hegemonic stability theory. Like all theories it has its critics, but there is a practical case that can be made too. A single numeraire for the world economy minimizes transaction costs through economies of scale. Imagine the complexity and costs if there were numerous currencies benchmarks. As the cross border movement of goods, services and capital have increased, minimizing transaction costs becomes increasingly important.

Perhaps not immediately after WWII, but after the collapse of Bretton Woods, surely there was an opportunity to develop a multicurrency regime, if countries, producers and investors truly wanted one. Even the advent of the euro could have formed the basis of at least a dual currency regime. The euro is almost eleven years old and it is roughly the size of its main constituent parts, the ECU, the Deutschemark and French franc.

Privilege

Charles De Gaulle first called the power the US enjoyed by providing the numeraire *an exorbitant privilege*. Yet it may not be as great as the French nationalist thought. In 1994, then Federal Reserve Governor Lawrence Lindsay estimated that the cumulative additional seignorage accruing to the Federal Reserve due to the increased public holding of dollars was about $64 bln. Other calculations estimate the seignorage emanating for foreign holdings of dollars at around $12 bln a year. This figure is derived from taking the fraction of currency outstanding that is in foreign hands and multiplying by the T-bill interest rate. Given the low rate on U.S. T-bills presently, this type of seignorage is rather minor at the moment.

There is another type of seignorage that is more difficult to measure. The dollar's extensive use as a reserve currency allows the U.S. Treasury to pay a lower interest rate on its liabilities than other borrowers. This difference is another, albeit likely smaller source of seignorage.

The U.S. has encouraged other countries to develop their own capital markets and internationalize their currencies. Harvard Professor Jeffrey Frankel has recounted a story about how in 1984 then Treasury Secretary Donald Regan berated the major Japanese business association for paying for imports in dollars rather than yen. The U.S. persistently lobbied for deeper and more accessible Japanese capital markets.

More recently the U.S. has pressed China along similar lines to open and further develop its capital markets. It is true that this may reduce the Chinese appetite for U.S. Treasuries. However, it may be offset by a more balanced international economy that would generate smaller deficits in the U.S. and smaller surpluses in China; implying less need for foreign investors to buy Treasuries in the first place.

The dollar is not being foisted on the world. Its role is a function of various considerations like patterns of output and trade, financial markets, political and military leadership, and yes, inertia and crowd behavior. There is of course also an important role for confidence of foreign investors. No doubt the crisis has shaken that confidence, but there is a feedback loop and the dollar's decline itself in turn undermines confidence. An economic recovery sufficiently strong to prompt the Fed to normalize monetary policy may see that the confidence has not been irretrievably lost, as some fear.

Recent discussions about reform of the international monetary regime seem a great deal like attempts to drop English and develop another *lingua franca*. Esperanto anyone?

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