Can the US dollar be supplanted as the world’s currency?

Contrary to some expert predictions, the US dollar continues to serve the world as the ‘de facto’ international currency and safe asset in times of crisis. ***Gordon Alexander Schlicht*** *writes that the dollar is irreplaceable due to its incumbency, stability, liquidity, and absence of present alternatives.*

While academic discourse has long prophesied a future of currency multipolarity, 2022 has shown us that the idea remains just that: academic. Amid global recession fears and a Federal Reserve resurfacing with long-lost resolve to hike interest rates, the greenback is on a run. The US dollar is up 14 per cent against the euro, 18 per cent against the pound sterling, and a whopping 24 per cent against the yen this year. If you ask the foreign exchange market, this paints a crisp picture. There is a sole and uninterrupted monetary hegemon: the United States. But why is this role unthreatened?

In short, the dollar prevails as a unit of measure, medium of exchange, and store of value vis-à-vis global market participants. Critically, it maintains this asymmetric position on account of four discrete variables: incumbency, stability, liquidity, and a lack of alternatives.

We first encounter the notion of “monetary hegemony” in Michael Hudson’s “Super Imperialism” (1972: 9–60) as one state’s asymmetric relationship with respect to the global economy and its institutions. Adding Cohen’s layer of “acknowledged responsibilities and privileges” (1976: 37–50) – and Germain and Schwartz’s understanding of an “international currency” as one used beyond its political borders (2017: 765–787) – it is clear that the dollar fulfilled this role officially during the Bretton Woods era beginning in 1944. Despite the removal of fixed pegs in 1973 — the “Nixon Shock” — the dollar proved to be sticky. It maintained its incumbency through the Volcker years, as measured by its usage as the IMF’s reserve currency and the *de facto* currency of trade.

The U.S. has extended Barry Eichengreen's (2004) notion of "exorbitant privilege," built on its post-war domination, into a new form of Bretton Woods, wherein growth-targeting economies rely on it to drive currency stability and account surplus. Closing fiscal year 2021, approximately 60 per cent of global reserves and 45 per cent of international transfer of funds comprised dollar-denominated assets (Kofinas and Eichengreen, 2018). This market share originates from a point of incumbency inherited from the Bretton Woods era, and remained largely stable through major shocks, such as the Cold War, 9/11, financial crises, and the COVID pandemic. The dollar has proven itself as the ultimate backstop of the global financial system through a rollercoaster of global political events.

The dollar's reserve stability largely mirrors the United States' political-economic state. A key component of its appeal as a currency hegemon lies in its democratic privilege. Federally embedded checks and balances do not allow for the state to unilaterally change the rules of the game. An investor-trader will only view a currency as a reliable store of value if she can maintain relative certainty that fiat paper will buy a nearly equivalent (cost-of-capital, time-discounted) basket of goods and services tomorrow, in a year, or a decade. Politically, the US also has a track record of periodic domestic legislation that fuels high consumption consumer growth, from the New Deal to the Great Society, and recently, unprecedented fiscal stimulus in reaction to the pandemic. It further benefits from the so-called "financial reform nexus," (Seabrooke, 2018), the idea that US policymakers may adjust domestic cost and purchasing power parity on an ongoing basis, in contrast to the restrictions of China's long-term economic planning cycle, for instance.

The American government has reliably generated demand without eliminating any legislative choke points purposefully built into its governance. Meanwhile, its fiscal and monetary authorities have proved credible and independent. Finally, its sovereign debt issuances face virtually no threat of insolvency – as it is not pledged against another asset or financial instrument (Wray, 1998). In conclusion, the dollar embodies a symbiosis between currency, economy, and democracy… or put in academic terms, by Martijn and Panitch (2009), a "mutually constitutive relationship between the state and financial markets". Facing the renminbi and cryptocurrencies as challengers, stability is a striking differentiator in favour of dollar hegemony. Market participants may view the Chinese Politburo's ability to make consolidated and swift changes as unpredictable.

Stability and the *perception* of stability are a self-reinforcing cycle, which Norloff has termed the “third face of power” (2014: 1063). Here, the dollar’s dominance transcends from the empirical to the ideational. Owners of the greenback live in a monetary panopticon, with unrestricted transparency and accessibility.

Explicitly, this accessibility comes in the form of ultra-liquid capital markets. Due to its financial openness paired with its status as the market and lender of last resort, the US maintains asymmetric monetary capability. Its central bank can provide unrivalled capacity for dollar-funding to global markets – where the greatest liquidity crunch in recent history, at the peak of COVID-19-induced uncertainty – serves as evidence. During March 2020, the Federal Reserve extended ca. $440 billion in dollar-denominated swaps abroad, at a maximum spread of 50 bps (FRED Dataset). In doing so, it practiced its role as a lender of last resort and effectively capped dollar costs to foreign counterparties. The scramble for dollars is a symptom of crisis, echoing a “flight to quality” in 2007 and 2011.

Perhaps more interestingly, this phenomenon also serves to highlight the dollar’s dual monetary role; while the Federal Reserve’s mandate is theoretically domestic, its self-assumed obligation to fund dollars abroad has far wider implications. US financial institutions are *de facto* married to the international order that relies on them. However, the US also has no incentive to promote the official use of the dollar when it is already the crowd’s favourite medium of exchange. Absent formal dollarisation, dollar-denominated bond issuances dominate the public and private markets. The euro, which may succeed in stability, falls short here; it accounted for only 17 per cent of global AAA-rated debt financing (Kofinas and Eichengreen, 2018), on average. Accessibility to the renminbi is equally problematic, given stringent capital controls on RMB-denominated bonds. How useful is a transactional token if one cannot transact with it?

Finally, we can grapple with the alternatives to the dollar. Will peripheral fiat alternatives, central bank digital currencies (CBDCs), or cryptocurrencies be viable challengers? I believe hegemony persists with the dollar’s incumbency, stability, and liquidity, precisely because the alternatives fall short in each of the discussed categories.

Starting with China’s renminbi, I argue that several factors impede its potential. First, China is currently unable to challenge the dollar precisely because it accepts and, implicitly, endorses its incumbency. Its export-driven central plan contributed spectacular economic growth over the past decades, but it lives intrinsically within the confines of US hegemony. To preserve artificially low forex valuation and fuel exports, the Chinese government accumulates immense dollar reserves. Forsaking this “Bretton Woods II” mechanism means China must first explicitly reject the monopolar orthodoxy and then, find a path to ascribe value to the renminbi as an asset that is not a financial derivative of the dollar. One such strategy is to internationalise the renminbi as a tool to access an economic ecosystem built around it.

The Chinese government has undertaken such an internationalisation project beginning in 2015, with increasing account openness: The PBOC gradually lifted some capital controls, established swap lines with the BoE and other central banks (permitting interbank settlement in RMB), and diversified its investor population. Moreover, it has demonstrated its long-term commitment to digitising the yuan. Ostensibly, the e-yuan could enable a self-serving ecosystem to thrive, with China’s monetary authorities acting as gatekeepers to an economy built on Alibaba, TenCent, and an array of digital services necessary to existence in the modern world. To overcome the dollars’ transactional dominance, it must build a separate use case for global consumption. Conversely, no matter how successfully the e-yuan is implemented, it carries the same major deficit as its paper forbearer: mistrust. Market participants evaluate the degree of monetary independence within a country’s political contours before transacting with its currency *en masse*. The Chinese banking system, and specifically, its central bank, is inseparable from its head-of-state’s policymaking, leading to a permanent misallocation of capital to the industrial infrastructure and real estate sectors. This has unhealthy repercussions for macroeconomic indicators; its cumulative stock of corporate, household and public debts exceeded 300 per cent of GDP and comprised nearly 15 per cent of all global debt at its peak (Bloomberg, 2019).

The state’s involvement has necessitated its socialisation of corporate mismanagement and loss-making, further lowering the appeal of Chinese markets to external counterparties. To this end, the looming default of Evergrande would provide a salient case study. Conclusively, it demonstrates that China has yet to show its own “third face” of power to the world. Investor-traders struggle to resolve the question of authoritarianism and overcome the arbitrary application of power by the executive. Morality aside, China’s political system has been the cause of suboptimal economic outcomes.

Ruling out the yuan (for now), could the euro share responsibility with the dollar? While internationalising the euro is now the official policy of the EC and the ECB, its influence – as measured by global reserves – is extremely slim. Its 750€ billion recovery fund pales in comparison to the trillions of treasuries available for sale, much of which is ultimately purchased by European corporations and reserve managers. As with China, the EU implicitly endorses US incumbency due to an inadequate supply of safe (AAA-rated) assets.

Another option, of course, is that global markets use a basket of currencies, each with their own best-use case. The idea of China, South Korea, Japan, and ASEAN states engaging with a joint focus on East Asian regionalism has long been a latent fear in the minds of US legislators. This possibility can be swiftly ruled out under a subsequent realist examination. As of today, regional actors rely on their security relationship with the United States, which translates directly to a financial dependency on the US dollar. This relationship is discussed at length in international relations theory, and Eichengreen et al. recently set out to cement it empirically. Countries that rely on US military spending to undergird their own sovereignty act largely agnostic towards regional financial influence and hold significantly more dollar reserves than one would neutrally expect. As a stylised example, Japan and Germany hold disproportionately more dollar-denominated assets than France and the United Kingdom, which maintain independent nuclear capability.

Finally, a brief note on cryptocurrencies. On cursory perspective, the proliferation of bitcoin played into the multipolar narrative, as it provides an outside option to the dollar. In China, mining operators initially took on a nearly mercantilistic role in amassing bitcoin within its borders, but output declined rapidly after it was banned. An economy's ability to mine bitcoin also rests on its material resources and ability to generate power on a cost-efficient basis – which only raises yet another category in which the US holds primacy. Alternatively, there is an array of emerging centralised, private, third-party currencies, ranging from Facebook's libra to Sotheby's art auction token. Traditional fiat currencies, decentralised alternatives, and CBDCs still dwarf the market capitalisation of private tokens. However, one could imagine a limited system wherein each currency has its unique use case, e.g., libra to buy and sell data, Bezos bucks for consumer goods, NFTs for art auctions, etc. Ultimately, no unpegged cryptocurrency can effectively store value for every type of transaction, while so-called "stable coins" (which pledge convertibility to another asset) are ultimately just derivatives of derivatives of dollar reserves à la "Bretton Woods II".

In answering the question of hegemony today, there are no alternatives to the US dollar. It is the sole and only international currency.

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Notes:

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