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The Dollar Dilemma

The World's Top Currency Faces Competition

Barry Eichengreen

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Legions of pundits have argued that the dollar's status as an international currency has been damaged by the great credit crisis of 2007–9—and not a few have argued that the injury may prove fatal. The crisis certainly has not made the United States more attractive as a supplier of high-quality financial assets. It would be no surprise if the dysfunctionality of U.S. financial markets diminished the appetite of central banks for U.S. debt securities. A process of financial deglobalization has already begun, and it will mean less foreign financing for the United States' budget and balance-of-payments deficits. Meanwhile, the U.S. government will emit vast quantities of public debt for the foreseeable future. Together, these trends in supply and demand are a recipe for a significantly weaker dollar. And as central banks suffer capital losses on their outstanding dollar reserves, they will start considering alternatives.

This is especially likely because these trends are superimposed on an ongoing shift toward a more multipolar world. The growing importance of emerging markets has sharply reduced the United States' economic dominance, weakening the logic for why the dollar should constitute the largest part of central-bank reserves and be used to settle trade and financial transactions.

As emerging markets grow, they naturally accumulate foreign reserves as a form of self-insurance. Central banks need the funds to intervene

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in the foreign exchange market so that they can prevent shocks to trade and financial flows from causing uncomfortable currency fluctuations. This capacity becomes more important as previously closed economies open up and when international markets are volatile, as has been the case recently. It is only logical, in other words, for emerging markets to accumulate reserves.

But in what form? There is a growing feeling among economists and government officials that any system that uses a national currency, such as the dollar, as international reserves is seriously flawed. In order to acquire dollar reserves, countries must run current account surpluses with the United States. The U.S. government, for its part, finds it easy to finance its current account deficit: the foreign central banks that buy its debt securities are a kind of captive market. Insofar as foreign central banks are net buyers of U.S. debt securities—that is, so long as demand is high—U.S. interest rates are lower than they would be otherwise. This allows the U.S. government and, indirectly, the household and corporate sectors in the United States to assume more debt. And as has been shown at considerable cost recently, excessively low interest rates and easy credit are conducive to asset bubbles and, ultimately, financial instability.

These problems were not so pronounced while the U.S. economy was large relative to the world economy and the additional demand for dollar reserves was modest. But over the last decade, neither condition has prevailed. The flow of foreign finance for the U.S. current account deficit grew disturbingly large—a manifestation of what is sometimes referred to as the problem of global imbalances. To be sure, this was not the only factor to set the stage for the crisis; at least as important were distorted incentives created by skewed compensation practices for institutional investors and lax government supervision and regulation. But to the extent that global imbalances did play a part in the crisis, the dollar-based reserve system is implicated.

Like its economic logic, the political logic for a dollar-based international monetary and financial system also seems less compelling today. After World War II, when the United States stationed significant numbers of troops in Europe and Asia, the host countries viewed providing limited support to the U.S. debt market (by accumulating dollar securities) as a quid pro quo. Today, it is not obvious to them why they should subsidize the U.S. government and prop up Americans' living standards. Foreign officials increasingly object to the United States' "exorbitant privilege," as Valéry Giscard d'Estaing, then the French finance minister, put it in the 1960s, and are actively contemplating alternatives to dollar reserves.

AN INCONVENIENT TRUTH

THE ONLY problem is that, for all the talk about change, the dollar's importance to the world has not diminished. In the foreign exchange market, the dollar actually strengthened following the outbreak of the crisis. When investors fled to safety, they fled to U.S. Treasury bills. In the face of spreading illiquidity, U.S. and foreign investors alike sought refuge in the most liquid market, the market for U.S. government debt securities. Since then, the dollar exchange rate has fluctuated, but there has been no dollar crash. And there is no evidence of a massive loss of confidence.

The same conclusion follows from data on the composition of the foreign currency reserves of central banks and governments. According to the International Monetary Fund (IMF), 64 percent of all identified official foreign exchange holdings were in dollars at the end of 2007, down only marginally from 66 percent in 2002–3 and still considerably higher than during the first half of the 1990s. (The dollar represented 71 percent of all identified holdings in 1999, but this unusually high number reflected the one-time destruction of Germany's French franc reserves and France's deutsche mark reserves; these became domestic-currency-denominated claims when the euro was created.) IMF data on the composition of international reserves are incomplete, since some countries, notably China, do not report theirs. One way of inferring those countries' dollar reserves is to look at the U.S. Federal Reserve's custodial holdings of U.S. Treasuries on behalf of foreign central banks. These show that foreign authorities have continued to accumulate dollars, and even accelerated their purchases in the first half of 2009.

All that has changed is that foreign central banks are now accumulating U.S. Treasury obligations rather than the securities of government agencies such as Fannie Mae and Freddie Mac and that they are favoring short-term bills over long-term bonds. Late last year, the further accumulation of Treasuries arguably could have signaled that foreign public investors were shifting from bank deposits to Treasuries because they were alarmed by the condition of the U.S. banking system. But this is a less likely explanation today, now that confidence in the U.S. banking and financial system has begun to return. The crisis may have deterred private foreign investors from investing in the United States, but it has not deterred foreign central banks, which are accumulating dollars at least as fast as before. They are providing a growing share of the financing for the United States' current account deficit.

FIRST-MOVER ADVANTAGE

WHAT, THEN, explains the gap between rhetoric and reality? At the most basic level, the economic logic for holding reserves in dollars, although less overwhelming than in the past, remains compelling. It still makes sense for countries to hold their reserves in the same currency that they use to denominate their foreign debt and conduct their foreign trade, since central banks use the funds to smooth debt and trade flows and intervene in foreign exchange markets. And many countries continue to borrow and settle their trade in dollars, the rise of the euro and other potential competitors notwithstanding. At the end of 2008, some 45 percent of international debt securities were denominated in dollars, compared to only 32 percent in euros. And according to the 2007 triennial survey of the Bank for International Settlements, the dollar was used in 86 percent of all foreign exchange transactions, compared to just 38 percent in which the euro was used (the total for all currencies is 200 percent since two currencies are involved in each transaction).

As of April 2008, according to the IMF, 66 countries used the dollar as their exchange-rate anchor, compared with just 27 that used the euro. What peg a central bank chooses has an important influence on the currency composition of its reserves. Central banks want not just to maximize the returns on their portfolios but also to minimize their riskiness. In a state that pegs its currency to the dollar, for instance, domestic inflation tends to track U.S. inflation, and so, in that case, holding reserves in dollars will mean less variance in terms of domestic purchasing power.

Estimates of what mix of currencies maximizes a particular combination of risk and return typically assume that all currencies are equally easy to buy and sell—that is, they posit that all markets in bonds are equally liquid, no matter what currency they are denominated in. This liquidity is critical. If reserves are not readily convertible into cash, they cannot easily be deployed in market operations—hence the appeal of the market for U.S. Treasury bonds: it is the single most liquid government bond market in the world, as reflected in its high turnover and the narrow spreads between the bid price and the ask price (in investment speak, the "bid-ask spread"). This liquidity is partly a function of the U.S. economy's sheer size, but it is also a self-reinforcing feature. Foreign investors undertake their transactions and concentrate their holdings in U.S. markets because these markets are liquid, and that activity, in turn, makes them more liquid. As in politics, in the competition to be a leading international financial center and to hold the top reserve-currency status, incumbency is an advantage.

Other currencies struggle to compete. The pound sterling and the Swiss franc were once important reserve currencies, but the British and Swiss economies are too small today for the pound or the franc to serve as more than a subsidiary reserve currency; neither country can provide debt instruments on the scale required by the global financial system. Thus, at the end of 2007, the pound accounted for less than three percent of identified global reserves, and the Swiss franc accounted for less than one percent.

Japan's economy is bigger, but the Japanese government long discouraged the use of the yen internationally on the grounds that this would undermine its ability to maintain a low and competitive exchange rate and complicate its conduct of industrial policy. If foreigners had been able to buy and sell Japanese securities in large numbers, the Japanese government would have had more difficulty using the financial system to channel funds toward the domestic firms it favored. Japan now seems anxious to see the yen play a larger international role, especially within Asia, but its past policy has limited the market's current liquidity. More recently, Japan's economic stagnation and zero interest rates have made holding reserves in yen unattractive. (As of the end of 2007, the yen accounted for barely three percent of total identified official holdings of foreign exchange.) Japan's aging population will mean that its economy, as well as its currency, is unlikely to play an expanding global role.

THE EURO STAR

THIS LEAVES the euro as the only reasonably serious rival—not exactly a coincidence given that one motivation for introducing the euro in the first place was to create a European alternative to the dollar. The euro area, which comprises the 16 members of the European Union that have adopted the euro as their currency, possesses the requisite scale: it has a GDP comparable to that of the United States and, at least for the moment, an even greater ratio of debt to GDP. But the euro area's stock of government debt securities is heterogeneous, with the bonds of different governments offering different risks, different returns, and different degrees of liquidity. German government bonds have a reputation for stability, but since institutional investors tend to hold them to maturity, the market for them lacks liquidity. Other euro-area countries have serious financial problems. Ireland's sovereign debt has been downgraded by the rating agencies, and there are worries that ratings for the bonds of other euro countries, such as Greece, Italy, Portugal, and Spain, could drop, too. Italy has the largest outstanding stock of bonds of any euro-area country, but its economic troubles make them unattractive as reserve assets. The current global economic crisis has encouraged talk of issuing euro-area bonds with the backing of the entire set of euro-area members, including, most importantly, Germany. If this were done on a significant scale and if this debt were to replace the member states' national debt securities, the euro area would possess a market with roughly the uniformity and liquidity of the United States' Treasury market. But such radical fiscal federalism is not something to which the German government, among others, is likely to agree.

Financial markets in the euro area will undoubtedly expand as more EU members adopt the currency. If nothing else, the economic crisis has strengthened the euro's prospects as an international currency by driving home the fact that the euro area can be a safe harbor in a financial storm. The European Central Bank has more capacity to act as a lender of last resort than, say, the National Bank of Denmark.

And intra-European solidarity notwithstanding, the only way a state can guarantee its access to exceptional liquidity from the ECB is by adopting the euro. Markets in euro-denominated securities may not have all the liquidity that might be hoped for, but they are at least more liquid than the market in Danish krone. This became clear in the turbulence that followed the collapse of Lehman Brothers in the fall of 2008. Whereas the ECB was able to cut interest rates and flood distressed financial markets with liquidity, the National Bank of Denmark had to raise interest rates to defend the krone, which had fallen as a result of deleveraging by foreign investors. Now, opinion polls in Scandinavia and policy statements by eastern European officials indicate greater support for adopting the euro.

Not so in the United Kingdom, ever the outlier on these matters. There the crisis has tarnished the reputation of the pro-EU Labour government and strengthened the euro-skeptical opposition. The United Kingdom's adoption of the euro would make the biggest difference for the development of the euro's international role, given London's status as an international financial center and the pound's long history as a reserve currency. But this is not going to happen anytime soon. Meanwhile, EU members oppose accelerating the admission of new eastern European countries to the euro area. The implications are that the euro area will expand slowly rather than rapidly and that the euro's rise as a rival to the dollar will be gradual.

The euro's importance as a reserve currency will grow first and foremost on the euro area's own periphery. It is already the dominant currency for trade among EU countries outside the euro area. The EU is also seeking to develop stronger ties with the non-EU countries to its south and east. With leadership from French President Nicolas Sarkozy, it has put in place the Union for the Mediterranean, a partnership between the EU and most non-EU countries bordering the Mediterranean. The EU relies on its neighbor Russia for its energy supplies, and Russia, in turn, relies heavily on the EU for revenues.

As countries in the EU's neighborhood develop deeper links with the union, it will make sense for them to hold more of their reserves in euros. For example, in recognition of the growing importance of Europe for its trade and finance, Russia has recently raised the weight of the euro in the basket of currencies it uses to guide its exchange-rate policy. It follows that the country will also want to hold a larger share of its reserves in euro-denominated securities. Russia's central bank confirmed in its most recent annual report that it had increased the share of euros in its reserves from around 42 percent to more than 47 percent between the beginning of 2008 and the beginning of 2009 while reducing the share of dollars from 47 percent to under 42 percent. In June, Alexei Ulyukayev, the bank's first deputy chair, indicated that Russia intended to further reduce the share of dollar-denominated assets in its portfolio as its assets mature.

For these reasons, the central banks of countries on the EU's periphery are poised to further reallocate their reserves from dollars to euros. The euro is likely to become an increasingly important reserve currency in the EU's part of the world. That does not mean, however, that the euro will surpass the dollar globally. The dollar has a head start, and relatively unfavorable demographics in the euro area mean that in the years ahead growth will be slower there than in the United States.

PRISONERS OF THEIR OWN DEVICE

DIVERSIFICATION BY Russia would be one thing, but diversification by China, much less by emerging markets as a group, would be another. The economist Brad Setser has estimated that China's official dollar assets as of May 2009 were roughly eight times those of Russia. With some 60 percent of China's official reserves held in dollar-denominated assets, diversification by Beijing would be a very big deal.

And Chinese officials are facing mounting pressure to do something. The issue has become a flashpoint domestically—unsurprisingly, as China's foreign currency reserves amount to $2,000 per Chinese resident, the equivalent of a third of its per capita income. In a recent online poll conducted by the Chinese newspaper *Global Times*, 87 percent of Chinese respondents called China's holdings in dollars unsafe. On a visit to China in June, U.S. Treasury Secretary Timothy Geithner felt compelled to reassure an audience of students at Beijing University that U.S. Treasury bonds were secure.

At the same time, the Chinese government is aware that it is trapped by the magnitude of its current dollar holdings. Selling U.S. Treasury securities in the quantities needed to significantly alter the composition of China's reserve portfolio would make the prices of these securities tank. If the People's Bank of China moved significant amounts of money from dollars to other currencies, the dollar would depreciate, causing further losses on China's residual holdings. The specter of such effects deters Beijing from acting hastily. Moreover, disruptions to the U.S. Treasury market that raised interest rates in the United States would not endear Beijing to Washington. And transactions that caused the dollar to depreciate sharply, leaving other investors wrong-footed and roiling international markets, would not endear it to other governments. John Maynard Keynes' famous remark comes to mind: "If you owe your bank manager a thousand pounds, you are at his mercy. If you owe him a million pounds, he is at your mercy."

The sensible strategy under such circumstances is to make a series of small adjustments in the composition of one's portfolio over time. This, in fact, is what China's reserve managers appear to be doing—yet another reason why the decline in the share of the dollar in global reserves is likely to occur gradually.

FUNNY MONEY

UNDERSTANDABLY DISSATISFIED with existing alternatives, China and other countries have begun exploring other options. In March, the governor of China's central bank, Zhou Xiaochuan, made a splash by arguing that the dollar should be replaced as the world's reserve currency by Special Drawing Rights (SDRs), the accounting unit used by the IMF in transactions with its members and currently composed of a basket of four currencies (the dollar, the euro, the yen, and the pound). In June, Moscow suggested that it might be prepared to trade $10 billion of its U.S. Treasury holdings for IMF bonds, which would conceivably be denominated in SDRs. A United Nations commission headed by the economics Nobel laureate Joseph Stiglitz has advocated a greatly expanded role for SDRs in the international monetary and financial system.

The idea of a supranational reserve currency goes back to the 1940s—to Keynes' call for creating a new international unit (he called it "bancor") and to the Yale economist Robert Triffin's demonstration of the dynamic instability of an international system that uses a national unit as the main form of reserves. Empowering the IMF to issue SDRs so that it could meet central banks' growing demand for international reserves would eliminate the exorbitant privilege of existing national suppliers, such as the United States, and remove the asymmetry that has fed global imbalances and credit-market problems. It would also solve the dilemma faced by large reserve holders, such as China, by creating a real alternative to national currencies.

But reserves are attractive only if they can be used, and at the moment governments can use SDRs only to settle accounts with other governments and the IMF. They cannot use them to intervene in foreign exchange markets or in other transactions with market participants. Making SDRs more appealing would require developing private markets in which they could be bought and sold. It would be necessary to build liquid markets on which governments and corporations could issue SDR bonds at competitive cost. Accepting SDR-denominated deposits and extending SDR-denominated loans would have to be attractive to banks. And it would be necessary to restructure foreign exchange markets so that traders seeking to buy, say, South Korean won for Thai baht could, before buying won, sell baht for SDRs rather than for dollars.

This is a tall order: it is worth recalling that a previous attempt to commercialize SDRs in the 1970s never really got off the ground. Only a few public-sector companies issued SDR-denominated debt, and only a few banks ever accepted SDR deposits. It is not hard to see why: the first issuers of SDR liabilities would incur extra costs by virtue of the instrument's novelty; the first private SDRs, by definition, could not be traded on a liquid market. This puts them at a competitive disadvantage since there already exist liquid markets in dollar- and euro-denominated assets. Displacing national currencies is as much of an uphill battle now as it was in the 1970s.

Winning that fight would require significant investments by governments over an extended period. If China is serious about elevating the SDR to reserve-currency status, it should take steps to create a liquid market in SDRs. Specifically, it could issue its own SDR-denominated bonds. This would be a much more meaningful step than buying SDR bonds from the IMF—which China, Brazil, and Russia have recently said they are prepared to do—because those bonds cannot be traded and thus would not foster market liquidity. The first governments issuing SDR bonds would pay a price for the novelty, but that price would be the cost of investing in a more stable international system.

Then there is the question of who would be on the demand side of the market. Many government bonds are held by pension funds and insurance companies because the maturity of these bonds matches the maturity of their obligations to pensioners and policyholders; this means they can be confident that they will have the requisite money on hand when the time comes to pay out on outstanding contracts. But SDR bonds would not match the currency denomination of their liabilities. If, say, the dollar depreciated against the euro, a European insurance company with SDR bonds and euro-denominated liabilities would find itself in deep trouble. One day, pensioners and policyholders may be prepared to accept payouts in a basket of currencies. But putting it this way is a reminder that the day when there will be a deep and liquid market in SDRs, with adequate demand and supply, is very far away.

Yet another challenge would be creating an SDR-based foreign exchange market. The IMF would be the obvious market maker: it could trade SDRs with all participants, private and official, at narrow bid-ask spreads, competitive with those for dollars. The dollar first became an international currency in the 1920s, when the newly established U.S. Federal Reserve started buying and selling dollar acceptances, a kind of negotiable draft, thereby creating a liquid market for those instruments. If the international community is serious about SDRs as an international reserve unit, it will have to empower the IMF to similarly act as a market maker—and provide it with a budget for the undertaking.

Finally, in order for SDRs to truly become an international currency, the IMF would have to be able to issue additional SDRs in periods of shortage, much like the U.S. Federal Reserve provided dollar swaps to ensure adequate dollar liquidity in the second half of 2008. Under current rules, SDRs cannot be issued without the agreement of 85 percent of the IMF's members—not exactly a recipe for quick action. The IMF's management would have to be empowered to decide when to issue more SDRs; it would have to have independence and authority, like the monetary policy committee of a central bank. In effect, the IMF would have to become more like a global central bank and an international lender of last resort. And this clearly is not going to happen overnight.

RENMINBI TO THE RESCUE?

With Zhou, the governor of China's central bank, aware of these realities, one wonders why he was promoting SDRs last spring. One explanation is that he was making a political point. He wanted to signal China's unhappiness with prevailing arrangements and remind other countries, on the eve the G-20 economic summit in London, that China expected to actively participate in discussions of international monetary reform and to advocate a rules-based multilateral system. He may also have been playing to his audience at home, seeking to deflect criticism that the Chinese authorities, by failing to actively seek out alternatives to the dollar, have not been careful stewards of the country's international reserves.

Or the tactic may have been a diversion, designed to distract attention from China's real objective, which is to make the renminbi itself a reserve currency. This would free China of the need to hold foreign currencies to smooth its balance of payments, and it would allow it to print more or less of its currency as needed, just as the United States does now. Wang Zhaoxing, vice-head of the Shanghai branch of the China Banking Regulatory Commission, suggested to reporters in May that the renminbi could become a major reserve currency by 2020.

But for now, the renminbi remains inconvertible. Foreigners can only use it to purchase goods from China or in cross-border trade with China's immediate neighbors and the special administrative regions of Hong Kong and Macao. Last spring, Brazil and China announced that they wished to explore ways to use their currencies in bilateral trade, but the statement was mainly a way to advertise the extent of their trade. What use would most Brazilian firms have for renminbi when these cannot be converted into reais? Similarly, the swap agreements that China has concluded over the last year with Argentina, Belarus, Hong Kong, Indonesia, Malaysia, and South Korea are of little practical importance; they are largely a way for Beijing to signal its desire to be an international player. The central banks of these countries cannot use renminbi to intervene in foreign exchange markets, import merchandise from third countries, or pay foreign banks and foreign bondholders. China would become a more consequential supplier of emergency credits if it made these available in dollars—but that would undermine the use of swaps to enhance the renminbi's international role.

In time, China could strengthen the international role of the renminbi by developing liquid securities markets and liberalizing foreigners' access to them. In time, it could make its currency convertible for financial and trade transactions. The question is, in how much time? China has been feeling its way toward capital account convertibility, the ability to freely convert local financial assets into foreign ones and vice versa, for more than a decade, and it is still only partly there. As other Asian countries have learned, to their chagrin, maintaining financial stability while granting investors at home full freedom to trade foreign assets and investors abroad full freedom to trade domestic assets requires satisfying formidable preconditions. Markets must be transparent. Banks must be commercialized. Supervision and regulation must be strengthened. Monetary and fiscal policies must be sound and stable. The exchange rate must be flexible enough to accommodate larger flows of capital. In other words, China must move to full capital account convertibility; this is a prerequisite to the renminbi's coming of age internationally. But to do so, China would have to first abandon a growth model in which bank lending and a pegged currency have been two of the main instruments of development policy. This will not be easy. Witness how the Chinese authorities' first reactions to the economic crisis were to further rely on directed lending (in order to boost investment) and to reinforce the renminbi's peg to the dollar (in order to sustain exports).

All of this suggests that China's financial markets will continue to be opened up to foreign investors only gradually. Until now, renminbi-denominated bonds have been sold only in China and only by Chinese and multilateral banks, such as the Asian Development Bank and the International Finance Corporation. The Chinese government has been reluctant to allow foreign corporations to issue bonds, since this would interfere with its ability to channel savings to Chinese industry. The situation is beginning to change, if slowly. In May, HSBC Holdings and the Bank of East Asia announced that they were the first foreign banks authorized to sell renminbi-denominated bonds in Hong Kong. But Hong Kong has open markets, and the China Development Bank and the Bank of China are already permitted to issue renminbi-denominated bonds to individuals there. It would be much more significant if such activities were allowed in Shanghai. Permitting the United States, for example, to issue renminbi-denominated bonds there on a small scale might help turn Shanghai into an international financial center. (Guo Shuqing, chair of the China Construction Bank, called for this during a visit to the United States in June.) Households would presumably regard these bonds, with their returns guaranteed in renminbi, as an attractive alternative to bank deposits, which are often funneled into industrial development. But if they did, China's entire development model would be put at risk.

To be sure, the Chinese government would like to see the United States offer an exchange-rate guarantee on its dollar-denominated securities. Guaranteeing new Chinese holdings against a depreciation of the dollar against the renminbi would be tantamount to issuing those bonds in renminbi. Governments have been known to take such steps. But the strategy is rightly seen as a sign of desperation. It can backfire if the foreign currency appreciates. And as the renminbi is expected to appreciate against the dollar, U.S. authorities are not likely to see this as an attractive option.

That said, China's efforts to internationalize the renminbi should not be underestimated. Chinese policymakers are serious about making Shanghai an international financial center by 2020. But meeting that objective will require building broader and more liquid financial markets in renminbi-denominated assets and liberalizing the access of foreign investors to those markets. And this, in turn, will entail a host of policy changes that would amount to abandoning China's tried and true growth model. Such changes cannot occur overnight, and perhaps not even before 2020.

Another reason that 2020 may be an overly ambitious target date by which to turn the renminbi into a reserve currency is that even if China's economy grows at seven percent annually for the next decade—slower than in the past, given its less favorable demographics now, but still exceptionally fast by historical standards—in 2020 its GDP will be only half the size of the United States' GDP at market exchange rates (market rates being what matter for international transactions). Even then, in other words, the renminbi will have a smaller platform than the dollar from which to launch its international career. Liquidity and transaction costs in renminbi markets will not be comparable to those in dollar markets, and holding reserves in renminbi will therefore continue to have limited appeal. The option will be attractive principally to countries that conduct most of their trade with China and do most of their international financial business in Shanghai. For reasons of proximity, if nothing else, these countries will be Asian first and foremost. The market for renminbi reserves will thus be disproportionately concentrated in Asia, at least initially, much as the market for euro reserves is now disproportionately concentrated in Europe.

This raises the question of whether Asia might one day wish to follow Europe in creating a single regional currency. Much ink has been spilled over the question, but it seems unlikely. China does not need to participate in a monetary union in order to achieve the economic and financial scale necessary for its currency to play a role internationally. It does not have to share monetary sovereignty with its neighbors in order for its currency to become a reserve unit. Rather than pushing ahead toward a regional monetary union, in the manner of Paris and Berlin, Beijing would almost certainly prefer to wait, for the longer it waits, the more the renminbi will matter within the region. There are plenty of reasons why a pan-Asian monetary union is unlikely—ranging from the very different structures of the different economies in Asia to the limited appetite for political integration in the region. But the renminbi's own prospects as an international currency are an important one.

Can the renminbi serve as a regional reserve currency? Yes. As a subsidiary reserve currency? Yes. As a dominant reserve currency? For the foreseeable future, this is hard to imagine.

MEET THE NEW BOSS

BY PROCESS of elimination, it is clear that the dollar will remain the principal form of international reserves well into the future. It will not be as dominant as in the past, for the same reasons that the United States will not be as dominant economically as it once was. In the short run, the euro will gain market share, especially in and around Europe. In the longer run, the renminbi's role will also grow, especially in Asia. But for as far as one can see clearly into the future, the dollar will remain first among equals.

This state of affairs—with several national currencies sharing, albeit unequally, the status of reserve currency—would not be unprecedented. A similar situation existed for several decades before World War I, when the pound sterling was the dominant reserve currency but the French franc and the German mark held significant market shares, especially in regions commercially and financially linked to France and Germany. Recent research has shown that the pound and the dollar supplied roughly equal shares of global foreign exchange reserves in the 1920s. The view that there is room for only one reserve currency at any point in time is belied by history. The dollar may have dominated to the exclusion of other reserve currencies after World War II, but this reflected exceptional circumstances, including the United States' exceptional dominance of global markets and the fact that only it had deep and open domestic financial markets. And these exceptional circumstances are now a thing of the past.

The emergence of a reserve system based on multiple currencies should not be viewed as alarming. Such an arrangement functioned smoothly before World War I: the different reserve units coexisted peaceably, each in effect with its own constituency. This arrangement also avoided the kind of instabilities seen recently, in which a single supplier is flooded with foreign finance by reserve-hungry emerging markets, feeding asset bubbles. To be sure, the 1920s turned out less happily. When, in 1931, the United Kingdom experienced first a fiscal crisis, then a banking crisis, and finally a currency crisis, central banks around the world shifted their reserves from pounds to dollars. And when instability spread to the United States, some switched back to pounds, others to gold. The international monetary system was destabilized and ultimately destroyed by these erratic shifts. But, if anything, the lesson is that reserve-currency competition ratchets up the market discipline felt by policymakers. The more alternatives central banks and other international investors possess, the more pressure policymakers will feel to take the steps needed to maintain those investors' confidence. Given the proclivities of most policymakers, this is not a bad thing.