Reserve currencies

The dollar as a reserve currency

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The dollar was unsettled in the foreign exchange markets on a number of occasions in 1974. The most recent buffeting occurred in October and November, when the dollar fell back against the traditional European hedge currencies – the deutschemark and the Swiss franc. But there had been earlier periods of weakness in the spring and summer.

Each of these spasms of currency unrest could be attributed to specific short-term factors. The movement against the dollar in October was associated with disquiet at continuing inflation in the United States, and at reductions in US interest rates. The spring weakness was widely ascribed to the Watergate scandal and to the accompanying political uncertainty.

It would be easy to assume, therefore, that these short-term fluctuations in the dollar are unrelated to profound shifts in the structure of international monetary relations and to consider them as being of purely temporary significance. But this would be a mistake. It will be argued here that these day-to-day ups and downs are part of a long-term adjustment problem which will take many years to resolve. The crux of the problem is that the dollar no longer satisfies the conditions required of a successful reserve currency. Over a 20- or 30-year time span the dollar standard is doomed.

The vital characteristic of a dominant reserve currency is that its value must be stable. If there is any instability, the tendency of such changes as are allowed to occur should be in an upward, rather than a downward, direction. These points are related, since a hard currency is usually a stable one. If holders of dollars think it will depreciate, they will try to move into other currencies. Because of its reserve currency role, dollar holdings are large and highly liquid – with the consequence that selling pressure is liable to lose all sense of proportion. Any unrealistic downward movement must, however, be compensated by an equally violent upward movement, as fundamentals reassert themselves.

The resulting yo-yo pattern became extremely familiar in 1974. It probably reflects – at least in part – a failure by international fund managers and corporate treasurers to understand the nature of speculation under a floating rate régime. The herd instinct has replaced the commonsense principle of 'buy when prices are low and sell when prices are high'. But, where-ever the blame lies, the pattern is a nuisance for central bankers because they cannot be sure, from week to week, of the precise value of their major reserve asset.

The need for the reserve asset to gradually appreciate over time is also important. As in any other monetary system, Gresham's law operates in financial relationships between countries. As *Table 1* (page 16), shows, sterling has been phased out as a reserve currency since 1966. The devaluation of the pound in 1967, and subsequent concern about its prospects, have encouraged central banks to accumulate other, more trustworthy, assets.

Although no breakdown of currencies is given in *International Financial Statistics*, it is a plausible surmise that the deutschemark and the Japanese yen figured prominently in the $30 billion increase of world foreign exchange reserves which accumulated between 1966 and 1973 and which was not accounted for by US or UK liabilities. The deutschemark and, until 1973, the yen, have, of course, been two of the strongest currencies in this period.

There is, however, a serious problem here. A reserve currency must be a strong currency. Any country holding it must be able to rely on it maintaining or increasing its value. But, at the same time, it must be freely available in large amounts for commercial and financial use throughout the world.

These twin requirements are in conflict. A currency is overvalued if accompanied by persistent current account deficits; but payments deficits are indispensable if the rest of the world is to acquire the currency as a financial asset which can then be used as a medium of exchange internationally.

The way out of this dilemma is for the country which is the source of the reserve currency to export capital. As long as the capital account deficit exceeds the current account surplus, the rest of the world is accepting its financial liabilities. This is to everyone's benefit. The source country is increasing its ownership of fixed assets abroad which, in due course, will yield a stream of profit and dividend remittances. At the same time, other countries can use the reserve currency without fear of capital loss because the source country continues to have a healthy current account.

In the 1950s and 1960s the dollar and its source country, the United States, met these conditions to perfection. Year after year the United States earned a large current account surplus, and US companies invested heavily in Europe, the Middle East and Latin America. The 'dollar shortage' of the immediate post-war years was overcome, and exchange controls and trade restrictions were progressively removed. World trade increased rapidly and international capital flows reached a scale which would have been inconceivable in the 1920s and 1930s. The cornerstone of the system, the dollar, was so solid that a new market in Eurodollar loans developed – without official supervision or control from the country which, at least, nominally, was responsible for the standard of value it used.

Foreign confidence in the dollar was strengthened by America's comparative insensitivity to external trade flows. Exports constituted a mere 4·8% of gross domestic product in 1961. It was felt that, if the dollar were to become uncompetitive, a minor adjustment of the domestic economy would be sufficient to restore the necessary equilibrium.

Moreover, the United States was by far the largest and most technically advanced economy in the world. In 1961 its gross domestic product was more than eight times as large as its nearest rival in the non-Communist bloc. Whatever the size of America's financial liabilities to other countries (or the 'dollar overhang', as it came to be called), the output of the US economy was so huge that there would be no difficulty in redeeming them if the need arose.

However, the system generated its own internal contradictions. These difficulties were quite inevitable and no blame attaches to the US Government or to the architects of the Bretton Woods system. There is no way in which the problem can be, or could have been, avoided.

Only an extremely powerful economy can sustain reserve currency status for a long period of time. The obligation both to maintain a current account surplus and to invest heavily abroad, imposes severe strains. Heavy overseas investment transplants technology to other industrial countries, and starves domestic industry of capital. Eventually, the economy's competitive advantage – on which the strength of the current account depends – is eroded; and its exchange rate becomes susceptible to speculative pressure.

The government concerned can attempt to defend the reserve currency by deflating home demand and putting the country's international accounts in order. But this may prove counter-productive, since deflationary policies will deter domestic investment and will prompt further capital outflows to less wealthy countries. Demand restraint may initiate the 'vicious circle' of the low-growth, low-investment economy struggling to preserve an unrealistic exchange rate against formidable odds.

The importance of the weakness and eventual devaluation of the dollar since 1968 is that they are the first symptoms of these processes at work. The balance of economic power has tilted from the United States to Europe and Japan, and the standing of the dollar has been correspondingly

	1966	1967	1968	1969	1970	1971	1972	1973
US dollar	58·9	63·0	54·8	49·6	53·3	64·8	59·4	54·3
Pound sterling	31·0	28·5	30·3	27·5	14·9	10·1	8·5	6·3
Other	10·1	8·5	14·9	22·9	31·8	25·1	32·1	39·4

Table 1: Composition of foreign exchange in world reserves (percentages at end of period).

Source: *International Financial Statistics*, September 1974.

weakened. Although dollars are still as large a proportion of foreign exchange reserves as in the mid-1960s, recent accruals have taken place because the United States has been running a current account deficit – *not* because a current account surplus has been exceeded by a capital account deficit. The international monetary system is less happy to accept dollars under these circumstances, and has been much less stable than in earlier years.

The US trade position has moved from a position of $7 billion surplus in 1964 to one of $7 billion deficit in 1972. Although the devaluation of the dollar in 1971 and 1973 restored a $600 million surplus in 1973, the improvement has been jeopardised by the rise in oil prices; and a deficit has again emerged.

There has been a concurrent shift in the opposite direction on capital account. In 1964 and 1965 direct investment and private long-term capital flows showed a $4½ billion deficit. Although direct investment has continued to be in deficit (averaging $3 billion a year) in the 1966 to 1973 period, the real value of this has decreased because of inflation; and in recent years it has occasionally been more than matched in absolute amount by a surplus on other long-term private capital flows.

The change in the pattern of the US balance-of-payments is probably permanent. The former pattern was a by-product of the United States' overwhelming economic leadership and technical lead. But natural economic forces, combined with the overseas investment of US multinationals, have caused an international diffusion of technology and an equalisation of income levels. By 1972 US Gross Domestic Product was only four times as large as the Gross Domestic Product of Japan and West Germany – compared to the eight-fold lead enjoyed eleven years earlier (see *Table 2*).

The problem of adjustment posed by these changes in the distribution of economic power has been exaggerated by two accidents of history. The demotion of the dollar would have been a difficult process even in the most favourable conditions. But the conditions in 1973 and 1974 have been far from ideal.

The first accident was the four-fold rise in the price of oil. The result of this has been that oil producer countries have been receiving a flood of dollars which they are finding difficult to canalise into suitable investment depositories. The volume of footloose dollars has been greatly increased and funds have begun to run around in circles from one financial centre to another – contributing to the instability in the dollar exchange rate. Central banks are justifiably suspicious of such instability in a reserve asset.

The adverse effect of the higher oil price on the balance-of-payments positions of the industrial nations has been part of the general unrest. Countries, such as Italy, which would be fitting destinations for dollar loans under ordinary conditions, are bad credit risks; and the maldistribution of dollar reserves continues.

The second *deus ex machina* – although some insist that it is retribution for America's deficit financing in the late 1960s – is rampant worldwide inflation. The effect of this has been to stifle the long-term capital markets because the risks to both borrower and lender are too great. Funds are increasingly placed in short-term deposits, making the system more liquid and adding to the risk of capital movement volatility. The collapse of the Eurobond market, and the tendency of the oil producers to keep their money short-term, are aspects of this phenomenon.

What is the answer to this disagreeable conjunction of problems? It would be tempting, but quite wrong, to propose the abandonment of reserve currency status for the dollar. In the short- and medium-term this is inconceivable.

The dollar must remain the principal medium of exchange in international trade and finance for many years. There is no comparable asset of universal acceptability. Equally, so many contracts have been denominated in dollars that it must be the principal standard of value at least

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	1966	1967	1968	1969	1970	1971	1972
United States	50·3	49·8	50·2	49·3	47·8	46·6	44·2
EEC	30·1	29·7	28·9	29·1	29·9	30·6	31·4
Japan	6·8	7·5	8·3	8·8	9·5	9·8	11·1

Table 2: Share of the United States, EEC and Japan in OECD output (percentages at current prices and current exchange rates; calendar years).
Source: *National accounts of OECD countries*, 1961–72.

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until these contracts have expired. As an intervention currency, the dollar is still superior to its nearest rivals, the deutschemark and sterling, because a market for transactions involving dollars exists for *all* currencies whereas the markets for the deutschemark and sterling are often thin and their use would cause erratic rate movements. (The damage which is being done to sterling markets by the continued use of sterling as a 'phantom' reserve currency is discussed on pages 37–40).

More fundamentally, if reserve currency status were to be transferred to other countries they would confront the same problems as the United States. It has been suggested, for example, that the deutschemark would be, if not a good alternative, at least a satisfactory complement to the dollar. In fact the West German economy has begun to show all the signs of underlying weakness which are ultimately incompatible with a reserve currency role. The combination of capital account deficit and current account surplus has coincided with depressed investment levels, indifferent productivity growth and low profitability.

The United States remains the free world's leading economy. It is likely to continue to account for well over a third of OECD output for at least another decade. Its currency must necessarily be the dominant currency in international transactions of all kinds for the foreseeable future. The recent willingness of the US Government to pursue responsible demand management policies should reinforce the dollar's position for the time being, while the aberrations of the Bundesbank (over Herstatt, for example) and the Swiss National Bank (over exchange controls) may perform a useful supporting role.

But, in the long run, the dollar will have to share the medium of exchange function with other currencies. Instead of being pre-eminent it will become *primus inter pares*. ●