When currency empires fall

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I spent the first part of my career as a Currency Strategist in the City of London. One of the nice things about being a currency forecaster is that expectations of you are very low. Moderate success is a great surprise. But there are a few things which are more certain than others.

For example, at any one time, there tends to be a single dominant currency in the financial world, not two or more, just one. Some people believe that while the euro may not topple the dollar, it will at least share the spoils of financial hegemony. History suggests not. In the currency markets the spoils go to the victor, alone, they are not shared. Either the euro succeeds internationally, or it does not. (Which, least I anger my Europhile friends, does not make it a failure, just not an international currency widely accepted outside the euro-area. Many countries have credible, stable, currencies that are not international currencies, such as Canada, the UK, Switzerland, Japan and Sweden.)

In the past, it was worth asking what the spoils are to being an international or reserve currency. Some countries deliberately tried to avoid their currency becoming internationalized, such as post-war Germany. The Bundesbank felt that the more deutschemarks were held outside of Germany, the less control they would have over money supply and monetary conditions. European aspirations for the euro to become the world's reserve currency are more French than German, more dirigist than dirigisme.

Today, the spoils of reserve currency status are more clearly visible than ever before. If your currency is a reserve currency, you can pay for things by writing cheques, which nobody cashes. You can spend more than you earn to a far greater extent than anyone else. This is exactly what the US has done in recent years. National expenditure has exceeded national income by more than 20% over the last five years.

When that excess spending was due to investment in technology in the late 1990s, it was not clear whether the US was benefiting from being a reserve currency, or whether it was simply enjoying an investment boom. But today that excess spending is on unproductive consumption: tanks, bullets and pills. Few countries in the past have ever been able to sustain a deficit on external accounts as large as that in the United States today. And when other countries have run large deficits, they have had to pay significant premiums to borrow the money, not as in the case of the US today, receive a discount. These are some of the immediate advantages of being a reserve currency.

International and reserve currency status also lends the host country even greater influence than otherwise. One of the interesting passages of dollar diplomacy in recent years was in early 1998 when Japan and Singapore were both generously putting up the cash to support the east-Asian economies amid the Asian Financial Crisis, but the US Treasury, was dictating the terms.

There are good reasons why there is seldom more than one dominant currency. Reserve currencies have the attributes of a natural monopoly or in more modern parlance, a network. If it costs extra to trade with some one who uses a different currency than you, it makes sense for you to use the currency that most other people use, this makes that currency yet bigger and cheaper to use. There is a good analogy with a computer operating system. In that world, Windows is the dollar.

This networking power is why Central banks store dollars in their reserves in a far greater proportion than the proportion of trade with the US. While 30% of international trade is with the US, 70% of central bank reserves are in dollars. It is why most commodities, like oil, copper and coffee are priced in dollars, wherever they are found and whoever they are sold to.

Something else we can be more certain of is that reserve currencies come and go. They don't last forever. International currencies in the past have included the Chinese Liang and Greek drachma, coined in the fifth century B.C., the silver punch-marked coins of fourth century India, the Roman denari, the Byzantine solidus and Islamic dinar of the middle-ages, the Venetian ducato of the Renaissance, the seventeenth century Dutch guilder and of course, sterling and now the dollar.

A necessary condition of a currency becoming a reserve currency appears to be its breadth of use and cost and ease of transaction, not, as some might think, the ability to hold its value. Clearly hyperinflation would not serve a reserve currency, and the end of reserve currency status is often associated with a cycle of inflation. But within the normal bands of inflation, it is size as a trader that matters. In the long-term, the Swiss franc and yen have been better stores of value than the dollar. Since 1980, they have appreciated by more than 21% and 54% versus the dollar respectively. Yet for much of this time, combined, they have represented no more than 10% of central bank reserves.

In the 18th century Britain was the largest economy of the western world, London was the centre of international trade and finance, the currency was convertible and so sterling became the world's reserve currency. By the late 19th century, the US had become the world's largest economy, a position solidified by Europe's repeated attempt at self-annihilation from the 1880s to the 1940s. By the 1960s, the dollar had usurped sterling and was the world's new reserve currency with 60% of total central bank reserves being held in dollars, twice the level of sterling reserves.

But time doesn't stop. By the mid-21st century, the US will no longer be the world's largest economy. By then, China and India will have overtaken the US, western Europe and Japan, on purchasing power parity terms at least, which should represent where exchange rates are likely to be in the long-run. Indeed optimistic measures of sustainable growth in China and India suggest this will be the case in twenty years time. Ladies and gentlemen, within my life time, the dollar will start to lose its reserve currency status, not to the euro, but to the renimbi.

The process is likely to be long and drawn out, rather like sterling's slip, slide. Although the UK had lost its position of the world's largest economy in the late 19th century, by 1928, it was still the world's major reserve currency with twice as many central bank reserves being held in sterling than in dollars. In part this slow process was a result of the authorities' attempts to delay it. Gaining reserve currency status is heaven as you write checks and no one cashes them. Losing reserve currency status is hell as everyone starts to cash all the checks you ever wrote back in time. Britain's economic history and politics for the first three quarters of the last century was dominated by the overhang of sterling balances and the pressure on sterling as these were liquidated.

The principal way in which Britain tried to slow the process was through the use of imperial power and influence. By the 1930s, sterling's reserve currency status was largely a result of sterling balances held by the British colonies. The majority of sterling reserves were held by Ireland, India, Pakistan and Australia, not the major economies of the time, the US, France, Germany or Japan. In the post-war period, the British authorities formalized the sterling area within which there were few restrictions to trade but strict rules controlling the movement of goods and capital into and out of the bloc. One could argue that sterling had already lost its reserve currency status in the sense of a currency which third parties voluntarily choose to use as a vehicle currency. However, there is no reason to suppose that the US would not follow a new imperialism by exerting pressure on countries to stick to the dollar-bloc.

There are three further implications of this analysis. First, those Europeans who want the euro to become the major international currency must consider either substantial immigration or an aggressive enlargement eastwards. A European Union which by 2025 included the former Soviet-bloc, Turkey and North Africa could rival the dollar and renimbi, especially if the process brought greater political stability to the new member states.

Second, the loss of reserve currency status for the US will bring economic and political crisis. If it was economically and politically painful for the UK, even though its international financial position was not in heavy deficit, what will it be for the US which has become the world's largest debtor. There will be an avalanche of checks coming home to be paid when the dollar begins to lose its status. Of course excessive debt in your own currency is also spelled, inflation. That is the most likely outcome and it is how other governments have tried to cope with the loss of reserve status in the past. The solidus and dinari were ultimately consumed by a cycle of inflation and debasement.

Third, if the renimbi is to become a major reserve currency it first has to leave the dollar-bloc. This will happen later rather than sooner. One of the other certainties in foreign exchange, what I call the Second Rule of Foreign Exchange, is that the smaller, more open an economy is, the more the authorities manage the exchange rate and similarly, the larger, more closed an economy is, the less the authorities care about the exchange rate.

Policy makers perceive a trade-off, at least over the course of the political cycle between the economic flexibility afforded by a floating exchange rate that can respond to new and varying circumstances and the economic disruption that a volatile exchange rate, sensitive to external factors, factors often beyond the control of the country, can cause. This potential disruption is greatest the more open an economy is to international trade, small open economies opt for inflexible exchange rates. Large, closed economies prefer to keep the flexibility of a floating rate. EMU makes political economy sense for Belgium but not for the US.

We think of China as a vast country with a growing economy, but in many ways it has the characteristics of a small open economy today with the market sectors of the economy being led, driven and dependent on international trade. Although I am not altogether comfortable about the meaning of some of the national statistics in a command economy, for what they are worth, they suggest that in terms of trade as a percent of GDP, China is far more open than the United States or Euroland, countries which pursue exchange rate flexibility and is more akin to France, Spain and Korea, countries which choose exchange rate management. The current arrangement therefore is likely to persist for a while longer. That does not mean that there will not be a revaluation of the renimbi shortly, it could even happen around the end of this year, but that the Chinese will revalue the renimbi and stick to a pegged system, though the limits may widen a little from the current 1.0%. But a dollar peg is not China's destiny. It may have an open economy today, but longer-term, China will be a large economy, driven by domestic rather than the external sector. Then it will prefer a more flexible exchange rate. The decision by China to move from a peg to a float will mark the beginning of the end of the dollar's reserve currency status. You can see why the Chinese were invited for dinner by the G7 in September.

In summary, there are few if any instances of a single financial system having more than one key currency. Today that currency is unquestionably the dollar. But reserve currencies come and go. Perhaps the immediate economic advantages that they bestow seduce governments to over-extend themselves until the financial empire collapses upon itself. The collapse, as a couple generations of unpaid cheques are presented to be paid, will push the US into a series of economic and political crises in the middle of the 21st century. The most likely candidate to replace the dollar is not the euro, unless Europe embraces rapid eastward expansion, it is China. Through rapid economic growth and a massive population, China will become the largest economy within twenty years time and economic size is the key to the rise of new financial empires.

The principal risks to this forecast are whether China can continue growing rapidly and, more uncertain, whether it can maintain a degree of political stability. If Chinese leadership fails on both fronts the dollar's reign will probably last a little longer. There is a possibility that it finds itself under threat from another quarter, the rupee. India's democracy is remarkably stable for a poor country. Moreover, courtesy of the one child policy, it is India, not China that will end up with the largest population in the world by 2050. The fate of the average Chinese today is to grow old before they grow rich, the fate of the average American is more uncertain than most imagine.