Gold, The Dollar, *and* What Comes Next

The greenback may be felled not by a pair of giants, but by a swarm of midgets.

By Barry Eichengreen

President Richard M. Nixon's decision to close the gold window on August 15, 1971, almost exactly fifty years ago, marked the end of an era—the era when the United States was able to determine, all but unilaterally, the shape of the international monetary order. That decision launched Europe down the road that led to the Snake, the European Monetary System, and the euro. It led Japan to abandon the currency peg of 360 yen to the dollar put in place more than twenty years before at the behest of U.S. occupation authorities.

The one thing the demise of Bretton Woods didn't change, to the surprise of many, was the international role of the dollar. The dollar remained—and remains—the dominant international and reserve currency. More countries peg their exchange rates to the dollar than to any other currency. The dollar is the vehicle for the majority of international interbank transactions. It is the most traded currency on foreign exchange markets.

Why is not hard to see. The United States was then, when Nixon closed the gold window, and remains today the single largest economy in the world. The market in U.S. Treasury securities, by some measures, is the single largest and most liquid financial market.

The fact that the dollar's dominance survived not only the collapse of Bretton Woods but also the Great Inflation, the Global Financial Crisis

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(for which the United States was heavily responsible), and the Trump Administration (with its efforts to weaponize the greenback) points us to yet another supportive factor, namely, the absence of alternatives. Even if the bread is stale, the hungry man will eat it if it's the only bread he's got.

The question is whether this is about to change. The Trump Administration's threat to deny access to dollar credit to European entities doing business with Iran prompted the European Union to renew its efforts to enhance the international role of the euro. However, there's little evidence of progress. The practical obstacle to euro internationalization is the absence of an adequate stock of AAA-rated government securities for central banks to hold as reserves. The outstanding stock of AAA-rated euro area government bonds is just one-third the corresponding supply of U.S. Treasury securities. Moreover, nearly half the euro area total is held by the European System of Central Banks and other multilateral financial institutions. Much of the rest is held by Europe's own banks to meet their capital requirements.

This leaves little for central bank reserve managers in other parts of the world. And if central banks outside Europe don't have adequate euros to provide to the markets at times of stringency, they will be reluctant to allow their banks and firms to become indebted in euros or otherwise do cross-border business in the currency. The €750 billion of debt issued by the European Union to finance its Recovery Plan for Europe may be a first step in eliminating this shortfall. But there is a palpable reluctance to follow up on that precedent. Don't hold your breath, in other words.

Many will see the Chinese renminbi as a more serious potential competitor to the dollar. Compared to Europe, China is more successfully expanding the platform for its currency, by growing its economy and continuing to increase its international transactions. As a strategic rival of the United States, it has a stronger incentive to reduce its dependence on the dollar. The Chinese government is actively promoting use of the renminbi in transactions with other countries. And the People's Bank of China is poised to become the first major central bank to digitize its currency.

Many people see a Chinese CBDC as a game-changer. Digital renminbi that reside on an app on the cellphones of end-users will be easier to use in transactions with China and other countries than a plain-vanilla renminbi deposit in a bank account in Hong Kong. And lower transactions costs make for wider use.

But the People's Bank of China may limit how many renminbi can be held in a digital wallet as a way of preventing capital flight and to avoid disintermediating the Chinese banking system. If so, China's CBDC may be suitable for buying a cup of coffee, but not for shipping a container of iPhones across the ocean. And even if there are no limits on digital renminbi balances, there may be privacy and security concerns. Will the Chinese authorities be privy to who is using their CBDC, and for what? Other countries can point to strong rule of law and political checks and balances as allaying such security and privacy concerns. The Chinese authorities may deny that they have the ability to track transactions, but will we know for sure?

In all, it's hard to see a Chinese CBDC as upending the international monetary order. Rather, where new technology may change the game is by enhancing the role of what have been viewed, up to now, as second-tier international currencies. Central bank reserve managers are focused on the dollar and, prospectively, on the euro and the renminbi because, as the currencies of large economies with large financial markets, these units can be widely used subject to limited transactions costs. However, by digitizing their currencies, the central banks of smaller economies can bring down the cost of using their currencies as well. Adding the currency of a small, specialized economy may be unattractive to central bank reserve managers, even if it can be used in market operations, owing to that currency's volatility. But a diversified portfolio of such currencies may display just the stability that reserve managers and other investors desire.

In the end, the dollar may be felled not by a pair of giants but by a swarm of midgets. ◆

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