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"The Mighty Dollar"

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Some 80% of foreign exchange transactions are conducted with U.S. dollars, and 60% of reserves held by foreign governments and banks are American greenbacks. While the dollar has been the favorite world currency for 70 years, it's the latest in a conga line of world currencies which include the drachma, the solidus of Byzantium, the Dutch guilder, and British pound sterling. All were distinguished by broad usage outside the borders of the issuing country . . . and were further distinguished by the fact that they didn't last in their role of universal currency.

To be sure, there is immense prestige in being the home to the world's number one currency, and there are considerable economic and political benefits to it. But what would happen if most of the world's commerce wasn't conducted in U.S. dollars? And is it even feasible that global trade would be conducted in some other currency?

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These questions are seriously debated in major financial institutions across the globe, and pop up each time our elected officials in Washington argue over the debt ceiling and it's thought we might default on that debt. Could confidence in our currency and our monetary policy fall so far that the dollar would be replaced as the favorite global currency? More about that in a minute.

First, it's important to know that the dollar's status as the number one currency in the world is not currently conveyed by some international organization, nor is it voted on by heads of state. It is simply the easiest medium of international exchange, and has been since the Bretton Woods Agreement of 1944, when the United Nations agreed that an international foreign exchange rate system would help the reconstruction of countries devastated by the war. Soon after, the dollar –linked to the price of gold- was the standard, and foreign exchange reserves held in U.S. dollars have ranged from 59% to 70% since that time. Use of the dollar is voluntary, though.

If countries didn't generally agree upon an exchange currency, commerce would be an unmanageable scrum and global growth would suffer. The Bank of International Settlements (BIS) reports that there is in excess of $5.35 trillion traded in currencies *daily*. Imagine if every country traded with every other country using their own respective currencies, the value of which float all over the place. Hundreds of currencies, all potentially manipulated by their governments to gain trade advantages (if my currency is "devalued" our companies can export cheaper goods . . . if my currency raises in value, then our citizens can buy more of *your* goods). Having one dominant currency makes things much easier and helps global commerce and growth. And because the U.S. trades with our own currency, our transaction costs for international trade are just a little bit lower, too.

Not only does the stability of the dollar help international trade, but trillions of dollars of U.S. debt are purchased by foreign countries to hold in reserve for use in cross-border transactions, as a stable way to store value against their own currency fluctuations, and as a hedge against potential financial crises. This demand for relatively stable U.S. debt (China owns trillions), allows us to pay lower interest rates on this debt . . . if demand were lower we'd have to pay higher interest to entice buyers. So, that saves the U.S. billions of dollars in interest payments. In some respects, these low interest rates help U.S. consumers too, as you know.

The downside of dollar demand is that this demand can keep the value of the dollar higher than it might be otherwise, and a higher dollar hurts exports. Some financial writers suggest that our commitments to managing the stability of the dollar as a global currency cost us a couple of million jobs because we keep the dollar from drifting lower and potentially stimulating our export growth and reducing the trade deficit. Some would say that being the currency of the world is just not worth it.

Yet currency experts agree that the dominant status of the dollar will not change for a long time (decades). Peter Zoellner of the BIS states we could potentially see the U.S. share of international central bank reserves drop by 10-15% without threatening our role as the dominant reserve currency.

There really is no other currency to turn to even if there is a loss of confidence in the dollar and U.S. monetary policy. The euro looked like a possibility until the economic upheavals of the global financial crisis, and the EU is still at least 2 or 3 years behind us in terms of pulling out of their economic slump. Is the Chinese renminbi (the "yuan" is a denomination of their currency, the renminbi) a candidate? As large as the Chinese economy is, remember this is still a Communist country whose government continually manipulates their currency (devaluing) to make Chinese exports more competitive. They are not currently a serious contender to the mighty dollar.

What makes the dollar unrivalled is the depth of our financial markets (the Fed, the banking system, the openness and comparative transparency of our markets); the confidence in the value of our currency (even during the financial crisis, and the piling up of trillions of dollars of debt, countries still wanted to buy our dollars); the exchange convenience on the extensive global transactional network; and lastly – perhaps most importantly- inertia (John Williamson, Peterson Institute for International Economics). For a global currency market that transacts over $5 trillion daily, who really wants to shift to a new system, a new and untested currency? A wholesale change makes absolutely no sense. The dollar is here to stay for a long, long time as *the* international currency.

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But we are sometimes asked about the potential impact of a wholesale redemption of the trillions of dollars of bonds and Treasuries held by China, as an example. Wouldn't that throw us into a monetary crisis and drastically devalue the dollar? Surely that would hurt the economy and push inflation higher. However, both Williamson (Peterson Institute) and Eswar Prasad (International Monetary Fund) make the case that this would never happen. If China started redeeming their U.S. debt, the dollar *would likely* depreciate . . . so that as China sold back more debt they'd be getting paid dollars that were worth less and less, thereby reducing China's own wealth. Why would they do this? It's not a credible scenario. And where, in turn, would they reinvest these trillions, what safe haven could they turn to? In a sense, by owing trillions to China, we hold some very valuable cards.

Currency exchange, monetary policy, and international trade is complex. Investors rarely see the effects of currency fluctuations and manipulation, but that doesn't mean you shouldn't have a least some understanding of why things work the way they do . . . and why, for better or worse, the dollar will likely remain the dominant world currency for most of our lifetimes. Any contenders would really need to step up their game.

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