



## Politics and Economics of Global Currencies

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The Bretton Woods international monetary system that saw the light after the Second World War was a system of rules. The dollar stood at the center and countries pegged their currencies to that key currency. The US promised convertibility of dollars held by central banks into gold at a fixed price. The International Monetary Fund overlooked the system to make sure countries followed the rules.

Despite the fact that this was a rule-based system there was dissatisfaction among scholars about the way the system functioned. Numerous conferences were organized criticizing the functioning of the system and proposing ambitious reforms of the international monetary system. This was the time scholars' proposals, such as the creation of a new international money to replace the dollar, were actually implemented. The Special Drawing Rights (SDRs) were created. It never became important as an international currency though.

All this came crashing down in 1971-73. The Bretton-Woods system disappeared. Instead the new monetary “system” became one where rules disappeared and raw national power prevailed. Economists lost all interests in reforming the international monetary system. In this context it is interesting to see new books being published not on the system but on the politics and the economics of global currencies. Benjamin Cohen wrote a book on the politics of global moneys (Cohen(2019), and Eichengreen, Mehl and Chitu’s a book on the economics of international currencies (Eichengreen et al.(2018)).

Cohen’s book is very ambitious. It aims at developing a theory of the life cycle of global moneys. How do global moneys emerge? How do they come to maturity? And what determines their decline? These are important issues that are not always well understood. Benjamin Cohen is the ideal person to analyze them. His previous books have made of him one of the most respected analysts of the world of international money.

Benjamin Cohen introduces two concepts needed to understand the life-cycle of global moneys. The first one is the capabilities global money provides for a nation. This is the analysis of the different instruments an international money provides for a nation wishing to exert power in the world. As the world consists of many competing nations having a global money gives a nation additional options, thereby increasing its power.

The second concept, which is central in Cohen’s book is currency statecraft. An international money enlarges the set of options in exercising power, but that does not mean these options will be used. Currency statecraft is the art of making use of these options to achieve geopolitical objectives. Thus only countries with geopolitical ambitions will make the step towards developing a global money serving these ambitions. This then leads Cohen to develop a theory of currency statecraft that describes how nations fill in these ambitions.

Benjamin Cohen then goes on describing the three stages in the life-cycle of global moneys: The youth-stage, the maturity stage and the decline-stage. In the youth stage countries can be pro-active in promoting their currency to the international status. China comes to mind as the country that today is in this stage and actively promotes the international use of the Renminbi. This stands in contrast with West-Germany and Japan (before the 1990s) when these countries actively opposed the internationalization of their currencies. The key difference between China on the one hand and West-Germany and Japan on the other hand, is the intensity of the geopolitical ambitions of the former and the absence of such ambitions in the latter.

After the youth-stage comes the maturity stage. This is the stage enjoyed by the dollar today. It provides considerable benefits, both directly and indirectly. Directly, because it provides the “exorbitant privilege” to the US government to alleviate its budget constraint. Indirectly, because it provides an instrument of power to pursue geopolitical objectives that have little to do with money. The recent sanctions imposed by the US on Iran illustrate the position of the dollar in the international payments system. It has made it possible for the US to extend its jurisdiction outside the US and led many firms dealing with Iran to cut all their ties with that country. But as Cohen convincingly argues the power of the US is limited by the emergence of possible competitors in the world of international moneys and by the loss of credibility of the dollar as a generally accepted means of payments and unit of account when the US government abuses its monetary power.

This then leads to the final stage in the life-cycle of an international money, the decline. This stage is exemplified by the pound sterling. This decline is difficult to manage. It follows the economic, political and military decline of a nation, and leads to a lot of soul-searching. In a way it is inevitable, and as Benjamin Cohen points out this is also the likely fate of the US dollar.

The book of Eichengreen, Mehl and Chitu is a superbly well documented and original book. It contrasts with Cohen's book in analyzing the economic forces that drive the live-cycle of international currencies. The authors start by noting that the traditional theory of how international moneys arise, develop and decline is found wanting. This mainstream theory goes as follows. Money is characterized by network externalities. This means that it becomes more useful as more people use. A money that I am using on my own has no value. By adding more users the value of my money increases.

Network externalities typically lead to "corner solutions", i.e. situations where in equilibrium everybody uses the same money. This is the fundamental economic dynamics that leads to a dominant position of one money in international transactions. It led to the pound sterling becoming the dominant global currency in the nineteenth century until the First World War, and the dollar dominating the world after the Second World War.

The mainstream theory also implies that the decline of the dominant currency will typically be slow. The reason is that the incumbent international currency profiting from network externalities cannot easily be dislodged from its position by an upstart which initially does not enjoy the same network externalities. Only if the latter is supported by an overwhelming economic and political strength will it be able to take over from the incumbent. Eichengreen, Mehl and Chitu dispute this mainstream view. They start by noting that the dominant international currency is never so strong as to be alone. Even in the heydays of the pound sterling and the dollar, there were other currencies that had found a niche in the international monetary system. In fact in the last few decades this tendency for other currencies to compete with the dominant currency, the dollar, has intensified. The reason is that technological innovations have made it easier for users of money and portfolio managers to switch in and out of the dollar at declining costs. As a result, we should now expect to reach a state where several international currencies could co-exist.

Much of this exciting book is spent on presenting historical and econometric evidence sustaining the hypothesis of a world evolving towards a multi-currency outcome. This, of course, has important implications for the stability of the international monetary system. There is one view, often associated with Charles Kindleberger, saying that the world needs one global power and currency to stabilize the system. In such a world, the global power can have a stabilizing influence, by being the lender of last resort for the world. This is not based on some altruistic motive of the global power, but on enlightened self-interest. The US authorities, for example, realized that by being this stabilizing force, they also pursued their national interest which was enhanced by a stable international system.

In a world of increasing nationalism it is unclear whether any country will be willing to take on this responsibility. As a result, we will inevitably have to live with a multi-currency outcome. This also has advantages. When one of the key powers misbehaves it creates the possibility for the users of the international currency to switch to the another one.

How quickly we will stumble into this world of competing international currencies is unclear. The most likely candidate for such a competing international currency is the Renminbi. Both books are relatively optimistic about the prospects of the Chinese currency to become the international currency that will compete with the dollar. I am a little more skeptical.

One important contradiction in the Chinese geopolitical ambitions and the use of the currency as an instrument to realize this ambition is the following. A national currency can only become an internationally accepted currency

(medium of exchange and unit of account) if it is freely convertible into other currencies. There will be no appetite on the demand side for the use of a currency in international payments and financial transactions when this currency cannot be converted freely into other currencies. Obstacles that prevent such convertibility are also obstacles to the internationalization of any currency. At the same time, however, free convertibility leads to a significant loss of control over the financial flows in and out of the country. This can and often does disrupt borrowing and lending in a country. One characteristic of the Chinese economic model is the intrusive control the authorities exert on the direction and the size of financial flows to different domestic sectors. The domestic financial system in China is not one where market forces determine where domestic savings will be allocated. On the contrary decades of financial repression have made it possible for the Chinese authorities to guide these savings to those sectors and firms deemed important. Recently this authoritarian mechanism of channeling domestic savings to “worthwhile” projects and sectors has been enhanced and has made it possible, especially for the state-owned-companies to obtain cheap credit that they would not have obtained in a market system.

Thus, it appears that the objective of the internationalization of the Renminbi (requiring convertibility) and the authoritarian credit allocation mechanism within China conflict with each other. If China pursues its ambition to make the Renminbi an international currency the authorities will have to abandon their ambition to control the domestic allocation of credit. It is unclear today how the Chinese authorities wish to resolve this conflict. It seems to me that they are more likely to continue to pursue domestic financial control. As a result, it is unlikely that the Renminbi will challenge the dollar as an international currency soon. I also conclude that the future clash between the dollar and the Renminbi is not something to be expecting soon.

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Prior to joining LSE, **Paul De Grauwe** was Professor of International Economics at the University of Leuven, Belgium. He was a member of the Belgian parliament from 1991 to 2003. He is honorary doctor of the University of Sankt Gallen (Switzerland), of the University of Turku (Finland), the University of Genoa, the University of Valencia and Maastricht University. He obtained his PhD from the Johns Hopkins University in 1974. He was a visiting professor at various universities- the University of Paris, the University of Michigan, the University of Pennsylvania, Humboldt University Berlin, the Université Libre de Bruxelles, the Université Catholique de Louvain, the University of Amsterdam, the University of Milan, Tilburg University, the University of Kiel. He was also a visiting scholar at the IMF, the Board of Governors of the Federal Reserve, the Bank of Japan and the European Central Bank. He was a member of the Group of Economic Policy Analysis, advising President Barroso. He is a research fellow at the Centre for European Policy Studies in Brussels and the Centre for Economic Policy Research, London.



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