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# Will currency follow the flag?

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## Abstract

The 2008 financial crisis and its aftermath have triggered uncertainty about the future of the dollar as the world's reserve currency. China and other countries in the Asia-Pacific region have voiced support for a new global monetary regime. There are both economic and geopolitical motivations at the root of these challenges. Going forward, what will the future hold for the international monetary system? Crudely put, will currency follow the flag? This article addresses this question by considering the economic opportunity and geopolitical willingness of actors in the Pacific Rim to shift away from the current international monetary system – with a special emphasis on China as the most powerful actor in the region. While the dollar has shifted from being a top currency to a negotiated one, neither the opportunity nor the willingness to shift away from the dollar is particularly strong. The current window of opportunity for actors in the region to coordinate a shift in the monetary system is small and constrained. The geopolitical willingness to subordinate monetary politics to security concerns is muted.


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## 1 Introduction

For the past decade, there have been low-level debates about the future of the dollar as the world's reserve currency (Roubini and Setser, 2004; Levey and Brown, 2005; Morgan, 2008; Cohen, 2008). The 2008 financial crisis has forced that debate to the foreground, calling into question whether the Pax Americana of the post-Cold War era can be updated into the post-Great Recession era. China has pressed the United States on the dollar front. Prime Minister Wen Jiabao told reporters that he was concerned about China's investments in the United States: 'We have lent a huge amount of money to the US of course we are concerned about the safety of our assets. To be honest, I am definitely a little worried'.[1] China's central bank governor Zhou Xiaochuan (2009) proposed the creation of 'a super-sovereign reserve currency' patterned after the IMF's Special Drawing Rights (SDR) as a way to diversify away from the dollar. Zhou's proposal to reform the reserve currency was received positively in Russia, the developing world, the United Nations, and some IMF officials. By the fall of 2009, the dollar's decline against most major currencies prompted renewed concern about its utility as a store of value. A year into the Great Recession, gold reached its highest nominal price in history. This data point suggested a flight to precious metal away from the US dollar. These recent developments have reignited interest in reserve currencies among both scholars and policymakers (Bowles and Wang, 2008; Aiyar, 2009; Bergsten, 2009; Coats, 2009; Eichengreen, 2009; Helleiner and Kirshner, 2009; Schwartz, 2009).

The future of the dollar matters when assessing the future of Pax Americana in the Pacific Rim, for two reasons. First, a key reason for the dollar's continued hegemony in the international monetary system has been the strong security relationship between the United States and key capital exporters – Japan and the Gulf Cooperation Council states (Spiro, 1999; Murphy, 2006; Posen, 2008). While military alliances have clearly affected monetary politics, security tensions could deleteriously affect monetary relations. Geopolitical rivalry between China and the United States could lead to a rupture in international monetary relations (Layne, 2008; Economy and Segal, 2009). Second, the Asia-Pacific region is now responsible for more than two-thirds of all official currency

1 Quoted in Wines *et al.* (2009).

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reserves. The geopolitics of this region will play a pivotal role in determining the dollar's status in the future. What will be the future of the international monetary system? Crudely put, will currency follow the flag?

Using Most and Starr's (1989) framework, this article addresses this question by considering the *economic opportunity* and *geopolitical willingness* of actors in the Pacific Rim to shift away from the current international monetary system – with a special emphasis on China as the most powerful actor in the region. While the dollar has shifted from being a top currency to a negotiated one, neither the opportunity nor the willingness to shift away from the dollar is particularly strong. The current window of opportunity for actors in the region to coordinate a shift in the monetary system is small and constrained. The ability of countries like China to flex monetary power is more limited than at first glance. As for geopolitical willingness, the relationship between international monetary policy and international security is a weak one. The absence of bipolarity should permit international monetary cooperation to persist independently from any security tensions that might develop over the next decade. This has a mixed effect on the future of the dollar, however. On the one hand, it is unlikely that China or other rising powers will challenge the dollar's status in order to gain a strategic geopolitical advantage. On the other hand, US security alliances will not act as a backstop if economic calculations favor a shift in the international monetary regime.

This paper is divided into six sections. Section 2 discusses the significance of the reserve currency for the global political economy. Section 3 surveys the current international monetary system and why there are mounting concerns about the dollar's status as the reserve currency. Section 4 considers the ability of Pacific Rim economies to coordinate a shift away from the dollar. It concludes that there are high barriers to such a shift. Section 5 reviews the literature on the interrelationship between geopolitics and foreign economic policies. It concludes that geopolitics will only impinge on monetary relations under special circumstances. Section 6 concludes with a discussion of 'off the equilibrium path' possibilities that could disrupt the dollar's status in the medium term.

## 2 A primer on reserve currencies

All useful forms of money possess three key attributes: as a unit of account, a medium of exchange, and a store of value. Each of these

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properties has significant network externalities, so a single commonly accepted form of currency is a stable equilibrium outcome. By all three metrics, the dollar has functioned as the primary form of international money since the end of the Second World War. The most recent data from the International Monetary Fund and Bank of International Settlements show that the dollar is still the global reserve currency when compared with the euro. Most global commodity markets – including oil and gold – are priced in dollars, demonstrating its function as a unit of account. In 2008, 45% of international debt securities were denominated in dollars, and only 32% in euros (Eichengreen, 2009, p. 56). Additionally, the IMF reported in April 2008 that 66 countries used the dollar as an exchange-rate anchor; only 27 countries pegged to the euro. In 2007, the BIS found that 86% of international transactions were invoiced in dollars, demonstrating its utility as a medium of exchange. The euro was used in just 38% of transactions.[2] As a store of value, 64% of official currency reserves are held in dollars and dollar-denominated assets, compared with 26% for the euro (Carbaugh and Hedrick, 2009). The dollar outpaces all of its rivals in international bank deposits and the stock of international debt securities (Helleiner, 2008).

The reserve currency is independent of the exchange rate regime that governs the global economy. Exchange rates can shifted from fixed to floating to dirty floating while maintaining the same reserve currency – as has been the case with the dollar since the Bretton Woods conference.

Control over the reserve currency is a significant perquisite of monetary power in the global political economy (Andrews, 2005; Helleiner and Kirshner, 2009). For the United States, there are several benefits of producing the reserve currency. First, producing the reserve currency reduces the transaction costs in engaging in international exchange. When goods and services are bought and sold in dollars, US economic actors do not need to pay the transaction costs of converting their currency in order to make cross-border purchases. When goods are invoiced in dollars, American economic agents are better able to calculate their value than agents based in other countries. Many economists would argue that this transaction cost boils down to a simple exchange rate calculation (Baker, 2009). If prices are embedded into national markets, however, then it

2 Because two currencies are used in each transaction, this total adds up to 200%.

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remains the case that American actors do not have to translate price information. Other actors must bother with the translation.

The more significant benefit comes from seigniorage. Private and public actors in other national economies need to hold a certain amount of dollars in reserve in order to ensure the capital adequacy of their financial systems and to service demand for foreign exchange. These dollar holdings amount to an interest-free loan to the United States.[3] By stimulating additional demand for US government debt, seigniorage indirectly reduces the market interest rate for the US government to borrow money. The McKinsey Global Institute recently estimated the reduction of the US borrowing rate to be at least 50 basis points. They further calculated the net economic benefits of reserve currency status to range between $40 and $70 billion a year – or between 0.3 and 0.5% of America's gross domestic product (GDP) (Dobbs *et al.*, 2009) – a not insignificant sum.

The most important benefits for the United States are political in nature. Consider, for example, the US government's ability to issue debt denominated in its own currency. Because of this, the United States avoids significant exchange rate risk. Dollar depreciation has no effect on the ability of the US government to repay its debt. Foreign holders of that debt, on the other hand, must hedge against a decline in the dollar's value. In an extreme case, the United States has the option to inflate its debt burden downwards. During the depths of the 2008 financial crisis, the Federal Reserve pursued a modest version of this strategy by purchasing $300 billion in long-term debt securities (Drezner, 2009b).

For the United States, possessing the world's reserve currency is both cause and consequence of US economic hegemony. Historically, the dollar's status allowed the United States to displace much of its own economic adjustments onto other countries (Cohen, 2008; Mastanduno, 2009). It is no wonder that French President Charles De Gaulle referred to the 'exorbitant privilege' that the United States enjoys because of the dollar's status. In the 1970s, US Treasury Secretary John Connolly aptly put it to his colleagues, 'The dollar is our currency, but your

3 The United States only bears the cost of printing the money. If a foreign central bank holds Treasury bills instead of currency, then the holding amounts to a low interest rather than interest-free loan.

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problem'.[4] Some commentators believe that the benefits of possessing the reserve currency are overstated (Bergsten, 2009; Dobbs *et al.*, 2009). Nevertheless, to use Cohen's (2008) language, possessing the reserve currency gives a country both influence and autonomy in world politics. As Kirshner (2008) observes, an end to the dollar's reserve currency status would impose material constraints on the United States to finance its deficits, and lead to a major loss of prestige and power projection capabilities. Possessing the reserve currency is a classic example of what Gilpin (1981) referred to as the 'reputation for power' augmenting a state's actual capabilities.

## 3 The state of the international monetary system

In the decade prior to the Great Recession, concerns had been voiced about the future of the dollar (Roubini and Setser, 2004; Cohen, 2008). The creation of the euro a decade ago was the first political effort to create a rival to the dollar as a reserve currency. As the dollar has depreciated against the euro and other major currencies, its utility as a store of value has come into question. The biggest source of concern, however, has been the macroeconomic imbalances caused by the 'Bretton Woods II' nonsystem of exchange rates (Dooley *et al.*, 2003). In the wake of the Asian financial crisis, Pacific Rim economies consciously amassed sizeable foreign exchange reserves – so as to avoid having to go to the International Monetary Fund ever again during another crisis period. In pursuing this course of action, capital from these countries flooded into US asset markets, in order to acquire liquid hard currency assets. This jumpstarted what Federal Reserve chairman Benjamin Bernanke (2005) labeled a 'global savings glut' in 2003.

The macroeconomic effects of the global savings glut were significant. Capital inflows kept US interest rates low and asset prices high. This encouraged a decline in American savings, an increase in personal consumption, and an explosion in the current account deficit. Surging American aggregate demand, in turn, fuelled the export-led growth of the Pacific Rim and energy-exporting economies. Official creditors from these countries – central banks, sovereign wealth funds, and other government investment vehicles – purchased ever more dollars and

4 Both quotations come from Eichengreen (2008).

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dollar-denominated assets in order to prevent the appreciation of their national currencies vis-à-vis the dollar (Farrell *et al.*, 2008). Foreign purchases of US treasury bills and securities, Fannie Mae and Freddie Mac mortgage-backed securities, real estate, and equities all increased. These purchases contributed to the boom in asset prices, which further fueled American consumption, widening the trade deficit and reinforcing the cycle (Ferguson and Schularick, 2007).

The cumulative effects of the Bretton Woods II imbalances were sizeable. Consumption as a share of American GDP rose to an all-time high of 72%, while China's consumption as a share of GDP plummeted to a global low of 38% of GDP. The US savings rate turned negative, while Chinese savings approached 50% of GDP (Lardy, 2006; Eichengreen *et al.*, 2008; Roach, 2009). The US current account deficit peaked in 2006 at close to $800 billion, or 7% of GDP. This percentage vastly exceeded the previous peak of the US current account deficit in the mid-1980s (Mastanduno, 2009). By 2007, the US current account deficit equaled approximately 1.4% of *global* economic output, while China's current account surplus approached 0.7% of global GDP (Dunaway, 2009, pp. 15–16).

Even before the subprime mortgage crisis, the growth of these imbalances led many macroeconomists to predict a collapse in the dollar's value (Roubini and Setser, 2004). In purchasing so many dollars, sovereign investors had a powerful incentive to ensure that their investment retained its value – but they had an equally powerful incentive to sell off their dollars if it appeared that they would rapidly depreciate. This cost created a dilemma for central banks. Collectively, they had an incentive to hold on to their dollars, so as to maintain its value on world currency markets. Individually, each central bank had an incentive to sell dollars and diversify its holdings into other hard currencies. This fear of defection led to a classic prisoner's dilemma and the risk that these central banks will simultaneously try to diversify their currency portfolios poses the greatest threat toward a run on the dollar.

Bretton Woods II has survived the Great Recession (Dooley *et al.*, 2009). The stability of this arrangement in the future depends heavily on how much cooperation there is among the official purchasers of the dollar. It also depends on the attractiveness of other policy options – including the displacement of the dollar as the world's reserve currency. There is sufficient uncertainty on these questions for currency markets to

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be primed for a run on the dollar. Consider two examples. Back in February 2005, an official Bank of Korea report hinted at the possibility of diversification of its official currency reserves. That vague statement helped trigger a massive sell-off of dollars, causing the dollar to fall 1.4% against both the yen and the euro in a single day. Only after the Koreans issued a clarifying statement did dollar demand recover (Drezner, 2006). In October 2009, there was an unsubstantiated report in *The Independent* newspaper stating that Russia, China, France, and OPEC countries were meeting in secret to discuss invoicing oil in euros rather than dollars (Fisk, 2009). The dollar tumbled to a 14 month low in currency markets the week that story came out.[5]

In the wake of the crisis, China has now proposed a long-term replacement for the dollar as the global reserve currency. Beyond the white paper proposing a super-sovereign currency, the Chinese government raised the issue again at the June 2009 BRIC summit and the July 2009 G-8 summit.[6] Beijing concurrently adopted other measures to promote the internationalization of the renminbi. In the first half of 2009, the People's Bank of China initiated $95 billion of bilateral currency swaps with countries as diverse as Argentina, Belarus, and Malaysia.[7] China endorsed the expansion of the Chiang Mai Initiative, a set of bilateral currency swap arrangements among the ASEAN +3 countries, to $120 billion (Amyx, 2008; Grimes, 2009; Henning, 2009). Beijing allowed five trading cities, including Shanghai, Guangzhou, and Shenzhen, to settle cross-border payments in renminbi, and permitted two foreign banks to sell yuan-denominated bonds overseas. China agreed to contribute to the bolstering of IMF reserves, but through the purchase of IMF bonds denominated in SDR, a weighted basket of major currencies. In doing so, Beijing advanced its goal of generating alternatives to the dollar as a reserve currency.[8] Observers are viewing these moves in the broader context of Chinese foreign economic policy – which seems governed as much by geopolitics as economics (Drezner, 2009b).

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5 Healy and Keith (2009).

6 'China reiterates call for new world reserve currency', *Bloomberg News*, June 26, 2009; Parker and Dinmore (2009).

7 See People's Bank of China, 'Strengthen regional financial cooperation and actively conduct currency swap', press release, 31 March 2009, http://www.pbc.gov.cn/english//detail.asp?col=6400&ID=1299.

8 Davis (2009).

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The combination of the dollar's vulnerability and China's Hirschmanesque tactics on the foreign economic front has provoked concerns about the dollar's future from scholars and policymakers. Mastanduno (2009, p. 150) observes, 'America's partners in NATO are no longer the dominant holders of US dollars in reserve as they were during the cold war. The connection between dollar holders and security partners has been severed'. Roubini (2009) cautioned that, 'Sooner than we think, the dollar may be challenged by other currencies, most likely the Chinese renminbi'. In September 2009, World Bank President Robert Zoellick (2009) warned, 'The United States would be mistaken to take for granted the dollar's place as the world's predominant reserve currency. Looking forward, there will increasingly be other options to the dollar'.

In many ways, the Asia-Pacific region will be the pivotal group of actors on the future of the dollar (Cohen, 2008). Over the past decade, the Pacific Rim has gone from possessing one-third of the world's official currency reserves to possessing two-thirds. As the region becomes more institutionalized on issues pertaining to the global political economy, the possibility of a coordinated response to the dollar's vulnerabilities must be considered (Katzenstein, 2005; Amyx, 2008; Grimes, 2009). The Asia-Pacific region has certainly witnessed the most fervent efforts at institution-building in the past decade. The Asian financial crisis spurred the creation of a number of regional arrangements, including the East Asia Summit, Asian Bond Markets Initiative, and the ASEAN Plus Three meetings. What's noteworthy about these regional arrangements is the absence of the United States from all of them. The United States still maintains an active presence in East Asia through APEC, the ASEAN Regional Forum, the Six-Party Talks, and security alliances with Japan and South Korea. Most of the forward momentum in regional integration, however, does not include the United States (Feigenbaum and Manning, 2009).

The Democratic Party of Japan's ascent to power in 2009 could accelerate this trend. DPJ leaders have articulated a message similar to China about a need to rebalance away from American economic hegemony. If Japan and China were to articulate similar preferences about the dollar, the rest of the ASEAN +3 countries would not be far behind. This raises the key question – what are the conditions under which such a coordinated move would take place?

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## 4 The economic opportunity to shift currency regimes

The standard international political economy literature is of limited use in assessing the future of the dollar. To be sure, there is a large and robust literature on the political economy of international monetary relations (Broz and Frieden, 2001), and IPE scholars have certainly noted the link between the distribution of economic power and the allocation of reserve currencies (Gilpin, 1987). With a few exceptions, however (Bowles and Wang, 2008; Helleiner and Kirshner, 2009), there has been little work on the political economy of reserve currencies in particular. This is, in part, an empirical problem. The past few centuries of global economic history has witnessed a variety of international monetary regimes, but only two reserve currencies – the pound sterling and the dollar (Eichengreen, 2008). This amounts to one major switch in the reserve currency over the past couple of centuries of international economic history. Trying to develop and/or test models based on a single data point is fraught with methodological peril (Collier and Mahoney, 1996).

We can, nevertheless, rely on theories of coordination as a guide for developing expectations about the future of the dollar. The dollar is a 'negotiated' currency at this point (Strange, 1971) which means, to paraphrase Tennessee Williams, that the dollar depends on the kindness of strangers. Given the overhang of dollars held by central banks, sovereign wealth funds, and other government investment vehicles, there is some economic incentive to switch to a new reserve currency. If the rest of the world – and the Asia-Pacific region in particular – were to decide to coordinate around a different reserve currency, a switch would be possible.

When contemplating the future of reserve currency politics, one needs to assess both the opportunity and willingness of East Asian actors to switch away from the dollar (Most and Starr, 1989). The previous section suggests that the opportunity is present. A closer look, however, reveals the hard constraints placed on that opportunity.

The first and most obvious point is that even if US economic hegemony is waning, it nevertheless still exists. If one took a snapshot of the distribution of capabilities in the world in 2009, then the United States is still far and away the most powerful country in the world (Brooks and

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Wohlforth, 2008; Joffe, 2009). The US spends more on defense than the rest of the major military powers combined (and most of these countries are strong US allies). The US share of the global economy has hovered around 25% for the past decade – far larger than that of any other individual nation-state. Any measure of science, technology, or higher education outputs also reaffirms the United States as the most powerful country in the world. Historically, the United States is not only the current hegemon – the country controls a far greater share of the world's resources than most great powers of the past (Brooks and Wohlforth, 2008).

Even when an economic hegemon is on the decline, reserve currencies are remarkably persistent entities (Flandreau and Jobst, 2009). Compare and contrast the power transition between the United States and the UK and the reserve currency transition between the British pound sterling and the American dollar. The United States had overtaken the UK in terms of GDP as early as 1870 (Maddison, 1982). By the end of the First World War, America's GDP was demonstrably larger than Great Britain's. The depth of New York's financial markets and gold reserves outpaced London's. Despite America's economic and financial might, however, the dollar did not become the world's undisputed reserve currency during the interwar period. Even the most generous interpretation of the evidence suggests that central banks did not begin to diversify away from the pound sterling until six or seven years after the First World War (Eichengreen and Flandreau, 2008). The dollar did not become the undisputed world reserve currency until the 1944 Bretton Woods conference. It took the exogenous shock of a world war to force the necessary financial adjustments.

The network externalities of having a single unit of account and medium of exchange are massive. Every major study of currencies stresses the rewards from creating a single focal point currency (Kindleberger, 1967; Kiyotaki and Wright, 1989). A single reserve currency reduces the transactions costs of international exchange by ensuring a single unit of account. A common medium of exchange also reduces the political uncertainty that might exist with multiple reserve currencies. Eichengreen and Flandreau (2008) counter that the interwar global political economy sustained multiple reserve currencies, but this is a not terribly persuasive argument; the interwar period was also the peak of nonconvertible

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currencies and the nadir of international monetary cooperation (Simmons, 1994; Frieden, 2006; Eichengreen, 2008; Eichengreen and Irwin, 2009).

Previous work suggests that although globalization increased the rewards for coordination, the distribution of economic power and preferences will make macroeconomic policy coordination a rare occurrence (Drezner, 2007). The diffusion of economic power in the system makes coordination more difficult. A great power concert is a necessary condition for effective cooperation in macroeconomic policy. As the number of actors increases, however, the likelihood of creating a concert of common preferences among them necessarily declines (Axelrod and Keohane, 1985; Barrett, 2007; Cohen, 2008). Furthermore, while in the past coordination has been attempted between relatively like-minded regimes from the developed world, any new efforts at coordination will need to incorporate a more heterogeneous array of countries. Consider the BRIC economies – Brazil, Russia, India, and China (Wilson and Purushothaman, 2003). These economies are achieving great power status while still having low per capital incomes, which will likely contribute to greater preference divergence that could emerge among the great powers. Including the rest of the Asia-Pacific region merely heightens the heterogeneity of preferences and regime types.

Beyond the diffusion of power, the domestic adjustment costs of reserve currency adjustment will also make coordination much more difficult. The spread of democratization and nationalism across the globe has imposed serious constraints on the ability of governments to accept costly adjustments in return for greater cooperation in the global economy. The effect of these trends has been to multilateralize Robert Putnam's (1988) 'two-level game' problem. When all of the major actors have powerful domestic constituencies that increase the adjustment costs for international policy coordination, the bargaining core disappears (Drezner, 2007). Even the leaders of smaller and more fragile states face huge domestic political costs for accommodation. In the fall of 2008, for example, Iceland's financial system neared collapse. Even though Iceland was at the mercy of external official creditors, its government was leery of making the necessary policy adjustments because of domestic politics (Jónsson, 2009). If Iceland was this recalcitrant at making policy changes, the major economies of the Asia-Pacific region will be even more set in their ways.

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Consider China's adjustment costs in switching away from the dollar, for example. As the size of China's external portfolio increases, so have the Chinese leadership's domestic headaches. The Chinese elite is split between princelings and populists (Li, 2009). There is a fierce bureaucratic rivalry between finance ministry, central bank, and development bank officials – all of whom want to manage China's foreign exchange portfolio (Cognato, 2008; Shih, 2008). Domestic discontent has been brewing about China's foreign investment strategy.[9] Both officials and citizens debate whether holding so many dollars serves Chinese national interests (Wang, 2007). The political leadership has had to cope with the incongruity of investing trillions of government dollars in the developed world while tolerating significant pockets of domestic poverty. When these investments performed poorly, they faced fierce internal criticism. Officials at the China Investment Corporation received considerable domestic flak for their May 2007 investment in Blackstone, after that firm's stock value plummeted by 40%.

In this kind of domestic setting, a decision by China to switch away from the dollar would lead to a dramatic fall in the value of its sizeable portfolio of external reserves. Officially, China declared $1.95 trillion in hard currency reserves at the end of 2008, but that does not count holdings beyond the People's Bank of China. In all, Chinese state investors were estimated to possess roughly $2.3 trillion in US assets in September 2008, with approximately $1.5 trillion invested in dollar-denominated debt (Setser and Pandey, 2009). That figure has only increased in 2009. Any switch away from the dollar would cause that currency to fall in value – which would trigger concomitant losses to roughly two-thirds of China's holdings. Crudely put, a 10% appreciation of the renminbi would translate into a book loss of 3% of China's GDP in its foreign exchange reserves (Chin and Helleiner, 2008). Any financial losses from a switch away from the dollar – even if it was coordinated – would dramatically outweigh the losses from Blackstone.

The domestic political fallout would be equally great. In addition to anger at dollar losses, the Chinese leadership would have to cope with the effects of a dollar depreciation. Any appreciation of the renminbi would hurt the Chinese export sector. The only way for China to make up for that lost demand would be to boost domestic consumption.

9 Dyer (2009a,b).

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China has been well aware of this need in recent years, but has been unable to increase personal consumption (Lardy, 2006). Current projections have China's consumption remaining below 40% of GDP for the next 15 years; even if extraordinary policy measures are implemented, anticipated consumption levels are projected to remain below 50% (Woetzel *et al*., 2009). China needs global export markets to thrive, which means it would bear massive adjustment costs from letting the dollar depreciate.

Perhaps the hardest constraint on a concerted change in currency regimes is finding a focal point to replace the dollar. In order to engage in coordinated action, the key actors would need to construct or discover a new focal point around which to develop a reserve currency (Schelling, 1960). This leads to an awkward observation – the euro, the only truly viable substitute for the dollar, is not located in the region. It would be unlikely for the ASEAN +3 countries to agree to switch from the dollar to a new currency over which regional actors have no influence. This problem is compounded by the euro's weaknesses as a possible reserve currency. For example, the European Union has no consolidated sovereign debt market. This places a severe liquidity constraint on euro markets (McNamara, 2008; Posen, 2008). More importantly, the European Central Bank does not *want* the euro to become the new reserve currency. They have placed high barriers on any country joining the eurozone. In November 2009, ECB president Jean-Claude Trichet flatly stated, 'The euro was not created to compete with the U.S. dollar or to replace the dollar as the international reserve currency. . . . The ECB does not campaign for the international use of the euro'.[10]

Other alternatives are even less attractive. Candidate currencies beyond the euro – the yen, pound, Swiss franc, Australian dollar – are based in markets too small to sustain the inflows that would come from reserve currency status. The yuan remains inconvertible for now, and China's leaders will be reluctant to give up their control over the country's financial sector in the future. A return to the gold standard in this day and age would be infeasible – the liquidity constraints and vagaries of supply would be too powerful. Zhou (2009) has suggested using the SDR as a template for a super-sovereign currency, but this is an

10 Jean-Claude Trichet interview with *Le Monde*, accessed at http://ecb.int/press/key/date/2009/html/sp091117.en.html.

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implausible solution. As it currently stands, the SDR is not a currency so much as a unit of account (Aiyar, 2009). Even after the recent IMF authorization, there are less than $400 billion SDR-denominated assets in the world, which is far too small for a proper reserve currency. As one Chinese economist put it, the SDR is the Esperanto of currency options.

Luo Ping, a director-general at China's Banking Regulatory Commission, bluntly explained East Asia's predicament in 2009: 'Except for U.S. Treasuries, what can you hold? Gold? You don't hold Japanese government bonds or UK bonds, U.S. Treasuries are the safe haven. For everyone, including China, it is the only option'.[11] To paraphrase Winston Churchill, the dollar is a lousy, rotten reserve currency – until one contemplates the alternatives (Bordo and James, 2008; Eichengreen, 2009).

## 5 The geopolitical willingness to create a new currency regime

Beyond the coordination issues involved in a currency switch, there is the question of whether states have a strong geopolitical incentive to end the dollar's status. On the one hand, a large cluster of countries, including US allies, lament the 'hyperpower' of the United States. This suggests that the *realpolitik* balancing instinct would apply to currency politics as well as geopolitics. China, as the second most powerful state, is not closely allied with the United States, and would presumably have an incentive to augment its own power and legitimacy at the expense of the waning hegemon. Beijing's neomercantilist foreign economic policies suggest that the Chinese leadership would be willing to subordinate strictly economic criteria to security considerations (Liss, 2007/08; Fallows, 2008; Setser, 2008). At a minimum, China might view a switch in reserve currencies as a furthering of its effort to augment its own 'soft power' (Nye, 2005; Kurlantzick, 2007). Countries in the Asia-Pacific region might view a shift away from the dollar as one means to promote 'soft balancing' against US military power (Pape, 2005).

Despite China's rising soft power, its ability to charm the rest of the Asia-Pacific region into a coordinate shift away from the dollar *for geo-political reasons* would be a difficult task. Any metric of power is a

11 Quoted in Sender (2009).

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relative measure, and according to recent surveys, US soft power still outperforms China in the Asia-Pacific region (Whitney and Shambaugh, 2008; Wright, 2009). Furthermore, more aggressive Chinese 'soft balancing' against the United States would be likely to encourage a self-defeating countertrend – greater soft balancing against China. States on the Asia-Pacific periphery are likely to be more comfortable with a distant hegemon with a decent history of restraint than a local hegemon with a persistent history of territorial disputes (Walt, 1987; Wright, 2009).

On the currency question in particular, Beijing's post-2008 strategy of pegging the renminbi to the dollar has created tensions between China and other Asian exporters. The renminbi is strictly pegged to the dollar while other Pacific Rim currencies are pegged to a basket of currencies. Any fall in the dollar's value increases China's competitiveness at the expense of other exporters in the region. This forces other countries to either permit the appreciation in their own currencies (Japan), purchase more dollars to keep their currency from appreciating (ASEAN), or impose capital controls to forestall speculation about future appreciations (Taiwan). The situation likely triggers resentment against US macroeconomic policy – but the greater object of ire is China's reluctance to allow the renminbi to appreciate against the dollar (Wines, 2009).[12] This is not fertile ground upon which to build a geopolitical coalition against the United States.

There are also theoretical and historical reasons to doubt whether geopolitics significantly affects a rising power's currency diplomacy. Theoretically, without multilateral support, efforts at monetary statecraft have fallen short; the only exceptions are when the targeted state is a vulnerable ally of the primary architect of the influence attempt. Even with such support, however, the odds of success are long (Steil and Litan, 2006). Jonathan Kirshner (1995) reviewed past efforts to use financial power to subvert existing international monetary arrangements, and found no successful episodes. What he labeled 'subversive disruption' was next to impossible – because it inevitably involved a weaker actor taking on the most powerful actor in the system. Andrews (2005, p. 25) reached a similar conclusion: 'Among the central findings of our study are the substantial impediments to the efficient exercise of monetary

12 See also Murphy (2009), Brown *et al.*, (2009), and Beattie (2009).

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power as a deliberate instrument of economic statecraft. . . . The tools of monetary statecraft . . . are often too blunt to be effective when they would most be desired and too diffuse to be directed at particular targets without incurring substantial damage'. Drezner (2009b) reaches a similar conclusion.

Historically, it is questionable whether rising powers consistently use their monetary and foreign exchange policies to advance security interests. To be sure, security scholars and international relations theorists usually posit that security interests automatically trump economic concerns (Gilpin, 1981; Holsti, 1986; Mastanduno, 1991; Skålnes, 2000). The conventional wisdom in the IPE literature is that trade follows the flag (Gowa, 1994; Pollins, 1989a,b; Gowa and Mansfield, 1993; Keshk *et al.*, 2004). Similar results have been found with regard to FDI flows (Gupta and Yu, 2006).

What holds for trade and investment, however, does not appear to hold for monetary policy. Indeed, history suggests the absence of a correlation between *realpolitik* concerns and the degree of cooperation among monetary authorities. In the years prior to the First World War, central banking authorities cooperated across Europe to avert systemic crises even as foreign ministers engaged in balancing behavior on the continent (Frieden, 2006, p. 48). As Eichengreen (2008, p. 34) observes:

> In 1898 the Reichsbank and German commercial banks obtained assistance from the Bank of England and the Bank of France. In 1906 and 1907 the Bank of England, faced with another financial crisis, again obtained support from the Bank of France and the German Reichsbank. The Russian State Bank in turn shipped gold to Berlin to replenish the Reichsbank's reserves.

Despite heightened concerns about geopolitical rivalries, central bankers continued to act to preserve the status quo in international monetary relations. It was not until the 1911 Agadir crisis that this pattern of international monetary cooperation began to break down, and the Reichbank in particular began to hoard specie in preparation for armed conflict (Ahamed, 2009).

Looking at the current situation in geopolitical terms, China in particular and the ASEAN +3 in general appear to be pursuing a 'hedging' strategy rather than a revisionist strategy to topple the dollar (Grimes, 2009). This can be seen in China's approach to the United States and the

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region's approach to financial governance. While China has called in very public terms for a move away from the dollar, they have also issued repeated assurances that the dollar is here to stay for the short-to-medium run (Drezner, 2009b). Press reports suggest that China's technocrats are much more amenable to US macroeconomic policies in private consultations than they are in public discourse (Scheiber, 2009). This allows Chinese political elites to channel domestic frustrations with dollar politics while not disrupting the monetary status quo. Ikenberry (2008) argues that China has largely accepted – and profited from – the pre-existing financial rules of the game. China's tactics suggest that it is not prepared to challenge the dollar's hegemonic status at any point in the near future. Recent steps allow Beijing to lay the groundwork for a long-term challenge, while placating domestic pressures in the short term.

For the other countries in the region, the steps taken on economic governance also amount to a hedging strategy (Grimes, 2009). Institutionally, initiatives like the Chiang Mai Initiative have the potential to act as a possible substitute for the International Monetary Fund and other international financial institutions, creating the ability for Pacific Rim economies to forum-shop. Creating an exit option for the region enhances bargaining power within existing power structures (Krasner, 1991; Gruber, 2000; Johns, 2007; Drezner, 2009a). At the same time, these institutions remain embedded within the rules of IMF (Grimes, 2009). The Asia-Pacific region is prominently represented within the G-20 and the Financial Stability Board (*née* Financial Stability Forum). Countries in the Pacific Rim can agree on the need for expanded regional influence, and emergency measures in case the international monetary regime falls apart. Beyond this hedge, however, the countries of the region appear to be perfectly content to operate within the existing rules of the game – including the dollar's reserve currency status.

There is one cautionary note to this discussion. The theoretical and empirical record suggests that a bipolar distribution of power could lead to a breakdown of international monetary cooperation across the two poles. Theoretically, a bipolar distribution of power is most likely to lead to coherent and segmented blocs of countries (Waltz, 1979). It was during the bipolar era of the Cold War that foreign economic policies seemed to most strictly follow the flag (Ward and Hoff, 2007). If China's

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power approaches the United States without the presence of other possible poles, then a bifurcation of economic arrangements would be more likely. The rest of the Asia-Pacific region would then be faced with a choice of bandwagoning with the United States or China. Alliance politics suggests that the region would split their security allegiances rather than bandwagon *en masse* to one pole (Walt, 1987).

## 6 Conclusions and warnings

The precarious status of the dollar poses a threat to the Pax Americana in East Asia. In theory, a concert of powerful actors could coordinate a shift in the international monetary system that deemphasized the dollar. The Pacific Rim, with a burgeoning regional identity, could coordinate such a shift. This outcome, however, is not likely. The constraints on the opportunity to shift away from the dollar are formidable; if nothing else, there is no attractive alternative to the dollar as a reserve currency. The domestic adjustment costs of such a shift would also be formidable. The geopolitical willingness to challenge the dollar is also not terribly strong. History suggests that sustained monetary cooperation can coexist with rising security tensions. Unless and until the world shifts back to a bipolar distribution of power, geopolitical pressures for change should be muted. Countries in the Asia-Pacific region are pursuing a hedging strategy – but that is not the same as balancing against the United States. Currency, for now, is not following the flag.

Although it appears that currency politics can be kept separate from geopolitics, there are three possible pathways through which the current equilibrium could be disrupted. The first and most obvious is through a security crisis. As previously noted, monetary cooperation started to break down in the pre-1914 era after the Agadir crisis of 1911. If China and the United States were to have a militarized showdown over Taiwan, North Korea, or even Iran, then the calculations of all the salient actors might change. The interdependent nature of currency politics is such that if one of the major actors decided to subordinate their currency arrangements to concerns over national security, all of the actors in the region would likely follow suit. At that moment, the benefits of more autarkic economic policies would outweigh the network externalities of a common reserve currency. As previously noted, the likelihood of this

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happening increases as the distribution of power moves toward bipolarity.

Second, the tight coupling and complex interdependence between the United States and China will cause the incentive structures in monetary politics to more closely resemble the logic of nuclear deterrence. The balance of financial terror that exists under Bretton Woods II implies a peaceful coexistence, but at the same time it is a relatively nervous coexistence. Trembling hands – in the form of economic populism or bureaucratic rivalries – could trigger a cascade of inadvertent actions that ends with a currency war. This does not mean that the monetary equivalent of the Third World War will take place. It does mean that policymakers must be increasingly cognizant of that contingency.

Finally, the deteriorating US macroeconomic position might cause all of the actors in the region to force a shift away from the dollar. According to current US Congressional Budget Office (2009) projections, the ratio of US debt as a percentage of GDP will approach record levels before the year 2020. While increases in US domestic savings can absorb current increases in US government deficit spending, it is unlikely that domestic absorption can match the projected increase in deficit spending. If foreign purchases of US debt instruments increase, the incentive for the Federal Reserve to inflate its way out of America's debt quandary will increase – and the incentive for Asia-Pacific countries to find an alternative to the dollar also increases. Even if the geopolitical willingness of Asia-Pacific actors to switch away from the dollar remains weak, the economic willingness to switch might grow stronger with time.

In this scenario, the absence of geopolitical tensions could boost the chances of coordinated shift in currency reserves. America's allies in the region could maintain their security relationship but decide that the economic costs of adhering to the dollar have become too great. Ironically, it appears that the current system of dollar dominance will persist provided that geopolitical tensions do not become *too* important for policymakers – or not important enough.

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