Jonathan Kirshner

Bringing Them All Back Home? Dollar Diminution and U.S. Power

U.S. power is facing new macroeconomic constraints. They derive from a basic and generally underappreciated shift in U.S. engagement with the global macroeconomic order, which also complicates international politics. Since before WWII, the international monetary and financial system had served to enhance U.S. power and capabilities in its relations with other states. From the turn of the twenty-first century, however, underlying economic problems threatened to turn this traditional (if implicit) source of strength into a chronic weakness. The 2007–08 global financial crisis has increased this risk. The United States will likely face new constraints on its power from the crisis and from new complications managing the dollar as a global currency. Moreover, the unfamiliarity of U.S. elites and citizens in facing such constraints will play a crucial role in determining how severe they will be in practice.

Even before the global financial crisis, many observers anticipated a relative reduction in the dollar's role as an international currency. For a number of reasons, the crisis has served to accelerate that process, increasing pressure on the dollar and heightening its vulnerability. In particular, the discrediting of the U.S. economic model, especially in Asia, and the encroachment on the international role of the dollar from a number of sources, especially the Chinese Yuan (also known as the renminbi, or RMB) as well as the Euro, will present new challenges to the greenback and to U.S. macroeconomic management. This paper elucidates

Jonathan Kirshner is Stephen and Barbara Friedman Professor of International Political Economy at Cornell University, 2012–2013 World Politics Visiting Fellow at Princeton University, and author of *American Power After the Financial Crisis* (Ithaca: Cornell University Press, forthcoming). He can be reached at jdk5@cornell.edu. Earlier versions of this article were presented at Tobin Project meetings on Sustainable National Security Strategy.

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the likely international political consequences of these developments, for U.S. power in particular but also for international politics more generally.

The End of the Second U.S. Financial Order

The 2007–08 global financial crisis, the worst economic catastrophe since the Great Depression, was a fundamental disturbance of what I call the "Second Post-War U.S. International Economic Order."[1] The first order forged by the United States, the Bretton Woods system of 1948–1973, was based on an ideology that political scientist John Ruggie dubbed "embedded liberalism"—a market-oriented, internationalist philosophy, but one that was chastened by the failures of the Depression and therefore skeptical of unmediated market forces. The second order, however—the "globalization project" of 1994–2007—had as its touchstone the liberation of finance, both at home and abroad. This new order was based on a very different economic philosophy, one of "market fundamentalism." It was based on the idea that free and unsupervised markets, even financial markets, always know best and naturally provide the most efficient outcomes.

Encouraged by the industry and reflecting a new consensus among academic economists, the Clinton administration led a bipartisan charge to dismantle the Depression-era firewalls which had been designed to contain instability in the domestic financial sector. Key players in this effort were Treasury Secretary (and former Goldman Sachs co-chair) Robert Rubin, his deputy (and successor) Lawrence Summers, Senate Banking Committee Chair Phil Gramm (who would join the financial giant UBS immediately upon leaving the Senate), and Federal Reserve Board Chair Alan Greenspan. The efforts to withdraw both regulation and supervision of the financial sector were, if anything, accelerated by the transition to the Bush administration (coupled with continuity at Greenspan's Federal Reserve). The 1999 Gramm–Leach–Bliley Act codified many of these changes, including repealing the 1933 Glass–Steagall Banking Act that regulated and compartmentalized the reckless financial order which contributed so fundamentally to the Depression.

Dismantling existing regulations was only half of the great 1990s financial liberalization project. The other half was the fight *not* to supervise and regulate new and fantastically expanding sectors of the financial economy, which produced massive wealth and fueled the rapid growth of industry—but were inherent carriers of systemic risk. The interrelated phenomena of securitization (the repackaging, blending, and resale of bundles of financial assets such as mortgages) and the astonishing growth of trading in derivatives (any asset whose value "derived" from another asset, from simple futures and options to extremely complex risk and insurance dispersal exotica) forged the financialization of the

U.S. economy. These activities were largely unsupervised by an oversight and regulatory apparatus that was designed long before such products came on the scene.

A few voices raised concerns about these developments, such as the U.S. Government Accountability Office (GAO), which warned that "the size and concentration of derivatives activity, combined with derivatives-related linkages, could cause any financial disruption to spread faster and be harder to contain." The GAO was worried this could lead to "systemic crisis," and urged modernization of the regulatory structure. But its reports did little more than elicit a fierce industry backlash and massive lobbying effort, paving the way for the Commodity Futures Modernization Act of 2000 that prohibited the regulation of derivatives, including the credit-default swaps that would play a central role in the 2007–08 financial crisis.[2]

The rise of a Washington–Wall Street culture—abetted by a good-housekeeping seal of approval provided by academic economists—created the permissive environment of unsupervised securitization and the housing bubble. Bankers, politicians, and regulators became so enmeshed that the metaphor of the revolving door is inadequate—it looked more like a double helix, imprinting the shared DNA of efficient financial markets. This was also an era, as former chief economist for the IMF Simon Johnson argued, when Wall Street "translated its growing economic power into political power" and "the ideology of financial innovation became conventional wisdom in Washington." The financial sector invested $5 billion in the political process from 1998–2008.[3]

Not surprisingly in this environment, the U.S. financial sector became larger, more concentrated, and riskier. From 1980–2002, U.S. manufacturing fell from 21 percent of GDP to 14 percent, but finance (the biggest and fastest growing sector in the U.S. economy) increased its share from 14 percent to 21 percent. This was a remarkable transformation, especially when one pauses to remember that finance—like, for example, advertising—is supposed to serve the economy; it is not supposed to *be* the economy. But in 2007, finance accounted for 47 percent of U.S. corporate profits. And from 1981–2008, financial sector debt increased from 22 to 117 percent of GDP, the tip of an iceberg of risk that metastasized in the wake of deregulation.[4]

The Changing Balance of Power

The crisis is producing both material *and* ideational consequences. As a material phenomenon, it is creating new U.S. vulnerabilities and accelerating two pre-existing trends: reduced U.S international political capacity and the continuing emergence of China. What was novel about the 2007–08 crisis was not that it occurred—international financial crises are very common phenomena—but that for the U.S. economy, it "hit home." During the age of regulation in the 1940s–1970s, the United States experienced no major financial crisis. They only occurred (with regularity) in the unregulated 19th and early 20th centuries, and reemerged in the 1980s in the age of deregulation.[5] This crisis, then, is distinguished mostly by the fact that the United States was at its epicenter, and that it has born many of its costs. This is suggestive more generally of a new and unfamiliar level of U.S. economic exposure to external financial pressures.

Moreover, policy responses to the crisis have added to the underlying burdens and vulnerabilities that were already apparent in the U.S. economy. Essential emergency measures, like a flood of liquidity and a large injection of government spending, will present the formidable problem of how to dial them back in the coming years. Either the United States will fail to adequately do so, which would damage the long-term health of its economy (and thus its global power over time), or it will take bold measures to "put its house in order," which, among many other things, will imply reductions in both military spending and the U.S. appetite for international adventurism. In either event, the United States will emerge from this crisis in relatively worse international political shape.

One challenge to U.S. power concerns the trajectory of the dollar as an international currency. Although the dollar has served as a safe haven during this crisis, the longer-run prospects are more alarming. Because it has served as the world's "key currency," there are an enormous amount of dollars held abroad. Thus if a spark somewhere touched off a financial crisis which implicated the dollar, a tidal wave of dollars could flood the market, given the state of underlying expectations about its future value. In sum, the United States has emerged from the crisis with sluggish economic growth, exposed economic weaknesses, and a more suspect dollar.

If a future financial crisis implicated the dollar, a tidal wave of dollars could flood the market.

All this contrasts with China's relatively rapid recovery from the crisis, to date, which will eventually translate into greater military might as its defense spending will rise commensurately. (China's continued economic growth is however by no means guaranteed, raising a host of other important questions.) Differential rates of recovery from the current crisis have accelerated China's relative economic rise. If sustained, this will have profound *political* consequences. China is now the world's second-largest importer, taking on over $1 trillion worth of other countries' goods each year. As a result, China's status and influence have been enhanced. States that trade with China will consider how their foreign policy decisions might affect their relations with Beijing.

Beyond these changes to the balance of power and relative political influence, ideational consequences of the crisis will also affect world politics. Venerable old banks were not the only things that came crashing down in 2007–08—the legitimacy of the Second Post-War U.S. Order also collapsed. Even if one is inclined to reject the view that the U.S. model of uninhibited finance was flawed, the following three propositions are uncontroversial and consequential: (1) for much of the world, the global financial crisis was the second major financial crisis within ten years (most notably, for many, following the 1997 Asian financial crisis); (2) the United States was the epicenter of the crisis; and (3) important international actors do not share the interpretation of the crisis implied by U.S. policy.

In particular, the U.S. response to the crisis suggests that the "market fundamentalist" approach still holds sway. From this perspective, the global financial crisis was a "black swan"—a rare and unpredictable event. Lightning sometimes strikes, at times causing great destruction, but the financial system is about as safe as we can practically expect it to be. Modest tweaks or reforms could make the system even safer, but the underlying philosophy remains that finance is essentially efficient and self-regulating.

This interpretation contrasts with what I would dub a "KKM" perspective, named after John Maynard Keynes, Charles Kindleberger, and Hyman Minsky: these economists argued that financial markets, especially ones left to themselves, were prone to crisis. This view holds that financial crises are common throughout history, and invited by unregulated, unsupervised financial systems. This interpretation implies that the U.S. financial-economic model of the 1990s is flawed and in need of fundamental reform. I would note that KKM clearly has history on its side,[6] but it does not matter who is right for this discussion; it matters that now, after the crisis, a disagreement exists—with different actors holding pointedly different ideas about how to organize the financial economy. Prior to the crisis, the U.S. financial model was broadly accepted as the only game in town; that is no longer the case.

Divergent Paths Ahead

The U.S. push for liberated finance from the early Clinton years—both at home and abroad—was a purposeful, political project, designed to maximize U.S. comparative advantage and further enhance its geopolitical primacy. The style of that push, however, primed actors throughout the world to push back when given the chance—not just in Asia, but in Latin America, Russia, and elsewhere. The United States and its ally, the IMF, not only encouraged financial liberalization—they insisted on it. In the mid-1990s, the IMF moved to force member states to completely eliminate their capital controls (despite a lack of evidence to support it as appropriate economic policy). Bilaterally, the United

States was, if anything, even more aggressive. In 1995 for example, during negotiations for a Free Trade Agreement with Chile, Treasury representatives insisted that elimination of Chile's modest, innovative, market-friendly controls on short-term capital inflows must be included as a condition of the deal. In 1996, as Korea sought membership in the Organization for Economic Cooperation and Development (OECD), the United States insisted that Korea speed the pace of financial deregulation and provide increased access for U.S. firms.[7]

The IMF also embraced the ideology of financial liberation: on the eve of the Asian financial crisis, it declared that "international capital markets appear to have become more resilient and are less likely to be a source of disturbances."[8] But the U.S.–IMF push in the '90's corresponded, not coincidentally, with an increase in global financial instability, including the Asian financial crisis. Sparked by a currency crisis in Thailand in July 1997, an international financial crisis quickly and unexpectedly spread throughout the region, engulfing the Philippines, Malaysia, Indonesia, Hong Kong, and astonishingly South Korea, which announced in November 1997 that it had no choice but to turn to the IMF for a rescue package or it would face national bankruptcy.

This crisis, and the U.S.–IMF reaction to it, exposed an ideational and political fault line at the foundations of the U.S. system. In Asia and elsewhere, the crisis was easily recognized as a classic international financial crisis. But a different narrative held sway at the IMF, in Washington, and on Wall Street. In those quarters, blame rested squarely on the Asian economies. IMF accounts were typically myopic, not to mention amnesic, placing blame exclusively on the domestic economic policies of states whose economies and macroeconomic management the Fund had only recently been touting. Similarly, Greenspan placed the blame entirely on "poor public policy" within the affected states, and Summers argued that, if anything, the IMF should "accelerate" rather than "slow the pace of capital account liberalization."[9]

Much of the world disagreed with that assessment (including Japanese and Brazilian representatives at the IMF), but although the drive to amend the IMF's charter stalled in the wake of the Asian crisis, the underlying philosophy continued to hold sway at the Fund and in the United States. In 2003, completing Free Trade Agreements with Chile and Singapore, the United States demanded (over the vociferous objections of its counterparties) clauses in these trade treaties that each country renounce the right to introduce any form of capital controls. What this had to do with free trade, whether it is remotely wise policy, and that these were instruments the states in question did *not* want to give up were of little concern to U.S. negotiators.[10]

In Asia and elsewhere then, a defining attribute of the 2007–08 global financial crisis is that it came on the heels of the 1997–98 Asian crisis. Whereas the U.S. (non)response to the crisis (modest, qualified, and contested regulatory reforms, as well as the absence of any efforts to inhibit the size or concentration of the financial sector) suggests a belief that the crisis was epiphenomenal, much of the rest of the world views the crisis as a "learning moment"—the valedictory lecture in a long and difficult study demonstrating that unbound finance does not work.

The current crisis, then, has delegitimized the culture of U.S. capitalism, especially as it applies to finance. This will affect both state choices and international politics. John Ikenberry and Charles Kupchan have argued that "socialization"—the embrace by elites in secondary states of the substantive beliefs of a great power—is an important source of influence for a hegemon.[11] The coming years will witness the flip-side of that phenomenon—the likely *erosion* of that influence, as others come to reject the ideas which they once embraced or at least tolerated. With this legitimacy reversal, continuity in the United States and change elsewhere will contribute to a "new heterogeneity" of ideas about finance. States will commonly have divergent preferences about the global financial order, reducing U.S. influence and making cooperation on the governance of money and finance more problematic. In particular, many states will search for ways to insulate themselves from the dangers of unmediated global finance.

> The global financial crisis has delegitimized the culture of U.S. capitalism.

New Thinking in China

Prior to the global financial crisis, elites in China anticipated future RMB (Yuan) internationalization. But the dominant position of the dollar, the emergence of the Euro, and the fragility of China's sheltered domestic financial sector tempered expectations about how quickly the RMB might take its place as an important international currency. In fact on the eve of the 2008 crisis, observers agreed that "China's power in the international financial system, certainly growing, should not be overestimated."[12] Nevertheless, China's continued economic growth and massive holdings of dollar assets assured that, at the very least, discussions of the country's role as a potential monetary powerhouse would take place. As a long-term project, Beijing could envision the day when the Yuan would be the currency of choice in East Asia, a prospect that would further enhance China's political leadership and influence in the region. In the wake of the crisis, that timetable has been accelerated. A new and important motivation has also emerged—to establish some distance from the dollar, and to present a model of economic governance that offers some alternative to radically unmediated global finance.

China has always been wary of exposing itself to international capital markets, and understands that its controls spared it from the Asian financial crisis as well as other tumult since the mid-1990s. From the early 2000s, China embarked on a cautious path that accommodated controlled RMB appreciation and modest movements toward financial liberalization. But the global financial crisis provided a new impetus to promote the Yuan, while also, crucially, altering visions of the ultimate path. By exposing profound flaws in the U.S. model, the crisis elicited what might be called "buyer's remorse" in Beijing—China regretted its development model that had bound it so tightly to the U.S. economy and made it such a stakeholder in the dollar.

Buyer's remorse also reflects greater disenchantment with the way Washington has managed the dollar and its role in the international financial system more generally, two things about which Chinese observers are increasingly critical. These reassessments have contributed to a desire, in China and elsewhere, to find some insulation from anticipated future instability caused by U.S. mismanagement, and a desire to reform the global macroeconomic order. Economists in China reflect the view widely held among elites there that "only by eliminating the U.S. dollar's monopolistic position" can the system undergo reform. Many see RMB internationalization as necessary to reform and pluralize the international monetary system. A multiple currency system would reduce the influence of the dollar, contribute to systemic stability, increase China's voice, and provide some insurance against a dollar crisis. Nor are politics far behind: Li Ruogu, Chairman and President of the China Export–Import Bank, argues that U.S. policies have forced others to adjust "in accordance with the needs of the U.S. dollar."[13]

> The consensus Chinese view is that a multi-reserve currency era ought to replace the dollar order.

On March 23, 2009, Zhou Ziaochuan, Governor of the People's Bank of China, delivered a speech on "Reform of the International Monetary System." Nominally a call for a greater role for the SDR (the composite reserve asset created by the IMF), the Governor's statement was properly understood as a challenge to the dollar. As seasoned observers have argued, the speech reflects "the consensus Chinese view . . . that a multi-reserve currency era is coming, even if only gradually, and that it would be in China's strategic interests to promote such a scenario." Publications by Chinese elites and academics increasingly illustrate this perspective.[14]

Barriers remain to the emergence of the RMB, in particular the extent of the weakness and discomforting opacity of Chinese banks as well as of its domestic financial sector more generally, which raise doubts about the extent to which the Yuan is ready to step into the role of a major international currency.[15] Nevertheless, after the crisis, Chinese leaders decided to step up the pace of RMB internationalization, promote regional monetary cooperation, and encourage reform of global monetary management.[16] Notably, there is both an increase on the *supply side*, China's willingness to have the RMB deployed in a greater role internationally, and at the same time a clearly increased *demand*, a desire by states to find ways to transact business that do not bind them tightly to (or at least provide some diversification away from) the dollar, the U.S. financial model, and the U.S. economy.[17]

The signature move in China's new promotion of the use of the Yuan has been the bilateral currency swap. Such agreements allow China and its trading partners to settle their trading accounts without moving in and out of dollars. China's trading partners, of which there are many, welcome such pacts—the People's Republic is the world's second-largest importer and the most important trading partner for an increasing number of major economies, who share most if not all of China's motives in diversifying away from the dollar.[18]

In 2011, more than 9 percent of China's total trade was settled in Yuan, up from less than 1 percent the year before. In addition to its expanding roster of swap agreements, and the increasing (if still very modest) international use of the RMB in some country's foreign exchange reserves, China is also taking advantage of the distinct status of Hong Kong, permitting some local banks there (and Chinese banks based in Hong Kong) to issue RMB-denominated bonds. In sum, actions taken by both China and its economic partners suggest the pre-positioning of an apparatus which would support the emergence of the Yuan as the key currency in Asia.[19]

Encroachments on the Dollar

It should be remembered that it is not just the RMB that will be encroaching on the dollar, nor is it solely actors in Asia that will seek greater insulation from potential U.S. financial instability. Europe is certainly down, but not out, and in the longer run the Euro—possibly with China's quiet support—will resume its encroachment on the dollar's international role. Europe's own troubles have certainly exposed the weaknesses of the Euro as a potential peer competitor to the dollar, a status that the European currency seemed close to achieving before the global financial crisis exposed its own problems. And to a considerable extent, Europe's crisis has handed another get-out-of-jail-free card to the profligate dollar, left again as the only game in town.

But dollar-watchers ought to keep three troubling factors in mind: first, the economies of United States and the EU are deeply enmeshed—Europe's struggles are bad for the U.S. economy, which is bad for the dollar. Second, should Europe's sovereign debt crisis worsen, the exposure of U.S. financial institutions should not be underestimated. Third, the crisis will almost certainly force the EU into a "corner solution"—forward or backward—and in either case, the Euro is likely to emerge as an even stronger player on world markets. Again, in a relative sense, this can only come about at the expense of the dollar's reach.

Geopolitical Consequences of Relative Dollar Decline

What does it matter if the international role of the dollar comes under pressure? There are two distinct types of challenges faced by states managing international currencies in *relative* decline: (1) the loss of benefits associated with issuing international money, and (2) the difficulties associated with supervising a currency experiencing a contraction in its global use.[20] As a practical matter, the principal consequences of international currency diminution include pressure on defense spending, reduced macroeconomic autonomy (and thus the ability to finance ambitious foreign policies), vulnerability to currency manipulation, and greater exposure to debilitating financial distress, especially during times of international political crisis. In contemporary politics, these difficulties are likely to be exacerbated by increased disagreement and contestation among states over the politics of international monetary relations and global financial governance.

Eroding Global Power

The main perks of issuing a "key" international currency are (1) autonomy and flexibility of balance of payments and (2) structural power. With regard to the former, the United States generally underappreciates how much the special place of the dollar has allowed Washington to shake off the (often costly) burdens of macroeconomic adjustment, and essentially dump them on others.[21] (For example, in 1971, when pressure on the dollar might have led to painful deflationary measures at home, the United States instead changed the rules of the game, ending the Bretton Woods system and forcing others to adjust their policies.) The United States has also been able to sustain deficits on its international accounts that other states could not have, and to adopt economic policies that, attempted elsewhere, would have been overwhelmed by a "disciplinary" response from international financial markets. The erosion of these perks will circumscribe U.S. power and autonomy, and fights over the burdens of adjustment—the normal stuffing of international monetary politics—will become a more common and salient feature of U.S. foreign policy.

The dollar-centric international system has also rewarded the United States with structural power. Structural power is not easily measured, nor obviously "coercive," but reflects, in the words of international relations scholar Susan Strange, "the power to decide how things shall be done, the power to shape frameworks within which states relate to each other."[22] Structural power also affects the pattern of economic relations between states and their calculations of political interest. States that use the dollar (and especially those that hold their reserves in dollars) develop a vested interest in the value and stability of the currency. Once in widespread use, the fate of the dollar becomes more than just a U.S. problem—it becomes the problem of all dollar holders.

A relative contraction of the dollar's international role, then, would reduce both the "hard" and "soft" power the United States previously enjoyed—its coercive power enhanced by greater autonomy and its structural power implicitly shaping the preferences of others. It would also present new challenges and constraints.

Challenges of Relative Decline: Prestige and the Overhang

Were some dollar diminution to take place, the United States would face additional burdens in the costs associated with managing a currency in relative decline. For issuers of once-dominant international money, those new difficulties arise from what can be called the "overhang" problem, and from a loss of prestige.

The overhang problem arises as a function of a currency's one-time greatness. At the height of its attraction, numerous actors are eager to hold international money—governments for reserves, and private actors as a store of value (and often as a medium of exchange). But once the key currency is perceived to be in decline, it becomes suspect, and these actors will, over time, look to get out—to exchange it for some other asset. The need to "mop up" all this excess currency creates chronic monetary pressure on the once great currency; and macroeconomic policy will take place under the shadow of the past excess.[23]

The loss of prestige is also a crucial consequence of managing a currency in decline. Prestige is a very slippery concept, but it finds a home in monetary analysis under the rubric of credibility, which is generally acknowledged to play a crucial role in monetary affairs (even if it, too, is not easily measured). The unparalleled reputation and bedrock credibility of the key currency during its glory days is a key source of the power it provides. The willingness of markets to implicitly tolerate imbalances in accounts and impertinent macroeconomic politics which would not be tolerated in other states rests on these foundations.

The loss of prestige and reduced credibility (which the challenge of the overhang exacerbates) imposes new costs on the issuer of a currency in relative decline. Whereas in the past, the key currency country was exempted from the rules of the game—that is, placed on a much longer leash by international financial markets than other states—the opposite becomes true. With eroding prestige and shared expectations of monetary distress, market vigilance is heightened and discipline imposed more swiftly by the collective expectations of more skeptical market actors. A presumption of confidence is replaced with a more jaundiced reading of the same indicators, and the long leash is replaced by an exceptionally tight choker.

Some of these problems can be illustrated by historical analogies. The experience of the British pound in the decades following World War II offers one, demonstrating the challenges faced by an international currency under pressure. In the 19th and early 20th centuries, sterling served as the international currency of choice, and the pound's key currency status enhanced British power. But eventually, the management of sterling-in-decline became a vexing problem for British authorities, complicating economic management and exacerbating its chronic financial crises in the 1960s. The 1956 Suez Crisis truly showed the constraints of financial fragility: Britain and France invaded Egypt in order to seize the Suez Canal (and, hopefully, bring about the overthrow of President Gamel Abdel Nasser), but Britain was forced to abort the operation-in-progress. A run on the pound had become overwhelming, and the country did not have adequate reserves to save the currency on its own. In exchange for assistance from the United States and the IMF, the British agreed to an immediate cease-fire and prompt withdrawal from the Suez Canal zone.[24]

The 1956 Suez Crisis truly showed the constraints of financial fragility.

Suez was a flashpoint, but the crisis also underscored a fundamental new economic inhibition on the exercise of British power. Its suspect and vulnerable currency was routinely rocked by crises throughout the 1960s, which each time required spending cuts to shore up confidence in the economy, cuts that inevitably affected the military. Crisis-induced defense cuts in 1966 and 1967 eventually forced the country to reluctantly abandon its military role "East of Suez." This yielded phased withdrawals from Singapore, Malaysia, and the Persian Gulf. Neither devaluation (in November 1967) nor even the shift to floating exchange rates in the 1970s eliminated these chronic pressures. In 1976, a financial crisis forced Britain to seek help from the IMF, which insisted on still further cuts to domestic spending—including, of course, defense spending—enacted over the strong objections of the armed forces.

There are, of course, fundamental differences between post-war sterling and the contemporary dollar. But as a more extreme case, the British experience helps to expose and magnify the mechanisms by which currency diminution can affect national security. The politics of austerity—everywhere—will not spare military budgets, especially in peacetime and especially if such budgets appear large. Generally, a currency in decline faces increased and more skeptical market scrutiny, especially during moments of international crisis and wartime. Markets tend to react negatively to the prospects for a country's currency as it enters crisis and war, anticipating increased prospects for government spending, borrowing, inflation, and hedging against general uncertainty.[25] In that sense, the Suez analogy is not inappropriate. Nor was this an isolated incident—weak currencies make for timid states.

This axiom is well illustrated by the experiences of interwar France, a case that offers something of a laboratory for the national security consequences of currency weakness. In this instance, the franc came under withering pressure somewhat "voluntarily"—that is, domestic politics in France enforced an almost obsessive fixation on "defending the franc," which yielded deflationary monetary policies and constant pressure to cut the budget, with inevitable consequences for defense spending.[26] From 1930–1933, France cut defense spending by 25 percent. The 1930 level of military spending would not be reached again until 1937. Between 1933 and 1938, German defense spending practically tripled France's, and during roughly the same period, real military spending in Germany increased by 470 percent; in France, only 41 percent. Pressure on the franc routinely provided the major impetus for new rounds of deflation and budget cuts, and repeatedly new weapons programs and efforts at modernization were the first, easiest place to find savings from the defense budget.[27]

A commitment to maintaining the convertibility of the franc into gold at the level established in 1928, even more than the budget cuts, circumscribed French foreign policy. In 1933, the Bank of France explained that it was "resolved to consent to no measure whatsoever that could again endanger the stability of the franc." This contributed to France's sluggish response to Germany's rearmament, which was clearly understood in France by the end of 1932. The constant threat that a financial crisis would force the franc off gold paralyzed French leaders and contributed to a conciliatory bias in French foreign policy. Adherence to orthodoxy in France required, if not appeasement, something very close to it. France responded passively in the mid-1930s to numerous German provocations, as the threat of capital flight reinforced the policy of appeasement. This was seen most clearly in March 1936, when Germany, in violation of the treaty of Versailles, remilitarized the Rhineland. Any French response, such as the mobilization of its armed forces, would have exposed the franc to considerable market pressure. One student of the crisis observed that "Hitler and the rest of the world knew" that the French government would "above all . . . do nothing that would endanger the franc." Mobilization would have led to an immediate "full-scale monetary crisis" and would have "exposed the virtual bankruptcy of the French treasury and toppled the franc." A sensitivity to financial fragility guaranteed French inaction.[28]

The twenty-first century United States is not post-war Britain, nor is it inter-war France. But the experiences of those countries provide important insights into the types of challenges faced by a country attempting to navigate its grand strategy while nursing a suspect currency. Reduced autonomy, eroding structural power, vanishing prestige, and a growing overhang problem all suggest a challenging general macroeconomic context for U.S. power in the coming years.

New Vulnerabilities

The overextended dollar might also leave the United States vulnerable to economic coercion by other states. There is a real threat here, though one less apocalyptic than the suggestion that China might threaten to dump its enormous dollar holdings as an act of political coercion against the United States. This possibility is severely circumscribed by the fact that it is not in China's interest to do so, leaving this as a mostly empty threat.[29] China now has, as I have argued above, "buyer's remorse" with regard to its vast dollar holdings. But it did not accumulate those dollar assets as an act of philanthropy, and it currently finds itself as a major stakeholder in the future of the dollar and the health of the U.S. economy.

The overextended dollar might also leave the U.S. vulnerable to economic coercion by other states.

China would be a big loser in a confrontation that undermined either the greenback or U.S. consumer demand. Despite its remarkable record of economic growth, China's economy has visible fragilities. Significant dollar depreciation would be a blow to its economy; a collapse in the dollar that reduced U.S. demand for imported goods would be a disaster. Thus China could conceivably dump its dollars, but this would be the economic equivalent of the nuclear option. It is possible to imagine scenarios, especially regarding confrontations over Taiwan, where China might try and engage in dollar brinksmanship or even pull the currency trigger—but short of that, China's vested interest in the dollar undercuts the potential political advantages of such a gambit.

This does not, however, leave the dollar in the clear. China has a more subtle lever of monetary power at its disposal—it has the capacity to modulate the rate at which it acquires dollar assets, as well as the ability to manipulate the timing and publicity associated with rebalancing its reserve portfolio (an effort already underway). This channel of influence is more of a one-way street than threats of dumping. A more confident—or more aggrieved—China might use this more subtle technique of monetary power to get the attention of the United States during moments of political conflict.

Although the circumstances are (again) notably different, this capacity is parallel to the Franco–British monetary relationship in the late 1920s and early 1930s. In that period, the international monetary system essentially gave France the ability to draw gold from Britain at will. France rather self-consciously used this power to try and push Britain around whenever the two states disagreed on important international political issues. If Sino–U.S. relations deteriorate over economic or international political issues, it is likely that U.S. macroeconomic stability will be ruffled by China shuffling its dollar cards, even if it never folds them. Once again, even though the circumstances are quite distinct, the lessons are relevant—and alarming. France did not hesitate to resort to the exercise of monetary power (and it would be naïve to assume that China would abstain from the practice). France's efforts at monetary diplomacy ultimately backfired, and contributed to the collapse of the international financial system and the Great Depression—a reminder that even though China has every incentive to avoid undermining the world economy, intentions are not always enough to prevent costly blunders.

Much of the learning from the global financial crisis is taking place *outside* the U.S.

New Heterogeneity Abroad: Paralysis at Home?

Before the 2007–08 financial crisis, trends at home and abroad suggested new macroeconomic constraints on U.S. power. Assuming continuity in these underlying factors, that crisis has accelerated those underlying trends and left the United States more vulnerable to the possibility that macroeconomic factors will inhibit, rather than enhance, its capabilities on the world stage—a reversal of the experiences of the past seventy years.

The global financial crisis has presented (like the Great Depression and the inflation of the 1970s) a "learning moment" in world politics, but much of that learning is currently taking place *outside* of the United States. That lesson is that completely unbound finance is dangerous, and does not work, and that the U.S. model is disreputable. The emergence of a new heterogeneity of thinking about money and finance will mark the end of the Second Post-War U.S. Order. States will increase their demand for autonomy and insulation from global financial

New thinking about money and finance will mark the end of the Second Post-War U.S. Order.

instability, and due to ideological shifts and the acceleration of underlying material trends, U.S. power and influence will be relatively diminished in this new environment.

In addition to changes to the balance of power and political influence, these developments will also contribute to more acrimonious and chronic macroeconomic squabbling between states, which will place additional pressure on the management of the dollar. The underlying problem is that, in general, monetary cooperation is inherently difficult. The natural functioning of the international economy routinely generates pressures on states that require policy responses which affect interest rates, exchange rates, and government spending—involving costs that can be quite high and politically unwelcome. Not surprisingly, states invariably seek to shift the burdens of these adjustments abroad. (Much of Europe's current crisis is a fight over how to distribute the burdens of macroeconomic adjustment.)

Typically, it takes a confluence of exceptional factors for monetary cooperation to be sustained, each of which mitigates the costs of those burdens. A concentration of monetary power can help foster cooperation, because a hegemon can take on a disproportionate share of the costs of adjustment, or it can supervise, police, and enforce arrangements about the nature of adjustment. Ideological homogeneity can also foster cooperation by giving a cloak of economic legitimacy to the economic distress associated with adjustment. And shared, salient security concerns can increase the willingness of partners to bear the costs of adjustment, because they care more about the security situation.

Note that in contemporary international politics all of these variables are moving in the "wrong" direction. U.S. relative power (and monetary power) is in relative decline. There is a new heterogeneity of ideas about money and finance. And the security interests of key players at the monetary table have not been this divergent (if not necessarily oppositional) in over a century. This last change is particularly stark. Every major effort to reconstitute the international monetary order in the second half of the twentieth century was undertaken by the United States and its political allies and military dependencies. That is no longer the case. The United States will find it difficult to simply shrug off the burdens of macroeconomic adjustment (which will inevitably present themselves) onto others. This will compound the new U.S. sensitivity to external constraints.

The key word here is *new*. It is not just that the United States will very likely face external constraints—pressures for adjustment, new macroeconomic vulnerabilities, the danger of financial crisis—it is that such pressures are unfamiliar to the U.S. political system. That system is already under considerable stress, dealing (or failing to deal) with formidable domestic economic problems, first among which is the need to put its fiscal house in order. Given the strands of unilateralism and isolation that weave their way throughout U.S. history, it is possible that domestic politics will indeed magnify the "real" effect of these new pressures, and present an Achilles heel of U.S. power.

The key word here is *new*; such pressures are unfamiliar to the U.S. political system.

Notes

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