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## International Currency

International hierarchies are pervasive.  
—*David Lake*<sup>1</sup>

This book is about currency and power. But before we can explore the details of their relationship, we must first establish a clear understanding of each of the two concepts considered separately. What do we know about currency internationalization? What do we know about international power? These are the essential building blocks for the discussion to follow.

Power analysis will be the subject of chapter 2. This chapter focuses on currency, outlining the nature and implications of international money as generally understood by social scientists today. The aim is to provide a baseline and context for the analysis to follow: a consensus perspective on the basics of currency internationalization. Several critical questions are addressed. What drives the process of currency internationalization, what determines which currencies will become internationalized, and what does the universe of international currencies look like? Elsewhere I have referred to this last question as the “geography of money.”<sup>2</sup> Most importantly, what are the presumed implications of the process for the countries that issue an international currency?

### MOTIVATIONS

Currencies, if attractive enough, may be employed outside their country of origin for any of a number of monetary purposes. The standard taxonomy for characterizing the roles of international money, which I can

TABLE 1.1. The roles of international money

Levels of analysis	Functions		
	Medium of exchange	Unit of account	Store of value
Private	Foreign exchange trading, trade settlement	Trade invoicing	Investment
Official	Intervention	Anchor	Reserve

take pride in originating,<sup>3</sup> separates out the three familiar functions of money—medium of exchange, unit of account, store of value—at two levels of analysis—the private market and official policy—adding up to six roles in all. Specialists today generally speak of the separate roles of an international currency at the private level in foreign-exchange trading (medium of exchange), trade invoicing and settlement (unit of account and medium of exchange), and financial markets (store of value). At the official level, we speak of a money’s roles as an exchange-rate anchor (unit of account), intervention currency (medium of exchange), or reserve currency (store of value). Each of the six roles is distinct in practical as well as analytical terms. The taxonomy is summarized in table 1.1.

Currency internationalization alters monetary geography by accentuating the hierarchical relationship among currencies, expanding the domains of a few popular moneys well beyond the jurisdictions of the countries that issue them. The outcome is produced by a sort of a Darwinian process of natural selection, driven above all by the force of competition—much like Gresham’s Law, except in reverse. Instead of “bad” money driving out “good,” as Gresham’s Law traditionally holds, the good money drives out bad. There is nothing irrational about the process. On the contrary, internationalization may be regarded as a quite natural demand response to prevailing market structures and incentives.

Analytically, the motivations for internationalization can be easily appreciated. The incentive derives from the economies of scale, or reduced transactions costs, to be gained from concentrating cross-border activities in just one or at most a few currencies with broad transactional networks. To do business in each country in a separate money is analogous to barter and clearly inefficient. Within any single economy, monetary exchange—rather than barter—reduces the expenses associated with search and bargaining. So too between states. The costs of transactions are narrowed by making use of one or just a few currencies rather than

many. In the words of one study: “The necessity of ‘double coincidence of wants’ in a decentralized foreign exchange market may be overcome by using indirect exchange, through a generally acceptable medium of exchange instead of direct exchange of currencies.”<sup>4</sup> The greater the volume of transactions that can be done via a single currency, the smaller are the costs of gathering information and converting from one money to another. Monetary theorists describe these gains as money’s “network externalities” or, simply, the network value of money. Network externalities may be understood as a form of interdependence in which the practices of any one actor depend strategically on the practices adopted by others in the same network of agents.

In fact, currency internationalization improves the usefulness of money in all its roles. International standing enhances a currency’s value both as a commercial medium of exchange and as a unit of account for the invoicing and settlement of trade; and these effects in turn also broaden its appeal as a store of value, by facilitating accumulation of wealth in assets of more universal purchasing power. At a minimum, it will pay market agents to hold some level of working balances in a popular international currency. Depending on cross-border variations of interest rates and exchange-rate expectations, it will pay them to use it for longer-term investment purposes as well.

Moreover, once a money comes to be widely used by private actors, it is more likely to be employed by governments too, as a reserve currency, intervention medium, and anchor for exchange rates. Public actors too can benefit from the economies of scale offered by a broad transactional network. Historically, the typical pattern of internationalization is adoption first by the private sector, with the public sector then following.

## CHOICES

Why are there so few international currencies? Within individual countries, the role of a single money can be promoted by the coercive powers of the state. Sovereign governments can deploy legal-tender laws, exchange controls, and related regulatory measures to force residents to make use of the national currency for all legitimate monetary purposes. Inside their borders, states enjoy a *de jure* monopoly on the creation and management of money. But at the international level, the capacity for

coercion is more limited. Compulsion is of course possible in colonial or quasi-imperial clientalistic relationships. But in the more normal case, in relations among independent nations, monopoly is replaced by competition, and actors must be *persuaded* rather than compelled to make use of one currency rather than another. Rivalry for market share, as a rule, is the essence of the process of internationalization. Typically, to gain standing, a money must be *competitive*.

And what makes a money competitive? What determines which currencies will prevail in the Darwinian struggle? The principal qualities required for competitive success are familiar to specialists and hardly controversial. Both economic and political factors appear to be involved.

On the economic side, demand seems to be shaped most by three essential attributes. First, at least during the initial stages of a currency's cross-border use, is widespread confidence in the money's future value. The historian Carlo Cipolla, in his magisterial survey of the early moneys of the Mediterranean world,<sup>5</sup> laid particular emphasis on "high unitary value and intrinsic stability" as essential conditions for the emergence of a dominant international currency—in other words, a proven track record of relatively low inflation and inflation variability. High and fluctuating inflation rates increase the cost of acquiring information and performing price calculations. No currency is apt to be willingly adopted for cross-border purposes if its purchasing power cannot be forecast with some degree of assurance.

Second are the qualities of *exchange convenience* and *capital certainty*—a high degree of transactional liquidity and reasonable predictability of asset value. The key to both is a set of well-developed financial markets, sufficiently open to ensure access by outsiders. Markets must not be encumbered by high transactions costs or formal or informal barriers to entry. They must also offer considerable depth, breadth, and resiliency—the three most fundamental characteristics of an efficient financial sector. *Depth* means the ability to sustain relatively large market orders without impacting significantly on an individual asset's price. *Breadth* means trading volumes and enough market competition to ensure that the spread between ask (sell) and bid (buy) prices is small. And *resilience* means the ability of market prices to recover quickly from unusually large sell or buy orders. Secondary markets must be fully operational for most if not all financial claims.

Finally, a money must promise a broad transactional network, since nothing enhances a currency's acceptability more than the prospect of acceptability by others. Historically, this factor has usually meant an economy that is large in absolute size and well integrated into world markets. A big economy creates a naturally ample constituency for a currency; the potential for network externalities is further enhanced if the issuing state is also a major player in trade. As economist Jeffrey Frankel has suggested, "the currency of a country that bulks large in the world economy has a natural advantage."<sup>6</sup> No money has ever risen to a position of international preeminence that was not initially backed by a leading economy. The greater the issuer's weight in global commerce, the stronger will be the "gravitational pull" of its currency.

On the political side, both domestic and international considerations may play a role. Domestically, political stability and effective governance in the country of origin would seem critical. Potential users are unlikely to be attracted to a currency that is not backed by adequate protection of property rights and genuine respect for the rule of law. Nor will they be drawn to a regime that lacks a demonstrated capacity for successful policy management. As Andrew Sobel points out in an important historical study, success in the Darwinian struggle among currencies rests heavily on the key microfoundations of political stability and accountable government.<sup>7</sup> In past episodes of currency internationalization, from Britain's pound sterling to the US dollar and today's euro, there was never any doubt about the durability of these key attributes. Issuing governments could be counted upon to faithfully enforce contractual obligations. Had circumstances been otherwise, it is hard to imagine that any of these currencies would have gained much traction in international markets. Why would actors deliberately expose themselves to serious political risk if they do not have to do so?

Internationally, the experiences of the pound and dollar suggest that security considerations may also be of considerable importance. At the private level, a militarily powerful nation can provide a "safe haven" for nervous investors. A strong defense ensures a more secure investment climate. At the official level, currency preferences of governments may be influenced by broader foreign-policy ties—traditional patron-client linkages, informal security guarantees, or formal military alliances. Could the timing of sterling's ascendance in the nineteenth century, paralleling

the emergence of the formidable British Empire—the empire on which the sun never set—have been a mere coincidence? Can it be an accident today that with the conspicuous exceptions of China and Russia, most big dollar holders around the world are formal or informal allies of the United States? The greater the ability of an issuing state to project power beyond its borders, the more likely it is that friends and allies will feel comfortable using its money.

None of these attributes is a constant, however, as history amply demonstrates. Quite the contrary, in fact. Every one of a currency's attractions is subject to erosion with time, particularly if an issuing authority imprudently abuses the privileges derived from internationalization. Market preferences, which determine the outcome of the competitive process, may well change substantially from one period to the next. Shakespeare's words are as apt for money as they are for monarchs: "Uneasy lies the head that wears the crown." No currency has ever enjoyed a permanent dominance for international use.

## CANDIDATES

Few currencies are able to meet all the demanding economic and political qualifications for internationalization. That is not pessimism but realism. Given the substantial stakes involved, the competition that is at the core of the process of internationalization is bound to be unforgiving.

In some cases, currencies are effectively disqualified because they fail to perform all three of the standard functions of money. They are not *full-bodied* moneys. That is especially true of so-called artificial currency units like the Special Drawing Right (SDR) of the International Monetary Fund (IMF) or Europe's old European Currency Unit (ECU), which have existed primarily as notional units of account. Neither the SDR nor the ECU was ever available for use as a medium of exchange. The same was also true of the "transfer ruble" created by the former Soviet Union for denominating trade within the Soviet-led bloc of "socialist" nations before the end of the Cold War. Trade among bloc members was based on strict bilateral balancing. Monetary values were expressed in transfer rubles, but these existed solely for accounting purposes. Trade with non-bloc members was done entirely in dollars or other Western currencies. The ruble that was used inside the Soviet Union was tightly regulated

and rarely adopted for transactions abroad. Despite the Soviet Union's geopolitical importance at the time, its national currency never had any real international standing.

In other cases, currencies are disbarred in practical terms by inconvertibility. Technically, Article VIII of the Charter of the IMF imposes a convertibility obligation on all Fund members. To this day, however, a majority of the Fund's membership—mostly the least developed economies—still take advantage of a legal loophole afforded by the Charter's Article XIV to prolong rigid exchange and capital controls. No one would ever consider any of their currencies credible candidates for internationalization. A money need not be fully convertible to attain some measure of use by at least a few market actors or governments. But some minimal measure of transferability is essential if a currency is to go far in the Darwinian struggle.

Among more fully convertible currencies, many fail to appeal internationally because they lack one or more essential attributes. Some issuing states may have a poor record on inflation or lack sufficient depth and liquidity in their financial markets. Others may simply not be big enough to offer a broad transactional network or to project power effectively. And others may lack the requisite political stability or rule of law.

Incumbency also matters. International currency use is highly path dependent. The playing field is by no means a *tabula rasa*; at any given moment, market actors and governments are already locked into established patterns of behavior. Newcomers, therefore, start at a distinct competitive disadvantage that may be difficult to overcome. As the late Ronald McKinnon noted, “there is a tremendous first-mover advantage to the national currency already ensconced as international money.”<sup>8</sup>

In fact, currency choice is notoriously subject to inertia owing to the often high cost of switching from one money to another. The same network externalities that promote the use of a first mover can long delay the rise of other currencies. Why would market actors go to the trouble of adapting financial practice to a different money unless they can be sure that others will make use of it, too? A challenger must not just match at least some of the qualities of existing international currencies. It must somehow also offer advantages sufficient to persuade agents to risk making a potentially costly change. As we shall see in later chapters, lags are an inevitable part of the process, though scholars debate over how long (or short) the delay might actually turn out to be.<sup>9</sup>

In practical terms, it is not easy to compete with a money that is already as well established as the US dollar has been since World War II. America's greenback enjoys undoubted incumbency advantages. Not least is the fact that the language of its issuing country, English, happens as well to be the universal language of international business. The idea of converting from one money to another is less appealing if it also means switching from one language to another.

In recent experience, the currencies that have managed to achieve even marginal acceptance for cross-border purposes can be counted on the fingers of two hands. Over the post-World War II period, the dollar has dominated. Among all the world's other currencies, only West Germany's old Deutsche mark (DM), Japan's yen, and the euro have for a time been competitive enough to also gain a significant share of the market for international money. Others have exhibited lesser degrees of market appeal.

### THE CURRENCY PYRAMID

How, then, can we best visualize money's geography? International relations have always been characterized by a degree of hierarchy, as David Lake has usefully reminded us—a “rich tapestry,” as he describes it, with “varying hues and textures.”<sup>10</sup> There is no reason why the same should not also be true of international currencies. Cross-border competition naturally gives rise to a rich tapestry of hierarchy in the world of money. The use and influence of a few popular currencies can reach far beyond the legal jurisdictions of their issuing authorities, spanning large parts of the globe, while the effective domains of other currencies are sharply shrunk, sometimes dramatically.<sup>11</sup> The persistence of hierarchy among moneys has long been recognized by monetary historians.<sup>12</sup> In the modern era, elevated status has been affirmed by such labels as “key currencies” or even “dream currencies”—the moneys that investors dream in.<sup>13</sup>

Nearly half a century ago the noted British scholar Susan Strange introduced the first systematic taxonomy of the world's most widely used currencies.<sup>14</sup> Strange distinguished four types of international money: neutral currencies, top currencies, master currencies, and negotiated currencies. *Neutral currencies* are moneys that appeal to market actors for strictly economic reasons (stable value, network externalities, and the like). Add dominance by the issuing country in related structures and issue-areas, and a money may be described as a *top currency*. *Master*

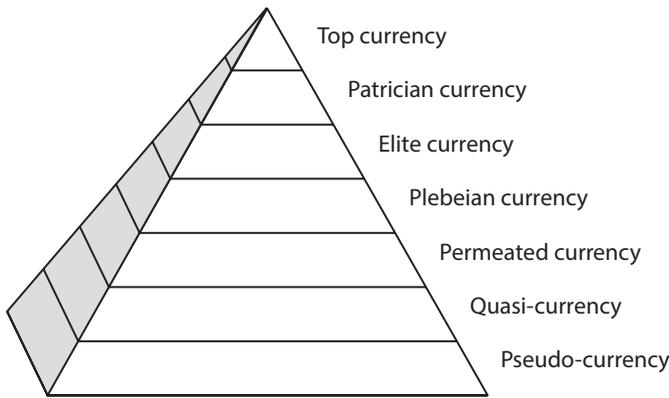


Figure 1.1. The Currency Pyramid.

*currencies* derive from formal dependency relationships, such as colonial ties, and rely on a degree of coercion. *Negotiated currencies*, by contrast, rely more on persuasion and result from diplomatic bargaining or informal understandings to promote or sustain foreign use.

More recently, I sought to build on Strange's foundation by introducing the image of a Currency Pyramid to more fully represent the hierarchy of moneys around the world (figure 1.1).<sup>15</sup> The Currency Pyramid is narrow at the peak, where one or a few moneys dominate, and increasingly broad below, reflecting varying degrees of competitive inferiority. The moneys at the top includes the four currency types that Strange identifies in her taxonomy. The advantage of the pyramid image is that it reaches further down to take account of other, lower rungs in the hierarchy as well.

Though difficult to operationalize for analytical purposes, the image of the Currency Pyramid is nonetheless useful to convey the colorful diversity of money's competitive relationships while at the same time not exaggerating the degree of refinement that we can bring to the exercise. In all, seven categories of money are identified. The labels for each stratum, though slightly tongue-in-cheek, are meant to accentuate the steeply vertical imagery appropriate to an accurate mapping of monetary geography.

The seven categories are as follows:

**Top Currency.** With a nod to Strange's use of the same label and with the same meaning in mind, this rarified rank is reserved only for the most esteemed of international currencies—those whose use dominates for

most if not all types of cross-border purposes and whose popularity is more or less universal, not limited to any particular geographic region. In the modern era just two currencies could truly be said to have qualified for this exalted status: Britain's pound sterling before World War I and the US dollar after World War II. In principle more than one top currency might be in favor simultaneously, as were the pound and dollar together during the interwar period, before sterling went into what proved to be a long and irreversible decline.<sup>16</sup> Today, however, the greenback alone occupies the highest stratum of the Currency Pyramid. No other money comes close. Though doubts about the dollar's future are widespread, generating heated debate, the currency's global preeminence, for now, remains undiminished.<sup>17</sup>

**Patrician Currency.** Just below the top rank we find currencies whose use for various cross-border purposes, while substantial, is something less than dominant and/or whose popularity, while widespread, is something less than universal. Historically, some of the moneys in this category, corresponding to Strange's category of neutral currency, have appealed simply because of their inherent economic qualities; others have resembled more her remaining categories of master currency or negotiated currency. Today the patrician category obviously includes the euro, which stands second to the greenback in most categories of cross-border use. Following its creation in 1999, many observers predicted that the euro was destined to achieve parity with the greenback, or perhaps even surpass it, in a relatively short period of time.<sup>18</sup> In practice, however, the euro's early promise as a rival to the dollar has remained unrealized. After a fast start, cross-border use of the currency soon leveled off and, especially after Europe's sovereign-debt problems that began in the spring of 2010, has come to be largely confined to the EU's immediate hinterland around the European periphery and in parts of the Mediterranean littoral and Africa. The only other patrician currency of note these days is the Japanese yen, despite some recent loss of popularity. Many observers expect the ranks of patrician currencies to be joined soon by China's yuan. Some even expect the RMB one day to eclipse the dollar, describing its ascent as "unstoppable."<sup>19</sup>

**Elite Currency.** In this category belong currencies of sufficient attractiveness to qualify for some degree of international use but of insufficient weight to carry much direct influence beyond their own national frontiers. Here we find the more peripheral of the international currencies,

little more than bit players on the currency stage. These moneys too may be considered to correspond to what Strange meant by neutral currencies. Today the list of elite currencies would include inter alia Britain's pound (sadly, no longer a top currency or even a patrician currency), the Swiss franc, and the Australian and Canadian dollars. All of these currencies are used to some extent in global currency and financial markets because of their inherent economic qualities. In addition, the Australian dollar and South African rand play significant roles as exchange-rate anchor and reserve currency in their respective neighborhoods in the southern Pacific and southern Africa.

**Plebeian Currency.** One step further down from the elite category are plebeian currencies—more modest moneys of very limited international use. Here we find the currencies of the smaller industrial states, such as Norway or Sweden, along with some middle-income emerging-market economies (for example, Singapore, South Korea, and Taiwan) and the wealthier oil-exporters (for example, Kuwait, Saudi Arabia, and United Arab Emirates). Internally, plebeian currencies retain a more or less exclusive claim to all the traditional functions of money, but externally they carry little weight (like the plebs, or common folk, of ancient Rome). They tend to attract little cross-border use except perhaps for a certain amount of trade invoicing.

**Permeated Currency.** Included in this category are moneys whose competitiveness is effectively compromised even at home, through what economists call *currency substitution*—adoption by residents of a popular foreign currency as a preferred alternative to the national currency. Although nominal monetary sovereignty continues to reside with the issuing government, foreign money supersedes the domestic alternative, particularly as a store of value, thus accentuating the local currency's degree of inferiority. Permeated currencies confront what amounts to a competitive invasion from abroad. Judging from available evidence, it appears that the range of permeated currencies today is in fact quite broad, encompassing many economies of the developing world, particularly in Latin America and Southeast Asia.

**Quasi-Currency.** One step further down are currencies that are superseded not only as a store of value but, to a significant extent, as a unit of account and medium of exchange as well. Quasi-currencies are moneys that retain nominal sovereignty but are largely rejected in practice for most purposes. Their domain is more juridical than empirical. Available

TABLE 1.2. Benefits and risks of an international currency

Benefits	Risks
Reduced transactions costs	Currency appreciation
International seigniorage	External constraint
Macroeconomic flexibility	Policy responsibility
Political leverage (hard power)	
Reputation (soft power)	

evidence suggests that some approximation of this more radical degree of inferiority has indeed been reached in a number of fragile economies around the globe.

**Pseudo-Currency.** Finally, we come to the bottom rank of the pyramid, where currencies exist in name only—pseudo-currencies. The most obvious examples of pseudo-currencies are token moneys like the Panamanian balboa, found in countries where a stronger foreign currency such as the dollar is the preferred legal tender. Along with the many small permeated currencies and quasi-currencies, pseudo-currencies have sometimes been scornfully dismissed as no more than “junk currencies.”<sup>20</sup>

## BENEFITS AND COSTS

Finally, what are the benefits and costs of an international currency? To approach an understanding of the relationship between currency and power, we must first have a firm grasp of all possible implications for the country of origin, whether positive or negative.

In a diverse literature stretching back decades, drawing from political science as well as economics, we should not be surprised to find wide variation in lists of possible gains and risks compiled by different analysts. From these many sources we can distill a consolidated catalog that may be regarded as reasonably inclusive. A comprehensive list would include a total of some five broad classes of gain and three major risks, as summarized in table 1.2. Benefits stressed by economists include a cluster of favorable impacts at the microeconomic level, subsumed under the rubric of *transactions costs*, as well as, at a more aggregate level, two forms of gain labeled *international seigniorage* and *macroeconomic flexibility*. Political scientists are inclined to add two effects that are more overtly

political in nature: *leverage* and *reputation*. Risks of internationalization include the possibility of undue *currency appreciation*, an unwelcome *external constraint* on domestic monetary autonomy, and a burden of *policy responsibility* that could go with the privilege of currency leadership.

### *Transactions Costs*

At the microeconomic level, several benefits accrue to residents of any country that provides an international currency. Perhaps most prominent is the boost to profits in the banking sector, long ago characterized by economist Alexander Swoboda as “denomination rents.”<sup>21</sup> Since home banks enjoy privileged access to the resources of the issuing country’s central bank, enabling them to more easily create monetary liabilities denominated in the national currency, a distinct competitive advantage is gained as compared with financial institutions elsewhere. Business can be expanded abroad at lower cost, generating greater earnings than would otherwise be possible. In Swoboda’s words, “the average level of profits of the banking system of an issuing country will tend, other things equal, to be higher [due to the extension of the market] than that of the banking systems of other countries.”<sup>22</sup> Included in these extra earnings may be commissions charged for an increased volume of foreign-exchange transactions as well as fees for loans, investment services, or other ancillary activities.

Nonfinancial enterprises in the issuing country also benefit in at least two ways. First, internationalization enhances their ability to do business abroad in home currency, thus lowering exchange risk. Though the gain for firms may be less substantial than typically assumed,<sup>23</sup> it can nonetheless be significant, particularly in the case of trade contracts where payment are due long after goods are initially ordered. And second, access to international financial markets is broadened, enabling select firms to borrow more cheaply and on a larger scale than they normally could at home. Ordinary citizens also benefit to the extent that they are able to use their own money when traveling abroad—a notable convenience.

Not all residents gain, of course. Most of an international currency’s benefits at the microeconomic level accrue to the more externally oriented sectors of the economy, implying potentially significant distributional consequences. But while some are favored by lower transactions costs,

few if any residents experience any direct increase of costs so long as the currency remains competitive. The gains of “winners” come mainly at the expense of actors abroad rather than at home. For the issuing country as a whole, relative to the outside world, the net impact is positive.

### *Seigniorage*

Technically defined as the excess of the nominal value of a currency over its cost of production, seigniorage at the international level is generated whenever foreigners acquire and hold some amount of domestic money in exchange for traded goods, services, or foreign investment assets. Cross-border accumulations of the national money represent an implicit economic transfer that constitutes a real-resource gain for the economy as a whole.

Two components are involved. One results from foreign accumulations of actual cash—bank notes and coins. Since no interest is paid on the cash liabilities of a central bank, holdings of its notes and coins abroad represent the equivalent of an interest-free loan to the issuing country. In the case of the United States, as much as 60 percent of the outstanding stock of Federal Reserve notes is estimated to be in circulation outside the country, amounting at end-2011 to perhaps \$650 billion.<sup>24</sup> Even at today’s low borrowing costs, that translates into an interest saving for the US government of as much as \$15 billion to \$20 billion a year—in absolute terms a not negligible sum, though little more than a modest one-tenth of one percent of America’s gross domestic product (GDP).

The second component, rather more substantial, derives from foreign accumulations of financial claims denominated in the home money, an increase of effective demand for assets that has the effect of driving the cost of borrowing below what it might be otherwise. Effectively, an interest-rate subsidy is generated. Economic theory would suggest that acquisitions are most likely motivated by liquidity considerations. The gain is often referred to as a “liquidity premium.” Political science would add a second motivation, a desire for a safe haven for investments, which can generate a further “security premium,”<sup>25</sup> sometimes also called a “security tax.”<sup>26</sup> In practice, the two motivations are difficult to disentangle. Overall, for the United States the total subsidy has been estimated to amount to as much as 80 basis points, producing an annual saving of at least

\$150 billion for the federal government and other domestic borrowers.<sup>27</sup> A comparable estimate for Europe suggests a gain of as much as 0.5 percent of GDP for the members of the euro zone.<sup>28</sup>

Alternatively, the value of the second component can be estimated by calculating the difference between the (higher) returns on foreign assets of an issuing country and the (lower) cost of foreign liabilities. For the United States as a whole, studies put the excess return on net foreign claims at 300 or more basis points per year.<sup>29</sup> At anywhere from 1 percent to 3 percent of GDP, these figures are anything but negligible.

### *Macroeconomic Flexibility*

Cross-border use of a currency can also loosen the constraint of external payments imbalances, enhancing policy autonomy. The greater the ability to pay for foreign goods and services with a country's own money, the easier it is for the authorities to sustain public policy objectives both at home and abroad. In effect, external market discipline is relaxed. For a resentful Valéry Giscard d'Estaing, French finance minister back in the 1960s, this was an "exorbitant privilege" that set the United States, with its dominant dollar, apart from other nations. Many outsiders still complain about America's presumed exorbitant privilege.

Here too, as at the microeconomic level, there are potentially significant distributional consequences. Not all domestic residents may benefit from the exorbitant privilege. As Jeffrey Frieden long ago reminded us,<sup>30</sup> some sectors of an economy—particularly those sensitive to the risk of inflation—might actually prefer more rather than less discipline on potentially spendthrift politicians. But from the point of view of the state as a whole, engaged as a sovereign actor in relation to other states, there seems little doubt that the greater degree of freedom for monetary and fiscal policy may be regarded as a net plus.

### *Leverage*

Foreign influence is a fourth possible benefit of an international currency. An element of dependence is created when outsiders come to rely on some national money for a variety of international roles. That dependence puts the issuer in a position to exercise leverage through its control

of access to a vital financial resource. The more others rely on a currency, the greater is the issuer's potential capacity for pressure or control.

Leverage can be exercised either directly or indirectly. Most familiar is direct political action in selective circumstances, deployed through the calculated use of available policy instruments, including side payments (bribery) or sanctions (coercion)—in other words, carrots or sticks. In *Currency and Coercion*, Jonathan Kirshner labeled such policies “enforcement” or “expulsion.”<sup>31</sup> Friendly countries may be granted loans or privileged access to its currency in the midst of a monetary or financial crisis; conversely, adversaries may be deprived of access to essential clearing networks when political tensions run high. Less familiar is a form of leverage that operates more indirectly by favorably altering material incentive structures—what Kirshner called “entrapment.” Because of an established currency's importance, foreign users develop a stake in its continued success and hence may more or less willingly adapt to the issuing country's preferences and requirements without even being asked.

### *Reputation*

Finally, at the symbolic level, widespread international use of a currency can promote the issuer's overall reputation in world affairs. Broad circulation may become a source of status and prestige, a visible sign of elevated rank in the community of nations. Internationalization of a money can provide a potent symbol of international primacy, working through co-option and attraction to shape the preferences of others. Economists may scoff at such psychological notions, which are certainly difficult to pin down empirically. But the importance of cognition and culture in monetary affairs has by now been well established by historical and contemporary research.<sup>32</sup>

### *Appreciation*

On the cost side, one frequently mentioned risk of internationalization is the exchange-rate appreciation that could result from increased foreign demand for a currency. The more a money gains in popularity, the greater is the likelihood that some degree of overvaluation could result, at least initially. For home consumers appreciation actually represents a

benefit, since purchasing power is increased. But for producers the effect is distinctly negative, since the competitiveness of exports and import-competing output will be impaired. Both sales and employment will be adversely affected. In the case of the United States, one source estimates a net financial cost that rises by as much as \$30 billion a year for each 5 percent movement upward of the dollar's exchange rate.<sup>33</sup> Another source estimates a net loss of as many as six million jobs in the United States in a typical recent year.<sup>34</sup> Again, these are by no means negligible amounts.

### *External Constraint*

Even more serious is the possible constraint that could be imposed on domestic policy autonomy by an excessive accumulation of liquid foreign liabilities. Macroeconomic flexibility could be compromised by a growing “overhang” of highly mobile debt, whether held abroad as cash or in the form of liquid claims denominated in the home money. To persuade foreigners to hold onto their accumulated holdings, interest rates may have to be raised, reducing or even eliminating seigniorage gains<sup>35</sup> and constraining domestic policy. Eventually both leverage and reputation could also be adversely affected.

Two specific dangers are posed for the issuer's central bank. One is the risk of volatile movements into or out of the currency, which could make the demand for money less stable in aggregate terms. Policy makers, at any given time, may find it more difficult to target interest rates or an appropriate growth rate for money supply. The other is the risk that over time domestic policy may become increasingly hostage to external factors, especially if doubts begin to mount regarding the currency's future value or usefulness. Ultimately, to persuade actors abroad to hold onto their accumulated balances, priorities at home may have to be compromised or sacrificed. Though neither danger is easy to quantify, both must be regarded as real and could be potentially significant.

### *Policy Responsibility*

Even more difficult to quantify is one last risk of internationalization—the possibility that in return for the benefits it receives, an issuing country will find itself obliged to assume greater responsibility for management of broad regional or global monetary structures. Quite apart from

market-driven pressures on its central bank, the issuer may find itself called upon to accommodate systemic needs or fragilities should conditions warrant. Monetary policy may have to be modified to contain a crisis, or subsidized credits may have to be provided to rescue economies in distress. A complete catalog of the benefits and costs of an international currency cannot ignore the contingent political claim that goes with monetary leadership. One source calls it the leader's "exorbitant duty"<sup>36</sup>—effectively, the flip-side of currency internationalization's "exorbitant privilege." The idea was well expressed by Timothy Geitner, then president of the Federal Reserve Bank of New York, in the midst of the financial crisis of 2008:

Another way to think about this is that the privilege of being the reserve currency of the world comes with some burdens. Not that we have an obligation in this sense, but we have an interest in helping these guys mitigate the problems they face.<sup>37</sup>

To paraphrase Robert Mundell: Great powers may not only have great currencies, they may also have great responsibilities.

### MISPLACED CONCRETENESS

In principle, all of these five classes of gains and three major risks should be included in any systematic analysis of the benefits and costs of an international currency. In practice, however, that is not usually the case. Indeed, much of the extant literature tends to suffer from what the philosopher Alfred North Whitehead called the "Fallacy of Misplaced Concreteness"—essentially, the error of mistaking the abstract for the concrete. The problem has long plagued mainstream economics. More than a half century ago, the distinguished economist Fritz Machlup highlighted the issue, berating his colleagues for "the general fallacy involved in jumping the distance between a useful fiction and particular data of observation."<sup>38</sup> Regrettably, though, his warnings have long been forgotten. Contemporary analyses of currency internationalization too often overlook the degree of abstraction in their models and draw unwarranted conclusions about material reality.

Typical was a study not long ago by McKinsey Global Institute,<sup>39</sup> which posed the question: What are the benefits and costs of being an international currency? The study purported to offer a firm empirical

calculus for the US dollar, concluding bluntly that “Today, it is not clear that the United States enjoys much of a privilege at all. . . . [At best] the United States derives a relatively modest net financial benefit.”<sup>40</sup> But was that dismissive conclusion warranted? McKinsey’s calculus included quantitative estimates for just two of the several effects of currency internationalization—specifically, seigniorage benefits and the cost of exchange-rate appreciation. A few other considerations were mentioned, but only in passing. The distance between the narrow empirical content of the study and the broad inferences drawn by its authors was clearly too great to be persuasive. Concrete reality was egregiously distorted by an undue reliance on a limited range of data.

Even more egregious is a recent polemic from Jared Bernstein,<sup>41</sup> formerly chief economist for Vice President Joe Biden. According to Bernstein, the United States should act decisively to terminate the internationalization of the greenback—in his words, to “dethrone king dollar”—as soon as possible. The reason, he argues, is that foreign demand for America’s currency costs millions of US jobs due to exchange-rate appreciation. No other effect of internationalization merits any notice. The possibility that there might be some offsetting benefits is never even considered.

Nor are commentaries like these by any means atypical. Economist Hans Genberg, to cite another example, bases a “calculus of international currency use” on just two specific considerations—seigniorage gains and impacts on transactions costs.<sup>42</sup> C. Fred Bergsten, a well-known commentator, concludes that the United States “would benefit from a reduction of the international role of the dollar” after focusing on just two costs—an increased external constraint on domestic policy and the risk of currency appreciation.<sup>43</sup> Elias Papaioannou and Richard Portes, assessing prospective benefits and costs for the euro, quite explicitly downplay political aspects in order to concentrate on empirical specifications of economic effects.<sup>44</sup> Similarly, two Chinese economists, Wen Hai and Hongxin Yao, evaluating the pros and cons of internationalization of the yuan, rely on estimates of just three possible factors—seigniorage, reduced transactions costs, and impacts on domestic monetary policy.<sup>45</sup> In all these cases, the concreteness attributed to reality seems seriously misplaced.

Why, then, does the fallacy persist? It could be because of the value that has long been attached to parsimony in mainstream economic research.

Typically, a reductionist style is favored that seeks to pare messy reality down to its bare essentials—aiming “to predict something large from something small,” as the economist Harry Johnson once put it.<sup>46</sup> In the social sciences we are always faced with a basic trade-off between parsimony and detail—between the refined abstractions required for theoretical generalization and the elaborate descriptions required to ensure external validity. The most prized work on currency internationalization today clearly follows contemporary fashion, tilting toward simplicity rather than complexity.

But it is also tempting to see more: an unfortunate inclination to permit analysis to be driven by data availability, even at the risk of distorting reality. Clearly, some of the effects of internationalization defy easy quantification—particularly the more political benefits and risks involved. How do we put a number on leverage or reputation? What metric do we use for flexibility or responsibility? It is so much more convenient simply to concentrate on factors that can putatively be estimated, however crudely, and just wave a hand at the rest. One is reminded of the old joke about the man seen late one night under a lamp post, down on his knees searching for a set of keys. Is that where you lost them?, he is asked. No, they were lost down the street, but the light here is better. Too much of the literature just goes where the light is.

## CONCLUSION

Overall, then, much is understood about currency internationalization—its motivations, choices, and presumed implications. Driven by the force of competition, the process of internationalization produces a distinct hierarchy among currencies. For the nations whose currencies come to play cross-border roles, benefits as well as costs may be considerable. But how does this all translate into power? Is state power necessary or sufficient for a currency to gain international status, besting competitive rivals? Conversely, does currency internationalization add to or subtract from a state’s power in relation to other states? Does a loss of state power necessarily reduce international use of its currency? Or does a loss of a currency’s competitive status diminish the power of the issuing state? About these questions we have remarkably little theory to guide us. The following chapters seek to provide some answers.