US DOLLAR HEGEMONY **PROF G A WALKER**

The US dollar has remained the principal international reserve currency since Bretton Woods in 1944. A reduction in economic power and increased political insulation create an unstable combination.[1] The dollar was used in international trade for payment purposes and as a store of value and reserve asset. This status reflected the size of the American economy in the post war period. By 2015, the US accounted for 23% of global GDP and 12% of merchandise trade although 60% of global output remained within a dollar zone.[2] US banking and financial services remained strong with fund managers holding 55% of global assets under management which had increased from 44% in ten years. Difficulties arose with the decrease in US economic power, an unstable international financial system and lack of any credible alternative reserve currency or currencies. Specific issues arose with regard to currency and investment instability,[3] lack of necessary monetary support,[4] and alleged political abuse.[5] Reserve status allows the US government and US corporations and individuals to borrow at lower rates. The currency nevertheless becomes subject to overseas instabilities with the US bond market becoming dominated by overseas investors. Any shift in investment from the Treasury bill market to the US securities markets could also lead to asset bubbles.[6]

The Economist notes that the transfer of reserve status from the United Kingdom to America between the world wars was orderly as the countries were allies and shared a common political cohesiveness or stability and adherence to the rule of law while also being dynamic economies.[7] The stability and continued existence of the euro was questionable while the renminbi could not assume full reserve status until Chinese financial markets were fully opened[8] and the rule of law guaranteed.[9] Great Britain's earlier dominance was replaced by the US which many thought would then be overtaken by Europe, Japan and then China although none of this has yet materialised. The international monetary system may have returned to another crisis moment as with the closure of the gold window by US President Richard Nixon and shift from managed to floating currencies in the early 1970s. This was forced on the US by a loss of gold reserves and increased financial demands, including the cost of the Vietnam War. The US can either now extend liquidity swap lines[10] or become more vulnerable to external shocks and the power of overseas investors holding government debt.[11] In the absence of any credible alternative reserve currency, the system will fragment as countries attempt to insulate themselves from dollar dependence which may further increase instability in the international financial system. Former Bank of England Governor, Mark Carney, has proposed the creation of a synthetic

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[1] 'The sticky superpower' in 'The World Economy – Special Report' *The Economist* (3-9 October 2015).
[2] 'Dominant and dangerous' *The Economist* (3 October 2015).
[3] Substantial fluctuations arise with $9 trillion of offshore dollar debts and deposits being dependent on Federal Reserve monetary policy decisions. Any compensatory effects of increased imports as capital outflows have been diminished with the relative decrease in the US trade position. Ibid.
[4] The Federal Reserve had to make available $1 trillion in liquidity to foreign banks and central banks following the global financial crisis in 2008/2009 with the offshore dollar markets having doubled since 2007 which was expected to increase to the same size as the US banking industry by the 2020s. Future emergency liquidity provision may also be limited by congressional or regulatory obstacles. Ibid.
[5] A number of countries, such as Russia and Iran, and corporations have complained about the use of the dollar payment system for political rather than purely financial purposes.
[6] Ibid.
[7] Ibid.
[8] The Economist notes that the Peoples Bank of China (PBOC) has opened a huge network of currency swaps with other central banks with little use. It compares this to 'the monetary equivalent of an eight-lane motorway' with no one on it. Ibid.
[9] Global trade was dependent on Chinese economic performance. It was expected that China would become a leading global power in trade and direct investment and arguably a 'mid-sized' power in finance, currencies and financial markets although this would still take time. 'China – A longer march' in 'The World Economy – Special Report' *The Economist* (n) 12-14.
[10] Kindleberger recommended that a hegemonic reserve power should in the event of a crisis maintain an open market for goods and provide short-term liquidity and long-term loans. Kindleberger (n).
[11] See also 'Global monetary system – Thrills and spills' in 'The World Economy – Special Report' *The Economist* (n) 8-12.

'Synthetic Hegemonic Currency' (SHC) in the form of a global digital currency to stabilise global financial systems against disruption through trade and currency wars.[12] While the US may be considered to have saved the global economy in 2007/2008 by extending US dollar swap lines, it may be financially impossible or politically impracticable for it to do so in future.[13] History indicates that, at least, one power has to assume responsibility for the stability of the system.[14] Continued disputes in US internal politics have made its economic diplomacy more difficult.[15] Without the US, it is unclear whether the IMF could act as lender of last resort to the international financial system.

The global financial crisis in 2008-2009 can be considered to have unfolded in a series of stages. An initial liquidity contraction in inter-bank markets in the principal economies in 2007 spread to a solvency crisis in autumn 2008, in particular, following the collapse of Lehman Bros on 15 September 2008. This led to a stock market collapse in many of the major economies at the end of 2008 which spread to a sovereign debt crisis in 2009-2010. The world has been undergoing continued trade and currency instability since. Despite massive efforts to refloat currencies and promote growth especially through quantitative easing in many major economies, global economic activity remained stagnant by 2015 increasing strains emerging international financial and trading systems. The global financial crisis lead to a period of extended global monetary relaxation which was further extended during the Coronavirus Crisis in 2019-2021 and only reversed with the Geo-political Crisis that arose following Russian's invasion of Ukraine on 24 February 2022 and rise in global interest rates that this caused. The US Federal Reserve subsequently confirmed, under Chairman Jerome Powell, that it would raise interest rates to whatever levels were necessary to control inflation reminiscent of former Chairman, Paul Volker during the 1980s[16] despite the damage that this may inflict in other countries and especially with a rising dollar value.

Other interim solutions to create a stable international financial system are possible although not attractive longer term. China launched the earlier Asian Chiang Mai Initiative (CMI) $120 billion multilateral currency swap arrangement on 24 March 2010 although this has been of limited use.[17] The US dollar could also be used by other central banks to create a dollar payments system through the collective management of dollar reserves with or without American support.[18] The IMF could be reformed or other regional agencies extended to compete with it. This may include the Asian Infrastructure Investment Bank (AIIB), which was set up on 4 October 2014, or by strengthening the role of the other regional development banks (RDBs)[19] and

[12] Marc Carey, 'The Growing Challenges for Monetary Policy in the current International Monetary and Financial System' Jackson Hole Symposium (23 August 2019)

[13] For similar comment, 'A new world economic order – Glad confident mornings' in 'The World Economy – Special Report' *The Economist* (n) 15-16.

[14] Charles Kindleberger refers to the transfer of responsibility from the British in the 19th century to the Americans in the 20th century. In examining the causes and effects of the Great Depression in the 1930s Kindleberger notes that, 'The international economic system was rendered unstable by British inability and the United States' unwillingness to assume responsibility for stabilising it…When every country turned to protect its national private interest, the world public interest went down the drain, and with it the private interests of all.' The inevitable result may be 'Stalemate, and depression.' Charles P Kindleberger, 'The World in Depression, 1929-1939' in *History of the world economy in the 20th century* (University of California Press Berkeley and Los Angeles 1973) vol 4, 336. For review and comment, Anna J Schwartz, 'Reviewed Work: *The World in Depression, 1929-1939* authored by Charles P. Kindleberger' *Journal of Political Economy* [1975] 83 (1) 231-237.

[15] 'American politics – Neither leading nor ceding' in 'The World Economy – Special Report' *The Economist* (n) 6-8.

[16] Paul Volker (1927-2019) raised the federal funds rate from an average of 11.2% in 1979 to 20% in June 1981 which created 1980-1982 recession. Paul Volker was the 12tth Chairman of the Federal Reserve Board between 1979-1987.

[17] The pool had initial reserve assets worth $120 billion although this was increased to $240 billion in 2012.

[18] 'A new world economic order – Glad confident mornings' (n) 16.

[19] RDBs include the Inter-American Development Bank (IDB), Central American Bank for Economic Integration (CABI), African Development Bank (AfDB), Asian Development Bank (ASB), Development Bank of Latin America (CAF), European Bank for Reconstruction and Development (EBRD), Council of Europe Development Bank (CEB), West African Development Bank (BOAD) and Development Bank of Central African States (BDEAC).

multilateral development banks.[20] The most desirable solution would be to extend the US dollar reserve system both in terms of liquidity[21] and solvency[22] support and with wider international financial institution (IFI) reform,[23] extend dollar liquidity[24] and global open trade.[25] The success of many of these initiatives may be dependent on the new US Presidential Incumbents with President Barack Obama (2009-2017), President Donald Trump (2017-2021) and President Joseph Biden (2021).

An alternative approach may be to create a new global reference asset (GRA) to act as a currency anchor. This could either be based on IMF special drawing rights (SDRs) or an alternative agreed basket of currencies, including the renminbi. As with the euro transitional arrangements, this could initially be used as an accounting unit in official dealings and then corporate and retail transactions on a voluntary basis with an exchange rate system being set up to convert the new GRAs into local currencies. This could be given a separate title such as the *globo* or *mondo* with a number of proposals already existing for the creation of a single global currency although without any clear rules and procedures. Emergency liquidity support would be provided through swap lines or a reformed or reconstituted IMF or new global monetary authority (GMF) working with the AIIB or RDBs. This could then be brought forward with a combination of other institutional regulatory and trade initiatives as referred to previously.

The international financial system had arrived at a further precarious inflection point by autumn 2022 after continued hostility in Ukraine and the announcement of a deficit funded growth package by the new UK Prime Minister Elizabeth Truss and Chancellor of the Exchequer Kwasi Kwarteng.[26] Kwarteng announced a £45 billion tax reducing growth package at a 'fiscal event' on Friday 23 September 2022. This included abolishing the higher income tax rate of 45% and the separate levy imposed on bank bonuses following the global financial crisis. This was accompanied by a substantial energy cost support package to assist households during the winter with high gas, oil and energy prices. The package of measures had nevertheless been uncosted and, in particular by the Office of Budge Responsibility (OBR) and apparently without clear policy coordination with the Bank of England.[27]

Continuing nervousness in foreign exchange markets and new concerns with the potential size of the UK government debt package lead to substantial falls in the value of sterling to 1.035 in the sterling dollar cross cable rate during the week beginning 26 September 2022. The Chancellor had announced that a full budgetary costing would be carried out by the OBR although it would take until November 2022 to prepare this out with a separate budgetary statement being released at that time. The Bank of England initially confirmed that no monetary action would be taken until the next scheduled meeting of the Monetary Policy Committee (MPC) in November 2022 although the Bank was forced to announce a £25 billion gilt purchase

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[20] MDBs include the African Development Bank (AfDB), International Fund for Agricultural Development (IFAD), Islamic Development Bank (IsDB) as well as the ADB, EIB, EBRD and IADB.

[21] The US could triple the funds made available to the IMF to $3 trillion and extend Federal Reserve liquidity swap lines including to China and India without limits. Ibid.

[22] The US could establish a sovereign wealth fund (SWF) funded through Treasury bonds with proceeds being invested overseas which would avoid the build-up of destabilising large overseas dollar reserves. Ibid.

[23] The US would cede its veto power over the IMF with voting structures being revised to reflect major emerging market economic weights. Larger regional trade arrangements would be opened to wider memberships to attempt to replace the 450 smaller regional trade arrangements in place. This could, for example, include involving China and India in the Trans-Pacific Partnership (TPP) deal or Transatlantic Trade and Investment Partnership (TTIP).

[24] Large foreign banks, in particular, from emerging markets, would be encouraged to open offices in New York with the regulatory system in the US being depoliticised and federalised insofar as possible. The issuance of excessive extraterritorial rulings would be avoided. Ibid.

[25] The World Trade Organisation (WTO) could also be reformed in parallel with the IMF and the Doha Development Round restarted after it was initially commenced in Qatar in 2001 and suspended in July 2008.

[26] 'Sterling falls to record low against the dollar' *Financial Times* (26 September 2022).

[27] 'Pound rises after hitting record low against dollar' *Financial Times* (27 September 2022).

programme on Wednesday 28 September to prevent instability in the gilt and pension market.[28] The collapse in the collapse in the value of sterling had effectively created a significant conflict between fiscal and monetary policy with the fiscal package being designed to promote growth after an extended period of stagnation while monetary action would force higher interest rates than was initially expected which would remove any other economic advantage.[29] The growth package represented a legitimate policy intervention although the timing and apparent lack of coordination arguably resulted in unnecessary market instability during a period of continuing market volatility and nervousness.[30]

Significant further instability arose in global relations during 2022. It was highly likely that the continuing belligerent and recalcitrant action adopted by the Putin government in Russia would lead to prolonged sanctions being maintained and the effective exclusion and separation of Russia as the 11th largest economy in the world from the rest of the international trading and financial system for a number of years. Continuing instability may also increase in the South East Asia with the increasingly protective and aggressive position adopted by China in relation to Taiwan. This could lead to a full dislocation and fragmentation of the international trading and financial system although this was much less likely and less damaging than Russia's forced exclusion.

Further instability and increased fragmentation of markets may continue to be threatened in the absence of clear global agreement, coordination of action and leadership going forward. Rather than expect or assume the US to assume full responsibility in this regard, a combination of initiatives has to be considered that can support this over time. This would clearly have to reflect US and other country interests to a significant extent to secure the necessary political engagement and commitment. Increased continuing monetary stability with stable trade and multilateral development systems would clearly be in the best interests of all countries. It may be time to discuss this within a new 'Bretton Woods III' treaty initiative following the earlier monetary, trade and development arrangements entered into after World War II. An appropriate reconciliation may still be possible to avoid continued uncertainty and instability with all of the full benefits that an open and integrated global financial and trading system should allow.

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[28] Paul Marshall, 'Economic consensus is crumbling, but the Bank of England has not got the memo' *Financial Times* (26 September 2022). This followed earlier disagreement on the proposed deregulation of the City of London following the UK withdrawal from the EU as part of further 'Big Bank' in UK markets. 'Bank of England battle looms over plans for second 'Big Bang'' *Financial Times* (17 July 2022).

[29] 'UK government borrowing costs suffer historic rise after hit to gilts' *Financial Times* (27 September 2022); 'UK business braced for higher costs as sterling falls' *Financial Times* (26 September 2022); and 'Traders bet on emergency interest rate rise after pound hits record low' *Financial Times* (26 September 2022).

[30] Kwarteng invokes Thatcher but UK faces very different times` *Financial Times* (24/25 September 2022).