

Free exchange | Taking a pounding

What America can learn from sterling's decline as a reserve currency

WHEN did Britain cease to be the world's pre-eminent power? Some date its dotage to the end of the first world war; others to the second. By the time of Britain's humiliation during the Suez crisis in 1956, America's hegemony was clear to all. Yet perhaps the most significant indicator of decline went relatively unnoticed by contemporaries: the dollar's usurpation of sterling as the world's main reserve currency.

Fears that a similar fate awaits America and the dollar, at the hands of China and the yuan, have burgeoned over the past decade. They have been fuelled by China's growing economic weight—last year it became the world's biggest economy in terms of purchasing power—and by the efforts of its government to promote the use of the yuan in international transactions. That has prompted economic historians to re-examine sterling's downfall, in search of clues about how the impending tussle between the dollar and the yuan might unfold. The research yields lessons in three broad areas—how a currency attains reserve status, whether a two-currency system is possible, and how poor policymaking can speed a currency's decline.

The pound dominated the financial world in the late 19th century: more than 60% of trade and 90% of public-debt issuance around the world was conducted in sterling. In part, this was owing to sheer economic clout: at its zenith, the British empire encompassed nearly a quarter of the world's people and territory. But as a recent series of papers* by Barry Eichengreen of the University of California, Berkeley, and several colleagues shows, this was not a sufficient condition for financial hegemony. After all, America's economy overtook Britain's in size around 1880, yet the dollar was rarely used abroad until after the first world war.

Mr Eichengreen argues that the "size, stability and liquidity" of financial markets are the most important determinants of reserve status. The pound was a reliable store of value, having been freely convertible with gold since the 1820s. It also offered access to London, the world's biggest and most stable financial centre. Moreover, as Charles Kindleberger, another economic historian, pointed out, sterling's place in the world was bolstered by international co-operation: to help deal with destabilising current-account surpluses and deficits, Europe's central banks co-ordinated monetary policy and extended one another loans.

As a result, the dollar only began to supplant the pound after the establishment of the Federal Reserve in 1913, which helped make America's financial markets both more liquid and more

stable. Soon after, the international co-operation that supported the pound collapsed amid acrimony regarding reparations and war loans following the first world war.

All this should reassure the dollar's defenders. America's capital markets remain massively bigger, more liquid and better regulated than China's, the financial crisis notwithstanding. Although the Chinese government is actively promoting the development of its financial markets, just as America did a century ago, progress has been fitful. The yuan is not fully convertible, the authorities meddle with the markets and Chinese stocks have become a byword for instability.

It need not be lonely at the top

Mr Eichengreen's research also suggests that two reserve currencies can co-exist for a long period. Although the dollar began gaining ground in the aftermath of the first world war, the pound remained an equally significant reserve currency throughout the interwar period (see chart). Nor is the road to a new reserve currency a one-way street: sterling regained some ground when America was hit by a series of banking crises in the early 1930s.

Economists had tended to assume that there are big gains to be had from using a single reserve currency, in the form of lower transaction costs for international trade and investment. That, in turn, should lead to a rapid transfer of allegiances during a switch from one reserve currency to another. But Mr Eichengreen argues that central banks and investors will continue to hold some reserves in a waning currency as long as it remains sufficiently liquid, since diversification brings even greater benefits by helping limit capital losses in the event of currency turmoil.

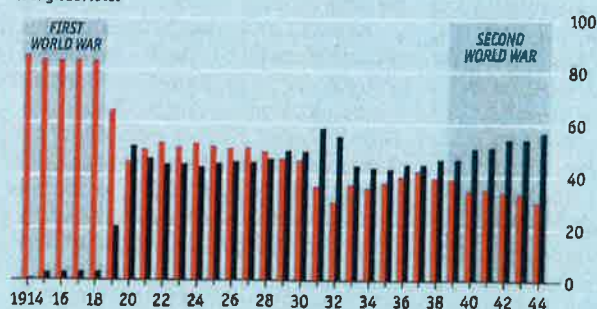
However, misguided policymaking during a period of overlap can hasten a reserve currency's decline. In the interwar years Britain took various steps to reverse London's waning status as a financial centre, including fixing the pound against gold at a rate that made its exports uncompetitive and introducing protectionist tariffs. In the long-run, such policies proved counterproductive: by dampening growth in Britain, they further diminished sterling's standing. Devaluations of the pound and exchange controls after the second world war terminally damaged its reputation for reliability and stability.

With luck, Congress will resist the temptation to erect obstacles to trade, despite the enthusiastic endorsement of the idea by populist politicians of the left and right. But it is not hard to imagine America undermining the dollar by refusing to co-operate with the world's other big economies. As it is, America is at loggerheads with China about reforming the IMF and the World Bank. It has also churlishly resisted Chinese initiatives such as the Asian Infrastructure Investment Bank.

The breakdown of international financial co-operation as a result of the first world war led to messy and unstable conditions in the interwar years. The IMF and World Bank were founded after the second world war to ensure that this error was not repeated. It would be ironic if those institutions themselves became emblematic of America's failure to learn the lessons of history: that the dollar will not soon be supplanted, that a rising currency need not be an adversary, and that insularity is the quickest way to hasten a reserve currency's demise. ■

Sterling shirk

Governments' foreign debt* issued in: ■ Sterling ■ Dollars
% of global total†



Source: Chitu, Eichengreen & Mehl (2014)

*Excludes Commonwealth countries
†At current exchange rates

*Studies cited in this article can be found at www.economist.com/reserves15

Economist.com/blogs/freeexchange

Schumpeter | Capitalism and its discontents

Anti-capitalism is being fuelled not just by capitalism's vices but also by its virtues



DAVE SPART has been a stalwart of *Private Eye*, a British satirical magazine, since the 1970s. The bearded Bolshevik has never wavered in his enthusiasm for denouncing capitalism (“totally sickening”). But in recent years the *Eye*’s editors gave their fictional columnist progressively less space as the left made its peace with free markets and consumerism. Now, Mr Spart is back—not only on the pages of *Private Eye* but in the corridors of power. Britain’s main opposition Labour Party this week held its first conference under a new, hard-left leader, Jeremy Corbyn. In Greece and Spain new left-wing parties have emerged. Greece’s Syriza has come out on top in two successive elections and Spain’s Podemos is set to make big advances in December’s general election. In the United States, Bernie Sanders, a self-described independent socialist, is making a spirited run for the Democratic nomination. And in the Vatican Pope Francis denounces the “invisible tyranny of the market” and recommends “returning the economy to the service of human beings”.

Why is anti-capitalism gaining ground? Dave Spart would no doubt argue that the people are finally realising that the free market is an illusion. Big companies act as rent-seeking monopolies, with their executives lobbying politicians for special favours and tax breaks. The boss-class awards itself huge pay packets regardless of success or failure: it is said that Martin Winterkorn, the departing CEO of Volkswagen, may leave with a pension-plus-severance package worth €60m (\$67m). This argument is gaining ground on the right as well as the left. On September 25th Charles Moore, Margaret Thatcher’s official biographer, wrote in the *Wall Street Journal* that Marx had a valuable insight “about the disproportionate power of the ownership of capital”. A Gallup poll of confidence in American institutions found that “big business” came second to bottom, just above Congress, with only 21% expressing “a great deal” or “quite a lot” of confidence in it.

Free-marketeers have a ready-made answer to this argument. Messrs Spart and Moore are complaining about the problems of corporatism rather than capitalism. The best way to solve the problems of “bad capitalism” (monopolies and cronyism) is to unleash the virtues of “good capitalism” (competition and innovation). The welcome news for such free-marketeers is that good capitalism is gaining ground. Look how hard it is nowadays for

big firms and big bosses to entrench themselves. The average time a company spends on the *Fortune* 500 list has fallen from 70 years in the 1930s to about 15 years today; and the average job tenure of a *Fortune* 500 CEO has gone from ten years in 2000 to five years today. The bad news is that good capitalism may be doing as much as bad capitalism to create the current backlash.

Globalisation and digitisation have speeded up the pace of creative destruction. Successful firms can emerge from obscure places such as Estonia (Skype) and Galicia (Inditex) to straddle the globe. Digital technology allows businesses to become huge in no time. WhatsApp, a mobile-messaging platform, reached 500m users within five years of its launch. But the champions of this brave new world can be disconcerting. They are usually light on both people and assets, partly because digital services are highly automated and partly because of outsourcing. Ten years ago Blockbuster had 9,000 shops in America with 83,000 employees. Netflix employs just 2,000 people and rents the computing power for its streaming video from Amazon. Gerald Davis of the University of Michigan’s Ross School of Business calculates that the 1,200 firms that have gone public in the United States since 2000 have each created fewer than 700 jobs worldwide, on average, since then. They are also ruthless: the new champions are constantly reinventing and reconfiguring themselves in order to avoid the fate of former champions such as AOL and Nokia.

Rapid change is provoking anxiety—and resistance. Supporters of good capitalism argue that employability is what matters, not employment. But what happens when change is so fast that “skills security” goes the way of job security? Those in the good-capitalism camp say, too, that rapid change is the price people pay for prosperity. But surely people value stability as well as the fruits of technology? In 1988 William Samuelson and Richard Zeckhauser, two economists, described a case in which the German authorities wanted to move a small town, so the coal underneath it could be mined. They suggested many options for the new town but, rather than something more suited to the age of the car, its citizens chose a design “extraordinarily like the serpentine layout of the old town, a layout that had evolved over centuries without (conscious) rhyme or reason.”

I am Spart

Pro-capitalists rightly argue that the creative bit of creative destruction outweighs the destructive side. Thanks to Google and its likes we can search a good portion of human knowledge in an instant. Thanks to firms like Apple we each carry a super-computer in our pockets. Thanks to sharing-economy companies such as Uber and Task Rabbit, people who do not want to work regular hours can find work whenever it suits them. The best way to solve some of our most nagging problems is to unleash the power of innovation. Airbnb is cutting the cost of temporary accommodation and MOOCs (massive open online courses) are democratising access to an Ivy League education.

But pro-capitalists should also remember two things. The first is that most people do not distinguish between good and bad capitalism: they see a world in which the winners are unleashing a tide of uncertainty while reserving themselves luxury berths on the lifeboats. The second is that the forces sweeping through the capitalist economy are also sweeping through politics: the old party machines are imploding, and political entrepreneurs have the wherewithal to take over old parties or to build new ones. Anti-capitalism is once more a force to be reckoned with. ■