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John Ryan

1. Introduction

China's economic and diplomatic ascendancy over the past decade has been nothing short of phenomenal in terms of world history. It has seen its influence on the world stage grow from playing a minor part at the start of the 20th century, when its territory sovereignty was encroached upon by the European colonial powers and when Japan mounted a campaign of conquest, to being seen as the biggest strategic threat to U.S. primacy in the global economy.

China's concern about its U.S. Dollar reserves is being amplified by the low returns of some of China' investments in the U.S. which leads to a broader concern about how the current reserve system basically entails China lending to the U.S. at very low interest rates. A two-currency reserve system would potentially be even more unstable than the existing one, because of speculation moves in and out of the U.S. Dollar and the Euro depending on their return, increasing volatility. U.S. Policymakers have started to realize that large external deficits, the dominance of the dollar, and the large capital inflows that necessarily accompany deficits and currency dominance are no longer in the U.S. national interest. The U.S. has to consider initiatives put forward over the past year by China and others to begin a serious discussion of reforming the international monetary system.

This chapter will examine four scenarios regarding the global currency regime of the future and the Chinese influence in this most important policy arena. It will focus on the U.S. Dollar decline as the Reserve Currency, on the Euro gaining strength slowly in a turbulent world, on the potential of the Renminbi to become a Reserve Currency, and on the future of the Super-Sovereign Reserve Currency, the IMF's Special Drawing Rights (SDRs).

Before that it will examine the role of the Renminbi in the Asian Financial Crisis in 1997 and its role in the global financial markets at that time and lessons learnt from the crisis. The crisis had significant macro-level effects, including sharp reductions in values of currencies, stock markets, and other asset prices of several Asian countries.

2. Revisiting the Asian Financial Crisis of 1997

The Asian financial crisis began in 1997 when Thailand was forced to devalue its currency after it had exhausted its foreign currency reserves in an effort to defend its currency peg from speculators and investors keen to 'cash out'. The transition from a pegged currency to a free floating one caused the Thai Baht to lose half its value. The Thai baht was pegged at 25 Baht to the US dollar and devalued to 56 Baht to the US dollar on 2 July 1997.

As investors' confidence collapsed throughout Asia, Indonesia, South Korea, the Philippines and Malaysia were all affected and their currencies devalued significantly (Milne 2009). Many factors were cited as causes to the Asian financial crisis (Blustein 2001, Kaufman, Krueger, and Hunter 1999) and many commentators see China's devaluation and subsequent export growth as one of the causes of the Asian financial crisis (Weisbrot 2007, Ries 2000). It is generally accepted that the increase in interest rates in the United States made the U.S. Dollar more attractive to short term investors. This led to an outflow of capital from the affected countries as international investors preferred U.S. investments. This outflow, coupled with slowdown in exports severely affected these economies' current account balance and led to devaluation. With local business and financial sector borrowing heavily denominated in U.S. dollars, devaluation and the lack of short-term capital (which had fled to the United States) led to a credit squeeze in the affected countries, which plunged many of them into recession. Other factors have also been highlighted as causes to the crisis, such as herd mentality by currency traders and speculation. Indeed Malaysian Prime Minister Mahathir Mohammed accused George Soros (Fratianni and Artis 1996), a currency speculator, of ruining the Malaysian economy with extensive currency speculation. Soros has also been implicated in Britain's 1992 exit from the Exchange Rate Mechanism of the European Monetary System, where he was alleged to have made £2 billion pounds overnight speculating against the British Pound in 1992.

China's role in causing the Asian financial crisis cannot be disputed. The role the Chinese currency (and by extension the Chinese government) played in maintaining financial stability in Asia during the crisis. The subsequent credit crunch arising from a round of devaluations would have further hobbled the affected East Asian economies. The January 1998 announcement by Vice-Minister Long Yongtu that China would not devalue because that would trigger a new cycle of devaluations led the financial markets to take note of the Renminbi's new role as one of Asia's potential lead currencies (Wu 1998).

After the Asian Crisis there was academic and policy criticism (Teh 1999, Gang 2006, Liew 2003 and Zhang 1996) of the devaluation of the Renminbi and the negative global consequences that would be brought about should it be devalued. An appreciation or floating of the Renminbi would have important consequences for growth and stability in China and knock-on effects on the rest of Asia. Due to China's current lack of sound financial and banking systems and the inherent structural problems China faced, a significant appreciation of the Renminbi, as Goldstein and Lardy (2008) suggest it is undervalued by, would lead to lower economic growth. The consequences on China's banking sector, due to its high amount of non-performing loans and would most likely lead to increasing deflationary pressures on an economy just emerging from deflation. Asset bubbles would most likely arise as well; foreign direct investment would drop, as investors flock to lower cost competitors.

The current debate on China's currency valuation and its effect on global trade imbalances can be seen as a distraction from the root causes of this imbalance. China's comparative advantage of cheap labour allows it a stronger hand when dealing with its trading partners, and the various fiscal policies implemented by its government make its exports much more competitive than any benefits an undervalued currency would confer. Since a sharp appreciation in the Renminbi would have dire consequences on the world economy, this would demonstrate the effect the Chinese currency has on the global financial market.

2. Potential Currency Scenarios for China

Each of the four scenarios outlined in this section represents an examination of the possible reserve currency development from Chinese perspective to the question of a global reserve currency for the future. Even if each single scenario is a stylised simplification and even if there are probably more scenarios to consider because of the interrelation and combination between the variables used, this approach is very helpful to draw the main trend we will have to face in the future.

Scenario 1: The U.S. Dollar decline as the Reserve Currency

"The dollar may be our currency, but it's your problem", a phrase that John Connally, US Treasury Secretary under President Nixon, used to a delegation of European visitors in 1971. The dollar is gradually losing its status as the world's reserve currency. The U.S. Treasury recently predicted that national debt would rise by more than $9,000bn over the next decade. A reserve currency has to be stable to be effective, and for some time now, it has been clear that the U.S. Dollar is gradually losing the confidence of global markets (Chinn and Frankel 2008, Posen 2008, Duncan 2005).

The United States supposed comparative advantage at financial engineering isn't worth as much now as it seemed to be worth a year ago. Finally, the fact that the U.S. now depends so heavily on central bank financing also makes the U.S. all the more sensitive to any change in the Dollar's status (Duncan 2005).

Confidence in the health of the U.S. economy, and therefore the U.S. Dollar, could plunge because of continued large U.S. current-account deficits, an unstable banking sector and a recession-busting, expansionist monetary policy. In late March 2009, U.S. Treasury Secretary Timothy Geithner sent the Dollar tumbling when he said he was "actually quite open" (Bloomberg, 2009) to China's proposal for a greater role for SDRs. The U.S. Dollar lost 1.3% against the Euro within 10 minutes of Geithner's unexpected comment.

Chinn and Frankel (2007) claim that rankings of international currencies change only very slowly, but when they change they do so with a bang, although the United States surpassed the United Kingdom in economic size very early (between 1860 and 1875 depending on estimates), the U.S. Dollar did not surpass the Pound as the major international currency until 1945.

The potential geopolitical implications of such a projected shift are immense. First, the U.S. will lose its privileged/seigniorage position- the ability to achieve permanently higher returns on foreign assets than the returns paid to foreigners who invest in the U.S. The current economic crisis has revealed that the U.S. legal framework for the regulation of financial markets and institutions is rather inadequate. Even given the dismal state of the legal framework, the actual performance of key regulators like the Federal Reserve and the Securities and Exchange Commission has been appalling, with astonishing examples of incompetence and regulatory capture (Eichengreen 2009).

The U.S. Federal government has taken on massive additional contingent liabilities through its bail out/underwriting of the U.S. financial system. Together with the foreseeable increase in actual Federal government liabilities because of vastly increased future Federal deficits, this implies the need for a future private to public sector resource transfer that is most unlikely to be politically feasible without recourse to inflation. The only alternative is default on the Federal debt. There is little doubt that the Federal authorities will choose the inflation and currency depreciation route over the default route.

China has been keeping the U.S. afloat for the best part of a decade, buying up vast quantities of Treasury bills to fund America's enormous budget and trade deficits. At any point, China could seriously damage the world's largest economy – by refusing to lend more money. So reliant is the U.S. on funding from Beijing that, by turning off the cash taps, China could spark an instant run on the dollar. The Chinese have not done that as it would harm their dollar-based holdings given the interdependencies existing between the two economies (Cooper 2009).

China's influence on U.S. policy faces two big constraints. The U.S. Dollar's status as the world's reserve currency gives the U.S. huge flexibility that other countries with large deficits do not enjoy, much to the frustration of many Chinese officials. China's unwillingness to let its currency appreciate more also limits its leverage. The Chinese-U.S. relationship in the past was dominated by lectures from Washington D.C. about China's undervalued currency and its closed financial markets. Over the last year the discussion has been about Chinese warnings on the risks of inflation in the U.S. economy and Dollar weakness. The Chinese government has started demanding guarantees for the $700bn of U.S. Treasury bills on its books (Halligan 2009).

There are four reasons why China might worry about a decline in the value of the dollar that would depreciate the value of their Treasury bill holdings. First, the U.S. government is racking up huge debts in its efforts to climb out of recession and purge the financial system of toxic assets. Massive government debt is a sure-fire means to put downward pressure on a nation's currency value. Second, printing money is a means to relieve temporarily some of the debt problems. However, this always leads to an inflation problem in the long term, which again places a declining bias on a nation's monetary unit. Third, U.S. interest rates are at exceptionally low levels. This will reduce the attraction for international investors of holding U.S. Treasury Bills, bonds and notes once the need for "safety" is deemed to be less pressing. Fourth, there are already signs that the "safety" effect may be waning. It appears that China is preparing to take a diversification and risk minimizing strategy by purchasing other assets such as gold (Waldmeir 2009).

The U.S. and the global community has an interest in continued globalization and efficient international financial markets, and so neither has any interest in entirely eliminating the international role of the dollar. The U.S. should consider two practical changes in the current international monetary order. The first is the further evolution of a multiple-currency system in which other currencies increasingly share the international position of the dollar in private markets. The Euro based on a collective European economy as large as the United States' and with capital markets as extensive in most respects, is the most obvious candidate. The Euro already rivals the dollar in some domains, such as currency holdings and private bond placements, and will become a full competitor whenever the Eurozone countries adopt a more integrated fiscal policy. The Chinese Renminbi is likely to acquire a significant international role once China allows it to be converted for financial as well as current account transactions and eases capital controls.

Scenario 2: The Euro gains strength slowly in a turbulent world

Today’s Chinese and Russian concerns that the U.S. can flood the world with Dollars and finance rising budget deficits at little cost, enhancing the U.S. dollar's global status and crowding out the borrowing efforts of other countries, echo earlier critiques from Europe. Since the 1960s, France has been a critic of U.S. alleged "exorbitant privilege" (Portes 2007) of international reserve asset power. One of the many reasons for the creation of the Euro was indeed to fulfil the Europeans' long-held wish to create a reserve asset that could counter the Dollar's global dominance. Today, large countries such as China and Russia could start to buy Euros on a grand scale instead of Dollars, or switch large quantities of the present reserves.

One reason why such a step change could take place is that the U.S. Treasury is indirectly provoking such action through recent talk of China's alleged manipulation of its currency. In the unlikely event that the People's Bank allowed the Renminbi to fall by stopping Dollar purchases, the Chinese current-account surplus would undoubtedly fall. The reality is that, if monetary hostilities between Beijing and Washington D.C. escalated then the Euro would become part of the collateral damage.

The fact that Euro, with the irrevocable locking of exchange rates, has already lasted a decade, that other countries have joined, and others are considering joining have demonstrated credibility in this new currency. The Euro may have proved a catalyst for greater economic integration but, at political level, its main effect has been external; the Euro has demonstrated the economic importance of the EU to the outside world.

In its assessment of the first 10 years experience of EMU (Directorate General Economics and Finance 2008), the European Commission has claimed a success. The European Central Bank successfully brought down interest rates and anchored inflation within the Eurozone to an average of just over 2 per cent. Externally, the Euro became increasingly important as a world currency in trade and financial services. It is now the second largest global reserve currency after the U.S. Dollar. Having fallen in relation to the U.S. Dollar and other currencies at the outset, the Euro gradually strengthened – from approximate parity with the Dollar to a rate which reached $1.36 to the Euro in March 2009.

The introduction of the synthetic Euro in 1999 and then physically in 2002 was the most far-reaching change in the international monetary system since the changeover to floating exchange rates in the early 1970s. Where the deutschmark and the yen failed in the 1970s and 1980s, the Euro now appears to have succeeded, namely in challenging the U.S. dollar as the undisputed leading international currency. The Euro has gained considerable clout as an international trade, investment, anchor and reserve currency over recent years and has firmly established itself as the second most important currency behind the U.S. Dollar. That is why, for the first time in many decades, there is serious debate about whether the U.S. Dollar will remain the premier international currency going forward (Galati and Wooldridge 2006).

It is revealing that, even in the midst of the worst financial crisis in 70 years, one widely and somewhat justifiably believed to have begun in the U.S. economy, the flight to safety of world savings was to U.S. Treasury bonds and not noticeably to the Euro currency. For the Eurozone to pose a serious challenge to the U.S. Dollar it needs to address four points of weakness. First, the European banking and financial supervision is still too largely under national control. There is no single market for government bonds (Galati and Wooldridge 2006). Second, it does not have effective representation at global level in fora such as the International Monetary Fund (Pisani-Ferry and Posen 2009). The Eurozone response to the 2008 emergency in the financial sector was slow and driven by national considerations but by 2009 the adoption of the de Larosiere report (De Larosière Group 2009). The de Larosiere report was an important contribution to providing a blueprint for the future global financial architecture. It takes several important steps forward, especially on its proposals for reform of the supervisory role in the European Union regulation.

The Euro already has effectively displaced the dollar as the key reserve currency of Europe. Eastern European countries, the Nordic countries and Switzerland hold most of their reserves in Euros. Russia is moving that way as well (ECB 2009). The central banks of countries that are members of the Euro increasingly hedge their Dollar holdings.

Scenario 3: Will the Renminbi become a Reserve Currency

We can define the role of the Chinese currency in the global financial markets. Having explored the past of the Renminbi and the implications of various decisions taken by the Chinese government with regard to its currency, the role of the Chinese currency in the global financial market can be defined and some conclusions on Chinese exchange rate policy can be drawn.

First, the Chinese government favours prudential financial management. It has demonstrated a willingness to succumb to international pressure, but only on its terms, with the Chinese economy as its priority. Second, the Asian financial crisis exposed weaknesses in neighbouring economies and lessons learnt from that episode seem to have been implemented; Third, China's capital account is becoming more open over time in both de jure and de facto terms, with the easing of capital controls and the inexorable rise in cross-border financial flows. This exposes the economy to volatile capital flows—tighter exchange rate management is seen as essential to control this process. But exchange rate flexibility by itself will not lead to greater capital account openness, a common misconception. Fourth, China's economy is becoming a leading global player which has many similarities with Japan in the 1960s and 1970s, thus Japan's experience of market liberalization might provide a test case (Goldstein and Lardy 2009).

At this juncture, it is pertinent to answer some important questions, such as: what roles will the Renminbi play in the global financial markets in the future? Will it ever become a reserve currency? To be eligible for reserve status, several prerequisites have to be fulfilled:

- The currency should be fully convertible and widely accepted;
- Its financial markets should be broad and liquid;
- Its value should be reasonably stable;
- Large amounts of trade should be transacted in it (Thimann 2009).

Beijing has already stated its intentions to have a convertible currency; assuming there are no deviations from its exchange rate policy, this is a question worth pondering (García-Herrero, and Koivu 2009).

An ensuing concern is that although heavy-handed government meddling may be more effective than market-based tools to pull an economy out of a deep downturn, it comes at a cost. The Chinese monetary authorities have simultaneously been taking cautious steps to make their currency more internationally relevant. Recently China signed a Renminbi 70bn currency swap deal with Argentina, designed to allow the Latin American nation to settle some trade bills in Renminbi. China is staking out a responsible position whereby it seeks a multilateral alternative monitored by a multilateral body.

China lacks the economic and political track record required to underpin a reserve currency. China would need to end capital controls so foreigners could invest in Renminbi assets and then freely repatriate their capital and income, but the government is wary of moving too quickly. A reserve currency also requires a deep and liquid bond market, free from government interference. U.S. GDP is around three times as big as China's, and its total trade is still larger.

On the 13 March 2009 China's Premier Wen Jiabao expressed concerns about the future of the U.S. dollar, the currency in which most of his country's official reserves are denominated; his remarks provoked contrasting reactions among U.S. economists. Some, like Fred Bergsten (2009) of the Institute of International Economics, exhorted the U.S. government to take Mr. Wen's concerns seriously and listen to Beijing's suggestion to create a substitution account in the

IMF, which would allow Fund members to exchange unwanted dollar balances for SDRs, as part of a gradual process to replace the Dollar with a supra-national reserve currency over the long run.

U.S. economists, such as Krugman (2009), China had fallen into a trap of its own making due to its reluctance to adopt a more flexible exchange rate policy in the past. Since any attempt by China or any other country to diversify away from the dollar too much or too quickly would be self defeating, there was no immediate threat to U.S. or world financial stability.

However, the most important drawback of the China/Bergsten proposal is that it does not really protect U.S. official creditors from a persistent fall in the Dollar. This is because in the event of protracted Dollar depreciation, it is highly unlikely that the central banks of Europe, Japan, and the UK will stay put and let their currencies appreciate. More likely, these countries will resist appreciation by engaging in a process of competitive devaluations, the end result of which will be an increase in global inflation. Over the last three decades there have been five co-ordinated interventions in major currencies. In 1985 the G7 signed the Plaza Accord to weaken the dollar. In 1987 the G7 changed stance at Louvre and pledged to support the falling greenback. Similarly, in 1995 the G7 again decided to intervene to help U.S. currency. In 1998 U.S. and Japan sold Dollars to prop up the yen. In 2000 the European Central Bank persuaded the Federal Reserve and the Banks of Japan, United Kingdom and Canada to support the Euro.

Four of these five interventions were ultimately successful in changing the trend of the currency markets. In 1985 the U.S. Dollar stopped overshooting against the yen and the German DM. In 1995 the greenback began a sustained rally that lasted throughout the late 1990s. In 1998 the “yen carry trade“ reversed sharply to the benefit of Japan’s currency and in the early 2000s the euro rarely traded below the levels where the G7 central banks had intervened to support it. The Louvre Accord is the one exception here. Though the G7 agreed in February 1987 to help the greenback, the dollar continued to slide as the German Bundesbank increased interest rates in the summer. If so, the reserves of China and other emerging markets will lose real value whether they are in dollars or SDRs. More importantly, inflation will be high everywhere in the world, and it will take years of high real interest rates and low growth to bring it down.

China continues to raise questions about the dominance of the US Dollar and the need for an alternative monetary system; other countries have also raised concerns about the dollars viability. An eclipse of the dollar would be mirrored by a rise in the use of the Renminbi (Garten 2009).

Scenario 4: Super-Sovereign Reserve Currency: A Nice Theoretical Debate

On 3 March 2009, the Governor of China's Central Bank has called for a "super-sovereign reserve currency" that would be run by the (IMF) International Monetary Fund, an idea that has been backed by Russia, Brazil and India. Losing the global reserve currency status might be healthier for the global economy in the long run, but it would not be a very comfortable adjustment for the U.S.

The idea of the super sovereign reserve currency would be to create a reserve currency that is disconnected from individual nations and is able to remain stable in the long run, thus removing the inherent deficiencies caused by using credit-based national currencies. This is a clear sign that China, as the largest holder of U.S. Dollar financial assets, is concerned about the potential inflationary risk of the U.S. Federal Reserve printing money (Eichengreen and Frankel 1996).

China has over-exposed itself to the U.S. Dollar-denominated securities. The U.S. puts domestic economic needs before its creditors; the Beijing authorities now worry that possible future inflation could cost them dearly. As the Bank of China's Governor says, a reserve super currency could be created through further issuance of the International Monetary Fund's Special Drawing Rights – the IMF's in-house reserve asset.

The value of SDRs is based on a basket of four currencies – the U.S. Dollar, Yen, Euro and Sterling – and they are used largely as a unit of account by the IMF and some other international organisations. But the SDR is unlikely to become a reserve currency any time soon. It would take years to develop SDR money markets that are liquid enough to be a reserve asset.

China's proposal would expand the basket of currencies forming the basis of SDR valuation to all major economies and set up a settlement system between SDRs and other currencies so they could be used in international trade and financial transactions. The long tradition of Presidents and Treasury Secretaries pretending that the U.S. has a "strong dollar" policy, regardless of what is actually happening in the international currency markets.

The People's Bank of China governor's proposal March 3, 2009 China's way of making clear that it is worried that the Fed's response to the crisis—printing of money—will hurt the Dollar and hence the value of China's huge foreign reserves (See Table 1). The current international financial system, which is based on a single currency, has two main flaws. First, the reserve-currency status of the U.S. Dollar helped to create global imbalances. Second, the country that issues the reserve currency faces a trade-off between domestic and international stability. Massive money-printing by the Fed to support the economy makes sense from a national perspective, but it may harm the Dollar's value.

Table 1
MAJOR FOREIGN HOLDERS OF TREASURY SECURITIES
(In billions of dollars) July 2009

China, Mainland	**800.5**
Japan	**724.5**
United Kingdom	**220.0**

Some specific steps are needed to improve the role of the SDR as a global reserve asset.
In order to make the SDR the principal reserve asset via allocation, close to $3 trillion in SDRs would need to be created. Wijnholds (2009) has thus suggested a so-called SDR Substitution Account. The idea is to permit countries whose official dollar holdings are larger than they desire to convert dollars into Special Drawing Rights. Conversion would occur outside the market and thus would not put downward pressure on the Dollar. This suggestion, however, requires settling who will bear the exchange (Dollar) risk as the SDR Substitution Account is likely to mostly hold Dollars as assets.

The SDR is unlikely to be a practical alternative to the Dollar. In theory, countries can purchase liabilities issued by the International Monetary Fund that are linked to the SDR. If the objective is to diversify out of dollars, reserve managers can achieve it more efficiently by directly increasing their holdings of Euro, Yen and Sterling (the other currencies to which the SDR is linked). More than half of China's reserves are denominated in dollars. So when the Dollar falls, China loses serious money. China has remained tight-lipped, worried less about diplomatic niceties than the financial implications of voicing its concerns. If the markets thought China would buy less dollar-denominated debt going forward, the U.S. currency would weaken further, compounding China’s loss.

U.S. financial diplomacy has complacently relied on this for some time because China is in so deep it has no choice but to carry on buy U.S. debt. But China has become so worried about U.S. expansionary monetary policy that it is speaking out, despite the damage that does to the value of China's currency reserves.

The U.S. Dollar is now being used as a "carry" currency. Currency traders are using low Federal Reserve rates to take out cheap U.S. Dollar loans, and then converting the money into currencies generating higher yields. "Carrying" credit in this way is currently the source of huge gains. No one knows the true scale, but the global economy has been flooded with cheap U.S. Dollars.

This presents serious global systemic danger. The U.S. Dollar is weighed down by Chinese divestment, then suppressed further by carry-trading, could easily spring back. Those who had borrowed in Dollars would owe more, while their Dollar-funded investments would be worth less. This "unwinding" could send financial shock around the globe. China has suggested the Renminbi be included in the SDR. While this may help other nations gain exposure to the Renminbi, China may need to accept a further increase in its own exposure to the Dollar

China’s proposal would have members surrender part of their reserves to the Fund in exchange for SDRs, effectively making the IMF a global vault. The benefit here would be simply one of diversification—the IMF would have no enforcement authority in the management of global liquidity beyond its current one. But how would that help China in its current problem? If everyone expects the Dollar to decline in value, reserve managers would only be willing to change their Dollars for SDRs, not their Euros. This would drive the Dollar weaker in the same way it would if China went and sold Dollars for Euros outright in the Foreign Exchange market (Aiyar 2009).

Conclusions

Both the SDR plan and measures to internationalise the Renminbi also seem to assume that China's problem is simply that too many of its reserves are in dollars. But China's real problem is that it is running a persistent current-account surplus; in order to keep the Renminbi closely tied to the dollar it has to keep buying more dollar assets. If China really wants to reduce its exposure to the greenback it must allow the Renminbi to rise. It would incur a loss on its existing reserves but stem future losses. But so long as China maintains its current exchange-rate policy, it is, ironically, helping keep the dollar dominant.

There are two reasons for the decline in the international role of the U.S. dollar. The first is persistent current account deficits combined with a long-term decline in the Dollar's exchange rate – and perhaps imperial overreach, too. The second is the emergence of a genuine alternative to the Dollar. Neither the Yen nor the D-Mark had a realistic chance of replacing the greenback. But the Euro is a real alternative. The Eurozone economy is almost as large as that of the US and may surpass it as it continues to enlarge. London is the Eurozone's de facto financial centre, even though the UK itself has not adopted the Euro.

The projected speed at which the Dollar will lose its predominant position as a global reserve currency obviously depends on the U.S. Treasury fiscal policy. The reckless monetary policy of the Federal Reserve has speeded up the Dollar's decline and caused a rise in inflationary expectations. We would expect U.S. inflation to pick up significantly once the present recession ends. Future inflation will weigh heavily on the global role of the U.S. Dollar. Another factor that pushes in the same direction is the weakening of the U.S. financial sector.

Chinese leaders frequently emphasise the U.S. responsibilities for the stability of the dollar as the premier reserve currency. The Chinese central bank, the guardian of the proceeds from Beijing's massive current account surpluses, warns obliquely that turning its back on the greenback would risk a monetary catastrophe. It is time, though, for a more balanced debate. To enhance its credibility, Beijing must put its own house in order. In the interests of a more stable monetary system, China needs to open its capital markets and allow broader international access to the Renminbi. The U.S. and its allies should insist on this unrelentingly.

Apart from being liquid, stable and backed by sophisticated financial markets, the two currencies dominate global transactions by far—with the U.S. Dollar accounting for two-thirds of international reserves; the Euro for about a quarter (Portes 2007). During the height of the crisis, the Dollar's volatility was comparable to that of the Sterling and the Euro and lower than that of other advanced economy peers. Second, to the extent that a country's external obligations remain largely denominated in U.S. Dollars, the Dollar's volatility does no undermine the ability to cover $-denominated obligations.

Importantly, it is unclear whether the diversification benefit would be enough to make reserve managers willing to hold SDRs instead of Dollars (or Euros), unless the SDR takes a prominent role as unit of account or medium of exchange in global trade and financial transactions. The use of an SDR in international trade and finance would be painfully slow. Geographical, historic and cultural ties create inertia in the currencies chosen as units of account in international trade and finance.

China's huge volume of Dollar reserves is now at the centre of serious concerns about the future of the US currency. The origin of this situation dates back to the early 2000s, after the Asian and Russian crises. At that time, accumulating foreign reserves was considered benign policy. Developing and emerging countries were encouraged in this way in order to insure against sudden reversals of capital inflows. China was pegging its currency against the Dollar and, due to the U.S. trade deficits, started acquiring U.S. assets.

Ten years on, the People's Bank of China (PBOC) has an extraordinary stock of U.S. Dollars, and one pressing question: "What to do out of them?" Increasing political tensions have given rise to fears that it might get rid of this huge bulk of securities and precipitate a Dollar crash. In August 2007 a Chinese official indeed reminded that Beijing was in a position to provoke a "mass depreciation" of the Dollar if it decided to do so. China's authorities have shown few signs of attempting to weaken the Dollar. The reason for this seems straightforward. After all, China is the world's largest Dollar investor, and no one else would have less interest in seeing the value of the U.S. currency plummet. The Peoples Bank of China might be the promptest to support the Dollar, not least because it would suffer a huge capital loss in the event of dollar depreciation. In a recent New York Times column, Krugman (2009) argues that China has "driven itself into a Dollar trap and that it can neither get itself out nor change the policies that put it in that trap in the first place."

In the past a strong and open U.S. financial system helped facilitate the Dollar's international use. While a high degree of feedback naturally exists between the Dollars's expanding role in trade and the growth of an accommodating financial structure, U.S. financial markets had the reputation of being innovative and relatively free of tighter regulation. Their breadth and depth enhance the liquidity of dollar-denominated assets. Moreover, as U.S. trade expand and U.S. financial markets grow, more and more foreign financial firms – even ones not located in the U.S. – offer dollar-denominated products. All this makes holding Dollars convenient and transacting in Dollars relatively easy.

As the global network for Dollars expanded, the benefits of using the Dollar in exchange rose. The process had been self-reinforcing. Moreover, once the network benefits of a particular currency become substantial, people are prone to continue using them, even if viable a competitor exists. The Euro matches many of the Dollar's qualities, and its use continues to expand. Making the jump to a new international currency, even one as widely used as the Euro, requires a substantial proportion of people to make the jump in close concert. Otherwise, the network benefits are lost. For that reason, the world is not likely to shift quickly away from Dollars even if the SDRs become a new international-reserve option.

Are the Dollar's Days as Reserve Currency Over? No. They aren't. But they are numbered. They aren't over because other nations still need the U.S. consumer. Until the Chinese manage to create a domestic consumer society, both they and other countries can't cut themselves lose from the U.S. consumer. What they will do, and what they are doing, is trying to manage how much the U.S. borrows and to take away the U.S. ability control the world's money supply. They will still have to keep the U.S. propped up for the time being, because in so doing they are propping up themselves. The key break point, the end of the dollar hegemony, will come when the Chinese are able to move to a consumer economy. At that point, the Chinese will no longer need U.S. as consumers, and they will let the Renminbi float.

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