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Theories of International Currencies and the Future of the World Monetary Order

Hyoung-kyu Chey *

* Economist, Institute for Monetary & Economic Research, The Bank of Korea

Institute for Monetary and Economic Research
The Bank of Korea

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Hyoung-kyu Chey*

* Economist, Institute for Monetary & Economic Research, The Bank of Korea, 110, Namdaemunro 3-Ga, Jung-Gu, Seoul, 100-794, Republic of Korea. Email: hkchey@bok.or.kr. The author wishes to thank Barry Eichengreen, Michael Marking, Byoung-Ki Kim and Geun-Young Kim for careful reviews of an earlier version of this paper, and also seminar participants at the Bank of Korea for helpful comments. The views expressed here are his alone and should not be interpreted as representing the Bank of Korea or its policy.

Contents

Theories of International Currencies and the Future of the World Monetary Order

The international standings of currencies form a principal characteristic of the international monetary order, which shapes the world economic and political system by influencing the economic and political relationships among countries. This paper provides a systematic review of the literature on international currencies, encompassing both economics and political science, with the aim of providing a useful groundwork to help develop a better analytical framework for the study of international currency standing. In particular, this paper discusses the international currency concept, the benefits and costs of issuing an international currency, and the determinants of international currency standing. It also assesses conflicting prospects for the future of the US dollar as the world's key currency. It in addition calls attention to certain domestic political economic factors, as salient issues for the future study of international currency standing.

Keywords: International currency, international monetary order, dollar, euro, renminbi

JEL Classifications: F02, F33, F50

I. Introduction

In the wake of the global financial crisis of 2007-10, active debate about the future of the US dollar (hereafter dollar), and accordingly that of the international monetary order, has resurfaced, particularly as the crisis originated from the United States and US crisis management policies have stirred strong concerns about the dollar's status as the leading international currency. In fact, the debate about the dollar's status as the key international currency is not new. It goes back as far as to the 1960s, when the sustainability of the Bretton Woods system began to be questioned, and has emerged almost any time the dollar has lost value substantially.[1] Until now, history has favored those forecasting sustainability of the dollar-centered international monetary system. Will the dollar maintain its key currency status again this time, or will a new international monetary order arise? Why does the future of the dollar matter, for the United States and for the world? To be able to answer these salient questions, we need a solid knowledge of the determinants of a currency's international status, and of what the international use of a currency entails for the country issuing it.

This study provides a systematic and comprehensive review of the literature on international currencies, embracing both economic and political studies, with a particular focus on the following issues: the international currency concept, the benefits and costs of issuing an international currency, the determinants of international currency status, and the future prospects for the current dollar-centered international monetary order. It also calls attention to the domestic political economy as an important area for future study of international currency standing, highlighting domestic groups' preferences regarding currency internationalization and the role of state actors in and the impact of domestic political institutions on currency internationalization. Through such discussion, this paper aims to provide groundwork for building a better analytical framework for the study of international currencies.

This paper is organized as follows. It first discusses the concept of an international currency, and then examines the benefits and costs of issuing an international currency. It next addresses economic and political factors that affect international currency standing, and following this examines and assesses conflicting forecasts for the future of the dollar. It moves on to consider issues on which more research is needed for further development of the study of international currencies, and then in the final section provides conclusions.

[1] Exchange rates are in fact only an imperfect indicator of a currency's international standing, since that depends fundamentally on the currency's use rather than its price (Cohen, 2009b: 742).

II. The international currency concept

An international currency is usually defined as a currency that is used beyond its home country. The concept of international currency can be further elaborated for more systematic analysis, however. There are broadly two ways of doing so. One is to conceptualize an international currency in terms of its functions, and the other to categorize international currencies in accordance with the natures of the factors that support their international use. The former approach is widely adopted in economics research, while the latter is used increasingly in political economy study.[2]

Functional conceptualization

Conceptualizing international currencies on the basis of their monetary functions is the most widely used way of defining them. This method was proposed by Benjamin Cohen (1971) in his writing in the early 1970s about the British pound sterling, and subsequently refined by Peter Kenen (1983), Paul Krugman (1984) and others. Just like a domestic currency, an international currency performs the three functions of money—as a medium of exchange, a unit of account, and a store of value. It does so at two distinct levels, however, for private and public transactions, and accordingly plays six roles in total. As a medium of exchange, it is used by private actors to settle international economic transactions or by governments as a foreign exchange market intervention currency. As a unit of account, at the private level it denominates international economic transactions while at the public level playing the role of an anchor to which governments peg their currencies. As a store of value, it is used as an investment asset at the private level or as a reserve currency at the public level. Each of these six functions can be interrelated with the others to some extent, although not inevitably (Cohen, 1971). Table 1 summarizes this standard taxonomy of the roles of an international currency.

[2] Meanwhile, Cohen (1998) classifies currencies into seven groups in accordance with the scopes of their 'authoritative domains,' which combine their territorial and transactional domains. Christian Thimann (2009) also suggests a new concept, 'the global roles of currencies.' This concept encompasses both the cross border and the domestic uses of currencies, to reflect their overall importances in the world economy.

Table 1. Roles of an international currency

	Private	Public
Medium of exchange	Settlement of international economic transactions	Intervention in foreign exchange markets
Unit of account	Denomination of international economic transactions	Anchor for pegging national currencies
Store of value	Investment assets	International reserves

The number of currencies that perform all of these roles of an international currency is obviously very limited. The dollar is currently the only one that does so on a global scale, in serving as the world's key currency. Some currencies such as the euro and the yen also perform all of these roles, but only within more limited geographical regions. Other currencies usually perform only some of the six money roles.

The functional conceptualization of international currencies makes significant contribution to the study of international currencies, by providing an analytical framework for evaluating currency internationalization in terms of the scope of the monetary functions of the currency concerned, and also the degree of its internationalization in terms of each of the recognized monetary functions.

The political economic conceptualization

The political economy approach in the study of international currencies was pioneered by Susan Strange (1971), who like Cohen (1971) considered sterling in the early 1970s. She raised the following two questions, directing attention to the *politics* of international currencies: 'Under what political, as distinct from economic, circumstances do people start to use—either for all or for only some monetary purposes—a currency which is either issued or controlled by a state other than their own?'; and 'What political consequences can be expected to follow, for both parties, from this international use of currency?' In addressing these questions, she classified international currencies into four categories: 'master currencies,' 'top currencies,' 'negotiated currencies' and 'neutral currencies,' highlighting how both economic *and* political factors shape currencies' international uses.

A master currency is the currency of a hegemonial or imperial state that coerces its use by other states. It thus always derives its status from the political relationships between the issuing and the subordinate states. Sterling in the sterling area and the franc in the franc zone in the past were examples. A top currency, in contrast, is one that is most favored by the world market for various monetary purposes, due to its economic superiority. Its status is therefore determined primarily by economic factors, and it tends to be the currency of the predominant state in the world economy. The dollar in the 1950s was one example. Meanwhile, a negotiated currency occurs when the issuing state bargains or negotiates politically with other states for their use of its currency, offering inducements such as military and diplomatic support or economic benefits, while it is at the same time also voluntarily used by some states and private actors due to its economic benefits. Examples of negotiated currencies include sterling in the postwar period and the dollar in the 1960s.[3] Finally, a neutral currency is a currency whose international use stems primarily from the strong, but not necessarily dominant, economic position of its issuing state, which has no interest in promoting its international use. Examples include the Swiss franc and the German mark (Strange, 1971).

This political economic typology of international currencies provides a useful framework for analyzing the effects of political as well as economic factors on international currency status, to expand our understanding of the mechanisms through which a currency is used internationally. This typology has in fact been neglected for a long time. However, Eric Helleiner (2008) has shed new light on it recently, and since then a growing number of political economy studies of international currencies use it, paying particular attention to the top currency and negotiated currency concepts.[4]

III. Benefits and costs of issuing an international currency

The international standing of a currency matters because the state issuing an international currency enjoys substantial benefits, both economic and political, while it may also bear certain costs. Thus, international currency standing affects the world economic and political orders significantly. What, then, are the major benefits and costs of issuing an international currency? We look at this question first from the economic, and then from the political economic perspective.

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[3] Strange (1971) characterizes a negotiated currency primarily as a currency in decline, that is, one that has lost or is losing its political dominance as a master currency, or its economic dominance as a top currency. However, as Helleiner (2008) points out, a negotiated currency can be a currency on the rise as well, if its increasing international use owes to the political relationships between the state issuing it and others, as well as its economic attractiveness.

[4] See, for example, Helleiner and Kirshner (2009a).

The economic perspective

One of the most familiar benefits from issuing an international currency may be seigniorage, which is technically defined as the difference between the face value of a currency and its production cost. Seigniorage is generated at the international level when foreigners hold the domestic currency, or financial claims denominated in it, in exchange for traded goods and services (Cohen, 2009a: 10).[5] More broadly, international seigniorage also encompasses gains due to the difference between the interest paid on foreign assets acquired by the issuing country and that on assets denominated in its own currency acquired by foreigners (Aliber, 1964: 446; Chinn and Frankel, 2007: 289).[6] Empirical studies usually show that, when it is defined narrowly, seigniorage is actually modest, albeit not negligible.[7]

The more significant benefit accruing to the state issuing an international currency may be its ability to finance balance of payments deficits with its own currency, and the expansion in its macroeconomic flexibility that results (Cohen, 2009a: 10; Kirshner, 2008: 424). It is also increasingly emphasized that the ability to borrow internationally in the domestic currency reduces the problem of currency mismatch, from which many emerging market economies suffered severely during the recent global financial crisis as well as the 1997 Asian crisis (Dobson and Masson, 2009: 125; Genberg, 2010: 66-67). In addition, domestic financial institutions in the country issuing an international currency may benefit in business through their competitive advantage in dealing in the currency (Chinn and Frankel, 2007: 289), while other domestic firms may benefit by shifting exchange rate risks to their foreign counterparts (Tavlas, 1991: 12). Moreover, a currency's international use may increase its purchasing power, as its broad acceptability raises its monetary value (Kannan, 2009; Wright and Trejos, 2001).

There are of course costs involved in issuing an international currency, as well. Indeed, it is widely indicated that Japan and Germany were in the past reluctant to push internationalization of their currencies due to such costs. One of the main costs is that domestic monetary policy can be constrained, as foreign holdings of the currency may render the demand for it less stable and limit the central bank's ability to affect

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[5] About half of all dollar notes and coins—around 400 billion dollars—are circulating outside the United States (Dobbs *et al.*, 2009: 20).

[6] According to one estimate, the annual return on US investments overseas is 1.2 per cent higher than its payments on overseas debt (Chinn and Frankel, 2007: 289).

[7] For example, Dobbs *et al*. (2009: 19) estimate US annual interest savings from foreign circulation of the greenback to have been about 10 billion dollars between July 2007 and July 2008, which was less than 0.1 per cent of US gross domestic product.

interest rates and the domestic money supply through open market operations (Genberg, 2010: 64-65; Kenen, 2009: 7). There is also a risk that foreigners will abruptly reduce or withdraw their holdings of the currency (Helleiner and Kirshner, 2009b: 6; Salant, 1964: 166). In addition, where other states peg their currencies to an anchor currency, the state issuing that currency loses its ability to use exchange rates for macroeconomic adjustment (Cohen, 1971: 42). Moreover, the state issuing an international currency is also expected to take into account the effects of its own monetary policies on the world economy (Chinn and Frankel, 2007: 290).

Yet such costs of issuing an international currency should not be overstated. Where the main tool of a central bank's monetary policy is short-term interest rate setting, the stability of money demand is a less relevant concern for that bank (Genberg, 2010: 65). The limitation on the central bank's ability to influence domestic interest rates and money supply tends not to be severe in a country whose domestic markets for government debt are large, such as the United States (Kenen, 2009: 7). The risk of foreign dumping of an international currency is likely to arise usually only when its attractiveness for international use lapses (Cohen, 1971: 39-41; Salant, 1964: 167). And in practice, of course, in its application of monetary policy the international currency issuer may care more about the domestic than the international effects, as seen in the recent massive quantitative easing by the US Federal Reserve since the global financial crisis.

The political economic perspective

Meanwhile, political economy study emphasizes that the international use of a currency enhances the issuing state's *power*, in particular its international monetary power—which exists when its monetary relationship with another state influences that state's behavior (Andrews, 2006: 1).

In greater detail, the international use of a currency boosts the issuing state's policy autonomy, which is the internal dimension of power, as it increases its ability to avoid the burdens of adjustment of its external imbalances—either by 'delaying' adjustment or by 'deflecting' these burdens onto others (Cohen, 2006). It is able to delay adjustment since the international demand for its currency enables it to finance its deficits effectively with its own money (Cohen, 2006). It can deflect its adjustment burdens onto others due to its ability to depreciate its currency, in which its debt to foreigners is denominated (Helleiner and Kirshner, 2009b: 6). Such a rise in the state's policy autonomy also boosts its potential for influence over others, which is the external dimension of power, in that autonomy is the essential precondition for such influence (Cohen, 2006).[8]

Indeed, a currency's international use is likely to increase its issuing state's coercive power—its 'hard power'—to influence others in direct ways.[9] For example, the United States has taken advantage of other states' vulnerability to it due to their dependence on US-based dollar clearing networks, as a foreign policy instrument (Helleiner, 1999; Kirshner, 1995). The dollar's status as the world's key currency also renders the United States capable of exercising substantial influence over international financial crisis management, as the country has unequalled ability to provide dollars for foreign governments and private financial institutions (Helleiner and Kirshner, 2009b: 6). During the recent global financial crisis, for instance, the swap lines of the Federal Reserve provided dollar liquidity for major foreign central banks, playing a critical role in stabilizing their economies.[10] Such an ability of the United States to support foreign countries in crisis may enhance its capacity to influence their policies in its favor in return for this support.

The state issuing an international currency may also increase its 'soft power'—its ability to get others to do what it wants through attraction rather than use of coercion or payment—via its 'structural power' (Kirshner, 2008: 425). Jonathan Kirshner (2008: 424-25) notes two distinct strands of structural power in relation to currency internationalization. One is Strange's (1988) concept, which emphasizes the power to shape the framework within which actors relate to each other. For example, the dollar's primary international status helps lead to discussions of the international monetary system taking place within the context of dollar primacy. The other concept of structural power relevant to international currencies is that focused on by Albert Hirschman (1980), who stresses that the structure of economic relations between actors can transform their perceptions of their own interests. For instance, those who use the dollar tend to develop a vested interest in dollar stability, or may support close ties with the United States (Helleiner and Kirshner, 2009b: 6). The international use of a currency enhances the issuing state's power in a symbolic manner as well, since currencies have long been regarded as core, tangible symbols of sovereignty (Helleiner, 2006: 82).[11]

[8] Cohen (2009a) argues that, while all six monetary roles of an international currency generate significant economic benefits to the issuing country, the rise in policy autonomy is attributable particularly to its private and public store of value and trade invoicing and settlement functions.

[9] Walter (2006: 66) contends that the potential for exercising monetary power over foreign states peaks when the currency is 'entrenched at the top of the currency pyramid.'

[10] For more on these swap lines see, for example, Aizenman and Pasricha (2010).

[11] Nobel laureate Robert Mundell (1993: 10) said 'Great powers have great currencies.'

Overall assessment

All in all, it appears fair to say that the international use of a currency generates substantial economic and political benefits for the issuing country. There are of course some costs, too, which should not be exaggerated as they are mostly limited to the economic sphere and the benefits there appear to surpass the costs. Indeed, it is generally agreed that the dollar's international standing has contributed substantially to US economic and political interests in the world.

IV. Determinants of international currency status

Although the international use of a currency can provide substantial economic and political benefits for the issuing country, the number of international currencies has historically been very limited. What factors, then, determine the international status of a currency? Economists have long addressed this question, presenting a list of possible economic factors. In recent years, political scientists have also begun to pay growing attention to this issue, providing a complementary analytical framework.

Economic factors

Three specific factors are generally citied as major economic determinants of international currency standing: confidence, liquidity and transactional network (Helleiner, 2008).

Confidence in the stability of a currency's value is critical to its international use, as instability in a currency's value raises the risk of holding it, diminishing its attractiveness as a store of value (Lim, 2006: 7). Confidence in a currency can be affected by diverse factors, including government monetary and fiscal policies and the issuing country's current account and net-debtor positions, which affect its solvency risk (Tavlas and Ozeki, 1992: 19).

Liquidity is another salient economic attribute of an international currency, as users of an international currency normally hold their international money in the form of liquid, interest-bearing assets, rather than currency balances. The presence of well-developed and open financial markets in the issuing country, which lowers the currency's transaction costs, is accordingly important for the currency's international use (Lim, 2006: 7).

The international use of a currency is affected by the scale of the issuing country's transactional networks in the world economy as well, since the benefits of using a particular currency increase with the number of other parties using it, due to network externalities, just as with the case of global use of English as a *lingua franca* (Kindleberger, 1967). Factors determining the issuing country's integration into the world economy, such as its economic size, thus influence the currency's international use. Yet network externalities also give rise to inertia and path dependency in the choice of use of an international currency, and thus create incumbency advantages for the dominant international currency, implying that the international use of a currency is nonlinearly related to the issuing country's economic size (Chinn and Frankel, 2007; Krugman, 1984). The slower erosion of sterling's international standing than that of actual British economic hegemony is one example widely referred to in this respect.[12] Furthermore, notably, the power of network externalities suggests that the use of a single international currency is more efficient than use of multiple ones, implying that monopoly by a single international currency is a natural consequence (Kenen, 2002; Lim, 2006).

Some recent studies argue, however, that the effect of network externalities on international currency choice is weak, particularly in connection with currency use as a store of value (although it may be strong in terms of use as a medium of exchange), and emphasize the feasibility of a multiple international currencies system.[13] These studies point out that reserve currency diversification provides benefits, that advances in information technology have substantially lowered the transaction costs of using multiple international currencies, and that the growth of the global economy has led to the possibility of deep and liquid markets for more than one international currency.

Indeed, Eichengreen (2005) shows that sterling, the French franc and the German mark shared a reserve currency role in the 1910s, and sterling, the franc and the dollar in the 1920s and 1930s. Eichengreen and Flandreau (2008) also find, contrary to the conventional account that sterling did not lose its dominant reserve currency status until the end of World War II, that the dollar first took over sterling's position as the leading reserve currency in the mid-1920s, although sterling did subsequently regain that position with the devaluation of the dollar in 1933. With regard to the prolonged usage of sterling as an international currency, they note that it was due largely to the use of sterling in the sterling area, which was a political rather than an economic factor. Ultimately, history thus appears to show the effects of network externalities to be limited.

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[12] See, for example, Chinn and Frankel (2007), Flandreau and Jobst (2009), and Krugman (1984).

[13] See, for example, Eichengreen (2005, 2010b) and Eichengreen and Flandreau (2008).

Political economic factors

Meanwhile, Helleiner (2008) provides a useful framework for understanding how politics influences international currency standing, identifying two discrete channels through which politics can impact a currency's international use: a direct and an indirect one. In the indirect channel, politics affects the currency's international use by impacting its economic determinants, which were discussed above. Through the direct channel, politics influences a currency's international status more directly, without regard to the economic determinants. Study as to which specific factors affect international currency standing through each of these channels has not yet developed much, although there is still some noteworthy work in this area.

In relation to the indirect channel, Andrew Walter (2006) argues that domestic policies and institutional arrangements affect a currency's international use by influencing the confidence in it and its liquidity. International monetary leadership requires conservative monetary policy, and the government's credibility in carrying this out is influenced by domestic political and economic institutions, such as central bank independence. Particular kinds of domestic institutions, such as limited government and pro-creditor legal frameworks, are also conducive to financial market development (Walter, 2006). A country's international security power influences confidence in its currency, as well, and its international political power may extend its transactional network (Helleiner, 2008: 360-62).

With regard to the direct channel, on the other hand, Helleiner (2008) elucidates the ways in which politics affects international currency standing by revisiting Strange's (1971) concept of an international currency. Politics matters in particular for master and negotiated currencies, as discussed earlier, while top and neutral currencies derive their international standings mainly from their inherent economic attractiveness, with the role of politics relatively limited. For a master currency, the issuing state plays the primary role, as it exercises coercive power over subordinate states. For a negotiated currency, however, both the issuing state and the foreign states supporting the currency and their interactions influence its international use (Helleiner, 2008).

The issuing state's decision on whether to promote or hinder the international use of its currency hinges on various political economic factors at both the international and the domestic levels, including the political struggle between those who benefit and those who lose from internationalization of the currency, policymakers' perceptions of the benefits and costs of internationalization, the political and economic relationships between the issuing state and other states, and the actions of states issuing other international currencies. A state's decision on whether to support a foreign currency's international use can also be affected by diverse political economic factors at both of these levels, for example its political, security and economic relations with the issuing state, pressures from private domestic interests having close ties to the issuing state, the ideational beliefs of key policymakers, and other states' choices concerning whether to support the currency's international standing (Helleiner, 2008).

Relative weights of determinants

The relative importances of the diverse determinants of international currency status remain controversial. Different perspectives or theories put different weights on various of these determinants, depending upon which type of factors between political and economic ones they regard as more critical, and also upon which individual political or economic factors they emphasize. However, there are some noteworthy points that may help in considering this salient issue.

Firstly, when a currency is either on the rise or in decline as an international currency, the weight of political factors is likely to increase and that of economic ones to decrease. The currency's intrinsic economic properties tend in such times not to be strong enough to secure its status as a top currency, and its characteristics as a negotiated currency are accordingly likely to strengthen.

The balance between states and markets in the global economic system may also affect the relative importances of the political and the economic determinants of international currency standing (Helleiner, 2009: 87). Given recent noticeable trends, such as the substantial rise in states' holdings of foreign exchange reserves and the emergence of sovereign wealth funds as new major global investors, states' influences in the global economy, relative to that of the markets, appear to have strengthened, implying a growing weight of political factors in determining international currency status (Helleiner, 2009: 77-78).

Meanwhile, history appears to show the critical importance of its liquidity in enabling a currency to leap to dominant international currency status. For example, the dollar's rise as an international currency took place only after creation of the Federal Reserve in 1913, which was an essential arrangement for the development of US financial markets (Broz, 1997). Sterling's position as the leading international currency was also supported by London's financial markets. In contrast, the tightly regulated financial markets in Japan and Germany were the principal obstacles to internationalization of the yen and the mark (Aliber, 1964; Tavlas, 1991).

There is, of course, still need for further study of other potential determinants of international currency standing, and this issue will be discussed in a later section.

V. The future of the dollar

Forecasts as to the future of the international monetary system differ depending upon which determinant of international currency standing is stressed and how contemporary developments related to that determinant are evaluated.[14] In this context, this section reviews conflicting prospects for the future of the dollar by highlighting their different assessments of the factors affecting the dollar's international standing.

The positive outlook

The sanguine view of the dollar's future argues that the dollar's economic attributes as an international currency remain strong and/or that political conditions are in its favor.[15]

In more detail, with regard to the dollar's economic attractiveness and its political underpinnings, the positive view emphasizes that the US's global supremacy in political and military power is the ultimate source of confidence in the dollar, that no other currencies have financial markets matching the US Treasury market in terms of liquidity and scale, and that network externalities and inertia are likely to help the dollar preserve its dominant position.[16] In addition, foreign states may have strong motivations to support the dollar. The so-called Bretton Woods II thesis claims that East Asian countries have supported the dollar's value by accumulating massive amounts of dollar reserves in order to keep their currencies undervalued and thereby boost their exports (Dooley, *et al.*, 2004, 2009). Ronald McKinnon (2009: 47) also argues that emerging economies peg to the dollar for the sake of domestic price stability.

In contrast, the political base of the euro's economic attractiveness is fragile due to the absence of a central political authority in the eurozone, which adversely affects confidence in the euro and the development of euro financial markets. Europe is moreover unlikely to assume the role of 'importer of last resort,' which would expand the opportunity for other countries to obtain the euro. In addition, European policymakers appear to have actually discouraged expansion of the eurozone, through measures such as imposition of strict requirements for eurozone entry and opposition

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[14] Helleiner and Kirshner (2009b) divide the conflicting perspectives as to the dollar's future into three categories, in accordance with their relative emphases on certain determinants of international currency standing: the 'market based,' the 'instrumental,' and the 'geopolitical' perspectives.

[15] See, for recent examples, Cohen (2009b), Cooper (2009), Eichengreen (2009a), and McNamara (2008).

[16] See, for example, Cohen (2009d, 150), Helleiner (2009), James (2009), and McNamara (2008, 449).

to unilateral pegging to the euro, due to their worries about appreciation of the euro, constraints on monetary policy, etc. The possibility that active promotion of euro internationalization could cause direct conflict with the United States is also likely to make them reluctant in invigorating euro internationalization.[17] Indeed, the euro's international role has a strong regional character, being largely limited to its European hinterland (European Central Bank, 2009).

Meanwhile, despite China's great economic size, strong economic growth, large current account surplus, low inflation, exchange rate stability, etc., the renminbi's economic attractiveness is at least at this moment far lower than that of the euro—due largely to its low convertibility and the underdevelopment of Chinese financial markets. The authoritarian nature of the Chinese political regime may also have a negative effect on financial market development and confidence in the renminbi, by raising foreign doubts about the Chinese commitment to a market economy. Moreover, the Chinese government is seen as not likely to adopt aggressive reform for development of the Chinese financial markets, as this would require abandonment of the Chinese development model, the main instruments of which include credit controls and export-led growth. The renminbi is consequently judged unlikely to post a serious threat to the dollar in the foreseeable future.[18]

The negative outlook

In contrast, the gloomy prospect for the dollar's future expects erosion of its dominant position due to a decline in its economic attractiveness and/or retreat of foreign, as well as domestic, support for it. Many of those holding this view tend to anticipate emergence of a multiple international currencies system, generally one based on the dollar, the euro and the renminbi.[19]

Firstly, regarding the dollar's economic attractiveness, the huge US current account deficit and the loose US fiscal and monetary policies since the global financial crisis are said likely to damage foreign confidence in the dollar (Ferguson, 2009; Roubini and Setser, 2004). Moreover, a fall in US import capacity following the crisis may

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[17] See Cohen (2009b, 2009d), Cooper (2009), D'Arista (2009), Helleiner (2009), McNamara (2008), and Pisani-Ferry and Posen (2009).

[18] See Cohen (2009d), Cooper (2009), Dobson and Masson (2009), Eichengreen (2009a), Helleiner (2009), Jaeger (2010), and Wu *et al*. (2010).

[19] See, for recent examples, Cohen (2009c, 2009d), Eichengreen (2010b), and Kirshner (2009). Meanwhile, Chinn and Frankel (2008), who emphasized the power of network externalities and inertia, estimated that the euro would overtake the dollar by as early as 2015 as the tipping point, due largely to the rise in economic size of the eurozone.

reduce foreigners' motivations for holding dollars. At the same time, trade patterns in many East Asian countries, major holders of huge dollar reserves, have been increasingly shifting away from the United States to the intraregional and European markets (Helleiner, 2009: 78-80). Skeptics of the dollar's future also stress the limitations of network effects and inertia in international currency use.[20]

The political foundation of foreign support for the dollar appears to have weakened as well, as China, a geopolitical rival of the United States, has become the biggest dollar holder (Helleiner, 2009: 81; Kirshner, 2009: 195-96).[21] Serious observers of course usually deny the likelihood of China dumping its enormous dollar holdings, as the collapse in the dollar that would result is not in its own interests.[22] Yet it is still possible that China will eventually diversify its reserve portfolio.[23] Traditional US allies such as Western Europe and Japan are in addition no longer bound to the United States with the end of the cold war, and have in fact become rather wary of US unilateralism.[24]

Meanwhile, there is also a possibility of US willingness to defend the dollar's international role faltering. If domestic support for it weakens, US policymakers may be reluctant to offer the inducements necessary to encourage continued foreign backing of the dollar's international position. For instance, an increase in protectionist pressures in the United States targeting China may reduce US willingness to provide an open market to the country, weakening its motivations to hold dollars (Helleiner and Kirshner, 2009b: 14).

A tentative assessment

Which forecast of the dollar's future is more convincing? In fact, as will be discussed in the following section, there remain a set of important issues needing further research before we can answer this question more accurately. It may nevertheless be also worth contemplating it now, albeit tentatively, given the fierce debate over the dollar's future currently going on. A key area in which the optimistic and the pessimistic views of the dollar's future conflict is in their contrasting assessments of the possibilities of the dollar's potential rivals, the strongest of which are the euro and the renminbi recently, challenging its international position. The sanguine view

[20] See, for example, Eichengreen (2005, 2010b).

[21] Russia, another geopolitical rival of the United States, is meanwhile the world's third largest foreign reserve holder.

[22] See, for example, Cooper (2009) and Kirshner (2009).

[23] See Bowles and Wang (2008) and Kirshner (2008, 2009).

[24] See Calleo (2009), Helleiner and Kirshner (2009b), and Kirshner (2009).

emphasizes that the dollar's attractiveness remains *relatively* strong vis-à-vis its potential rivals, due to their own defects as international currencies, while the negative view implicitly assumes the opposite, although it tends to concentrate more on highlighting the dollar's weaknesses.[25] Actually, there appears little doubt that the dollar's intrinsic economic attractiveness as an international currency has weakened since the global financial crisis.[26] It thus appears reasonable to assess the validity of the two opposing views of the dollar by evaluating the possibilities of its potential rivals, the euro and the renminbi, threatening its position.[27]

With regard to the euro, the European sovereign debt crisis, which started from Greece, has highlighted how the peculiar characteristic of the euro as a currency without a state could be a serious disadvantage to its further internationalization. In the absence of a central authority, eurozone countries' cooperative management of the crisis was clumsy, damaging the credibility of eurozone governance and accordingly confidence in the euro. Indeed, many observers, including Noble laureate Krugman (2010), even postulated a possible breakup of the euro. In fact, such a doomsday scenario appears exaggerated. The European crisis eased eventually, after the provision of a bailout for Greece and formation of the European Financial Stability Facility, with the euro strengthening against the dollar again. The political will for European integration, in creating and preserving the euro, should also not be underestimated, given that its collapse threatens the very existence of the European Union (Eichengreen, 2009b, 2010a). It may thus be reasonable to anticipate that the euro will manage to survive, but barring a substantial leap in strengthening its political foundations that its international use will be limited largely to its own European backyard.

In the case of the renminbi, meanwhile, it should be noted that the Chinese government has since the global financial crisis begun to push enthusiastically ahead with renminbi internationalization, through both the indirect and the direct channels of

25 The recent soaring in the value of gold appears to reflect the present low attractiveness of the dollar's potential rival currencies. However, gold is not likely to be a serious obstacle to these currencies' further internationalization, as it seems unlikely to regain its historical status as a reserve asset.

26 A weighted average published by the Federal Reserve, of the dollar's value against a group of major currencies, fell from 82.5 in January 2007 to 75.9 in August 2010 (March 1973 was 100), despite the dollar playing the role of safe haven currency temporarily during that span following massive shocks such as the Lehman Brothers collapse in fall 2008 and the European sovereign debt crisis in spring 2010.

27 The Special Drawing Right, a synthetic unit of account of the International Monetary Fund composed of the dollar, the euro, the yen and sterling, is incapable of seriously challenging the dollar as an international currency in the foreseeable future, owing to various economic and political problems. For more on this issue, see for example Cohen (2009c), Cooper (2009), Eichengreen (2010b), and Lago (2009).

politics impacting a currency's international standing discussed earlier, as part of a strategy to reduce China's dependence on the dollar (Zhang, 2009). Significant policy measures adopted for this purpose include pilot programs using the renminbi in cross-border trade settlements, bilateral local currency swap arrangements with foreign countries, and allowing the issuance of renminbi-denominated bonds in Hong Kong. Moreover, the government has allowed offshore banks to transfer renminbi among themselves, paving the way for creation of renminbi-denominated financial products. It has also allowed select offshore banks and foreign central banks to invest in the mainland's interbank bond markets, significantly broadening investment opportunities for international holders of the renminbi (*Financial Times*, 2010a). The government has in addition increased diversification of its reserve portfolio, reducing its dollar holdings while increasingly buying government bonds of Asian countries such as Japan and South Korea instead (see Back and McMahon, 2010). China has also begun to provide loans to foreign countries in the renminbi (Cancel, 2010).

Such Chinese government efforts for renminbi internationalization appear to have begun producing meaningful outcomes recently, despite the constraints on reminibi convertibility. For example, the volume of cross-border trade transacted in renminbi jumped from 3.6 billion renminbis in the second half of 2009 to 70.6 billion renminbis in the first half of 2010. A number of the world's prestigious banks, meanwhile, such as HSBC, Standard Chartered, Citigroup and JP Morgan, have launched international roadshows for use of the renminbi in trade deals with China by their corporate customers (Cookson, 2010). In addition, the Malaysian central bank has even bought renminbi-denominated bonds for its reserves (Brown*, et al.*, 2010). Given all of these considerations, internationalization of the renminbi seems likely to proceed faster than skeptics expect.

There is certainly concern, as discussed earlier, that development of the Chinese financial market will require abandonment of the Chinese development model, and that the Chinese government is thus not likely to push ahead with it. However, note that the government has adopted a plan to build Shanghai into a global financial center by 2020, and that Shanghai's status as a global financial center has actually been rising rapidly in recent years, with it ranked sixth in the Global Financial Centres Index of the Z/Yen Group in September 2010 (Yeandle, 2010). In addition, Hong Kong is expected to play the role of global center for the offshore renminbi business, complementing the role of the mainland's financial markets in renminbi internationalization. Furthermore, as China's economy grows, its dependence on export-led growth may decrease, reducing the need for exchange rate control and, in turn, altering the Chinese development model (Jaeger, 2010: 2-3).

Of course, this does not mean that the renminbi will overtake the dollar in the near future. China's economic size is still only one-third that of the United States, and even if it continues growing at its current rate it is unlikely to surpass the United States until the late 2020s (Lu, 2010; Wu, *et al.*, 2010: 71). The renminbi is, however, likely to manage to develop into a regional currency in Asia, where China has strong influence both economically and politically.

Ultimately, an uneven multiple international currencies system seems likely to emerge, in which the dollar shares the major international currency role with the euro and the renminbi to some extent, although these two currencies still lag behind it. In this system, the euro's international role may not change substantially from what it is at present, being still limited mainly to its European hinterland. The renminbi is likely to encroach on the dollar to a significant extent, however, particularly in Asia, even if the dollar may not completely lose its position in the region.[28]

VI. Some salient issues for further study

This study's forecast for the future of the international monetary order in the previous section is tentative, and there remain some important issues worth greater investigation for a better understanding of international currency standing. Among them, this paper points out in this section three particular domestic political economic issues: social preferences regarding currency internationalization, the role of state actors, and domestic political institutions. It goes on to finally mention an issue critical to the empirical study of international currencies: selection of a variable indicating the extent of a currency's internationalization.

Clear identification of the preferences of domestic groups is a prerequisite for understanding who drives currency internationalization. The importance of this issue may be very obvious for international political economy students, particularly those familiar with the domestic interest approach and, recently, open economy politics.[29] And there are in fact some studies identifying the preferences of domestic groups regarding currency internationalization, based upon its benefits and costs.[30] A problem with them, however, is their tendency to indicate, without cautious qualification, that domestic financial institutions having high levels of international

[28] The renminbi is not likely to dominate absolutely even in Asia, as China's geopolitical rivals such as Japan and India may not want to depend solely on the renminbi if there is a credible alternative, which the dollar may continue to be (see Jaeger, 2010).

[29] Regarding open economy politics, see, for example, Lake (2009).

[30] See, for example, Broz (1997).

business are the strongest advocates of currency internationalization,[31] although this appears inapplicable to the cases of the yen and the German mark. As Kenen (2009: 6) notes, domestic financial institutions' new profit opportunities from internationalization of the home currency can be partly offset by foreign financial institutions' entry into the domestic financial markets. In this regard, the following hypothesis will be worth testing in a future study: domestic financial institutions' preferences regarding internationalization of their home currency are affected by their competitiveness vis-à-vis foreign financial institutions, as the financial liberalization associated with currency internationalization will push them to face foreign competition.

Another political economic issue deserving greater attention is the role of state actors in currency internationalization. Notably, the recent drive by the Chinese government for renminbi internationalization provides an excellent opportunity to study this issue, especially with regard to two particular policy strategies of currency internationalization. The first strategy is the Chinese government's permission for only a limited group of prestigious and influential foreign financial institutions to participate in the renminbi business at the early stage of renminbi internationalization. This may offer these financial institutions opportunities to capture rents from renminbi internationalization, and thereby lead them to become its powerful, and effective, promoters. Indeed, as discussed above, prestigious international financial institutions have recently been encouraging use of the renminbi to their clients. The other notable strategy of the Chinese government is its purchases of the sovereign debt of Asian neighbors. This policy puts upward pressure on the values of these countries' currencies, and is thereby likely to increase their incentives for buying Chinese debt in response, if allowed, in order to keep the values of their currencies from rising and in turn defend their exports, which will ultimately help renminbi internationalization.[32]

More attention also needs to be paid to the effects of domestic political institutions on currency internationalization. There are, as discussed earlier, a few studies that note the impact of domestic institutions on currency internationalization. They in general argue that the existence of democratic political institutions helps currency internationalization, partly since such institutions are conducive to financial market development.[33] However, the recent, albeit still rudimentary, rise in

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[31] See, for example, Broz (1997). Meanwhile, Frank (2003) argues that multinational corporations are strong supporters of the international uses of their home currencies.

[32] As the yen appreciated due to Chinese purchases of Japanese government bonds during fall 2010, Oshihiko Noda, the Japanese finance minister, complained about how China's closed capital account prevented Japan from reciprocating (*Financial Times*, 2010b).

[33] See, for example, Walter (2006).

internationalization of the renminbi, despite the continued authoritarian nature of China's political regime, appears to raise questions about this argument. Domestic political institution type may not after all significantly affect currency internationalization. Further research on the effects of domestic political institutions on currency internationalization appears needed.

In addition to these issues, finally, this paper would like to touch briefly on one further matter regarding the empirical study of international currencies. Most such studies of international currency choice focus on the currency composition of foreign exchange reserves as evidence.[34] This may be due largely to the high availability of this data, which is recently publicly provided by the International Monetary Fund (IMF). The data has several drawbacks, however. For example, it does not cover China, the biggest holder of foreign exchange reserves. Moreover, currency compositions can change owing to fluctuations in values of the currencies held, rather than changes in central bank choice.[35] Given that the United States, the world's largest economy, has a relatively small amount of foreign exchange reserves, research using this data may also be unable to properly reflect US firms' use of foreign currencies (Bobba*, et al.*, 2007: 5). It thus seems desirable to use more diverse measures in analyzing currencies' international use.[36]

VII. Conclusions

The international monetary system shapes the world political, as well as economic, order, by affecting the political and economic relationships among countries. The study of international currencies, which affect the characteristics of the international monetary system, is thus vital for understanding the establishments of and changes in these world orders. Toward this end, this paper has offered a systematic review of the literature on international currencies, with the aim of providing a solid stepping stone

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[34] See, for example, Chinn and Frankel (2007, 2008), Dooley *et al*. (1989), and Eichengreen (2005, 2000).

[35] Truman and Wong (2006) present changes in the quantity share of the dollar in total foreign exchange reserves reported in the IMF data, rather than changes in share of the dollar. This eliminates valuation effects and thus reflects the 'active' reserve diversification by central banks.

[36] Recently, empirical studies examining variables other than foreign exchange reserves as indicators of currencies' international use have been growing. For example, Goldberg and Tille (2005) analyze the choice of currency in invoicing international trade transactions, and Meissner and Oomes (2008) examine the determinants of anchor currency choice. Research such as Bobba *et al*. (2007), Cohen (2005), Flandreau and Jobst (2009) and Habib and Joy (2008), meanwhile, address the choice of currency for international bond security denomination and the circulations of currencies in the foreign exchange markets.

for development of a better analytical framework for the study of international currency standing.

This study has also suggested a provisional outlook for the international monetary order, suggesting that it may shift to a multiple international currencies system in which the dollar, the euro and the renminbi unevenly share the major international currency status. Further development of our understanding of international currencies will of course help to make such forecasts more reliable, and in this regard this study has highlighted, among others, three political economic issues—domestic groups' preferences regarding currency internationalization, and the roles of state actors in and the impact of domestic political institutions on currency internationalization—as salient factors needing further study for a better understanding of international currency standing, in addition to the empirical issue of how currency internationalization should be measured. Our efforts to address these issues can be expected to develop the study of the international monetary order substantially.

In closing, this paper briefly discusses what might happen if a multiple international currencies system actually emerges, as it tentatively anticipates. Under such a system, competition for monetary leadership among the countries issuing these international currencies is likely to increase, especially between China and the United States in Asia. If this competition is focused on strengthening the economic attractivenesses of the rivals' own currencies, it is likely to contribute positively to the world economy; the competition may encourage them to adopt sounder and more stable policies by imposing market discipline on them, while hindering their abuse of the 'exorbitant privilege' that comes with international currency issuance (Eichengreen, 2009a, 2010b; Zhang, 2009). In such a situation, problems like the current one of global imbalances are less likely to arise. The future courses actually followed by such rivalries, however, particularly between the United States and China, will depend on the future developments of countries' relationships.

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< Abstract in Korean >

최형규*

글로벌 금융위기 이후 미 달러화의 기축통화 지위 하락 가능성이 제기되면서 국제통화질서의 미래에 대한 논의가 활발히 이루어지고 있다. 달러화 중심의 국제통화질서 변화 여부 및 통화질서 변화가 국제정치·경제체제에 미칠 영향 등을 보다 심도 있게 논의하기 위해서는 통화국제화 결정요인, 통화 국제화에 따른 편익과 비용 등 국제통화 이론에 대한 견고한 지식이 필요하다. 이러한 관점에서 본 논문은 동 주제와 관련하여 경제학 뿐 아니라 정치학적 관점에서 이루어진 기존 연구를 모두 포괄한 체계적인 리뷰를 제공한다. 보다 구체적으로, 국제통화의 개념, 국제통화 발행에 따른 편익과 비용, 통화국제화 결정요인을 조사하고, 달러화의 기축통화 지위 향방에 대한 상반된 견해를 검토 · 평가한 후 향후 국제통화질서에 대한 전망을 제시한다. 더불어 국제통화 이론 발전을 위해 추가 연구가 필요한 주제를 국내 정치경제 요인을 중심으로 논의한다.

향후 국제통화질서는 달러화가 제일의 국제통화 지위를 유지하지만 그 지위는 이전에 비해 상당히 하락하고 위안화가 아시아에서 달러화의 지위를 상당 부분 잠식하면서 지역통화로 성장하는 한편 유로화도 현재처럼 유럽의 지역통화로 기능하는 "Uneven Multiple International Currencies System"으로 이동할 가능성이 클 것으로 전망된다. 이러한 국제통화질서가 형성되면 특히 아시아에서 중국과 미국의 통화주도권 경쟁이 발생할 가능성이 있으나, 양국의 경쟁이 건전한 거시경제 운용 등 자국통화의 국제통화로서의 경제적 경쟁력을 강화하는 방식으로 전개될 경우 세계경제에 긍정적 기여를 할 수 있을 것으로 여겨진다. 다만 양국의 통화주도권 경쟁이 실제로 어떠한 형태로 전개될 지는 궁극적으로 양국 관계의 미래에 좌우될 것으로 예상된다.

* 한국은행 금융경제연구원 동북아경제연구실 과장

금융경제연구 발간목록

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Ji Wu·Alina C. Luca·Bang Nam Jeon

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김윤영·박준용

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이승환

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Kyungsoo Kim, Byoung-Ki Kim and Young Kyung Suh

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Byoung-Ki Kim

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