The globalization of currencies is a topic that captivates economists, politicians, and laymen alike as it evokes notions of hegemonic power, exorbitant privileges, and races to become the dominant currency in the world. (When) Will the Chinese Renminbi overtake the United States dollar as the dominant international currency is a question that attracts much attention, just as the possibility of the Euro or the Japanese Yen challenging the Dollar once did.

Economists are drawn to the subject in part because it is believed that issuing the dominant international currency brings economic advantages for the issuing country inter alia in the form of lower borrowing costs in international markets and seignorage gains associated with use of the physical currency by non-nationals. Speaking of the United States dollar, the former French Minister of Finance, Mr. Valéry Giscard d'Estaing coined the term exorbitant privilege to refer to such advantages.

Researchers have also tried to identify factors that determine whether a currency becomes dominant in international markets. The size of the economy, its importance in international trade, and the depth of its financial markets are often mentioned. An intriguing feature of the models used for this purpose is that they incorporate the notion of network externalities to suggest that once a certain critical mass of international transactions is carried out in a particular currency, the advantages for additional transactions to use the same currency will be such that it will eventually become overwhelmingly dominant. The same argument implies that it will be difficult for potential rivals to dethrone the dominant currency which will remain in this position for a considerable time.

In his most recent book on the international monetary system, Barry Eichengreen together with co-authors Arnaud Mehl and Livia Chiţu refer to the established network-based model as the traditional view where “…economic dominance and monetary dominance go together…” and where “strong network externalities … are sufficiently powerful that the result is ‘winner takes all’” (p.3). The authors challenge this view by examining carefully the existing historical record and, most impressively, by assembling new facts about the use of international currencies as official international reserves, their role in financing international trade, and their importance in international bond markets. Based on the data that they gather and analyse, Eichengreen, Mehl and Chitù (EMC), posit a ‘New View’ “… in which several national currencies can play consequential international roles and in which inertia and persistence are not as strong as traditionally supposed.” (p.8)
Evidence for the New View is based in part on a re-examination of already published data, and in part on new data painstakingly obtained from previously unpublished central bank records. With respect to international reserve holdings four findings are highlighted: (i) the ‘winner takes all’ hypothesis is not borne out, (ii) the co-existence of the Pound Sterling and the US dollar as the most prominent currencies in official reserves lasted longer than previously maintained, (iii) there was no unique tipping point after which the dollar took over from sterling as the leading reserve currency, and (iv) politics played a significant role in central banks’ decisions on the composition of their reserves.

For the denomination of trade credit, the authors also find evidence that challenge the traditional view of overriding network effects and persistence during the interwar period, as sterling and the dollar shared the role of an international currency. Likewise for bond issuance.

The finding by EMC that the international monetary system can accommodate more than one global currency is important not only when we interpret the historical record. It suggests, for example, that worries, or hopes as the case may be, that the renminbi will one day dethrone the dollar as the dominant international currency may be overstated. Network effects and the associated increasing returns may not be sufficiently strong to leave room for only one of them. In other words, “…we might very well be entering an era where several international and regional currencies will subsist as transaction costs decline due to improved trading platforms and payment infrastructures.” (Genberg (2009), p. 228. See also Eichengreen (2005))

The presentation of the empirical evidence is put in context by very lucid descriptions of the role of the establishment and actions of the US Federal Reserve in promoting the US dollar as a reserve asset, the ambiguous views of the Bank of Japan and the Deutsche Bundesbank towards the internationalization of the Yen and the Mark respectively.

The book also contains a chapter devoted to the potential rise of the Chinese renminbi as a significant international currency. The high and rising role of China in international trade points to an increasing use of its currency in trade invoicing and settlement in Asia in particular. Combined with network externalities this could, according to the traditional view, lead to an eventual big bank where the renminbi dethrones the dollar. But several factors caution against such an interpretation. Financial markets in China are nowhere near as liquid and open to international participants as the US market, limiting its attractiveness for international bond issuance and foreign trade financing which requires the ability to manage foreign exchange positions actively. The Japanese and German experience with the internationalization of their currencies may also give the Chinese authorities reasons to proceed cautiously. In addition, the New View of currency internationalization suggests that even if the renminbi will become more widely present in international portfolios and transactions, it need not unseat the dollar but rather provide one more alternative in a multi-polar international currency system.

The work of Eichengreen, Mehl and Chiţu makes us think anew about internationalization of currencies. It presents a convincing analysis of how globalization of currencies comes about and works, embedded in a historical narrative. Economists and non-economists will benefit from the description of the historical context and the speculation about the rise or not of the renminbi as an international currency, and specialists will also benefit from studying and evaluating the empirical work. They may, however, regret that the underlying data are not included.
References


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