Is the Dollar In *Trouble?*

If the dollar continues to deteriorate, and as east Asian countries peg their currencies to the Chinese currency to maintain exchange rate stability, the greenback could lose its key currency status by the end of the 2020s, just as it did in Europe in the 1970s.

BY GUNTHER SCHNABL

In the wake of the coronavirus crisis, U.S. President Joe Biden aims to accelerate the economic recovery with another fiscal stimulus package. Given the package's large dimensions and the expectation that the U.S. Federal Reserve will continue to purchase large amounts of government bonds, "Bidenomics" are reminiscent of Japan's "Abenomics," which have been pursued since 2013. A main difference between the United States and Japan is, however, the international role of the currencies: whereas the dollar remains the leading international currency (including East Asia), the yen has in the past failed to take over this role in the region.

Now China may make an attempt to challenge the international role of the dollar in East Asia. The time may have come, as the large purchases of U.S. government bonds have inflated the balance sheet of the Federal Reserve, thereby eroding the trust in the dollar. At the same time, the Chinese economy is up and running again. Neither Chinese government debt nor the balance sheet of the People's Bank of China has grown to the same extent as in the United States. The Chinese government has signaled with the Regional Comprehensive Economic Partnership its economic leadership in East Asia.

History provides a blueprint of how de-dollarization in East Asia in favor of the Chinese renminbi could work. Beginning with the Bretton Woods system in 1944, the dollar became the foundation of the postwar monetary and economic order. The central banks at the periphery of the Bretton Woods system had to stabilize their exchange rates against the dollar as the anchor currency. This also brought the dollar into position

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as the international reserve currency. When the United States financed the Vietnam War with the help of the Fed, the dollar came under depreciation pressure and the peripheral central banks had to buy large amounts of dollars to keep their exchange rates stable.

As the periphery countries *de facto* co-financed U.S. government spending, then-French Finance Minister Valéry Giscard d'Estaing complained about this "exorbitant privilege." Stanford University Professor Ronald McKinnon later dubbed this phenomenon a "quasi unlimited line of credit" within an "unloved dollar standard." In the early 1970s, the resulting fast accumulation of dollar reserves in the balance sheets of the central banks at the periphery of the Bretton Woods system came along with strong monetary expansions. The German central bank, which was strongly committed to low inflation, became concerned about imported inflation and—finally—delinked the German mark from the dollar. The mark strongly appreciated, other countries followed, and the Bretton Woods system collapsed. Europe became decoupled from the dollar, with the stable German mark becoming the regional anchor and reserve currency.

In contrast, the Asian countries (except Japan) kept stabilizing their exchange rates against the U.S. currency. When China opened up to international transactions by adopting IMF Article IV in 1994, it introduced a tight dollar peg. An informal dollar standard in East Asia emerged, with many countries commonly stabilizing their exchange rates—more or less tightly—against the dollar. The resulting high degree of exchange rate stability within the region intensified the division of labor and trade in the region, thereby promoting growth and welfare. China plays a pivotal economic role in East Asia, because unlike Japan it has been growing strongly since the 1990s.

This has favored the emergence of an East Asian production network: Southeast Asian companies often supply subcomponents to Chinese companies which export to the United States, the European Union, and other industrialized countries. China and the renminbi's close dollar peg stabilized the region during the 1997–1998 Asian crisis and the 2008–2010 global financial crisis, when neighboring countries' currencies sharply depreciated. And during the current coronavirus crisis, China and the renminbi are standing like a rock in the surf. Nevertheless, the renminbi has not yet become the regional anchor and reserve currency, as China's capital market remains strictly regulated and internationally sealed off by capital controls.

For China, dependence on the dollar has long been a thorn in its side. Between 2000 and 2014, China was forced to co-finance the U.S. rescue packages for Wall Street by following the expansionary monetary policy of the Fed in response to the bursting of the dot.com bubble and the outbreak of the subprime crisis. Chinese leaders have repeatedly expressed discontent about the international role of the dollar. To delink from the dollar, China may follow the path of Germany taken in the 1970s, which transformed the German mark into a serious competitor of the dollar as an international currency. By the late 1970s, the U.S. government had to issue bonds in German marks and Swiss francs (Carter bonds) to stabilize the dollar, which showed the endangered key currency status of the dollar.

China has already taken important steps. During the coronavirus crisis, the balance sheet of the People's Bank of China has grown much more slowly than the balance sheet of the Fed. In contrast to the Fed, China has signaled willingness to lean against speculative bubbles in the real estate sector and in financial markets. Since May 2020, the People's Bank of China has allowed the renminbi to appreciate against the dollar by more than 10 percent. China's holdings of U.S. Treasury bonds have gradually declined, from $1.3 trillion at the end of 2011 to about $1 trillion by the end of 2020. China is spearheading the development of a central bank digital currency including its own payment system. As the digital renminbi is being prepared for use in cross-border transactions, this may allow the renminbi to bypass the dominance of the United States in the international payment system.

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If the renminbi continues to appreciate, the temptation will rise for other East Asian countries to peg their currencies to the renminbi to maintain intra-regional exchange rate stability. If the Southeast Asian countries exchange their dollar reserves into renminbi, this could allow them to capture substantial revaluation gains against the dollar.

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An informal renminbi block would emerge with the renminbi as an anchor and reserve currency for the smaller Southeast Asian countries. Sooner or later, even Japan may decide to join as economic and financial linkages with East Asia are strong. The resulting seigniorage gains would allow China to deal with the large stock of potentially nonperforming loans in its corporate sector.

Thus, the U.S. dollar may lose its key currency status in East Asia in the 2020s, as it lost its key currency status in Europe in the 1970s. This process may be already reflected in the international holdings of U.S. Treasury bonds. The share of foreign and international investors in holdings of U.S. Treasuries has declined from 43 percent in 2013 to less than 30 percent currently. Instead, the Fed is holding a growing share of the outstanding Treasuries, which is likely to increase inflationary pressure in the United States, thereby further undermining the international role of the dollar.

It remains to be seen whether the potential loss of exorbitant privilege will trigger a turnaround in U.S. fiscal and monetary policymaking. In the late 1970s, Fed Chairman Paul Volcker broke the backbone of inflation with decisive interest rate increases, accompanied by the structural reforms of the Reagan Administration. Yet by then, one decade of high inflation had substantially reduced U.S. government debt in real terms. From this point of view, the Fed is trapped, as a general government debt level of 130 percent of GDP seems to prevent a monetary tightening. China's leaders may have recognized the window of opportunity. But in order to achieve their goal, two more high hurdles have to be taken: China's financial markets have to be liberalized, and the renminbi has to be fully floated against the dollar. ◆