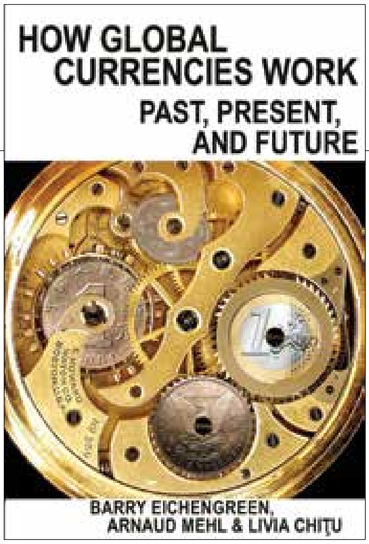
Jockeying for Position

THE STATUS OF a key currency—one used in international trade and bond issuance and held in official reserves—is more contestable and fluid than most think. So argue Barry Eichengreen, Arnaud Mehl, and Livia Chițu in a readable and timely book. Their argument generalizes previous research by Eichengreen and Marc Flandreau showing that the dollar caught up with the pound sterling in the 1920s, only to fall behind again in the 1930s.

The book begins with a history of 19th century foreign exchange reserves before describing the founding of the Federal Reserve—or "Fed," as the US central bank is usually called—and the interwar sterling-dollar rivalry. It then analyzes the key roles major currencies can play: trade financing and denominating bonds during the 20th century interwar period and serving as official foreign reserves after World War II. Currency chronicles follow: the retreat of the United Kingdom's pound sterling, the Japanese yen's rise and fall, the euro playing second fiddle, and the prospects for the Chinese renminbi.



Barry Eichengreen, Arnaud Mehl, and Livia Chițu
How Global Currencies Work: Past, Present, and Future
Princeton University Press, Princeton, NJ, 2017, 272 pp., $39.50

The authors take issue with theorists who say that network effects (a currency, like a language, is handier the more people use it) and inertia (in this case, incumbency of a given currency) lead to a winner-take-all race. Instead, national policies to develop markets made a difference, they say. Through large-scale purchases, the Fed promoted dollar IOUs to finance US exports and imports, thereby reducing US dependence on sterling IOUs. They should note, however, that the Federal Reserve Act of 1913 spared such IOUs costly reserve requirements that, in effect, amounted to a 0.5 percent tax. Eurodollars (dollar deposits at banks outside the United States and beyond the Fed's requirements) enjoyed a similar competitive edge later in the 1950s.

In analyzing currency choices for foreign exchange reserves, the authors face a methodological question: how to measure a currency's domain. Where are network incentives at work? The authors choose the scale of the currency's own domestic economy.

This choice does not jibe with the authors' story about the interwar sterling-dollar rivalry. In the 1930s, sterling returned to its top dog status and replaced the dollar, but not because the UK economy outgrew the US economy. Instead, countries such as Japan shifted their foreign exchange reserves into sterling after they joined the sterling area, a group of jurisdictions that kept their currencies more stable against the pound sterling than against the dollar.

Thus, the dollar area rather than the US economy may define the dollar network. This area includes the US economy, economies such as Hong Kong SAR with dollar-linked currencies, and most of the economies with currencies that move less against the dollar than against the euro. The dollar area covers about half of the global economy, according to the 2015 *Annual Report* of the Bank for International Settlements. Taking the US economy as the dollar's domain is like using the US population to count global English speakers.

Is a renminbi area forming with Asian currencies moving together with the renminbi? Could the dominant international currency change as fast now as it did in the 1920s and 1930s? The book never answers these questions directly, but this sweeping history's idea that policy can boost a challenge to an incumbent key currency leaves the reader well placed to ponder them. FD

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Views expressed are those of the author and not necessarily those of the Bank for International Settlements.