Dollar dominance means US risks also pose risks to others

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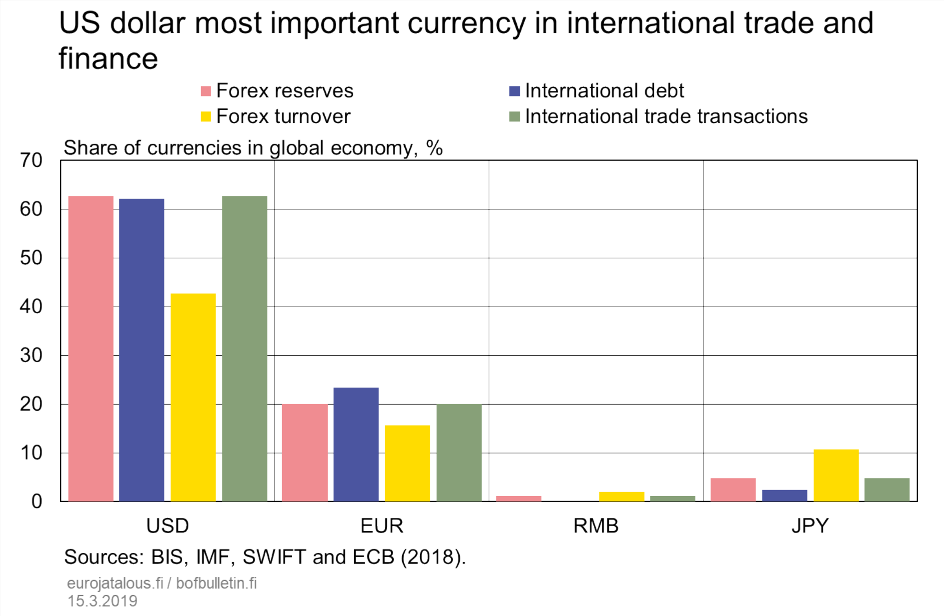
The dominant position of the US dollar exposes other countries to changes in the economy and domestic policies of the United States, while also creating global systemic risks. The role of the dollar is expected to decrease with time as the roles of other economic areas and their currencies increase. Given the lack of a realistic competing currency, however, it is rather unlikely that the status of the dollar will weaken at the moment, which highlights the need for cooperation in terms of managing risks to the international financial system.

The US dollar has been the most important international currency since the introduction of the Bretton Woods system after World War II. Despite the collapse of the Bretton Woods system and instabilities in the 1970s, the dollar was able to maintain its status as a safe haven and as the most important reserve currency. The dollar has not only obtained reserve currency status; it is also the most important international currency used as a unit of account in international trade, payment transactions and financial commitments (Chart 1).

Chart 1



Through the decades, the dollar-centric financial system has attracted criticism for a variety of reasons. The dominance of the dollar exposes other countries to policy and financial developments in the United States and makes other countries dependent on the smooth flow of dollars (IMF 2016). It has been asserted that the United States enjoys an exorbitant privilege compared with other countries, benefiting from the reserve currency status of the dollar. The key benefit is that reserve asset demand lowers funding costs (Canzoneri et al., 2013). In recent years, increasing political uncertainty has sparked growing criticism of the dollar's current status. The international financial system is built on trust, which current policy unpredictability and the weakening conditions for international cooperation do not encourage.

The existence of a dominating vehicle currency facilitates trade and financial intermediation, but also creates system-wide risks. One key vulnerability – the structural liquidity risk of dollar funding – was exposed by the financial crisis, when the supply of short–term dollar funding suddenly declined after uncertainty increased.[1] In order to restore financial stability on the international financial markets, the US Federal Reserve had to offer dollar liquidity to several central banks outside of the United States.

Another systemic risk is the long-term sustainability of the US federal debt, which has been discussed in connection with the Federal Government's fiscal stimulus policy. According to the Triffin Dilemma presented in economic literature, the growing demand for dollar reserves may raise US external debt unsustainably (Bordo & McCauley, 2018). The risk is that, at some point, assets considered as safe havens cease to live up to that expectation. However, the dollar's status makes it especially difficult to define how much debt is too much debt for the United States.

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1. Koskinen & Laakkonen (2018) detail the risks of the international financial system related to dollar dependency and the evolution of those risks in the years following the financial crisis.

In the last few decades, the economic power of the United States has decreased, for example in terms of the country's share of global GDP. Many have expected the dollar's role to decline over time (Seghezza & Morelli, 2018). However, in addition to the size of the economy, the internationalisation of a currency also requires financial market depth, the importance of which may have been underestimated in the literature on the dollar's role (Frankel, 2012). Measured by the size of its economy, the United States' role may be weakening, but the country is still by far the most important financial market. The current dollar-centric financial system is the result of decades of development and has become a hybrid system consisting of central, commercial and shadow banks, where a major part of liquidity creation takes place beyond US borders. A large financial market also equals a wide supply of safe assets in the form of US Treasury bonds and other high-quality collateral (Tooze & Odendahl, 2018).

Other key components in modern financial intermediation are laws and regulations that guarantee property rights, supervisory and executive bodies, and the trust of the international community that the system is reliable and efficient. According to Seghezza and Morelli (2018), at present no competing currency fulfils these requirements. In the euro area, legislation and regulation are still highly diverse across different countries and progress in Capital Markets Union and Banking Union is slow. As for China, property rights legislation is still in an evolutionary phase. In the long term, if European integration moves forward and China opens its financial markets, and if both Europe and China seek to actively facilitate the internationalisation[2] of their respective currencies, this could enhance the capacity of the euro and renminbi to challenge the dollar's reserve currency status. It is, however, highly unlikely that the dollar will lose its current key currency status in the years ahead.

Due to the status of the dollar, the international interconnectedness of the United States' economy and financial markets is more complex than traditional macroeconomic models are able to describe. This makes it more difficult to predict the impact channels for potential market disruptions and their final impacts. Even though post-crisis regulatory reforms have improved the stability of the financial system, there is no way to eliminate all risks. From the perspective of global financial risk management, this stresses the importance of international cooperation to improve regulation and cooperation between central banks to improve their ability to react to potential shocks.

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2. For more on the ambitions to internationalise the renminbi and the euro, see for example Nuutilainen (2018) and Pösö (2018).

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Tags

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