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What America can learn from sterling's decline as a reserve currency

WHEN did Britain cease to be the world's pre-eminent power? Some date its dotage to the end of the first world war; others to the second. By the time of Britain's humiliation during the Suez crisis in 1956, America's hegemony was clear to all. Yet perhaps the most significant indicator of decline went relatively unnoticed by contemporaries: the dollar's usurpation of sterling as the world's main reserve currency.

Fears that a similar fate awaits America and the dollar, at the hands of China and the yuan, have burgeoned over the past decade. They have been fuelled by China's growing economic weight—last year it became the world's biggest economy in terms of purchasing power—and by the efforts of its government to promote the use of the yuan in international transactions. That has prompted economic historians to re-examine sterling's downfall, in search of clues about how the impending tussle between the dollar and the yuan might unfold. The research yields lessons in three broad areas—how a currency attains reserve status, whether a two-currency system is possible, and how poor policymaking can speed a currency's decline.

The pound dominated the financial world in the late 19th century: more than 60% of trade and 90% of public-debt issuance around the world was conducted in sterling. In part, this was owing to sheer economic clout: at its zenith, the British empire encompassed nearly a quarter of the world's people and territory. But as a recent series of papers* by Barry Eichengreen of the University of California, Berkeley, and several colleagues shows, this was not a sufficient condition for financial hegemony. After all, America's economy overtook Britain's in size around 1880, yet the dollar was rarely used abroad until after the first world war.

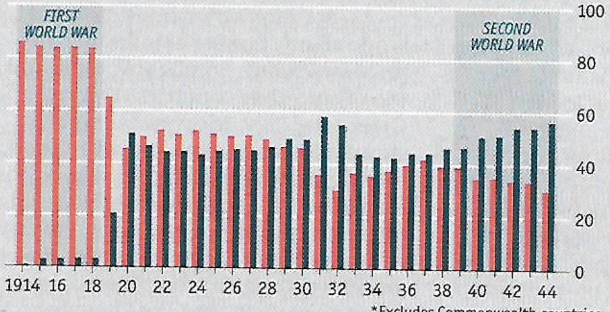
Mr Eichengreen argues that the "size, stability and liquidity" of financial markets are the most important determinants of reserve status. The pound was a reliable store of value, having been freely convertible with gold since the 1820s. It also offered access to London, the world's biggest and most stable financial centre. Moreover, as Charles Kindleberger, another economic historian, pointed out, sterling's place in the world was bolstered by international co-operation: to help deal with destabilising current-account surpluses and deficits, Europe's central banks co-ordinated monetary policy and extended one another loans.

As a result, the dollar only began to supplant the pound after the establishment of the Federal Reserve in 1913, which helped make America's financial markets both more liquid and more stable. Soon after, the international co-operation that supported the pound collapsed amid acrimony regarding reparations and war loans following the first world war.

Sterling shirk

Governments' foreign debt* issued in: Sterling Dollars

% of global total†



Source: Chitu, Eichengreen & Mehl (2014)

*Excludes Commonwealth countries
†At current exchange rates

All this should reassure the dollar's defenders. America's capital markets remain massively bigger, more liquid and better regulated than China's, the financial crisis notwithstanding. Although the Chinese government is actively promoting the development of its financial markets, just as America did a century ago, progress has been fitful. The yuan is not fully convertible, the authorities meddle with the markets and Chinese stocks have become a byword for instability.

It need not be lonely at the top

Mr Eichengreen's research also suggests that two reserve currencies can co-exist for a long period. Although the dollar began gaining ground in the aftermath of the first world war, the pound remained an equally significant reserve currency throughout the interwar period (see chart). Nor is the road to a new reserve currency a one-way street: sterling regained some ground when America was hit by a series of banking crises in the early 1930s.

Economists had tended to assume that there are big gains to be had from using a single reserve currency, in the form of lower transaction costs for international trade and investment. That, in turn, should lead to a rapid transfer of allegiances during a switch from one reserve currency to another. But Mr Eichengreen argues that central banks and investors will continue to hold some reserves in a waning currency as long as it remains sufficiently liquid, since diversification brings even greater benefits by helping limit capital losses in the event of currency turmoil.

However, misguided policymaking during a period of overlap can hasten a reserve currency's decline. In the interwar years Britain took various steps to reverse London's waning status as a financial centre, including fixing the pound against gold at a rate that made its exports uncompetitive and introducing protectionist tariffs. In the long-run, such policies proved counterproductive: by dampening growth in Britain, they further diminished sterling's standing. Devaluations of the pound and exchange controls after the second world war terminally damaged its reputation for reliability and stability.

With luck, Congress will resist the temptation to erect obstacles to trade, despite the enthusiastic endorsement of the idea by populist politicians of the left and right. But it is not hard to imagine America undermining the dollar by refusing to co-operate with the world's other big economies. As it is, America is at loggerheads with China about reforming the IMF and the World Bank. It has also churlishly resisted Chinese initiatives such as the Asian Infrastructure Investment Bank.

The breakdown of international financial co-operation as a result of the first world war led to messy and unstable conditions in the interwar years. The IMF and World Bank were founded after the second world war to ensure that this error was not repeated. It would be ironic if those institutions themselves became emblematic of America's failure to learn the lessons of history: that the dollar will not soon be supplanted, that a rising currency need not be an adversary, and that insularity is the quickest way to hasten a reserve currency's demise. ■

*Studies cited in this article can be found at www.economist.com/reserves15

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