The Dollar as Reserve Currency: Benefit or Burden?

By Kerry Pechter *Thu, Mar 9, 2017*

Should the dollar abdicate its role as the lingua franca of money? In this exclusive interview, economist Barry Eichengreen of the University of California, Berkeley offers some much-needed perspective.

"There's no such thing as a global currency," President Trump told an audience at the Conservative Political Action Conference recently. This was a bold, even brash statement, given the fact that the U.S. dollar has been the world's reserve currency since the first Boomer was born. The president seemed to suggest that it isn't, or shouldn't be.

The president didn't elaborate on his comment. But, based on his well-known concerns about the size of the U.S. debt, he may believe that the U.S. became the world's biggest debtor by providing the reserve currency, and that, in the spirit of Ayn Rand's *Atlas Shrugged*, Uncle Sam should shrug off that burden as a step toward shrinking its debt.

Should the dollar abdicate its role as the *lingua franca* of money? To better understand that issue, *RIJ* called economist Barry Eichengreen of the University of California, Berkeley. He wrote ***Exorbitant Privilege: The Rise and Fall of the Dollar and the Future of the International Monetary System*** (Oxford University Press, 2011).

Here's a transcript of our conversation:

RIJ: How does the U.S. benefit from being the provider of the so-called "reserve currency?"

Eichengreen: The most obvious effect is that there's an additional demand for dollars, and specifically for U.S. Treasury bonds, from the People's Bank of China and other holders of foreign reserves. That allows the U.S. government to borrow at lower interest rates. And as other investors look around for more attractive yields, they buy U.S. corporate bonds, among other things, enabling U.S. firms to similarly enjoy the ability to borrow and fund their operations at lower costs.

More generally, the global financial system—not just central banks but other financial institutions—runs on dollars. So if there's a technical problem, or a crisis, the Fed can resolve it by providing additional dollars. Other central banks, which can’t print dollars, lack that ability.

RIJ: What is the main drawback to being the provider?

Eichengreen: The dollar exchange rate is stronger than otherwise, because foreigners are buying dollar-denominated assets, which makes U.S. exports at least modestly less competitive. By my estimates, however, this effect is relatively small.

RIJ: Does the size of U.S. debt and deficits pose an immediate crisis for the nation? Is it like a cancer for the country?

Eichengreen: Less government debt is better than more government debt from a national-economic-health point of view. But a cancer? We’ve learned that there’s no magic number—no cliff at a debt-to-national-income ratio of 90%, for example—where cancer suddenly sets in. The best way to stabilize, even bring down, the debt to national income ratio is of course to grow the denominator. Easier said than done, alas.

RIJ: Is a funded debt a source of wealth, as perhaps Alexander Hamilton saw it?

Eichengreen: That debt is a source of liquidity—that’s how I think about it. Recall how in the late 1990s, toward the end of the Clinton Administration, people were worried about the entirety of the federal government debt being retired, and the problem that there wouldn’t be enough liquid, high-grade debt securities to lubricate the financial system. Well, that scenario certainly didn’t develop.

RIJ: Many people worry about the size of the U.S. debt and deficits, and think of the national debt as they would a large credit card balance for a household. Is that an accurate way to think about it?

Eichengreen: The analogy between the household balance sheet and the government balance sheet doesn’t make sense; this is one of the first things students learn in first-year macroeconomics. Under certain circumstances—namely depressed economic conditions—more deficit spending can boost economic growth. In that situation, running a deficit is less of a problem—just like a household needs to worry less about its credit card balance when its income is rising rapidly.

It also makes a big difference whether the additional deficit spending is being devoted to productive investments or not, just like it matters whether a household is using its credit card to pay for the kids' college education or to go to Disney World.

RIJ: People sometimes hear that China and other large holders of U.S. debt could bully us by threatening to stop buying our debt and "financing our deficits." Is that a legitimate worry?

Eichengreen: It is something to pay attention to. But were a country like China to sell off a significant share of its U.S. Treasury portfolio, it would drive down the price of its remaining holdings. So this attempt to "bully" the United States would impose significant costs on the bully. Selling off the entire Treasury portfolio would of course only be possible at fire-sale prices.

RIJ: Do other countries benefit from holding U.S. debt? Do they value it as the world's safest financial asset and a substitute for gold? Or do they suffer from holding it?

Eichengreen: They benefit from the reliable stream of interest payments and lower volatility than is provided by alternatives like gold. They also benefit from being able to hold an asset whose value is a bet on the vigor of the U.S. economy, since the more vigorous the U.S. economy the stronger the dollar. If they didn't reap benefits, they wouldn't hold dollars, after all.

RIJ: People also hear that the interest on the U.S. debt will soon become the biggest item in the U.S. budget, with terrible consequences. Given that much of the debt is held by U.S. government agencies, by the Fed, or by U.S. citizens, and that the Fed sends the interest that it earns on its own assets to the Treasury, is the interest on the debt such an apocalyptic threat?

Eichengreen: To the extent that we Americans hold our own debt, either directly or through our own government agencies, interest payments on it is a transfer from one set of Americans to another. To be sure, there exists a small subset of U.S. citizens who regard every transfer payment as an apocalyptic threat. I wouldn't count myself amongst them.

RIJ: Thank you, Professor Eichengreen.