Will the *Dollar* Go the Way Of the *Pound*?

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An important economic historian sets the parameters.

Since the Second World War, the U.S. dollar has been the world's hegemonic currency. It took over that role from the British pound, and it is not surprising that the story of the pound often looks like a *memento mori,* the skull that medieval rulers placed before them in order to remind themselves of the transience and fallibility of the human condition.

Ever since the U.S. dollar became the central anchor of the international monetary system at the 1944 Bretton Woods conference, every currency prophet has thought that it could not stay the course. At first, critics worried about a permanent dollar shortage, in which countries would not be able to acquire enough dollars to trade with the United States. But from the early 1960s they worried about American deficits and the excessive creation of dollars.

Charles de Gaulle's critique from 1965 has been continually echoed ever since in barely modified formulations: "The United States is not capable of balancing its budget. It allows itself to have enormous debts. Since the dollar is the reference currency everywhere, it can cause others to suffer the effects of its poor management. This is not acceptable. This cannot last." In each episode of dollar weakness since the 1960s, pessimistic prophets have seen the dollar following the pound on the path of decline and yielding to a new currency: in the 1980s, it was the deutschemark and the yen; in today's debates it is the

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Those Damned Yankees

Charles de Gaulle's critique from 1965 has been continually echoed ever since in barely modified formulations: "The United States is not capable of balancing its budget. It allows itself to have enormous debts. Since the dollar is the reference currency everywhere, it can cause others to suffer the effects of its poor management. This is not acceptable. This cannot last."

—H. James

euro or perhaps the yuan. On every previous occasion, the criers of "wolf" got it wrong.

The story of the decline of sterling is the story of Britain's slow transformation from the world's largest creditor to a pariah status as an impoverished debtor. It was a transformation that was driven by declining rates of economic growth, and fading competitiveness; and it was punctuated by stark political crises.

The City of London was the financial center of the nineteenth-century world, most commodities were priced in pounds, and London banks played a preeminent part in financing international trade. Before the First World War, some emerging market countries, notably Japan and India, began to hold reserves in sterling bills in London rather than in gold, as a way of earning a higher return. Britain's international role rested chiefly on her importance as an international capital exporter, with ever-rising current account surpluses in the decades before the First World War.

Before 1914, some critics suggested that the international role of sterling imposed a cost, but no one thought that the position of sterling was unsustainable. The cost to Britain lay chiefly in the continued outflows of capital that were thought to be responsible for slowing rates of economic growth and a loss of relative competitiveness.

The end to the international role of sterling came in part because of the massive costs of the First World War, which forced Britain to liquidate a large part of its international assets; and from the emergence of the United States as the major international creditor. In 1925, in a heroic effort, the British government and the Bank of England brought the pound back to gold convertibility at the prewar rate. Anything less, they thought, would have been a humiliating abdication of the international role of the pound.

The result, however, was an overvalued currency, and a much sharper loss of competitiveness in relation to other industrial countries. In the Great Depression, as unemployment mounted, some participants in financial markets began to wonder whether the commitment to convertibility was really credible, and whether the influence of labor unions at a time when the Labour Party was in power would not lead to fiscal measures that were incompatible with the maintenance of the exchange rate. In addition, financial and banking crises in Central Europe and Latin America led to the freezing of the assets of many of the leading British banking houses, and consequently to doubts about liquidity and even solvency. Given the pressures emanating from politics and from the financial markets, the Bank of England did not even try seriously to defend the pound's position by borrowing from other central banks or by hiking interest rates. Its emotionally sensitive Governor, Montagu Norman, had a nervous breakdown and took a boat trip across the Atlantic to recover. In his absence, the Deputy Governor simply advised the government that the sterling parity was unsustainable, and the government introduced emergency legislation suspending the act that provided for gold convertibility.

The final stage of the sterling tragedy and of British decline was played out when the Second World War finally

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pushed Britain into debtor status. But the pound remained in the 1950s and 1960s the second largest reserve currency, in large part because of political pressure on former British colonies to maintain their reserves in sterling. In October 1956, Britain and France involved themselves in a military adventure, supported by Israel, to seize the Suez canal zone from Egypt. When the operation stalled, the United States was deeply embarrassed and called on Britain and France to withdraw. The prime lever of political pressure for the United States was the financial panic that set in. It was the precipitate loss of British reserves which forced the government to ask for support from the International Monetary Fund, and changed British policy. The run on sterling was thus the final coffin nail for Britain's remaining imperial pretensions, and Britain almost immediately embarked on a rapid process of decolonization.

How much of this story can be applied to the transformation of the United States from the world's largest creditor to the world's largest debtor, sucking in something like three-quarters of net international capital movements? Unlike the British story, the United States draws in capital because it is an innovative society that is growing rapidly. It is also attractive because it seems secure. The safe haven dimension of American inflows explains the often noted paradox that foreigners accept much lower rates of return on investments in the United States than U.S. residents receive on their investments abroad.

For Britain, the long continuation of sterling's reserve role generated quite distinct benefits, in that the "sterling balances" held by South American, Middle Eastern, and African, as well as other formerly imperial territories, allowed Britain to live above its means while there were no active international capital markets. De Gaulle had the same suspicion about the Americans in the 1960s. The American "exorbitant privilege" that became a standard part of French rhetoric was the ability of the United States to use seigniorage to fund its debt abroad. But as capital markets developed, more and more countries (including eventually mid-level emergers such as Mexico) could borrow on international markets in their own currency, and the most obvious advantage of the key currency disappeared.

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By contrast with the British case, the U.S. dollar's role in the international system was first legally embodied in the 1944 Bretton Woods agreements. After the end of the par value system in 1971, however, the dollar's dominance was exclusively informal. The world in reality still remained a dollar-based system, in part because the United States was still the world's largest single market, and perhaps consequently the overwhelming majority of commodity prices were denominated in dollars, and in consequence there existed an obvious rationale for many countries to continue to hold reserves in dollars.

The dramatic growth of Asian and Middle Eastern reserves over the past decade nevertheless raises the specter of a humiliation of the type that hit twentieth-century Britain. It is possible to imagine a combination of 1931 and 1956 that would present a perfect dollar storm. In a Suez-like panic, a controversial foreign policy action might lead to a politically motivated run on the dollar. In the 1931 scenario, foreign investors would be convinced that political pressures within the United States (for instance, to avoid a disaster in the housing market) were the real driver of interest rate policy. As in the British interwar panic, the central bank might be unable to raise interest rates because of the fear of bad domestic consequences. In this case, there would be an impossible predicament for monetary policy. Tightening would depress the economy, and reduce the level of stability and prosperity which had previously driven inflows. Loosening would reduce returns, so that the current account deficit would no longer be funded.

Britain passed through this scenario in the trauma of 1931. A big and important financial center, and a major imperial country, suddenly took on the dynamic of a vulnerable and unstable debtor country. It began to resemble an emerging market economy. The shock was not just economic: it produced for a deep blow to Britain's politics and indeed to its national psyche. ◆