The New York Times

Business Day

Imagining the Dollar Without Its Privilege

Published: October 15, 2013 By EDUARDO PORTER

Remember the last time the country came to the brink of default? It was August 2011. For the first time in history, Standard & Poor's, the ratings agency, downgraded United States government debt.

The New York Times

"The effectiveness, stability, and predictability of American policy making and political institutions have weakened at a time of ongoing fiscal and economic challenges," it said. Investors around the world rushed to find a safe place to put their money.

Rather than dump America's downgraded bonds, however, investors flocked to them. The dollar strengthened. The United States might have become a threat to the world economy, but with even worse troubles developing elsewhere, including a flare-up in the euro crisis, it was still its safest place.

As George Soros, the hedge fund investor, told me in an interview last Friday, "The dollar is the weakest currency except for all the others."

The dollar's resilience comes to mind as Congress again flirts with financial disaster.

As time ticked down to a possible government default as early as Thursday, Republicans in the House failed once again on Tuesday to agree on a proposal to relieve the impasse, reopen the government and lift the debt ceiling.

"How can the United States preserve its financial and security leadership role when it conducts itself with such ineptitude and such disregard for the consequences for the world?" asked Charles Dallara, a senior Treasury official for the former presidents Ronald Reagan and George H. W. Bush who until earlier this year headed the Institute of International Finance, a lobby group of international banks.

Hosting finance ministers from around the world last week at the International Monetary Fund's fall meeting in Washington, Christine Lagarde, the fund's managing director, told NBC's "Meet the Press" that failing to lift the debt ceiling would cause so much disruption to the world economy that "the standing of the U.S. economy would, again, be at risk."

Indeed, the United States' erratic policy making has kindled fears that the dollar could lose its perch as the world's reserve currency — what the former French president Valéry Giscard d'Estaing, while de Gaulle's finance minister, once called America's "exorbitant privilege."

Today almost two-thirds of the world's foreign currency reserves are held in dollar assets, mostly Treasury bonds. Nearly half the foreign debt securities in the world are in dollars, as are more than half the world's cross-border loans and deposits.

It made sense for other countries to embrace the dollar in an earlier era, when the United States was willing to act as guarantor of global stability. But today, with Republicans in Congress wielding default as a lever in a vain attempt to kill Obamacare, perhaps it is no surprise that the rest of the world is getting more serious about finding an alternative.

"It is perhaps a good time for the befuddled world to start considering building a de-Americanized world," said a statement on Monday by Xinhua, the state news agency of China — which holds some $1.3 trillion in Treasury bonds.

The prospect is sending shivers down Americans' spines. Robert J. Barbera, the co-director of the Center for Financial Economics at Johns Hopkins University, told my colleague Floyd Norris that allowing the dollar to lose its status as the world's premier reserve asset "would be the single greatest mistake in American economic history."

Yet for all the dysfunction on display in Washington, the hand-wringing is overwrought. Several things must be kept in mind: first, it is inevitable that the dollar will gradually lose its position as the world's monopoly reserve currency. In some ways, it already has.

Second, barring a true act of default — a veritable catastrophe that Mr. Soros told me on Friday "everybody knows won't happen" — it has no chance of losing its reserve currency status anytime soon.

Third, the dollar's losing reserve status might not be such a bad thing, either for the United States or the world.

Today the dollar is hobbled not only by Washington's appetite for self-destruction.

The job of reserve currency is too big for the dollar to shoulder alone. Under the current system, every time some country on the other side of the world wants to add one dollar to its reserves, the United States government must issue one additional dollar worth of debt.

As a recent report about how to reform the world monetary system pointed out, the balance sheet of the United States government is not big enough to accommodate the reserves demanded by the rest of the world. Other currencies — most likely the euro and the Chinese renminbi — must eventually provide feasible alternatives.

"The United States will inevitably lose its reserve currency monopoly," wrote its authors, the economists Hélène Rey of the London Business School, Pierre-Olivier Gourinchas of the University of California, Berkeley, and Emmanuel Farhi of Harvard University. "It can only be a matter of time before the world becomes multipolar."

Officialdom is thinking about this, too. In the spring of 2010, months before the midterm elections put the Tea Party into the national spotlight, the International Monetary Fund issued a document that noted how "reserves concentration in the government debt of one country introduces idiosyncratic risks to the international monetary system."

It meant, of course, the United States. Inflation could erode the value of dollar assets, loose monetary policy by the Federal Reserve could inflate bubbles abroad, American budget deficits could push up interest rates everywhere. And, unthinkable as it was then, the American government might default. The I.M.F. suggested it might be "worth exploring whether different arrangements could underpin a more robust system for the long term."

A multipolar world might be a riskier one than the one we know. If countries and investors viewed the dollar, the euro and the renminbi as substitutes, an economic wobble in any of the three currency areas could set off a giant switch of reserves to the others — sending shock waves through the financial system.

Barry Eichengreen of the University of California, Berkeley, estimates that losing the dollar's position as the leading international currency would cost the United States some 2 percent of its gross domestic product, about a year's worth of growth.

But multipolarity also presents advantages.

For starters, the world's store of safe, liquid assets would expand to include Chinese and European bonds, allowing central banks around the world to build reserve cushions without creating the kind of large imbalances spawned by the mass accumulation of dollars by China, Japan and others, which fed large trade deficits and a huge financial bubble in the United States. For another, a cheaper dollar would enhance the ability of United States companies to sell their goods abroad.

"The dollar's international role represents the ultimate moral hazard," C. Fred Bergsten, who runs the Peterson Institute for International Economics, told me.

"It allows us to finance our external imbalances and through that our internal imbalances to an important extent. It removes the market pressure that forces politicians to get serious about reducing internal imbalances."

Whatever the merits of diminishing the role of the dollar, though, nobody should expect any of this to happen soon. The euro is hobbled by Europe's inability to overcome its economic disparities. China's capital account is still tightly controlled by the government.

On Tuesday, Britain became the first country to sign an agreement with China allowing investors in London to get a license that will allow them to invest directly in shares and bonds in renminbi. It's a long way from there to the kind of open capital market China would need for its currency to become a reserve asset.

And there's inertia. "Once you have reserve currency status you are embedded in a lot of contracts all over the world," said Lord Adair Turner, former chairman of Britain's Financial Services Authority. "It is very difficult for this suddenly to flip."

Britain's experience might serve as precedent. The world's foremost power during much of the 1800s, Britain saw its influence peak by 1870. By the turn of the century, it had largely lost its capacity to enforce Pax Britannica.

Still, it took 10 years after the end of World War II and a 30 percent devaluation of the pound before the share of dollar reserves in the world exceeded that of sterling.

The United States appears to be in the middle of a similar process. "During the cold war there was strong bipartisan consensus that United States leadership in the world was a good thing for us and a good thing for the rest of the world," said Jeffrey Frankel, an economic adviser for President Clinton, now at Harvard's Kennedy School. "In the last 10 years we completely blew it."

Tea Party adherents in Congress are doing their best to erode that leadership. But to really tip the dollar off its perch, they will have to keep at it for 15 or 20 more years.

E-mail: eporter@nytimes.com;

This article has been revised to reflect the following correction:

Correction: October 16, 2013

An earlier version of this column misidentified a former French official who referred to the advantage of having the world's reserve currency as America's "exorbitant privilege." It was Valéry Giscard d'Estaing, while finance minister under President Charles de Gaulle, not de Gaulle himself. The column also misstated the academic affiliation of Hélène Rey, a co-author of a paper on the international monetary system. She is at the London Business School, not the London School of Economics. And the column referred incorrectly to an era of British primacy. Britain was the world's foremost power during much of the 1800s, not the 1900s.