



Harvard Model Congress Boston 2022

PRESERVING THE GLOBAL ROLE OF THE UNITED STATES DOLLAR

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INTRODUCTION



Exchanging Indonesian rupiah for USD. In countries with unstable currencies, people save and transact dollars.

Bloomberg

Almost 90% of all trades globally are conducted in US dollars.

For the past eight decades, the United States Dollar has maintained its largely unchallenged status as the world's currency. A global currency is one that is widely accepted and transacted throughout the world. After World War II, a dollar-dominated global financial system was established, cementing the supremacy of the United States as an economic superpower. The clearest indication of this leadership is the dollar's role as the primary global reserve currency, which is held at central banks across the world in large sums. In 2020, US Dollars made up almost 60% of all known central bank foreign exchange reserves according to the International Monetary Fund (IMF). Far behind the dollar, the next closest global reserve currency — at a share of about 20% of all reserves — is the Euro (IMF Data). One of the reasons such large quantities of dollars are held internationally is that many foreign countries can't use their own currency for international transactions, such as paying for imports. As the world's currency, the dollar is the most used vehicle for conducting international trade. Even when a transaction is made between two foreign countries, it is still very common for it to be invoiced in dollars. In fact, in 2019 the USD was the world's most traded currency, being used in 88% of all trades (BIS, 2019).

Backed by the world's largest economy, the USD is considered a safe haven currency because of its reliability as a long-term store of value. This corresponds to a heightened demand for dollars, especially in times of crisis. The attractiveness of the greenback is significantly larger in countries with volatile, unreliable currencies. When this is the case, individuals and institutions decide to hold part of their assets in an alternate, more stable currency — most likely

USD. In some cases, this results in the dollarization, either de-facto or official, of a foreign economy.

While the US Dollar is unquestionably the world's leading currency today, foreign ambitions have challenged the prevalence of the status quo in recent years. A new age seems to be setting upon the global financial system, and the dollar's share of reserves is facing a downward trend. The USA has long benefited from its privileged position with the ability to leverage it for its foreign policy interests and expand the country's global influence. Because of this, it is in the country's best interest for the USA to evaluate and address these challenges in a timely fashion.

EXPLANATION OF THE ISSUE

Historical Development

The start of the privileged position of the dollar worldwide is a result of the 1944 Bretton Woods agreement which established the rules for the international monetary system, creating the World Bank and the International Monetary Fund. At Bretton Woods, the world's developed countries agreed to peg the exchange rates of all their currencies to the United States Dollar, which had its value tied to gold and held the largest gold reserves at the time. Instead of the gold standard, this agreement meant foreign countries held their reserves in USD, instituting the dollar as the global reserve currency for the first time.

Even though the United States unilaterally terminated the dollar's convertibility under President Nixon in 1971, the dollar has retained its status. Since then, their currency has become a powerful tool for furthering foreign policy and an emblem of global prestige for the United States. During his presidency in the 1910s, President Taft advanced what is known as Dollar Diplomacy. He believed that "the goal of diplomacy should be to create stability and order abroad and through it promote American commercial interests." The guiding principle behind his policy was to minimize the threat of military power, instead employing the USA's financial strength to further its foreign policy goals, specifically in the regions of Latin America and East Asia. Instead of substituting bullets with dollars, in reality, they both worked alongside each other and his policies proved largely unsuccessful (Office of the Historian). This has led in part to a sometimes-negative perception of American power in the global financial system abroad stemming from an anti-imperialist sentiment. For instance, in 2007, Venezuelan President Hugo Chavez said that "the fall of the dollar is not the fall of the dollar—it's the fall of the American empire" (New York Times). Certainly, foreign powers have ambitions of a de-dollarized global financial order.



Delegations reunited at the 1944 Bretton Woods Conference in New Hampshire.

DW

China, for instance, would like to see its currency replace the greenback's supremacy and expand its influence to regions typically associated with the United States. These recent challenges to the status quo might pose a threat to the privileged position enjoyed by the USA.

In spite of any criticism and disapproval, dollar notes remain a prized possession abroad, which is especially true in Latin America (Demirgüç-kunt and Klapper). When citizens of a country lose confidence in their own currency and its ability to retain its value, they turn to the USD as a safe-haven currency. When this happens repeatedly and in large numbers, the result is de-facto currency substitution or dollarization (Ganti). This is the case for several Latin American countries, including Argentina, Uruguay, and Venezuela. Going one step further, when a country effectively gives up its own national currency altogether to adopt a foreign one, it is known as official dollarization. This was the case, for instance, in El Salvador and Ecuador, both Latin American countries that adopted the US Dollar as last resort measures around 20 years ago. Other foreign countries and regions using the US Dollar exclusively as their currency include the British Virgin Islands, Palau, and the Turks and Caicos Islands. There are also cases, such as that of Panama, in which the USD is accepted as legal tender along with the country's own currency. Cases like these contribute to the idea that dollars are the USA's greatest export. While it is difficult to estimate the value of banknotes circulating abroad, it is estimated this value could be as much as half of the currency in circulation (U.S. Currency Education Program).

In all of the aforementioned cases, dollarization was done unilaterally, without any formal encouragement or assistance from the issuing country — in this case, the United States. While historically the US government's policy towards official dollarization has been one of passive acceptance, there are potential benefits, both quantifiable and intangible, to be gained by America when a country dollarizes its economy. Their role in helping perpetuate the dominance of the USD as the world's currency shall be evaluated.

While the supremacy of the dollar is still going strong, concern has arisen over the ability of this position to be sustained in the long term. In Q4 of 2020, the share of dollar global reserves fell to its 25-year record low, dipping below 60% for the first time since 1995 (IMF, 2021). Even though all reports still show the USD ahead of any other currency by a huge margin, many are left wondering about a potential decline in the role of the dollar in the global order. China's newly introduced digital currency — yet unchallenged by an American counterpart — and their aspirations for a new financial order pose additional challenges to the status quo which many in Congress strive to preserve.

Scope of the Problem

Seigniorage – The difference between the value of money and the cost to produce

After almost 80 years since the agreement that pushed the greenback to the center of the international financial order was signed into effect, the United States still has every interest in defending the status earned for its currency, and the advantages it derives from this prestige. The dollar's authority as the global reserve currency brings numerous benefits to the US economy. Thanks to the global demand for dollars, the US is able to borrow capital at a low cost. Furthermore, the dominance of the dollar in international transactions reduces the exposure of the US to outside influences, exchange rate risks, and transaction costs. The international circulation of banknotes, which exists in huge quantities for the USD due to its dominance, is also very profitable for the United States because of **seigniorage**, the implicit tax associated with creating money. All of these more tangible benefits, however, might be shrinking in recent times due to challenges to the dollar's supremacy, according to Ben Bernanke, former Federal Reserve chair (Bernanke, 2016).

For the United States, however, some of the most relevant benefits of the greenback's power are symbolic rather than quantifiable. As Rep. French Hill (R-AR) put it, the dollar's role as the world's reserve currency is "good for American companies and workers, as well as U.S. global influence." The dollar has become an important global symbol for the country, and the status and political power gained with this dominance enables the United States to exercise its influence in international affairs. The US can leverage the strength of the dollar like virtually no other country in the world can. This allows the US to advance its democratic values and foreign policy agenda while maintaining a favorable dollar-centered world order. An example of how this has been achieved in the past is US sanction power (Durkin). This authority and the benefits it confers to the country are worth preserving for the USA.

The Future of Money

CBDCs – Central Bank Digital Currency. A digital currency issued by a country's central bank.

Technological advances have upended the status quo of finance globally. Now, people are starting to question the future of paper money. Digital currencies are on the rise, and central banks want in. According to the Bank of International Settlements, 60% of central banks are conducting experiments with **CBDCs** as of 2020 (Boar and Wehrli, 2021). Even though this is only the third BIS survey conducted on the topic, this figure already represents a jump in interest of 18% from the previous year. The creation of government digital currencies, or govcoins, might be revolutionary for the world's financial order – including a potential challenge to the dollar's status as reserve currency. Notwithstanding the perceived risks and

benefits of a new system in which paper money would become obsolete, governments around the world are hopping on the trend and researching, developing, and testing CBDCs. What does this changing landscape mean for USD supremacy and the benefits it allows?

In April 2021, Chair of the Federal Reserve Jerome Powell noted his lack of concern towards other countries developing digital currencies first, adding that the dollar is "the world's reserve currency, and that means that the dollar is used in transactions all around the world, far more than any other currency." While this still holds true, a changing landscape in which the world slowly moves away from the dollar might result in pressure for the United States and its currency to be more dynamic and adaptive around rapid shifts. In summer 2020, Goldman Sachs warned that "real concerns around the longevity of the U.S. dollar as a reserve currency have started to emerge." (Bitcoin News)

Particularly, a growing threat concerning members of Congress comes from China. In September 2020, Morgan Stanley analysts predicted that the Chinese **yuan** would become the third-largest global reserve currency by the next decade, behind the US dollar and the Euro (Cheng). In 2020, the share of global reserves in **renminbi** was just 2.25% according to the IMF, a number which has been rising since 2016. In addition, the yuan's popularity for global payments hit a 5 year high in January 2021, becoming the world's fifth most favored currency, after a rapid climb from the 35th spot on the list since 2010 (Barton, 2021). While these numbers do not seem too concerning at face value yet, some members of Congress agree that "China is playing a long game to displace the dollar and our capital market system with a global economy that has China as the center," according to Rep. French Hill (R-AR). These claims come after the introduction of the digital renminbi (e-CNY) in 2021. The transformative power of a Chinese digital currency — the first one to be issued by a major economy — in the absence of an American counterpart might jeopardize the dollar's status of leadership, and the international influence this confers to the United States. China seeks to destabilize the existing greenback-centered world order, thereby reducing American bargaining power in foreign policy.

Position Towards Dollarization

As the world's leading currency, not only do governments hold US dollars, businesses and individuals abroad do so too, sometimes replacing their own currency. Latin America, because of its economy and close proximity to the United States, has typically been the most natural host for this scenario. Besides the officially dollarized countries discussed previously, the Latin American region as a whole is already extensively de-facto dollarized.

Yuan & Renminbi
– The renminbi is the official currency of China and one of the world's reserve currencies. By definition, the yuan is the primary unit of account of the renminbi, but both terms are used interchangeably to refer to the currency itself.

The formal dollarization of foreign economies by substituting their currencies with greenback leads to benefits for the US and the status of the dollar. The most obvious benefit accrued is profitability from seigniorage, which is the cost faced by the dollarized country to acquire the necessary dollars for their economy. Additional advantages to the United States include faster growing and more stable export markets, less currency risk in international trade and investment, and less of a need to bail out foreign central banks, as discussed in a 1999 senate hearing on the topic of whether the USA should encourage official dollarization (United States, Congress, Cong. Senate, Committee on Banking, Housing, and Urban Affairs). Under a single currency – the dollar – the US also benefits from expanded trade relations, easing the flow of international trade between dollarized economies. These economic advantages are accompanied by the increased political power and influence the US achieves in the region with official dollarization.

Thus far, official dollarization has occurred exclusively unilaterally. The policy of the US towards dollarization has been one of passive acceptance, where the US government provides dollarized economies with little or no encouragement and assistance. Given the status of de-facto dollarization that already exists in Latin America, the benefits America obtains from going a step further and dollarizing officially are reduced, since the US already reaps some of the benefits from the current situation. The US, however, has it in its best interest to – at least – perpetuate the level of dollarization that exists presently. When the dollar faces new challenges to its status from different fronts, a more proactive approach towards dollarization policy might be warranted in order to defend the prestige of the dollar and therefore American influence abroad.



The now-defunct Ecuadorian sucre, replaced by the dollar in 2000.

Milken Institute Review

Congressional Action

The debate surrounding the future of the USD as the world's reserve currency has garnered more attention in the past few months due to the threat of a rapidly changing global financial environment stemming partially from technological advances, foreign influences, and events surrounding the COVID-19 pandemic. In May 2021, bipartisan legislation supporting the role of the USD as the global reserve currency to preserve American interests globally was introduced. This bill – HR 3506 – addresses a growing threat from China as well as the disruptiveness force of digital currencies and was sponsored by Rep. French Hill (R-AR) and co-sponsored by Rep. Jim Himes (D-CT).

In 1999, the idea of encouraging official dollarization as US policy, particularly in Latin America, gained interest in Congress. This debate was in line with the fragile economic state of the region, which led to dollarization being seriously considered by several Latin American countries during the period. In 2000 and 2001, El

Salvador and Ecuador dollarized unilaterally. Other countries such as Argentina, Mexico, and Guatemala also debated the prospect.

Other Policy Action

Since 2020, the Digital Currency Initiative at MIT has collaborated with the Federal Reserve Bank of Boston to conduct research on CBDSs and explore the creation of a hypothetical central bank digital currency. The project is a multi-year collaboration extending two to three years.



The Massachusetts Institute of Technology in Cambridge, MA, where the Digital Currency Initiative is held.

Shutterstock

IDEOLOGICAL VIEWPOINTS

Conservative View

While support for the issue is mostly bipartisan, conservatives have a variety of views towards the proposed solutions.

In general, conservatives would agree about the importance of preserving the US foreign policy and economic power in order to further its influence and agenda abroad by maintaining the status of the USD. Conservatives are also more likely to be wary of foreign influences threatening the prosperity of the dollar, especially when discussing the ambitions of China of a global shift away from the dollar. Conservatives would therefore be very motivated to address these threats.

While researching the implementation of central bank digital currencies in response to this debate will often garner bipartisan support, in practice conservatives are more skeptical of privacy concerns and increasing government involvement in daily citizens' lives. Therefore, they would be strongly opposed to CBDCs like the one implemented in China where all transactions can be tracked by the central bank.

Although not all conservatives will share this view, under the Trump administration, economic power derived from the dollar strength was frequently leveraged in foreign policy by allowing the administration to impose unilateral sanctions, even despite negative repercussions to the image of the US abroad.

Liberal View

In general, liberals would also be concerned with defending the status and influence of the United States.

The liberal view of the implementation of a digital dollar is strongly positive in most cases, especially focusing on guaranteeing easy access to banking through a digital wallet to every American. This is not to say there would not be situations of skepticism when adopting disruptive technology.

While liberals share a skeptical view towards foreign influences such as that of China with conservatives, even if to a lesser extent, they typically support less tough policy towards them.

Liberals, much like conservatives, care about portraying a vision of American leadership abroad and furthering a foreign policy agenda based on promoting American values of democracy and human rights. However, democrats would typically be less supportive of leveraging the dollar's power for imposing harsh unilateral sanctions. While opinions vary across the spectrum, they would not agree on their effectiveness as a policy to promote their foreign policy goals.

AREAS OF DEBATE

Defend the Dollar as the Global Reserve Currency

As discussed, the United States is deeply interested in maintaining the supremacy of the dollar, motivated by both economic and foreign policy reasons. While the dollar remains mostly unchallenged, monitoring and addressing new challenges through policy might be important for Congress. It is widely believed that Chinese ambitions along with their newly introduced digital yuan might pose a threat to the privileged position of the US dollar. Finding ways to address these threats will be a primary consideration to defending an order that advances American interests worldwide. Support for many of these policies is expected to be bipartisan.

The 21st Century Dollar

Part of the challenge in enshrining the dollar as the primary global reserve currency and preserving its influence will be adapting to the disruption of technology in the global financial order. The push for a new monetary system might be a perfect opportunity to displace the US dollar from its position of power if it does not effectively and nimbly adapt to global changes in order to maintain the global power and strength of the dollar.

While most interested parties are invested in researching and exploring the possibility of a digital currency, the adoption of a government-backed digital dollar still seems far off. From the federal reserve, the current attitude is not one of urgency towards the matter. There has been interest in Congress to push advances in research of US CBDCs during this year

Change in Policy Towards Dollarization

Historically, American foreign policy towards official dollarization has been one of passive acceptance. Although dollarized economies, as explained previously, exist, they have done so

The earliest examples of CBDCs emerged just years ago in the mid-2010s

unilaterally without US support. While America has accepted and sometimes welcomed the moves from these nations, it has not made dollarization more attractive through its position.

In light of the potential challenges to the dollar order, the benefits of official dollarization of foreign countries might be large enough to warrant a change in policy that would encourage more countries to dollarize, in an aim to protect the influence of the US dollar globally by gaining leverage over Latin American governments. This would entail a shift to a more proactive position of encouragement.

There is a range of policies that would support this position, from offering incentives to technical assistance. The most obvious one would be to alleviate the implicit seigniorage costs of adopting the dollar. A way for this to happen would be to repay some of the extra profit earned from issuing the dollars used by foreign countries. In essence, sharing seigniorage. Seigniorage, however, is a very profitable benefit of official dollarization, and the costs of a proposal of this kind should be evaluated against the gains from the incentive. Other more controversial incentives proposed include giving seats at the Federal Reserve Board to dollarized nations, and the Federal Reserve acting as a lender of last resort.

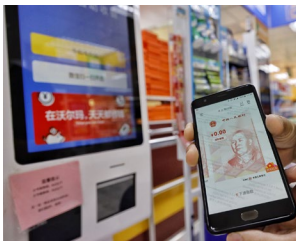
BUDGETARY CONSIDERATIONS

At the time, most policies introduced will call for research and development for the exploration of solutions that will address the challenges presented. For some policies, it is also important to consider the cost stemming from a loss in revenue. This would be the case, for instance, in a policy of shared seigniorage.

CONCLUSION

Maintaining the leadership of the US dollar in the global financial landscape is in the best interest of the United States for both economic and foreign policy reasons. The dollar has become an important symbol for American leadership abroad and a tool to leverage the USA's sphere of influence and advance its policy agenda abroad. While the supremacy of the dollar remains unquestionable, a change to the status quo would be very detrimental to American goals. For this reason, it is imperative for Congress to address any threats arising in a timely matter, as well as for the US to remain at the forefront of international monetary developments to continue to assert its leadership.

In an age of increasing global interconnectedness, US authority is essential to maintaining an order correlative to the values of democracy. In responding to this challenge, groundbreaking



Paying with the digital renminbi in 2021.

Li Hao/GT

solutions related to new technologies as well as increased interest in debates and ideas from the past will both play a role

GUIDE TO FURTHER RESEARCH

News sources with a focus on international finance and trade will be very helpful when conducting further research, especially as we see the development of the global economy in light of the disruptive forces of the COVID-19 crisis recovery and introduction of new technologies in the financial landscape.

It will also be extremely important to stay up to date with the introduction and discussion of new bills pertaining to the topic as well as comments from relevant institutions, such as the Federal Reserve.

Lastly, it is interesting to look back at literature from previous debates pertaining to the topic. For the specific point of dollarization, reading material from the early 2000s, when interest in the proposal was at its peak, and understanding the different perspectives at the time, would be helpful.

GLOSSARY

CBDCs – Central Bank Digital Currency. A digital currency issued by a country's central bank.

Renminbi – The official currency of China and one of the world's reserve currencies.

Seigniorage – The difference between the value of money and the cost to produce and distribute it.

Yuan – By definition, the primary unit of account of the renminbi, China's currency. Generally, the currency itself is also known simply as the yuan, and both terms are used interchangeably, especially in international contexts.

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