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THE EMPIRE AND THE DOLLAR

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The Empire and the Dollar

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About the Series

The *Studies in Applied Economics* series is under the general direction of Prof. Steve H. Hanke, Founder and Co-Director of The Johns Hopkins Institute for Applied Economics, Global Health, and the Study of Business Enterprise (hanke@jhu.edu). The views expressed in each working paper are those of the authors and not necessarily those of the institutions that the authors are affiliated with.

About the Author

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Abstract

In our multicurrency world, the U.S. dollar is widely used for pricing internationally traded goods, for international payments, and for denominating the assets governments and companies hold as reserves. Why is that and what are its implications for U.S. behavior? What would a better system look like?

In a world of many different national currencies, the payment for international trade has found economy in using an intermediate, so-called vehicle currency to facilitate the exchange of the buyer’s currency into and delivery of the seller’s currency. Following the collapse in 1971 of the dollar-based gold exchange standard overseen by the International Monetary Fund, the dollar continues to dominate in this role. This role has given the United States important political power and financial benefits.

The author will quickly review these benefits, and how they have come to encourage the U.S. to exploit them in exercising its international power, the forces that are building to seek an alternative, and the potential for the IMF's Special Drawing Rights (SDRs) to provide an alternative.

The Dollar's International Reserve Status

Cross border commerce and investments require a common currency to price and denominate them and the mechanisms for cross border payments. While modern technologies continue to increase the speed and ease and lower the cost of domestic payments of domestic currencies, cross border payments remain relatively slow and costly.

The payment and receipt of a currency is ultimately reflected/settled on the books of that currency's issuer. If I pay you for something and your account is in a different bank than mine, the transfer of funds from my bank to your bank and to you will pass through a Federal Reserve Bank. My bank's account at the Fed will be debited and yours will be credited. A fundamental difference between national and international currencies is that the central bank issuers of national currencies only hold deposits for banks that are domestically licensed, while the issuers of international currencies, such as the Special Drawing Right (SDR) of the International Monetary Fund, hold deposits from banks almost anywhere in the world, enabling the settlement of their payments to enjoy the efficiencies of domestic payments in domestic currencies.

The older gold standard functioned more like an international central bank issuer of currencies but without such an international central bank. Instead, national currencies were tied to gold by virtue of the commitment of central banks on the gold standard to redeem their currency for gold at a fixed price. Thus, any net flow of payments from one country to another was ultimately settled by transferring the ownership of the gold it was fixed to from the deficit to the surplus country. This could occur by debiting the deficit country's gold account at the New York Federal Reserve Bank and crediting the surplus country's gold account at the same place or by physically shipping the gold.

In today's world, cross border payments generally involve the need to exchange one currency for another at exchange rates that fluctuate. To facilitate the comparison of prices of globally traded goods (e.g., oil, gold, copper, and other commodities) they are generally priced in one common currency. The U.S. dollar is the currency most widely used for this purpose (79%). This contributes to the use of the dollar for cross boarder payments as well even when the buyer's currency differs from the seller's ultimate currency (the currency paid to its workers, etc.).¹

Some economy is brought to the markets for foreign exchange needed for cross boarder payments by using a common so called vehicle currency as a common go between. The adoption by airlines of a hub and spoke model for connecting all airports in a country or the world illustrates the economy of a single or small number of vehicle currencies (hubs) to exchange currency X for currency Y. The U.S. dollar is the most widely used vehicle currency for this purpose. This is supported by and reflected in the dominance of the dollar in invoicing internationally traded goods and in the foreign exchange reserves of banks (central and commercial) around the world. The Euro is the second most used currency in these ways.

¹ <https://www.federalreserve.gov/econres/notes/feds-notes/the-international-role-of-the-u-s-dollar-20211006.htm>

In 2021 40.5% of international payments were made in US dollars. The use of Euros in international payments and in reserves has moved up to second place behind the dollar at 36.7% of payments. The Pound sterling is a distant third at 5.9%. Having passed the Japanese yen a few years back for fourth place the Chinese RMB achieved 3.2% of international payments in January of this year from almost zero a decade ago. ["China's currency scores a win during the Olympics"](#) The Federal Reserve has constructed an “aggregate index of international currency usage.” The dollar has remained in the neighborhood of 70% for the last two decades. ["The international role of the U.S. dollar"](#)

To pay for things with a currency, one must hold some amount of that currency. It is this demand for dollar reserves resulting from the widespread international invoicing and payments in dollars, that underlies foreign financing of US debt. For starters, about half of dollar currency (actual banknotes) are held abroad. That is the extent to which we pay for imports with cash and the sellers just hold the cash. Foreign central banks hold almost 13 trillion dollars in foreign exchange reserves of which over 7 trillion is in U.S. dollars (much of that is held in the form of US government debt). About 60% of the foreign currency claims of banks are dollar claims.

The dollar grew into its vehicle and reserve currency roles because of the size of the U.S. economy and its extensive trade with the rest of the world, the size and liquidity of financial assets denominated in dollars, public confidence in the stability of the dollar’s purchasing power, and in its trusted contract enforcement (rule of law).

U.S. Benefits from reserve currency status

The so-called exorbitant privilege of a reserve currency--the ability to borrow abroad in your own currency--makes it easier for the U.S. government to finance its military and other expenditures with debt. For countries to accumulate dollar reserves they must have a balance of payments surplus, i.e., they must sell more to the U.S. than they buy from the U.S.. As a result, American’s enjoy cheaper imports and the excess of dollars paid for such imports over those paid back for US exports are held in foreign reserves (generally in the form of US treasury debt).

As an aside, it is simply wrong to attribute much of the so-called offshoring of our manufacturing to the above phenomenon. The somewhat lower exchange rate for the dollar needed to generate the surplus China and other countries need for the trade surplus with which they buy American debt, does make imports somewhat cheaper. However, even if the dollar was totally replaced in foreign reserves and trade balanced, we would continue to be better off producing what we export and importing what China and the others produce and sell to us. Freely pursuing our comparative advantages increases our incomes and the incomes of the Chinese and others selling to us. Free trade is win-win. Contrary to the myth, U.S. manufacturing is at an all-time high. (Manufacturing employment is lower because of increased labor productivity).²

The U.S. dollar’s dominance in global trade and finance contributes to the existence of the American Empire in two ways. It attracts foreign financing of the U.S. government and its

² <https://www.macrotrends.net/countries/USA/united-states/manufacturing-output>

military industrial complex thus reducing the burden of the empire on the American taxpayer and it provides a tool by which the U.S. can impose its will on other countries or individuals in managing its empire. Borrowing to pay our government's bills is politically easier than raising taxes and avoids (or delays) a debate over guns versus butter.

Three factors now challenge the dollar's reserve currency role. 1) Cumbersome payment technology: Existing arrangements for cross border payments via the Society for Worldwide Interbank Financial Telecommunication (SWIFT) are technically crude and outmoded. 2) Weaponization of the dollar: The U.S. has abused the importance of its currency for cross border payments to force compliance with its policy preferences not always shared by other countries, by threatening to block the use of the dollar. 3) Growing risk of a decline in the dollar's value: The growing expectation of dollar inflation and the skyrocketing increase in the U.S. fiscal deficit are increasing the risk of holding and dealing in dollars.

The first factor--payment technology--is temporary. It is being modernized. While payment technology (ease, speed, security, and cost of making cross border payments) is important, it is not as important as the features of the currency being paid. As a currency, the dollar excels for the reasons given earlier.

The second factor--weaponization of the dollar--has been growing in importance as the U.S. has increasingly sanctioned trade and dollar payments without broad international support--Iran, etc. The EU has sought work arounds in Euros. China and Russia are building alternative payment arrangements using China's Renminbi. Even with the dramatic increase in coordinated sanctions against Russia, restricting the use of dollars is less effective than directly blocking trade.³ The broad support for sanctions on Russia more likely increases support from the dollar as the dominant international currency rather than reducing it. On the other hand, those on the other side (e.g., Russia and China) will work harder to find alternatives. The balance of these contradictory forces is difficult to assess.

The third factor has never been taken very seriously until now. At the end of February (2022) the US national debt was over 30.1 trillion dollars or 125% of US output (GDP). Federal government interest payments on its net debt were \$426 billion per annum. But with the increase in inflation, interest rates are rising. Uncle Sam's debt service payments are likely to double or triple over the next five to ten years, rising to 15% to 20% of the Federal budget. The world still expects the US to regain control of its spending, but the risks of default are creeping up. Paul "Samuelson stated in 2005 that at some uncertain future period these pressures would precipitate a run against the U.S. dollar with serious global financial consequences."⁴

It is the second factor, US abuse of its ability to sanction the use of the dollar that is most threatening to push the dollar over the cliff.

The Alternative to the dollar

³ <https://wcoats.blog/2022/03/04/how-to-stop-russia-in-ukraine/>

⁴ https://en.wikipedia.org/wiki/International_use_of_the_U.S._dollar

An internationally defined and issued currency would have a number of advantages over the use of a national currency for cross border payments.

While the value of the dollar has been quite stable for many years, using a basket of major currencies for pricing internationally traded goods and financial instruments would be even more stable. This is what the International Monetary Fund's unit of account--the Special Drawing Rights (SDR)-- offers. The value of one SDR is equal to the current market value of fixed amounts of the US Dollar, Euro, British pound, Japanese yen, and Chinese yuan. Thus, its widespread use for pricing internationally traded goods and financial instruments would provide even greater stability than would any one of these currencies. Every morning when I check movements in the price of oil, I must ask myself whether it was really a change in the price of oil or in the exchange rate of the dollar. See my: ["Why the World Needs a Reserve Asset with a Hard Anchor"](#)

The IMF's SDR can only be held and used by member central banks and a few international bodies. Thus, private SDRs--so called Market SDRs--are needed for payments by the private sector (perhaps issued by the IMF or the BIS). Being issued by an international body, such Market SDRs would have the equivalent of a central bank for settling cross boarder payments allowing the simplifications and economy increasingly available for domestic payments in the domestic currency. `

Moreover, as an internationally issued currency the SDR would be far better protected from the political abuse increasingly experienced with the US dollar and might be expected with the Chinese RMB or other national currencies.

[Getting from here to there](#)

But first things first. Before considering the reform of the international monetary system, let's consider the reform of the dollar--the reform of U.S. monetary policy. The price of the dollar should be fixed to a hard anchor and issued according to currency board rules.

During the heydays of the gold standard (1820-1913) international trade flourished dramatically increasing global incomes and reducing poverty. According to Antoni Estevadeordal, Brian Frantz and Alan M. Taylor "Until 1913 the rise of the gold standard and the fall in transport costs were the main trade-creating forces."⁵ However, to cope with WWI, the Great Depression, and WWII, the gold standard failed and was abandoned because of weaknesses in banking systems and because the countries that fixed the value of their currencies to gold did not fully play by the gold standard's rules.

Under a strict gold standard, the central bank would issue and redeem its currency whenever anyone bought it for gold at the official price of gold. In fact, however, by actively buying and selling (or lending) its currency for other assets whenever it thought appropriate, the Federal Reserve's monetary liabilities (base money) were partially backed by U.S. treasury bills and other assets. In addition, the fractional reserve banking system allowed banks to create deposit

⁵ <https://www.jstor.org/stable/25053910>

money that was also not backed by gold. The market's ability to redeem dollars for gold kept the market value of gold close to its official dollar value. However, the gap between the Fed's monetary liabilities and its gold backing grew until the market (most conspicuously, France) lost confidence in the Fed's ability to honor its redemption commitment and President Nixon closed the "gold window" in 1971 rather than tighten monetary policy.

Currency Board Rules

A reformed monetary system that returns to a hard anchor (firmly fixed price of the currency for gold or some other asset) should require the Fed to adhere strictly to currency board rules. Such rules oblige a central bank to buy and sell its currency at a set price in response to public demand. Under the Gold Standard, the price of the currency was set as an amount of gold (a gold anchor). For existing currency boards, the price is typically an amount of another currency or basket of currencies. See my book on the establishment of the Central Bank of Bosnia and Herzegovina ("[One currency for Bosnia-creating the Central Bank of Bosnia and Herzegovina](#)"). The Fed would provide the amount of dollars demanded by the market by passively buying and selling them at the dollar's officially fixed price for its anchor. All traditional open market operations by the Fed in the forms of active purchases and sales of T-bills or other assets would be forbidden.

The Anchor

Another weakness of the historical gold standard was that the price of the anchor, based on one single commodity, varied relative to other goods, services and wages. While the purchasing power of the gold dollar was relatively stable over long periods of time, gold did not prove a stable anchor over shorter periods relevant for investment.

Expanding the anchor from one commodity to a basket of 5 to 10 commodities with greater collective stability relative to the goods and services people actually buy (as measured by, e.g., the CPI index), would reduce this volatility. The basket would consist of fixed amounts of each of these commodities and their collective market value would define the value of one dollar. There have been similar proposals in the past, but the high transaction and storage costs of dealing with all the goods in the valuation basket doomed them. However, with indirect redeemability discussed next, the valuation basket would not suffer from this problem.

Indirect redeemability

Historically, gold and silver standards obliged the monetary authority to buy and sell its currency for actual gold or silver. If the dollar price of gold in the market was higher than its official price, people would buy gold at the central bank increasing its market supply and reducing the money supply until the market price came down again. These precious metals had to be stored and guarded at considerable cost. More importantly, taking large amounts of gold and silver off the market distorted their price by creating an artificial demand for them. A new gold standard would see the relative price of gold rising over time due to the increasing cost of discovery and extraction. The fixed dollar price of gold means that the dollar prices of everything else would

fall (deflation). While the predictability of the value of money is one of its most important qualities, stability of its value, such as approximately zero inflation, is also desirable.

Indirect redeemability eliminates these shortcomings of the traditional gold standard. Indirect redeemability means that currency is issued or redeemed for assets of equal market value rather than the actual anchor commodities. Market actors would still have an arbitrage profit incentive to keep the supply of money appropriate for its official value. As the economy grows and the demand for money increases, this mechanism would increase the money supply as people sell their T-bills to the Fed for additional dollars at its official (gold or whatever) price.

Towards a global anchor

The United States could easily amend its monetary policy to incorporate the above features – adopting a government defined value of the dollar as called for in Article 1 Section 8 of the U.S. Constitution and a market determined supply. The Federal Reserve would be restricted by law to passive currency board rules. Additional financial sector stability would be achieved by also adopting the Chicago Plan of 100% reserve requirements against demand deposits. This would be a natural byproduct of the Fed creating a two-tier Central Bank Digital Currency (CBCD) now under consideration.

The gold standard was an international system for regulating the supply of money and thus prices in each country and between countries and provided a single world currency (via fixed exchange rates). Balance of trade and payments between countries was maintained (when central banks played by the rules) because deficit countries lost money (gold) to surplus countries, reducing prices in the former and increasing them in the latter. This led to a flourishing of trade between countries. This was a highly desirable feature for liberal market economies.

The United States could adopt the hard anchor currency board system described above on its own and others might follow by fixing their currencies to the dollar as in the past. The amendments to the historic gold standard system proposed above would significantly tighten the rules under which it would operate and strengthen the prospects of its survival.

However, there would be significant benefits to developing such a standard internationally. One way or the other, replacing the fluctuating exchange rates between the dollar and other currencies with the equivalent of a single currency would be a significant boon to world trade and world prosperity. Replacing the U.S. dollar as the world's reserve currency with an international unit would have additional benefits for the smooth functioning of the global trading and payments system.

In a small step to create an internationally issued currency the IMF created its Special Drawing Right (SDR) in 1969 in the expectation of supplementing the gold-based US dollar. But in today's world of fiat currencies with floating exchange rates the SDR has several limitations as a reserve currency, most of which can be lived with for a while. The SDR allocated by the IMF can only be held and used by the central banks of IMF member countries and a few international organizations such as the World Bank and BIS. The SDR falls short as a challenger to the US dollar because of the absence of widespread private market use of the unit.

To become a serious supplement to, if not replacement for, the US dollar in the international monetary system the SDR would need to be usable for payments by private sector parties. This would require the creation of private or Market SDRs. This could be done in much the same way banks now create dollar deposits.

Digital SDR currency

As with national currencies, the internationally issued SDR needs a central issuer of the base money version of market SDRs (M-SDRs). The IMF should oversee the develop of a procedure for issuing M-SDRs following currency board rules and backed 100% by official SDRs or by an appropriate mix of sovereign debt of the five basket currencies.

The IMF might establish an IMF trust fund that would issue M-SDRs to AAA or AA international banks upon their request and payment of the equivalent value of one or more of the five basket currencies (and would redeem them under similar arrangements). As with other IMF trusts, the IMF might approach the BIS to operationally manage the issuance and redemption of M-SDRs and the maintenance of the official SDR asset backing (or its equivalent in the five currencies in the valuation basket).

Banks offering M-SDR deposits/currency to their customers would hold an M-SDR reserve backing with the IMF SDR trust fund. The base money M-SDRs issued by the IMF trust fund would perform the same payment settlement function as do central banks for the base money they issue, with the critical difference that its depositors/participants would be global rather than national. This would enable virtually instantaneous final settlement of M-SDR payments globally.

An M-SDR would facilitate and be facilitated by invoicing internationally traded goods and financial instruments in SDRs. More, if not most, internationally traded commodities could and should be priced in SDRs. Cross border borrowing can and should be denominated in SDR starting with bond issues and lending by international development institutions (as is now the case with the IMF, and to a very limited extent the World Bank).⁶

To go all the way with SDRs, the IMF's Articles of Agreement would need to be amended to replace the allocation of SDRs with issuing them according to currency board rules as discussed earlier. Furthermore, the valuation basket that now consists of key currencies would need to be replaced with a commodity basket as outlined in my [Real SDR Currency Board proposal](#).

The shift from dollar to SDR international reserves, payments, and invoicing would give the world a more stable currency for all of these purposes. This would further promote trade because of more efficient cross boarder payments thus further lifting incomes around the world. Being an internationally issued and controlled currency, the potential for its political abuse by the U.S. would be greatly reduced. But eliminating the seigniorage that the U.S. now enjoys supplying its

⁶ <https://www.brettonwoods.org/article/proposal-for-an-imf-staff-executive-board-paper-on-promoting-market-sdrs>

currency to the rest of the world, i.e., the foreign financing of some of its debt, would remain without further measures.

As central banks and foreign firms shifted from dollars to SDRs they might simply transfer the US treasury bills (and other US investments) that they now hold to the issuers of the M-SDRs. In that case the U.S. would continue to enjoy its exorbitant privilege of foreign financing in exchange for holding its currency. In this case M-SDRs rather than USD would also be backed by US debt. Thus, rules are need for what currency or assets must be paid to buy M-SDRs and/or what assets M-SDRs are backed by. This could take the form of buying M-SDRs with USD but the issuer exchanging the dollars for a more balanced portfolio of assets. While the SDR value continues to be defined by a basket of currencies, the assets backing issued SDR might reflect the same proportions of the same currencies.

The reduction in this way of the role of the dollar as a reserve currency would be a win-win. It would provide for more stable and more efficient international trade and payments. It would help demilitarize money and it would modestly increase the cost of US debt finance, hopefully encouraging more careful spending.