CURRENCY POWER & INTERNATIONAL SECURITY

by Benjamin J. Cohen

For anyone concerned about U.S. national security, international finance today poses an intriguing dilemma. On the one hand, in geopolitical terms, the United States seems to have entered a period of relative decline. Some commentators speak of a broad power transition from unipolar *hyperpuissance* to a new, more threatening multipolar world. Others focus more narrowly on the rise of China and the risk of a "Thucydides Trap."[72] Yet in global finance, the U.S. dollar remains undeniably dominant, still by far the most popular national monetary unit in use for international purposes.[73] The greenback is as mighty as ever. Can this disparity continue, or should we expect that geopolitical decay will be followed by—perhaps even exacerbated by—an erosion of the dollar's standing?

Much rides on the answer. An international currency is a source of power for the economy that issues it.[74] For some three-quarters of a century, the greenback's central role in monetary affairs has enhanced the political capabilities of the United States. America's security has been amplified by currency power. At a time, therefore, when the nation is feeling increasingly vulnerable to adversaries abroad, the outlook for the dollar's future takes on added importance.

Three questions are addressed in this essay. First, how does a currency's international standing affect the political capabilities of the issuing country? Second, how has currency power been used by the United States? And third, what are the prospects for the greenback looking forward? Much analysis suggests that the outlook for the currency is not bright.[75] Some experts worry that we are approaching a tipping point that could lead to an abrupt and panicky dumping of the dollar. I disagree. No sudden rush to the exits would appear to be likely. But over time it does seem plausible to anticipate a gradual, maybe even accelerating loss of monetary primacy. The threat to the greenback—and hence to U.S. security—is not the sudden appearance of a wolf at the door. The risk, rather, is a persistent spread of termites in the woodwork.

CURRENCY INTERNATIONALIZATION

From the days of the earliest coins in Asia Minor, some two-and-a-half millennia ago, competition among currencies has repeatedly thrown up a few market favorites—currencies that, for a period of time, predominate in use for trade and finance across borders. Though they are issued by national governments, we call them "international currencies" or "international money." The process by which they come to be used across frontiers is termed "internationalization."

The number of international currencies at any given time tends to be small. Throughout history, monetary relations have often been dominated by a single favorite that sets a standard for many other currencies. Examples in the Western world include the silver drachma of ancient Athens, the gold solidus of the Byzantine Empire, the Florentine florin and Venetian ducat of Renaissance Italy, the Dutch guilder in the seventeenth century, and the Spanish-Mexican silver peso in the eighteenth century. In every era a few other moneys also gained international status, but on a more modest scale.

More recently, the principal international currencies have been Britain's pound sterling, which reigned supreme before World War I, and the U.S. dollar, which took top place after World War II. Other moneys of note since World War II have included the old West German Deutsche mark (since absorbed into the euro), the Japanese yen, and the euro. Though much diminished, sterling is still used by some, as are the Swiss franc and the dollars of Canada and Australia. And of course there is China's renminbi, the "people's currency"—also known as the redback—which many see as the next great international currency.[76] In total, the sample is small but large in impact.

The economic rationale for currency internationalization is clear and has long been understood by economists. Without a world government, the global economy lacks a global currency. Hence, markets throughout history have had to rely on selected local moneys to play vital cross-border roles. Variously, international currencies may be used for trade invoicing and settlement, as an investment medium in financial markets, as an anchor for exchange rates, or as a reserve asset for central banks. The consequences of internationalization for efficiency and ease of transaction are profound. Without international money, exchanges between sovereign states would be reduced to a crude form of barter. International currencies supply the lubricant needed to keep the wheels of the global economy turning.

But there are also profound political implications. International currencies add to the capabilities of the countries that issue them.[77] They thus play a fundamental role in shaping the distribution of power among states. Not insignificant is the fact that in every instance throughout history, an international money's issuer, at least at the start, was also a major power.[78] Each issuer, in its own day, was a highly ranked, if not dominant, player in the great game of world politics. It was undoubtedly that pattern that Robert Mundell, a Nobel Laureate in economics, had in mind when he memorably declared that "Great powers have great currencies."

Currency internationalization, at least for a time, tilts the balance even more in favor of the powerful. If that were not so, why would there be such widespread resentment over the advantages that the United States enjoys because of the extensive use of its currency? Why else would China seem so determined to internationalize its redback? As a practical matter, currency internationalization is unavoidably associated with state rivalry in broad geopolitical terms. There can be no doubt of the practical stakes involved.

Internationalization adds to capabilities in two ways: direct or indirect.[79] On the one hand, the money *itself* may provide an effective instrument of state power, available for direct use as a means to achieve selected foreign policy goals. In effect, the currency can be "weaponized." Political objectives can be promoted by putting the money to work variously as either carrot or stick: sometimes making it available as a form of reward or encouragement, at other times, withholding access to it as a form of punishment or disapproval. On the other hand, the role of the currency may be more indirect, reinforcing power by enhancing the utility of *other* policy weapons.

Widespread foreign acceptance of a currency enables the issuer to finance expenditures abroad with its own money, thus removing a payment's constraint on government spending around the world. The nation can run "deficits without tears"—what Charles De Gaulle many years ago referred to enviously as America's "exorbitant privilege."

De Gaulle had a point. For as long as it has reigned supreme in monetary affairs, the greenback has been counted as an important part of the nation's foreign-policy arsenal. Washington decision makers have not hesitated to exploit U.S. currency power, both direct and indirect, when national security seemed at stake.

SIDE PAYMENTS

Instances of America's use of direct currency power are numerous. By long tradition, stretching back to the days of "dollar diplomacy" around the Caribbean during the late nineteenth century, political objectives have frequently been promoted by using the greenback as a weapon. Side payments and sanctions have long been an integral part of U.S. foreign statecraft.

An apt illustration of Washington's use of the dollar for side payments, little remembered today, came in the summer of 1989 when Poland became the first Eastern European nation in the post-World War II era to hold free elections. The winner was the reform-minded Solidarity movement. The emergence of a new Polish democracy was seen as the beginning of the end of the Soviet Union's grip on Central and Eastern Europe—a boon for U.S. security. It was clear that Warsaw's most immediate need was for dollars to help stabilize its currency, the zloty. So within months, a $200 million credit line was provided to the Poles, of which some $86 million was drawn in late December 1989 and repaid two months later. The amount of money involved was not great. But the signal it sent in support of the political changes then sweeping through the Eastern Bloc was enormous and could certainly be termed successful. A limited currency gesture paid huge dividends by helping to lay the foundation for the end of the Soviet empire—and, ultimately, for the end of the Soviet Union itself.

Another more dramatic example came a few years later in late 1994 when Mexico, America's next-door neighbor and third largest trading partner, was suddenly struck by a major liquidity crisis. The stakes were high. Here was a country of vital interest to Washington, which just a year earlier had joined together with the United States and Canada in the North American Free Trade Agreement (NAFTA). The economic health and political viability of an important ally was at risk. Mexico was in desperate need of greenbacks to service the government's massive foreign debt. The Mexican economy was imploding, banks were collapsing, and inflation was on the rise. Default, under active discussion, would hurt U.S. investors. Recession might trigger a flood of immigrants across America's southern border. Protectionist forces in Mexico might be stirred to disrupt implementation of NAFTA. So once again, after a bit of political wrangling between President

Bill Clinton and Congress, Washington rode to the rescue in early 1995 with a series of loans totaling some $30 billion. The price was higher than in the Polish episode but equally successful. A vital friend was restored to health, and when the loans were subsequently paid off, Mexico's interest payments yielded a handsome profit for the U.S. Treasury of some $500 million.

A third case emerged in the midst of the global financial crisis of 2008, when the world economy appeared to be teetering on the edge of a precipice. Once again the stakes were high. Capital markets had frozen, threatening to bring international trade and investment to a grinding halt. The United States, along with many allies, seemed about to be sucked into the vortex of another Great Depression. But then, in an unprecedented move, the Federal Reserve stepped in to provide the liquidity needed to avoid widespread collapse, acting in effect as a global lender of last resort. Very quickly, new dollar lines of credit ("swaps") were arranged with the central banks of some fourteen friendly governments. In return for reciprocal currency pledges, the Fed supplied greenbacks that could then be lent onward by each monetary authority to dollar-hungry constituents. At their peak, in December 2008, credits outstanding under these arrangements totaled some $580 billion. In addition, more quietly, some $500 billion or more was provided under a variety of other Fed programs in direct support of private banks abroad. Here too currency statecraft could be termed a success. Order was soon restored to the financial sector, and once the crisis subsided most of the new swap lines and other programs were allowed to expire. America's friends were spared much pain, and political instability was averted.

SANCTIONS

The mirror image of side payments are sanctions: deliberate measures to withdraw or withhold access to dollars for political reasons. An early—and quite dramatic—example of U.S. financial sanctions came in October 1956 when a crisis erupted over the Suez Canal, recently nationalized by Egypt. Ironically, the intended target was not a Cold War foe but one of Washington's best friends, the United Kingdom. Britain and France had concocted a plan to send a joint military force to occupy the canal zone. The Eisenhower administration, however, was adamantly opposed. U.S. policymakers knew that the British were particularly vulnerable at the time to financial pressure. Sterling, long troubled, was once again under speculative pressure, and the Bank of England's foreign-exchange reserves were running dangerously low. The Americans also knew that the British cabinet was counting on U.S. financial support to ensure the Anglo-French plan's success. So Washington turned up the screws, pointedly refusing to provide the needed assistance. America's direct currency power was nakedly projected and proved decisive. Within days, London capitulated and agreed to a cease fire. Before the end of the year, all British and French troops were gone from the canal zone.

An even more striking demonstration came in 1988, when a crisis arose in U.S. relations with Panama. Once again, dollars were denied to a foreign government as a form of penalty—albeit this time with a somewhat different outcome. The target was Panama's strongman, Manuel Noriega, who was giving signs at the time of shifting his nation's Cold War allegiance towards the Soviet Union. Increasingly worried about possible threats to the neutrality of the Panama Canal, the administration of President Ronald Reagan turned to financial sanctions, starting in March 1988. Panamanian assets in U.S. banks were frozen and all payments or other dollar transfers to Panama were prohibited, including even fees owed for use of the canal. The cut-off of access to the greenback was comprehensive.

In a sense, Panama was an easy target. Ever since the country came into existence in 1903, its economy had relied on the dollar as legal tender for most domestic monetary purposes. In no time at all, therefore, the sanctions began to bite. Lacking access to greenbacks, most local banks were forced to shut their doors, and the economy was squeezed by a severe liquidity shortage. The effect was devastating. The country was essentially demonetized. Over the course of the year output fell by nearly one-fifth and unemployment soared. Yet for all the damage they caused, the sanctions in the end proved insufficient to dislodge Noriega on their own. Ultimately, in late 1989, the newly elected President George H.W. Bush felt impelled to invade militarily in order to ensure future access to the canal. Financial sanctions, in this case, helped greatly but turned out to have a practical limit.

Finally, there is the sad case of Iran, an implacable foe of the United States ever since the Islamic revolution of 1979. Over the years, U.S. financial sanctions have been expanded repeatedly in hopes of restraining Iran's nuclear ambitions. Starting as early as 2002, a program of remarkable severity—known in Washington as the "constriction campaign"—was introduced seeking to curtail and, if possible, wholly cut off Iran's access to greenbacks. The campaign included both asset freezes and a global embargo on dollar transactions with Iran: in all, a comprehensive currency blockade. The impact was severe and ultimately proved instrumental in bringing Tehran to the bargaining table. By 2013, no less an authority than Iran's President Hassan Rouhani publicly acknowledged that the effects of the sanctions were severe enough to justify negotiations to address the nuclear question. In 2015, the famous Joint Comprehensive Plan of Action was struck, significantly limiting Iranian nuclear activities in return for an easing of the sanctions regime. Though the deal was subsequently abandoned by Donald Trump, the value of the constriction campaign during the prolonged negotiation was clearly demonstrated. Washington's currency blockade was not the only reason why the deal was agreed; other pressures, up to and including military threats, also played a role. But there is little doubt that the U.S. sanctions were pivotal. The unavailability of greenbacks was making the price of intransigence by Iran increasingly unbearable.

INDIRECT CURRENCY POWER

And then there is America's "exorbitant privilege," which Charles De Gaulle so envied. In reality, it is difficult to exaggerate the extent to which the United States has benefitted over the years from its ability to run persistent "deficits without tears." That is the essence of indirect currency power: the ability to spend overseas without constraint. Other countries have to earn or borrow internationally acceptable currencies if they wish to undertake foreign expenditures. All the United States has to do, by contrast, is print up more greenbacks, which are the most widely accepted currency of all. For decades, Washington has been able to fight wars, support investment abroad, and extend aid to friends and allies seemingly without concern for any external payments deficits that might result. The U.S. military is able to maintain as many as 900 bases or installations in some 130 countries, and the Pentagon can afford to spend nearly as much as the next ten major military powers combined to project American influence around the world.

None of this would be possible without the greenback's enduring popularity as a store of value. For institutional investors and central banks alike looking for a good place to park their wealth, nothing is more attractive than the vast global pool of financial assets denominated in dollars. That includes, in particular, U.S. Treasury bonds. In an insecure world, Treasuries are regarded as the ultimate "safe haven" for private investments or official reserves. So long as foreign appetite for the greenback stays robust, Washington will remain unshackled, free to spend abroad as much as seems needed to protect American security interests.

There are limits, of course—at least in principle. One is what can be called the *competition* factor: the availability (or not) of sufficiently attractive alternatives to the dollar. The other is the *vulnerability* factor: the magnitude of already existing foreign holdings of the greenback. The competition factor is important because it determines America's ability to dominate the supply of international money. The greater the number of currencies out there that might offer a rival safe haven, the more policy makers will have to worry about a possible abandonment of the dollar, which in turn would tighten constraints on U.S. power projection. The vulnerability factor is important because it affects the demand side of the equation. How many greenbacks are too many? Every additional dollar held by foreigners is one more dollar of debt for Americans. Will the United States always be able and willing to stand behind its swelling liabilities? At issue here is the elusive matter of market psychology—the ever-present possibility that the greenback might suffer from an abrupt crisis of confidence. The weaker the world's faith in the dollar's reliability, the more policy makers will have to worry about the risk of sudden capital flight.

Until now, however, neither factor has proved to be a serious threat. The demise of the greenback as an international currency has long been predicted, going back decades. Some "dollar pessimists" anticipate the rise of powerful alternatives to America's currency (the competition factor). Every international money in history has ultimately met its match and gone into decline. Why not the dollar, too? Others point to America's persistently growing debt, which jeopardizes U.S. financial credibility (the vulnerability factor). Once the world's largest creditor nation, the United States now is history's greatest debtor. For the nation as a whole, foreign liabilities have come to exceed external claims by more than eleven trillion dollars, equal to half of America's gross domestic product. In the opinion of many, this massive "overhang" of debt is bound sooner or later to shake the market's faith in the greenback. A day of reckoning, it is argued, is surely coming.

Yet in practice the dollar continues to prevail, and for good reason.[80] On the supply side, challengers have turned out to be weaker than expected. There is still no match for the greenback—no attractive new safe haven ready to take center stage at a moment's notice. The euro is beset by internal governance problems. The Japanese yen is hampered by a stagnant economy and declining population. The British pound and Swiss franc are too small to match the scale of the dollar-denominated pool of investment-grade claims. And China's renminbi is handicapped by underdeveloped financial markets and an autocratic government. Conversely, on the demand side most investors and central banks still seem inclined to place their trust in the venerable greenback. Given the extraordinarily low level of U.S. interest rates in recent years, which have reduced the cost of debt service, America's overhang of liabilities has not yet proved to be the burden that many have feared. On neither side, therefore, have limits to Washington's indirect currency power yet been reached. No wonder, then, that the dollar remains undeniably dominant in global finance despite signs of U.S. geopolitical decay.

OUTLOOK

But can that dominance continue? Until recently, I was convinced that it would long persist. I thought that the pessimists were wrong. The greenback would remain unchallenged for years to come. Both the competition factor and the vulnerability factor could be expected to continue working in America's favor. But then along came Donald Trump, unexpectedly elected president in 2016. Trump's actions during his time in office shifted the odds significantly. As early as the spring of 2016, when he was still a candidate, he suggested that Washington should negotiate with its creditors to buy back much of America's debt at a discount—in effect, a partial default on the nation's trillions of dollars of liabilities. That was the same sort of deal he had previously demanded in private life whenever his properties ran into trouble. What better way could there be to undermine the world's confidence in U.S. fiscal credibility? And then came four years of rashly breaking one U.S. commitment after another: the Iran nuclear deal, the World Health Organization, the Paris climate accord, the UN Human Rights Council, the Open Skies Treaty, and many more—all at the same time that America's debt overhang was being swollen first by a two trillion-dollar tax cut and then by several trillion dollars more of borrowing to combat the Covid-19 pandemic. Investors and central banks could not be blamed for fearing that the greenback might no longer be as safe as was long assumed. Could America still be counted upon to keep its word? By the time Trump's term ended, the chances of a tidal shift of sentiment against the dollar were clearly on the rise.

Fortunately for the United States, there is no immediate risk of a fire sale, no matter how much market psychology has been affected. A sale of one currency means the

purchase of another. Efforts to dump the greenback on a large scale would still be hampered by the absence of an appealing alternative. That is why I do not expect to see a wolf suddenly appearing at the door. But spurred by Trump's unpredictable behavior, the search for substitutes for the greenback has clearly accelerated. Some investors and central banks look to the euro, others to the renminbi, and yet others to gold or even Bitcoin and other cryptocurrencies. Owing to natural inertias caused in good part by high switching costs, the process of change is apt to be cautious and incremental at most. That is why I expect the real threat to the dollar to be more like termites gradually chewing through the woodwork.

Ultimately, the greenback's fate rests in the hands of Trump's successor, Joe Biden. Can his administration allay the fears of America's creditors? Can investors and central banks be persuaded that the Trump brand of xenophobic nationalism was no more than an aberration, never to be repeated? Or will Biden himself prove to be the interlude, a brief interruption in a longer-running drama of U.S. geopolitical decline? National security hangs in the balance. Two millennia ago, the Roman statesman Cicero wrote that "The sinews of war are infinite money." Washington's exorbitant privilege has been the equivalent of infinite money. The risk is that America's access to infinite money may now be on the wane.

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[80]Cohen, *Currency Power*, 160-184.

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