

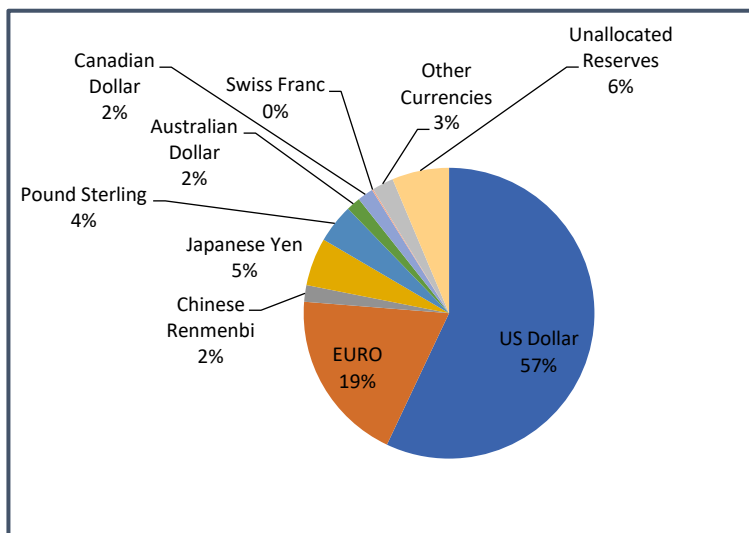


The Dash for Dollars

As COVID-19 struck and the global economic order came under immense strain, reaction of the financial markets was more than predictable: there was a rush for the dollar and dollar denominated assets. In mainstream economics, this kind of behavior is commonly referred to as ‘flight to safety’. For countries like Pakistan, such a situation can have telling repercussions. This is evident by the amount of dollar outflows since December 2019. Pakistan, primarily owing to its high interest rate set by SBP, had managed to attract substantial amounts of dollar inflows (commonly known as ‘hot money’). But as soon as the effects of COVID-19 became apparent, the dollars inflows reversed course immediately. By now, estimates suggest that \$3.27 billion has flowed out of Pakistan¹.

This invites several queries. First, the differential between the central bank administered rates in Pakistan and the developed world (primarily rates set by European Central Bank or ECB, and the US Federal Reserve) is still quite substantial, allowing for the possibility of ‘interest arbitrage’. Second, the US’s public debt is above \$22 trillion, and its economic growth has been anemic since at least the Great Recession of 2008. Moreover, its present government does not aspire much in terms of global confidence and ability to mend its relations with the world. Third, we do not observe a similar flight to safety towards Euro area or British financial assets.

This has been the case since WWII, as dollar became the dominant currency around the globe. Its hold has elicited complaints from several quarters, with the former French



President Charles De Gaulle labeling its influence as an ‘exorbitant privilege’. But despite all challenges, it continues to hold sway. Much of the global trade in important commodities such as oil is still denominated in dollars. By end 2019, the dollar’s share as a percent of total reserves held by central banks around the globe was 57 percent², as depicted by the graph. In the coming days, this is set to increase as demand for the dollar has gone through the roof. By the 2nd

and 3rd week of March, when COVID-19’s real impact began to be felt across the globe, all the demand in the \$6 trillion daily foreign exchange market was for dollars³.

Why are the dollars so sought after?

The Lure of the Greenback

By the end of WWII, the US was firmly in place as the world's leading financial and military power. The meeting at Bretton Woods anointed the dollar as the world's premier currency. Simply put, other countries did not have anything to offer in terms of challenge to the US. Britain, whose sterling was the leading currency of the global financial order, had to take recourse to loans from the US in order to finance its war effort. And a broken Europe, with a dilapidated infrastructure, could hardly make a stand in front of the US. The setting in motion of the 'Marshall Plan' cleared the way for provision of dollar credit to Europe.

It was complemented by the smart move to allow for dollar 'convertibility', meaning that dollar could be exchanged for domestic currency in any country at a particular exchange rate. In the aftermath of WWII, the US government (along with the Canadian government) were the first ones to allow convertibility of their currencies, a decision that allowed for its widespread use around the globe and development of primary and secondary markets in dollar denominated assets. In contrast, leading European nations allowed convertibility of their currencies in late 60's. The world needed the help of the largest economy in the world, to trade with it and help gain access to much needed capital to finance their domestic plans. The US was more than happy to oblige, helping perpetuate its own currency by financing trade in it. As the size and volume of global trade and financial markets grew, as well as the size of the US economy, it led to development of a financial and trade system run mainly on dollars.

The strength of the institutions in the US and consistency in policies have helped US gain confidence of the world in terms of safety of their investments. Whether the ruling dispensation is republican or democrat, institutions like the Federal Reserve and US Treasury have continued performing their tasks without much hindrance. The independence of these kinds of institutions has ensured that any upheaval in financial markets extracts a swift, coordinated response that anchors markets out of probable elongated declines. The Great Recession of 2008 was an ample demonstration of this fact.

Having the most liquid and deep financial markets helps attract investments from around the globe, especially in times of financial stress like COVID-19. Led by US treasury bills, which are considered the most liquid asset in financial markets, and a liberal capital account policy, America's financial markets (and thus its currency) remain the most attractive destination. As Vambrey and Ganziro (2016) commented, the strength of US financial markets into these pre-requisites is second to none⁴.

The challengers to the dollar have been few. From Soviet Ruble to Chinese Renminbi, predictions about challengers ending dollar's reign have been made a plenty. So far, though, all those predictions have failed to materialize for various reasons. Japan's economic prowess in the 80s elicited hopes that its currency, Yen, would rival dollar in terms of global influence. But that challenge fell flat after Japan's economy got mired in a 'liquidity trap' in the 1990's, whose effects are still being felt by the Japanese economy. Similarly, Euro's predicament is tarred by the dis-unity amongst its many member countries over fiscal and monetary issues, and Britain's exit (BREXIT) has dealt its standing a substantial blow. The most in-demand bonds of the Euro area, for example, are of the German bonds, but the German government has been traditionally averse to the idea of issuing debt to finance Euro area growth. Meanwhile, during all this time, the US economy (and dollar's demand) kept growing despite hiccups like the Great Recession of 2008. China still exercises restrictions upon carrying renminbi outside its borders, and issues plaguing its economy (troubled private credit, centrally controlled policies, etc.

Another feature of the dollar that makes it a globally coveted currency is the consistency of its purchasing power and it being a good store of value over time. Since the Volcker era of the 1980s, inflation in the US has remained low, ensuring that the purchasing power of the dollar is not eroded. In the foreign exchange market, the movement in its valuation against other leading currencies has been minimal. In fact, it has gained substantially against currencies of developing nations. This persistency in maintaining a certain level of purchasing power has made it a leading 'store of value', leading the investors/savers around the world to covet it. All these features also impart upon the dollar the characteristic called 'sound money', making it much sought after.

Advantage USA

The dominance of the dollar gives US unprecedented leverage in terms of enforcing its will and discretion upon the globe. Since the wheels of global trade are oiled by the dollar, and financial institutions invest large amount of their holdings in dollar denominated assets, sanctions by the USA against a country (like Iran and North Korea) prove to be largely successful. Put another way, the participants of global economic order cannot take the risk of ignoring Washington's commands, lest they be excluded from this order. We can also gauge the influence of the dollar on global financial order through liquidity statistics. According to Bank of International Settlements (BIS), dollar denominated lending outside of the US increased to 14 percent of global output in 2018 from 10 percent in 2007⁵. This is set to increase further as investors dump other currencies for dollars post COVID-19. Euro was (and still is) considered a competitor to the dollar. Yet a substantial portion of EU trade is still conducted in dollars. In September 2018, the outgoing EU President Jean-Claude Juncker lamented that 80 percent of EU's energy imports were being paid in dollars!

There is also financial advantage in supplying the world with dollars, known as 'seigniorage', which basically is the difference between the cost of printing a note and its face value (or nominal buying power). The cost of printing \$1 and \$2 bills is 7.7 cents, while its 19.6 cents for a \$100 bill⁶. In 2018, America exported \$65.3 billion dollars, taking the total holdings of US dollars outside of US by end of that year to \$774 billion⁷. Different estimates of revenues through seigniorage are estimated by various sources, with the revenues differing by domestic and foreign holdings. According to an earlier estimate by Feige (1997)⁸, the seigniorage from dollars held outside of US was about \$6 to \$7 billion in that year. A US Senate hearing in 1999 was informed that the total revenue from seigniorage stood at \$25 billion⁹. Given that the total stock of dollars printed and in circulation has increased since then, it can be safely assumed that the revenue is far greater than before, although no concise estimate is available.

The revenue from seigniorage is not the only advantage conferred by the dollar to the US. Arguably, an even bigger advantage accrues in the form of the world financing the US consumption at remarkably cheap rates. The US provides its currency for exchange of goods and services from the world, with a large portion flowing back to the US through investment by foreigners' in its debt instruments and assets (mainly in US treasuries). At the end of 2019, the total stock of US treasury debt was \$17.72 trillion¹⁰. Out of this, 38 percent (\$6.77 trillion) was dollar money invested by foreign governments. Nobel Prize winning economist Paul Krugman opined that the foreign holding of dollars is equivalent to \$500 billion loan per year to US at zero interest rate¹¹. Going by this consideration, currency is

the most profitable exports of America as it helps sustain ultra-cheap provision of domestic credit, thus helping drive growth and consumption.

All in all, dollar's reign as the leading global currency is set to continue well into the future.

Notes:

1. During the current fiscal year, the inflow of dollar investment into treasury bills, PIBs and equity market totalled \$4.14 billion till now. See 'Capital market outflows jump to \$3.27 billion'
2. Source- International Monetary Fund (IMF)
3. 'Shockwave', London review of books
4. p.24, 'The exorbitant burden'
5. 'Global liquidity: changing instrument and currency patterns', BIS Quarterly Review, September 2018
6. https://www.federalreserve.gov/faqs/currency_12771.htm
7. US Federal Reserve
- 8 'Revised estimates of the underground economy: Implications of US currency held abroad'
- 9 'Hearing on official dollarization in emerging market countries', US Senate
10. Data taken from <https://www.thebalance.com/who-owns-the-u-s-national-debt-3306124>. More than \$2 trillion of foreign holdings in US treasury debt is by Japan and China
11. <https://krugman.blogs.nytimes.com/2013/10/22/godwin-and-the-greenback/>

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