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The Future of the Dollar

U.S. Financial Power Depends on Washington, Not Beijing

By Henry M. Paulson Jr.
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Chinese banknotes at a market in Beijing, February 2014
Kim Kyung-Hoon / Reuters

In late March, global financial markets were collapsing amid the chaos of the novel coronavirus pandemic. International investors immediately sought refuge in the U.S. dollar, just as they had done during the 2008 financial crisis, and the U.S. Federal Reserve had to make huge sums of dollars available to its global counterparts. Seventy-five years after the end of World War II, the primacy of the dollar has not waned.

The enduring dominance of the dollar is remarkable—especially given the rise of emerging markets and the relative decline of the U.S. economy, from nearly 40 percent of world GDP in 1960 to just 25 percent today. But the dollar's status will be tested by Washington's ability to weather the COVID-19 storm and emerge with economic policies that allow the country, over time, to manage its national debt and curb its structural fiscal deficit.

The stature of the dollar matters. The dollar's role as the primary global reserve currency makes it possible for the United States to pay lower rates on dollar assets than it otherwise would. Equally significant, it enables the country to run larger trade deficits, reduces exchange-rate risk, and makes American financial markets more liquid. Finally, it favors U.S. banks because of their enhanced access to dollar funding.

That the dollar has maintained this stature for so long is a historic anomaly, particularly in the context of a rising China. The Chinese renminbi (RMB) has by far the greatest potential to assume a role rivaling that of the dollar. China's economic size, prospects for future growth, integration into the global economy, and accelerated efforts to internationalize the RMB all favor an expanded role for the Chinese currency. But by themselves, these conditions are insufficient. And China's much-touted successes in the realm of fintech—including its rapid deployment of mobile payment systems and the recent pilot project by the People's Bank of China to test a digital RMB—will not change that. A central bank–backed digital currency does not alter the fundamental nature of the RMB.

Beijing still has major hurdles to overcome before the RMB can truly emerge as a primary global reserve currency. Among other transformative measures, it needs to make more progress in moving to a market-driven economy, improve corporate governance, and develop efficient, well-regulated financial markets that earn the respect of international investors so that Beijing can eliminate capital controls and turn the RMB into a market-determined currency.

Washington should be clear-eyed about what is actually at stake in the competition with China. The United States should maintain its lead in financial and tech innovation, but there is no need to exaggerate the impact of a Chinese digital reserve currency on the U.S. dollar. Above all, the United States must preserve the conditions that created the dollar's primacy in the first place: a vibrant economy rooted in sound macroeconomic and fiscal policies; a transparent, open political system; and economic, political, and security leadership abroad. In short, sustaining the dollar's status will not be determined by what happens in China. Rather, it will depend almost entirely on the United States' ability to adapt its post-COVID-19 economy so that it remains a model of success.

CHINESE COMPETITION IN FINTECH

Many who return from China breathlessly remark on how cashless the country has become. From buying snacks at the corner store to giving money to panhandlers, everything is now conducted through smartphones and QR codes (scannable square-shaped barcodes). ATM lines are a fixture of the past. Chinese companies are increasingly competitive in fintech, and Chinese consumers are its largest users.

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These facts regularly lead pundits to opine that Chinese fintech dominance could soon jeopardize the dollar's global status. That is not a serious concern—nor is it clear that the United States is actually falling behind in matters of fintech. China was not a pioneer of fintech but rather a rapid adopter and scaler of the technology. The Chinese tech giants Alibaba and Tencent have led the way in creating services that make digital transactions much more efficient, while tapping into a large market of unbanked customers, particularly in rural China. The uptake of their services has been phenomenal. In 2018, for example, the volume of mobile payment transactions in China **totaled $41.5 trillion.**

[https://www.caixinglobal.com/2019-03-22/chart-of-the-day-chinas-mobile-payment-transaction-volume-hits-4151-trillion-in-2018-101395789.html]

This success was possible largely because China's existing financial infrastructure was antiquated and its state banking system inefficient. Just as important, credit cards never took hold in China, so when smartphones became cheap and widespread, it made perfect sense to leapfrog from a cash-based economy directly to mobile banking.

What's more, for all of how "cashless" China has become, many Americans, too, would be hard-pressed to recall the last time they used cash for anything other than a minor transaction. They can move money from one bank account to another instantaneously and seamlessly. Mobile payment services such as Venmo and Apple Pay work just as well as Alipay and WeChat. But by and large Americans still prefer credit cards, because using them is as convenient as using a phone and the existing financial infrastructure is safe, robust, and trustworthy.

Chinese tech companies have ramped up innovation to meet consumer demand and compensate for the country's inadequate financial infrastructure. Moreover, they have begun to deploy these technologies in developing markets, whose nascent economies encouraged the immediate acceptance of smartphones and thus offered an enormous opportunity for Chinese companies to gain market share.

A customer scans a WeChat QR code to pay at a market in Beijing, April 2020
Tingshu Wang / Reuters

FORM VERSUS FUNCTION

Although the Chinese central bank could launch a digital currency as early as this year, the headlines exaggerate how transformational it will actually be. Those who worry that this development might herald the end of U.S. dollar primacy misunderstand that while the form of money may be changing, its nature has not.

A digital RMB would still be a Chinese RMB. No one is reinventing money. The token used for transactions may be different, but China's prospects for reserve currency status depend on the same set of factors that apply to the issuer of that currency. And although the Chinese government has promoted use of the RMB to settle trade transactions as part of an effort to internationalize its currency, oil and other major commodities are still priced in U.S. dollars.

The privilege conferred on the U.S. dollar as the global reserve currency was hardly preordained. The dollar's preeminence came about only through a combination of historical happenstance, geopolitical conditions after World War II, U.S. Federal Reserve policies, and the sheer size and dynamism of the U.S. economy. Today, the "natural monopoly" of the U.S. dollar may seem like a fixture of the international system, but during the first half of the twentieth century, the U.S. dollar and the British pound sterling were essentially head-to-head as reserve currencies.

Over time, the international monetary system will likely once again give relatively equal weight to two or more global reserve currencies. The RMB is a chief contender, as it is already a reserve currency along with the yen, euro, and pound. And short of a major catastrophe, the Chinese economy is on course to becoming the world's largest in the foreseeable future. It will also be the first major economy to recover from the COVID-19 crisis.

Still, that the RMB can join the U.S. dollar as a primary reserve currency is not a foregone conclusion. To achieve such a status, China will need to reform its economy and develop its capital markets in ways which are difficult and involve complex domestic political considerations. Recent Chinese ambitions that required similar transformations—such as establishing Shanghai as a full-fledged global financial hub by 2020—have so far been deferred: a financial hub simply is not viable when capital controls are in place and the currency is not market determined. The same holds true for the RMB's prospects as a major reserve currency.

Although a Beijing-backed digital currency in and of itself is unlikely to undermine the dollar's supremacy, it could certainly facilitate China's efforts to internationalize the RMB. In countries with unstable currencies, such as Venezuela, a digital RMB is an attractive alternative to the local currency. Chinese firms such as Tencent, which already have a sizable presence in developing countries in Africa and Latin America, could scale up their presence there, leading a future digital RMB to gain market share. This could help enhance the RMB's global status and become part of a broader strategy to project Chinese economic and political influence abroad.

ENCOURAGING U.S. INNOVATION

For the time being, the United States should worry less about the end of the dollar's supremacy as a global reserve currency and more about the ability of its private sector to deploy new financial technologies. Digital currency is not just a Chinese idea, nor is it solely the province of central banks—financial innovation in digital currencies and mobile payments is taking place in the U.S. private sector, too.

While the form of money may be changing, its nature has not.

At the same time, these new technologies contain inherent risks. Without the assurance of robust data privacy, wide adoption of these technologies will prove difficult. Moreover, these new technologies could facilitate money laundering and other illicit financial activities, all legitimate causes for concern.

Silicon Valley and Wall Street have long led the way in creating financial innovations, new digital platforms for transactions, and new forms of money. If the fruits of those innovations are realized, U.S. companies could create the world's best, safest, and most secure digital currency, with robust controls against illicit finance. The resulting gains in efficiency and reduction in transaction costs would yield tangible benefits to consumers.

Policymakers, then, need to strike a careful balance between mitigating the risks of these new technologies and supporting the ability of private U.S. companies to innovate. The danger is that overzealous U.S. regulators might raise the entry barrier for U.S. firms to serve those who prefer digital finance over conventional banking in the United States and unbanked consumers around the world—about two billion people, according to the World Bank, the bulk of whom reside in developing countries with weaker financial markets and volatile currencies.

U.S. DOLLAR PREEMINENCE BEGINS AT HOME

To be sure, the United States needs to take China seriously as a formidable economic competitor. But when it comes to the primacy of the dollar, the main risk stems not from Beijing but from Washington itself. The United States must maintain an economy that inspires global credibility and confidence. Failure to do so will, over time, put the U.S. dollar's position in peril.

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The dollar's status is a proxy for the fundamental soundness of the American political and economic system. To safeguard the dollar's position, the U.S. economy must remain a model of success and for emulation. That, in turn, requires a political system capable of implementing policies that will allow more Americans to flourish and achieve economic prosperity. It also requires a political system capable of maintaining the country's fiscal health. History knows of no country that remained on top without fiscal prudence over the long term. The U.S. political system must be responsive to today's economic challenges.

The United States' economic policy choices abroad also matter greatly because they affect U.S. credibility and, to a large extent, determine its ability to shape global outcomes. To sustain that leadership, the United States should champion an initiative to adjust and update the global rules and norms that govern trade, investment, and competition in technology to reflect twenty-first-century realities.

Washington should also be mindful that unilateral sanctions—made possible by the primacy of the dollar—are not free of cost. Weaponizing the dollar in this way can energize both U.S. allies and foes to develop alternative reserve currencies—and maybe even to join forces to do so. That is precisely why the European Union has been pushing to **further promote** [https://www.reuters.com/article/us-eu-euro/eu-pushes-for-broader-global-use-of-euro-to-challenge-dollar-idUSKBN1O41CU] the euro in international transactions.

By the same token, whether the RMB joins the dollar as a major reserve currency will be determined entirely by how China reshapes its own economy. But if Beijing successfully implements the needed reforms, it will create an economy that is more attractive for the export of U.S. goods and services and establish a more level playing field for U.S. companies operating in China—changes that will benefit the United States.

The value of a national currency to its holders is ultimately a reflection of the country's economic and political fundamentals. How the United States emerges in the years following the COVID-19 crisis will be an important test. First and foremost, the country must foster macroeconomic policies that put it on a sustainable path to manage the national debt and the trajectory of the structural fiscal deficit, and it must not squander the fundamentals that have sustained its economic might, all of which are rooted in a spirit of innovation and effective government. If Washington adheres to this course, there is every reason to have confidence in the dollar.

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