



Rule of law and balance of power sustain US dollar preeminence

Elena Seghezza^{a,*}, Pierluigi Morelli^b

^a Dept. of Economics, University of Genova, Via Vivaldi 5, 16126 Genova, Italy

^b Italian Banking Association, Piazza del Gesù 49, 00186 Roma, Italy

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Abstract

In the last few decades, and especially since the financial crisis of 2007–2008, uncertainty about the future of the US dollar has been mounting. A broad-based theoretical debate on the decline of the dollar and its consequences has begun. There is a large body of studies that sees the origin of an international money as a market-led process. In this view, because the United States will very soon lose its economic pre-eminence the US dollar will consequently share its international role with other currencies or even be replaced by the renminbi. In this paper we contest this argument, focusing on the conditions that make a fiat money acceptable in international transactions. Trust in a type of money like this needs an institutional framework that guarantees the property rights of currency holders. This framework implies a high level of rule of law domestically and a high level of state capability in the international balance of power. Since at present no other currency fulfils these two requirements at the same time, the dominance of the US dollar as an international money is going to last.

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1. Introduction

The dollar has played a dominant role in the international monetary system throughout the post-World-War II period (Goldberg, 2010). However, in the last few decades various factors

* Corresponding author.

E-mail address: seghezza@unige.it (E. Seghezza).

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have contributed to the rise of widespread uncertainty about the future of the dollar re-opening a broad theoretical debate on the decline of the dollar and its consequences.

Two main positions can be distinguished within this debate. Followers of the so-called “market view” according to which now as in the past the international currency is the currency most frequently used in trade and, therefore, that of the country that is biggest in terms of GDP and exports.¹ They argue that over the next few years, China will almost certainly surpass American power, both in terms of its share of exports in world trade and the size of its GDP. Consequently, the dollar is likely to be replaced by the Chinese currency in the role of the international currency (Angeloni et al., 2011; Dorucci & McKay, 2011; Eichengreen, 2011a, 2011b; Subramanian, 2011).

A more cautious position is taken by those who believe that the success of the dollar as an international currency is due to the political state capability and the possible exercise of coercion on the part of the United States. In this view, which we can call the “coercive view”, the decline of the dollar is due to the geopolitical decline of the United States. This decline, however, is slower than the economic one, and therefore the decline of the US dollar will be similarly slow (Calleo, 2009; Cohen, 2015a, 2015b).

The two positions just put forward obviously underlie two different hypotheses about the origin of the international currency. In the “market view”, the currency, both domestically and internationally, is the outcome of impersonal market mechanisms which lead to become money the good most accepted in trade. While the “market view” insists on the importance of the economic dimension of the issuing country, the “coercive view” attributes to geo-political power a decisive role for the existence of an international currency. Both approaches, however, neglect the problem of the evolution of the means of payment, in primis the transition from commodity to fiat money.

To put it briefly, consideration is not given to the fact that trust in a currency varies in relation to its different forms (Giannini, 2011). This problem basically does not exist in the case of commodity money, for which face value corresponds to intrinsic value, while it is important in relation to a fiat currency. In the case of the latter, given the existence of information asymmetries, agents are not certain whether a particular currency might not be counterfeited. Hence the need to make the money “recognizable” (Lester, Postlewaite, & Wright, 2012). As Jevons (1875; chap. V, p. 16) writes: “By this name [that is “recognisability”] we may denote the capability of a substance for being easily recognized and distinguished from all other substances. As a medium of exchange, money has to be continually handed about, and it will occasion great trouble if every person receiving currency has to scrutinize, weigh, and test it.”

While at the national level the problem of recognisability is solved by the state that guarantees the property rights of the holders of the money it issues, at the international level, the solution to this problem is more complex given the absence of a supranational authority.

In this paper we argue that for a fiat currency to be used internationally two steps must be fulfilled. On the one hand, it is necessary that the fiat currency that aspires to the rank of international key currency is recognizable. Hence the importance of the issuing country having an adequate rule of law. When this happens the currency can be a reserve currency.

On the other hand, a reserve currency is not yet a key currency. It can only assume that rank if the issuing country guarantees compliance with the rules and institutions that ensure the proper working of an international monetary system based on fiat money. This step only applies under particular conditions, illustrated in the paper.

¹ According to Kindleberger (1967) international money is made “not on merit, or moral worth, but on size”.

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