



Barry Eichengreen, *Exorbitant privilege: the rise and fall of the dollar*, Oxford University Press, 2011. 215pp. ISBN 9780199596713

On February 4, 1965, the French president General Charles de Gaulle, addressing a gathering of journalists, delivered a visceral attack on the special status of the dollar under the Bretton Woods system. “*The fact that many states accept dollars as equivalent to gold,*” he said, “*In order to make up for the deficits of [the] American balance of payments has enabled the United States to be indebted to foreign countries free of charge. Indeed, what they owe those countries, they pay ... in dollars that they themselves can issue as they wish. ... This unilateral facility attributed to America has helped spread the idea that the dollar is an impartial, international [means] of exchange, whereas it is a means of credit appropriated to one state.*” Valéry Giscard d’Estaing, then the finance minister of France, coined the phrase “exorbitant privilege” to describe the international hegemony of the dollar.

Nearly half a century has elapsed since then. The Bretton Woods system was dissolved in 1971, but the “exorbitant privilege” of the dollar has persisted. To this day, the greenback continues to be a staple of central banks, investors and drug dealers around the world [the dollar is not only world’s premier reserve and “safe haven” currency, but also the premier currency for illicit transactions]. The indignation of the rest of the world at this state of affairs has persisted as well. Echoing his predecessor from almost half a century ago, Nicolas Sarkozy, when he was the finance minister of France, noted that “any other country that lived beyond its means would have to devalue its currency, print more money to pay its bill, cut spending, and endure the inflation that follows.” But the US didn’t have to resort to this dire option since the rest of the world needed to keep buying dollars in order to transact trade. The current Chinese president, Hu Jintao, before

embarking on his first state visit to the US last year, took time to deplore the unique status of the dollar as “*a product of the past*”.

Why is it that the dollar is still unrivalled in its domination of international trade and finance, despite the collapse of the Bretton Woods system and the emergence of many new economic power hubs? Is it true that the international role of the dollar has enabled the US to draw extremely important economic benefits, as alleged by various world leaders from time to time? Is this role of the dollar an unqualified blessing for the US or is it, in some ways, a curse in disguise? Most importantly, how long into the future will this complete hegemony of the dollar last? The answer to this last question is “perhaps as few as 10 years,” if we trust Barry Eichengreen. His latest book, *Exorbitant Privilege: The Rise and Fall of the Dollar and the Future of the International Monetary System*, addresses all the questions raised above by tracing the history of the rise of the dollar to its present state of dominance and forecasts the future trends in international finance.

Barry Eichengreen is a professor of economics and political science at University of California, Berkeley. He is one of the world’s leading historians of international money and finance. His first book, co-authored with Alec Cairncross and published in 1983, was *Sterling in Decline*. The book under review, therefore, could have been his second obituary of a major international currency, but it turns out that it is not exactly an obituary.

Exorbitant Privilege is primarily an exercise in economic history and questions of theoretical importance have been relegated to the sidelines of the main narrative. It is essentially a biography of the dollar, the story of its ascent to the throne of the kingdom of international finance. The author spices up the dry historical details with interesting anecdotes and descriptions of the main characters involved. We are told, for example, that the proposal for a central bank in the US was so controversial that the founding fathers of the Fed had to meet in a clandestine manner in Jeckyll Island off the Georgia coast to deliberate upon the issue, “traveling by private railcar, disguised as duck hunters”.

The rise of the dollar as an international currency commenced with the founding of the Federal Reserve System in 1913. After the First World War, both Great Britain and its currency, the Sterling, were at the twilight of their international influence. The space vacated by Britain and the Sterling was quickly assumed by the United States and the dollar. By the time of the beginning of the Great Depression, the dollar was rivaling the Sterling as the world's premier reserve currency. At the conclusion of the Second World War, the dollar had conclusively toppled the Sterling and its singular hegemony was formalized in the form of the Bretton Woods Agreement. This chronology indicates that the international stature of a currency is very closely correlated with the international stature of the issuing state. In fact, as Barry Eichengreen notes, the causality runs from the latter to the former. "Sterling lost its position as an international currency because Britain lost its great-power status, not the other way around."

Under the Bretton Woods system, the centrality of the dollar to the international monetary system was undisputed. However, the collapse of the Bretton Woods system in 1971 did not diminish the dominance of the dollar, despite sharp declines in its value. The reason was simple: there was no alternative to the dollar. France was too financially unstable for the French franc to rival the dollar; the Bundesbank was wary of the inflationary effects of foreign capital inflows were the Deutschmark to be adopted as a reserve currency; Britain was on a perpetual economic decline. Japan had emerged as a new player on the international stage, but the Japanese government, similar to the Chinese government today, had adopted an export-oriented development model which hinged on an undervalued exchange rate for the Japanese yen. Therefore, the Japanese government actively discouraged the use of the Japanese yen as a reserve currency. Lacking any alternatives, foreigners continued to bank on the dollar as the reserve currency of choice.

It was not until 1999 that a serious alternative to the dollar emerged with the creation of the euro. Even though the euro is a currency without a state and the euro zone has its problems as evidenced by the ongoing euro zone debt crisis, it is in a better position to challenge the longstanding dominance of the dollar than any other currency. The euro is backed by a strong central bank with explicit commitment to the objective of price stability, its financial markets are sufficiently well-developed and the euro area has significant trading relations with countries around the world. The

Chinese Renminbi can position itself as another contender for international dominance over the next decade, if the Chinese government chooses to liberalize its capital controls and exchange rate regime. Eichengreen predicts that the world is moving towards a new international monetary arrangement, in which the dollar will share the status of reserve currency with the euro, the Renminbi and possibly the special drawing rights (SDRs) issued by IMF.

Exorbitant Privilege does well to achieve its main purpose which, as mentioned by the author in the introduction, is to reveal how much of what passes for conventional wisdom on the issue of the international status of the dollar is wrong. While being the issuer of a currency which is widely accepted for international payments is certainly a privilege, it is not as exorbitant as the French would have us believe. As Paul Krugman, the Nobel Laureate international economist, has often reminded us, the gains to the US from the dollar's special status do not amount to much in the context of the size of the US economy.¹ A recent study by the McKinsey Global Institute² has estimated the net financial benefit accruing to the US from the dollar's special status. "Seigniorage" revenue, the effective interest-free loan generated by issuing additional currency to nonresidents that hold US notes and coins, generates an estimated financial benefit of \$10 billion for the US every year. The large purchases of US Treasuries by foreign central banks and government agencies for reserve purposes depress the interest rate on those securities by an estimated 50 to 60 basis points, which yields a financial benefit of \$90 billion to the US government. However, the additional demand for the dollar generated by its reserve currency status keeps the exchange rate overvalued by an estimated 5 to 10 percent, which (assuming downward inflexibility of wages in the US) hurts the competitiveness of US exporters, imposing a cost of an estimated \$30 billion to \$60 billion. Therefore, in a "normal" year for the world economy, the net financial benefit to the US of the "exorbitant privilege" is between \$40 billion to \$70 billion, or 0.3 to 0.5 percent of the US GDP.

Some costs of the "exorbitant privilege" are less quantifiable. Americans are encouraged and enabled, by virtue of the cheap foreign finance that comes their way as foreign central banks

¹ See, for example, "*Speaking of International Money*" by Paul Krugman at <http://krugman.blogs.nytimes.com/2011/04/25/speaking-of-international-money-wonkish/>

² Available at http://www.mckinsey.com/Insights/MGI/Research/Financial_Markets/An_exorbitant_privilege

accumulate dollar reserves, to live beyond their means. “The cheap finance,” writes Eichengreen, “that other countries provided the US in order to obtain the dollars needed to back an expanding volume of international transactions underwrote the practices that culminated in the crisis.” Whereas it would be naïve to suggest that the crisis was caused entirely by this perverse effect of the “exorbitant privilege”, some culpability should certainly be assigned to it.

If these costs of the “exorbitant privilege” could somehow be quantified, its net financial benefit to the US would very likely be reduced to a fistful of dollars on the scale of the US GDP. This makes one wonder if this privilege is really worth protecting.

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