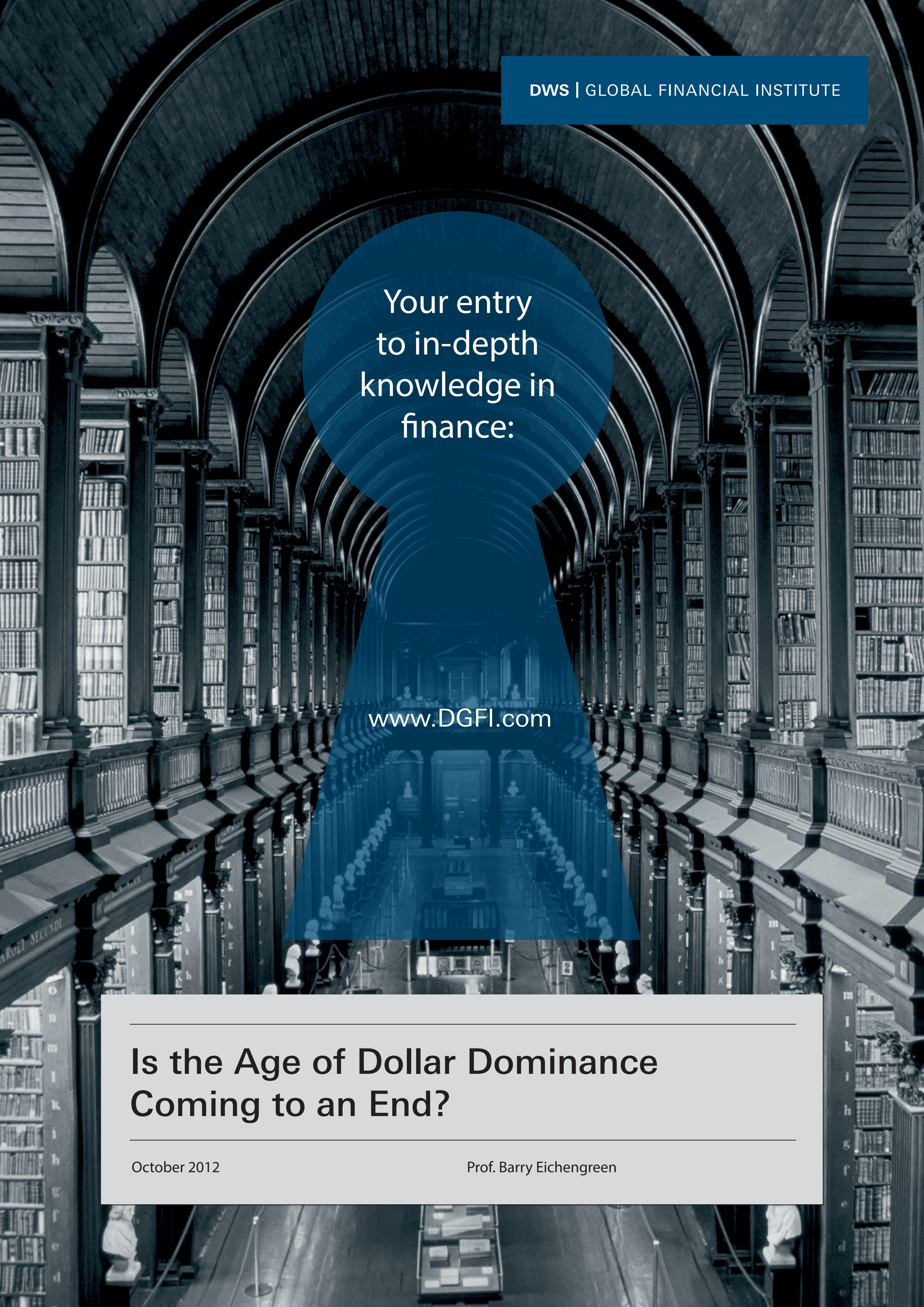
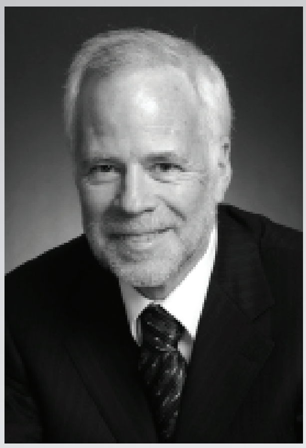


DWS | GLOBAL FINANCIAL INSTITUTE

Is the Age of Dollar Dominance Coming to an End?

October 2012

Prof. Barry Eichengreen



PROF. BARRY EICHENGREEN

George C. Pardee and Helen N.
Pardee Professor of Economics and
Political Science
Department of Economics
University of California, Berkeley

Email:
eichengr@econ.berkeley.edu

Web Page:
→ Click here

Barry Eichengreen is the George C. Pardee and Helen N. Pardee Professor of Economics and Professor of Political Science at the University of California, Berkeley, where he has taught since 1987. He is a Research Associate of the National Bureau of Economic Research (Cambridge, Massachusetts) and Research Fellow of the Centre for Economic Policy Research (London, England). In 1997-98 he was Senior Policy Advisor at the International Monetary Fund. He is a fellow of the American Academy of Arts and Sciences (class of 1997).

Professor Eichengreen is the convener of the Bellagio Group of academics and economic officials and chair of the Academic Advisory Committee of the Peterson Institute of International Economics. He has held Guggenheim and Fulbright Fellowships and has been a fellow of the Center for Advanced Study in the Behavioral Sciences (Palo Alto) and the Institute for Advanced Study (Berlin). He is a regular monthly columnist for Project Syndicate.

Professor Eichengreen was awarded the Economic History Association's Jonathan R.T. Hughes Prize for Excellence in Teaching in 2002 and the University of California at Berkeley Social Science Division's Distinguished Teaching Award in 2004. He is the recipient of a doctor honoris causa from the American University in Paris, and the 2010 recipient of the Schumpeter Prize from the International Schumpeter Society. He was named one of Foreign Policy Magazine 's 100 Leading Global Thinkers in 2011. He is Immediate Past President of the Economic History Association (2010-11 academic year).

TABLE OF CONTENTS

INTRODUCTION TO DWS GLOBAL FINANCIAL INSTITUTE

Launched in November 2011, DWS Global Financial Institute (DGFI) is a new-concept think-tank that seeks to foster a unique category of thought leadership for asset management professionals in the global mutual fund investment community by effectively and tastefully combining the perspectives of two worlds - the world of asset management and the world of academia - concerning the economic, political, financial, and social issues facing the world.

DGFI's publications combine the views of DWS' asset management experts with that of leading academic institutions in Europe, the United States, and Asia. The publications span a wide variety of academic fields from Macroeconomics and Finance to even Sociology in the form of research papers, interviews, debates, and more.

Is the Age of Dollar Dominance Coming to an End?

Prof. Barry Eichengreen
October 2012

ABSTRACT

The dollar has been the dominant international and reserve currency for more than 50 years. Now, however, the forces supporting dollar dominance are weakening. US economic and financial dominance is less than it was after World War II. Technological change is undermining the dollar's first-mover advantage. And, increasingly, questions are being asked about the capacity of the United States to provide an adequate supply of safe and liquid assets to the rest of the world.

This paper asks what comes next. It revisits the analysis in the author's 2001 book, "Exorbitant Privilege," which pointed to the emergence of a multi-polar monetary world with international roles not just for the dollar but also for the euro and the Chinese renminbi. It inquires again into the dollar's prospects in the wake of the 2011 S&P downgrade and the looming fiscal cliff. It asks whether there is hope for a smooth resolution of Europe's crisis and for the emergence of the euro as a consequential international and reserve currency. It documents how China is making even faster progress than anticipated on renminbi internationalization but also points to challenges lying ahead.

1 THE END OF DOLLAR DOMINANCE?

We live in turbulent economic and financial times. Amidst all the upheavals, however, one constant remains: the dominant international and reserve currency role of the dollar. Consider the foreign exchange market, where the dollar is still on one side of fully 85% of all foreign exchange transactions; that is, 85% of all foreign exchange trades worldwide are trades of other currencies for dollars. The dollar accounts for 60% of the reported foreign exchange reserves of central banks and governments around the world. It accounts for 45% of all international debt securities. It is the dominant funding currency for international banks: of all cross-border liabilities of non-U.S. banks denominated in a currency other than that of their home countries, nearly two-thirds are in dollars.

Critics of the dollar's so-called "exorbitant privilege" have been predicting the demise of this situation for years. They have observed that the United States is no longer as dominant economically as it once was, diminishing the convenience of using the dollar. Using dollars made perfect sense after World War II, when the United States accounted for half of all industrial production and trade outside the Soviet bloc. It makes less sense today, when the U.S. accounts for just 20-25% of the global economy, depending on details of measurement and currency conversion, and an even smaller fraction of global trade.

Second, America no longer possesses a financial monopoly. The U.S. is no longer the only country with deep and liquid financial markets accessible to international investors. Things were different as late as the 1990s, when Europe finally removed its residual capital controls, but no longer.

Third, the network effects and first-mover advantages favoring the dollar are weaker than in the past. Once upon a time, it could be argued that international currency status was what economists refer to as a "natural monopoly" – that there was room for only one national unit in international markets. The reason to use dollars in international transactions was that everyone else used dollars. If you were a firm seeking to trade in international markets, you priced your exports in dollars because everyone else priced their exports in dollars. Doing otherwise would have made it difficult for potential customers to compare prices; to get an exchange rate quote, you had to buy a newspaper or call a broker. All this inflated the cost of transacting in other currencies. There was room for only one monetary standard in the global economy, just as there was room for only one operating system for personal electronics. And in the international monetary domain, that standard was the dollar.

Today, in contrast, everyone carries in their pocket a device called a smartphone with which exchange rate quotations can be obtained and prices denominated in different currencies can be compared in real time. Just as we have learned to build open standards for consumer electronics, allowing multiple operating systems to coexist, there is no intrinsic reason why multiple international currencies cannot coexist. This in turn undermines the dollar's first-mover or incumbency advantage.

A fourth factor challenging the dollar's dominance is the limited fiscal capacity of the United States. The global economy needs a supply of safe and liquid assets to be held as reserves by central banks and other investors. For many years these have taken the form of U.S. Treasury bonds. The market in U.S. Treasuries is the world's single largest financial market. The assets traded there are standardized. The market in Treasuries is backstopped – in other words, its liquidity is guaranteed – by the Federal Reserve System. Ultimately, U.S. Treasury bonds are backed by the full faith and credit of the United States government.

But this last fact is precisely the problem. The world economy is growing faster than the United States. This is simply another way of saying that the U.S. accounts for a declining share of global GDP and that the trend will persist as emerging markets continue to emerge and developing countries, via catch-up growth, join the ranks of those closing the per-capita GDP gap vis-à-vis the United States. This in turn means that the capacity of the U.S. government to provide safe assets, backed ultimately by its power to tax, will eventually be overwhelmed by the scale of the world economy. The international liquidity provided by the dollar will not suffice; it will have to be supplemented by other sources. Additional safe assets will have to come from somewhere else.

Fifth and finally, the United States faces economic challenges that may precipitate a crisis of confidence and flight from the dollar if they are not successfully addressed, including the slow growth of the U.S. economy and the country's unresolved fiscal problems. These ills occur against the backdrop of a polarized political system that has shown little capacity for constructively addressing them.

2 SCENARIOS FOR THE FUTURE

What does this imply for the future? In *Exorbitant Privilege,* published at the beginning of 2011, I sketched out two possible scenarios.[1] In the positive scenario, the United States succeeds in putting its fiscal and financial house in order, and the dollar retains its international currency role. But it loses its monopoly: over time it is joined on the international stage by the euro and the Chinese renminbi. The Eurozone and China are the only economies large enough to support a first-class international currency. They engage in a large volume of external transactions, notably on the trade side, where those transactions are as large, or larger, than those of the United States. The sheer size of their economies is what makes it possible, if not inevitable, that they will succeed in building financial markets whose liquidity will approach that of the United States.

Looking ten years out, I suggested, the dollar would likely remain first among equals, but that the euro and the renminbi could be nipping at its heels. And I suggested that this was not necessarily an unhappy outcome. In this scenario, the 21st-century global economy would be supplied with adequate international liquidity as a result of its joint provision by the United States, the Eurozone, and China.

But there is also a gloomier scenario, in which fiscal and financial follies in the United States undermine confidence in the dollar, and where neither the Eurozone nor China succeeds in building liquid financial markets and internationalizing their currencies. This alternative scenario would resemble nothing so much as the 1930s, when confidence in the two international currencies of the interwar era, sterling and the dollar, was lost. Sterling and the dollar were of roughly equal importance in 1929 as sources of international reserves for central banks and governments and as sources of international liquidity generally. But between 1929 and 1931, in reaction to a currency crisis in the United Kingdom and then a banking crisis in the United States, central banks liquidated some two-thirds of their foreign exchange reserves. They all attempted to flee out of currencies and into gold, but there was only so much gold to go around, which they sought to attract, perversely, by raising interest rates in the teeth of the 20th century's most serious slump.

The result was the deflationary crisis that came to be known as the Great Depression. As international liquidity grew scarce, international trade and lending collapsed. The first era of globalization, which dated to the late 19th century, came to a catastrophic close. The deflation and financial distress that followed, more than anything, were what made the Great Depression so great.

[1] Published by Oxford University Press in January 2011. Portions of this essay draw on the new drafted afterword for the appearance of the paperback in the autumn of 2012.

3 U.S. POLITICS AND ECONOMICS

Which scenario is more likely? In contemplating this question, I feel compelled to ask how events have developed since the manuscript of *Exorbitant Privilege* went off to the publisher in mid-2010. Not surprisingly, subsequent events force us to re-think the prospects for all three potential candidates for the role of leading international currency. Start with the dollar. The summer of 2011 saw high drama in the U.S. Congress over whether to raise the statutory ceiling on the issuance of federal government debt. Agreement was reached only after political brinkmanship threatened to push the Treasury into default on its obligations. The rating agency Standard & Poor's, impressed by this demonstration of the dysfunctionality of American politics, responded with an unprecedented downgrade of U.S. Treasury securities. The bipartisan "supercommittee" of six Democrats and six Republicans appointed to craft a joint proposal for closing the budget gap then adjourned without tabling a proposal.

These events did not exactly instill confidence in U.S. economic policy or burnish the reputation of the dollar. Nor were they supportive of consumer confidence and economic recovery. The weak economic growth to which this political uncertainty contributed forced the Federal Reserve to keep interest rates close to zero. With the housing market and economy still in the doldrums, in September 2011 the Fed then launched what was dubbed "Operation Twist." This involved exchanging Treasury bills (30- and 90-day securities that the Fed had purchased previously) for long-term bonds, with the goal of driving up bond prices and putting downward pressure on the long-term interest rates on which fixed-investment decisions depend.[2] These actions were widely seen as a series of increasingly desperate efforts to revive a moribund economy.

But this was not the only interpretation – or effect – of the Fed's actions. The fear abroad was that Fed Chairman Ben Bernanke's hidden agenda was to push the dollar down against foreign currencies in order to boost U.S. exports. Federal Reserve policy, in this view, was designed to stimulate economic growth at the expense of America's trading partners. Moreover, the Fed's near-zero interest rates, in combination with higher interest rates in other countries, had the effect of pushing financial capital toward emerging markets where returns were higher. This tsunami of liquidity flowing into foreign markets worked to fan inflation and create asset bubbles there. Policy makers in other countries were perturbed. The Brazilian finance minister Guido Mantagna sensationally accused the United States of launching a "currency war." German finance minister Wolfgang Schäuble charged the U.S. with "artificially depressing the dollar exchange rate by printing money." In comments indicative of the hostility that U.S. monetary policy engendered abroad, the normally diplomatic Schäuble harshly dismissed U.S. policy as "clueless."[3] The Fed's policies, he implied, were hardly those of the responsible steward of a global currency.

The events of 2011 thus heightened the perceived urgency of changing a system in which, owing to the dollar's exorbitant privilege, U.S. policy makers can do as they please and other countries are forced to accept their dictates. Then Russian Prime Minister Vladimir Putin put it memorably when he accused Americans of "living like parasites off the global economy and their monopoly of the dollar."

Other more sober observers, while not echoing Putin's inflammatory rhetoric, nonetheless shared the conclusion that the situation could not be allowed to stand. Either the international system would be reformed, or else markets would take matters into their own hands, as banks, companies, and governments, disenchanted with America's policies, dumped their dollars for more reliable alternatives.

But, not for the first time, the reaction in financial markets was not as anticipated. Contrary to these dire expectations, the dollar strengthened in response to events. Each time uncertainty spiked, including even instances of heightened uncertainty about U.S. policy, investors fled into dollars, not out of them. When Standard & Poor's downgraded U.S. Treasury debt from AAA to AA+ in the wake of the debt-ceiling debacle,

[2] The original Operation Twist in the 1960s was an attempt by the Fed to similarly twist the term structure of interest rates, lowering the long-term rates to which fixed investment is sensitive while raising short-term rates to dampen inflation. The Fed's balance-sheet operations in the autumn of 2011 were inspired by this earlier experience.

[3] Chris Isadore, "Global Fed Bashing Casts Shadow Over G20," CNN Money (18 November 2011), www.cnnmoney.com.

the dollar immediately rose. Supposedly astute analysts suggested that this was no more than a knee-jerk reaction – that investors used to thinking about the dollar as a safe haven were instinctively moving into it one last time. The longer-term implications of the downgrade, they insisted, were dollar negative.

But this was not the case. In the four months following the S&P downgrade, the greenback appreciated by more than 4% against a representative basket of foreign currencies. U.S. Treasury bonds were the best performing government bonds in the world in 2011, reflecting continued strong demand in the second half of the year.

How is it then that despite its problems the dollar remains the only true safe-haven currency and the dominant vehicle for international transactions of all kinds? The answer has three parts. First, U.S. financial markets remain far-and-away the most liquid in the world, and there is nothing that investors value more than liquidity in uncertain times. They can get their money when they want it without incurring losses. They can buy and sell large numbers of Treasury bonds without moving prices.

Second, there has been no attempt by the United States to inflate away the value of its debt. The Fed may have increased the amount of cash and credit in circulation, but this has done nothing to fuel inflation, given the depressed state of the economy, or to drive down the price of Treasury debt. Stability is the second attribute of a safe-haven currency valued by international investors, and by official investors like central banks in particular. And, all warnings to the contrary, the dollar has remained stable.

Finally, the dollar, despite its warts, is still the least unattractive belle at the ball. Or, as the California-based bond-fund manager Bill Gross has put it, it is the least dirty shirt in the pile. The absence of other, equally attractive options is thus the third and final factor helping the greenback to retain its exorbitant privilege.

4 TRIALS AND TRIBULATIONS OF THE EURO

The trials and tribulations of the euro exemplify the point. In 2011, what had previously been seen as a Greek debt crisis exploded into a pan-European crisis that threatened the very existence of the single currency. Topics that European policy makers once regarded as taboo, such as whether a country like Greece might dump the euro and whether the monetary union might break apart, were broached for the first time. German Chancellor Angela Merkel and then French President Nicolas Sarkozy, exasperated by the failure of the Greek parliament to adopt the reforms they prescribed for it, warned that Greece's choices boiled down to accepting their dictates or abandoning the single currency. In December, *The Wall Street Journal* reported that European central banks were making contingency plans for the possibility that the currency union might collapse. At least one, the Central Bank of Ireland, reportedly evaluated whether it needed to secure additional access to printing presses in order produce new bank notes.[4]

The possibility that the euro might break up hardly rendered it an attractive alternative to the dollar. This was not the stability expected of a global currency. As worries mounted about the solvency of additional European governments, the prices of their bonds plunged, and the volume of transactions cratered. The Eurozone's sovereign bond markets had never been as liquid as the U.S. Treasury bond market, but the events of 2011 heightened the contrast. Late in the year European governments desperately encouraged Asian sovereign wealth funds and central banks to up their investments in Eurozone bonds. Asian investors understandably showed little interest. As Li Daoku, an

[4] David Enrich, Deborah Ball, and Alistair MacDonald, "Banks Prep for Life after Euro," *Wall Street Journal* (8 December 2011), www.wsj.com.

academic member of the monetary policy committee of the People's Bank of China, put it, "The last thing China wants is to throw away the country's wealth and be seen as just a source of dumb money."

The question is whether Europe can get a handle on its problems, allowing the euro to emerge from its crisis strengthened, or whether the currency's ills are incurable. Stabilizing Europe's public finances and beginning to grow its economies again will require sacrifices all around. Where social spending and public-sector compensation have risen wildly, they will have to be cut. To put pensions on a firm footing, retirement ages will have to be raised.[5] Greek doctors, accustomed to receiving payment in cash, will have to pay taxes. Italy's closed professions, from taxi driving to pharmacology, will have to be opened to entry and competition. Barriers to hiring and firing and other labor market restrictions will have to be removed. And where debts have risen to unsustainable levels, they will have to be written down, imposing losses on banks and other investors.

These measures will be resisted by those who benefit from the status quo. Overcoming their resistance will require effective political leadership, something that Europe has not always had in abundance. It will also require a contribution from Northern European countries. Countries like Germany will have to pay to create an adequately capitalized financial rescue facility. They will have to provide financial support for at least a portion of the debts of weak Southern European countries, whether directly by extending a joint guarantee or indirectly by allowing the European Central Bank to purchase the bonds of the crisis countries.

It is not obvious to the average German why he should have to sacrifice in order to bail out his Southern European neighbors. As the *Frankfurter Allgemeine* put it in one of its milder editorials, "Should Germans have to work in the future to 69 rather than 67 so that Greeks can enjoy early retirement?"

In fact, there are several reasons for Germany to help. First – to put it bluntly – Northern European countries were complicit in the crisis. For every feckless borrower there is a feckless lender. Someone, after all, loaned Southern European countries all that money. And that someone was, in good part, Northern Europe's banks.[6]

Second, Germany has benefited enormously from the euro. Being in bed monetarily with weaker countries in Southern Europe, so to speak, has kept Germany's exchange rate down against the currencies of the rest of the world. That in turn enabled the country's automobile and machinery producers to grow their exports. Exports have been the main driver of Germany's economic renaissance since the turn of the century. And there is no way those exports would have been so dynamic in the absence of the euro.

Then there is the shock to financial systems and economies from any attempt to dismantle the monetary union. If a weak Southern European country contemplates abandoning the euro, depositors will flee its banks and dump its bonds. There will be fears that where one country leads others will follow; bank runs and financial turbulence will not be limited to one country. Germany could not remain a calm and prosperous island in this turbulent sea.

Finally, it is important to recall that the reunification of Germany might have helped to accelerate the introduction of the euro prematurely. But even if the decision to proceed with monetary unification was premature, this does not mean that it is reversible. Like it or not, the euro is now central to the larger European project. European integration was designed to lock Germany into Europe. It was designed to allow post-World War II Germany to rebuild its economy while reassuring its neighbors that its industrial capacity no longer posed a military threat. European integration is now woven into the country's political culture, all grumbling about profligate Southern Europeans notwithstanding. And the European Union would not easily survive the collapse of its monetary union.

Once the immediate challenges of stabilizing Europe's finances and restarting growth are surmounted, it will then be necessary to complete what is still an

[5] A process that is already underway across Southern Europe.

[6] Not just German banks but French banks even more. So what goes for German taxpayers goes for French taxpayers as well.

incomplete monetary union. For Europe to have a single currency and a single market but dozens of separate national bank regulators is madness. An arrangement that allowed French and German bank regulators to ignore the impact of their decisions on the Greek government's ability to borrow is part of what created Europe's crisis in the first place. Responsibility for bank regulation will have to be centralized at the level of the European Union. That will require common funding for a pan-European deposit-insurance scheme and a bad-bank resolution mechanism. There is now movement toward creating what is euphemistically referred to as "banking union," but the devil is in the details. In addition, the E.U. will also have to have a larger budget to enable its members to jointly guarantee at least a portion of the debts of its member states. The Eurozone, in other words, will have to create a limited fiscal union to accompany its monetary union.

Will Europe cross this Rubicon? Half a century and more of history suggests that, when faced with the choice of going forward or going back, Europe goes forward. Confronted with a crisis of confidence in its union, Europe responds by moving forward toward deeper integration. The French technocrat Jean Monnet, who was heavily involved in the original design of the European Economic Community, famously remarked that "Europe is forged in crises, and will be the sum of the solutions adopted for those crises." History offers no guarantees, but historical precedent suggests that Europe will do what is necessary to save its monetary union. If so, the euro will emerge from its crisis strengthened and eventually offer an alternative to the dollar in the international sphere, as intended by its architects. Not soon, perhaps, but eventually.

5 ADVANCE OF THE RENMINBI

If the euro's advance on the international stage has slowed, the renminbi's has, if anything, accelerated. For some years now China's strategy for reducing its dependence on the dollar has been to encourage international use of its currency. Movement in this direction is gaining momentum. Growing numbers of firms involved in export and import trade with China are invoicing and settling their merchandise transactions using China's own currency. In 2010, the first full year in which cross-border renminbi transactions were permitted, their value was just $78 billion. By the first quarter of 2011, however, trade settlements in renminbi were running at an annual pace of $220 billion. China then reached an agreement with Japan to build a market where firms receiving renminbi in payment for their exports could exchange them directly for yen without first having to trade them for dollars.[7] Given the extent of China's foreign trade, which now exceeds the foreign trade of the United States, there is room for significant additional international use of the renminbi for trade-related transactions.

Foreign firms have been happy to accept renminbi as payment for their shipments to China, given expectations that the currency will become more valuable over time. They have accumulated a rapidly expanding pool of renminbi deposits, mainly in Hong Kong, to the point where 10% of all funds on deposit there are now denominated in China's currency.

To encourage use of the currency in financial transactions, Chinese policy makers have allowed banks and firms to use their renminbi deposits in a number of ways. In August 2010 they introduced a pilot scheme allowing select offshore financial institutions to use their renminbi funds to invest in China's bond market. Foreign firms seeking to invest in China can issue renminbi-denominated bonds in Hong Kong and use the funds to invest in operations on the mainland.[8] Domestic nonfinancial institutions have been encouraged to issue renminbi-denominated bonds in Hong Kong for similar purposes. At the end of 2011, Chinese regulators then permitted offshore renminbi to be

[7] Chinese firms receiving yen in payment for their exports will similarly be able to exchange them directly for renminbi on this market, although one suspects that transactions in this direction will be less common.

[8] This market in what are informally known as "dim sum" bonds tripled in size from mid-2010 to mid-2011.

used to purchase shares on China's stock market, and the Japanese and Chinese governments concluded an agreement under which the government-affiliated Japan Bank for International Cooperation would sell renminbi-denominated bonds in China. And in early 2012 the British Treasury and Hong Kong Monetary authority reached an agreement to permit trading of offshore renminbi in London.

Where private financial markets lead, central banks will ultimately follow. If private transactions are in renminbi, then central banks will want to hold a portion of their reserves in that form to permit them to intervene as needed in private financial markets. At least two central banks, those of Malaysia and Nigeria, already hold a portion of their reserves in this form. Japan has indicated a willingness to do so as part of its agreement to encourage more use of the renminbi in bilateral transactions. China has also sought to foster the practice by signing bilateral arrangements under which foreign central banks can swap their currencies for renminbi with Hong Kong, Indonesia, Malaysia, New Zealand, Singapore, South Korea, and, more far afield, Argentina, Belarus, Iceland, and Uzbekistan.

This is a carefully orchestrated strategy for developing a global role for China's currency. Start by using it to invoice and settle foreign trade. Follow by facilitating its use in a growing range of international financial transactions. Finally encourage its adoption as a reserve currency. Focus initially on Asia but with an eye toward wider adoption.

But while China is a large economy, its financial markets remain small by international standards. Bond market capitalization is barely a tenth that of the United States. Most of the bonds of the government and Chinese financial and nonfinancial corporations are held to maturity by banks and credit cooperatives, unlike the situation in countries with more developed financial markets where such assets are actively traded. As a result, turnover on Chinese bond markets is low. Trading volume as a share of the value of bonds outstanding is barely a hundredth of that in the United States and Europe. Even small transactions can therefore move prices by large amounts. China is still a considerable distance, in other words, from having the kind of deep and liquid markets that have made the dollar an attractive international and reserve currency.

Ultimately, inducing private investors and central banks to hold a significant fraction of their assets in renminbi will require not just financial development but also policy reform. Along with building a more diverse clientele of investors as a way of encouraging more trading and developing a more liquid bond market, China will need to reform its banking system so that central banks and other foreign investors feel comfortable holding deposits there. The banks will have to be placed on a purely commercial footing, where they are not longer relied upon to lend to local governments for infrastructure projects or to property developers to keep construction activity humming. Top management positions will have to be filled on the basis of a global search rather than given as rewards for past service in the public sector. Residual doubts about the security of foreign financial investments will have to be removed. China will have to commit to rule of law.

Beyond the financial sector, internationalization of the renminbi will ultimately entail far-reaching changes in economic policy and in the structure of the economy. As Chinese banks abandon directed lending, local governments and state-owned firms will have to fend for themselves, financially speaking. As restrictions on the ability of foreign investors to move funds in and out of the country are lifted, the capacity of Chinese policy makers to keep the exchange rate at artificially low levels where it serves to boost export competitiveness will be eroded. As capital inflows and outflows grow, China will have to embrace greater exchange rate flexibility in order to cushion its economy from the effects of fluctuations in capital flows. In other words, key elements of China's tried-and-true growth model – directed lending, export dependence, and an exchange rate pegged to the dollar – will have to be abandoned.

Chinese leaders have made clear that this is what they have in mind. They want to rebalance the economy away from exports in order to reduce its vulnerability to shocks from the rest of the world. They want to commercialize the banks and commit to rule of law. They want to impose hard budget constraints on local governments and construction companies. But such far-reaching transformations are not completed overnight, which is why the renminbi will not steal the spotlight from the dollar anytime soon. Still, China's currency is coming, and it is coming even faster than previously thought.

6 CONCLUSIONS

Recent events thus place the trends described in *Exhorbitant Privilege* in a somewhat different light. They have reinforced the dollar's international role. They have delayed the euro's emergence as a full-fledged rival while accelerating the emergence of the renminbi. But they have done nothing to alter the central conclusions. First, the dollar remains the only true global currency for the time being. But what is true now will not be true forever: just as the world economy is becoming more multipolar, the international monetary and financial system will become more multipolar. Sooner or later the dollar will face rivals in the international sphere. Just how successfully it copes with the challenge they pose to its international role will depend, more than anything, on the policies of the United States.

DWS Investments is the global mutual fund business of the Asset Management division of Deutsche Bank Group, collectively referred to as "Deutsche Bank". In the US, DWS Investments is the brand name for the US retail asset management and financial institutions group, a division of Deutsche Asset Management.

This material was prepared without regard to the specific objectives, financial situation or needs of any particular person who may receive it. It is intended for informational purposes only and it is not intended that it be relied on to make any investment decision. It does not constitute investment advice or a recommendation or an offer or solicitation and is not the basis for any contract to purchase or sell any security or other instrument, or for Deutsche Bank AG and its affiliates to enter into or arrange any type of transaction as a consequence of any information contained herein. Neither Deutsche Bank AG nor any of its affiliates, gives any warranty as to the accuracy, reliability or completeness of information which is contained in this document. Except insofar as liability under any statute cannot be excluded, no member of the Deutsche Bank Group, the Issuer or any officer, employee or associate of them accepts any liability (whether arising in contract, in tort or negligence or otherwise) for any error or omission in this document or for any resulting loss or damage whether direct, indirect, consequential or otherwise suffered by the recipient of this document or any other person.

The opinions and views presented in this document are solely the views of the author and may differ from those of DWS Investments and the other business units of Deutsche Bank. The value of shares/units and their derived income may fall as well as rise. Past performance or any prediction or forecast is not indicative of future results.

Any forecasts provided herein are based upon market conditions as at this date and are subject to change, dependent on future changes in the market. Any prediction, projection or forecast on the economy, stock market, bond market or the economic trends of the markets is not necessarily indicative of the future or likely performance. Investments are subject to risks, including possible loss of principal amount invested.

Publication and distribution of this document may be subject to restrictions in certain jurisdictions.

R-29024-1 (8/12))

DWS | GLOBAL FINANCIAL INSTITUTE