CURRENCY STATECRAFT

Monetary Rivalry and Geopolitical Ambition

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Monetary Rivalry and Geopolitical Ambition

BENJAMIN J. COHEN

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For my students,
past, present, and (hopefully) future

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ABBREVIATIONS

AIOC	Anglo-Iranian Oil Company
ASEAN	Association of Southeast Asian Nations
BIS	Bank for International Settlements
CMI	Chiang Mai Initiative
CIS	Commonwealth of Independent States
DM	Deutsche mark
ECB	European Central Bank
ERM	Exchange Rate Mechanism
EMS	European Monetary System
EU	European Union
ESF	Exchange Stabilization Fund
GDP	gross domestic product
IMF	International Monetary Fund
HKMA	Hong Kong Monetary Authority
IPE	international political economy
IR	international relations
NAFTA	North American Free Trade Agreement
NATO	North Atlantic Treaty Organization
NPT	nonproliferation treaty
PBOC	People's Bank of China
P5+1	the five permanent members of the UN Security Council, plus Germany
RMB	renminbi
SDR	special drawing right
UK	United Kingdom
UN	United Nations
US	United States

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Introduction

What is the role of currency statecraft in world politics? At any given time, a limited number of national currencies come to be used across political frontiers for various international purposes. That is what we call currency internationalization. Currency statecraft is about what a country chooses to do—or not do—when its money gains international appeal. Will internationalization be welcomed or promoted by the issuing government? Will it be exploited? Will it be defended? Or will internationalization be actively opposed or perhaps just passively tolerated?

Currency statecraft is important because an international money generally adds to the capabilities of the nation that produces it. Currency internationalization is not only a consequence of state power; it also a cause, augmenting a country's underlying power resources. That is what is intended by the term "currency power" (Cohen 2015). There can be no doubt of the practical stakes involved. Monetary relations may be mutually beneficial in purely material terms, but there is no denying that, as in all economic relationships, there is also an element of competition involved—to some degree, a conflict of interest. In the persistent contestation that characterizes global politics, the extra edge provided by currency power clearly matters. Monetary rivalry is an integral part of geopolitics.

Today, the world's major example of monetary rivalry is the emerging confrontation between the US dollar, long the dominant currency in the global economy, and the Chinese yuan, also known as the renminbi (RMB, "people's currency") or "redback." In recent years China has chosen to vigorously promote the international standing of its currency, even at the risk of roiling relations with the United States. In effect, Beijing has challenged America's dollar to a duel: the redback versus the greenback. The outcome could play a major role in shaping the broader geopolitical engagement

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between this century's two giant superpowers. But to anticipate how the duel might turn out and where it might lead, it is essential to develop a fuller understanding of the uses and utility of currency statecraft. That is the purpose of this book.

Currency Statecraft

An international currency adds to a state's capabilities in two ways, either directly or indirectly. The money itself may provide an effective policy instrument, available for direct use as a tool to achieve selected foreign-policy goals. Or, alternatively, its role may be more indirect, reinforcing policy by enhancing the utility of other pathways to leverage. Most important, internationalization enables a country to finance external deficits with its own currency. The willingness of foreigners to hold the nation's money effectively removes any balance-of-payments constraint on spending abroad—"deficits without tears," in the memorable phrase of French economist Jacques Rueff (1972). Either way, directly or indirectly, the issuing state gains a fundamental power resource. The government's ability to exert influence in international affairs is increased, tipping the global balance of power to some degree in its favor.

But what will a government choose to do—or not do—about its monetary power resource? That is where statecraft comes in. Contrary to conventional wisdom, the answer to the question is not at all obvious. Most observers, without much reflection, take the link between currency internationalization and policy outcome more or less for granted. An international money, it is assumed, naturally translates into a taste for leverage. Ability acquired is automatically equated with a propensity to project power. The enhanced capacity for influence will of course be welcomed, will of course be exploited, and will of course be defended. One source calls it the "common narrative" (Helleiner 2017, 9). I call it the *Immaculate Conception of Power*, an unquestioned article of faith.

The Immaculate Conception of Power has a distinguished pedigree with roots in the well-established realist tradition of theory in international relations (IR) and international political economy (IPE). The world, according to realists, is anarchic and dangerous—a self-help system in which each state is compelled to accumulate as much power as it possibly can. Security is the name of the game. An internationalized currency is seen as just one more arrow in the nation's quiver, to be used to advance particularist or state interests. Representative of this point of view is political scientist Jonathan Kirshner (2014, 108, 110), who argues that "great powers have rou-

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tinely sought to expand the international use of their currencies. . . . Most states that have been in a position to extend their monetary influence have attempted to do so."

In the past, I too was a believer. "Much is at stake," I wrote just a few years ago, "and the benefits of market leadership will not be conceded without a struggle. . . . Rational policymakers are unlikely to turn their back on the considerable benefits that may be derived from broader circulation of their currency" (Cohen 2011, 21, 46). But I now realize that I was wrong. In practice, as we shall soon see, the correlation between money and the pursuit of influence is anything but certain. Currency internationalization does not automatically mean that a degree of authority will be sought. Nor does it mean that power will necessarily be projected. Nor does it mean that status will inevitably be championed at all costs. Monetary rivalry is just not that simple. Power is not destiny.

The problem is that the Immaculate Conception of Power mistakenly conflates capabilities and statecraft. Power as a measure of capabilities is a structural concept, all about the underlying sources of influence. Where does power come from and how does it manifest itself? In short, it is about *potential*. Power as an exercise of statecraft, by contrast, is more about agency (action). It is a behavioral concept, directing attention to discretionary decisionmaking and the uses and limits of influence. Will the leverage be exercised, and what determines the effective range of power? In short, it is about *converting potential into deed*—"influence attempts," in the jargon.

The distinction between structure and agency is a familiar one in the formal literature of IR and IPE. But it often gets lost in discussions of currency internationalization. Using a handy metaphor, the contrast can be likened to the difference between bodybuilding and wrestling. Bodybuilding is all about muscles—getting "ripped." The aim is to nurture the strongest biceps and triceps, the flattest abdomen, the tightest glutes. In a word, it is about capabilities. Wrestling, by contrast, is about what to do with all those muscles—strategic behavior in a competitive environment. The aim is to put capabilities to work, offensively or defensively. In a word, it is about decision making—calculated efforts to attain selected goals. Muscles are structure. The use of muscles is agency.

This book is about currency statecraft—the use (or nonuse) of monetary muscle. My premise is that the decision processes relating to currency internationalization are much more complex than is generally assumed. Currency statecraft involves discrete judgments about strategy and tactics that should not be taken for granted.

Formally, the concept of currency statecraft may be defined in instru-

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mental terms. Currency internationalization offers a policy tool, a country's own money,that can potentially be used in global affairs to promote national goals. *Currency statecraft refers to a government's management of its currency instrument.* There are four essential elements in this definition. First, currency statecraft is assumed to be *intentional*—deliberate willful acts (or, in many instances, willful decisions not to act). Second, it is a matter of *public* policy—crafted at the initiative of a state's central authorities, rather than at the behest of markets or civil society. Third, it is *purposive*—undertaken with specific ends in mind. And fourth, it is about the *management* of a nation's currency, which may or may not involve actual influence attempts. Management may mean making use of potential power, but it may also mean abjuring or even resisting it. All four elements are vital to a firm understanding of currency statecraft.

Effectively, currency statecraft is one slice of a much wider concept—what is generally referred to as *economic* statecraft. At its most basic, the notion of economic statecraft refers to the strategic management of economic instruments to advance political objectives. Currency statecraft, rather more narrowly, focuses on one economic instrument in particular—namely, a country's own money. Currency statecraft has its own unique characteristics that set it apart from other forms of statecraft in international affairs. But like all forms of statecraft, currency statecraft is inherently political and potentially contentious. It is impossible to fully comprehend the geopolitics of the world today without an appreciation of the role played by currency statecraft.

Power

Currency statecraft is about power. The opportunity for currency statecraft arises from the pronounced hierarchy that has always tended to exist among the world's many moneys. From the days of the earliest coins in Asia Minor, competition among currencies has repeatedly thrown up a few market favorites—currencies that, for shorter or longer periods of time, predominate in use for trade and finance across borders. Though issued by national governments, we call them international currencies or international money. The process by which they come to be used across borders is termed internationalization.

The number of international currencies at any given time tends to be small. Throughout history, monetary relations have often been dominated by a single favorite that sets a standard for many other currencies. Examples in the Western world include the silver drachma of ancient Athens, the

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gold solidus of the Byzantine Empire, the Florentine florin and Venetian ducat of Renaissance Italy, the Dutch guilder in the seventeenth century, and the Spanish-Mexican silver peso of the eighteenth century. In each era a few other moneys also attained international status, but on a more modest scale.

More recently, the principal international currencies have been Britain's pound sterling, which reigned supreme before World War I, and the US dollar, the greenback, which took top place after World War II. Other moneys of note since World War II have included the old West German Deutsche mark (DM)—since absorbed into the euro, Europe's joint currency—the Japanese yen, and the euro. Though much diminished, the British pound is still used by some, as are the Swiss franc and the dollars of Canada and Australia. And of course there is China's yuan, which many see as the next great international currency. In total the sample is small, but large in impact.

The economic rationale for currency internationalization is clear, and has long been understood by economists. Without a world government, the global economy lacks a global currency. Hence, markets throughout history have had to rely on selected local moneys to play vital international roles. Variously, international currencies may be used for trade invoicing and settlement, as an investment medium in financial markets, as an anchor for exchange rates, or as a reserve asset for central banks. The consequences of internationalization for efficiency and ease of transactions are profound. Without international money, exchanges between sovereign states would be reduced to a crude form of barter. International currencies supply the lubricant needed to keep the wheels of the global economy turning.

But there are also profound political implications. By adding to the capabilities of the countries that issue them, international currencies play a fundamental role in shaping the distribution of power among states. Not insignificant is the fact that in every instance throughout history, an international money's issuer, at least at the start, was also a major power. Each issuer, in its own day, was a highly ranked if not dominant player in the great game of world politics. It was undoubtedly that pattern that Nobel laureate Robert Mundell (1993) had in mind when he uttered his famous aphorism: "Great powers have great currencies."

Currency internationalization, at least for a time, tilts the balance even more in favor of the powerful. If that were not so, why would there be such widespread resentment over the advantages long enjoyed by the United States owing to the widespread popularity of its greenback? Why else

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would China today be making such a determined effort to internationalize its rival redback? And why would so many other governments be thinking about promoting international roles for their own state money? The attractions of currency internationalization are considerable.

As a practical matter, currency internationalization is unavoidably associated with state rivalry in broad geopolitical terms. There can be no doubt of the practical stakes involved. In the words of one respected scholar, "Security and money are inextricably linked. . . . [An international currency] is the monetary component of hard power" (Viotti 2014, xvii, xxi). Should it be any surprise, then, that governments might want to think long and hard about the practice of currency statecraft?

Aim

Remarkably, however, the subject of currency statecraft has received only limited attention in the scholarly literature. My aim in this book is to fill in some of the blanks in our understanding of currency statecraft, in order to better assess prospects for monetary rivalry today and in the future. I cannot claim to offer a comprehensive formal model capable of precise empirical predictions. That goal is beyond my limited abilities. But I can hope to push out the frontiers of our knowledge by explaining what appears to drive currency statecraft and what its effects are likely to be. The rudiments of a credible theory of currency statecraft are possible.

In practical terms, my analysis will depend primarily on close examination of available empirical evidence. My focus will be on the period dating from World War II—what we may call the modern era—since currency conditions prior to that cataclysmic conflict were fundamentally different from what came later. The monetary system created at Bretton Woods in 1944 represented a sharp discontinuity in the history of international finance. Before World War I, currencies were convertible directly or indirectly into gold or silver. And then, during the interwar period, monetary relations were destabilized and distorted by the Great Depression. The last seventy-five years, by contrast, offer a relatively homogenous era for comparative purposes.

We know that the sample of international moneys in the modern era is small. That means that the subject of currency statecraft is not easily amenable to standard quantitative methodologies of the sort that are so popular among mainstream scholars in IR and IPE today. In context, the best we can do is rely on systematic qualitative evaluation of the available historical record. Much, I would argue, can be learned from the study of a

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limited number of cases, even if the insights provided by the approach cannot claim to be absolutely definitive.

In turn, lessons from the past can be used to evaluate the outlook for global monetary rivalry in the future. What kind of behavior can be expected from the suppliers of today's international currencies—established incumbent moneys like the dollar, euro, and yen? What does China's determined campaign on behalf of the yuan portend for relations with the United States and its dollar? What changes may be expected in the population and ranking of international currencies in the future? And, most importantly, what risk is there of outright policy conflict arising from collisions of currency statecraft? These are not unimportant questions. It would be no exaggeration to suggest that much rides on the answers.

Policy Options

To fully appreciate the complexity of currency statecraft, analysis must begin with the recognition that currency internationalization is a process, not a static condition. If the past teaches us anything, it is that international currencies *evolve*. They have a *life cycle*. International moneys are born, they may flourish, and in the end they can be expected to pass away. That has been the story of every great currency over the ages, from the Athenian drachma to the pound sterling, and in the long run of history it is likely to be the fate of the US dollar too (though perhaps not any time soon). Currency statecraft, therefore, must be expected to evolve as well. Analysis must focus on how states act or react at each stage of that evolution. Our subject is not a destination, but a journey.

For analytical convenience, the life cycle of an international currency may be divided into three stages: youth, maturity, and decline. Each lap of the journey poses its own unique challenges for currency statecraft. During each stage, three broad policy options are possible.

In a currency's youthful stage, the challenge is existential: Is internationalization even wanted? The three policy options available during this stage can be labeled as promotion, prevention, and permission. The issuer may actively seek to *promote* foreign acceptance; conversely, it may wish to take action to *prevent* wider use of its currency; or, less decisively, it may elect simply to *permit* internationalization. My use of alliteration in labeling the three options may seem frivolous, but it can in fact serve as a useful mnemonic device. In this respect I follow the lead of Kirshner, who memorably put alliteration to good use in his celebrated book *Currency and Coercion* (Kirshner 1995).

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Once a currency reaches maturity, the nature of the challenge changes. The question now is more practical: How should the international money be managed? Options at this stage may be labeled (again alliteratively) as exploitation, evasion, or enjoyment. The issuer may seek consciously to *exploit* the advantages that are offered by the newfound power resource; conversely, it may look for some way to *evade* potential risks of currency internationalization; or, in a more passive mode, it may simply opt to sit back and *enjoy* whatever benefits may come its way.

Finally, there is the prospect of decline, when a currency begins to lose its international appeal. The challenge now is to cope—to determine how best to live with fading eminence. Again, the choices are three: resistance, reinforcement, or relaxation. Policy makers may strive to *resist* abandonment of their currency, hoping thereby to preserve at least some of the benefits of international use. Alternatively, they can seek to *reinforce* the process of decline in hopes of managing a "soft landing" for the currency. Or, finally, they may just *relax* and let market actors and foreign central banks decide the matter.

Questions and Answers

Two central questions of theory frame the discussion in this book. The first has to do with use. How do states respond to internationalization, and what determines their policy choices at each stage of a money's life cycle? The second question is about utility. What sets the limits to the effectiveness of currency statecraft, and what determines whether a government's chosen policies will succeed or fail? For short, these queries may be referred to as the use question and the utility question. An understanding of both questions is vital if we are to better comprehend the practicalities of monetary rivalries in the world today, and to assess how competition among international currencies can be expected to evolve over time.

My response to the use question highlights the pivotal role of *ideas* in shaping policy responses to currency internationalization. The historical record surveyed in this book, the period since World War II, strongly suggests that much more is involved in currency statecraft than a narrow calculus of strictly material benefits and costs. Conventional economic and political considerations plainly matter, of course. But factors like those operate mainly to set the parameters for policy choice—the outer boundaries of a government's "policy space." Within that space, other considerations of a more nonmaterial nature arguably matter even more—cognitive considerations having to do with a society's sense of its own underlying norms

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and priorities; in short, its sense of *identity*. Analysis of currency statecraft, I contend, must be set in this broader ideational context. In all three stages of a money's life cycle, the issuer's sense of identity appears to be the single most telling factor in determining what policy option will be selected.

This does not mean that the nation as a whole somehow makes the decisions. The state cannot be reified. We know that as a practical matter, decisions are made by policy elites—subsets of individuals who, by one means or another, come to exercise authority on behalf of the nation. We also know that in any given country, different policy elites may differ quite substantially over how to interpret their society's sense of identity in practical policy terms. But certain fundamental principles can be expected to prevail no matter who is in charge—general notions of legitimacy or rectitude on which virtually all members of the community can be assumed to agree. Donald Trump, elected as president of the United States in 2016, and his predecessor Barack Obama could not have disagreed more on a wide range of specific policy issues. Yet there is no doubt that they both shared an abiding faith in the exceptionalism of the United States as a global leader. Similarly, Xi Jinping could be replaced as Chinese president today and Beijing's policy elites would still expect respect from others for China's historical standing as a great power. At this basic cognitive level, government officials are simply a channel for the nation's most deeply held assumptions and beliefs. Though policy specifics may vary, statecraft in general can be expected to draw heavily on the shared values and goals by which a society defines itself.

Empirically, one goal in particular seems to stand out as a motivation for currency statecraft. That is the extent of an issuer's *geopolitical ambition*—how driven it is to build or sustain a prominent place in the community of nations. Does the society see itself as a significant player in the broader game of global politics? For states eager to exercise influence in the world, proactive strategies of promotion, exploitation, or resistance (depending on where their currency may be in its life cycle) clearly make sense. Conversely, for nations that would prefer to avoid the risks or responsibilities of great-power status, the reverse would be true. The options of prevention, evasion or reinforcement are more likely to be adopted. The passive choices of permission, enjoyment, or relaxation may be seen as default settings for issuers who are ambivalent, unable, or unwilling to make up their minds.

My response to the utility question focuses mainly on two groups of actors: currency users and competing suppliers. Regarding the former, the case studies suggest that much depends on the interaction between the

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ambitions of a currency producer (on the supply side) and the responses of those who actually handle international currencies—traders, lenders, investors, and the like (on the demand side). At each stage of a money's life cycle, outcomes will depend greatly on whether or not the supplier's policy is congruent with demand-side sentiment. Is there convergence or divergence between the preferences of the currency's users, on the one hand, and its issuing authority on the other?

Similarly, at the level of inter-state relations, much depends on the interaction between the ambitions of the currency producer and the responses of competing governments. Is there convergence or divergence between the preferences of the producer, on the one hand, and other issuers on the other? Where statecrafts collide, a supplier may find its initiatives thwarted by the resistance of other issuing governments. Outcomes will depend on both relative capabilities and the way those capabilities are managed.

The historical record also suggests that the effectiveness of currency statecraft at either level must be evaluated not holistically, but in terms of the individual roles that a currency may play. For each role, active efforts to either increase or decrease use of a currency are more likely to succeed if there is no dissent from either market sentiment or other states. Outcomes may vary considerably, depending on the use in question. A government may succeed in achieving its goal for one role of its currency and yet fail with respect to other roles.

Contents

I begin in chapter 1 with introductory material intended to set the stage for subsequent discussion. The aim is to provide the first building blocks needed for analysis, serving essentially as a primer for the uninitiated. (Specialists may wish to skip directly to chapter 2.) The perspective here is structural. In a concise manner, chapter 1 reviews what is generally known about the nature of currency internationalization and its implications for state power. The focus is on capabilities: what the diverse roles of an international money can mean for a country's ability to exercise leverage in foreign relations. The main emphasis is on the contingent nature of currency power. Since international moneys typically play quite different combinations of roles, political implications can differ substantially as well.

Chapter 2 then turns to the concept of currency statecraft, our central topic. What can be gleaned from scholarly literature on the subject, and what do we know about the uses and limits of currency statecraft? Hark-

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ing back to the core distinction between power as a measure of capabilities and power as a matter of decision making, the perspective of chapter 2 is not structural but behavioral, and concentrates in particular on matters of strategy. The aim of the chapter is to set the agenda for the remainder of the book. The two central analytical issues are the use question and the utility question. What accounts for how the capabilities generated by currency internationalization will be managed, and what might determine the effectiveness of currency statecraft?

Chapter 3 is the theoretical heart of this book, stressing the central importance of geopolitical ambition—its presence or absence—as a driving force in currency statecraft. Here the rudiments of a credible theory of currency statecraft are laid out in some detail. Three key steps are involved. First, the chapter shows that there is indeed policy space—practical opportunity for choice. Currency strategy in any given circumstance is not likely to be limited to a single policy option dictated by economic logic. Human agency is implicit in the notion of statecraft. Second, the plausibility of geopolitical ambition as a legitimate causal variable is established by grounding the notion firmly within the more conventional concept of national identity, which is already quite familiar to students of IR and IPE as a driver of behavior. And third, the practical connection of the general concept of geopolitical ambition to the specific issue of currency internationalization is confirmed. Causal links between identity and money are not difficult to find.

The next three chapters review the full range of available cases in the modern era. The aim of the historical narratives is to test the theoretical claims of chapter 3. In succession, we look at each of the three stages of an international money's life cycle. Chapter 4 focuses on currencies during the stage of youth. Since World War II these have included the early examples of West Germany's DM and Japan's yen, as well as today's RMB. Chapter 5, in turn, discusses currencies at the stage of maturity, including second-tier elite moneys such as the euro or Britain's pound as well as the era's top currency, America's greenback. Chapter 6 takes a look at two currencies that have experienced unmistakable decline during the period under review: the pound and the yen.

At first glance, the empirical record looks daunting. At each of the stages, policy choices have varied dramatically. Yet upon closer inspection, a reasonably consistent pattern does emerge, determined in large part by the presence or absence of pronounced geopolitical ambition. The claims of chapter 3 do appear to be affirmed. Along the way, the chapters also offer

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some observations on the utility question, stressing the importance of congruence with the preferences of market actors and competing governments for each of a currency's possible roles.

Finally, in chapter 7 we take up the issue of what happens when currency statecrafts collide. In principle, the potential for policy conflict between rival monetary powers would appear to be great. But in practice, strikingly, outright inter-state contestation has been relatively rare in the modern era. With the rise of China, however, we have an exception: a potentially historic confrontation between an emerging power openly committed to do all it can to move currency preferences in its favor, versus a longtime incumbent that is unlikely to surrender its traditional privileges without a fight. This is the central drama on the world currency stage today. Chapter 7 assesses how the redback/greenback duel is evolving, and where it is likely to lead in an increasingly multipolar world. Given the central role of geopolitical ambition driving currency statecraft, the chapter suggests, a new era of open and potentially costly monetary hostilities would seem to be approaching.

Chapter 8 then draws all the threads of the discussion together in a brief summary and conclusion.

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ONE

From Currency to Capabilities

All statecraft starts with capabilities. If influence is the ultimate aim of statecraft, power resources are its raw material. For currency statecraft, the raw material is a nation's money. The more a national currency gains international appeal, the greater is the potential degree of political leverage that may be made available to the issuing authority.

But what exactly is the relationship between currency internationalization and state power? The aim of this book is to understand how currency statecraft may—or may not—convert potential into action, and what the consequences of currency statecraft may be. But first we must understand where that potential comes from. This introductory chapter explains how, in practical terms, state capabilities are affected by an international money. The leverage derived from currency internationalization, we shall see, stems directly from the broader patterns of international monetary power.

Currency Internationalization

We begin with some basics. What precisely is an international money, what drives the process of currency internationalization, and what does the universe of international currencies look like?

Roles

An international money is a national currency that is used internationally. Typically, at any given moment in history, a number of national currencies may gain international appeal. Indeed, as Barry Eichengreen and colleagues (Eichengreen, Mehl, and Chiţu 2018) have convincingly demonstrated, there has never been a time when only a single money has dominated in

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the global economy to the exclusion of all others. Absolute monopoly may exist in theoretical models but not in the real world. More commonly, two or more moneys coexist and operate simultaneously.

International currencies, however, are not all alike. Currency internationalization is not a monolithic concept. The universe of international money is in fact highly variegated. As a practical matter, international currencies may differ significantly along two key dimensions. First, they can differ in terms of geographic reach—what is referred to as their *domain*. Circulation of some currencies may be limited to just a handful of economies, while others may be used far more widely. And second, they can differ in terms of the range of roles they play—their *scope*. Currencies may be employed outside their country of origin for any of a number of purposes, and different currencies may play very different combinations of roles.

The standard taxonomy for characterizing the diverse roles of international money separates out the three familiar functions of money—medium of exchange, unit of account, store of value—at two levels of analysis, the private market and official policy, adding up to six roles in all. Specialists today generally speak of the separate roles of an international currency at the private level in foreign-exchange trading (medium of exchange), trade invoicing and settlement (unit of account and medium of exchange), and financial markets (store of value). At the official level, we speak of a money's roles as an exchange-rate anchor (unit of account), an intervention currency (medium of exchange), or a reserve currency (store of value). Each of the six roles is distinct in practical as well as analytical terms. The taxonomy is summarized in table 1.1.

In foreign-exchange trading, an international currency acts as an intermediary—a "vehicle"—for most wholesale trades, in order to minimize transactions costs. The idea is to take advantage of the economies of scale afforded by the broad market for the vehicle currency. In moving between less widely circulating moneys, it is actually more efficient to use one peripheral currency to buy the vehicle currency, and then to use the vehicle

Table 1.1. The roles of international money

	Functions		
Levels of analysis	*Medium of exchange*	*Unit of account*	*Store of value*
Private	Foreign exchange trading, trade settlement	Trade invoicing	Investment
Official	Intervention	Anchor	Reserve

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currency to buy the other peripheral currency. In cross-border markets for goods and services, an international currency provides a common medium for invoicing and settlement—often referred to simply as its trade role. And in capital markets, an international currency provides a convenient venue for storing financial wealth—its investment role. Similarly, at the official level, an international currency can provide a convenient *numéraire* for pegging exchange rates (its anchor role), an efficient medium for managing exchange rates (its intervention role), and an attractive asset for backing a national currency (its reserve role).

Competition

No matter what role we may be talking about, the driving force behind currency internationalization is competition. Within individual economies, the coercive powers of the state are typically deployed to create a de jure monopoly for a national money. Means toward that end include legal-tender laws, exchange controls, and related regulatory measures. Currency choice is meant to be determined on the supply side of the market. Sovereign governments enjoy considerable latitude to seek exclusivity for their national money inside their own borders.

At the international level, however, where there is no overriding sovereign authority, the capacity for coercion in monetary affairs is more limited. Instead, it is competition that rules. Compulsion may be possible in dependent territories or quasi-imperial clientilistic relationships. But in the more normal case, in relations among independent states, monopoly is replaced by competition, and actors must be *persuaded* rather than compelled to make use of one particular money rather than another. Currency choice is determined more on the demand side of the market. To gain standing, a money must be competitive.

And what makes a money competitive? Overall, historical evidence suggests that both economic and political capabilities are deeply involved (Cohen 2015, ch. 5). Five types of power resource stand out as particularly salient. These are economic size, financial development, foreign policy ties, military reach, and effective governance.

First is *economic size*—the heft of the issuer's national economy and importance in world trade. Above all, a money must promise a broad transactional network, since nothing enhances a currency's acceptability more than the prospect of acceptability by others. Historically, this element has usually meant an economy that is large in absolute size and well integrated into world markets. A big economy that is a major player in trade creates a

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naturally ample constituency for a currency. No money not initially backed by a leading economy has ever risen to a position of international preeminence. The greater the issuer's weight in global commerce, the stronger will be the "gravitational pull" of its currency.

Second is *financial development*—the sophistication and openness of the issuer's banking and capital markets. To be competitive, a money must also promise the qualities of *exchange convenience* and *capital certainty*—a high degree of transactional liquidity and reasonable predictability of asset value. The key to both is a well developed financial sector, unburdened by high transactions costs or formal or informal barriers to entry or exit. Markets must offer considerable depth, breadth, and resiliency—the three most fundamental characteristics of an efficient financial sector. Depth means the ability to sustain relatively large market orders without impacting significantly on an individual asset's price. Breadth means trading volumes and enough market competition to ensure that the spread between ask (sell) and bid (buy) prices is small. And resilience means the ability of market prices to recover quickly from unusually large sell or buy orders. Secondary markets must be fully operational for most if not all financial claims.

Third are *foreign policy ties*, which are especially likely to influence the currency preferences of governments. In an uncertain world, geopolitical leadership can also exercise a form of gravitational pull, encouraging use of the leader's currency. Links to a geopolitical leader may take many forms, ranging from traditional patron-client relationships to linkages based more on cultural, linguistic, or historical affinities. Ties may also be more or less institutionalized. The deeper the relationship, the more likely it is that friends and allies will feel comfortable using the leader's money as an anchor or reserve asset. In monetary matters, familiarity breeds not contempt but confidence, encouraging a currency's acceptance and making its use come to seem part of the natural order of things.

Fourth is the factor of *military reach*—the security dimension of international relations, which is often neglected in discussions of currency internationalization. For nervous investors, a militarily powerful nation can provide an appealing "safe haven." A strong defense structure ensures a more benign climate for storing wealth. Likewise, currency preferences of governments may be influenced by security guarantees in one form or another. A leading country's ability to project power abroad will exercise yet more gravitational pull—though only so long as the issuer is seen as a guardian of peace and stability. The opposite effect is more likely if the issuer is seen as a destabilizer or aggressor. Eichengreen and colleagues (Eichengreen, Mehl, and Chiţu 2017) estimate that a formal military alli-

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ance will boost the share of a currency in a partner's foreign reserves by as much as thirty percentage points.

Finally, last but not least, is *effective governance*. In narrow terms, this means a proven track record of successful macroeconomic management—a policy regime capable of sustaining relatively low inflation and inflation variability over time. No currency is apt to come into widespread use for cross-border purposes if its purchasing power cannot be forecast with some degree of assurance. More broadly, effective governance means political stability, adequate protection of property rights, and genuine respect for the rule of law. Market actors will not be naturally attracted to a currency whose home government cannot be counted upon to faithfully enforce contractual obligations.

Together, these five types of power resource make a formidable package. Few nations can claim them all. More typically, countries exhibit at most just one or a few of the necessary elements in varying combinations, resulting in considerable differences among currencies in terms of both scope and domain. In effect, each economy may be said to have a natural comparative advantage in some dimension or dimensions of the competitive struggle among currencies. Overall, therefore, the competition that drives internationalization is likely to produce highly differentiated results. For example, an economy that looms large in international trade but lags in financial development is likely to find its money used more for invoicing and settlement than as an investment or reserve asset. Conversely, a country with a more advanced financial sector will attract greater interest from investors and central banks even if its share of world trade is smaller. Currency domains are apt to be less extensive geographically if an issuer's trade or financial links are concentrated in a particular region. Use at the official level will probably be more extensive if an issuer has widespread foreign policy ties or military reach.

With such variance in terms of capabilities, is it any wonder that we observe such a pronounced hierarchy among the world's moneys?

The Currency Pyramid

Nearly half a century ago, the noted British scholar Susan Strange (1971a, 1971b) introduced the first systematic taxonomy of the world's most widely used currencies. Strange distinguished four types of international money: neutral currencies, top currencies, master currencies, and negotiated currencies. *Neutral currencies* are moneys that appeal to market actors for purely economic reasons (economic size, financial development, stable

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value, and the like). Add dominance by the issuing country in related political or military structures and a money may be described as a *top currency*. *Master currencies* derive from formal dependency relationships, such as colonial ties, and rely on a degree of coercion. *Negotiated currencies*, by contrast, rely more on persuasion and result from diplomatic bargaining or informal understandings to promote or sustain foreign use.

More recently, I built on Strange's foundation by introducing the image of a currency pyramid to more fully represent the hierarchy of moneys around the world (Cohen 1998, 2004). The currency pyramid is narrow at the peak, where one or a few moneys dominate; and increasingly broad below, reflecting varying degrees of competitive inferiority. The moneys at the top include the four currency types that Strange identifies in her taxonomy. The advantage of the pyramid image is that it reaches further down to take account of other, lower rungs in the hierarchy as well.

The seven categories are:

Top currency. With a nod to Strange's use of this same label and with the same meaning in mind, this rarified rank is reserved only for the most esteemed of international currencies—those whose use dominates for most if not all types of cross-border purposes, and whose domain is more or less universal, not limited to any particular geographic region. In the last two centuries just two currencies could truly be said to have qualified for this exalted status: Britain's pound sterling before World War I, and the US dollar since World War II. In principle, more than one top currency might be in favor simultaneously, as were the pound and dollar together during the interwar period before sterling went into what proved to be a long and irreversible decline. Today, however, America's greenback alone occupies the highest stratum of the currency pyramid. No other money comes close.

Patrician currency. Just below the top rank we find currencies whose scope, while substantial, is something less than comprehensive, or whose popularity, while widespread, is something less than universal. Historically, some of the moneys in this category, corresponding to Strange's category of neutral currency, have appealed simply because of their inherent economic qualities; others have resembled more her remaining categories of master currency or negotiated currency. Today the patrician category comprises two major currencies: the euro, which stands second to the greenback in most categories of cross-border use, and the Japanese yen, which, though not as popular as it once was, is still widely used for investment and reserve purposes. Many observers expect this tier to be occupied soon by China's yuan as well. Some even believe that the yuan is destined one day to eclipse the dollar as top currency.

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Elite currency. In this category belong currencies of sufficient appeal to qualify for some degree of international use but with only limited scope or domain. Here we find the more peripheral of the international currencies, little more than bit players on the currency stage. These moneys, too, may be considered to correspond to what Strange meant by neutral currencies. Today the list of elite currencies would include, among others, Britain's pound (sadly, no longer a top currency or even a patrician currency), the Swiss franc, and the Australian and Canadian dollars. All these currencies are used to some extent in global currency and financial markets because of their inherent economic qualities. In addition, the Australian dollar and South African rand play significant roles as exchange-rate anchors and reserve currencies in their respective neighborhoods in the southern Pacific and southern Africa.

Plebian currency. One step further down from the elite category are plebian currencies—more modest moneys of very limited international use. Here we find the moneys of the smaller industrial states, such as Norway or Sweden, along with some middle-income emerging-market economies (e.g., Singapore, South Korea, and Taiwan) and the wealthier oil exporters (e.g., Kuwait, Saudi Arabia, and the United Arab Emirates). Within their own sovereign borders, plebian currencies retain a more or less exclusive claim to all the traditional functions of money. But outside those borders they carry little weight (like the plebs, or common folk, of ancient Rome). They tend to attract little cross-border use, except perhaps for a certain amount of trade invoicing.

Permeated currency. Included in this category are moneys whose competitiveness is effectively compromised even at home, through what economists call currency substitution—adoption by residents of a popular foreign currency as a preferred alternative to the national currency. Although nominal monetary sovereignty continues to reside with the issuing government, foreign money supersedes the domestic alternative, particularly as a store of value, thus accentuating the local currency's degree of inferiority. Permeated currencies confront what amounts to a competitive invasion from abroad. To judge from available evidence, it appears that the range of permeated currencies today is in fact quite broad, encompassing many economies of the developing world, particularly in Latin America and Southeast Asia.

Quasicurrency. One step further down are currencies that are superseded not only as a store of value but, to a significant extent, as a unit of account and medium of exchange as well. Quasicurrencies are moneys that retain nominal sovereignty but are largely rejected in practice for most purposes.

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Their domain is more juridical than empirical. Available evidence suggests that some approximation of this more radical degree of inferiority has indeed been reached in a number of fragile economies around the globe.

Pseudocurrency. Finally we come to the bottom rank of the pyramid, where currencies exist in name only: pseudocurrencies. The most obvious examples of pseudocurrencies are token moneys, like the Panamanian balboa, that are found in countries where a stronger foreign currency such as the US dollar is the preferred legal tender. Along with the many small permeated currencies and quasicurrencies, pseudocurrencies have sometimes been scornfully dismissed as being no more than "junk currencies."

Monetary Power

Overall, a hierarchy like the currency pyramid necessarily implies something about the distribution of power among states. The notion of hierarchy—any hierarchy—is inherently political, suggesting varying degrees of reciprocal influence. As in any pecking order, therefore, higher rank in the currency pyramid should, on balance, be expected to mean greater potential for leverage. But where does that capability come from? Ultimately, I argue, the potential comes from broader patterns of monetary power among states. To comprehend the unique politics of an international currency, we must first explore the role that power plays in monetary relations more generally.

Context

Again, we can begin with the basics. To explore the role that power plays in the specific realm of monetary relations, we must first consider the generic concept of power as such. The essential properties of power are not in fact well understood. We know that the distribution of capabilities among states is central to the study of international relations. Yet for all the attention that power receives in the IR literature, the idea is remarkably underdeveloped in formal theoretical terms—a "somewhat mysterious notion," in the words of one authoritative source (Dowding 2011, xxiii). In many ways, the nature of power remains highly contested. Consensus remains elusive across a wide range of conceptual issues (Baldwin 2016).

In the absence of consensus, we have no choice but to settle for pragmatism in power analysis (Cohen 2015, ch. 2). We must accept that power is an elusive concept that in fact comes in many guises; it is a complex and multifaceted phenomenon, almost chameleonlike in character. There is no

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single formulation that will serve for all purposes. We must be prepared to choose among multiple dimensions and interpretations of power, depending on the circumstances at hand. Whatever the issue we propose to study, we must assume that the characteristics and implications of power are all highly contingent. As two prominent scholars, Michael Barnett and Raymond Duvall, advise (2005, 40), scholars "must work with multiple conceptions of power, suggest how they can accomplish this task, and demonstrate how a consideration of power's polymorphous character will enhance and deepen theoretic understanding of international politics." Or as Joseph Nye (2011, xiv) puts it, more bluntly: "Power always depends on context."

In monetary affairs, the context is the *balance of payments*—the record of all monetary transactions between the residents of a country and the rest of the world. Attention is directed to the macroeconomic level of analysis. Every nation, by definition, has a balance of payments. In turn, that means that every nation lives with the risk of external imbalances that may sooner or later have to be corrected. The process by which imbalances are corrected is known as the process of *adjustment*, technically defined as a marginal reallocation of productive resources and trade in goods and services under the influence of changes in relative prices, incomes, and/or exchange rates. That is the classical concept of "real" adjustment, the basic tool of open-economy macroeconomics.

In this context the central issue confronting states, first and foremost, is the distribution of the burden of adjustment to external imbalance. While payments disequilibria are necessarily experienced in common—one nation's deficit is someone else's surplus—the costs of adjustment need not be shared at all. Governments thus have every incentive, ceteris paribus, to maximize their capacity to avoid adjustment costs relative to others. The ultimate foundation of monetary power lies in a capacity to avoid the costs of payments adjustment: to maintain the nation's room for maneuver, as free from external constraint as possible. Elsewhere I have referred to this as the *macrofoundation* of monetary power (Cohen 2006).

Some scholars would go further. Perhaps most prominent is Eric Helleiner, who in a notable contribution (Helleiner 2006) would add what he calls the "micro-level" sources of monetary power. These include a dominant state's ability to influence regulatory trends and crisis management in financial markets, as well as a capacity to influence perceptions of identity and self-interest. "Attention to how a dominant state can shape these elements," he argues (Helleiner 2006, 89), "provides important insights into the nature of . . . monetary power."

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But there is a problem with this approach. There is no denying the relevance of the factors Helleiner highlights. But can these elements really be regarded as *sources* of power? In reality, each is best understood as a manifestation of a state's *capabilities* in monetary affairs rather than as one of monetary power's ultimate roots. Any analysis of power should distinguish clearly between the sources of power and its possible modes of expression—between muscle (to recall the metaphor suggested earlier) and the way in which muscle is used. The capacity to avoid adjustment costs is what gives a money muscle. Only after that endowment of muscle is developed can a state then exert authority in ways such as those proposed by Helleiner. Influence over financial regulation or crisis management illustrates the instrumental use of capabilities, not the foundational roots of power.

In reality, the macro-level of analysis is where the real roots of monetary power are to be found. Other scholars courageous enough to explore the sources of monetary power have also placed the distribution of the burden of adjustment at the heart of their analysis. These have included David Andrews (1994), Michael Webb (1994), Randall Henning (1998), Matthias Kaelberer (2001, 2005), and, most recently, Mattias Vermeiren (2014). All emphasize that in the context of monetary affairs, the dimension of power that matters most is *autonomy*—effective insulation from outside control.

Autonomy

Admittedly, autonomy is not the meaning that most often comes to mind when power is discussed in IR or IPE. In most of the scholarly literature, power is much more likely to be equated with *influence*: the ability to alter the behavior of others. Formally, the conventional approach goes back to the early work of Robert Dahl (1957, 202–3), who famously argued that "A has power over B to the extent that he can get B to do something that B would not otherwise do." Power is understood as a capacity to control outcomes—"letting others have your way," as diplomacy has jokingly been defined. A state, in this sense, is powerful to the extent that it can effectively pressure or coerce others; in short, to the extent that it can exercise leverage.

Influence, however, is not the only possible meaning of power. Autonomy represents an equally valid meaning, corresponding to the dictionary definition of power as a capacity for action. An actor is also powerful to the extent that it can act unilaterally; that is, to the extent that it is able to operate freely, insulated from outside pressures, and to deflect the influence of others. In this sense, power does not mean influencing others; rather, it means not allowing others to influence *you*—others letting *you* have your

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way. As Dahl himself noted (1984, 33): "The logical complement of influence is autonomy."

The distinction between autonomy and influence has profound implications for the way we understand the balance of power among states. There is in fact a critical organic relationship between the two dimensions of power. Though not all scholars agree, logic suggests that power must begin with autonomy, which generates a *potential* for leverage. Influence—the deliberate *activation* of leverage—should then be thought of as functionally derivative. In practice, effective statecraft abroad would seem inconceivable without the state first attaining and sustaining a relatively high degree of policy independence at home. First and foremost, states must be free to pursue their policy goals without much outside constraint. Only then would they be in a position, *in addition*, to exercise authority elsewhere. As the saying goes in American football, the best offense starts with a good defense.

In short, statecraft may be said to begin at home. Decision makers must have effective room for policy choice—"policy space," in the jargon. They must be relatively free to pursue critical objectives without outside constraint, or to avoid compromises or sacrifices adopted to accommodate the interests of others. Autonomy may not be sufficient to ensure a degree of foreign influence. But it would certainly appear to be necessary—the essential foundation of power. In any given context, it is possible to think of autonomy without influence; but it is very difficult to think of influence without autonomy.

In no context is the salience of autonomy more evident than in monetary affairs, where states are inescapably tied through the balance of payments. The risk of unsustainable payments disequilibrium represents a constant threat to policy independence. Excessive imbalances automatically generate mutual pressures to adjust, to help move the balance of payments back toward equilibrium. But no government likes being forced to compromise key domestic policy goals for the sake of restoring external balance. All, given a choice, would prefer to see others make the necessary sacrifices. In monetary affairs, therefore, the capability that matters most is *the capacity to avoid the burden of adjustment required by payments imbalance*. Ceteris paribus, the greater a state's capacity to avoid adjustment costs, relative to that of other countries, the greater is its potential for leverage.

Hands of Power

The key to monetary capability thus lies in what we mean by adjustment costs. Previously (Cohen 2006, 2015), I have contrasted two distinctly

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different kinds of adjustment cost—one "continuing," the other "transitional." Both kinds are integral to the process of payments adjustment. Corresponding to each, however, is a very different sort of monetary power—what I have referred to as the two "hands" of power. Monetary power, I argue, is fundamentally dual in nature. On the one side, states have the *power to delay*; on the other, they have the *power to deflect*. A two-fisted government prefers both.

The continuing cost of adjustment is the cost of a new payments equilibrium *prevailing after all change has occurred*. With the restoration of external balance, a deficit country will unavoidably suffer a real economic loss, which will persist indefinitely. That is because, for the deficit country, adjustment requires a sustained reduction of imports of goods and services relative to exports, which is possible only if its real national "absorption"—the sum total of spending by all domestic residents—is reduced relative to that of the counterpart surplus country. At the new payments equilibrium, therefore, the deficit country must be worse off than the surplus country, in the sense that it will now receive a smaller proportion of the combined output of the two economies. That is what I mean by the continuing cost of adjustment. I label it a continuing cost because it is open-ended—the ongoing sacrifice imposed by the new equilibrium prevailing after the necessary rebalancing is complete. At the new equilibrium, deficit countries will receive a smaller share of combined world output—a thinner slice of the pie. That is a sacrifice no matter how you cut it.

Deficit countries, therefore, have every incentive to put off the process of adjustment for as long as possible. Delay pays. So long as there is no change in the status quo, there will be no redistribution of the pie—hence, no new burden. The power to delay is the capacity to avoid the continuing cost of adjustment by postponing the process of rebalancing. The scale of a state's power to delay is indicated by its capacity, in relative terms, to effectively put off the payments adjustment process.

The transitional cost of adjustment, by contrast, may be defined as *the cost of the required process of adjustment*. Apart from the continuing cost of adjustment, the process of rebalancing itself imposes a sacrifice: the cost that must be incurred to make the change in the status quo. Each adjustment implies transition, a once-for-all phenomenon; and each transition has its own cost, separate and quite distinct from the presumed burden of the new equilibrium obtaining after the transition is complete. That is what I call the transitional cost of adjustment—in effect, the price of getting from here to there.

Governments have every incentive to avoid the transitional cost, too.

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No country wants to make more sacrifices than absolutely necessary. Importantly, the distribution of the transitional cost of adjustment is, a priori, indeterminate. Unlike the continuing cost of adjustment, which is never shared, the transitional cost is in effect up for grabs. Hence, where the process of adjustment cannot be put off, every government has an incentive to deflect elsewhere as much of the transitional cost as possible. The scale of a state's power to deflect is indicated by its capacity, in relative terms, to effectively divert the transitional cost of adjustment to others.

Sources of Power

Given the dual nature of monetary power, it should not be surprising that separate factors might account for the strength of each of the two hands. The roots of the two powers are in fact quite different.

Most critical for the power to deflect are fundamental structural variables that determine how much real sacrifice will be required once the process of adjustment gets underway. The easier it is for an economy to resist imposed changes of prices, incomes, or exchange rates, the greater will be its ability to deflect the pressures of adjustment onto others. In this respect, two features stand out. These are the degree of openness and the degree of adaptability of each individual economy. The power to deflect is a function of both.

At issue is what Nye and his colleague Robert Keohane, in their classic *Power and Interdependence* (Keohane and Nye 1977), meant by the concepts of *sensitivity* and *vulnerability*. Sensitivity interdependence, as Keohane and Nye put it, involves the susceptibility of an economy to impact from the outside—the degree to which conditions in one country are liable to be affected, positively or negatively, by events occurring elsewhere. Vulnerability, by contrast, involves the possible reversibility of impact from the outside—the degree to which (in other words, the cost at which) a country is capable of overriding or accommodating to the effects of events occurring elsewhere. The distinction is relevant here because it highlights the fact that every adjustment process can be decomposed into two separate elements: stimulus and response. The stimulus is the initial impact of disequilibrium on an economy; response refers to the ease with which the initial impact can be reversed. The sensitivity/vulnerability dichotomy neatly captures these two elements for analytical purposes.

The power to deflect is a function of both elements of the adjustment process, stimulus and response. Openness matters for the power to deflect because it is the key determinant of an economy's sensitivity to payments

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disequilibrium, relative to others. The more open the economy, the greater is the range of sectors whose earnings and balance sheets will be directly affected by adjustment once the process begins. Openness makes it more difficult for a country to avert at least some significant impact on prices and incomes at home. Adaptability, meanwhile, matters because it is the key determinant of an economy's relative vulnerability to disequilibrium. For any given degree of openness, the adaptability of an economy determines how readily diverse sectors can reverse a disequilibrium without large or prolonged price or income changes. At issue here is allocative flexibility. The more easily productive resources can be switched from one activity to another, overriding or accommodating to outside pressures, the less likely it is that domestic repercussions will involve serious pain. The power to deflect is a negative function of openness, and a positive function of adaptability.

Most critical for the power to delay, conversely, are financial variables that determine each economy's ability to pay for external imbalances over time. Collectively, this is what we refer to as a country's international liquidity position: its stockpile of central-bank reserves plus access to external credit. The ultimate purpose of international liquidity is payments financing—to cover deficits in the balance of payments, via either a net reduction of external claims or a net increase of borrowing. The easier it is for an economy to finance deficits, the greater will be its ability to postpone pressures for real adjustment.

In turn, the availability of financing to an economy, relative to others, can have a significant impact on the timing of adjustment, and hence on the distribution of adjustment costs among deficit countries. More liquidity means more capacity to stave off any unwelcome reallocation of resources. Every deficit country has an obvious incentive to postpone the continuing cost of adjustment for as long as possible, regardless of longer-term consequences. The longer one deficit country can manage to put off adjustment, the greater will be the pressure on other deficit countries to bear the burden of the transition instead.

The Exorbitant Privilege

So where does currency internationalization fit into all this? The answer should now be evident. An international currency adds to a country's power to delay by augmenting the nation's overall liquidity position. From that root source comes what we call "currency power" (Cohen 2015).

Clearly, for the privileged few countries whose national money is used for international purposes, borrowing capacity is effectively enhanced by

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the willingness of outsiders to accept and hold the currency. These may be private market actors or central banks. From the point of view of an issuer, expanded foreign holdings are the equivalent of a loan from abroad—an increase of claims on the country of issue. Outsiders in effect take the currency as a form of IOU, though, unlike other kinds of credit, the loan is neither negotiated nor even perceived as a debt. It is seen simply as providing an attractive asset that nonresidents can use for a variety of cross-border purposes. The heartier the appetite of nonresidents for a given currency, the greater is the home country's ability to finance imbalances with its own money—a right to run "deficits without tears," as Jacques Rueff famously put it. As a result, the state's power to delay is amplified. A need for international liquidity in the conventional sense is obviated when national liquidity is all that is required.

In short, the key to understanding the politics of currency internationalization is to recognize the contribution a money can make to a country's power to delay. The longer a nation can effectively postpone the process of adjustment at home, the greater will be its potential for exercising leverage abroad. Capabilities are enhanced in two ways: directly or indirectly. The money itself may provide an effective policy instrument, available for direct use as a tool to achieve selected foreign-policy goals. The currency can be offered to friends in need as a positive incentive, a reward for cooperative behavior; it can also be withheld from adversaries as a negative incentive, to punish unwanted acts. Or, alternatively, the money's role may be more indirect, reinforcing the utility of other pathways to influence by easing the constraint of the balance of payments. Valéry Giscard d'Estaing, French finance minister half a century ago, knew what he was talking about when he spoke bitterly of the "exorbitant privilege" of an international currency like the dollar—a privilege sadly lacking to France's franc. (The phrase is often mistakenly attributed to Charles de Gaulle, France's president at the time.)

Capabilities

It is indeed a privilege to be able to divert the transitional cost of adjustment to others. It is not a privilege, however, that is equally shared. Not all international currencies enjoy the exorbitant privilege to the same degree. We must not forget how variegated the universe of international money tends to be. Currencies at or near the top of the monetary hierarchy actually differ substantially, particularly in terms of scope—the roles they play. And detailed analysis shows that the diverse roles of an international cur-

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rency can have significantly different implications for a government's potential capabilities in international affairs (Cohen 2015, ch. 4). To be able to compare the currency power of any one issuing authority with that of others, we must be clear about the distinctive impact of each of a money's several possible roles.

The economic side of the picture is familiar and uncontroversial (Cohen 2015, ch. 1). At the microeconomic level, most of the six roles can be expected to yield some measure of material benefit. In foreign-exchange trading, transactions costs are lowered for local enterprises while so-called "denomination rents" accrue to banks and other financial intermediaries from the volume of business done in their home currency. The trade role benefits domestic firms by reducing exchange risk, while the investment and reserve roles generate earnings for banks and other financial institutions that manage the claims owned by foreign investors and central banks. Large enterprises may also gain broader access to international financial markets, enabling them to borrow more cheaply and on a larger scale than they normally could at home. And ordinary citizens can also benefit to the extent that they are able to use their own money when traveling abroad—a not inconsiderable convenience.

Likewise, at the macroeconomic level, substantial gains can result from what is known as international seigniorage—the net material benefit that is generated whenever foreigners acquire and hold some amount of domestic money (including assets denominated in the domestic money, as well as cash) in exchange for traded goods, services, or foreign investment assets. Cross-border accumulations of the national money represent an implicit economic transfer that constitutes a real-resource gain for the economy as a whole.

The political side, by contrast, is less widely understood. How is state power affected? The key is whether monetary autonomy is increased, generating a potential for influence. In practice, only two of the six roles can be said to contribute directly to the issuer's capabilities in that sense. These are the two store-of-value roles—the roles that a money may play in financial markets and in central-bank reserves. Only the investment and reserve roles create a potential for expanded foreign holdings, thus making it easier for an economy to delay adjustment costs. None of the other currency roles offer the same value-added in power terms. If a money enjoys some measure of exorbitant privilege, that is due first and foremost to these two roles.

On its own, the investment role is the lesser of the two. That is because of the greater degree of currency diversification that we typically see in fi-

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nancial markets as compared with official reserves. At the private level, as many as eight to ten moneys figure prominently in global finance, spreading the contribution to autonomy widely. Nonetheless, the investment role is critical because it is an essential first step toward reserve-currency status. A given money can play an investment role even if never used as a reserve asset. The reverse, however, is unlikely ever to happen in a market-based currency system. Monetary history suggests that the investment role comes first and then, for a select few currencies, is followed by a reserve role in addition. And the reserve role is apt to add to capabilities much more than the investment role, because the currency composition of central-bank holdings tends to be more highly concentrated.

Indirectly, one other role also contributes significantly. That is the trade role, which plays a prominent part in determining the reserve preferences of central banks. In principle, most national monetary authorities are free to diversify the currency composition of their holdings as much as they like, so long as the assets they retain can be quickly converted, when needed, into a medium that is useful for intervention purposes. In practice, however, reserve holdings in most countries tend to be distinctly skewed, favoring one or two currencies in particular. Politics aside, reserve composition tends most often to reflect the pattern of currency denomination in an economy's foreign commercial relations. In that sense, the trade role too can be said to contribute to the exorbitant privilege.

By contrast, the remaining roles of an international currency—the vehicle, intervention, and anchor roles—offer little or no benefit in terms of state power, since they have little impact on monetary autonomy. None involves any accumulation of long-lasting holdings. Hence, none has any significant impact on the issuing country's ability to delay adjustment costs. No constraint on state action is removed or alleviated.

Significantly, the net impact of one role, the anchor role, might even turn out to be negative. The problem here is that pegging by followers can actually add to constraints on the issuing country's ability to resort to exchange-rate shifts as part of the adjustment process. With pegs, the nominal value of an anchor currency is determined not by the home government but by the intervention practices of others; and foreign preferences cannot always be expected to coincide with the interests of the issuer. Faced with external deficits, the issuing authority might wish to engineer a depreciation of its currency, to gain a competitive edge in foreign trade. But depreciation is impossible unless it is ratified by the interventions of the nation's trading partners, who might prefer that the currency is not depreciated. Other

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states retain the freedom to manage their own exchange rates. The market price of the anchor currency simply adjusts as a residual. In this sense, the issuer might actually lose a degree of policy autonomy.

The scope of a currency, therefore, matters a great deal. A money whose use is limited primarily to the foreign-exchange market or to international trade contributes little to the issuer's potential for leverage abroad. A money that is popular for store-of-value purposes, on the other hand, adds considerably to a country's foreign capabilities. I have emphasized that currency internationalization is not a monolithic concept. It is evident that neither is the exorbitant privilege.

Conclusion

State capabilities, it is evident, may be significantly affected by currency internationalization. But the impact turns out to be anything but simple, defying facile generalization. Outcomes are highly contingent. International currencies typically play different combinations of roles, and the power implications of those diverse roles can diverge quite substantially. Hence, potential degrees of political leverage can vary considerably as well. A nation's money provides the raw material for statecraft. The question is: What will policy makers do with it?

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TWO

From Capabilities to Statecraft

Currency statecraft is about the strategic management of a country's money to advance political objectives in international affairs. Now that we know where the potential for action comes from, we can begin to explore what governments may—or may not—try to do with it. Once a currency begins to gain appeal abroad, we can expect state capabilities, on balance, to be enhanced. The challenge for policy makers is twofold. First, what will they wish to do about their newfound capabilities? And second, will their actions be effective? These are the use and utility questions. Neither question is easily answered; nor are the outcomes of currency statecraft entirely predictable. The aim of this chapter is to set the agenda for the analysis to follow.

Influence

To begin, we must return to the generic notion of *influence*—the dimension of power that is most often emphasized in the IR or IPE literature. Autonomy may be key to understanding the roots of power—the potential for leverage. But influence will in many contexts be the ultimate goal of statecraft—putting capabilities to work. Varying degrees of influence can be observed every day in world politics.

For our purposes, however, it is important to keep in mind that influence can be exercised in more than one way. The most obvious route, as implied by Robert Dahl's (1957) early formulation, is the most direct: a calculated use of available policy instruments by A, including various forms of side payments (bribery) or sanctions (coercion), to get B to do something that B would not otherwise do. But as subsequent scholarship has made abundantly clear, it is also possible to exercise leverage more indirectly through

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the systemic infrastructure that determines the payoffs available to B. As Peter Bachrach and Morton Baratz (1962) usefully pointed out long ago, direct purposive action represents just one "face" of power, and perhaps not even the most important. Power may also have a *second* face that operates more indirectly through the constraints and opportunities created by the overall structure of relations. Susan Strange (1988) had the same idea in mind when she developed her notion of "structural power," which she defined as "the power to decide how things will be done, the power to shape frameworks within which states relate to each other" (1988, 24–25). Structural power, for Strange, was the power to set the agenda that defined the choice set available to others, regardless of their preferences.

There can even be a third route to influence that addresses not incentive structures, but rather the manipulation of preferences themselves. The idea of preference shaping was broached early on by Steven Lukes (1974) in what has since come to be called the *third* face of power—a capacity to influence the thoughts of actors in ways that persuade them to desire things that they might otherwise have ignored or opposed. In Lukes's words: "A may exercise power over B by getting him to do what he does not want to do, but he also exercises power over him by influencing, shaping, or determining his very wants" (1974, 23). The third face of power is essentially cognitive in nature, working through constitutive impacts on identity and interests along lines suggested by constructivist theory (Onuf 1989; Wendt 1992).

Closely related is the now familiar distinction between "hard" power and "soft" power first introduced by Joseph Nye (1990). Hard power derives from the material capabilities of a state, and is manifest in both the first and second faces of power. Soft power, by contrast, involves more intangible forms of influence derived from the attraction of a state's culture and ideologies, working at the cognitive level to shape perceptions, beliefs, and values. With its emphasis on co-option and identity, soft power corresponds most closely to the third face of power. As Nye himself put it recently, "Soft power rests on the ability to shape the preferences of others to get them to want what you want" (2008, 29). The third face of power is also roughly analogous to Antonio Gramsci's idea of cultural hegemony, which the well-known Marxist theorist identified as one of the central control mechanisms of global capitalism. Through a hegemonic culture, Gramsci argued, the values of capitalism become the "common sense" values of all, thus helping to maintain the status quo.

The three faces of power have been summarized by Colin Hay (1997) under the headings of *decision making*, *agenda setting*, and *preference shap-*

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ing. As we move forward in our discussion of currency statecraft, all three routes to influence should be kept in mind.

Context

What do we already know about currency statecraft? Not much, it seems. We know, broadly, how to define currency statecraft, and we know that it requires some measure of power resources derived from the pattern of monetary relations between nations. And we know that currency statecraft, like all forms of statecraft, is a behavioral concept demanding agency—a deliberate response to the opportunity offered by internationalization to convert available capabilities into effective action. Power resources alone are not enough. Purposive strategy is also involved. Currency statecraft is the joint product of both.

Beyond those generalities, however, our understanding is remarkably limited. The subject has received only rudimentary attention in the formal literature. Coverage is fragmentary at best. Most observers simply assume that with an international currency must come the exercise of influence, more or less as night follows day—a natural, spontaneous correlation. As Strange, in her typically pithy fashion, put it years ago: "It is highly probable that any state economically strong enough to possess [an international currency] will also exert substantial power and influence. The rich usually do" (1971a, 222). That is what I call the Immaculate Conception of Power—an unquestioned article of faith. But is the assumption necessarily accurate? The approach ignores the critical distinction between the potential leverage that is created by currency internationalization and the calculated effort that must be made if potential is to be converted into action. Capabilities are the starting point, outcomes are the end point—but what about the pathway from one to the other? The question is of vital importance, yet the literature offers few clues.

Economic Statecraft

Not that we should be surprised. Statecraft of any kind, currency or otherwise, remains a remarkably underdeveloped concept in formal theoretical terms. The word "statecraft" is bandied about a great deal in popular discussions of diplomacy or foreign affairs; one recent source, for instance, speaks of "institutional statecraft" as a shorthand simply for how governments think about the creation or management of multilateral institutions (Ikenberry and Lim 2017). Yet, in fact, the essential properties of the

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notion are not well understood. We know that statecraft goes beyond mere details of policy to some broader conception of grand strategy. But what determines the design of statecraft? When it is likely to be implemented? What explains the choice of instruments? What accounts for observed outcomes? Like power, statecraft is another somewhat mysterious notion.

Indeed, even its very definition is contested. Do we conceive of statecraft in terms of the tools that it uses or the goals that it might serve? Do we include actions that are domestic in nature, focused on the interests of the state at home, or do we concentrate more on the management of bilateral or multilateral relations abroad? Do we restrict the concept to coercive measures of one kind or another, or do we include positive inducements as well? Here too, as with the concept of power, consensus remains elusive across a wide range of issues. Hence, here too we have no choice but to settle for pragmatism in our analysis. Statecraft, too, must be regarded as contingent and dependent on context.

For our purposes, it seems most apt to follow the lead of Harold Lasswell's classic work *Politics: Who Gets What, When, How* (Lasswell 1936), as updated by David Baldwin in his highly regarded study *Economic Statecraft* (1985). In simplest terms, the two sources agree, statecraft can be defined as the art of conducting state affairs. Four broad categories of statecraft are distinguished:

1 *public diplomacy*: deliberate manipulation of symbols and information
2 *formal diplomacy*: representation and negotiation
3 *economic statecraft*: managing the availability of goods, services, or money
4 *military statecraft*: actual or threatened use of violence, weapons, or force.

Of interest here is the category labeled economic statecraft—regrettably, also an underdeveloped concept. One of his reasons for writing *Economic Statecraft*, Baldwin declared, was the "neglect of scholarly attention" to the topic (1985, 10). The literature needed "conceptual tidying up" (1985, 29). But only rarely in the decades since has his lead been followed by others, as surveys of the literature have mournfully noted (Mastanduno 1998). Economic statecraft, in the words of one recent commentary, has remained "an orphaned subject . . . underexplored territory" (Blackwill and Harris 2016, 6, 21). Baldwin's book, says another, remains stranded as a "single classic text" (Steil and Litan 2006, 1).

Scholars do generally agree on the basic meaning of the term. For Baldwin, the notion of economic statecraft was equated with the use of economic tools in pursuit of political goals. Most later discussions concur. For

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Benn Steil and Robert Litan, economic statecraft is "the use of economic means in the service of . . . traditional foreign policy ends" (2006, 2). For Robert Blackwill and Jennifer Harris, it is "the systematic use of economic instruments to accomplish geopolitical objectives" (2016, 1). And for Leslie Armijo and Saori Katada, it is "the employment by the state of economic levers as a means to achieve foreign policy ends" (2015, 46). But beyond that definitional starting point there is little true theoretical development. Scholarly literature on the subject, taken as a whole, is thin at best, leaving unanswered many questions about both the means and ends of policy. Rather than address the broad idea of economic statecraft as a conceptual challenge, most sources prefer more applied analysis of the policy behavior of individual nations. Not surprisingly, the United States draws a fair amount of attention (Dobson 2002; Steil and Litan 2006; Goldman and Rosenberg 2015; Blackwill and Harris 2016), but so too do other major powers—not least, today's China (Norris 2016).

Why is there so little formal study of economic statecraft as a general concept? In good part it would seem to have something to do with the multiplicity of instruments involved. In *Economic Statecraft*, Baldwin enumerated more than thirty policy tools "by which foreign policy makers might try to influence other international actors" (1985, 40), including everything from foreign aid and tariff preferences to trade boycotts and blacklists—and not even that lengthy list could be regarded as complete. Clearly, it is difficult to build a parsimonious theory with such a vast gaggle of variables. We could, of course, try to alleviate the problem by aggregating individual instruments under more general policy headings. By this strategy, one recent study was able to reduce the number of tools considered "suited to geopolitical application" to no more than seven (Blackwill and Harris 2016, 49). These included trade policy; investment policy; economic and financial sanctions; cyber policy; aid policy; financial and monetary policy; and energy and commodities policy. But even with that approach, the complexities are daunting.

Not surprisingly, therefore, most scholars take a more pragmatic approach, disaggregating the concept into component parts and narrowing their analytical focus to just one aspect of economic statecraft or another. For many, this means focusing on the *goal* of policy. Is the aim a good defense, in the hope of preserving autonomy at home; or is it more in the nature of a targeted offense, intended to exert influence elsewhere? For David Andrews (2006a), this is a choice between measures that are either internal or external in their orientation. For Armijo and Katada (2015), more colorfully, it is a choice between a shield and a sword. Either way, the distinction

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reduces to the question of what the purpose of state capabilities is meant to be. What meaning of power is at stake—autonomy or influence?

Following convention, most studies of this sort concentrate on influence rather than autonomy—on the use of leverage in one form or another to exercise authority or extract concessions. One source calls these "coercive economic measures" (Goldman and Rosenberg 2015, 1). For most of the world they are known simply as *sanctions*, including everything from trade embargoes to asset expropriations. Sanctions were at the core of Baldwin's *Economic Statecraft* (1985) and have continued to draw scholarly attention ever since. Indeed, a veritable cottage industry has grown up around the subject. Some analysts seek to identify the conditions that will determine the success or failure of sanctions (Drezner 1999; Blanchard and Ripsman 2008, 2013; Hufbauer et al. 2007; Early 2015). Others ask who can be expected to gain or lose from sanctions (Naylor 2001; Lektzian and Patterson 2015). A few even consider what role coercive economic measures may play in peacemaking (Lobell and Ripsman 2016).

More common, however, are studies that narrow the focus not in terms of goals, but rather in terms of *tools*—not the ends of statecraft, but the means. Attention is directed to specific economic policy categories that might be used for political purposes. Among the most salient of these categories is, of course, financial and monetary policy.

Money and Finance

The role of money and finance in statecraft should be a no-brainer. "No working politician," Strange and a colleague once rightly noted, "needs to be reminded of the political nature of monetary policy. . . . Decisions concerning the management of money substantially affect other matters of great political sensitivity" (Calleo and Strange 1984, 91). Yet here, too, we encounter a paucity of formal scholarship. Only a handful of serious studies can be found addressing the underlying characteristics and consequences of what is variously referred to as monetary statecraft or financial statecraft. Worse, there is not always a high degree of consistency across the literature.

Early in the development of the modern field of IPE, there were some scattered attempts to explore money's role in statecraft by, among others, Strange (1971b), Charles Kindleberger (1973), and myself (Cohen 1977). But then a hiatus set in that lasted more than two decades, until publication of Jonathan Kirshner's seminal *Currency and Coercion* in 1995 (Kirshner 1995), which systematically explored alternative strategies for the exer-

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cise of monetary influence. Pressure could be brought to bear, Kirshner wrote, in three ways: (1) currency manipulation, (2) fostering and exploiting monetary dependence, or (3) systemic disruption. Though he never actually used the term "monetary statecraft"—preferring instead labels like "international monetary diplomacy" or, simply, "monetary power"—statecraft clearly was what he had in mind. At issue, he said, was a state's use of "international monetary relations as an instrument of coercive power" (1995, 3). *Currency and Coercion* made a valuable contribution in reviving interest in the role of money as a geopolitical tool. But it could be faulted for failing to take much note of any distinction between capabilities and agency. For Kirshner, there was no difference. If a power resource was available, it would be used.

In more recent years, following Kirshner, a few other exploratory works have appeared. But for the most part, useful contributions have remained few and far between. The crucial distinction between monetary power as a measure of material capabilities and monetary statecraft as a matter of strategic behavior did not begin to receive any serious attention until publication of a landmark collection of essays on international monetary power edited by Andrews in 2006 (Andrews 2006b). As Andrews wrote in his introduction, "It is one thing to claim that power exists. . . . Efforts to exploit this relationship . . . are quite another matter" (2006a, 16). But little energy has gone into serious analysis of when the power of money might be actually be used. As one reviewer of the Andrews volume noted, "The contributors do not explain the conditions under which a powerful state will or will not refrain from translating its monetary power into monetary statecraft" (Halabi 2008, 101). The literature remains thin.

Indeed, scholars even seem unable to settle on a common working vocabulary. Is the subject *monetary* statecraft, typically defined to encompass such key issues as currency values (exchange rates), exchange-rate regimes, and currency use? Or is it *financial* statecraft, emphasizing more investment flows and the management of capital markets? While Andrews (2006a) saw fit to subsume both under the single heading of "monetary statecraft," others prefer to use the term "financial statecraft" to cover the same range of policy categories (Steil and Litan 2006). And then there are others who insist on a sharp separation between the two labels, such as Armijo and Katada (2015), though they also acknowledge that there may be unavoidable overlaps in some policy areas (what they call "modalities"). In their words: "In some cases, a given modality . . . may display a dual character" (2015, 48).

Whatever the vocabulary, it is clear that the number of policy catego-

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ries involved is considerable, inhibiting parsimonious theorizing. On pragmatic grounds, therefore, a case may be made for yet more disaggregation for analytical purposes—not just from the general concept of economic statecraft, where we started, narrowing down to the issue area of money and finance, but even further down to specific subsets of monetary or financial policy instruments. In this book, attention is directed to one policy instrument in particular: a country's own money. At issue are the special policy considerations raised by currency internationalization.

The justification for this narrow focus is the trade-off inherent in any study of statecraft: an unavoidable need to compromise between empirical breadth and analytical tractability. Currency statecraft may capture just one slice of the much wider concept of economic statecraft. But it is an especially important slice, with its own singular characteristics. Regrettably, in the extant literature, commentary on currency statecraft is typically embedded in broader treatments of monetary and financial relations. Questions specific to currency internationalization are obscured or glossed over. That is misleading. In practice, a country whose money may have international appeal faces issues like no others. Unique circumstances call for a correspondingly tight scrutiny.

Two issues, in particular, stand out: the use and utility questions. When will the potential of an international money be activated, if at all, and what determines the effective range of currency power?

Uses

Start with the use question. An international money, to repeat, generally adds to the power resources of the nation that produces it. Currency statecraft is about what the producer chooses to do with those power resources. What are the options available to policy makers?

The Immaculate Conception of Power implies a very limited menu of choice. Monetary muscle, if available, will be used—full stop! The correlation between currency internationalization and power projection is presumed to be direct, automatic, even deterministic. But that is wrong. In reality, governments have a much wider range of options to choose from. Considerable latitude exists for discretion in crafting policy.

Life Cycles

To understand the full menu of options that may be available, we must begin with a sense of history. If the past teaches us anything, it is that inter-

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national currencies evolve. They have a life cycle. Hence, the policy options available to issuing governments can be expected to evolve as well. Currency statecraft, too, will have a life cycle. Analysis must focus on how states act at each stage of a currency's evolution. Our subject is not a destination but a journey.

Conceptually, an international currency's life cycle can be characterized as a succession of two broadly self-reinforcing processes (Cohen 2015, 97–100). The model is elemental. First comes a "virtuous circle" in which the issuing state's underlying power resources promote internationalization of its money even while currency internationalization augments state power. But then, at some point, the virtuous circle is replaced by a more "vicious" circle in which underlying power resources come to be diminished. Over time, geopolitical decline saps the appeal of the currency, while simultaneously the weakening currency erodes economic and political capabilities. In the end, to revive an expression I first used decades ago (Cohen 1971), the currency becomes "domesticated," reduced largely to the monetary system at home. Others use terms like "de-internationalization" (Helleiner 2014) or "contraction" (Kirshner 2008).

The forces that drive the initial virtuous circle have already been described in chapter 1. They include an issuing state's economic size, financial development, foreign policy ties, military reach, and effective governance. As state power accumulates, the country's currency will gradually move up in the global hierarchy. A few moneys may even make it to the very top of the currency pyramid. The virtuous circle has been repeated in the rise of every international money in history, from the Athenian drachma in classical times to, quite strikingly, the Chinese yuan today.

The duration of the virtuous circle may be quite lengthy, lasting decades, and in some cases even centuries. International currencies are not born fully developed like Athena from the forehead of Zeus. Rather, competitiveness tends to cumulate slowly, as market actors and central banks gradually come to appreciate the advantages that a new entrant may have to offer. The mutual reinforcement of currency internationalization and state power may then go on for a very long time.

Sooner or later, however, a tipping point will be reached. History is clear on this. Across the ages, no international money, however popular, has managed to escape the clutches of time forever. The journey has not only a beginning but an end. Who, apart from students of numismatics, now remembers the Byzantine solidus or the Spanish-Mexican silver peso, though both were once widely used? "One thing about life is for sure," an old joke goes. "None of us will get out of here alive." That would seem to be true

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of international currencies as well. In effect, the money starts to slide back down the currency pyramid and is used for fewer and fewer international purposes. In the twentieth century, that is what we saw in the long, agonizing decline of the pound sterling. Today it is what many fear we may be seeing—or may soon see—in the historical arc of America's greenback. Such fears are almost certainly premature, as I shall suggest in chapters 5 and 6. But even so, it is hard to imagine that the greenback will remain on top forever. Forever is a very long time.

The tipping point comes when outsiders begin to abandon the currency, limiting the borrowing capacity—the ability to run "deficits without tears"—that is at the foundation of a money's contribution to state power. Two factors are most likely to influence outcomes. On the one hand is the vulnerability associated with an accumulation of an excessive "overhang" of foreign liabilities, which affects the demand side of the equation. The more the issuer comes to rely on its exorbitant privilege, thus adding to its external debt, the more likely it is that investors and central banks will eventually begin to look elsewhere for a more reliable store of value. On the other hand is the availability (or not) of sufficiently attractive alternatives, affecting the supply side of the equation. How dominant is the currency? Investors and central banks may wish to find a safer place for their wealth, but will there be any out there? Even if vulnerable, an incumbent benefits from path dependence. Challengers may find it difficult to offer advantages sufficient to persuade agents to make a potentially costly change. Since both factors rely much on market psychology, which is notoriously fickle, the timing of the tipping point is obviously difficult to predict. But with history as our guide, we can be sure that the turn will inevitably arrive.

In Hollywood's film industry, it is often said that there are really only three basic stories in the journey we call life: coming of age, midlife crisis, and coping with the approach of death. Correspondingly, three comparable stages can be distinguished in the life cycle of an international currency. These may be labeled *youth*, *maturity*, and *decline*. Each lap of the journey poses its own distinct challenges for the strategic management of a nation's money.

Policy Options

At each stage, in principle, three broad policy options are possible. Statecraft may be proactive *in favor of* internationalization; it may be proactive *in opposition to* internationalization; or it may be *passive*, declining to take action either for or against internationalization. Three options at each of

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three stages makes for a total of nine options over the full length of an international money's life cycle—a comprehensive taxonomy of currency policy choices. None of the nine options is without relevance. As we shall see in subsequent chapters, every one of these possibilities has been adopted in the modern era by one country or another at some time or other.

During a currency's youth, while the money's appeal is still being established, the capabilities associated with internationalization are not yet fully ripe. At this stage, the challenge for the issuing authority is not what to do with an international currency. That would be premature. The question, rather, is more existential: Is internationalization even wanted? For some, internationalization may be viewed as a welcome opportunity. For others it may seem an ominous threat, posing more risk than reward.

In response, three options are possible: promotion, prevention, or permission. Attracted by the potential advantages of internationalization, the issuer may wish to take action to *promote* wider use of its currency. Conversely, worried about possible costs or risks, it may actively seek to *prevent* foreign acceptance. Or alternatively, it may wish to avoid any intervention at all, electing simply to *permit* internationalization to proceed on its own. These three options define the menu of choice for currency statecraft at this early stage.

Once a promising young international money manages to reach maturity, however, the menu changes. The question now is not existential but practical: How does the nation live with an international money? Options at this stage are exploitation, evasion, or enjoyment. The issuer may consciously seek to *exploit* the advantages offered by the newfound power resource; conversely, it may look for some way to *evade* potential risks of currency internationalization; or, in a more passive mode, it may simply opt to sit back and *enjoy* whatever benefits may come its way.

Each of these three options, obviously, is an analogue of one of the three strategies available during the preceding youthful stage. None, however, is necessarily dictated by a previous choice. A country that initially tries to promote wider use of its money may come in time to regret its choice, and may now opt for escape. Conversely, an issuer that first seeks to prevent internationalization may eventually learn to enjoy or even exploit its potential for influence. Past is not necessarily prologue when governments decide what to do as their currencies reach maturity. Faith in the potency of the temptation to exploit currency power is what animates the Immaculate Conception of Power. But the historical record, as we shall see, demonstrates that the exploitation option is not an inevitable choice.

Finally, there is the prospect of decline, when a currency begins to lose

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its international appeal. The challenge now is to *cope*: how best to live with fading eminence. Again the choices are three: resistance, reinforcement, or relaxation. These, too, are analogues of the preceding sets of choices, but are not dictated by them. Just as policy makers may seek to promote internationalization during the youthful stage, they may now strive to *resist* abandonment of their currency, hoping thereby to preserve at least some of the benefits of international use. Alternatively, analogously to prevention in the youthful stage, they can seek to *reinforce* the process of decline in hopes of managing a "soft landing" for the currency. In this case their aim is to get out of the international currency business as painlessly as possible. Or, finally, as with the permission option, officials may just *relax* and let market actors and foreign central banks decide matters. None of the three options is what observers normally think of when considering the concept of currency internationalization. But all are also inherent parts of currency statecraft's journey.

Obviously, only a few governments are ever obliged to make a choice among any of these options—only those whose currencies actually show promise of international appeal. We know that the number of such moneys will always be small. That is part of what makes the challenge of currency statecraft so singular. But, notably, these few suppliers are apt to be among the biggest powers in the global system. In geopolitical terms, they inevitably carry a lot of weight.

Utility

The menu of choice, however, is only half the story. Equally important is the utility question. Policy officials may know their mind, but that does not mean they will always get their way. However much central decision makers may wish to impose their will on currency choice, they are rarely in a position to dictate outcomes. They may well find their statecraft frustrated by forces beyond their control. As the old Scottish saying has it, the best laid plans of mice and men oft go awry. What determines how successful governments may be in realizing their monetary preferences?

Limits on currency statecraft may be broadly distinguished in terms of their origins. Some constraints arise at home, others abroad.

At home, the issue is whether the government can effectively implement relevant policy measures. In practice, central decision makers may be stymied by resistance from key interest groups or by the complexities of the country's political institutions. Domestic socioeconomic cleavages may shrink a government's room for maneuver in foreign relations. Or strategic

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aspirations may be thwarted by the institutional settings through which diverse interests are mediated and converted into policy. As Robert Putnam (1988) famously reminded us years ago, statecraft is a "two-level game" in which external initiatives can be severely hampered if they do not accord with the configuration of internal preferences.

Abroad, strategy may be blocked by user preferences or by the actions of competing states. Nations, being sovereign, are free in principle to implement measures to influence currency choice if they like. But whatever their aim, whether to encourage or discourage use of their money, the outcome in practice will very much depend on what the outside world chooses to do in response. Currency statecraft is not made in a vacuum.

On the one hand are currency users of all kinds, including foreign central banks (in their reserve asset decisions) as well as private traders, lenders, and investors. Nonresidents, we know, typically cannot be compelled to make use of one money rather than another. As indicated, they must instead be *persuade*d to go along with an issuing government's preferences. That may not be easy to do. The greater the divergence between the issuer's ambitions and demand-side sentiment, the less likely it is that currency statecraft will be successful.

On the other hand are other issuing governments, who may have quite different ambitions of their own. Monetary rivalry, it will be remembered, is an integral part of geopolitics. The stakes are high and the risk of contestation is ever present. Any one state's policies might meet with resistance, if not outright opposition, elsewhere. The greater the threat of conflict with competing states, the more likely it is that currency statecraft will fail.

Conclusion

In summary, our agenda is clear. Two questions dominate. First, what accounts for a government's choice of strategy at each stage in the life cycle of an international currency? And second, what explains why their currency statecraft may succeed or fail? The following chapters seek to provide answers.

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THREE

A Theory of Currency Statecraft

We have established that over the life cycle of an international currency, the menu of choice for decision makers is considerable: a trio of broad options at each of the three stages of youth, maturity, and decline, comprising a taxonomy of nine policy alternatives in all. The central question is: Can we explain the choices that governments actually make, from among these options, at each stage? Can we move beyond taxonomy toward a genuine *theory* of currency statecraft?

A good place to begin is with the empirical record. How have governments behaved in the past? This chapter will start by laying out in broad strokes what we know about the general orientation of international currency policies in the modern era. Practical details will be kept to a minimum in order to highlight key similarities and differences. Fuller historical narratives will be provided in the chapters to follow. My aim here is to show that even a cursory review of recent experience suffices to provide a reasonably consistent explanation of government choices.

Most discussions of international money are dominated by professional economists and typically concentrate on technical economic and financial matters. But if the evidence cited here is to be believed, that is far too narrow a view of the way the world actually works. In practice, much more is involved at each stage in a currency's life cycle. Beyond purely material concerns, I contend, policy is shaped by deeper cognitive considerations having to do with a nation's sense of its underlying norms and priorities—in short, its sense of *identity*. At issue, in particular, is the extent of a society's *geopolitical ambition*. How driven is it to build or sustain a prominent place in the community of nations? A credible theory of currency statecraft, the record suggests, must be set in this wider ideational context, where policy

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choices are grounded in the shared values and goals by which a society defines itself.

As emphasized in the introduction to this book, this does not mean that the nation as a whole somehow makes the decisions. The state is not a unitary actor. Currency statecraft is the responsibility of policy elites who, among themselves, may differ quite substantially over how to interpret their society's sense of identity in practical policy terms. My assumption is that certain fundamental principles can be expected to prevail no matter who is in charge. At this basic cognitive level, government officials can be regarded simply as a channel for the nation's most intensely held assumptions and beliefs.

In short, currency statecraft is about much more than just currency. At bottom, it is about how a society sees itself in relation to others—an integral part of what IR scholars mean by grand strategy in foreign policy. War, Georges Clémenceau famously declared, is too important to be left to the generals. My argument, by analogy, is that currency strategy is too important to be left to the economists.

The Empirical Record

As we know, the sample of international currencies in recent history is small. Included, in addition to the US dollar, are no more than a half dozen or so of other moneys, ranging from patrician currencies like the euro and yen to lesser elite currencies like the British pound, the Swiss franc, the Australian and Canadian dollars, and, increasingly, China's yuan. Yet even in this small handful of cases, the diversity of policy choices is striking. Behavior has been anything but uniform. There is no central tendency toward which all governments gravitate.

In fact, every one of the nine policy options outlined in the menu of choice has been adopted at some point in time by one country or another. The full taxonomy of options can be represented by a simple three-by-three matrix, as in table 3.1. A brief review of experience since World War II shows that there is not a single empty box in the matrix. Every possible option has been elected at least once.

For instance, in the first row of the table, representing currencies in the stage of youth, we see all three options represented. Back in the 1960s and 1970s, when the Deutsche mark and yen were becoming increasingly popular for a variety of cross-border uses, both West Germany and Japan tried hard to resist internationalization. Prevention clearly was their pre-

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Table 3.1. Policy options

	Proactive (in favor of internationalization)	Proactive (opposed to internationalization)	Passive
Youth	Promotion (China, 1990s Japan)	Prevention (West Germany, pre-1990s Japan)	Permission (eurozone)
Maturity	Exploitation (US most of the time)	Evasion (US on occasion)	Enjoyment (other top-tier currencies)
Decline	Resistance (pre-1960s Britain)	Reinforcement (1960s Britain)	Relaxation (post-2003 Japan)

ferred option. By contrast, China more recently has taken precisely the opposite tack, actively promoting the international status of its currency, as did Japan briefly in the 1990s before formally giving up the effort in 2003. Members of the eurozone, meanwhile, declared from the start that they would remain steadfastly neutral on the issue of internationalization, preferring the passive permission option.

Similarly, in the second row—representing the stage of maturity—we find that most top-tier currencies have also settled for passivity, choosing simply to enjoy whatever advantages internationalization might provide. These include today's euro and yen, closest to the US greenback in most international rankings, as well as the British pound, Swiss franc, and Australian and Canadian dollars. Only the United States, in the modern era, has shown much inclination to self-consciously exploit the capabilities created by internationalization, though even here there have been exceptions—particularly on occasions when the dollar has come under intense speculative pressure, as in the late 1960s and again in the late 1970s. At such moments, Washington has also considered initiatives to evade the risks involved.

Finally, in the bottom row, representing decline, we find two currencies. One is Britain's pound, once the world's top currency, now just a shadow of its former self. The other is the yen—today a mature top-tier currency, but one that suffered through a prolonged and painful decay of status after the bursting of Japan's "bubble economy" in 1989. For the United Kingdom, currency statecraft evolved from actively resisting decline prior to the 1960s to a policy of managed "domestication" in the 1960s and 1970s. For Japan, the passive relaxation option has prevailed since Tokyo abandoned its promotion strategy in 2003. Some might suggest that the US dollar too should be placed in this category, but signs of decline in the greenback's

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popularity to date have been faint at best. By virtually every practical measure, the dollar remains as widely used as ever (Cohen 2015).

Geopolitical Ambition

How do we explain this mixed empirical record? Without any central tendency in policy choices, the analytical challenge appears daunting. Though the sample of cases is small, the differences of behavior are great. Where some issuers have favored internationalization, others have opposed it; and over time a few have shifted their preferences considerably from one option to another. Amidst such diversity, any theoretical generalization would seem difficult if not downright foolhardy.

In principle, any number of causal variables might be expected to be involved. We are all aware of the limitations of monocausal explanations of behavior in the social sciences. But at first glance we find few consistent relationships in the mosaic of choices described in table 3.1. Economists might emphasize the role of an issuing country's economic size, the sophistication and openness of its financial markets, or the quality of its macroeconomic management—all key factors that make a money competitive internationally, as noted in chapter 1. But none of these attributes distinguish clearly between nations that have been proactive in favor of internationalization and those that have been opposed. Large economic size, financial development, and effective inflation control are characteristic of nearly all the economies listed in the table, whatever the particular orientation of their currency policies.

Similarly, political scientists might lay stress on political regime type or foreign policy ties (also noted in chapter 1), but here too there is little to distinguish among currency statecrafts. Apart from China, all issuing countries have been democracies, and all including China have been extensively engaged in international affairs; yet their monetary strategies have been strikingly different. Moreover, in cases such as Britain or Japan, currency policies have changed dramatically even as regime type or foreign ties have remained largely stable.

Finally, some might point to domestic politics—the role of diverse interest groups and the social and political institutions through which preferences are aggregated and mediated. Over the past quarter century, an extensive literature has arisen addressing the purported domestic determinants of monetary or exchange-rate choices, much of it inspired by the seminal work of Jeffry Frieden (1991). While some scholars focus directly on prefer-

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ence formation (Walter 2015; Frieden 2015; Steinberg 2015), others concentrate on the influence of institutional arrangements (Leblang 1999, Bernhard and Leblang 1999; Broz 2003; Bearce 2003; Bearce and Hallerberg 2011). But the sad fact is that for all the effort that has gone into such scholarship, little consensus has emerged to provide a practical guide to policy analysis. In the real world, both group interests and sociopolitical institutions tend to be too opaque and fluid to permit unqualified generalizations (Cohen 2017).

Upon closer inspection, however, one remarkably consistent pattern of behavior does begin to emerge. One factor, above all, seems to correlate closely with policy choices. That factor is the extent of an issuer's *geopolitical ambition*. For analytical purposes, geopolitical ambition may be defined broadly in terms of power relations.

Power, I have suggested, has two distinct dimensions: autonomy and influence. Autonomy, the ability to act with a minimum of outside restraint, is the objective of every sovereign nation. But only a minority of states can aspire to build on their autonomy to exert influence as well—to project force and seek to control outcomes beyond their borders. Geopolitical ambition embodies a desire to exercise authority in relation to others; to be considered a significant player in the broad game of world politics. Does the state take an active role in international affairs? Does it expect others to follow its lead? Does it assume some measure of deference as its natural due? Ultimately, geopolitical ambition is a reflection of *how a nation defines its proper place in the global order*.

Of course, material capabilities also matter. For a small nation with few sources of leverage, global aspirations must perforce be limited. Liechtenstein can hardly ever hope to rank as a great power. Geopolitical ambition is unrealistic if not backed by a fair amount of muscle. But that does not mean that material capabilities are all that matter. That way, once again, lies the misleading Immaculate Conception of Power, which fails to distinguish between potential and agency. To repeat: power is not destiny. Throughout history, some potentially influential nations have chosen *not* to put their muscle to work, however tempting the prospective dividends. A high level of capability may be necessary in order to aspire to influence, but it is not sufficient.

A connection between currency choice and geopolitical ambition seems logical. For societies eager to project power in the world, proactive currency strategies of promotion or exploitation or resistance (depending on where their money happens to be in its life cycle) clearly make sense. A desire to build or sustain an international currency follows naturally from an aspi-

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ration to be a major regional or global power. Conversely, for issuers that would instead prefer to avoid the risks or responsibilities of a leadership role, the reverse would seem to be true. The options of prevention, evasion or reinforcement are more likely to be adopted. The passive choices of permission, enjoyment or relaxation may be seen as default settings for nations that are more ambivalent, unable or unwilling to make up their mind. Some countries in this category may settle for a neutral stance because they are genuinely unsure whether the benefits of a more proactive policy would outweigh the costs. Others might be hampered by domestic political divisions. The connection is not tautological but causal, emphasizing a motivating factor that is largely ignored in conventional discussions of currency statecraft.

Most importantly, the connection is supported by the evidence. A pattern linking currency choice and geopolitical ambition is clearly visible in the columns of table 3.1. All the issuers in the first column, who chose proactive policies *in favor of* internationalization, are countries that were or are well known for their geopolitical ambition. That is certainly true of today's China, which has made no secret of its determination to regain its historical place as one of the world's great powers. Likewise, it is obviously true of the United States, sometimes called the world's last superpower. It was so for Britain in the early years after World War II, when London still aspired to preserve the remnants of its once grand empire. And it may also be said of Japan briefly in the 1990s, when Tokyo was confronted with the sudden emergence of China as a serious regional rival.

Conversely, most of the issuers in the middle column, which have chosen proactive policies in opposition to internationalization, were at the time well known for their *rejection* of geopolitical ambition. These include both West Germany and pre-1990s Japan, each content during the years of the Cold War to shelter beneath America's nuclear umbrella. And of course they include the United Kingdom as well, once London accepted that the days of imperial glory were over. The only possible anomaly would seem to be the United States, which as indicated has at times seemed ready to abdicate some of its hegemonic privileges. Such moments of self-doubt, however, have been relatively rare.

Finally, there are those in the third column, whose currency statecraft has remained essentially passive. On the one hand, none of these issuers—neither the eurozone nor the producers of today's lesser elite currencies nor post-2003 Japan—have shown much inclination to project power beyond their borders. Yet on the other hand neither are they shy wallflowers, eager to retreat from the world. For them a nonactivist posture, receptive but not pushy, makes the most sense.

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Can a credible theory of currency statecraft be built on the foundation of this observed pattern of behavior? Three steps are required. First, we need to show that there is indeed policy space—practical opportunity for choice. Currency strategy in any given circumstance cannot be limited to just a single policy option. There must be room for human agency. Second, the plausibility of geopolitical ambition as a legitimate causal variable must be established. That requires grounding the notion firmly within the more conventional concept of national identity, which is already quite familiar to students of IR and IPE as a driver of behavior. And third, the practical connection of the general concept of geopolitical ambition to the specific issue of currency internationalization must be affirmed. There must be a demonstrable causal link between identity and money.

Policy Space

The first step is the easiest. We know that economic policy making, whether domestic or international, is as much art as science. Pure economic theory, based on a rationalist methodology, can point us in the right direction, but it is rarely unequivocal. At best, economic logic can set the parameters for policy choice in any given instance—the outer boundaries of a government's policy space. But within that space other considerations come into play to determine policy outcomes in practice. Human agency is at work. The point has been well summarized by Jonathan Kirshner (2003, 4,7):

> Economic theory is indeterminate in its ability to account for most policy choices. . . . Economic logic limits the range of policy choices to a plausible set, but the outcomes observed are largely attributable to politics. . . . Economic theory rarely tells us anything definitive. . . . In any given setting economic logic will effectively rule out certain options. But there will almost always remain a range of policies that are plausible—that is, economically coherent. And here economic theory will have little to tell us about the path chosen from this plausible set.

The indeterminacy of economic theory as a guide to policy is especially evident in the context of currency internationalization. For any country whose money gains international appeal, there are both benefits and costs (Cohen 2015, ch. 1; Helleiner 2017). Multiple trade-offs, therefore, are inevitable. A rationalist cost-benefit calculus may rule out some options, but it is unlikely to settle unambiguously on a single choice in any given circumstance. With so many variables at play, there can be no single optimum

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to dictate policy behavior. Kirshner (2003, 3) calls this "the inescapable politics of money."

The list of an international currency's benefits and costs is lengthy, including both economic and political considerations. On the positive side are at least five broad classes of potential gain:

Transactions costs. At the microeconomic level, as suggested in chapter 1, currency internationalization promises a variety of benefits to domestic market actors. Perhaps most prominent is a potential boost to profits in the banking sector, which enjoys privileged access to the resources of the issuing country's central bank. Business can be expanded abroad at lower cost, generating greater earnings than would otherwise be possible. Nonfinancial enterprises also gain from their enhanced ability to do business abroad in home currency, thus lowering exchange risk. And ordinary citizens can enjoy the convenience of using their own money when traveling abroad.

Seigniorage. Technically defined as the excess of the nominal value of a currency over its cost of production, seigniorage at the international level is generated whenever nonresidents acquire some amount of domestic money in exchange for traded goods and services. Foreign accumulations of the currency represent an implicit economic transfer that constitutes a real-resource gain for the economy as a whole.

Macroeconomic flexibility. Cross-border use of a currency can also loosen the constraint of the balance of payments on domestic monetary and fiscal policy, enhancing the issuing state's power to delay external adjustment—in the familiar phrase, the power to run "deficits without tears," otherwise known as the "exorbitant privilege." In effect, external market discipline is relaxed. The greater the ability to finance payments deficits with a country's own money, the easier it is for policy makers to pursue public spending objectives.

Leverage. Political influence is a fourth possible benefit of an international currency. Involved here is what political scientists call "hard" power. As we saw in chapter 2, material capabilities may be enhanced either directly or indirectly—the first and second faces of power. Key to either face of power is the element of dependence that is created as nonresidents come to rely on a national money for a variety of international purposes. The dependence of others puts the issuer in a position to exercise leverage through its control of access to vital financial resources. The more others rely on a currency, the greater is the issuer's potential capacity for pressure or control.

Reputation. Finally, at the cognitive level, widespread international use of a currency can promote the issuer's overall reputation in world affairs.

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Broad circulation may become a source of status and prestige, a visible sign of elevated rank in the community of nations. Influence is exercised through "soft" power—the third face of power—rather than via hard power. The national currency can play a potent role as a symbol of international primacy.

Conversely, on the negative side are at least three possible costs or risks:

Appreciation. One risk of internationalization is the undue exchange-rate appreciation that could result from increased foreign demand for a currency. The more a money gains in popularity, the greater is the likelihood that some degree of overvaluation will result. For the nation's consumers, appreciation actually represents a benefit, since purchasing power is increased. But for producers the effect is distinctly negative, since the competitiveness of exports and import-competing output will be eroded.

External constraint. Even more serious is the possible constraint that could be imposed on domestic monetary autonomy by an excessive accumulation of liquid foreign liabilities. Macroeconomic flexibility could eventually be compromised by a growing "overhang" of easily movable debt, whether in cash or in the form of claims denominated in the home money. Two dangers are posed for the issuer's central bank. One is the risk of volatile movements into or out of the currency, which could make the demand for money less stable in aggregate terms. At any given time, policy makers may find it more difficult to target interest rates or an appropriate growth rate for money supply. The other risk is that over time, domestic policy may become increasingly hostage to external factors, especially if doubts begin to mount regarding the currency's future value or usefulness. Ultimately, to persuade investors abroad to hold onto their accumulated balances, priorities at home may have to be compromised or sacrificed.

Policy responsibility. Last is the possibility that in return for the benefits it receives, an issuing country will find itself obliged to assume greater responsibility for management of broader regional or global monetary structures. Quite apart from market-driven pressures on its central bank, the issuer may find itself called upon to accommodate systemic needs or fragilities should conditions warrant. Monetary policy may have to be modified to contain a crisis, or subsidized credits may have to be provided to rescue some country in distress. The contingent political claim that goes with monetary leadership is in effect the flip side of internationalization's exorbitant privilege—a kind of "exorbitant duty."

The challenge for policy makers is twofold. First is the issue of measurement. How can all these diverse elements be estimated for purposes of comparison? To some degree it might be possible to quantify consider-

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ations like transactions-cost savings or seigniorage, though even for these it is easy to see how judgments might differ significantly. But in some cases it may not even be possible to offer any sort of reasonable estimation in monetary terms. What number can be placed on the benefit of reputation, for instance, or on the cost of policy responsibility? Measurement in such cases is inherently subjective, if not purely conjectural.

Second is the issue of weighting: the relative importance to be attached to each of these diverse elements. Here is an apt example of what is known as the "index number problem"—the difficulty of constructing a single valid index to represent a cluster of diverse variables. Opinions may differ over what is more or less critical. How valuable is the potential for leverage, say, as compared with the risk of external constraint? How essential is macroeconomic flexibility as compared with the possible costs of exchange-rate appreciation? Here too, subjectivity reigns.

With challenges like these, can there be any doubt that in policy-making circles, sincere individuals might sincerely disagree? The parameters for policy choice inevitably leave room for some degree of discretion. Decisions are by no means limited to a single policy option. In Eric Helleiner's words (2017, 10),

> There are numerous implications of [international currency] status, many pulling in opposing directions. . . . In this context, any official effort to determine the national interest from an aggregate cost-benefit calculation will be shaped heavily by the subjective values and specific concerns of the policymakers making the assessment. Politics, in other words, will be central to the choices that governments make about policy toward the [international] status of their country's currency.

National Identity

How, then, are choices ultimately made? Within the policy space afforded to governments, cognition inevitably takes center stage—ideas that are rooted in the subjective values stressed by Helleiner. We have long known that norms and logics of appropriateness usefully create a focal point around which decisions can coalesce (Goldstein and Keohane 1993). Policy makers may like to think of themselves as wholly objective, but in reality subjective influences are bound to creep into their judgments. That means ideas. As Kirshner (2003, 23) puts it, "It is impossible to understand the choice of policy from the plausible set without understanding the role of ideas."

Admittedly, psychological considerations of this sort are notoriously

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difficult to pin down empirically. But that does not deny their centrality. The interplay of beliefs and decision making lies at the heart of the new behavioral revolution that has been imported in recent years into IR and IPE from the disciplines of psychology and economics (Hafner-Burton et al. 2017). Increasingly it is understood that the traditional rationalist approaches to international studies, while undoubtedly valuable, provide at best an incomplete model of social behavior. In the real world, our choices are ruled as much by subjective raw emotions as they are by objective utility calculus. To some degree, we are all prisoners of our ideas.

As a practical matter, policy is almost always made under some shadow of obscurity, where actors' interests are unclear. Economists, following the early lead of Frank Knight (1921) and John Maynard Keynes (1936), conventionally distinguish between *risk*—conditions where the probability of outcomes can be calculated with some reasonable degree of confidence—and *uncertainty*, where underlying structures may be in flux and not enough information is available to fully inform decisions. In the real world, risk and uncertainty are inextricably mixed, forcing actors to look for heuristic devices and mental shortcuts for guidance. The greater the degree of uncertainty, as Stephen Nelson and Peter Katzenstein (2014) have recently reminded us, the more decision makers can be expected to fall back pragmatically on shared beliefs and social conventions to help them find their way. The ideas that motivate policy choices may at times be explicitly articulated. In most circumstances, however, they need not even rise to the level of consciousness in order to influence behavior. They may be fully internalized, existing as no more than hidden, unquestioned assumptions.

In the case of currency internationalization, the ideas that matter most involve connections with the outside world. What drives a government toward one currency strategy rather than another? My argument is that, above all, statecraft is shaped by a society's sense of identity in relation to others. At issue, I contend, is the extent to which geopolitical ambition figures in a nation's approach to international affairs. My assumption, to repeat, is that the specific decisions of policy elites are fundamentally grounded in the nation's most cherished values and norms.

The Broad Concept

National identity has been broadly defined in the social sciences as "what a state, explicitly or implicitly, regards as distinctive in contrast to other states deemed important" (Rozman 2012, 1). In recent years the concept has come to be widely accepted among scholars as a valid contributor to

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our understanding of economic statecraft. In the words of Helleiner and his colleague Andreas Pickel (Helleiner and Pickel 2005a, vii), "National identities . . . exert an important influence on economic policy in a wide range of countries and contexts." An apt example is provided by the sociologists John Campbell and John Hall (2017), who examine why many small states can cope effectively with the forces of economic globalization despite considerable vulnerability. The key, they argue, lies in the strength of their sense of national identity and solidarity. In their words, "a sense of 'we-ness' . . . facilitates building thick institutions that lead to resilient outcomes."

In the literature of international relations, the concept of national identity has a distinguished lineage dating at least back to the rise of nationalism in nineteenth-century Europe. In 1945 the eminent historian E. H. Carr (1945) wrote a seminal book devoted to exploring the powerful role of nationalism in international politics. And just a few years later Hans Morgenthau, in his magisterial *Politics among Nations*, placed great emphasis on the centrality of what he called "national character" in global affairs. National character, he insisted, stands out for its "permanent and often decisive influence upon the weight a nation is able to put into the scales of international politics" (Morgenthau 1948, 134). By the 1970s, discussions of the role of "national role conceptions" were becoming commonplace among IR scholars (Holsti 1970; Walker 1979). And in the 1990s the role of decision makers' perceptions received new emphasis in a strand of the literature that came to be known as "neoclassical realism" (Rose 1998). In neoclassical realism, factors such as identity are seen as critical intervening variables in the causal relationship running from power to action.

In formal studies of international political economy, however, the concept of national identity did not come into its own until the late 1990s, influenced above all by the introduction of constructivism as a new way for scholars to think about world affairs (Onuf 1989; Wendt 1992). There had been some earlier hints, of course. As early as 1951, Charles Kindleberger wrote that "a rounded theory of social behavior would include economic drives as only one strand in a broad web of social motivation" (Kindleberger 1951, 30). But there were no serious efforts to develop the notion of "social motivation" before the arrival of the constructivists, for whom the role of identity is all-important. In the words of Richard Ned Lebow (2016, 1): "Identity is as central to the constructivist paradigm as power is to realism and wealth to liberalism." Identity is important because it is what drives the formation of interests—what Kindleberger seemed to have in mind when he spoke of social motivation. First we must know ourselves; then we will know what serves us best. That is as true for nations as it is for indi-

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viduals. Rawi Abdelal (2001, 1) makes the point succinctly: "What societies want depends on who they think they are."

The core focus of constructivism is on socialization: the construction of shared values and norms. Where do conceptions of identity come from, and how do they influence behavior? As Emanuel Adler (2013, 113) summarizes, "Because the material world does not come classified, the objects of our knowledge are not independent of our interpretations and our language, and are therefore social artefacts." Ideas matter, not just instrumentally but also in constitutive terms, as fundamental determinants of identities and interests. Perceptions, values, norms, beliefs—all rest on a foundation of shared, intersubjective understandings and narratives that give content to the material world and legitimize a particular version of reality. Meanings are socially constructed; they are "social facts."

The construction of national identity begins with the notion of the nation itself. A basic premise of students of nationalism, going back to seminal contributions from, among others, Ernest Gellner (1983) and Anthony Smith (1991), is that the nation as such does not exist in some primordial sense. Nations are not given by nature. Rather, the idea of a nation is a mental construct, the product of experience and long-term socialization; in Benedict Anderson's (1983) memorable phrase, the nation is an "imagined community." To imagine a nation necessarily involves differentiating it from others. A nation cannot claim to exist if it is not assumed to have a separate and distinctive identity.

Particularly influential in bringing cognitive analysis into IPE was Katzenstein—for example, in his monumental *A World of Regions* (2005), where elements of political economy were skillfully interwoven with security and cultural analysis in an effort to understand the role of regions in an increasingly globalized environment. It is ironic, given Katzenstein's earlier role as a pioneer of the modern field of IPE (Cohen 2008), that his first forays into constructivism would turn out to center on international security issues rather than economic affairs (1996a, 1996b). His aim was to highlight how distinctive national identities shaped perceptions of a state's security interests. But his lead was soon followed by a new generation of younger IPE scholars, including Abdelal (2001), Andrei Tsygankov (2001), and Helleiner and Pickel (2005b)—all stressing how national identities could help shape perceptions of economic interests as well. Abdelal was a student of Katzenstein, and Helleiner and Pickel specifically credit Katzenstein's work on security issues as an inspiration for their own efforts.

Since the turn of the century, studies of the role of national identity in economic statecraft have multiplied exponentially. Both Abdelal (2001)

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and Tsyganskov (2001) focused on the strikingly divergent policy paths followed by various successor states after the breakup of the Soviet Union in 1991. While some of the former Soviet republics quickly embraced a Western orientation in trade and finance, others struggled to reintegrate as much as possible under the banner of the newborn Commonwealth of Independent States (CIS). What could account for such marked differences? Abdelal and Tsygankov both located the explanation in variations in each new state's sense of self. The stronger the sense of a genuine national identity, the more likely a government was to distance itself from the CIS.

Subsequently, the national-identity theme has been extended to many other parts of the world. Some scholars have looked to East Asia, addressing such salient cases as Japan (Lehman 2007), Taiwan (Chow 2012), and China (Rozman 2012), while others have applied the idea to explain policy behavior in Latin America (Leiteritz 2012) or Europe (Hooghe and Marks 2004; Kaelberer 2004; Lehman 2007; Johnson and Barnes 2015). By now, the concept of national identity has become a standard part of the conversation among IR and IPE scholars. As Dani Rodrik (2018: 20) summarizes, "National identity remains alive and well, even in some surprising corners of the world."

Caveats

Admittedly, there are caveats. As useful as it may be as an explanation of policy choices, the concept of national identity clearly also has its limitations. Two key reservations may be mentioned.

First, the concept is inherently *ambiguous*, difficult to pin down with any degree of precision. The problem is that no society can be expected to be absolutely unanimous in its sense of self. Since many complex elements are involved, both internal and external, another "index-number problem" arises. What weight should be placed on the many separate factors that go into the concept of identity? Judgments of what is to be considered more or less important can vary dramatically. Hence, different members of the community may see the world—and their nation's place in it—in distinctly different ways. The political economist George Crane (1998) was instrumental in "bringing the nation back in" to studies of IR and IPE. Yet even he conceded the measurement problems involved (1998, 55):

> Definitions of "nation" are notoriously difficult to fix empirically. One theme that runs through the literature on national identity . . . is the contingency and multidimensionality of the nation. It emerges from complex and

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> fluid interpretations of ethnicity, race, religion, language, geography, shared historical experience, political culture, and economic life. . . . The indeterminateness of the concept "nation" confounds any categorical specification.

Second, the concept is also *mutable*, subject over time to considerable change in how it may translate into policy. The problem here is the multiplicity of possible interpretations among different factions of decision makers. Truly fundamental principles can be expected to endure. But there can also be much contestation over practical applications, and the relative dominance of competing interpretations may wax or wane from one period to the next. At times, change may be the result of gradual socialization or underlying economic developments. On other occasions, more abruptly, it could be the consequence of political transition or a sudden transformation in the external environment. National identity does not dictate a single policy choice. A prime example is provided by Peter Trubowitz (1998) in his monumental study of the domestic politics of US foreign policy. Conflicts over specific policy choices, he argues, are grounded in America's regional diversity. As elections shift power from one region to another, the operational definition of national identity may be correspondingly altered.

Both caveats are apt. The ambiguity and mutability of national identity cannot be denied. But that hardly disqualifies the concept for the purposes of analysis. The evidence that, apart from other considerations, deep beliefs about identity do indeed matter in the design and implementation of statecraft is too strong for that, as we shall see. Rather, caveats like these stand as a warning. Caution must be exercised in making use of the idea. While national identity's role as a legitimate causal variable may be considered plausible, reservations about its use must be kept in mind.

The Geopolitical Element

How does the notion of geopolitical ambition fit in? The concept of national identity lays claim to the distinctiveness of a society. Geopolitical ambition (or its absence) may be understood as one of the most central of those claims. To what extent does the nation seek to exercise authority on the world stage?

In practice, a society's sense of self has many roots. Economic and political factors clearly matter. So too do culture, language, religion, and territory. But perhaps most salient of all are "historical memories"—shared experiences of the past that help to shape the way a community chooses to interpret its present and future. For many scholars, that is the irreducible

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core of the concept. For Abdelal (2001, 25), national identity is "a collective identity . . . defined by historical memory." For Smith (1991, 14), it is "a named human population sharing . . . common myths and historical memories." Crane (1998, 68) poses the central question: "What kinds of experiences are remembered as formative moments of nationhood?"

Historical memories need not be positive. It helps if a society can look back to some heroic past for inspiration—to great imperial achievements, for instance, or stunning military triumphs. The collective sense of self that the British carry around is undoubtedly influenced to this day by their country's experience of having once reigned over an empire on which the sun never set. Similarly, Chinese national identity cannot help but recall the centuries when China was the fabled Middle Kingdom, sitting "under heaven" at the center of the universe. But memories may also be negative—a painful reminder of where a people has come from and what it has managed to overcome. Much of America's sense of identity is tied up with the recollection of the injustice in colonial times of "taxation without representation" by the British crown. Much of present-day Israel's sense of identity traces back millennia to the legend of ancient Jewry's four hundred years of slavery in Egypt.

Indeed, historical memories need not even be true. They may not have been genuinely experienced. Mythological renderings of the past often substitute effectively for more mundane origin stories. Many historians question whether the Biblical children of Israel truly did pass four centuries as slaves in Egypt, as the Book of Exodus describes. Corroborating evidence is scarce. Yet that does not stop Jews around the world, including myself, from retelling the tale every year at the start of the festival of Passover. Similarly, who in Japan really believes that today's emperor is a direct descendant of the ancient Goddess of the Sun? The fable is far-fetched, yet it still suffices to help bind the Japanese nation to a common sense of identity. Somewhat comparable, in a more sinister vein, was the fiction propagated during the years of the Weimar Republic that Germany lost World War I because it had been "stabbed in the back" by treacherous elements at home and abroad. That too was far-fetched, yet the widespread sense of victimhood was compelling enough to help bring Adolph Hitler to power. What matters are not the brute facts of the material world, but the social facts that are created through the accumulation of interpretations and intersubjective understandings.

Examples like these, though obviously simplified, demonstrate the indelible power of myth. Once embedded in the nation's psyche, historical memories—positive or negative, true or not—serve to promote all kinds of

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values, assumptions, and expectations. Distinctive self-images evolve stressing the uniqueness of the nation: pride in achievements, claims to entitlements, insistence on grievances. Some characteristics are largely internal to the community itself, the result of a long-term process of self-categorization. Does national identity come to value individuality or conformity, competition or community, optimism or pessimism? It is no exaggeration to contrast the group loyalties of Japanese society with the far more individualistic cultures of the Anglo-Saxon world. Nor does it seem unfair to suggest that most Northern European nations, by and large, place a higher premium on the reciprocal obligations of society than do some of their neighbors to the south. Every nation's self-esteem is founded in some set of prized attributes. Alexander Wendt (1994, 385) call this *corporate* identity—"the intrinsic, self-organizing qualities that constitute actor individuality."

Other elements, however, are more concerned with the external dimension of identity: where the nation situates itself in the larger global community. Wendt (1994, 385) calls this *social* identity—"the terms of individuality through which agents relate to each other." Or, as Smith (1991, 17) puts it, "A sense of national identity provides a powerful means of defining and locating individual selves in the world." This is a question of how the society categorizes itself in relation to the proverbial "other." Is the "other" a threat or benign, an adversary to be resisted or a potential ally to be befriended? A nation, a wag once suggested only half tongue-in-cheek, is "a people with a common confusion as to their origins and a common antipathy to their neighbors" (Harmelink 1972). That is surely a caricature. Not all relations with neighbors need be antagonistic. But we know that every society makes these kinds of distinctions all the time. The United States is bordered by Canada and Mexico. Who would deny that Americans see their relations north and south in two very different lights? When Donald Trump campaigned in 2016 on a promise to build a border wall to keep out unwanted immigrants, no one thought he was talking about the famously mild-mannered Canadians.

And that is where geopolitical ambition fits in. Social identity defines a nation's interpretation of its own proper place in the world. What makes the society distinctive, if not superior to others? What role should it rightfully play on the global stage? Broadly speaking, choices are framed by two polar alternatives familiar to students of international relations. On the one hand, self-identification may mean projecting power to the extent possible, in one form or another. The exercise of influence is taken as something akin to a birthright, an integral part of the natural order, even if cloaked

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in the rhetoric of "exceptionalism" or "manifest destiny" or "*une mission civilsatrice*." One source labels this "imperial nationalism" (O'Toole 2017, 46). On the other hand, self-identification can mean the opposite—an "anti-imperial nationalism" disinclined to make waves, even if that were feasible; a preference instead to be left alone or to emphasize the virtues of cooperation. Abusive use of leverage may be viewed as antithetical to the society's basic values and norms. Either way, self-esteem is promoted. Geopolitical ambition, or its absence, is a direct reflection of how societies prefer to be seen by others.

The notion is a bit crude, of course, and may be said to be just as ambiguous and mutable as the broader concept of national identity from which it is derived. Here too there are many complex elements that can make specification difficult. And here too there can be shifts in interpretation as a result of domestic or external political developments. But once again, caveats like these hardly disqualify the notion for purposes of analysis. The idea retains value as a rough indicator of how societies compare in their orientation toward the international environment.

As a description of reality, geopolitical ambition is undoubtedly more continuous than dichotomous in nature—in essence, a matter of degree rather than of either/or. Empirically, nations can be assumed to vary along a continuum contrasting an expansive appetite for influence at one extreme with a more self-effacing preference for quiet autonomy at the other. But, as a first approximation for building a theory, the story can legitimately be reduced to a straightforward binary choice between the polar alternatives of imperial or anti-imperial nationalism. Some states clearly are inclined to throw their weight around, while others simply want to be left alone to do their own thing. We may not be able to produce a precise calibration of either inclination, but we can certainly recognize the difference when we see it.

Identity and Money

Finally, we come to the link between identity and money. Geopolitical ambition may have plausibility as a causal variable in international relations *in general*. But can it be assumed to play a significant role in the realm of monetary relations *in particular*? That is the final step in building a credible theory of currency statecraft.

Fortunately, the challenge is not too demanding. Concurrent with the introduction of constructivism into the field of IPE, a substantial literature has developed in recent years focusing specifically on the many ways that

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identity and money may interact (Sørensen (2016). Causal links are clearly involved. The main question is: In which direction does the causal arrow point?

From Money to Identity

For many scholars, the arrow points clearly from money to identity. Currencies play a role in defining a society's sense of self. Particularly influential is the early work of Helleiner (1998, 2003), who pioneered a useful conceptual framework for understanding precisely how the connection works. Currencies, he argued, may directly help to promote national identity in five ways: (1) providing a vehicle for nationalist imagery that reinforces a sense of collective memory; (2) acting as a common medium of social communication that may encourage similar frameworks of thought; (3) creating collective monetary experiences that can bolster the feeling of membership in the national community; (4) contributing to a sense of popular sovereignty; and (5) strengthening the underlying religious-like faith that is associated with nationalism. Others who have followed Helleiner's lead include Joseph Galloy (2000), Emily Gilbert (1999), and Marcia Pointon (1998).

Interest in the causal role of money was stimulated in particular by the introduction of the euro in 1999. What effect would a common currency have on conceptions of group membership in Europe? Would the euro persuade Europeans to feel more "European?" Or would historical loyalties to the individual nation remain intact? Numerous studies have been undertaken to explore the relationship between money and identity in various EU countries, with mixed results (Fishman and Messina 2006; Hobolt and Leblond 2009; Jupille and Leblang 2007; Moro 2013). The general consensus is that while identities have indeed been affected, the impact to date has been mild at best. More substantial transformations will be a long time in coming, if they ever come. As Thomas Risse (2006, 69, 80) summarizes, "The euro has already left its mark on the attitudes of citizens toward the EU including identification processes, albeit to a limited degree. . . . The more their past currencies leave the mental maps of Euroland citizens, the more current ambivalences in popular attitudes will recede in the background."

From Identity to Money

However, as numerous sources have emphasized, the arrow may also point in the opposite direction, from identity to money. Currencies can be as-

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sumed to play a role in the construction of national identity. But conceptions of identity may also play a role in how a society chooses to manage its money. As Matthias Kaelberer (2004, 161) has argued, "The relationship between money and collective identity is reciprocal." Echoes Risse (2006, 65), "The causal arrows . . . flow in both directions." The way a currency is managed may be a direct reflection of a particular sense of self.

An apt example was provided by West Germany's Deutsche mark, which for many Germans was the most visible symbol of the new respectable Germany that was born from the ashes of World War II—"an indispensable talisman of the 'good' Germany," as a keen observer once put it (Shlaes 1997, 188). In the words of a former president of West Germany's central bank (as quoted by Shlaes 1997, 190): "The German people have a broken—an interrupted—relationship with their own history. They can't parade like others. They can't salute their flag with the same enthusiasm as others. Their only safe symbol is the mark." Accordingly, West German officials did everything they could to protect the DM's reputation.

For any country whose money begins to gain international appeal, the issue of reputation is central. We know that currency internationalization can become a source of status and prestige—a form of soft power. But is elevated rank in the global community part of what a society sees as its due? Or would the nation be content to let others compete for primacy in world politics? Within the policy space that an international money affords governments, such questions become pivotal. Indeed, it is difficult to see how geopolitical ambition or its absence could fail to play a role in such matters, explicitly or implicitly. The external dimension of national identity must be regarded as a critical input into currency statecraft.

Conclusion

A credible theory of currency statecraft, therefore, does indeed seem possible. We began with the question: How do we explain the diversity of policy choices evident in the empirical record? The answer, I have argued, is that within the policy space available to decision makers, behavior is driven above all by the extent of an issuer's geopolitical ambition. The greater a society's commitment to build or sustain a prominent position in the community of nations, the more likely it is to pursue a proactive strategy in favor of currency internationalization.

The theory rests on three critical propositions. First, there must be room for policy discretion. This is ensured by the mixed bag of an international currency's potential benefits and costs, which makes convergence on a sin-

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gle policy choice highly unlikely, if not impossible. Second, the notion of geopolitical ambition must have plausibility as a legitimate causal variable. This is assured by grounding the notion firmly within the conventional concept of national identity, which is widely acknowledged in the literature of IR and IPE as a key driver of state behavior. And third, there must be a demonstrable causal link between identity and money. This is provided by a wealth of prior scholarship.

A good theory, however, must rely on factual evidence as well as logical reasoning. My suggestion of a causal relationship between geopolitical ambition (or its absence) and currency statecraft is based on nothing more than a cursory review of recent experience summarized in table 3.1. Does the link stand up to closer inspection? To answer that question, we must go back over the relevant policy histories in much fuller detail. That is the purpose of the chapters to follow.

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FOUR

Youth

The earliest stage in the life cycle of an international currency is youth—the vital formative years when a national money first starts to show signs of acceptance for international purposes. The issuing authorities, in response, have a choice among three strategic options: prevention, promotion, or permission. Recent history provides examples of all three choices, with outcomes that have varied considerably. Yet taken together they form a remarkably consistent pattern. They all illustrate the importance of geopolitical ambition—its presence or absence—as a motivating force for currency statecraft.

We begin with descriptions of the experiences themselves—brief historical narratives laying out the bare elements of each story. The prevention option is illustrated by the early West German and Japanese efforts to resist internationalization of their currencies, respectively, the DM and the yen. Examples of a promotion strategy include both a short-lived experiment by Japan in the 1990s and China's more recent campaign for the RMB, which is still ongoing. The permission option is represented by Europe's "non-policy" response to the rise of the euro after the currency's birth in 1999. The remainder of the chapter will then follow with analysis, concentrating on the use and utility questions. What motivated the choices we have observe, and what has determined their effectiveness?

Strategy and Tactics

In practical terms, of course, we know that implementation of a strategy requires suitable *tactics*. Strategic options like prevention, promotion, and permission define a state's broad goals—what the authorities would like to accomplish. But on their own they say little about how those goals will

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actually be achieved. That is the role of tactics, the material means employed to gain objectives. Tactics make use of specific resources and instruments to carry out a strategic game plan. What are the main tactics that may be employed by a government when its money begins to move up the currency pyramid?

For the prevention option, the best available tactic is *denial*: limiting the availability of the issuer's currency. At the border, this can take the form of exchange restrictions or capital controls. Domestically, denial may be implemented via taxes or regulations of various kinds to restrict foreign access to the currency. At the level of official transactions, the approach may include threats or other coercive measures intended to dissuade governments elsewhere from using the currency as an anchor or reserve asset—a hint of sanctions, say, or a withdrawal of past commercial or financial privileges.

For the promotion option, the choices are twofold. In principle, two classes of proactive strategy are available to a government hoping to persuade actors to make more use of its money—policies that may be either *indirect* or *direct* in their implementation (Helleiner 2008; Cohen 2015).

An *indirect* strategy aims to maintain or improve the market appeal of a money—to stimulate demand by manipulating the economic attributes that help to determine currency choice. Targets could include foreign governments as well as market actors. The idea is to explicitly cater to preferences on the demand side of the market. Ostensibly "sound" monetary and fiscal policies—meaning high interest rates and low budget deficits—might be implemented to build confidence in the currency's future value. Financial development and an open capital account might be emphasized to offer lower transactions costs or greater liquidity. Or the currency's usefulness for trade purposes might be promoted by lowering import barriers and opening new export markets. In Eric Helleiner's words (2008, 362): "Politics can help determine international currency standing through these indirect channels of influencing confidence, liquidity, and transactional networks in ways that influence the economic choices of both market and state actors."

A *direct* strategy, by contrast, aims to alter behavior more overtly by manipulating currency choice itself. Targets here would be mainly other governments. The idea is to use more traditional instruments of statecraft—carrots and sticks—to alter existing preferences on the demand side of the market. Currencies might be directly imposed on client states in a manner similar to what Susan Strange meant by a master currency. Alternatively, attractive inducements of an economic or political nature might be offered to reshape policy preferences in a manner analogous to Strange's notion

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of a negotiated currency. Again in Helleiner's words (2008, 373), "In the second category . . . politics matters more directly by prompting states . . . to support a currency's international position for reasons unrelated to their inherent economic attractiveness."

Finally, for the permission option, the proper tactic is, in effect, none of the above. The issuer remains neutral, avoiding any overt effort to shift user preferences, pro or con. Instead, matters are left to the decentralized decision-making processes of the open market—an exercise in what in today's language might be called "crowdsourcing." Private actors and foreign central banks are expected to determine on their own whether to use a currency or not.

Prevention

At the end of World War II, the global monetary picture was clear. There was just one dominant international currency: the US dollar. Within the sterling area, Britain's pound was still in use for some cross-border purposes, but it had already begun its long twilight decline to fringe status. Ironically, when the first serious rivals to the greenback later emerged, they were the moneys of America's two biggest wartime enemies, Germany and Japan. From the 1960s onward, the Deutsche mark and yen began increasingly to circulate internationally. Yet neither the Germans nor the Japanese welcomed the prospect of internationalization. Indeed, quite to the contrary, both countries actively discouraged foreign interest in their currencies, particularly through limits on access to their domestic capital markets. Despite their efforts, however, the DM and yen were soon established as, respectively, the second and third most widely used moneys in the world.

West Germany

Remarkably, the first currency to challenge the dollar, the Deutsche mark, did not even exist in 1945 when World War II ended. The DM was created in 1948 as part of a major economic reform in the Western zones of occupied Germany, presaging the inauguration a year later of the new Federal Republic of Germany (otherwise known as West Germany), with the quiet university city of Bonn as its capital. Little more than three decades later, the DM was firmly established as the second most important currency in the world, before being absorbed into the newborn euro in 1999.

The Deutsche mark's beginnings were not auspicious. Following the devastation of war, the Third Reich lay in ruin, its cities and industries

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largely destroyed. But then began the *Wirtschaftswunder*—West Germany's economic miracle—which generated rapid growth and persistent export surpluses. By the end of the 1950s, the Federal Republic could already be described as the leading economy on the European continent and the region's preeminent monetary power. By the 1960s, the DM's internationalization was well under way. By the 1970s, evidence of the currency's growing prominence was manifest. Though never more than a distant second to the US dollar, it was leagues ahead of all other currencies apart from the Japanese yen.

Internationalization was noticeably uneven. At the private level, the DM quickly emerged as one of the world's most widely used currencies for both foreign-exchange trading and trade invoicing and settlement. Early estimates for turnover in the interbank market in New York put the DM share of trades against the dollar in the range of 31 to 34 percent over the decade of the 1980s (Tavlas and Ozeki 1992, 32–34). By 1989 the DM was involved on one side or the other of 13 to 14 percent of all currency trades across the globe. That was far below the dollar's share of 45 percent, but well above that of any other money aside from the yen, whose share as a vehicle currency was comparable (Bank for International Settlements 1999). In 1998, just prior to the birth of the euro, the DM's share of global currency transactions was up to 15 percent. Similarly, by as early as 1980 the DM's share in the denomination of global trade was estimated at 13.6 percent, rising to 15.3 percent by 1992, some 40 percent greater than West Germany's share of total world exports (Thygesen et al. 1995; McCauley 1997). Only the US dollar, with a share of global trade close to 50 percent, accounted for a larger proportion of invoicing.

In financial markets, however, the DM's gains were more muted. Indicative is a composite index of the currency composition of international assets constructed at the Bank for International Settlements (BIS) for the years 1980 through 1995 (Frenkel and Goldstein 1999, 712–13). This "international assets" aggregate combined holdings of bonds, notes, and cross-border banking claims for purposes of ready comparison. Over the period covered by the index, the DM never attained a global market share greater than 14 to 15 percent. Though second only to that of the greenback, this was well below the US dollar's share of 50 percent or more.

At the official level, West Germany's currency was quickly adopted by a number of European neighbors as a de facto anchor for the exchange rates of their own currencies—a nascent DM zone. Stability vis-à-vis the DM became a high priority. Correspondingly, West Germany's money also became the preferred intervention medium for neighboring central banks,

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mostly replacing the US dollar. According to one informed source (Tavlas 1991), the DM share of exchange-market interventions within Europe rose from some 25 to 30 percent in 1979 to as much as 75 percent by the end of the 1980s. And that development in turn encouraged accumulations of DM in reserves, also in preference to the greenback. Estimates culled from various issues of the annual report of the International Monetary Fund (IMF) suggest that the West German currency came to account for anywhere from 12 to 16 percent of global reserves during the 1980s and 1990s. In all these roles, however, the DM's reach remained essentially limited to the Federal Republic's hinterland on the European continent. Its domain was regional, not global.

Strikingly, all of this occurred despite determined resistance from the West German government. Bonn had little objection to adoption of the DM as an anchor for neighboring currencies; exchange-rate stability ranked high among German priorities, too (Henning 1994). But until the early 1980s, the Federal Republic's central bank, the Deutsche Bundesbank, fought actively to restrict cross-border use of its currency for most other purposes, particularly as a store of value. Firm control, for example, was exercised over the issue of DM obligations in the external bond market (Neumann 1986, 110). Although convertibility of the DM for current-account transactions was introduced as early as 1958 (along with that of most other European currencies), a panoply of capital controls persisted until as late as the mid-1980s, restricting foreign participation in the domestic financial system. Strict limits were imposed on purchases of money-market instruments by nonresidents. Moreover, institutional development was slowed by a variety of complex regulations and taxes. West German bond and equity markets were notably thinner than corresponding markets in New York or London, offering no more than a limited menu of financial instruments. As a result, trading in DM-denominated claims was narrow and expenses remained high, hampering use of the Federal Republic's currency as an investment medium.

At issue was control of monetary policy, so critical to sustaining domestic price stability. The German people's antipathy to inflation—its so-called "stability culture"—is well known. Opinion research suggests that in recent years, inflation aversion in Germany may have faded somewhat (Pfefferle 2013; Howarth and Rommerskirchen 2017). But there is no doubt that back in the early decades of the *Wirtschaftswunder* a fear of runaway price increases, recalling the traumatic hyperinflations that struck after each of the world wars, was still deeply ingrained and widely shared by financial interests and other key constituencies across West German society (Hen-

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ning 1994; Scheve 2004). In the short term, as noted in chapter 1, internationalization could offer material benefits at both the microeconomic and macroeconomic levels. But Germans generally—and policy elites in particular—feared that shifting currency preferences might also generate much exchange-rate volatility and uncertainty, threatening the country's newfound prosperity. Worse, over the longer term, an undue constraint might be imposed on policy at home by an excessive accumulation of liabilities abroad. At no point, accordingly, did the government take a proactive stance on internationalization.

Japan

In many ways, the story of the yen was similar. At the end of World War II, Japan, too, lay in ruin, its economy shattered and its currency virtually worthless. And then Japan, too, enjoyed an economic miracle, sustaining double-digit growth rates from the late 1950s onward that were the envy of the world. By the late 1960s Japan's economy had come to be the second largest anywhere, bigger even than West Germany's. Though the yen never managed to climb above third place among international currencies, behind not just the US dollar but the DM as well, its international standing was firmly cemented by the 1970s.

As in the case of the DM, the rise of the yen was uneven in both scope and domain. But the pattern was different. Unlike the DM, the yen came to be used more as a store of value than as a medium of exchange or unit of account. Geographically its reach, like that of the DM, remained primarily regional, for the most part limited to the nations of East Asia.

Internationalization was most notable in private financial markets, where persistent appreciation made the currency an especially attractive store of value. According to the composite index constructed at the BIS, the yen's share of claims in international asset markets accelerated swiftly from little more than 3 percent in 1980 to some 12.4 percent by 1995 (Frenkel and Goldstein 1999, 712–13). Growth was especially rapid in the offshore bond market, where the proportion of new issues denominated in yen more than tripled between 1980 and 1995, from under 5 percent to above 17 percent (Iwami 2000). By the 1990s, the yen's share of the global bond market matched that of the DM, though both remained well short of the dollar. Activity was mainly concentrated in the East Asian region, where the yen soon supplanted the dollar as the predominant vehicle for foreign issues. Borrowers included, most notably, larger neighbors like Indonesia, Malaysia, the Philippines, South Korea, and Thailand. Within Japan, non-

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resident holdings of both bank deposits and securities expanded steadily through the 1980s and into the 1990s.

Likewise, for central banks the yen became an attractive complement to the dollar or DM for purposes of portfolio diversification. IMF estimates suggest that during the 1980s and early 1990s the yen's share of global reserves more than doubled, from just over 3 percent to close to 8 percent. That was only half the portion accounted for by the DM, but well ahead of any other currency. Here too, use was mainly concentrated in East Asian nations, where the yen's share of reserves topped 17 percent by 1990 (Tavlas and Ozeki 1992, 40; Kawai 1996, 319–20).

But for other uses, the yen's performance was less impressive than that of the DM. Though the yen share of trades in foreign-exchange markets accelerated over the course of the 1980s to a peak of 14 percent in 1989, Japan's currency never did manage to surpass the proportion accounted for by the DM (Bank for International Settlements 1999). Here too, the appeal was mainly regional. The yen was most favored as a vehicle in East Asia, in financial centers like Hong Kong and Singapore, where the proportion of business done in yen was considerably higher than anywhere else. And in the invoicing of global trade, available evidence suggests that the yen played a much smaller role than the DM. While there was some expansion of use for trade settlement, it was from a very low base and again concentrated mainly in East Asia. The yen's share in the denomination of trade more than doubled during the 1980s, but in 1992 it still accounted for less than 5 percent of the world total. That represented little more than half of Japan's share of global exports at the time (Thygesen et al. 1995).

In one respect, the yen made no impact at all. That was as a possible anchor for the exchange rates of other currencies. Starting in the 1980s and increasingly in the 1990s, there was much debate about whether—or to what extent—Japan and its neighbors might be coalescing into some kind of yen bloc, comparable to the emerging DM zone in Europe. In fact, most governments in East Asia preferred to maintain a managed float. Usually the float was in line with a currency basket of some kind, though the components of their baskets were rarely disclosed. Econometric analysis suggests that increasingly, some of Japan's neighbors—including in particular South Korea, Singapore, and Thailand—did begin to shadow the yen more closely, increasing the weight of the yen relative to the US dollar (Frankel 1993; Frankel and Wei 1995). But in no economy other than South Korea did the yen actually surpass America's greenback as an anchor, and no country ever pegged to the yen formally. If there was a yen bloc, it was a feeble one. In the words of one contemporary analysis (Maehara 1993,

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164), "From a policy perspective, it appears that the yen has not yet been perceived as a key regional currency to the extent that the Deutsche mark is incorporated as an anchor currency in [Europe]." Declared another source (Bénassy-Quéré and Deusy-Fournier 1994, 138), more bluntly: "The yen zone is [limited] to Japan." Correspondingly, there was also very little increase in the use of Japan's currency for intervention purposes.

The yen's internationalization occurred despite determined resistance from the authorities. Tokyo's response to the growing popularity of its currency was not unlike that of West Germany, and was implemented for much the same reason. The Japanese, too, felt that domestic prosperity might be threatened. They, too, worried about a possible loss of control of monetary policy; Japanese society has its own version of a stability culture. In addition, there was also much fear that broader use of the yen would drive up the exchange rate, eroding the competitiveness of Japan's vital export industries. West Germany had less concern on that score because of the eagerness of its neighbors to use the DM as an anchor for their own currencies. Japan, by contrast, had no yen zone. And so Japan, too, fought actively to restrict cross-border use of its currency. Convertibility of the yen for current-account transactions was delayed until 1964, and even after that date foreign access to the domestic bond market remained severely constrained.

Under pressure from the United States, some modest deregulation did begin in the 1970s and continue into the 1980s. And a major breakthrough came in May 1984, when Tokyo reluctantly committed to a panoply of further liberalization measures outlined in a major pact negotiated with Washington. The so-called Yen/Dollar Agreement grew out of discussions of the Working Group on Yen/Dollar Exchange Rate Issues—known as the Yen/Dollar Committee—that had been created jointly by the US Treasury and the Japanese Ministry of Finance in 1983. Subsequent years saw additional initiatives to widen the scope of allowable foreign activity in the domestic banking and capital markets (Kawai 1996; Takagi 2015), though the pace of reform remained "glacial" (Eichengreen, Mehl, and Chiţu 2018, 161).

None of this, however, had anything to do with a sudden ambition to push the yen higher up the currency pyramid. Quite the contrary, in fact. At the time, opposition to internationalization remained strong. The Ministry of Finance even went so far as to follow the Yen/Dollar Agreement immediately with a report of its own reiterating many of Tokyo's reasons for caution (Japanese Ministry of Finance 1984). In part, the financial reforms were meant to counter a slowing economic growth rate. Mainly, however, they were a grudging concession to the United States, which had

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been urging Tokyo for years to liberalize its financial structure in hopes of raising demand for the yen. Washington's aim was not to encourage broad internationalization but rather, more narrowly, to engineer an exchange-rate appreciation that would help US goods compete with their Japanese counterparts—precisely what Tokyo had hoped to avoid. For most Japanese, therefore, an international role for their currency was not a goal to be sought, but rather a price to be paid to retain the good will of the Americans. Overall, the process of liberalization was kept on a slow track, and at the end of the 1980s it was still far from complete, as contemporary accounts emphasized (Garber 1996).

Promotion

Not everyone resists internationalization, of course. In principle, some issuers might instead choose to embrace the prospect and do whatever they can to encourage it. One source calls this "managed internationalization" (McCauley 2011). In practice, however, the promotion option has been chosen only rarely, and in recent history there has yet to be a clearly successful model.

Promotion was belatedly adopted by the Japanese after the bursting of their bubble economy in 1989, and since the mid-2000s it clearly has become the preference of the Chinese government as well. In both cases, great energy has gone into enhancing the appeal of each country's money—aiming to improve their respective currency brands, as it were. Sadly, Japan's program of managed internationalization for the yen met with little success and was soon abandoned. The RMB, by contrast, seems to be doing better, though the jury is still out on its ultimate destiny.

Japan

The turning point for the Japanese was the collapse of the bubble economy, which many in Japan blamed on the United States. The appreciation of the yen that Washington had worked so hard to encourage did finally occur after the Plaza Accord of 1985—an historic five-nation agreement to realign exchange rates, negotiated at the famous Plaza Hotel in New York City (Frankel 2015)—but with consequences that were not anticipated at the time. To soften the adverse effects of the appreciation, Japan's central bank pushed interest rates to historically low levels. The result was a marked increase of speculation in Japanese equities and real estate, feeding the swelling bubble that finally burst at the end of the decade, sending

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Japan's economy into a deflationary tailspin. Many in Japan still hold the United States responsible, at least in part, for the prolonged stagnation that followed, harking back to the pressures Washington exerted through the Yen/Dollar Agreement and Plaza Accord (e.g., Okina et al. 2001; Hamada and Okada 2009). With the Japanese economy in retreat, foreign interest in the yen began to fade.

Within the Japanese government there had long been a vocal minority in support of more, not less, yen internationalization. Most notable was the Council on Foreign Exchange and Other Transactions, an advisory body to the Ministry of Finance, which in 1985 had called for further financial liberalization, beyond what had been conceded in the Yen/Dollar Agreement, to add to the yen's already considerable appeal. In effect, the argument went, policy should favor promotion, not prevention. But these were voices in the wilderness until Tokyo was forced to come to grips with the nation's postbubble downturn.

Over the course of the 1990s, opinion among policy elites did a sharp U-turn, for two reasons: one domestic, the other geopolitical. At home, fears of a possible threat to prosperity evaporated. Instead, internationalization of the yen now came to be seen as a plausible route to economic recovery. What Japan needed, it was increasingly felt, was a shield to insulate itself from the vicissitudes of the global economy. By doing more business in their own currency, Japan's firms and government could reduce their exposure to the volatility and risk of overseas transactions. As an added bonus, a more internationalized yen might also help Tokyo defend itself against further demands from the United States. William Grimes (2003) called it Japan's "new politics of monetary insulation."

Abroad, internationalization was seen as a key to retaining Japan's long-standing economic leadership in East Asia (Katada 2008). Once the postwar recovery got under way, Japan soon regained the dominance in regional trade and investment relations that it had enjoyed before the disasters of World War II. By the 1980s, therefore, the nation's self-esteem had been largely restored. Most Japanese had come to see their primacy in the neighborhood—or even globally—as more or less an integral part of the natural order. They were leading the way in a "flying geese" pattern of economic development. There was no challenger in the region. But now confidence had been severely shaken—not only by the bursting of the bubble economy, but also by the sudden rise of China following Beijing's turn to market reforms after 1979. Japan's geopolitical standing in the area suddenly seemed threatened by a newly invigorated giant on the mainland.

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Was the proverbial Middle Kingdom about to supplant Japan at the center of the East Asian region?

The result was a dramatic policy reversal. Promotion of the yen, particularly through a new round of financial reforms, now became a declared national objective. In the words of an official report published by the Ministry of Finance in 1999, "The promotion of the internationalization of the yen now stands as an indispensable requirement" (Council on Foreign Exchange and Other Transactions 1999). The hope was that yen internationalization might help bolster both domestic recovery and regional leadership. Previously, growth at home and primacy in the neighborhood could be taken for granted—hence the earlier lack of interest in internationalization. Japan's peak position among Asian nations had been uncontested. But now, suddenly, a more proactive policy seemed necessary if the nation's newly restored self-esteem was to be preserved. The fundamental beliefs of Japanese society had not changed. Japan still thought of itself as the region's natural leader. But the perception of what policies were needed to sustain that leadership did undergo a radical transformation.

Most dramatic was a multiyear liberalization program announced in 1996, dubbed the Big Bang in imitation of a swift deregulation of Britain's capital markets that had occurred a decade earlier. Under the Big Bang, all remaining capital controls were to be eliminated and a variety of other ambitious measures were scheduled, including tax reductions and increases in the range of available financial products. Especially after the Asian financial crisis of 1997–98, a concerted effort was made to promote broader use of the yen for investment and reserve-currency purposes, guided by the recommendations of the Finance Ministry's Council on Foreign Exchange and Other Transactions. Best known was Tokyo's 1997 proposal for an Asian Monetary Fund, which if implemented could have enshrined the yen as the dominant currency in the Asian region. But the idea was ignominiously rejected by the United States and IMF (Amyx 2002; Katada 2002).

Further ideas were floated in the next few years by a Study Group on the Promotion of Yen Internationalization appointed by the Ministry of Finance, but all to no avail. In the end, Japan's efforts came to naught. As domestic economic stagnation dragged on, the government's campaign failed to reverse the decline of foreign interest in the yen. Market sentiment simply could not be moved back in the yen's favor. Defeat was admitted in 2003 when the strategy was officially abandoned in a final report of the Study Group. By then, in the words of one Japanese observer, "it was clear

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that any further attempt to internationalize the yen . . . would be futile" (Takagi 2015, 203). Tokyo retreated from the promotion option to a more neutral stance, which has prevailed ever since.

China

In contrast to the Japanese case, no precise date can be identified when China first leaned toward the goal of internationalization. Public discussion among Chinese academics began as early as the 1980s, following the first successes of the market reforms launched by Deng Xiaoping in 1978. Increasingly, Chinese scholars debated the pros and cons of wider use of the RMB (Peng et al. 2015). What might be the costs and benefits? What conditions would be required? What consequences could be anticipated? Little doubt was expressed about the desirability of internationalization. That the redback was destined for greatness was essentially taken for granted. The question was simply what should be done about it. What reforms were needed? What would be the proper sequencing of interventions? And how quickly should the authorities move? For years, however, the government equivocated, seemingly unsure whether the time was yet ripe for decisive action. Even after the shock of the Asian financial crisis in 1997–98, policy remained hesitant.

A key turning point seems to have been reached in 2006 with publication of a report titled "The Timing, Path, and Strategies of RMB Internationalization" by a study group set up by the People's Bank of China (PBOC), China's central bank (PBOC Study Group 2006). "The time has come for promotion of the internationalization of the yuan," the study group argued. Internationalization could "enhance China's international status and competitiveness significantly [and would] increase its influence in the international economy." China would "have a greater say" and would enjoy "a rise in power standing." China "should take advantage of the opportunity," the report concluded. Internationalization was "an inevitable choice."

By then, evidently, many in China's leadership had come to the same conclusion. Within policy circles, a distinct shift of attitude was soon apparent. After long vacillation, Beijing committed to making internationalization of the people's currency a top policy goal, and a concerted strategy was put into motion with that lofty ambition in mind. The RMB was launched on a long march toward global status, reminiscent of the Long March that was so pivotal in the Communist Party's victory in China's civil

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war. Enlightened statecraft would see to it that the Middle Kingdom would now have a money worthy of a great power.

Not that Chinese elite opinion has been unanimous. In fact, divisions over the issue in Beijing have long been evident (Helleiner and Malkin 2012; McDowell and Steinberg 2016). On one side are factions led by the PBOC who see internationalization as a means to push forward with liberal financial reforms. Many Chinese who were on the liberal side were also spurred by the 2008 global financial crisis, which highlighted the vulnerability of Beijing, with its vast hoard of dollar reserves, to a sudden shift of exchange rates (Zhao and Song 2009). In the Chinese literature this became known as the "dollar trap" (Yu 2010). Internationalization of the RMB would offer the advantage of a shield to help reduce dependence on America's greenback. But on the other side are an array of producer interests and banking institutions, many of them state-owned, that have long benefited from the government's firm controls over interest rates and credit allocation. Their resistance to wider use of the RMB was initially quite strong. Whatever the merits of internationalization, they felt, it should not come at the expense of their privileged place in the Middle Kingdom's financial system.

By the mid-2000s, however, it was abundantly clear which way the wind was blowing. The PBOC and its domestic allies had prevailed. As one informed observer put it, "The Chinese Government obviously changed its mind and became enthusiastic about RMB internationalization" (Zhang 2009, 24). By 2011, according to an influential advisor to the PBOC (as reported by the Dow Jones News Service, 17 February 2011), internationalization had assumed a place "at the heart of China's financial strategy." More recently, it seems, the pace of the process has slowed somewhat, as Beijing has struggled to cope with rising debt levels and a sizable exodus of capital. But even so, no one doubts that the promotion option remains the government's preferred currency strategy.

But how was the strategy to be implemented? Up to the time of the PBOC's Study Group report, China had one of the most tightly controlled currencies in the world, hemmed in by all manner of exchange restrictions and capital controls. How could cross-border use of the RMB be encouraged if the money was not yet readily convertible? Moreover, the country's leadership knew that there was no successful model in recent history for promoting an international currency. Japan's failed post-bubble experience was seen as a depressing cautionary tale. Chinese policy makers had no road map to help guide their actions. Not surprisingly, therefore, Beijing's

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statecraft has been noticeably risk-averse, a careful choreography stressing gradualism above all. Following Deng Xiaoping's famous dictum to "cross the river by feeling the stones," tactics have been developed incrementally in multiple small steps. China's ruling Communist Party is no stranger to the idea of a long march.

Effectively, managed internationalization has been pursued along two interrelated tracks (Subacchi 2017). One track focuses on cultivating use of the RMB in foreign trade. At the official level, currency swap agreements with some three dozen foreign central banks have been initiated facilitating use of the RMB as a means of payment (Liao and McDowell 2015). At the private level, regulations have been gradually eased to permit more import and export transactions to be settled in yuan, bypassing traditional invoicing currencies like the US dollar. The second track focuses on use of the redback in international finance as a store of value. Emphasis has been placed on the development of active markets for yuan deposits and yuan-denominated bonds, mainly "offshore" in Hong Kong, the former British crown colony that is now a "special administrative region" of China. Along both tracks, initiatives have been implemented patiently in finely calibrated phases.

To date, the trade track has seen much more progress than the finance track. By 2016, some 30 to 35 percent of Chinese trade was being settled in yuan—up from essentially zero a half decade earlier—though it might be noted that most of the increase was local. As much as 70 percent of the trade settled in yuan is between mainland China and Hong Kong and amounts to little more than a shuffling of cash between mainland enterprises and their own offshore subsidiaries. Nonetheless, yuan invoicing has gradually spread, supported by agreements designating selected clearing banks for RMB trades in nearly a score of financial centers around the world. These include not only neighboring East Asian outposts like Singapore, Seoul, Taipei, and Tokyo, but also others further afield, such as Doha, Frankfurt, London, Toronto, and Zurich. Offshore clearing banks act as a conduit with China's domestic banking system to settle RMB payments outside the mainland. According to the Society for Worldwide Interbank Financial Telecommunications (SWIFT), which processes global financial transactions, the yuan in 2016 rose to fourth place among the world's top payments currencies, with an almost 3-percent share of global payments. Separately, the BIS has reported that the currency's share of aggregate turnover in the global foreign-exchange market fully doubled between 2013 and 2016, from 2 percent to 4 percent (Bank for International Settlements 2016).

Results on the finance track, while not insignificant, have been rather

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less impressive. For the most part Beijing has proceeded with care, relying heavily on Hong Kong's established position as a leading financial center. With its own currency and capital markets, Hong Kong offers a useful offshore laboratory for experimenting with innovations that the leadership is not yet prepared to introduce "onshore" on the mainland. As frequently noted (Frankel 2011) this is an unusual pattern, to say the least. Never before has any government sought deliberately to develop an offshore market for its currency while still maintaining strict financial controls at home. In effect, Beijing is drawing up its own road map, depending on the Hong Kong Monetary Authority (HKMA)—Hong Kong's de facto central bank and chief financial regulator—to act as its faithful proxy. Under the HKMA's tutelage, the markets for both yuan deposits and yuan-denominated bonds have grown considerably, but aggregate sums remain minuscule by international standards. Yuan deposits in Hong Kong have never exceeded RMB 900 billion ($130 billion), and the volume of dim sum issues has been limited. From 2009 to 2015 the total value of dim sum bonds came to just RMB 443 billion ($65 billion). Both numbers are minuscule by international standards.

A noteworthy milestone was reached in late 2015 when the RMB was formally admitted into the basket of currencies used by the IMF to set the value of the special drawing right (SDR), a reserve asset created by the Fund itself to supplement the supply of international currencies. Admission into the basket was an honor previously accorded only to the US dollar, euro, pound, and yen, and was the subject of much discussion (Wang 2015). Many doubted whether the redback had yet met the necessary criteria for inclusion. Reservations were overcome, however, by a vigorous campaign mounted from Beijing. China's hope, clearly, was to trigger increased use of its currency as a reserve asset, which until now has remained limited. According to one knowledgeable source (Liao and McDowell 2016), as many as three dozen central banks have invested in yuan-denominated claims in recent years. But accumulations are small. In all, RMB holdings still add up to no more than a puny 1 percent or so of foreign-exchange reserves. Even lesser currencies like the Australian and Canadian dollars or the Swiss franc account for larger shares of the global total.

Overall, China's strategy seems well framed to achieve the enhanced influence and prestige that the PBOC Study Group set as its goal back in 2006. We know from chapter 1 that a currency's roles in trade, financial markets, and central-bank reserves are paramount in contributing to its issuer's external capabilities. As it happens, these are precisely the roles that are being promoted by Beijing's dual-track approach. The finance track is

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critical to establishing the RMB's appeal as an investment medium, which in turn is an essential first step toward attaining reserve-currency status. And the link between the two store-of-value roles is the trade role, owing to the vital part that the currency denomination of trade plays in determining which among several investment currencies will emerge as well as a favored reserve asset. Whether by chance or design, Beijing seems to have gotten its strategy right. The Hong Kong and Shanghai Banking Corporation summarizes succinctly: "First trade, then investment; and after that, reserve currency status. That is the road map for the renminbi in a single sentence" (2011, 5).

But doubts remain whether the Chinese have the right resources and instruments to make their strategy succeed. Tactics may not match up well with objectives. Certainly the country has the economic size needed to encourage more use of the redback for trade purposes. A broad transactional network stands out as China's trump card: the principal advantage that Beijing brings to the table. The Chinese economy is already a giant among nations—the second largest in the world—and it could surpass the United States in as little as a decade. China is also now the world's leader in exports and its second biggest market for imports, and dozens of countries now count the Chinese as their largest trading partner. Despite some decline of trade volumes in 2015 and 2016, there remains no doubt about the Middle Kingdom's massive gravitational pull in today's global commerce. There should be no significant resistance from market actors to a continuing expansion of the role of the RMB in trade invoicing and settlement.

In other respects, however, Beijing's hand is considerably weaker. That is especially evident on the finance track where, for all the success of the Chinese economy, capital-market institutions remain rudimentary and border controls still limit investment opportunities. Observers generally agree that without major reforms to develop and open China's financial sector, there is unlikely to be much enthusiasm among market actors or central banks to increase use of the RMB as a store of value. Prospects for the yuan as an investment currency or reserve asset will remain limited at best (Eichengreen and Kawai 2015; Prasad 2017; Subacchi 2017). The game is still being played, and its ultimate outcome is still a matter of conjecture.

Permission

Between the proactive strategies of either prevention or promotion is the more passive "nonpolicy" option of permission—a stance of "benign neglect," to borrow a term from another era. Nascent internationalization is

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neither resisted nor encouraged but rather, faute de mieux, is left up to the collective wisdom of market actors and central banks. In the modern era, the prime example of a nonpolicy approach is provided by the euro, Europe's joint currency. Essentially, benign neglect has been the formal program of the eurozone since the money's birth in 1999. Results have been mixed.

Officially, European governments remain neutral on the subject of internationalization. Time and again, the European Central Bank (ECB), which manages the currency, has insisted that internationalization "is not a policy objective [and] will be neither fostered nor hindered by the Eurosystem. . . . The Eurosystem therefore adopts a neutral stance" (European Central Bank 1999, 31, 45). There will be no overt initiatives, pro or con, to influence foreign demand for the euro. Cross-border use may grow, concedes the ECB. But if it does, it will be a purely market-driven affair, simply one of many possible byproducts of Europe's monetary union. Europe's authorities will not intervene in the process.

This does not mean that the ECB is indifferent to prospects for the euro; the eurozone's central monetary institution can hardly ignore the implications of internationalization for its conduct of monetary policy. Nor does it mean that European governments are unaware of the advantages that internationalization could bring. But it does mean that the euro's future as international money is, in principle, to be determined entirely on the demand side of the market—by societal actors and foreign central banks—rather than by the Europeans themselves as the currency's suppliers. Policy amounts to a nonpolicy.

Behind the scenes, of course, views may differ. The ECB's carefully considered words could actually be little more than diplomatic rhetoric, intended mostly to paper over internal differences. Even before 1999, it was known that there was discord among policy makers over the issue. Many in Europe were indeed inclined to leave the future of the euro to the logic of market competition. But many others, aware of the potential benefits of internationalization, yearned for a more proactive stance to reinforce the monetary union's potential. In some circles, particularly in France, an internationalized euro was seen as Europe's best chance to challenge the exorbitant privilege of the US dollar. Outsiders could not be blamed for suspecting that hidden behind the ECB's bland rhetoric, there might well be substantial support for the promotion option.

Especially suggestive was the ECB's controversial early decision to issue euro notes in denominations as high as five hundred euros—sums far greater than most Europeans were likely to find useful for everyday trans-

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actions. Why do it? Knowledgeable experts like Kenneth Rogoff (1998) and Charles Wyplosz (1999) suggested that the decision could have had something to do with the familiar phenomenon of "dollarization"—the already widespread circulation of large-denomination dollar notes in various parts of the world, especially of the one-hundred-dollar variety (the greenback's highest denomination). Dollarization translates into a considerable interest saving for the US government, part of the seigniorage earnings that result from the ample foreign appetite for greenbacks as a store of value. Were the Europeans aiming to divert some of those earnings to themselves by offering a potentially attractive alternative? As Rogoff opined (1998, 264): "Given the apparently overwhelming preference of foreign and underground users for large-denomination bills, the [ECB's] decision to issue large notes constitutes an aggressive step toward grabbing a large share of developing country demand for safe foreign currencies."

In practice, however, such suspicions seem to have been overwrought. High-denomination euro notes might well have captured some seigniorage earnings. But it seems clear that the ECB's main motive was to reassure the German public, fearful of losing their beloved Deutsche mark, that notes comparable to existing high-denomination DM bills would be readily available. And even that motive became moot once the euro came to be generally accepted across the nations of the monetary union. In 2016 the ECB announced that the five-hundred-euro note would be gradually phased out. Overall, the bank does seem to have lived up to its word. As far as any international role is concerned, Europe's policy has remained determinedly hands-off.

For some measure of proof, we might only look to the Middle East, with its concentration of wealthy oil exporters. If there is any part of the world where the Europeans might have been tempted to push for greater use of the euro, it would be in this nearby region, as I have suggested elsewhere (Cohen 2011). One reason is the sheer scale of monetary riches controlled directly or indirectly by local regimes. What these governments decide to do with their money can have a major impact on the relative fortunes of international currencies. Second is the considerable instability of political alignments in the Middle East, which creates an opportunity for a more active European role. With significant and long-standing economic and cultural ties in the area, European states have an incentive to continue playing an important part in regional affairs.

And third is the seeming contradiction between the region's commercial ties with the outside world and its financial relations. Foreign trade is dominated by Europe, which is by far the biggest market for the Middle

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East's oil as well as the largest source of its imports. Yet financial relations are dominated by the United States and its dollar. America's currency is not only the standard for invoicing and payments in world energy markets. It also accounts for the vast majority of central bank reserves and government-held investments in the region and is the anchor, de jure or de facto, for most local currencies. In the eyes of many Europeans the disjunction seems anomalous, even irrational. Often the question is asked: Would it not make more sense to do business with the area's biggest trading partner, Europe, in Europe's own currency rather than the greenback? And if so, would it not then make sense to switch to the euro as a reserve currency and monetary anchor as well? Yet, so far as one can tell, there has not been even the hint of a campaign to raise the euro's profile in the region.

In these matters, as in so many others in Europe, it is Germany's attitude that matters most; and here German views have not changed all that much since the heyday of the Deutsche mark (Zimmerman 2013). Though inflation aversion in the general population may have faded somewhat in recent years (Pfefferle 2013; Howarth and Rommerskirchen 2017), German policy elites still fear that internationalization could weaken control of monetary policy or generate exchange-rate volatility and uncertainty (Eichengreen, Mehl and Chiţu 2018, 174). The potential costs, they worry, would simply be too high. Hence, resistance to any overt influence attempt on behalf of the euro remains strong. So long as that remains the case, the future of the currency is most likely to be left to the logic of market competition. Policy will continue to be passive. Internationalization will not be managed.

In practical terms, Europe's benign neglect has not been particularly kind to the euro's international prospects. Following creation of the monetary union in 1999, many observers predicted that the joint currency was destined to emerge as a potent rival to America's greenback, or perhaps even to surpass it, within a relatively short period of time. Enthusiasm was rampant. Typical was Robert Mundell, who expressed no doubt that the euro would "challenge the status of the dollar and alter the power configuration of the system" (2000, 57). Polls taken in late 2008, just ahead of the euro's tenth birthday, indicated that a majority of Europeans expected their money to overtake the dollar in as little as five years. A destiny of shared currency leadership with the greenback—perhaps even global dominance—seemed imminent (Chinn and Frankel 2008; Papaioannou and Portes 2008; De La Dehesa 2009).

Euro enthusiasm was by no means unjustified. In fact, the new currency's global credentials were excellent. At the time of its birth, the euro

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clearly enjoyed many of the qualities necessary for competitive success on the world stage. These included a large economic base in the membership of the monetary union, which initially numbered some eleven countries—including some of the world's richest economies—and is now up to nineteen. They also included deep and resilient financial markets, political stability, and an enviably low rate of inflation, all backed by a joint monetary authority, the ECB, that was fully committed to preserving confidence in the currency's future value. Hence it was no surprise that in the euro's early days, international use seemed set to expand exponentially.

Very soon, however, momentum slowed. After a steep takeoff, internationalization appears to have peaked sometime around 2003–4. Thereafter, use for cross-border purposes leveled off at rates well below those enjoyed by the dollar, and lately has even begun to trend sharply downward. The euro's share of central-bank reserves, for example, has dropped from above 27 percent in 2009 to under 20 percent at the end of 2016. For some observers, these reversals may well prove to be nothing more than a temporary setback. Jonathan Kirshner (2014, 137), for instance, is convinced that "Europe is down but not out, and in the longer run, the euro will resume its encroachment on the dollar's international role." But for most informed commentators, optimistic assertions like these evoke a familiar definition of second marriages: the triumph of hope over experience. In reality, there is scarce evidence to suggest that Europe's money could still pose much of a threat to the greenback. In the words of the economist John Williamson (2013, 76): "For a time it looked as though the euro might become a serious competitor, but given the recent [difficulties] in the euro area, it no longer threatens the pre-eminence of the dollar."

Indeed, some experts worry whether the currency can survive even within Europe. Could the monetary union disintegrate? Imperfections in the euro area's governance structure were evident from the start (Cohen 2015, ch. 8) and were only exacerbated by a rash of sovereign debt problems around the monetary union's periphery following the great financial crisis that struck the world economy in 2008. With the recent rise of anti-euro populism across the EU, personified by the likes of Marine Le Pen in France and the Alternative for Deutschland in Germany, the challenge to the currency has become existential. For many, enthusiasm has been replaced by apprehension. In the words of one astute observer (Goodman 2017b), there is a "gnawing fear that the euro could still succumb to whatever blow history delivers next. The euro confronts a chronic shortage of faith in its ability to persevere, along with a surplus of threats to its existence." Kathleen McNamara (2018) is not alone in worrying that with the

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future of the euro increasingly in question, the currency could become, as she puts it, a "risk generator" or even a "spoiler" in the broader monetary system.

At best, the euro has done little more than hold its own in international use as compared with the past aggregate market shares of the monetary union's "legacy" currencies. In view of the fact that the old Deutsche mark had already attained a number-two ranking in the currency pyramid, second to the greenback, anything less would have been a real shock. But beyond that, a limit does appear to have imposed itself. Benign neglect does not seem to have seriously hurt the euro's global prospects; it certainly has not prevented the newborn currency from taking on much of the DM's old international roles. But given rising doubts about the money's long-term sustainability even within Europe itself, neither does the monetary union's nonpolicy appear to have been of much help. Without official support, the euro has survived—but it has not prospered.

Motivations

What do we learn from these stories about the motivations of statecraft during an international currency's youth? That is the use question. Contrary to the Immaculate Conception of Power, governments clearly have varied in their responses to the prospect of internationalization. Some have actually preferred the prevention option, even as others have sought either to encourage internationalization (promotion), as the Immaculate Conception of Power would imply, or to remain neutral (permission).

One factor above all seems to drive choice among the three options: the extent of an issuer's *geopolitical ambition*. The more a country aspires to great power status, the more likely it is to opt for a proactive policy of promotion. Conversely, the more modest its sense of place in the world, the more it will be deterred by the prospective risks or responsibilities of currency internationalization. Prevention or permission will be the preferred strategy.

The salience of geopolitical ambition is amply demonstrated by the contrast between West Germany and pre-1990s Japan, on the one hand, and China more recently on the other. At the time that each of their currencies first began to gain international appeal, the three states could all be regarded as rising powers in the global system. All three were the beneficiaries of seemingly miraculous economic growth, and all were seen as emerging leaders in their respective regions. Yet of the three, only China openly welcomed the prospect of currency internationalization and has chosen to

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campaign actively on its behalf. The other two resisted. Much of the difference, it seems clear, turns on the role that each of the three nations saw itself playing in regional or global politics.

Neither West Germany nor Japan, during the years of their currencies' ascendance, harbored any noticeable great power ambitions. Devastating defeat in World War II had left them both more or less content to shelter under the security umbrella provided by the United States and to concentrate on rebuilding their broken economies. Their ambitions were defensive and limited primarily to the world of commerce. Beset by historical memories, neither country had any wish to do anything that might seem politically or militarily threatening to their neighbors.

For the Germans, this meant submerging themselves in broader collective arrangements like the European Community, now known as the European Union (EU), and the North Atlantic Treaty Organization (NATO), where their relative weight would be less conspicuous. For the Japanese it meant accepting the restraints of their postwar constitution, imposed during the US occupation, which limited Japan's reborn military to a purely defensive posture. Neither country, to recall the imagery of Armijo and Katada (2015), was looking for a new sword—a new means for projecting power abroad. Nor did either wish to jeopardize its security relationship with the United States. Hence, neither country showed much interest in the enhanced capabilities abroad that might result from internationalization of their currencies.

Contrast that with China, whose geopolitical aspirations would appear to be much less modest. Admittedly, given the secretive nature of Chinese politics, no one outside the ranks of the country's close-knit leadership can know for sure what Beijing really wants in foreign policy. Analysts argue endlessly about the country's ultimate intentions (Gurtov 2013; Rapkin and Thompson 2013; Shambaugh 2013; French 2017). Is China a more or less conventional power, prepared to accept the continuing legitimacy of the existing world order? Is it a revisionist state, seeking greater deference from others along with some limited reforms of the status quo? Or is it a disruptive revolutionary, looking toward a radical alternative to the prevailing regime—an entirely new system based on "Chinese characteristics?" Labels are thrown around with abandon. One source describes China as a "reform-minded status quo power" (Ren 2015). Another calls China a "true revisionist" (Chin 2017). The debate remains unresolved.

Whatever Beijing's long-term goals may be, however, one fact is clear. With economic success has come a drive to regain the rights and privileges

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that many in China have long regarded as the Middle Kingdom's natural due. Since as early as the seventh century, dating from the start of the Tang dynasty in 618, the Chinese have been conditioned to think of themselves more as an empire than as a country—as the dominant center of a vast "tribute system" (French 2017). In return for gifts of various kinds (tribute), the Chinese emperor graciously bestowed recognition on neighboring rulers. As one informed observer warns, we cannot forget "the lingering place of the tribute system in the Chinese psyche" (French 2017, 10). After what they recall as a "century of humiliation" at the hands of the barbarian West, the Chinese are set on a "peaceful rise" to the glories of renewed great power status. The nation's leadership has made no secret of its desire to restore the pride and dignity of historical Chinese civilization, and it spares no effort in projecting a strong positive image to the rest of the world (Wang 2003). At the heart of what President Xi Jinping calls the "China dream" is a determination to attain a much larger measure of influence in global economic and political affairs. In his keynote speech before the quinquennial congress of the Chinese Communist Party in October 2017, Xi made reference to China's coming status as a "great power" or "strong power" more than twenty times (Buckley and Ryan 2017). The time has now come, he declared, for China to take center stage in the global order.

In that context, an internationalized yuan has naturally been valued because of what it could add to the country's geopolitical capabilities. As the PBOC Study Group said, China would enjoy "a rise in power standing." The contrast in this regard between China's bold aspirations and the earlier self-restraint of West Germany and Japan is telling. Where West Germany and Japan defined themselves primarily in terms of economic success, China's sense of self is far more expansive. Many suspect that, first and foremost, Beijing is intent on equipping itself with a handy new sword.

In turn, these contrasting geopolitical ambitions had a pronounced effect on the weight each country placed on the issue of domestic monetary stability. Here too, the contrast between China and the others is telling. For both West Germany and Japan back in the 1970s and 1980s, the issue of monetary autonomy at home could be treated as paramount precisely because of the absence of competing goals abroad. Currency internationalization was viewed as little more than a distraction. Any appeal that an international money might offer as a possible sword paled in significance relative to the perceived risk of a weakened shield against increased inflation or exchange-rate volatility. In each case, the authorities had long relied on monetary policy as their principal instrument to maintain macro-

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economic order at home, and they were reluctant to allow anything that might threaten their policy autonomy. For them, therefore, prevention rather than promotion seemed the logical choice.

As a practical matter, the fears of the West Germans and Japanese were a bit overblown. The example of the United States was obviously on their minds at the time. Washington's policy flexibility seemed increasingly at risk because of its persistently growing overhang of dollar debt. But that may have misled the Germans and Japanese into discounting the near-term benefits of internationalization—in particular, the advantage of being able to run "deficits without tears," which increases rather than decreases monetary autonomy. The exorbitant privilege is especially evident in the earliest stage of internationalization, when a money is most popular; and, as the example of the greenback demonstrates, it may be many decades, even centuries, before confidence in a currency truly begins to fade. The Federal Republic and Japan were not necessarily wrong to worry about the possibility of eventual constraints on their domestic policy. Arguably, however, in choosing the prevention option, they may have been more cautious than they needed to be. Implicitly, the point was conceded by the Japanese in the 1990s when they abruptly, albeit unsuccessfully, switched to the "new politics of monetary insulation." Now internationalization was seen not as a threat, but as a shield.

For China today, by contrast, interest in a shield is secondary. Beijing already has solid financial protection—a monetary Great Wall, as it were—in a panoply of controls that is still far tighter than anything ever imposed by West Germany or Japan. Investment funds can be moved in or out of the country only through authorized banking institutions, and only with approval from the relevant agencies. It is understood, of course, that future reforms to loosen restrictions could increasingly compromise policy independence, at least at the margins. But given the measures long in place, Chinese policy makers have not—or not yet—seen fit to prioritize the risk to the same extent as did West Germany and Japan. With their monetary Great Wall in place, they could afford to be less worried about domestic autonomy. Instead, they could focus on the role that the yuan might possibly play in extending their country's external influence.

The implication, therefore, is clear. The choice among the three options —prevention, promotion, or permission—is heavily affected by the relative weight given to the goal of international influence. The promotion option goes hand in hand with an emphasis on geopolitical ambition. The point is vividly demonstrated by China's determined long march toward global

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status for the RMB, which is quite openly motivated by considerations of power and prestige. It can also be seen in Japan's brief post-bubble campaign for the yen, which ended so humiliatingly. Beset throughout the 1990s by stagnation at home and the threat of a rising China abroad, the Japanese had reason to worry about erosion of their previous leadership role in East Asia. Yen internationalization seemed to promise some respite from geopolitical decline, though in the end the vision turned out to be a mirage.

In an inverse example, the point can also be seen in the neutral stance of the eurozone. Europe's common currency is backed by a coalition of states that have never come close to the degree of political and military unification that would be required to effectively project power beyond their joint borders. There is no United States of Europe. Unable to attain full reconciliation of their individual interests and concerns, the Europeans have in effect abdicated any pretense to collective great power status. It is hardly surprising, therefore, that in their currency statecraft they would settle for a nonpolicy. In the absence of consensus, a stance of tolerant forbearance would seem to be the most prudent course to follow. The permission option is, in effect, Europe's default choice.

Conversely, where geopolitical ambition is self-consciously limited, greater emphasis correspondingly can be placed on domestic stabilization. The prevention option becomes more attractive. The point is well demonstrated by the sustained resistance mounted by both West Germany and Japan to the internationalization of their currencies during the years of the Cold War. Reassured by the defense commitments of the United States, they could afford to concentrate on the management of their economies at home. For them, autonomy trumped influence. But for China, a rising nation intent on restoring its great power status, the calculus obviously tilted the other way. Since monetary stability at home was a less urgent concern, emphasis could be placed instead on considerations of power and prestige abroad. An ambitious promotion strategy logically followed.

Effectiveness

Turn now to the utility question—the issue of limits. Not surprisingly, given how little attention has been paid to the subject of currency statecraft in the formal literature, existing scholarship offers few clues about the limits, if any, to policy interventions in this context. A rare exception is a recent study by Barry Eichengreen and colleagues, which cites some empirical evi-

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dence to suggest that it is easier to discourage than to encourage use of a currency for reserve purposes (Eichengreen, Mehl, and Chiţu 2018, ch. 7). But no systematic explanation is offered to explain the finding.

What do we learn from the cases under review here? In the case of China, it is still too early to render judgment; further discussion will be postponed until chapter 7. And of course little can be said about the euro, since it is difficult to assess the utility of a nonpolicy that lacks explicit goals. But in the other cases, enough time has now passed to provide some valuable insights.

Here one lesson stands out: the salience of *scope*. We know that the roles that individual currencies may or may not play can differ quite considerably. Some moneys might be used more for trade invoicing, others more as an investment medium or reserve asset. Some may be popular more at the private level, others at the official level. Some may be employed extensively as anchors for exchange rates, others hardly at all. Since World War II, only the US dollar has been used for all possible roles in just about every part of the world. That is why the greenback alone enjoys the status of top currency, at the peak of the currency pyramid. Other moneys, further down in the patrician or elite category, are more uneven in their degree of internationalization.

We also know that the differences among currencies reflect differences among the countries that issue them—the varying combinations of factors that determine each nation's natural comparative advantage in the competitive struggle among currencies. As noted back in chapter 1, these factors include economic size, financial development, foreign policy ties, military reach, and effective governance. In choosing what money to use and for what purpose, societal actors and central banks—the demand side of the market—can reasonably be expected to base their decisions on these essential elements. For each role, they will gravitate toward the currency that seems to best embody the relevant considerations, and they will shun those that do not.

In turn, this suggests that the effectiveness of currency statecraft here cannot be judged holistically. Rather, success or failure must be evaluated in terms of individual roles. For each role, the outcome will depend very much on whether policy is in line with user sentiment or opposed to it. Efforts to promote or resist use of a currency for a given purpose are more likely to succeed if the demand side agrees with the government's aims rather than if users disagree. It all depends on whether there is congruence or divergence between the preferences of a currency's users and its issuing

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authority. With congruence, policy is pushing against an open door. With divergence, the battle is more apt to be lost than won.

The point is well illustrated by the cases of West Germany and Japan. At first glance, both countries would appear to have been unsuccessful in their strategic choices. West Germany and Japan, in the 1970s and 1980s, both broadly failed to prevent the emergence of the Deutsche mark and yen as major international currencies. Likewise, after the bursting of the bubble economy, Japan conspicuously miscarried in its brief attempt to reverse course and promote wider use of the yen. A closer look, however, suggests a more nuanced interpretation. Policy did fail for roles where the preferences of users and issuers diverged, but not necessarily for other roles where preferences were more congruent.

West Germany and Pre-1990s Japan

Consider, first, the contrast between West Germany and Japan in the period prior to the 1990s. For a long time, both countries did their best to resist internationalization. Yet both their moneys rose close to the peak of the currency pyramid. In that sense, it would seem fair to conclude that in each case the government's prevention strategy proved unsuccessful. But that broad judgment would be misleading, since it overlooks the unevenness of internationalization in the two cases, which reflected strikingly differing relationships between official and demand-side preferences. Whereas the Deutsche mark came to be used more as a medium of exchange and unit of account, the yen gained greater popularity as a store of value. In both cases, policy succeeded when preferences coincided, and failed when they did not.

In the German case, it proved difficult for policy makers to prevent widespread adoption of the DM for trade invoicing and settlement. Use was directly linked to the Federal Republic's emerging dominance in global commerce, both as exporter and importer. By the 1990s West Germany had become the world's second largest trading nation, with a share of international trade (exports plus imports) of around 10 percent—second only to that of the United States. Especially in the European region, West Germany's large economy was bound to exercise a strong gravitational pull, which in turn was reinforced by the European integration project. As neighboring economies became increasingly tied to the Federal Republic, both as a market and source of supply, it was only natural that they would be eager to do more business in DM. As a practical matter, there was really little that the West German authorities could do to block wider use of their currency.

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In finance, however, the story was different. Given the relative backwardness of the Federal Republic's capital market, foreign interest in the DM as an investment medium was never very strong. Since much more attractive alternatives were on offer in London or New York, it was considerably easier for the Bundesbank to discourage adoption of the DM as a store of value. On the trade side, where official and market preferences sharply diverged, West Germany's statecraft could be judged unsuccessful. But on the finance side, where demand for internationalization was much weaker, policy was more effective.

Conversely, in the Japanese case it proved difficult for policy makers to forestall widespread use of the yen for investment purposes, but easier for them to forestall its use in trade relations. As indicated, the government did what it could to limit foreign access to the domestic bond market. But persistent upward pressure on the yen exchange rate made the currency especially attractive to international investors. Japan was the Land of the Rising Yen. On the trade side, Tokyo's task was made much easier by the unique pattern of invoicing in Japanese trade, which limited foreign interest in adopting the yen as a medium of exchange. Unlike companies in most other advanced economies, Japanese firms preferred to avoid doing much overseas business in their own currency. Whereas in the United States virtually all exports were denominated in home currency, and in Germany 80 percent were thus denominated, in Japan the corresponding figure at the time was no more than 30 to 35 percent. Most Japanese exports were denominated in US dollars, reflecting the Japanese economy's high degree of dependence on the US market. A practice of "pricing to market" was a rational strategy to maintain market share in the United States. Only sales to developing countries, where Japan enjoyed relatively more commercial leverage, tended to be denominated in yen.

In practical terms, therefore, Japan's outcome differed considerably from Germany's. The investment role flourished more than the trade role. Yet in analytical terms, its story is very much the same as that of Germany. Policy was most effective where the preferences of issuers and users were congruent, and was least successful where they were not.

West Germany and Postbubble Japan

Now consider the contrast between West Germany before the 1990s, when prevention was still the government's preferred option, and Japan after the bursting of its bubble economy, when its policy shifted from prevention to promotion. Right up to the birth of the euro, West Germany resisted efforts

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to make the Deutsche mark the effective anchor for other European currencies. In the 1990s, by contrast, Japan grew increasingly enthusiastic about the idea of a yen bloc to rival the US dollar and the DM, for both domestic and geopolitical reasons. Yet neither country, in the end, got its wish. The DM was merged into Europe's new monetary union—which many saw as the DM writ large—and the yen zone remained limited to Japan itself. In both cases, the reason was that the preferences of issuers and users were divergent rather than convergent.

For West Germany's neighbors, anchoring to the DM made eminent sense given the Federal Republic's central position in regional import and export markets. Because of its deeply held stability culture, West Germany consistently ranked among the world's least inflationary economies. Nearby states were therefore motivated to keep their own prices in line in order to avoid a loss of competitiveness relative to the Germans. Neighbors felt compelled to anchor their nominal exchange rates to the DM as a kind of check to their own inflationary propensities.

And here, too, the impact was reinforced by the European project, which from the late 1960s onward featured repeated attempts to promote some form of regional monetary integration. First, in 1972, came the so-called "snake," a mutual intervention system aiming to link the currencies of West Germany and its European Community partners together in a joint float. When that experiment proved unsustainable, agreement was reached in 1978 to launch a new European Monetary System (EMS), designed in effect to create an improved "supersnake" for Europe. At the heart of the EMS was the Exchange Rate Mechanism (ERM), where in principle all interventions to sustain the joint float would be symmetrical within a matrix of bilateral cross-rates. In practice, however, the ERM soon evolved into something more like a spoke-and-wheel construct, with West Germany's money placed, despite German government resistance, at the center—a de facto DM zone. The Germans wanted exchange-rate stability, but not necessarily the responsibility of being at the center of the system. Studies show that by the 1980s almost all of Europe's currencies were shadowing the DM to a greater or lesser extent (Bénassy-Quéré and Deusy-Fournier 1994; Frankel and Wei 1995). Here too, as a practical matter, there seemed little that the West German authorities could do to block the process.

For post-bubble Japan, the challenge was the reverse—not to resist coalescence of a currency bloc, but to encourage it. But once the Asian Monetary Fund proposal died, Tokyo found itself with few levers, other than foreign aid programs, with which to influence the currency preferences of nearby countries. The Japanese were certainly in no position to offer lead-

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ership on security issues. Limited by its Occupation constitution, Tokyo was incapable of projecting military power beyond the country's home islands. Nor could the slumping Japanese economy offer much gravitational pull to encourage use of yen for trade purposes.

As a practical matter, there were simply no nations in the region prepared to follow Japan's lead. On the one hand, memories were still fresh of Tokyo's wartime atrocities and prewar attempts to build an imperial Greater East-Asia Co-Prosperity Sphere. No one wanted to go that route again. On the other hand, the emergence of a newly ascendant China inspired many to hedge their bets, waiting to see whether Beijing might successfully challenge Japan for leadership in the region. As Saori Katada (2002, 105) has observed, Asian governments were inclined to "avoid any attempts by Japan that might result in locking those countries into power relations." Here too, strategy faltered because of a wide gap between official and demand-side preferences.

Conclusion

The formative years of an international currency are manifestly a testing time for governments. Two challenges must be faced. First, policy makers must, in broad strategic terms, decide how to respond to the prospect of internationalization. Should they, like China in recent years, welcome wider use of their money? Or rather, should they actively seek to resist it, like West Germany and Japan in earlier years? And second, once they make a decision, they must figure out how to make their strategic choices effective. Can they find a way to impose their will on the demand side of the market, either directly or indirectly, or will they fail? Neither challenge is easy.

The historical record suggests that the choice among the three options of prevention, promotion, or permission will depend most of all on the issue of geopolitical ambition. States like China, with evident great power aspirations, may welcome internationalization while others like West Germany and Japan, more concerned about domestic stabilization, are more likely to resist. But the evidence also suggests that whatever governments decide, they may have a hard time getting their way. For roles where official preferences are more in line with demand-side sentiment, government policy may prevail. But where preferences diverge significantly, the result will be less favorable. Use of a currency for some purposes may flourish despite determined efforts to stop it. Conversely, use of a currency for other purposes may languish despite a government's best efforts to promote it. Currency statecraft clearly has its limits.

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FIVE

Maturity

Maturity is the stage that most people have in mind when they think of an international currency. At this stage, the tests of the first lap of the journey are over. Whether promoted by policy makers or not, the money has become internationalized. It has come to play some combination of roles over some geographic range, and material capabilities have been enhanced. So the challenge for currency statecraft is transformed. The main question now is what to do about the new currency power. How should the money be managed: by exploitation, evasion, or enjoyment? Should the issuer seek consciously to *capitalize* on the advantages that are offered by the newfound power resource? Alternatively, should it look for some way to *escape* potential risks of currency internationalization? Or should it, in a passive mode, simply relax and *accept* the benefits of internationalization as they come? Once again, a brief review of recent history illustrates the importance of geopolitical ambition—its presence or absence—in determining which of these three options will be chosen.

This chapter begins with a short discussion of the handful of states that in the modern era have seen their money rise to the upper ranks of the currency pyramid, just below America's top-ranked greenback. These include today's euro and yen—two patrician currencies—plus Britain's pound, the Swiss franc, and the Canadian and Australian dollars, previously characterized as elite currencies. Collectively, I will refer to them as the *top-tier club*. (China's RMB may soon be added to this rather exclusive club, but is not quite there yet.) All the members of the top-tier club have mature currencies that play a variety of international roles. Yet all have settled for the enjoyment option, eschewing the attractions of currency power. Nothing better demonstrates the error of the Immaculate Conception of Power.

The bulk of this chapter will then be devoted to a much lengthier look

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at the United States, where of course the story is quite different. If there is one nation that seems to embody the Immaculate Conception of Power, it is America, still acknowledged three-quarters of a century after World War II as the greatest of great powers (though for how much longer is a matter of much debate, especially since the election of Donald Trump as president). No one doubts Washington's will to exercise influence in the world. Nor, when it comes to matters of money, is there any question about the magnitude of potential payoffs. Few would expect US policy makers to voluntarily refrain from making use of their currency power when possible. For an ambitious country like the United States, deeply enmeshed in geopolitics in every corner of the globe, passivity is not a natural option. America's currency statecraft is bound to be more proactive. In the US case, the key issue is not motivation (the use question) but rather effectiveness (the utility question). What sets a limit, if any, to the currency power of a dominant country like the United States?

The Top-Tier Club

Many observers, not surprisingly, are inclined to expect the exploitation option to be adopted whenever a currency reaches maturity. That is the Immaculate Conception of Power in a nutshell. Since the great game of geopolitics is never-ending, it seems only natural to assume that if an opportunity exists to exercise influence, it will be seized. Otherwise, it would be like leaving cash on the table, wasteful and negligent. Ability acquired is expected to translate automatically—even mechanically—into power projected.

Indeed, in earlier times, that was just the way the world seemed to work. Instances of such behavior have often been manifest in the past, especially back during the bitter years of the Great Depression. In the midst of the economic warfare that followed the collapse of international finance in the 1930s, the exploitation option appeared particularly tempting for nations that were disposed to engage actively in realpolitik. Three cases in particular stand out. One was Britain, which used offers of privileged access to the London capital market through the newly created sterling bloc to retain a degree of international leverage (Cohen 1971; Kirshner 1995, 140–48). Another was Japan, which promoted construction of a yen bloc (formally, a Greater East Asia Financial Area) to help cement its repressive Greater East Asia Co-Prosperity Sphere (Katada 2002). And a third was Nazi Germany, which openly deployed its Reichsmark as part of an aggressive foreign policy to gain influence, especially in central and southeastern Europe.

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With unmistakable cunning, Berlin crafted a formal clearing system that helped to consolidate the trade dependence of poor nearby countries like Bulgaria, Greece, Hungary, Romania, and Yugoslavia (Hirschman [1945] 1969; Kirshner 1995, 121–40). In all three cases, the currency instrument was used purposively on behalf of geopolitical ambition.

Since World War II, however, it is clear that the Immaculate Conception of Power no longer accords with historical reality. In the modern era, a handful of states have joined the top-tier club as junior partners of the dollar. Yet among them, not a single issuing authority has made any serious effort to employ the potential leverage generated by internationalization for political gain. Instead, the neutral enjoyment option has been the preferred choice. Despite considerable use of their currencies for diverse cross-border roles, none of these suppliers seems inclined to engage in any systematic exploitation of the geopolitical advantages on offer. For all the club members, currency statecraft has generally remained passive. The contrast with the United States, which is much more accustomed to throwing its weight around in global affairs, could not be sharper.

Why do members of the top-tier club chose passivity?

Insufficient Benefits?

Superficially, the answer would seem obvious: insufficient benefits. It may be that the exploitation option is rejected simply because the possible gains, in terms of currency power, do not loom large enough to make the effort seem worthwhile.

Recall where currency power comes from. First and foremost, it derives from the two store-of-value roles—the roles that a money may play in financial markets and central-bank reserves. These two roles are the source of an international currency's exorbitant privilege. The more that foreign investors or monetary authorities are willing to expand their holdings of a money, the greater will be the issuer's power to delay adjustment costs—to run "deficits without tears." Some measure of potential leverage is the automatic corollary.

But how big a measure? For some in the top-tier club, such as Australia or Canada, neither store-of-value role appears to correspond to their natural comparative advantage in currency competition. The appeal of their dollars tends to lie more in the trade role (and for Australia, in its regional anchor role). Hence, their ability to rely on outsiders to finance any payments deficits is limited. For others, such as Britain or Japan, the investment or reserve functions may be greater, but are still marginal at best as

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compared with a top currency like the US dollar. The two store-of-value roles do not automatically make a country a monetary superpower. There are clearly limits to the exorbitant privilege.

What sets the limits? Back in chapter 2 we noted two factors that dominate in determining the tipping point in an international currency's life cycle. These are, first, the availability (or not) of sufficiently attractive alternatives; and second, the magnitude of already existing foreign holdings of the currency. In the maturity stage, prior to the tipping point, these same two factors are critical in determining how much leverage a currency may enjoy before it (eventually) passes its peak. We may call them, respectively, the monopoly factor and the vulnerability factor.

The monopoly factor is important because it determines the issuer's ability to control the *supply* of international money. At issue is the currency's degree of monopolistic command over the availability of investment-quality assets—in other words, its competitive edge over rivals in providing an attractive store of value. How dominant is the issuing authority in this respect? How big is the currency's market share in capital markets or central-bank reserves? Conversely, the vulnerability factor is important because it has an effect on the *demand* side by helping to shape market sentiment regarding the reliability of the issuer's liabilities. At issue here is vulnerability to an adverse shift in creditor trust—in other words, the risk of a confidence crisis.

We cannot forget that in acquiring claims denominated in a given currency, nonresidents are automatically extending a form of credit to the issuing country. For market actors and central banks, as I have said, the issuer's liabilities are no more than a kind of IOU, and thus are always subject to the vagaries of crowd psychology. The more that foreign holdings accumulate, piling up an ever greater overhang of debt, the more that doubts may begin to creep in regarding the issuer's ability to honor its financial commitments. Confidence will be eroded, increasing the issuer's exposure to the danger of capital flight. Indeed, if the erosion of confidence is great enough, the critical tipping point may be reached where the early virtuous circle in a money's life cycle is replaced by the later vicious circle.

For today's top-tier club, the demand side does not seem to pose much of a constraint. With the exception of the euro, which has had its share of sovereign debt difficulties since the global financial crisis, none of the other top-tier currencies has faced a serious confidence issue in years. This includes even the venerable British pound, which has actually enjoyed a bit of a renaissance as an international currency since postwar sterling balances were wound down and the sterling area dissolved back in the 1970s.

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And even for all its recent challenges, the euro remains the second most widely used currency in the world. All the issuing nations in the top-tier club, apart from Japan, receive very high creditworthiness scores from the three major rating agencies—Standard and Poor's, Moody's, and Fitch. Trading Economics (2017), a private New York-based information service, combines the scores of all three services along with some additional analysis into one rating system that runs from zero (default) to 100 (riskless). Other than Japan, which received a score of 78, all the top-tier currencies were rated in early 2017 at 95 (Britain) or above (Australia, 97; Canada, 99; Switzerland, 100).

For all these countries, the limit lies not on the demand side but on the supply side. Simply put, none has much monopolistic power. The reason is their small market share, which means that there are plenty of alternatives available should any member of the club seek to exploit its currency power by restricting supply. Users can shift elsewhere. In global reserves, for example, the shares of the pound and yen in early 2016 were not more than 4 to 5 percent each, far too small to exercise much direct leverage in foreign policy. And the shares of the Australian and Canadian dollars and Swiss franc were even tinier, under 2 percent each. This compares with a US dollar share of more than 65 percent. Only the euro, with a market share still close to 20 percent, could conceivably achieve some measure of effective leverage. But any overt influence attempt would require a much higher degree of cohesion among the monetary union's many partners than has seemed possible until now. It is likely to be a long time, if ever, before we see any departure from the eurozone's current nonpolicy of benign neglect.

Geopolitical Ambition

Limited benefits, however, cannot really provide an adequate explanation. If the Immaculate Conception of Power is to be believed, any gain at all—no matter how trivial—would be exploited. The world is thought to be too dangerous to ignore a useful instrument of statecraft. Yet that, in effect, is what members of the top-tier club do. Passivity prevails. So the question remains: Why?

The answer, arguably, lies in a lack of broad geopolitical ambition. These are nations without great power aspirations. That is certainly true of the club's smaller members, such as Australia, Canada, and Switzerland—all rightly regarded as quietly peaceful citizens of the global community. It remains true of Japan as well, just as it did back in the 1970s and 1980s. And it may even be said of Britain, especially since that country's vote in

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2016 to leave the European Union. Without the amplification provided by EU membership, Britain's voice on the world stage cannot be expected to ring very loudly.

In none of these states, therefore, is the attraction of currency power particularly strong. External leverage is simply not their highest priority. Their sense of identity does not require a drive to project power abroad. Rather, they are much more concerned with maintaining monetary stability at home. As for West Germany and Japan earlier, so for all of them today: autonomy trumps influence. Their interest is in a shield, not a sword.

Their choice, accordingly, is the enjoyment option. They are content to savor the material gains available—savings of transactions costs, denomination rents, even some modest measure of seigniorage. But they lack the motivation to go further, to make any serious attempt to use their currency as an instrument of influence. That privilege is left to others—most importantly, the United States.

Evasion

For the United States, with a money as dominant as the dollar has been for so long, a proactive policy seems natural. Even for America, however, it may be noted that the attraction of currency power has never been absolute. US policy makers have undoubtedly enjoyed the capabilities granted them by the greenback's popularity. Interestingly, though, there have been moments when proactive policy meant the evasion option for America rather than exploitation—times when Washington, contrary to expectation, has actually thought about trying to cut back on international use of the greenback. Although such instances have been relatively rare, they demonstrate that, even for the country at the peak of the currency pyramid, exploitation will not always prove to be the default choice. On occasion, it may seem more advisable to evade the risks of internationalization rather than to persist in leveraging its advantages.

The explanation is simple. For America to continually capitalize on its exorbitant privilege, the future of the value and availability of the dollar must be unquestioned. Market actors and foreign central banks must be prepared to accept and hold the currency without hesitation. In practice, however, not even the United States has been wholly immune to the risk of an occasional confidence crisis. Instances have arisen when creditor trust has appeared to weaken significantly, threatening America's historic ability to run deficits without tears. The benefits of internationalization were overshadowed by the danger of capital flight—a "run on the bank"—caused

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by a seemingly excessive overhang of debt. At times, there were even fears that a tipping point had indeed been reached, presaging a transition from maturity to decline. At such junctures it appeared to make more sense for Washington to seek to limit rather than promote the growth of US liabilities. Prudence took precedence over pride.

Two such junctures stand out. The first came in the 1960s, when the US dollar was still convertible into gold for foreign central banks. In the aftermath of World War II, nations had become accustomed to relying on US payments deficits to avert a global reserve shortage. America, in effect, had become the monopoly supplier of international liquidity. But, as the celebrated economist Robert Triffin pointed out in his classic *Gold and the Dollar Crisis* (Triffin 1960a), this was bound in time to undermine confidence in the greenback's continued convertibility. Already, Triffin noted, America's overhang of liabilities had grown larger than its gold stock. Governments, therefore, were caught on the horns of a dilemma—what came to be called the Triffin Dilemma. To forestall a run on the dollar, US deficits would have to cease. But that would confront nations with a liquidity shortage. To forestall a reserve shortage, US deficits would have to continue. But that would then confront governments with a confidence problem. The international community could not have its cake and eat it too. Some manner of reform was needed.

In response, a variety of initiatives were undertaken, ranging from creation of a new network of mutual credit facilities to help defend the greenback, to formation of a gold pool to stabilize the price of the yellow metal in private markets (Frasher 2014). Most notably, Washington led negotiations to establish a substitute source of liquidity growth in order to reduce dependence on dollar deficits in the future. What emerged was an agreement in 1968 to create the SDR, an entirely new type of world reserve asset to be provided through the IMF. The idea was now to rely on new issues of SDRs to sustain global liquidity. The United States would then be free to initiate measures to move closer to balance-of-payments equilibrium, thus averting a confidence problem. The international community *could* have its cake and eat it too. America's greenback would not be displaced at the center of the currency system. But, by accepting some dilution of its monopoly role, Washington could hope to evade the risk of crisis going forward.

The second such juncture arose in the late 1970s, when the dollar once again came under pressure. Concerns about the Triffin Dilemma had understandably faded after President Richard Nixon chose to terminate the dollar's gold convertibility in 1971. No longer was confidence in the greenback threatened by an inadequate stock of the yellow metal. But by now,

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new foreign rivals, the DM and yen, were emerging as credible alternatives for central banks seeking a safe reserve asset, even as US liabilities continued to mount. By 1978, fears were rampant that a flight from the US dollar might grievously destabilize the global monetary system. In response, voices at the IMF and elsewhere began to call for creation of what came to be called a substitution account, in which central banks might be able to offload some of their dollar reserves in exchange for claims denominated in SDRs. The idea was considered seriously by US policy makers, who once again were hoping to evade the risk of crisis. But in the end, the proposal foundered over the question of how to guarantee the exchange value of the new SDR-denominated claims (Boughton 2001a, 936–43). Efforts to revive the idea after the global financial crisis in 2008 similarly came to naught (Kenen 2010).

Such moments, however, were exceptional. Most often, Washington's choice of statecraft has been what we would expect of a dominant power: exploitation, not evasion. Proactive policy for the United States typically has meant using currency power, not abjuring it. US authorities clearly understand that the global dominance of the dollar gives them an exorbitant privilege. They also appreciate that the dollar's widespread appeal can add to America's capabilities in two ways, either directly or indirectly. On the one hand, the greenback itself has provided an effective policy instrument, available for direct use as a tool to achieve selected foreign-policy goals. That is the first face of power: direct purposive action. On the other hand, more indirectly, the dollar's widespread appeal has enhanced the utility of other pathways to leverage by enabling the United States to finance external imbalances with its own money, thus removing any payments constraint on government spending overseas. That is the second face of power, otherwise known as structural power. Through the central position of the greenback, both tracks have been available to decision makers in Washington.

Our question, to repeat, is: What are the limits, if any, to either sort of currency power?

Indirect Currency Power

Begin with indirect currency power. It is difficult to exaggerate the extent to which the United States has benefited over the years from its structural ability to run persistent "deficits without tears." For decades, Washington has been able to fight wars, support investment abroad, and extend foreign aid to friends and allies seemingly without concern for any payments imbalances that might result. The US military is able to maintain as many

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as 900 bases or installations in some 130 countries, and the Pentagon can afford to spend nearly as much as the rest of the world combined to project American influence around the world. None of this would be possible without the dollar's enduring popularity as a store of value. For the United States, external financing has been available when needed. Adjustment has been perpetually delayed.

The privilege is aptly summarized by Paul Viotti (2104, 4, 18), an international security scholar:

> U.S. foreign and national security policy-makers depend to a greater degree than even they sometimes realize upon the purchasing power and continued acceptance of the dollar, which they use around the clock to finance military and other governmental expenditures abroad. . . . In sum, being able to spend vast sums without the same constraints others face certainly has facilitated the making and implementation abroad of U.S. decisions and actions over some seven decades since World War II.

But can it go on? The future of America's power to delay is a subject of great controversy. It is clear that at some point in the long run of history, a limit of some kind must be reached. As the American economist Herbert Stein put it, in what has come to be known as Stein's Law: "If something cannot go on forever, it will stop." But it is also evident that any limits in this context are flexible, to say the least. In the case of the greenback, it seems unlikely that a ceiling will be reached anytime soon.

Limits

At issue are the same two factors emphasized earlier in this chapter: the monopoly factor and the vulnerability factor. These, in principle, are the limits that the issuer of a mature international currency has to worry about. An exorbitant privilege like America's will be lost either if attractive new alternatives appear to offer more intense competition or if a growing overhang of foreign liabilities begins to endanger financial solvency. Otherwise, the advantage goes to the incumbent.

In the eyes of many observers, both factors suggest that the days of the dollar's exorbitant privilege are numbered. Some "dollar pessimists" emphasize America's persistent deficits and mounting external debt, which jeopardize US financial credibility; others, the emergence of potentially appealing alternatives to the greenback, such as the euro or perhaps even the yuan. Surely, it is argued, a day of reckoning is coming. Typical is Jonathan

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Kirshner, who expresses little doubt about the prospect of "dollar diminution" (2014, 140). Over the coming years, Kirshner asserts, "the dollar's international role is likely to come under pressure." Echoes James Rickards, an investment manager and former government official: "Threats to the dollar are ubiquitous. . . . It is too late to save the dollar" (Rickards 2014, 303–4).

In fact, we have heard predictions like these before—literally for decades. Well over half a century ago, Triffin was already warning about "the imminent threat to the once mighty US dollar" (1960b, 230). Likewise, in the mid-1970s Charles Kindleberger famously declared, "The dollar is finished as international money" (1976, 35). Yet America's currency continues to prevail. Retrospective econometric studies confirm that the greenback's popularity is no less today than it was decades ago (Cohen and Benney 2014; Ilzetzki et al. 2017). In the words of one recent analysis, "The dollar is as dominant today . . . as it was at the time of the early Bretton Woods era" (Ilzetzki et al. 2017, 4).

Not even the gale-force winds of the global financial crisis seemed able to topple the dollar from its perch at the peak of the currency pyramid. Indeed, if anything the greenback came out of the 2008 crisis more robust than ever. Observes Eric Helleiner: "In the wake of the crisis, the dollar quickly faced new challenges. . . . [Yet] the dollar's status as the world's dominant currency emerged remarkably unscathed" (2014, 9–10). In response to a premature obituary, Mark Twain is alleged to have said, "The reports of my death have been greatly exaggerated." Hyperbolic forecasts of the greenback's demise appear to be similarly overdone. The indirect power of the dollar remains undiminished.

What explains the dollar's endurance? The answer is clear. America's external debt has proved to be less of a burden than presumed, and potential alternatives to the greenback have turned out to be more deficient than anticipated. Dollar pessimists, from Triffin onward, have not been wrong about the factors that matter most in this context. But they do seem to have repeatedly underestimated the elasticity of the limits to America's power to delay. If there is any threat to the greenback's standing, it originates at home, not abroad.

Debt

Consider the debt issue. There is no question that America's overhang of foreign liabilities looks risky—indeed, even scary. In the early years after World War II, the United States stood tall as the world's biggest net credi-

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tor. Overall, the nation's claims abroad (including private-sector investments as well as government assets) far exceeded foreign liabilities. Even as late as 1980, the US net international investment position was still a positive $360 billion. But, starting in the 1970s, America's current account moved into deficit, gradually adding to net external debt. In 1986 the balance of international indebtedness turned negative for the first time in the post–World War II period by a modest $27 billion, and it has worsened ever since. By 2000 net debt had passed $1.3 trillion. By 2016 it reached an astronomical $8 trillion. America is now the world's—indeed, history's—biggest net debtor. Who could be blamed for worrying about where all that might lead? As Alan Wheatley, an economic commentator, asks (2013a, 13): "How much more debt can the US accrue without undermining . . . the very confidence in the dollar that makes those securities so appealing in the first place?"

Risk can be exaggerated, however. For a proper measure, the magnitude of a country's deficits or debts should be scaled to the size of its economy—its gross domestic product (GDP). In the most recent period, US current-account deficits have been on a downward trend, from as high as $800 billion in 2006 (the equivalent of 6.2 percent of GDP) to under $500 billion in 2016 (equal to just 2.4 percent of GDP). And a net foreign debt of $8 trillion, while hardly trivial, is still only the equivalent of a little more than 40 percent of US GDP. In gross terms, the United States holds some $25 trillion of claims on the outside world—an amount of overseas wealth far greater than that of any other nation. There is still a lot of money in the till to reassure nervous creditors.

More to the point, risk is greatly overshadowed by reward. For investors and central banks, the dollar offers two enormous advantages as an international store of value: unsurpassed liquidity and safety. The downside of US debt is far outweighed by the upside of America's extraordinarily well-developed financial sector, which promises both efficiency and security.

Liquidity is assured by markets for dollar-denominated claims that are broad, deep, resilient, and open to all. The range of services is wide, transactions costs are low, and property rights are well protected. Outsiders, whether private investors or central banks, know that they can count on an exceptionally high degree of exchange convenience and capital certainty when they do business in the dollar. The evidence can be easily seen in the ample seigniorage that the United States enjoys at the expense of the rest of the world. Foreign demand for dollar-denominated claims generates a substantial interest-rate subsidy for Americans, estimated to amount to as much as 2.0 to 2.4 basis points for every percentage-point increase

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in overseas holdings (Csonto and Tovar 2017). Cumulatively, the subsidy adds up to as much as 80 basis points, equivalent to an annual saving of at least $150 billion for the federal government and other domestic borrowers (Warnock and Warnock 2009; Kaminska and Zinna 2014).

Even more striking is the degree to which overall returns on US assets abroad exceed the aggregate cost of overseas liabilities. Studies put the difference at some 300 basis points or more per year, worth anywhere from 1 percent to 3 percent of GDP (Gourinchas and Rey 2007; European Central Bank 2010). Even with a net external debt of $8 trillion, the United States enjoys a positive net return of investment income, with earnings abroad that exceed foreign interest payments by more than $100 billion. In effect, outsiders collectively seem prepared to pay a considerable price, in terms of revenue foregone, for their right to make use of the greenback as a store of wealth. One source refers to this as a kind of "saver's curse" in international finance (Jeanne 2012, 3).

Is it rational for outsiders to tolerate the saver's curse? In terms of economic theory, the outcome would not seem unreasonable. In effect, the price reflects a natural trade-off—a "liquidity premium" paid in return for the dollar's promise of operational and valuation efficiency (Gourinchas and Rey 2007; Kaminska and Zinna 2014). Particularly relevant is the market for US government debt, which includes everything from three-month Treasury bills to much longer-term notes and bonds, along with so-called agency securities—bonds issued by quasigovernmental agencies like the Federal Home Loan Mortgage Corporation ("Freddie Mac") and the Federal National Mortgage Association ("Fannie Mae"). Federal debt is a popular investment medium for private actors around the globe; it is also the principal form in which central banks hold their dollar reserves. Overall, Treasury obligations and agency securities in general circulation exceed $13 trillion. With a turnover of more than $500 billion daily, the government debt market offers a degree of liquidity that is difficult to match. Nothing in the world comes close to the US Treasury bill—commonly referred to simply as the T-bill—for transactional ease or assurance of value.

And then there is the consideration of safety. Outsiders are also willing to pay a price for the promise of a safe haven for investments or reserves—what may be called a "security premium" on top of the greenback's liquidity premium. That too is a natural trade-off. For many analysts today, the single most important role that an international currency can play is that of a safe haven: providing a range of claims that are as free of risk as possible. Properly understood, insists one commentary, the essential feature of a dominant money is that it "delivers a secure financial asset that fa-

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cilitates the functioning of financial markets" (Fields and Vernengo 2013, 746). And no issuer among today's top-tier currencies has been in a better position to deliver secure financial assets than the United States, the era's dominant military power. Much has been written since the global financial crisis about the dangers of a growing shortage of high-quality claims around the world, relative to demand (Caballero at al. 2017). Only the United States, it seems, with its unprecedented military reach, is capable of supplying safe and liquid investment-grade assets on anything like the scale required. One source calls US federal debt the "quintessential liquid safe asset" (Caballero et al. 2017, 41). In the words of one New York investment strategist, as quoted in *The New York Times* (13 May 2012): "When people are worried, all roads lead to Treasuries." Should it be any surprise, then, that outsiders might be prepared to tolerate the saver's curse?

Alternatives

By comparison, there are simply not enough attractive alternatives elsewhere. None of the other top-tier currencies comes even close to promising the same combination of liquidity and safety; nor are they available in the necessary volume. Back when she was secretary of state under President Bill Clinton, Madeleine Albright liked to describe the United States as the "indispensable nation," the one superpower that the world could not do without. Arguably, the dollar could be called the *indispensable currency*, the one money that the world cannot do without. "There are now few genuinely safe assets," declares a prominent British journalist (Tett 2014). In the absence of adequate alternatives, he says, the greenback "has become ultra-attractive because of bountiful supply." Or, as the economist John Williamson puts it more simply: "The dollar is unrivaled" (2013, 76).

The other top-tier currencies do offer some of the same attractions as the greenback—but by no means on the same scale. The eurozone, combining the financial sectors of all its members, was initially expected to pose a serious competitive challenge to the dollar. But, as indicated, its early promise has remained largely unrealized; and after a fast early start, international use has even regressed under the pressure of Europe's sovereign debt problems. Since the global crisis exploded in 2008, European banking and capital markets have actually fragmented, with many financial sectors retreating once again behind national frontiers. Any claim to breadth or depth has been lost.

Nor can the EU pretend to offer anything like the military reach of the United States, which helps to make the dollar so attractive as a safe haven.

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Quite the contrary, in fact. In the words of one informed source, "the EU's dependence on the United States for its security precludes the EU from having the kind of political leverage to support the euro that the United States has with the dollar" (Brooks et al. 2013, 140). More bluntly, a senior official of the European Commission concedes, speaking anonymously: "We're a political dwarf." Given a choice, few governments outside the European time zones would opt for the EU as a political patron in preference to the United States; few investors would see the euro as a safer haven than the greenback. As a practical matter, Europe's political capabilities are simply too limited. Concludes Adam Posen (2008, 88), "Foreign policy and national security ties . . . continue to favor the dollar's global use."

Elsewhere, among the other members of the top-tier club, financial markets are efficient, but are in no way capable of offering the range of investment opportunities available in the United States. None—not even Japan after the Big Bang reforms of the 1990s—can provide financial assets in the quantity required by the global system. Nor do any have the kind of military reach that would be necessary to provide a safer haven than the United States. It is no accident that their market share, even collectively, remains so small.

In truth, in today's world there is simply no other currency that can match the US dollar's appeal for investment or reserve purposes. No talented understudy is lurking in the wings, just waiting for an opportunity to take center stage. This means that even if there were to be a crisis of confidence in the greenback, skittish investors and risk-averse central bankers would be faced with a tricky dilemma: Where would they go? To sell off one money means buying another. But if there is no obvious alternative, creditors may feel that they have little choice but to stick with the dollar, the leading player in the global system, whether they like it or not. America's vulnerability, as a result, is reduced.

Analytically, this clearly qualifies as a form of structural power, where the choice set for actors is defined for them, regardless of their own preferences. That is what Chinese sources have in mind when they speak of the "dollar trap," as noted in the previous chapter. Illustrative is the oft-cited response of Luo Ping, a senior Chinese official, when asked in 2009 whether China would continue to buy US Treasury bonds. "We hate you guys," he said. "Except for Treasuries, what can you hold? . . . US Treasuries are the safe haven. For everyone, including China, it is the only option. . . . Once you start issuing $1 trillion–$2 trillion . . . we know the dollar is going to depreciate, so we hate you guys but there is nothing much we can do" (as quoted in *Financial Times*, 12 February 2009). Nor are the Chinese

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alone. Their resentment is, in fact, shared by many (Helleiner 2014; Prasad 2014). Foreigners may appreciate the attractions of a dollar-based system, but that does not mean that they must like it. The late Ronald McKinnon (2013) was not far off when he called it the "unloved dollar standard."

Unloved or not, however, the US dollar endures. Limits to America's exorbitant privilege exist, but until now at least, they have failed to make much of a dent. Analysts often comment on the extent to which currency choice is subject to inertia, owing to the often high cost of switching from one money to another. To succeed, a challenger must not only match the qualities of an incumbent top currency like the greenback; it must somehow also offer advantages sufficient to persuade agents to risk making a potentially costly change. In McKinnon's words, "There is a tremendous first-mover advantage to the national currency already ensconced as international money" (2013, 6). For the time being, the US dollar prevails as first mover.

Direct Currency Power

Given the remarkable endurance of its dollar, the United States has not been shy about making direct use of the currency as an instrument of statecraft when the need seems to arise. That has been true ever since the greenback began to approach the peak of the currency pyramid in the years before World War II. Political objectives have been promoted by using America's currency variously as either carrot or stick—sometimes making dollars available as a form of reward; at other times, withholding access as a form of punishment. Side payments and sanctions, manifestations of the first face of power, are an integral part of economic statecraft in general and of currency statecraft in particular. In *Currency and Coercion*, Kirshner labeled this form of monetary power *enforcement*—"an attempt to coerce by altering the nature and availability of the home currency, which is itself important to the target state" (1995, 116).

Examples of America's use of direct currency power are too numerous to describe in full. For illustrative purposes, a half dozen cases will be briefly examined here for what they can teach us about the advantages as well as the limits of the exploitation option. The six cases may be regarded as representative of how direct currency power has worked for the United States, and how its use has evolved over time.

The first three episodes highlight the role of the dollar as a carrot, demonstrating what can be accomplished when greenbacks are offered for the purpose of assisting friends or allies in need of liquidity. The second three

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episodes highlight the currency's role as a stick, showing what can happen when dollar liquidity is withheld for the purpose of deterring foes or adversaries. The six cases are

Poland, 1989
Mexico, 1995
global financial crisis, 2008
Suez crisis, 1956
Panama, 1988–89
Iran, 1979–?

Poland, 1989

In the summer of 1989, Poland became the first Eastern European country since World War II to hold free elections. The winner was the reform-minded Solidarity movement. After more than four decades of the Cold War, the emergence of a new Polish democracy was seen as the beginning of the end of the Soviet Union's dominance of Central and Eastern Europe. In the US Congress, a consensus quickly emerged that something should be done to express America's support for the new Polish leadership. Warsaw's most immediate need was for dollars to help stabilize its currency, the zloty.

Where would the dollars come from? In the view of many in Congress, the answer lay in a little known relic of the Great Depression—the Exchange Stabilization Fund (ESF), which had been established as early as 1934 as an emergency reserve fund of the Treasury Department. As its name implies, the ESF was intended for foreign-exchange interventions. Over the years it had gone about its business quietly, far from the public eye, making small short-term bridge loans to a wide range of countries in temporary financial distress. Between 1977 and 1989, credits were provided to some dozen nations on more than twenty separate occasions, usually for amounts well under a billion dollars each (McDowell 2017). The aim was to smooth out transitory strains in currency markets. So why not do the same to reward America's new friends in Warsaw?

At first, Treasury officials expressed reluctance, primarily because at the time Poland had no assured source of repayment in hard currency in place. But once negotiations were concluded for a loan to Warsaw from the IMF, the department came around. A $200 million credit line was provided, of which some $86 million was drawn in late December 1989 and repaid two months later. Admittedly, the amount of money involved was small.

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But the signal sent in support of the political changes sweeping through the Eastern Bloc was enormous and could certainly be termed successful. A limited gesture of currency statecraft helped lay the foundation for the end of the Soviet empire—and, ultimately, for the end of the Soviet Union itself.

Mexico, 1995

Contrast that experience with what happened just a few years later in late 1994 when Mexico, America's next-door neighbor and third-largest trading partner, was suddenly struck by a major liquidity crisis. Here was a country of vital interest to Washington, which just a year earlier had joined together with the United States and Canada in the North American Free Trade Agreement (NAFTA). The economic health and political viability of an important friend was at risk. Mexico was in desperate need of greenbacks to service the government's massive foreign debt. Yet this time, assistance proved much more difficult to arrange and ultimately required a tactical maneuver by the US Treasury that brought the wrath of a Republican-dominated Congress down on the administration of President Bill Clinton, a Democrat. Mexico was successfully rescued. But this time, in contrast to the Polish case, success came at a considerable price in domestic political terms.

The roots of the crisis lay in a number of growing threats to Mexican political stability during a heated presidential election campaign in 1994. These included a violent uprising in the southern state of Chiapas and the assassination of a popular presidential candidate. Foreign investor confidence was severely dented, leading to accelerating capital flight. When central-bank reserves began to look dangerously low, the Mexican authorities felt they had no choice but to devalue the country's currency, the peso, in mid-December, and then, a few days later, to allow the exchange rate to float freely. Cumulatively, the peso lost almost half its value. Eventually, the sharp depreciation could be expected to help stimulate demand for Mexican exports. Initially, however, it served only to greatly increase the government's burden of debt, much of which was denominated in dollars. The Mexican economy was tanking severely, banks were collapsing, and inflation was on the rise. Unable to raise new funds, the government faced the possibility of default.

For President Clinton this was, in one observer's words, "the most severe economic crisis of his first administration" (Henning 1999, 62). Prospects were grave. Default, should it come, would hurt US investors. Recession might trigger a flood of illegal immigration across America's southern

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border. Protectionist forces in Mexico might be stirred to disrupt implementation of NAFTA. Treasury officials were unanimous in their belief that Mexico needed to be rescued. Something had to be done to provide the Mexicans with the greenbacks they desperately needed to keep their ship of state afloat.

This time, however, it was the Congress that proved reluctant. In early January 1995 the Clinton administration asked for legislation to authorize US government guarantees for up to ten years on repayment of the principal and interest on private-sector loans to the Mexican government, including bond issues. Funding on the order of $20 to $30 billion was mooted. But that was far too much for the Congress—especially for the House of Representatives, which had now come under Republican control. Within days, it was clear that opposition on both sides of Capitol Hill was overwhelming. The proposed Mexican Stabilization Act would never even get out of committee. Some other solution had to be found.

So once again, the Treasury turned to the ESF. Mexico's crisis could in no way be described as temporary financial distress; a mountain of debt had to be serviced. The need was for much more than a minor bridge loan to help defend an exchange rate. But it turned out that there was nothing in the ESF's charter that prevented its use for other purposes as well, at the discretion of the treasury secretary. So at the end of January the legislative route was abandoned. In its place, the president directed the Treasury to extend up to $20 billion in credits to Mexico through the ESF. With the congressional roadblock circumvented, lending began almost immediately. Ultimately, a total of some $30 billion of aid was provided to the Mexican government.

The rescue was successful—a "happy ending," as one source puts it (Steil and Litan 2006, 135). A vital friend was restored to health. Though Mexico's gross domestic product initially fell by more than 6 percent, growth soon resumed, reaching an annual rate of 5 to 6 percent over the next three years, and inflation was brought firmly back under control. Default was avoided, investment capital began to return, and all the loans from the ESF were repaid ahead of maturity. Indeed, for the US Treasury the program even yielded a handsome profit of some $500 million (Greenspan 2007, 159).

But there was also a price to be paid that was bound to have longer-term consequences. Many members of Congress, particularly on the Republican side of the aisle, were offended by the administration's end run around their legislative authority and sought some way to limit the Treasury's discretion in the future. What finally emerged was an amendment

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to an appropriations bill specifying that henceforth, any ESF loan of more than $1 billion and six months' duration would require the approval of Congress unless the president certified in writing that a foreign financial crisis threatened "vital United States economic interests" or "the stability of the international financial system." Moreover, even if such a waiver were proposed by the President, Congress could veto any loan with a binding resolution of disapproval. Most observers agree that with these restrictions, emergency use of the ESF was effectively hamstrung—as was clearly evident two years later when a Mexican-style storm hit East Asia. As much as the administration wanted to help Asian friends, it felt handicapped by congressional resistance. Capitol Hill intransigence clearly had a chilling effect. Since 2002 there has not been a single ESF credit to any foreign government. Future lending in the event of another serious crisis is not precluded, but it could be a lot more difficult to implement than it was in 1995. A battle was won that year, but it was something of a Pyrrhic victory.

Global Financial Crisis, 2008

A third case emerged in the midst of the global financial crisis of 2008, when the world economy appeared to be teetering on the edge of a precipice. Once again, as at the time of the Mexican rescue, the stakes were high. Capital markets had frozen, threatening to bring international trade and investment to a grinding halt. The United States, along with many friends and allies, seemed about to be sucked into the vortex of another Great Depression. But then, in an unprecedented move, the Federal Reserve stepped in to provide the liquidity needed to avoid widespread collapse, helping soon to restore order to the financial sector. Here too, currency statecraft could be termed a success, though in this instance, as in the Mexican case, a price may yet be paid in domestic political terms.

Ironically, the crisis could be said to be a direct result of the US dollar's dominant role as an international store of value. For a long time, nonresidents—particularly European banks—had been borrowing greenbacks heavily to invest in a wide range of dollar-denominated claims. Especially attractive were the many varieties of derivative mortgage-backed securities spawned by years of real-estate boom in the United States. But after the housing bubble burst, beginning in mid-2007, spreading losses among financial institutions and a few headline bankruptcies led to a growing sense of panic. Who might be next? Who could be trusted? Soon interbank and other wholesale short-term markets were shut tight, making it virtually impossible for foreign banks and institutional investors to find the greenbacks

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they needed to cover their funding obligations. Where could they find the dollars to square their books and meet collateral requirements as the value of their US assets deteriorated? The vaunted liquidity of the greenback, it seemed, had evaporated in a puff of smoke.

Fortunately, the Federal Reserve was prepared to ride to the rescue, acting in effect as a global lender of last resort. As early as December 2007 a new program, the Term Auction Facility, was set up to provide supplementary liquidity to US banks. And then, over the next year, new dollar swap lines were quickly arranged with some fourteen foreign central banks. In return for reciprocal currency pledges, the Fed supplied greenbacks that could then be lent onward by each monetary authority to its dollar-hungry constituents. At their peak, in December 2008, credits outstanding under these arrangements totaled $580 billion. The biggest users included the Bank of England, the European Central Bank, and the Bank of Japan. In addition, more quietly, some $500 billion or more was provided under a variety of other programs in direct support of private banks abroad. Though the sums involved were huge, most of the facilities were arranged quietly with little fanfare or publicity. One source described the Fed's operations as "the biggest United States government bailout that most people do not know anything about" (Irwin 2014). Once the crisis subsided in 2010, most of the new swap lines and other programs were allowed to expire.

The Fed could hardly claim sole responsibility for averting a Great Depression, of course. But there is little doubt that the crisis might have been a lot worse had America's central bank not risen to the occasion. It was certainly a timely reminder of the country's direct currency power. The Fed could not have acted so effectively had it not been for the greenback's central role in the global system. In Wheatley's words: "This was a powerful reaffirmation of the dollar's dominance and the geo-economic reach of the United States" (2013b, 33).

The episode was also a reminder of the political dimension of currency statecraft. The fourteen countries that were granted new swap lines were not the only ones looking for help. Others also applied but were turned down, ostensibly because their need was not great enough. But, as Eswar Prasad points out, it was hardly surprising that the fortunate fourteen were all "countries with which the U.S. shares strong common economic and political interests" (2014, 207). Careful analysis suggests that these were the nations whose troubles were thought most likely to jeopardize the stability of the US financial system (McDowell 2017). First and foremost, the aim was to protect America's own vital interests.

A troubling question remains. Will the Fed ever be able to do it again?

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That the intervention was effective cannot be doubted. The Fed even earned a profit of some $4 billion in the process. Yet in the program's aftermath there was much pointed criticism in Congress and elsewhere that could, in a manner similar to what happened to the ESF, have a severe chilling effect in the future (McDowell 2017, 184). In acting as a lender of last resort not just for US banks but for foreign financial institutions as well, critics asserted, the Fed had gone beyond its legal mandate and might well have put US taxpayers' money at risk. It had also acted secretively to avoid public scrutiny. Typical were the words of Gerald O'Driscoll (2011), a former vice president of the Federal Reserve Bank of Dallas: "It is difficult to count the number of things wrong with this. . . . The nontransparency of the swap arrangements is troublesome in a democracy." Though no formal legislation was ever enacted that might have limited Fed discretion, it was clear from the reaction on Capitol Hill that any repeat performance down the road would be severely frowned upon. Here too. the outcome was something of a Pyrrhic victory.

Suez Crisis, 1956

Turning now from carrots to sticks, we come to financial sanctions—deliberate measures to withdraw or withhold access to monetary resources for political reasons. In one way or another, dollars are denied as a form of penalty. As with currency rescues provided through the ESF or the Federal Reserve, the aim of financial sanctions is to achieve strategic objectives. But the tactics are different. In effect, the two approaches are mirror images of one another, opposite sides of the same coin. Currency assistance seeks to reward or incentivize behavior; sanctions seek to punish or discourage behavior. The national interest may be served either way.

An early—and quite dramatic—example of US financial sanctions came in 1956 when a crisis erupted over the Suez Canal. Ironically, the intended target was not a Cold War foe but one of Washington's best friends, the United Kingdom. Aggressive military action by Britain, in cooperation with France and Israel, was effectively blocked by the United States when Washington pointedly refused to provide needed monetary assistance to London. America's direct currency power was used nakedly, and it proved decisive (Kunz 1991; Kyle 1991).

The proximate cause of the Suez crisis was a decision by Egyptian President Gamal Abdel Nasser in mid-1956 to nationalize the Suez Canal, which previously had been managed by a private international consortium under Anglo-French control. For the British and French governments, this

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was seen as a grave strategic threat that might jeopardize access to essential oil supplies from the Gulf region. London and Paris were determined to reverse Nasser's démarche. Secretly, they hatched a plan to send a joint military force to occupy the canal zone. Israel, acting in collusion with the British and French, would provide the pretext by invading the Sinai peninsula. London and Paris could then claim that they were merely acting as peacekeepers, intervening to separate the opposing Israeli and Egyptian forces. The plan was set in motion when Israel struck into Sinai on 29 October.

The US government, however, was adamantly opposed. With the violent uprising that had erupted in Hungary just a few days earlier, the administration of President Dwight Eisenhower already had a lot on its plate. Moreover, a national election was coming up within a fortnight. Eisenhower had every reason to try to maintain his reputation as a peacemaker. The American electorate had little appetite for another military adventure so soon after the end of the Korean conflict. And there may well have been a deeper motivation as well, albeit unspoken. As Kirshner delicately suggests, "The United States was not opposed to the decline of European influence in the oil-rich Middle East" (1995, 66). More bluntly, Washington saw an opportunity to shift the international balance of power significantly in its own favor. This was raw geopolitics.

On the diplomatic front, Washington backed a United Nations (UN) resolution calling for an immediate ceasefire and withdrawal, which duly passed on 2 November. But the most effective action was taken on the financial front, where Britain was particularly vulnerable. The pound, long troubled, was once again under speculative pressure, and the Bank of England's foreign-exchange reserves seemed to be running dangerously low. The British cabinet had counted on US support, which they knew was essential to their plan's success (Boughton 2001a). But that turned out to be a miscalculation. Not only did the Eisenhower administration refuse to offer any financial assistance; the Americans also used their veto power at the IMF to block British access to IMF credit, and prevented Britain from using US government securities as collateral against new commercial borrowing in New York. The embargo was total.

The denouement was not long in coming. Within days, London capitulated and agreed to a ceasefire. Was surrender necessary? Some historians think it was hasty, more a reflection of fear than of financial reality, since the Bank of England's reserves were still far from depleted. One source describes the British government's reaction as "a sensational loss of nerve" (Kyle 1991, 465). But others disagree. James Boughton (2001b), the IMF's official historian, declares that "by December the threat of a forced devalu-

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ation or float was very real." British reserves may not have been under severe attack, Boughton concedes, but they were obviously "dripping away" and could soon have become a flood. Eichengreen (2011, 158–59) concurs, declaring that any further prevarication by London would almost certainly have triggered a massive run on the pound.

In any event, there is no denying that with so much at risk, Britain's policy makers might reasonably have felt that they had little choice. Before the end of the year, all British and French troops were gone from the canal zone. In turn, Washington then granted Britain a loan of $500 million from the US Export-Import Bank, and dropped its objections to a British drawing from the IMF. Sterling received renewed backing, and Britain's "special relationship" with the United States was restored. In terms of final outcome, Washington's currency statecraft clearly worked. Indeed, victory was total. Simply by denying access to its greenback, the administration was, as Kirshner puts it, "able to stop a military invasion in its tracks" (1995, 70), certainly no small achievement. For many, the episode set the mold for US policy in the future. One source calls it the "paradigmatic case" (Blackwill and Harris 2016, 80). America's direct currency power was vividly demonstrated.

Panama, 1988–89

An even more dramatic demonstration came in 1988 when a crisis arose in US relations with Panama. Once again, dollars were denied to a foreign government as a form of penalty—albeit this time with a somewhat different outcome.

The story began more than a decade earlier, in 1977, when the so-called Torrijos-Carter Treaty was signed by Panama's strongman, General Omar Torrijos, and President Jimmy Carter of the United States. The pact provided for a gradual transfer of control over the Panama Canal to the Panamanian government by the end of the century. But when Torrijos was replaced as head of state by the chief of the Panamanian National Guard, Manuel Noriega, relations with the United States began to deteriorate. Washington accused Noriega of corruption and drug smuggling. Noriega, in retaliation, gave signs of shifting his nation's Cold War allegiance towards the Soviet Union, soliciting and receiving military aid from Cuba, Nicaragua, and Libya. Increasingly, the administration expressed concern about possible threats to the neutrality of the canal; and by 1988 influential voices in Washington were openly calling for an invasion. A pretext could have been easily fabricated under the Torrijos-Carter Treaty, which gave the United

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States a legal right to intervene militarily to protect the canal. But the irony could not be missed. In 1956 the US government had been resolute in opposing military action to take back control of a vital waterway. Now it was the United States itself that was contemplating such an action.

President Ronald Reagan, however, was opposed, in good part because of worries about the negative impact that an invasion might have on the upcoming presidential campaign of his designated successor, Vice President George H. W. Bush. So the administration turned instead to financial sanctions, starting in March 1988. Panamanian assets in US banks were frozen, and all payments or other dollar transfers to Panama were prohibited, including even fees owed for use of the canal. The cutoff of access to the greenback was comprehensive.

As it happened, Panama was especially vulnerable to an attack of this sort. Ever since the country came into existence in 1903, its economy had relied on the US dollar as legal tender for most domestic monetary purposes. In practical terms, the economy was wholly "dollarized." Although a national Panamanian currency, the balboa, existed in principle, only a negligible amount of token coins actually circulated in practice. The great bulk of the money supply, including all paper notes and most bank deposits, was accounted for by the greenback. Hence, the local authorities had no control over the money supply, which was determined solely by net transfers to and from the United States. Nor could the government finance revenue shortfalls or overspending by resorting to monetary creation. In financial terms, the country was defenseless.

In no time at all, therefore, the sanctions began to bite. Lacking access to dollars, most local banks were forced to shut their doors, and the economy was squeezed by a severe liquidity shortage. The effect was devastating, despite rushed efforts by the authorities to create a substitute currency, mainly by issuing checks in standardized denominations that they hoped recipients would then treat as cash. The country was essentially demonetized. In the words of Ambler Moss, a former US ambassador to Panama, Washington's coercion had done the most damage "to the Panamanian economy since Henry Morgan, the pirate, sacked Panama City in 1671" (as quoted by Kirshner 1995, 162). Over the course of the year, domestic output fell by nearly one-fifth and unemployment soared.

Yet for all the damage they caused, the sanctions on their own proved insufficient to dislodge Noriega. Ultimately, in late 1989, the newly elected President Bush, using the pretext provided by the Torrijos-Carter Treaty, consented to a military invasion. Noriega was overthrown and the country was temporarily occupied until a new, friendlier government could be

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installed. That outcome was in sharp contrast to the "paradigmatic" Suez case, where currency statecraft alone was all that was needed to bring the British to their knees. There can be no doubt that the liquidity squeeze on Panama was painful; it certainly contributed greatly to the pressures on Noriega. But, as matters turned out, currency power alone was not enough to do the job. Panama's dependence on the dollar was much greater than that of the British in 1956. Yet even in circumstances that were so favorable to a US influence attempt, additional measures were needed. Financial sanctions, in this case, turned out to have a practical limit.

Iran, 1979–?

Finally, we may consider the enduring case of Iran, an implacable foe of the United States ever since the Islamic revolution of 1979. Previously, during the long reign of Mohammad Reza Shah Pahlavi, Iran had been one of Washington's closest friends in the Middle East. But relations deteriorated sharply once the ayatollahs assumed control in Tehran, particularly after student revolutionaries stormed the embassy of the "Great Satan" in November 1979 and took some fifty-two US diplomats and citizens hostage. In response, Washington began imposing sanctions of various kinds, many of which still remain on the books. Among these, over the years, have been financial sanctions intended to punish or deter selected aspects of Iranian behavior.

The earliest sanctions on the Islamic Republic came in response to the November 1979 embassy attack. Imports of most Iranian products into the United States were immediately banned, and the Iranian government's stockpile of financial assets in the United States or in the foreign branches of US banks, some $12 billion in all, was frozen. By far the largest such action in US history, the asset freeze ultimately proved to be pivotal in helping to gain the release of the American hostages in January 1981 (Cohen 1986, ch. 6). The freeze was not decisive in and of itself; the trade embargo surely also helped. But by denying the Iranians the liquidity they needed to prop up their balance of payments, it did provide important extra leverage to Washington. Currency power worked. In the words of one official involved (Carswell 1981/82, 262–63): "The blocked assets proved a key bargaining chip in obtaining the hostage release." Less than half of the frozen funds were actually returned to Iran. The rest were made subject to a formal settlement procedure before a duly constituted international arbitration panel, the Iran–United States Claims Tribunal. Some $5 billion was allocated to the settlement of debts owed to US and other foreign banks;

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and an additional $1.1 billion was set aside in an escrow account to secure payments of any future arbitral awards to nonbank claimants on Iran. Once the hostages were safely home, the trade ban was lifted as well.

The end of the hostage crisis, however, was only the beginning of a very long story that has still not ended. The last four decades have seen round after round of new sanctions on the Islamic Republic, imposed both unilaterally and multilaterally (Sharma 2015). The main reasons have been twofold.

On the one hand, Iran has been penalized repeatedly for its alleged support of militant groups such as Hezbollah in Lebanon and Hamas in Gaza. A first round of actions came as early as 1984, during Ronald Reagan's presidency, when the US State Department designated Iran as a state sponsor of terrorism. Tehran was suspected of being involved in the bombing of a US Marine Corps barracks in Beirut that killed 241 American servicemen. Trade bans were reinstated, and Washington acted to block World Bank loans to Iran. Subsequent installments in the 1990s and the first decade of the new century added new measures, including a prohibition on all investment activity with the Islamic Republic and asset freezes targeting groups or individuals thought to be linked to terrorist activities. In 2007, some twenty organizations associated with Iran's Islamic Revolutionary Guard Corps were cut off from the US financial system.

On the other hand, there has been concern about Iran's nuclear ambitions, which appeared to violate Tehran's commitments under the Treaty on the Non-Proliferation of Nuclear Weapons, commonly known as the nonproliferation treaty (NPT). As a signatory of the NPT, Iran has a right to conduct research on the production and use of nuclear energy—but for peaceful purposes only. Anything that might lead to the development of weapons of mass destruction was strictly prohibited. In 2002, however, it was revealed that the Iranians had secretly constructed both a uranium enrichment facility and a heavy-water plant, feeding suspicions that the Islamic Republic was in fact engaged in a clandestine nuclear weapons program. In response, new rounds of sanctions were imposed by the United States, as well as by the EU and the UN.

Prominent among Washington's actions were several financial measures of remarkable severity, a "constriction campaign" (Zarate 2013) designed to curtail and, if possible, wholly cut off Iran's access to US dollars. At one level, asset freezes were imposed on a substantial number of Iranian actors thought to be engaged in nuclear-weapons proliferation, including both firms and individuals. At another level, Iran's links to the US financial sys-

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tem and the dollar were effectively broken. Iranian banks were blacklisted; US financial institutions were forbidden to do business with the Islamic Republic; and in a form of secondary boycott, foreign banks were threatened with reprisals if they attempted to provide Iranian institutions with a backdoor route to greenbacks. In effect, dollar transactions with Iran were almost totally embargoed—a comprehensive currency blockade.

How successful have Washington's financial sanctions been in achieving their ostensible objectives? In the case of terrorism-related actions, the deterrence effect appears to have been minimal. Iran continues to provide support for Hezbollah and others. Tehran also remains heavily involved in the Syrian civil war, on behalf of a brutal authoritarian regime, and in Yemen, backing Shiite rebels known as Houthis. Conceivably, there could be more impact on Iran's behavior in the future, but there is little sign of any serious change yet.

In the case of Iran's nuclear programs, by contrast, the impact was major. Since business in the global energy market is traditionally done in dollars, Washington's currency blockade largely prevented most other countries from financing oil purchases from Iran. The Islamic Republic was effectively locked out of most global credit networks. Export revenues were curtailed by more than half from their peak in 2011, slowing domestic growth dramatically. In April 2015, US Treasury Secretary Jacob Lew estimated that Iran's economy was 15 to 20 percent smaller than it would have been without the sanctions. The measures worked as well as they did because of the global centrality of the dollar—and, by extension, the centrality of the US banking system. Directly or indirectly, all offshore dollar transactions must be cleared through America's payments mechanisms. More than $100 billion in Iranian assets was thus corralled in restricted accounts around the world, and few banks anywhere were willing to circumvent the US embargo, for fear of losing their own access to the American financial market. The cost of defying Washington's currency power would have been prohibitive. As one informed source ruefully summarizes:

> As the US currency is the main source of global liquidity, the US banking system has come to function as a sort of central processing core through which funds are routed. Accordingly, it has become correspondingly easier for the US to enforce financial sanctions against peripheral financial centres. The ability of the US, by harnessing large parts of the global banking system, to deploy the dollar as a tool of geo-economic warfare against Iran is a prime example (Rajendran 2013, 92).

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Ultimately, the financial sanctions proved instrumental in bringing Tehran to the bargaining table. By 2013, no less an authority than Iran's President Hassan Rouhani publicly acknowledged that the effect of the financial measures was severe enough to justify negotiations to address the nuclear question (as quoted in *The New York Times*, 13 September 2013). Two years later, in July 2015, a joint Comprehensive Plan of Action was agreed between Iran and the so-called P5+1 (the five permanent members of the UN Security Council, plus Germany), significantly limiting Iranian nuclear activities in return for an easing of the sanctions regime. Upon signing the controversial pact, the Islamic Republic immediately gained access to some $4.2 billion of oil revenues frozen in foreign banks, plus another $2 billion or so via a temporary pause of other sanctions measures. Six months later, once international inspectors certified that the Iranians were following through on their promises, the rest of the $100 billion of the country's frozen assets was released.

Washington's financial sanctions were not the whole story, of course. Other pressures also helped to gain Iranian compliance, including the initiatives of the EU and UN as well as threats of military action. But, as was the case during the hostage crisis decades earlier, there is no doubt that the dollar embargo was pivotal. The centrality of the greenback was making the price of intransigence increasingly unbearable. How else can we explain the high priority that Teheran attached to sanctions relief as a quid pro quo? Though the damage done to the Iranian economy was not as crippling as the harm suffered by Noriega's dollarized Panama, it was undeniably massive. The constriction campaign may have provided just one bargaining chip alongside others, but it was one of the biggest chips on the table.

Confirmations

What do we learn from these cases? Though the sample is small, the six episodes are rich in implications for the effectiveness of direct currency power. As indicated in chapter 2, a vast formal literature addressing the subject of sanctions and related issues has grown up since publication of David Baldwin's classic *Economic Statecraft* in 1985 (Baldwin 1985). In some respects, our six cases serve merely to confirm what we already know from previous scholarly discussions. That bears especially on the assessment of results and the role of domestic politics. But in other respects it is evident that direct currency power has unique attributes of its own and offers sin-

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gular insights. Lessons can be derived involving both the utility question in general and the role of geopolitical ambition in particular.

Assessing Results

To begin, it is clear that direct currency power can achieve its declared objective. Whether employed as carrot or as stick, a popular international money does provide a potentially handy instrument to advance political goals. That could be seen in the successful outcomes of the Polish episode in 1989, the 1995 Mexican rescue, and the Federal Reserve's extensive credit programs in 2008. It could also be seen in the effectiveness of US financial sanctions over the years against Britain, Panama, and Iran. Monetary side payments and sanctions are not mere empty gestures.

By itself, of course, this is not a particularly controversial observation. If there is any consensus in the formal literature, it is that given the right conditions, tactics of reward or punishment should be able to produce tangible results. That consensus is confirmed by our six cases.

What is controversial is how to assess results. In our six cases, the declared objectives were indeed achieved to a greater or lesser extent. Friends and allies were given the material support they needed. Objectionable actions by targeted governments were reversed. But, as Baldwin rightly instructed us back in 1985, evaluation of the impact of economic statecraft in terms of formal goals alone is superficial and potentially quite misleading. In fact, much more is involved than might appear at first glance. Like the concept of power, the issue of effectiveness is highly contested. As one source puts it, "assessment remains problematic" (Dobson 2002, 287). Scholars debate endlessly over the proper criteria for judging success or failure (Drezner 1999; Blanchard and Ripsman 2008, 2013; Hufbauer et al. 2007; Early 2015).

That is especially true of sanctions, financial or otherwise. Even if a particular sanctions measure fails to attain its formal goal, it may nonetheless serve valuable public policy purposes. Domestically, it may satisfy the demands of important domestic constituencies. It is well known, for example, that when the US government years ago imposed trade sanctions on South Africa, ostensibly to help bring about an end to that country's longstanding apartheid regime, no one really expected much change. But the step did serve to mollify the US African-American community, which had been calling for action of some kind. Internationally, sanctions can play a valuable role as a signal to foreign audiences of a government's policy

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preferences. And sanctions can also act as a deterrent to future unwanted actions, even if they cannot reverse past behavior. These are all aspects of what scholars call the *expressive* function of sanctions—their symbolic role.

In principle, results should be assessed in terms of the potential costs and benefits of all the alternative forms of statecraft that might be available, though that kind of calculus may be difficult in actual practice. Use of force (military statecraft) might promise a greater chance of success than sanctions, but could also prove more costly. Sanctions do not necessarily come cheap, of course; they may in fact carry a high price in terms of jobs lost or business opportunities foregone. But overt military action can be even more expensive, not only in monetary terms but in terms of blood and matériel as well. Public diplomacy or formal negotiations, conversely, might be less costly than sanctions, but in most cases are apt to offer an even lower chance of success. And doing nothing would of course incur no direct cost at all, but might be seen as tantamount to complicity, actually tarnishing a country's reputation. When Washington imposed sanctions on Russia in 2014 after that country's takeover of the Crimean Peninsula, it is unlikely that the Obama administration expected a quick capitulation by the Kremlin. But it was clear that some form of punishment had to be imposed if the United States was to avoid a charge of guilt by association. The point is well capsulated by Gary Hufbauer and his colleagues in their comprehensive study of sanctions effectiveness, now in its third edition (Hufbauer et al. 2007, 5):

> US presidents seemingly feel compelled to dramatize their opposition to foreign misdeeds, even when the likelihood of changing the target country's behavior is remote. In these cases, sanctions are often imposed because the cost of inaction—in terms of lost confidence both at home and abroad in the willingness of the United States to act—is seen as greater than the cost of the sanctions.

In short, the criteria for success or failure are many and complex. Even if the stated goals of sanctions (or their counterpart, side payments) are not achieved, specific measures may nonetheless be judged effective in their expressive dimensions—for example, in terms of domestic politics or foreign reputation. But the symbolic roles of statecraft are difficult to assess in any objective sense. Within this complex calculus, it is clear that the hardest test of all is the tangible one of whether declared goals are in fact attained. By that test, the potential impact of direct currency power stands out. From the cases under review, it is evident that an international money like the

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dollar can indeed prove to be a potent policy instrument. The exploitation option promises real gain.

Political capacity

But how much gain? That brings us back to the question of limits. Side payments and sanctions may not be empty gestures. But neither are they a magic wand, capable of satisfying every wish. That too is not a particularly controversial observation. Political goals may be advanced by tactics of reward or punishment, but not without limits. Effectiveness may be constrained, in particular, by domestic institutional complexities—most importantly, by the often contentious relationship between the executive and legislative branches of government. That observation too is confirmed by our six cases.

At issue is what is known as *political capacity*, which for our purposes may be defined simply as the practical ability of a government to formulate, implement, and enforce formal policy decisions. Political capacity is greatest when central decision makers can carry out initiatives without constraint. Political capacity is curtailed to the extent that individuals or groups exist, within the state structure or in the wider society, with the ability to effectively block executive action. In the language of modern political science, these are known as *veto players*—political actors with the ability to nullify a policy choice (Tsebelis 2002). The greater the number of veto players, the less room there is for effective autonomous statecraft.

In the case of the United States, the presence of influential veto players is actually guaranteed by the principle of checks and balances built into the country's hallowed Constitution. Political capacity is *meant* to be curtailed, in order to limit the risk of any hasty or arbitrary exercise of power. Under the so-called Commerce Clause of the Constitution (article 1, section 8), Congress is granted the power "To regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes." Courts and commentators have tended to discuss each of these three areas of commerce as a separate power granted to the Congress. It is common to see the individual components of the Commerce Clause referred to under specific terms: the Foreign Commerce Clause, the Interstate Commerce Clause, and the Indian Commerce Clause. Over the years, the executive branch has assumed ongoing responsibility for the framing and implementation of foreign economic policy, including currency policy. But that is with the full understanding that the executive's powers are formally delegated by the legislative branch, which retains ultimate authority under

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the Foreign Commerce Clause. In a very real sense, the Congress is one giant veto player.

As we have seen in the cases under review, the two branches do not always see eye to eye. When they do agree, as in the Polish case in 1989, statecraft can be carried out relatively quickly and effectively. When help was mooted for the Poles, the only disagreement was where the dollars should come from, not whether they should be provided. But where rapport between the branches is lacking, statecraft is manifestly handicapped.

The handicap is less severe in the case of punitive measures like those employed in the Suez, Panama, and Iran cases. When sanctions are at issue, the executive branch has more authority to act unilaterally, without formal congressional involvement. No funds must be appropriated on Capitol Hill. But the handicap is clearly evident when new money must be found, as in the Mexican episode and during the financial crisis of 2008. In both cases the impact of divided government was glaringly obvious. Mexico was rescued from a financial calamity, but only because the Treasury had a backdoor source of funding to circumvent congressional resistance. And subsequently even that backdoor was effectively locked by congressional legislation. Likewise, in 2008 the Federal Reserve was able to ride in as lender of last resort, but again over congressional opposition that may well have a chilling effect in the future. In neither instance did the limits on executive branch autonomy prove wholly prohibitive. In both cases, means were found to make the needed dollars available. But, as indicated, in each episode there was also a considerable price paid in domestic political terms that could narrow the executive's room for maneuver going forward.

In many respects, of course, America's political institutions are distinctive. But the challenge of domestic veto players is hardly unusual. Every political system, no matter how autocratic, is likely to compromise political capacity to some degree. The only question is: How much? Here observers note a big difference between the United States, with its constitutionally ordained division of powers, and China, with its far more centralized decision-making processes. America's currency statecraft would appear to be more subject to limits than China's. I will have more to say about that in chapter 7.

Unique Attributes

However, even while confirming some conventional understandings, our six cases also suggest ways in which direct currency power brings unique attributes to the table. Currency statecraft may not be entirely in a class by

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itself. But a case can be made that financial measures, whether intended to reward or to punish, appear to enjoy an advantage as compared with more conventional trade concessions or sanctions. Limits are less constraining.

A few scholars, such as Daniel Drezner (1999) and Kimberly Ann Elliott (2002), have long argued that financial sanctions can be more effective than trade sanctions, and have offered several reasons. Because banking and investment markets tend to be more regulated than goods markets, financial sanctions are easier to enforce. As compared with trade sanctions, which can often be dodged by means of smuggling or stockpiling, they are also more difficult to evade. And they can be much more costly if a violator is caught in the act, since for financial institutions, punishment in the form of denial of access to global financial networks could be the equivalent of a death sentence. Penalties for smuggling may be painful as well, but are unlikely to be life-threatening. As Drezner (2015, 758) summarizes: "These dynamics mean that market forces strengthen financial sanctions, whereas they tend to weaken trade sanctions." Arguably, financial sanctions also strike a target country much more deeply, since modern market economies rely so heavily on access to credit and clearing mechanisms.

The three sanctions episodes under review would certainly seem to substantiate the Drezner-Elliott argument. Britain was brought to heel during the Suez crisis by financial measures alone, and in both the Panama and Iran cases the currency blockades imposed by Washington proved far more decisive than parallel trade penalties. But the evidence would seem to suggest two ways in which the contention may actually be expanded.

First, it is clear that the comparative advantage is actually quite substantial when a dominant international money is involved. That is the monopoly factor at work. A currency sanction is not just a matter of freezing a few deposits or depriving a target government of a bit of credit. Rather, it aims directly at a country's lifeline—the liquidity and market access that nations need in order to do business. Panama may have been an extreme case because it lacked a national money of its own. Dollarization obviously made it especially vulnerable. But the Iran episode demonstrates that an economy need not be fully dollarized to be greatly susceptible to leverage of this kind.

Second, it is also clear that the comparative advantage works not just for punitive measures but for financial rescues as well—carrots as well as sticks. When an exchange rate needs to be defended, as in the Polish case, or when defaults are meant to be avoided, as in the Mexican episode and the global financial crisis, the issuer of the world's top currency has a distinct edge. It can simply make use of its own money. In effect, once the

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decision to help out is agreed to, the issuer can simply turn to the printing press, as the Federal Reserve did in 2008. That is far easier than trying to provide emergency assistance in the form of goods or services.

Neither of these points is meant to suggest that currency statecraft can do everything on its own. The Suez case, in which US financial sanctions alone proved sufficient to reverse a military invasion, must be seen as exceptional. More representative are the Panama and Iran cases, in which other measures were also required. In Panama, a fully dollarized country, conditions could hardly have been more favorable for an exercise of leverage. The nation was especially vulnerable to a cutoff of access to the greenback; and as we have seen, the impact of Washington's financial blockade was indeed devastating. Yet for all that, Manuel Noriega was able to cling tenaciously to power. In the end, military force was required to achieve the US government's objectives. Likewise, in the Iran story it is evident that financial sanctions were successful in strictly economic terms; Iranian access to the global banking market was effectively curtailed, slowing needed investment and retarding domestic growth. But the measures clearly were not enough to moderate Iran's aggressive support of Hezbollah and others, and on their own they did little to slow the country's ambitious nuclear program. Here too, other forms of statecraft were ultimately required, including both a formidable diplomatic effort and implicit threats of military attack.

Overall, therefore, a tempered conclusion seems warranted. Direct currency power may be more potent than many other forms of economic statecraft. But it is not omnipotent.

Geopolitical Ambition

Finally, we return to the issue of geopolitical ambition. In all of the six cases under review, Washington's will to exercise influence was clear. Currency statecraft was obviously intended to advance political goals. But it is also clear that success or failure for US policy rested heavily on the *intensity* of motivation in each specific instance. How *strong* was America's ambition? Rescues or sanctions can be expensive, either in strictly monetary terms or in terms of possible nonpecuniary risks of one kind or another. In none of the six cases, as it happens, did material costs appear to be an absolute barrier to action by the United States. But a closer look indicates that if potential costs had loomed large enough relative to the importance attached to projected benefits, initiative might well have been inhibited.

Compare, for example, the three cases in which the dollar was used to

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help out friends. Back in 1989, when support was offered to Poland, cost does not seem to have figured prominently in the calculations of US policy makers. In Washington's eyes, the amount of dollars involved hardly counted as "real" money. But a few years later, when Mexico got into trouble, Congress balked at the idea of stepping in, forcing the Clinton administration to stretch the mandate of the old Exchange Stabilization Fund as an alternative. And then in 2007–8 even that route was closed, despite the gravity of the global crisis. Congress was willing, reluctantly, to approve a domestic fiscal stimulus, along with some aid to US financial institutions. But for outsiders—nothing. In the absence of any aid from the Treasury, the Federal Reserve felt obliged to step in with its newly created swap lines and other support programs for foreign banks. However, while the dollar total was substantial, it was all very short-term in duration, and it carried interest charges high enough to extract a considerable profit for the Fed. Overall, the trend has been toward ever lower levels of generosity. Sensitivity to cost has increased, particularly on Capitol Hill.

A similar trend can be seen in the three sanctions cases as well. In 1956 the Eisenhower administration was single-minded in its determination to block a takeover of the Suez Canal, no matter what it might mean for US relations with erstwhile allies in Europe or Israel. During the Panama episode, by contrast, there was much more worry about possible costs, particularly to US business interests. Three times in 1988, Washington yielded to pressure from domestic banks and corporations to ease the new restrictions on private transfers to Panama (Kirshner 1995, 162–63). And during the years of sanctions on Iran, concerns over lost business opportunities were even more evident.

But it should be noted that these parallel trends are not necessarily a matter of costs *in absolute amount*. Even after adjusting for inflation, the Fed's aid programs in 2008 far exceeded the size of the Mexican rescue. Likewise, the costs to US business interests of the Iranian sanctions far exceeded the pain of the Panama asset freeze. America is still the wealthiest country in the world, despite its net foreign debt; and its economic capacity remains unmatched. If the United States is becoming increasingly sensitive to cost, it is not because the country can no longer afford the price. The wherewithal is there if needed to support an activist foreign policy.

Rather, the trends appear mainly to be a matter of costs relative to anticipated benefits. Back at the time of the Suez crisis, in the early years of the Cold War, US policy makers thought big. There were few limits to geopolitical ambition when the fate of the world order seemed at stake. As President John Kennedy put it a few years later in his celebrated inaugural

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address, America was prepared to "pay any price, bear any burden, meet any hardship . . . to assure the survival and the success of liberty." But as the decades have passed, that bold pledge has come to look increasingly anachronistic. The Soviet Union may have disintegrated, leaving the United States for a time as the world's one remaining superpower. But with the resurgence of Russia and the rise of China and others, the great game of geopolitics has grown more complex, and certainly more challenging. In response, Washington's aspirations appear to have moderated considerably and turned more inward, especially since the election of Donald Trump. Policy makers may not have become ostriches, burying their heads in the sand; but they do appear to have become more insular.

Thus, the real limit to the potency of currency statecraft would appear to be not cost, but the intensity of geopolitical ambition. Even if the risks of using the direct power of a currency like the US dollar appear bearable, the money's potential may not be fully exploited if policy makers prefer disengagement in foreign policy. Some observers would argue that herein lies one of the biggest differences between the greenback and China's redback in today's global currency competition. Where Washington's growing circumspection appears to leave some of the dollar's power underutilized, Beijing's forceful campaign for great power status seemingly drives Chinese policy to exploit the yuan's potential to the fullest. More will be said about that, too, in chapter 7.

Conclusion

For the money (or, on occasion, moneys) at the peak of the currency pyramid, the attractions of the exploitation option are substantial. As the contemporary example of the United States demonstrates, dominant currency status offers an issuer considerable benefits along two separate tracks, direct or indirect. Indirectly, a top currency's widespread appeal weakens any payments constraint on overseas spending, providing the issuer with greater latitude to pursue foreign political objectives. And directly, the currency itself can be used as an instrument of statecraft to exercise influence, rewarding some and penalizing others. It is faith in the potency of either or both of these tracks that animates the Immaculate Conception of Power.

Even for a currency as dominant as the US dollar, however, the Immaculate Conception of Power has its limits. Indirect currency power relies on both a currency's own credibility and an absence of sufficiently attractive alternatives. Inertia may favor an incumbent, but nothing is guaranteed. Sooner or later, foreign confidence in the money could falter, or appeal-

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ing new rivals could emerge. Likewise, direct currency power relies on the utility of the monetary instrument as either carrot or stick. A review of Washington's use of the dollar suggests that currency side payments and sanctions can definitely produce meaningful results, and may well be more effective than corresponding trade measures. But here too, nothing is guaranteed. One important limit can result from domestic institutional complexities that erode political capacity. Another is set by the intensity of the issuer's geopolitical ambition in any specific instance. The power of a top currency is undeniable, but by no means does it translate automatically into an effective degree of leverage.

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SIX

Decline

After maturity comes decline—the beginning of the end that, sooner or later, must come to every international currency. A tipping point will be reached when the virtuous circle enjoyed during a currency's youth is supplanted by a vicious circle of "domestication." Geopolitical decline saps the appeal of the currency, while simultaneously the weakening currency erodes economic and political capabilities. The timing of the tipping point cannot be easily predicted. The turn may be reached because the issuer's "overhang" of foreign liabilities comes to be judged as excessive. Or it may be caused by the emergence of a more attractive rival money. Either way, the challenge for currency statecraft is transformed once more, just as it was in the transition from youth to maturity. The challenge now is to *cope*: to determine how best to live with fading eminence. Again the choices are three: resistance, reinforcement, or relaxation. Policy makers may actively strive to *resist* abandonment of their currency, hoping thereby to preserve at least some of the benefits of international use. Alternatively, they can seek to *reinforce* the process of decline in hopes of managing a "soft landing" for the currency. Or they may just *relax* and let market actors and foreign central banks decide matters.

Historical cases of decline in the modern era are scarce but instructive, again illustrating the importance of geopolitical ambition. The prime example is, of course, Britain's pound sterling, which over the last century has fallen a long way from its once proud perch at the peak of the currency pyramid. To cope with the challenge of decline, London's currency statecraft gradually evolved from resistance to reinforcement. Starting in the interwar period and continuing after World War II, London struggled mightily to sustain a role for the pound commensurate with Britain's historical role as a great imperial power. But by the 1960s strategy was beginning to shift,

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and it soon moved decisively from opposition to accommodation, once the British people and policy elites began to accept their nation's diminished place in the world. Today, Britain's policy on sterling may be best described as resigned acceptance.

The main focus of this chapter, after some brief preliminary remarks on Japan and the United States, will be on the British case. Once again, our aim is to see what we can learn from historical experience about the motivation and effectiveness of currency statecraft, this time in the final stage of a money's life cycle.

Japan

Like Britain's pound, the Japanese yen has seen better days—much better days, in fact. A pinnacle of sorts was reached in the 1980s, when the currency's future looked particularly bright. But then came the collapse of the bubble economy in 1989, which, as noted previously, sharply curtailed foreign interest in the yen. Not even Tokyo's dramatic U-turn of strategy in the 1990s could revive the money's fortunes. Over the past three decades, international use of the yen has gradually shrunk, relative to other currencies, in all key roles. In trade, the yen's use for invoicing and settlement has fallen along with Japan's contribution to global commerce. Japan's share of world trade has been cut in half since its peak in the 1980s, while the percentage of Japanese exports denominated in yen has remained flat at around 35 to 40 percent, and the percentage of imports at around 20 to 25 percent (Ito et al. 2016). In financial markets, the appeal of yen-denominated assets faded once persistent exchange-rate appreciation no longer seemed so assured. In the foreign exchange market, the yen's portion of market turnover has dropped from a high of 14 percent to under 11 percent. And in global reserves, the yen's share has wilted from 8 percent to not much more than 4 percent.

Yet on the whole, the posture of the Japanese government has remained determinedly neutral since abandonment of Tokyo's ill-fated promotion campaign in 2003. Yen internationalization has disappeared from the agenda. In contrast to the widely publicized report of the Finance Ministry's Council on Foreign Exchange and Other Transactions in 1999, not a word has been heard from the government in more recent years. Its silence speaks volumes. Effectively, the Japanese currency has been left on its own. Residual advantages from its remaining elite roles will be enjoyed, but no defense will be mounted to preserve them.

Why, after its efforts in the 1990s, has Tokyo chosen to retreat to a much

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more passive position? Obviously, the country's sluggish economic performance has played a part. Since the bubble economy burst, GDP growth has been weak and plagued by feeble demand, frequent recessions, and periodic bouts of deflation. Policy makers have been forced to acknowledge that poor prospects at home were bound to dim the luster of their currency abroad. But even more decisive has been the accelerated rise of China, which clearly has shaken Japan's self-esteem to its core. The days of Japan leading a "flying geese" pattern of development in East Asia are clearly over. The threat of the newly invigorated giant on the mainland has become a reality. The Japanese have come to realize that their geopolitical aspirations must now be much more modest. A proactive policy in favor of yen internationalization no longer seems the natural choice for a country in such reduced circumstances.

Indeed, for the Japanese today, the challenge is no longer to assert their leadership in financial affairs, as they were wont to do in the past. The center of gravity in the region has clearly moved from the Land of the Rising (Setting?) Sun to the freshly emboldened Middle Kingdom. Japan's ambition now is simply to cling to whatever status it can before it is too late. For instance, Tokyo has tried to keep up with China's growing web of currency agreements by negotiating or expanding a number of swap arrangements of its own with Asian neighbors. But it is notable that in contrast to the Chinese agreements, which provide for an exchange of RMB for local currencies when needed, Japan's arrangements specify US dollars, with the yen offered only as a secondary option. That suggests that yen internationalization, as such, is no longer the issue. The government's aim, it would appear, is simply to retain what influence it can by whatever means may be available.

Particularly telling was what happened back in 2009, when Tokyo was engaged in negotiations with China, South Korea, and the ten-member Association of Southeast Asian Nations (ASEAN) over expansion of a mutual liquidity mechanism known as the Chiang Mai Initiative (CMI). First launched in May 2000 at a meeting in the Thai resort town of Chiang Mai, the CMI established the basis for a network of bilateral swap arrangements across the region. The aim was to provide an effective safety net in the event of another financial crisis like the one that hit East Asia in 1997–98. The purpose of the negotiation in 2009 was to "multilateralize" the CMI, pooling funds together to enhance the amounts that any single country might draw when in need. A key issue was the size of the quotas that would be assigned respectively to Japan and China, CMI's two largest members. Inter alia, quotas would determine each state's voting rights in the arrangement.

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Bargaining was intense (Pitakdumrongkit 2015). Tokyo was determined to claim the largest quota, reflecting its past dominance in regional finance. In effect, the Japanese appeared anxious to institutionalize a leading role for themselves while they still could. The Chinese, however, insisted that their own growth and size now entitled them to an equal share of the total—an "equal firsts" policy. Beijing had no intention of allowing Japan to lock China into a subordinate position. In the end, a compromise was reached, giving China (with 28.5 percent) together with Hong Kong (3.5 percent) a quota equal to Japan's 32 percent. That was despite the fact that Hong Kong was not formally a participant in the CMI. The outcome would have been laughable had the stakes not been so serious. With this arcane formula, the Japanese could claim—truthfully—that they were still the biggest single contributor. Yet China could make an equally valid claim that it had now attained parity with Japan, since Hong Kong, though technically an autonomous region, is legally a part of the sovereign Chinese state ("two systems, one country"). Both sides could go home as winners.

Over the longer term, however, the Japanese know that the balance of power is tilting more and more decisively in Beijing's direction. They also know that China, consistent with its "peaceful rise," is doing all it can to promote internationalization of the RMB as an alternative to the yen (and US dollar). Given China's many geopolitical advantages—including a huge population, expansive territory, and a rapidly growing military—it is understandable that the Japanese might conclude that any attempt to resist the yen's persistent decline is bound to prove futile.

United States

What about the United States? In previous chapters, the dollar was described as still the world's dominant international money, comfortably ensconced at the peak of the currency pyramid. But is the greenback's preeminence due entirely to the preferences of currency users? Or is it really a money in decline, whose appeal is preserved only by the efforts of the US government? Put differently, is the dollar's endurance demand driven, or is it the result of deliberate influence attempts by its supplier? Has Washington already adopted a resistance strategy?

The issue may be expressed in terms of Susan Strange's distinction between a top currency and a negotiated currency (chapter 1). A negotiated currency must rely on formal diplomacy or informal understandings to sustain foreign interest; a top currency needs no such support. For all intents and purposes, the US dollar would appear to be a genuine top currency,

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popular because of America's inherent economic and political qualities. But not everyone agrees. For many, the greenback seems to endure only because of the determination of US policy makers to preserve and promote its use. The perception is widespread. Increasingly, it is said, the dollar has become a negotiated currency, more and more dependent on inducements from Washington—in effect, slipping inexorably from top standing to one or two rungs down in the currency pyramid. "Questions about the role of foreign political support in sustaining the dollar's international position have grown," proclaims Eric Helleiner (2009, 76), suggesting that the greenback can by now be considered to have at least "partial negotiated status." Many financial elites in key emerging market economies, according to one recent report (Otero-Iglesias and Steinberg 2013, 328), seem persuaded that "the dollar is increasingly sliding from top to negotiated international currency."

Is that perception accurate? Recall from chapter 4 that, broadly speaking, two classes of strategy are available to a government in this context—proactive policies that can be either *indirect* or *direct* in their implementation. An indirect strategy aims to underscore and enhance the market appeal of a currency, deliberately catering to the preferences of users whether at the private or official level. A direct strategy, by contrast, aimed more specifically at governments, relies on more traditional instruments of statecraft—carrots and sticks—to alter existing preferences in favor of a currency. Is there evidence that either type of strategy is actually being applied by Washington to support the dollar?

The answer is No. Certainly there seems to be no indirect strategy at work to burnish the greenback brand. No nation wishing to promote or sustain demand for its currency would abuse its exorbitant privilege as much as has the United States. There are many actions that US policy makers could take to avoid abandonment of the dollar—including deficit reduction, export promotion, and reinforced financial regulatory reform. And surely more could be done to overcome Washington's dysfunctional political divisions that have already led to one downgrade of America's credit rating and could lead to more. But little along these lines has actually been undertaken. The American political system does not appear to treat the reputation of the dollar as a high priority. Reasons for this will be explored in the next chapter.

Nor does there appear to be much evidence of a more direct strategy to defend the greenback. Indeed, if anything, the trend seems to be the other way—away from, not toward, overt currency interventions. Back when the dollar was still convertible into gold, the first face of power was clearly

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visible. Washington rarely hesitated to make use of its ample political resources to twist the arms of allies or client states on the greenback's behalf. Francis Gavin (2003, 2004) has exhaustively documented the extent to which Washington actively manipulated its military deployments and defense commitments to convince other governments to help back the currency, gaining commitments not to use new dollar accumulations to drain gold reserves from Fort Knox. The exercise of leverage was most obvious in West Germany and Japan, the two biggest dollar holders at the time. Eager to remain sheltered under America's security umbrella, both were vulnerable to coercion from their friends on the Potomac. In one famous 1967 incident, West Germany's Bundesbank was persuaded to submit a formal letter to its US counterpart, the Federal Reserve, officially pledging not to seek conversion of any portion of the Federal Republic's large stockpile of dollars. Although in fact the "Blessing letter"—named after Karl Blessing, Bundesbank president at the time—merely confirmed a policy that had already been in force for years, the pressure from Washington was deeply resented (Zimmermann 2002, 226).

Likewise, less than a decade later, following the first global oil shock in 1973, Washington moved quickly to exploit its military reach to persuade Saudi Arabia to avoid any actions that might trigger a flight from the dollar. As the biggest oil exporter in the world, Saudi Arabia might have been tempted to use its newfound riches as an instrument of linkage to pressure the United States on Middle Eastern political issues. In principle, the threat of a "money weapon" seemed plausible. At the time, the Saudis were thought to account for as much as one-half to three-quarters of all Arab holdings of greenbacks (Cohen 1986, 126). In practice, however, accommodations were quickly found. In return for crucial concessions from Washington—including, in particular, informal security guarantees against possible threats from enemies within or without—the Saudis gave assurances of continued support for the greenback. The Kingdom was promised top-secret confidentiality for its holdings, and was even provided a separate "add-on" facility to handle its purchases of Treasury securities outside the normal auction process (Spiro 1999).

In more recent years, one searches in vain for any comparable example. As Helleiner concedes (2008, 368), "Scholars have produced little evidence so far of any explicit deals between the US and dollar supporting countries." Benign neglect appears to prevail. Of course, Helleiner quickly adds, "This is not to say that implicit understandings are not in play" (2008, 368). He cites, for instance, the heavy reliance of large dollar holders like Japan and South Korea on the US market for their exports. Their loyalty to

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the greenback, he suggests, may be a quid pro quo for Washington's commitment to keep its market open to their products. But is that "negotiation," or is it simply confirmation of the structural power that the United States enjoys as a result of its still massive GDP? In reality, there seem to be no influence attempts at all. The perception that the greenback is becoming a negotiated currency may be widespread, but it is not supported by the available evidence.

United Kingdom

About Britain's pound, on the other hand, there was never any doubt. As early as the 1930s, sterling could already be described as a negotiated currency. It was plainly the pound that Strange, an Englishwoman, had in mind when she invented the label as part of her taxonomy of international moneys back in the 1960s. But for all of London's desperate efforts to prop up the currency, the policy of resistance failed and eventually yielded to a strategy of accommodation—managed domestication—paralleling Britain's broader retreat from its once expansive imperial ambitions. The evolution of British currency statecraft clearly reflected the country's gradual acceptance of its reduced geopolitical status. Indeed, the fate of sterling became a metaphor for the nation as a whole. In the words of one regretful commentary (Stephens 1996, xi): "There is no more potent symbol of Britain's postwar decline than sterling."

Retreat from Empire

At the end of World War II, Britain still saw itself as a great power, second only to the United States among the victorious Allies. Half a decade of bloody conflict had obviously taken its toll on the British economy. Many factories and cities lay in ruins, much of the country's overseas financial portfolio had been liquidated to help pay for the war, and massive debts had piled up. Yet aspirations remained far-reaching. For London's policy elites, the United Kingdom still had a grand leadership role to play in global affairs. Britain remained the vital core of a vast commonwealth and empire. London also had a permanent seat on the newly created UN Security Council. It could boast of a "special relationship" with the United States. And it even had a nuclear weapon, thanks to a secret program begun in 1947. What better measure of geopolitical status could there be than a capacity to deliver an atomic bomb? In October 1952, the United Kingdom became the third nation in the world (after the United States and the

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Soviet Union) to test an independently developed nuclear device. In the words of one commentary (Busch 1994, 571), "British statesmen [were] inhabiting a dream world of the future, in which Britain was projected to emerge as powerful as ever."

As a practical matter, however, the dream turned out to be illusory. Britain's reach far exceeded its grasp. As former US Secretary of State Dean Acheson famously put it in a speech in 1962, "Great Britain has lost an Empire and has not yet found a role." For a time, London was able to "punch above its weight," intervening actively and maintaining armed forces across wide swaths of Africa and the Middle East, and even as far afield as Malaya (later Malaysia) and Singapore. But under the pressure of sluggish recovery at home and financial stresses abroad, the British were gradually forced to retreat from many of their overseas commitments. Their resources could no longer support their ambitions. Today, we know that the country has come to accept its rank as no more than a middle power at best. But it took literally decades for UK society to come to terms with its diminished role in the world.

Signs of Britain's decaying influence began as early as 1947, with the decolonization of the Indian subcontinent. Independence for India (along with Pakistan and Ceylon, now known as Sri Lanka) meant that the United Kingdom had lost the crown jewel of its empire. Nothing could more glaringly symbolize the beginning of an imperial retreat. The event was mourned by many in Britain—not least Winston Churchill, who despised the Indian independence movement and its spiritual leader, Mahatma Gandhi. Churchill did not mince words; in his eyes, Gandhi was a "seditious fakir" (holy man).

In the same year, London also decided to end its involvement in the civil war that was then raging in Greece. The British had been providing material support to the Greek government to help defend against communist guerrillas. But, exhausted by the high cost of its efforts, London felt compelled to back away, asking the United States to take over in its place. The British told Washington that they simply could no longer afford to subsidize the authorities in Athens (Lykogiannis 2002). Just a few months later, UK forces withdrew as well from Palestine, where London had ruled under a mandate dating back to the early years of the League of Nations. Arabs and Jews were left on their own to battle for control of the Holy Land.

Further troubles erupted in 1951 after Mohammad Mossadeq, a radical nationalist politician, was appointed as prime minister of Iran. Following a dispute with London over revenue sharing, Mossadeq nationalized the

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assets of the British-owned Anglo-Iranian Oil Company (AIOC), including in particular the AIOC's refinery at Abadan. The action was considered a direct affront to the UK government, which at the time relied on Abadan for virtually all of the fuel used by the Royal Navy throughout the world. For many in the United Kingdom, British power and prestige were under grave threat and required a robust response. As one historian (Onslow 2003, 4) put it, it seemed to many that "nothing less than Britain's future as the premier imperial power—the basis of her great power status—was at stake." London did exert considerable pressure on Iran, imposing a series of economic sanctions, including not least a ban on purchases of Iranian oil exports. But there were limits to British influence, and the so-called Abadan crisis was not finally resolved until Mossadeq was removed from office in 1953 by a coup engineered by the United States.

Yet more troubles emerged in Egypt following the overthrow of that country's crumbling monarchy in 1952 by a group of revolutionary army officers. Britain had long maintained a large military base in the Suez Canal zone, authorized by an Anglo-Egyptian treaty signed in 1936. The base was considered vital to British interests. In the words of one historian (Mason 1991, 45), it was seen "as the keystone of the entire arch of British power in the Middle East and East Africa." But it soon became clear that without active support from the United States, London had little leverage with Cairo and would soon have to leave the installation. A treaty for full withdrawal of British troops was concluded in October 1954, setting the stage for the humiliation of the Suez crisis two years later, as described in chapter 5. The outcome of the crisis might well have been different had the British canal base then still been occupied.

After Suez, it was clear that the handwriting was on the wall. In February 1960, Prime Minister Harold Macmillan signaled the beginning of the end with a widely noted speech before the South African parliament. "The wind of change is blowing," Macmillan declared, "and whether we like it or not . . . we must all accept it as a fact." The implication was that the days of the empire were numbered. Independence would soon be coming to the UK's remaining colonies in Africa, Asia, and the Caribbean. Britain must adapt to a new reality.

For the moment, London did still maintain a significant presence around the edges of the Arabian peninsula, from Kuwait at the north end of the Persian Gulf to Aden in the southwest. Kuwait had become a vital source of oil, providing upwards of 40 percent of Britain's needs. Aden, then one of the world's busiest commercial ports, was a key strategic asset that enabled London to continue to project power into the Persian Gulf, East Africa, and

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the Indian Ocean. Even after the debacle of 1956, influence could still be exerted "east of Suez" (Fain 2001). But not even these toeholds could be sustained for long. Kuwait gained its independence in 1961 and Aden in 1963 (eventually becoming part of present-day Yemen). By the mid-1960s it seemed undeniable that Britain's global presence was definitively on the wane.

The denouement came in January 1968 when Harold Wilson, who had become prime minister in 1964, announced an immediate withdrawal from all military bases in Malaysia and Singapore. Any special security role "east of Suez" was to be formally abandoned (Pham 2010). Henceforth, London's foreign priorities would be redirected to the European Community, which Britain formally joined in 1973, and to the remains of the country's "special relationship" with the United States. By the 1970s there were few in Britain who still saw the nation as destined to remain one of the world's great powers. The retreat from empire was largely complete.

Shrinking Domain

The parallels between Britain's retreat from empire and the evolution of its currency statecraft are close. In matters of money, as in foreign relations more generally, policy moved slowly but inexorably from far-reaching aspiration to resigned acceptance—from resistance to reinforcement. The process was painful but, in the end proved unavoidable. Catherine Schenk (2013, 179) calls the story of the pound "an interesting case of prolonged disintegration of monetary relations." Barry Eichengreen (2008, 123), more colorfully, describes it as a "long and rocky road."

The story began even before World War II. As early as the 1920s it was already evident that for many purposes, sterling was being eclipsed by the US dollar. The rise of the newly popular greenback has been amply documented by Eichengreen and colleagues (Eichengreen and Flandreau 2009, 2012; Chiţu et al. 2014; Eichengreen, Mehl, and Chiţu 2018). By the end of the decade, the dollar had surpassed the pound in central bank reserves as well as in trade finance and bond markets. The British authorities, meanwhile, were desperately trying to cope with the consequences of their ill-advised decision in 1925 to return to gold convertibility at an overvalued exchange rate. With a large overhang of overseas liabilities weighing the currency down, confidence in sterling steadily weakened. And then came the Great Depression, which sparked a massive capital flight from London. In September 1931, gold convertibility was hastily suspended, never to be restored. The value of the pound dropped precipitously.

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The immediate impact was a decisive shrinkage in sterling's domain (Cohen 1971). Before 1931, virtually the entire world made use of the pound for one purpose or another. But with gold convertibility suspended and exchange rates free to float, foreign governments had to decide whether or not to go on linking their own currencies to sterling as they had done in the past. Many gave up on the pound, preferring instead to stick to gold, or to peg to some other currency like the dollar. Those that remained anchored to sterling, still holding the bulk of their reserves in the form of sterling balances in London, became known as the "sterling bloc." The bloc was not small. In addition to the British Empire and Commonwealth (except Canada, which had deeper financial ties with the United States), members included a good number of other states in Europe, the Middle East, and East Asia with traditionally close trading and banking connections with Britain. But it was certainly a humbling experience for a once-great international money. Britain could still exercise a degree of influence through its control of access to the London capital market, but it was now for a much smaller range of clients. Currency strategy was implemented through a variety of targeted measures, including credit rationing and preferential interest rates.

In 1939, after the outbreak of war, the pound's domain shrank even further, as most of the European members went "off" sterling. The rump that remained, now popularly dubbed the sterling area, became more or less coterminous with the borders of the empire and commonwealth (Canada still excepted, but including oil-producing Middle Eastern states). At the same time, membership was formalized, making the arrangement a clearly circumscribed and identifiable statutory entity for the first time. To protect its monetary reserves in wartime, London put in force a comprehensive system of exchange-control regulations, prohibiting conversion of sterling into other currencies. But rather than build a wall around the United Kingdom alone, the government chose instead to include the whole group of sterling-associated countries in one ring-fenced arrangement. Restrictions on payments for foreigners would not be applied to states that—in addition to pegging to the pound and maintaining their reserves in London—agreed to enforce a system of exchange controls similar to Britain's. The main advantages for the so-called "scheduled territories" were their continued access to the financial resources of the City of London and freer trade. The principal advantages for Britain were preservation of an international role for sterling, with its attendant benefits, along with cheaper access to food and raw materials.

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A Losing Struggle

Once the war was over, however, preserving those benefits became an increasingly arduous task, as has been ably described by both Strange (1971b) and Schenk (2010). For upwards of two decades, London did what it could to resist the pound's decline, making liberal use of persuasion, bargaining, and incentives to keep sterling in the game. But in the end, it turned out to be a losing struggle.

Problems began almost immediately, following negotiation in 1946 of a loan of some $3.75 billion from the United States to aid postwar recovery, supplemented by an additional US$1.19 billion from Canada (Gardner 1956). A key condition of the loan, insisted upon by Washington, was that convertibility of the pound into other currencies would be restored within one year, despite the fact that at the time sterling balances in the hands of foreign governments outnumbered Britain's dollar reserves by a ratio of two to one. More broadly, the country's overall net sterling liabilities, at $15 billion, were six times its gold and foreign currency holdings (Eichengreen 2011, 40). Not surprisingly, therefore, when controls were duly removed in July 1947, money flooded out of the country as outsiders raced to exchange their pounds for dollars while they could. The "dash to convertibility" proved a costly failure. In Eichengreen's words (2008, 101), it was "the height of recklessness. . . . a disaster." After six weeks the government felt it had no choice but to reimpose controls alongside drastic cuts in domestic and overseas expenditures. The rapid loss of more than $1 billion from the country's reserves only served to highlight the weakness of sterling, which two years later was formally devalued from $4.04 to $2.80.

But not even devaluation to a more competitive rate could slow sterling's decline as an international currency. New crises hit the pound with disturbing regularity, on average every two years, further eroding its appeal and reputation. Not least was a massive run in 1957 provoked by the previous year's Suez debacle. Throughout the 1950s and into the 1960s, one possible scheme after another was brought up for consideration, only to fall by the wayside (Schenk 1994, ch. 5). One was the so-called Robot Plan—named after its originators *Ro*wan, *Bo*lton, and *Ot*to Clarke—first floated in 1952, which would have combined a return to convertibility with a floating exchange rate. Another, also dating from 1952, was an abortive "Collective Approach," calling for a common European move to convertibility funded by credits from the United States. The European nations, including Britain, did finally return to current-account convertibility at the end of 1958, but the action did sterling little good.

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Nor could Britain call on a lingering sense of loyalty to the Commonwealth to keep sterling area members "on side." Instead, London had to make use of whatever currency power it still possessed to keep the bloc from disintegrating. The key remained the scheduled territories' privileged access to the British capital market—an important consideration at a time of tight borrowing limits in Europe and the United States. The UK government was not above using its influence over credit allocation and interest rates to coerce recalcitrant members and reward the more compliant. But by the 1960s, even that source of leverage was beginning to weaken as the postwar recovery of international finance gradually took hold.

That left just one card to play: sterling's importance to the broader international monetary system that had been created at the end of World War II. As indicated in chapter 5, growing awareness of the Triffin Dilemma in the early 1960s led to increased efforts throughout the decade to negotiate some manner of global monetary reform. For London, that provided an opportunity. The sterling area, it could be argued, was a vital component of the overall system. Hence, any threat to the pound could be considered a danger for the system as well. And so any reform of the system would necessarily require some degree of collective support for sterling. Britain's weakness could become a source of strength. As Schenk (2010, 6, 31) summarizes:

> [London] sought to internationalize the resolution of the vulnerabilities posed by sterling's use overseas by shifting some of the burden to other countries. . . . Successive British governments were able to use sterling's weakness and the threat this posed to the international monetary system to garner substantial support.

In short, sterling was not Britain's problem alone. Resistance to decline would be in everyone's interest.

From Resistance to Reinforcement

By that time, however, it was too late. The long struggle was finally lost in November 1967, when once again the pound was devalued, this time from $2.80 to $2.40. Sterling's death knell was sounded (Oliver and Hamilton 2007). Eichengreen and colleagues call it the "final nail in the coffin" (Eichengreen, Mehl, and Chiţu 2018, 156).

The devaluation followed closure of the Suez Canal in the aftermath of the Six-Day War between Israel and its neighbors, which threatened to

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disrupt international trade and raise the price of Britain's vital oil imports. Devaluation may have been "unavoidable" (Eichengreen 2011, 57), but it was bitterly resented by the thirty-four remaining members of the sterling area. Stung by the hit on the value of their holdings, they began to flee for the exits. To many observers, it seemed like a classic case of locking the barn door after the horse had bolted. But for the governments involved, it reflected a determination never to be burned again. Between March and September 1968, official sterling balances fell by more than 15 percent; it was clear that more withdrawals were on tap unless some action was taken. The solution, it turned out, was an agreement worked out under the auspices of the Bank for International Settlements in Basel, Switzerland—an arrangement known to history as the Basel Facility. With the Basel Facility, London's currency statecraft formally switched from resistance to reinforcement.

The arrangement consisted of three parts. First, the central banks of twelve major industrial countries agreed to provide Britain with a $2 billion standby credit through the BIS to finance any further net withdrawal of sterling balances. Second, London guaranteed to maintain the dollar value of the bulk of each member's sterling reserves, meaning that in the event of any future devaluation every member would receive a payment in sterling to restore the value of its guaranteed reserves. And third, each member pledged in return to keep not less than an agreed percentage of its total reserves in pounds (the Minimum Sterling Proportion).

The retreat of sterling, it was now clear, would be not opposed but managed. What had once been the world's top currency was now officially on life support. The aim of the Basel Facility was to pave the way for a gradual winding down of Britain's remaining liabilities. As Schenk (2013, 190) puts it: "From 1968 the strategy for Britain as well as for overseas members of the sterling area was clearly to manage disengagement while avoiding a tipping point that would push sterling to collapse." The fate of the pound was thus sealed. Originally agreed for a period of three years, the Basel Facility was renewed in 1971 (just before termination of the dollar's convertibility into gold) and again in 1974 for a final nine months before being allowed to lapse.

The death of the sterling area came quickly once London embarked on a "temporary" float of the pound in mid-1972. The float was triggered by a flood of sales from currency speculators (memorably branded by British politicians the "gnomes of Zurich"). To forestall any risk of yet more flight for the exits, Britain's remaining exchange controls were quietly reimposed on the scheduled territories, reducing sterling's once-proud global domain

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to a mere shadow of its former self—no more than the United Kingdom plus Ireland and the Channel Islands. *Sic transit gloria mundi*. After a third of a century, the sterling area was gone.

Analysis

The coincidence of timing between the Basel Facility and Harold Wilson's decision to retreat from "east of Suez" was no accident. They were in fact both rooted in the same cause: a lack of sufficient resources. Both could be thought of as part of the same agonizing process of managed domestication. It is no easy thing to rein in national ambition.

That the British would initially seek to preserve sterling's status was of course understandable. The resistance option is a natural reflex for a nation whose money has seemingly reached a tipping point—almost a default response, in fact. Privileges long promoted or exploited are not apt to be easily surrendered. One of the fundamental premises of behavioral economics, based in the discipline of cognitive psychology, is that material losses are far more powerful in emotional terms than are equivalent gains, and thus are apt to be resisted more strongly. Theorists call this loss aversion. Seen in this light, it is hardly surprising that sterling's decline would have been fought almost from the moment it started. This was loss aversion on a grand scale. London struggled for years to sustain the venerable pound's place in the global system, even after large parts of the world had long since switched their allegiance to America's greenback.

But it was also understandable that, sooner or later, a country in geopolitical retreat might come to the conclusion that the game is no longer worth the candle. At some point, policy makers in such circumstances are bound to conclude that any effort to prolong their money's standing is likely to be in vain, and loss aversion will be overcome. Once a slide down the currency pyramid starts to look inevitable, the more rational response is not to stubbornly oppose decline, but rather to seek to soften the blow as much as possible. Instead of bargaining and cajoling to preserve foreign use, terms might be sought to ease the pain and phase out responsibilities. That was the point reached by the British with the devaluation of 1967.

Not that the transition occurred overnight. Outside government, there had long been many in Britain who questioned the wisdom of London's sterling policy. For economist Alan Day (1954), postwar efforts to re-establish the pound's international standing were pure folly, based on little more than delusions of imperial grandeur. Likewise, for Andrew Shonfield (1958), also an economist, the government's sacrifice of domestic priori-

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ties for the sake of maintaining foreign confidence in sterling was tragic and absurd. And even inside government, opinion was less than unanimous. According to Schenk (2010), as early as the late 1950s there were already voices in policy circles calling for a reduction of sterling's international role. For many officials, the 1956 Suez crisis "forced a reassessment of the United Kingdom's strategic power, after which the status of sterling became closely linked with the perception that British governments had overreached the limits of their global influence, with disastrous results" (2010, 3). As Schenk notes, these voices grew even louder in the 1960s as the broader retreat from empire accelerated. But the extent of their impact on official planning remains a matter of some dispute. Schenk is inclined to believe that the policy was already being remolded by the early 1960s. But, as she ruefully concedes (2010, 424), "the direct evidence of their influence is not as certain."

In reality, it seems that a really big shock—something on the order of the 1967 devaluation—was needed to finally force a decisive shift from resistance to reinforcement. If it had not been manifest before 1967, it was abundantly clear then that the geopolitical ambitions of the early postwar years were simply no longer tenable. The dream had become a nightmare. Before 1967, policy elites were divided. After 1967, defeat had to be conceded.

Conclusion

If the British experience teaches us anything, it is that coping with decline is not easy. During a currency's youth, a society can indulge in a measure of optimism, anticipating better things to come. And similarly, during maturity, a certain degree of complacency might not be unwarranted. But defeat is another matter altogether. It may take a considerable amount of time to overcome loss aversion. In the British case, it took decades.

Why did it take so long? Here the comparison with Japan is instructive. In the Japanese case, grand geopolitical ambitions had long been laid to rest by military defeat and postwar occupation. The most Tokyo aspired to was some degree of economic leadership in East Asia. Hence, less seemed at stake when the yen began its retreat after the 1980s. Japan resisted for only a relatively short time before giving up the struggle. For the British, victors in World War II who still thought of themselves as a great power, the challenge to sterling was far more portentous. The pound was a symbol of imperial grandeur. Its defense was a matter of national pride.

In the end, of course, neither the Japanese nor the British could reverse

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the decline of their currencies, despite their best efforts. Sentiment on the demand side of the market could not be brought in line with official preferences. In Britain's case, the clincher was the devaluation in 1967, which managed to destroy the last shreds of overseas allegiance to the pound. In Japan's case, it was the combination of lingering war memories in East Asia, and the rise of China.

Are there lessons here for the US dollar, today's top currency? Despite some claims to the contrary, the greenback does not yet appear to have passed its peak. But sooner or later, in the long run of history, the day will come when the tipping point arrives, either because of America's own policy errors or because of the rise of a truly attractive alternative. How might Washington then respond—more like the Japanese, acquiescing passively, or more like the British, fighting on gallantly? In the world of currency statecraft, that is today's biggest question.

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SEVEN

When Statecrafts Collide

What happens when currency statecrafts collide? In principle, the potential for policy conflict between monetary rivals would appear to be great. Since all power is relative, the rise of one international money necessarily implies some loss of capability elsewhere; and since loss aversion is a natural reaction for states as much as it is for individuals, it hardly seems unreasonable to assume that some defensive steps might be taken in response. The risk is high, therefore, that currency competition could at some point become politicized, alienating friends or arousing adversaries. Any commentary on prospects for the future is of course inherently speculative. But the analysis in this book allows us, at least, to make a few educated guesses about what may lie beyond the horizon.

In practice, strikingly, outright inter-state contestation over currency power has been relatively rare. The modern era, to date, has seen little overt warfare between international moneys. With the emergence of China's RMB, however, we have an exception—a unique and potentially historic confrontation between a rising monetary power, China, seemingly committed to do all it can to move currency preferences in its favor, versus a longtime incumbent, the United States, that is unlikely to surrender its traditional privileges without a fight. In effect, by choosing the promotion option so forcefully, Beijing has challenged the American dollar to a duel: China's redback versus America's greenback. One can almost hear the Chinese calling from behind their Great Wall: "Yuan a fight?" The currency statecrafts of the twenty-first century's two leading powers are now in open conflict. This is the central drama on the world monetary stage today.

In terms of capabilities, it would seem, the advantage is all to the greenback, which is backed by power resources that—so far, at least—greatly outstrip anything available to the RMB. But in terms of statecraft, China has

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shown a determined and nimble strategic sensibility that is well beyond anything we have yet to see come out of Washington. Both sides appear to be well equipped for a momentous battle. Much rides on the outcome.

Three questions are addressed in this chapter. First, why is the dollar/yuan confrontation so exceptional? Second, how is the duel likely to turn out? And third, what are the implications for possible collisions of currency statecraft in the future? Answers to all three questions will draw heavily on what we have learned in the preceding chapters.

The China Exception

One lesson we learned is to distrust the Immaculate Conception of Power. If there really were a close correlation between money and the pursuit of influence—as, for instance, Jonathan Kirshner (2014, 108–13) has argued—politicized confrontations between issuing authorities would be the rule, not the exception. Proactive policies in favor of internationalization would inevitably create sparks. Governments would battle to divert demand-side actors to their currency (promotion); they would fight over who gets to benefit from an exorbitant privilege (exploitation); they would defend their money against any sign of encroachment by others (resistance). Currency statecrafts would be in persistent collision.

But if the empirical record demonstrates anything, it is that the Immaculate Conception of Power is wrong. Issuers do not always welcome internationalization of their money; nor do they necessarily seek to exploit their currency power; nor do they automatically resist any incipient sign of decline. Rather, in the majority of cases, policy has been neutral (permission, enjoyment, relaxation) or even proactive in opposition to internationalization (prevention, evasion, reinforcement). Direct collisions between states, as a result, have for the most part been avoided in the modern era.

Moreover, after our review of historical experience, we know the main reason *why* overt currency conflict has been so rare. It follows directly from an absence, in most cases, of open geopolitical ambition. Politicization of monetary rivalries has been infrequent in the modern era because few issuers of international currencies have manifested any sort of appetite for the risks or responsibilities of international leadership. Most have shown little interest in throwing a lot of weight around. Hence, most have resisted the temptation to boost their currencies at the expense of others.

Certainly that was true of West Germany and Japan back in the 1970s and 1980s, as we saw in chapter 4. Both countries were military clients of the United States, content to concentrate mainly on rebuilding their war-

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shattered economies. Neither was inclined to question America's leadership of the broad free-world alliance that Washington had constructed against the perceived threat from the Soviet Union. Accordingly, neither chose to push their currency into combat with the US dollar, despite the growing international appeal of both the Deutsche mark and the yen. As Kirshner accurately observes (2008, 421), "During the Cold War . . . the high politics of the bipolar world order served as an 'emergency break' [*sic*] that placed a limit on just how far monetary squabbles between the Western allies could go."

Frictions with the Germans and Japanese were not avoided entirely, of course. In the 1970s there were many complaints from Washington about the relatively tight monetary policies of the Deutsche Bundesbank, which were increasing the attractiveness of DM-denominated claims relative to the dollar. High interest rates in West Germany were attracting capital from the United States, forcing the Federal Reserve in turn to raise rates despite sluggish economic growth at home. For a brief time, alarmists spoke of an emerging "interest-rate war" across the Atlantic, before US monetary policy joined the Germans in fighting inflation at the end of the decade. Likewise, in the early 1980s there were some grueling negotiations between Washington and Tokyo under the auspices of the Yen/Dollar Committee, leading under US pressure to the unpopular Yen/Dollar Agreement of 1984. But those tensions, too, blew over once Tokyo began to implement some modest market-opening measures. For the most part, spats like these amounted to little more than minor skirmishes. The risk of outright currency combat was never very great.

The same can also be said of the eurozone more recently. When the EU's joint money came into existence in 1999, a forceful challenge to the greenback's dominance was widely expected. Yet European authorities have kept to a strict hands-off policy, a passive stance of benign neglect. Partly this is because the nineteen members of the monetary union simply find it difficult to act as one; they are hamstrung by the many well-known imperfections in the euro area's governance structure. But it is also partly because most of the nations involved are allies of the United States. None is about to challenge US geopolitical supremacy. And of course, that is true of the other members of the top-tier club as well, including Britain, Canada, and Australia. All have long counted themselves as friends of Washington, not adversaries.

The one outlier among America's free-world allies was France back in the 1960s, when French President Charles de Gaulle showed great eagerness to challenge the dominant role of the dollar. De Gaulle resented Washing-

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ton's exorbitant privilege, and certainly did not lack for geopolitical ambition. But he did lack a currency that could compete head-to-head with the greenback. The French franc at the time had little international standing, other than in postcolonial Africa. This was not a collision of two leading moneys. Rather it was, as Charles Kindleberger (1985) described it, more in the nature of an attack by a "near-great power" on the incumbent at the peak of the currency pyramid—a "systemic disruption," in Kirshner's (1995) words. De Gaulle's aim was not to pose the franc as an alternative to the dollar; in fact, he put most emphasis on restoring gold to a place of prominence in monetary relations. Gold, he famously proclaimed, "has no nationality [and] is considered, in all places and at all times, the immutable and fiduciary value par excellence. . . . The supreme law, the golden rule . . . must be enforced and honored again" (De Gaulle 1965). His aim was simply to curb Washington's influence by any means possible.

In the modern era, we have just one example of a direct confrontation between two top-ranked currencies. That has been the confrontation between the United States and China—plainly, the exception that proves the rule. For the first time since World War II, the dollar faces a rival from a nation that is not a friend or ally. To the contrary, in strategic terms, China clearly sees itself as an adversary of the United States—or, at best, a "frenemy"—not at all reluctant to advertise its own geopolitical aspirations. As noted in chapter 4, Chinese society instinctively feels entitled to the mantle of regional, if not global, leadership. The notion of the Middle Kingdom, the dominant core of a tributelike system, is integral to the Chinese sense of national identity. "Even when the Chinese state was at its weakest, in the late 19th and early 20th centuries," historian Odd Arne Westad (2013) remarks astutely, "its elites felt that . . . other countries in the 'Confucian zone' were simply to accept China's natural leadership." Today, the ruling Communist Party seems set on reclaiming an influential role for China in as many areas of international relations as possible, even if it comes at America's expense. And among these, of course, are currency relations. In promoting the "China dream," Beijing does not appear at all reluctant to risk a collision between the RMB and the dollar.

That does not necessarily mean that Beijing aspires to wholly supplant the greenback at the peak of the currency pyramid—at least not for the moment. In practice, Chinese policy preferences have been cloaked in ambiguity (Chin 2017), leaving much to guesswork. Many observers believe that China's real goal, like that of de Gaulle half a century ago, is limited simply to curbing America's overweening currency power. As Paola Sub-

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acchi (2017, 4) puts it, "Chinese leaders are eager to break up the dollar's hegemony—but not to replace the dollar system with the renminbi system." For de Gaulle, breaking up the dollar's hegemony meant promoting gold. For China, it means promoting the yuan and perhaps also the IMF's special drawing right, all in the name of "diversification" or "rationalization" of the system. But how can we be sure? Is it realistic to think that Beijing's monetary ambitions are truly so limited? Another famous aphorism of Deng Xiaoping was "Hide our strength and bide our time." Given the nation's innate sense of superiority, it seems possible that for the Chinese, a weakened greenback would represent no more than a transitory rest stop along their money's long march toward global status. Only one thing is for certain. Never before has the dollar faced such a formidable challenge.

In short, the redback/greenback duel is exceptional because, in broader terms, the geopolitical relationship between China and the United States is exceptional. Alone among today's suppliers of international money, the Chinese seemingly feel no obligation to concede US leadership, which they see more as "imperialism." For them, therefore, there appears to be no built-in limit—no emergency brake—on how far they are willing to go with their "monetary squabble." Currency combat is welcomed.

China's Challenge

Can China's challenge to the dollar succeed? Beijing's ambitions for its currency are grand, maybe even grandiose. But they fit well with the country's broader geopolitical aspirations. For the Chinese elite, the collision of currency statecrafts is just one front in what they appear to see as an epochal confrontation between world powers—a struggle, in effect, for global dominance in the 21st century. The outcome of the monetary rivalry with the United States will depend on much more than money alone. To repeat: Currency statecraft is not just about currency.

Aspirations, however, no matter how strongly held, do not on their own guarantee success. For all its achievements to date, the yuan remains far behind the dollar, and even most other elite moneys, by nearly any measure of international use. Beijing's currency statecraft to date has been astute, but it is handicapped by a relative lack of monetary muscle. In its duel with the greenback, China is somewhat deficient in terms of relevant material capabilities. A key question is how effectively the Chinese leadership can play a comparatively weak hand. Another is how Washington, in its turn, can be expected to respond.

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A Long March

Considering where it started, the yuan's rise as an international currency in recent years has been nothing short of meteoric. At the turn of the new century, the RMB was tightly controlled and rarely used by anyone outside mainland China. Less than two decades later, the Middle Kingdom's money occupies a rank not far below the peak of the currency pyramid. The RMB reached fourth place among the world's top payments currencies, and ranked eighth among the most widely traded moneys in the global foreign exchange market. A lively market for yuan deposits and yuan-denominated bonds was created in Hong Kong, and more than three dozen central banks have added some amount of RMB to their reserves.

But all that was, in a sense, the easy part—getting started. The currency still has a long way to go if it is to catch up with the US dollar. The RMB's long march has really only begun. In no category of use, for all its gains, has the yuan yet come anywhere close to eroding the greenback's overwhelmingly dominant position. In the foreign-exchange market, the dollar appears on one side or the other of almost half of all trades, some eleven times the RMB's share. In global reserves the greenback's share is 65 percent, as compared with the redback's 1 percent. The disparities remain enormous. Subacchi (2017) is not far off in describing the RMB today as still something of a "dwarf currency."

Worse, there are signs that the dwarf currency's gains have decelerated and, in some categories, may even have gone into reverse (McDowell and Steinberg 2017). A peak of sorts appears to have been reached following a surprise devaluation of the RMB in mid-2014. The size of the devaluation was small, only 1.9 percent, but the effect on expectations about the currency's future value and usefulness was huge. No longer could RMB appreciation be regarded as a one-way bet. Whereas the dollar value of the RMB had risen nearly every year from 2005 to 2013—in total by some 37 percent—after 2014 it came under strong downward pressure, falling by nearly 13 percent through the end of 2016. The result was a major shift of market sentiment regarding the currency's prospects as a store of value. Yuan deposits in Hong Kong, for instance, plunged by nearly half after 2014, and the share of China's total trade settled in RMB dropped from above 30 percent to no more than 15 percent Capital flight from the mainland forced the PBOC, starting in 2015, to spend more than $1 trillion of its reserves to prop up the exchange rate.

In response, reversing Beijing's previous policy of gradual capital-account liberalization, the authorities in 2016 began to impose strict new

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rules to curb the flow of RMB offshore for conversion into dollars, making their monetary great wall even higher than before. Limits on foreign direct investment by Chinese corporations were reinforced, and scrutiny of cross-border transactions was tightened. And then in May 2017, following a downgrade of China's credit rating by Moody's Investors Service, the government announced that it was stiffening its control of the yuan exchange rate. After a decade of rapid internationalization, promotion of the RMB appeared to have been put on hold.

That did not necessarily mean that the currency's rise was now "well and truly over," as one source declared (Steil and Smith 2017, 44). It is, after all, entirely possible that the slowdown may ultimately prove to be no more than transitory, merely a brief pause in a long-term upward trend. No one doubts that Beijing remains as committed as ever to its strategy of managed internationalization. In late 2017 the People's Bank of China explicitly reiterated its determination to go on boosting global use of its currency (*China Daily* 2017). Nonetheless, it is clear that, for a brief moment at least, the yuan's long march had more or less stalled, in a manner reminiscent of the yen after 1989 or the euro after the mid-2000s. The setback cannot be denied.

A Weak Hand

What can Beijing do about it? I have suggested (chapter 4) that in overall design China's statecraft seems well crafted, focusing on an international currency's key roles in trade, investments, and reserves. But doubts remain as to whether the Chinese have the right resources and instruments to make their strategy succeed. It is clear that in many respects, China is playing a relatively weak hand.

On the positive side is Beijing's trump card, the massive size of the Chinese economy, which is bound to exercise a strong gravitational pull in global commerce. Given the country's far-flung transactional network, encouragement of further use of the redback for trade purposes should not be difficult. Another strong card is China's growing web of foreign policy ties, which Beijing has cultivated through strategic investments and bilateral aid programs, as well as its wide array of currency swap agreements. As Steven Liao and Daniel McDowell (2016) have ably demonstrated, investments in the yuan for reserve purposes have been strongly influenced by political alignments with the Middle Kingdom. The more governments identify with Chinese foreign-policy preferences, Liao and McDowell find, the greater their tendency to diversify reserves into the RMB. And there is

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also no doubt that China's leadership has established an admirable track record of monetary management. Inflation has not been allowed to pose any threat to the value of the people's currency.

But there is also a negative side, where Beijing's hand is considerably weaker. Utmost in many minds is the authoritarian nature of China's domestic political regime, which is so different from the more democratic forms of governance that prevailed in all previous instances of currency internationalization in the modern era. In some respects, autocracy may be regarded as an advantage, since it eases institutional constraints on the leadership's ability to formulate and implement strategic decisions. We know that Chinese elite opinion on the future of the RMB has not been unanimous. As noted in chapter 4, some domestic interest groups in China were initially quite skeptical about the benefits of internationalization. But in Beijing's centralized governance structure, once a policy choice is made, everyone is expected to toe the party line. Dissent is not encouraged. That is in sharp contrast to the much more extensive limits on political capacity we see in a country like the United States, with its intricate system of checks and balances and large number of potential veto players. Recall the headwinds that the executive branch ran into in some of the cases discussed in chapter 5. As compared with the kinds of handicaps that encumber Washington officials, Chinese policy makers enjoy a fairly high degree of freedom.

In other respects, however, autocracy is a distinct disadvantage, particularly when it comes to cultivating the trust of outsiders. For all the potential appeal of the RMB, the Chinese regime does not inspire a high level of confidence. To date, Beijing has shown little regard for the sanctity of property rights or the faithful enforcement of contractual obligations. The country's governance structure is not known for transparency or accountability. Quite the reverse, the ruling Communist Party has always been dictatorial in nature and often arbitrary in behavior. In its survey of global governance indicators, the World Bank (2016) recently ranked China in just the 44th percentile for the rule of law, while Transparency International (2015) places China no higher than 83rd among 168 nations in its corruption index. Indeed, over the medium term, it is not even clear whether domestic political stability in the Middle Kingdom can be assured.

China's rulers do not deny the problem. Indeed, at the annual meeting of the Communist Party's central committee in late 2014, under the leadership of President Xi Jinping, the issue of governance quality was noted and a formal commitment made to firmly establish the "rule of law" by the year 2020. In practice, however, there was less here than meets the

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eye. The party clearly did not have Western-style democracy in mind. "We absolutely cannot indiscriminately copy foreign rule-of-law concepts and models," declared the Central Committee. The goal, it seemed, was to refine party control, not dilute it. As *The Economist* (1 November 2014) commented: "Official English translations refer to the importance of the 'rule of law.' But Mr. Xi's tactics appear better suited to a different translation of the Chinese term *yifa zhi-guo*: 'rule *by* law.' His aim is to strengthen law to make the party more powerful, not to constrain it." And this intention became even more evident in Xi's speech to the Communist Party congress in October 2017, where he pledged to further "improve the national security system [and] clearly oppose and resist the whole range of erroneous viewpoints" (Buckley and Bradsher 2017). In this light, only the most sanguine of investors or central banks would see today's China as a safe haven for their wealth.

Nor are many encouraged by China's vast military buildup, which seems clearly designed to project coercive power well beyond the country's borders. Rather than volunteer formal or informal security assurances, as the United States has done in many cases, Beijing has increasingly chosen to act more like a bully, aggressively asserting what it regards as its core national interests. That has been most notable in the East and South China Seas, where expansive territorial claims have embroiled the country in disputes with a number of nearby states. In East Asia, the expansion of Beijing's military reach is seen as anything but reassuring. Few neighbors share China's nostalgia for the idealized tradition of a regional tribute system, with the Middle Kingdom at its center, as prevailed centuries ago. Beijing's historical sense of entitlement is widely resented.

Most salient of all is the primitive quality of China's financial sector and its isolation from capital markets elsewhere. For all the success of the Chinese economy since reforms began, domestic financial institutions remain rudimentary at best. Equity and bond markets are still unable to provide the depth, breadth, and resiliency that are so prized by investors and central banks. Liquidity is low, asset prices are volatile, and values are distorted by heavy government involvement. Moreover, there is a distinct shortage of high-quality securities. When monetary authorities hold a currency, it is usually in the form of central government debt. For the yuan's share of global reserves to rise much at all from its present 1 percent, foreign central banks would have to acquire an implausibly high proportion of all Chinese government liabilities, given the current size of the Middle Kingdom's public bond market. At a 7 percent share of global reserves, foreign holdings of government debt would rise to one-third of the total outstanding.

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At a 20 percent share, the entire stock of Beijing's debt would be held by foreigners (Steil and Smith 2016).

Moreover, the onshore financial sector remains largely cut off from the offshore world by Beijing's monetary great wall, which remains as imposing as ever. Effectively, the yuan is still an inconvertible currency for most capital transactions, weakening even further any attraction the currency may hope to have as a store of value. The negative effect of financial closure on the RMB's future prospects is widely recognized. In the words of the noted economist Jeffrey Frankel (2011, 13): "If China is not yet ready to liberalize its domestic financial markets [and] to legalize capital inflows . . . then full internationalization is probably a long way off."

On balance, therefore, it is clear that there is good reason—several good reasons, in fact—why the yuan can still be considered a dwarf currency. Though Beijing holds some strong cards, its hand overall is not commanding. China still lacks some of the capabilities that help to make a money competitive at the international level. If the Beijing's statecraft is to prove effective, the hand will have to be played masterfully.

Gradualism

To their credit, China's leaders seem to understand what might be needed to compensate for their currency's deficiencies, and have acted accordingly. But, as indicated previously, the promotion option has been pursued with considerable caution, stressing gradualism above all. No one can doubt that China's currency statecraft has been busy—but it has been at a speed that is largely of Beijing's own choosing.

At the official level, for instance, the attraction of the yuan for many foreign governments has been enhanced by Beijing's build-up of a network of currency swaps and designated clearing banks, as well as by its successful campaign to include the RMB in the SDR basket. But the pace of each of these efforts has been slow and measured. Likewise, at the private level the usefulness of the yuan as an investment currency has been improved via a series of initiatives intended to open the domestic financial sector more to both inflows and outflows of capital. But here too, the process has been prudent and incremental. The result has been what Subacchi (2017, 130) calls an "alphabet soup of programs."

For nonresidents, for instance, there are now arrangements known as QFII (for qualified foreign institutional investors) and RQFII (for renminbi foreign qualified investors), which permit a widening range of foreign investors to buy and sell limited amounts of selected stocks and bonds inside

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China. Conversely, for residents there are schemes like QDII (for qualified domestic institutional investors), R-ODI (for renminbi overseas direct investment), and QDLP (for qualified domestic limited partnership), all designed to enable some domestic investors to add foreign assets to their portfolios. In 2014, an innovative direct link between the Shanghai and Hong Kong stock exchanges was introduced—the so-called "Shanghai-Hong Kong Stock Connect"—aiming to allow both foreign and domestic investors to move funds between the two exchanges in a less restrictive manner. In 2016 that was followed by a similar trading link with the Shenzhen stock exchange, and in 2017 the new Bond Connect program was created to further ease foreign purchases and sales of Chinese government or corporate bonds.

The reason for gradualism is evident. If Beijing is to fully address its currency's deficiencies, it will have to institute reforms that go straight to the heart of the Communist Party's distinctive model of political and economic management. It would have to make the country's governance structure more transparent and accountable, with more emphasis on genuine respect for property rights. It would have to tone down elements of nationalism and revisionism in foreign policy, to reassure apprehensive neighbors. And above all, it would have to put more effort into cultivation of a truly efficient and open financial sector, in order to enhance the RMB's appeal as a store of value.

All of these steps would risk seriously eroding the party's authority and grasp on power. More rule of law would mean less rule *by* law. Less emphasis on nationalism would dilute one of the party's key claims to legitimacy. And more financial liberalization would mean less predictability, weakening a critical tool of elite control: the leadership's long-standing ability to manage monetary and financial conditions. Domestically, monetary control has meant direct authority over interest rates and the availability of credit, enabling the state to allocate resources to favored borrowers and to minimize its own funding costs. Command is exercised through regulated deposit and lending rates, quantitative credit guidance, and bond market rationing. Internationally, control means a closed capital account and a managed exchange rate. Financial repression, as economists call it, is a vital cog in Beijing's machinery of political autocracy. Stability remains the highest priority.

It is hardly surprising, therefore, that even as China has promoted RMB internationalization as a goal, it has proceeded cautiously. Beijing's currency statecraft operates under some deeply rooted domestic constraints. The hope, plainly, is to be able to encourage wider use of the yuan abroad

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without seriously threatening party control at home. That is a delicate balancing act, to say the least. In effect, the government has been trying to promote internationalization on the cheap—to make as few concessions as possible in terms of financial or political reform, hoping that economic size alone will manage to do the job. Whether a compromise strategy like that can work effectively remains an open question.

America's (Non)Response

Until now, despite its domestic constraints, Beijing has played a weak hand skillfully, even craftily. But that is only half the story. The outcome of the redback/greenback duel will not be determined by the Chinese alone. Much also depends on how the United States responds to the Middle Kingdom's challenge. Geopolitics is about the *conflict* of statecrafts, not just one country's unilateral actions. It takes two to duel, even if one party may be reluctant to fight.

The RMB, of course, is not the first money to challenge the dollar. But in the eyes of many it threatens to be the greenback's most potent rival to date. "China's growing size and economic dominance are likely to translate into currency dominance," predicts one prominent economist (Subramanian 2011, 5). "The renminbi could surpass the dollar as the premier reserve currency well before the middle of the next decade." Echoes another influential commentator (Zweifel 2014), "The era of the renminbi is upon us." In effect, under pressure from the yuan, the dollar is thought to be tipping from the mature phase of its life cycle to the beginning of a possibly painful decline. Washington may soon be faced with a choice among the options of resistance, reinforcement, or relaxation.

If the Immaculate Conception of Power were to be believed, a decidedly proactive choice might have been expected from the Americans. But policy, in fact, has been mostly passive at best. Through the three successive administrations of George W. Bush, Barack Obama, and Donald Trump, Washington's response has turned out to be most akin to relaxation—deliberate *non*-action. In the face of the RMB's challenge, little has been done to protect the greenback's longtime exorbitant privilege (the resistance option), whether by direct means of intervention or indirectly. Nor, from all appearances, has any serious consideration been given to the alternative of a managed retreat along the lines of what Britain did in the 1960s and 1970s (the reinforcement option). Instead, despite the combative tone of China's currency statecraft, official US policy has remained quiescent—

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indeed, more or less indifferent. Benign neglect rules. The contrast with China's unabashedly assertive statecraft could not be greater.

What explains America's choice of (non)strategy? China's determined search for power and prestige is bound to come, in large degree, at the dollar's expense. Yet despite the formidable material capabilities at its disposal, Washington has shown little interest in mounting much of an organized defense. Intensity is lacking. Instead, the initiative has been left to the Chinese. Why?

We can rule out lack of political capacity. We know that in comparison to China's more centralized decision-making processes, America's complex division of powers impedes many policy initiatives by the executive branch. But that would be a problem in this instance only if the executive branch had actually shown some desire to respond to the Chinese challenge—which it has not. Washington's inaction through three administrations cannot be attributed to institutional gridlock. Likewise, we can surely rule out fear or intimidation. It is doubtful that the world's "last remaining superpower" could be cowed so easily.

Lastly, we can rule out an indifference to the attractions of economic statecraft in general. Some observers argue that Washington has abandoned economics as an instrument of foreign policy. In the words of one recent study, "economic techniques of statecraft have become a lost art in the United States. . . . The use of economic and financial instruments as tools of statecraft has become an orphaned subject" (Blackwill and Harris 2016, 1, 6). But that flies in the face of much evidence to the contrary—including the evidence, in chapter 5 of this book. of Washington's frequent use of direct currency power. In practice, US policy makers have shown little reluctance to make use of all kinds of economic carrots and sticks when the occasion has seemed to warrant it. Friends and allies have been the beneficiaries of a wide range of aid programs; enemies and adversaries have felt the sting of myriad trade and financial sanctions. Daniel Drezner (2015, 755) is undoubtedly closer to the truth when he declares that, in fact, "This is the golden age of economic statecraft."

So if there is no institutional impediment or principled reluctance to make use of economic statecraft, why is there so little resistance to China's currency offensive? A cognitive explanation would appear to make the most sense. In bluntest terms, US policy makers have become complacent. After nearly a century at the peak of the currency pyramid, overconfidence born of a lifetime of entitlement has become the greenback's own worst enemy. There have been times, of course, when confidence has been shaken by a

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threat of capital flight—as in the late 1960s and again in the late 1970s—but those moments were clearly exceptional, as I suggested in chapter 5. Over the decades, the power of the US dollar has come to be taken more or less for granted, part of the natural order of the universe. When was the last time that prospects for the greenback figured at all in domestic political debate?

Put more formally, the United States seems to have fallen prey to what political scientist Giulio Gallarotti (2010) calls the "power curse"—the risk that an accumulation of power may, in time, actually act to diminish a state's capabilities. In Gallarotti's words (2010, 9), "The quest for power often creates the seeds of its own destruction." Nations become victims of "power illusion"—a growing misperception of how strong they really are. Vulnerabilities may come to be underestimated; capacities may be wasted; countervailing actions and other negative feedbacks may be discounted. A case can be made that America's passivity in response to the RMB's challenge is a prime example of power illusion. America has enjoyed its exorbitant privilege for so long that it no longer feels any need to defend it.

Not that complacency is entirely unjustified. The dollar still enjoys many undoubted strengths. Indeed, no other currency comes even close to matching the ample power resources that back the greenback—America's still massive economy and importance in world trade, its extraordinarily well developed financial markets, its widespread network of foreign policy ties and extensive military reach, and its undoubted commitment to effective monetary management and the rule of law (Cohen 2015, ch. 7). By most measures of international use, the US dollar continues to outdistance every other money by a very wide margin. Moreover, as we know, America's greenback has easily shrugged off previous challenges from the likes of the Deutsche mark, yen, and euro. Though the RMB rivalry may be its most serious challenge yet, the dollar's competitive advantage remains enormous.

But it is clear that there are vulnerabilities as well, and they are growing. Most at issue are America's persistent payments deficits and mounting overhang of external debt, which could trigger a loss of confidence in the dollar at any time. That is an ever-present threat. At any moment, skittish investors or risk-averse central banks could suddenly try to flee to other currencies. Passivity in the face of such a risk would appear to be a textbook example of power illusion. After decades of deficits without tears, Washington seemingly has come to take its exorbitant privilege more or less for granted. Indeed, most Americans would seem to share the cynical view of John Connally, who, shortly after taking office in 1971 as Richard Nixon's secretary of the treasury, famously told a group of European

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finance officials that the dollar "is our currency, but your problem." Only rarely do US politicians or voters ever pay attention to the standing of the greenback when thinking about fiscal or monetary policy. As David Calleo (2009, 186–87) has ruefully commented, "Americans, it appears, have grown deeply habituated to our exorbitant postwar privileges. . . . Instead of consuming less and exporting more, we prefer exporting more dollars." Echoes Fred Bergsten (2014), "The primacy of the dollar has led the US to be complacent about its external economic position." Old habits are hard to break.

The dangers of America's increasingly entrenched sense of entitlement have long been evident. For decades the United States has lived beyond its means, relying heavily on the popularity of the greenback to finance its foreign deficits. US policy makers have exploited the borrowing capacity afforded by the dollar's worldwide acceptability to postpone payments adjustments indefinitely. Arguably, therefore, if a collapse of confidence comes, the onus will rest first and foremost on Washington. As Barry Eichengreen (2011, 162) puts it, "The plausible scenario for a dollar crash is not one in which confidence collapses on the whims of investors . . . but rather because of problems with America's own economic policies."

With the arrival of Donald Trump in the White House, those dangers appear to be intensifying. Even before the real-estate magnate was elected US president in 2016, he carelessly rattled financial markets by suggesting that Washington should negotiate with its creditors to buy back much of its foreign-held debt at a discount—in effect, a partial default on trillions of dollars of liabilities, intended to reduce the burden of debt service for taxpayers. That is the tactic that Trump himself used when his casinos went bankrupt. So why not use the same idea as president? Not surprisingly, investors and central banks recoiled with horror. Even the hint of a default would jeopardize the government's credit rating and raise the cost of future borrowing.

Even more damaging has been Trump's erratic and unpredictable policy behavior since taking office, which has shaken faith in the greenback as the world's premier safe haven. In the first two hundred days of the Trump presidency, the dollar surrendered almost 10 percent of its value as outsiders looked for alternatives wherever they were to be found. The greenback may be the world's indispensable currency, as suggested back in chapter 5, but it is not entirely without peers. Investors and central banks are becoming increasingly open to the option of placing their savings elsewhere. As one commentator has written (Goodman 2017a): "The fate of the dollar is now subject to the influences of a presidential administration that has

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given markets an expectation for the unexpected. As traders seek to divine the risks of geopolitical hot spots, this appears to be weighing on the American currency."

Indeed, some commentators believe that the Trump administration might actually favor a downsizing of the dollar, which the president may well see as more burden than benefit. Representative is Eric Helleiner (2017, 19), who suggests that "the election of President Trump could perhaps generate a more considerable change in U.S. policy because a number of Trump's ideas seem well-suited to a critique of the dollar's [international currency] status." Attention may come to focus more on the cost side of internationalization. How, for example, can Trump hope to "make America great again" if he has to worry about possible exchange-rate appreciation or the risk of capital flight? How can he achieve his priorities at home if he has to accept the responsibilities of an "exorbitant duty" abroad? Policy might conceivably shift from exploitation to something more like evasion, further draining foreign confidence in the greenback.

None of this, of course, means that we should soon expect a massive run on America's currency, with everyone suddenly stampeding to the exits. There just are not enough other safe-haven claims on offer today. Given the lack of sufficiently attractive alternatives to the greenback, a doomsday scenario like that would appear to be far too sensationalist. More likely, in the absence of a significant policy reversal, would be a prolonged bleeding out, a slow-motion drift away from the dollar as America's creditors seek to diversify their risks to the extent possible. Washington would continue to enjoy its exorbitant privilege, possibly for years. But in a process more akin to soil erosion than to a landslide, the advantage would gradually diminish.

Confrontation

The stage is set, then, for a dramatic confrontation. On the one side is a rising monetary power openly committed to doing all it can, subject to domestic constraints, to move currency preferences in its favor. On the other side is an incumbent largely content to rely on its money's established strengths to preserve its exorbitant privilege. The duel is well under way. How are the two sides doing?

This brings us back to the role of market competition in currency choice. It is tempting to measure achievement in statecraft simply in terms of policy initiatives that are effectively implemented on the supply side of the market. By that metric, China can be said to be doing very well indeed. In little more than a decade, it has skillfully managed to widen the appeal and

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availability of the RMB substantially. It has established an extensive network of currency swap agreements and designated clearing banks for the RMB. It has helped nurture offshore markets for yuan deposits and yuan-denominated bonds. And of course it has been able to gain admission for the people's currency into the SDR basket at the IMF—a notable contribution to the RMB's reputation. Despite a relatively weak hand, Beijing has run up an impressive list of strategic accomplishments.

But that is not the best way to measure effectiveness when statecrafts collide. In practical terms, as indicated in chapter 1, currency choice is determined not on the supply side of the market, but on the demand side. Actors normally must be *persuaded* to switch from one currency to another. That means that in judging effectiveness we should focus not on policy initiatives as such, but on their consequences—what substantive impact they may have on relevant agent behavior. Results, after all, are what the game is really all about. By that metric, China's accomplishments ring more hollow. For all of Beijing's efforts to transform currency choices, the yuan remains a dwarf, far behind the US dollar in every category of actual use.

Admittedly, initial gains of market share seemed considerable, particularly on the trade track. But the speedy growth rates for most uses of the RMB largely reflected a small base at the start, and in some categories, as noted, they are already beginning to decelerate. Moreover, it is clear that responses on the demand side have by no means been uniform, with some sectors and governments showing a marked reluctance to alter existing preferences (Chey 2015, 2017). In fact, judging from actual results, it is the United States that can make the stronger claim to success. In a vivid demonstration of path dependence (the extent to which past decisions structure future choices), market agents and central banks have in most respects remained persistently loyal to the dollar. The Chinese have tried hard to promote their currency. But they have yet to be in a position to offer advantages attractive enough to persuade many actors to bear the potentially high cost of shifting to the yuan. Inertia has favored the incumbent.

Strikingly, therefore, America's passive posture, relying on the greenback's enduring appeal, has so far proved remarkably robust. It is almost as if Washington has made China a victim of its own martial arts tradition, which emphasizes allowing an opponent's energy to be destructive to itself. In effect, the United States has simply stood aside while Beijing has invested more and more resources in its exhaustive effort to promote internationalization. We are reminded of the wily "rope-a-dope" tactic made famous by the boxer Muhammad Ali in his notorious "Rumble in the Jungle" with George Foreman. Pretending to be trapped against the

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ropes, Ali goaded his opponent into raining down one ineffective punch after another until Foreman was utterly worn out. In Ali's case, success was by deliberate design. In the case of America's currency the outcome may be more fortuitous, but is nonetheless convincing. Like Foreman, Beijing has put up a flurry of heavyweight blows; but the dollar is still standing tall.

The duel is not yet over, of course. Indeed, the collision of statecrafts can be expected to continue for a long time to come, and China brings to the confrontation an intensity of ambition that could in time prove to be a distinct advantage. Results to date, however, remind us not to be overly impressed by China's headline achievements. It is one thing to target currency users, whether private or official; it is quite another to actually modify their traditional preferences. As the ancient adage says, you can lead a horse to water but you can't make it drink.

Implications

What are the implications of all this for currency statecraft in the future? Much, it seems clear, will hinge on context—specifically, the broader structure of geopolitical relationships. Whether monetary rivalries in years to come are likely to be more or less confrontational will depend on considerations that go well beyond matters of money alone.

From the empirical record, it is evident that *collisions of currency statecraft are by no means inevitable*. That is an important implication. Admittedly, a risk of politicization lurks in the background. Indeed, how could there not be a chance of conflict given the stakes involved? The capabilities created by currency internationalization are difficult to ignore. But monetary power is not the only interest involved. Broader ambitions and goals are bound to frame the choices that are made among available policy options. Overt confrontations over currency are much less likely among friends or allies. The closer the ties between monetary rivals, the more probable it is that the fate of currencies will be left to the demand side of the market to decide.

Yet it is also evident that *collisions can indeed occur*. That too is an important implication. Direct policy conflict is more likely to the extent that relations are less than cordial, as would appear to be the case in today's rivalry between China and the United States. The more that issuing governments see themselves as competitors for geopolitical influence, the more probable it is that they will elect to be proactive on behalf of their respective currencies. The risk of politicization is increased accordingly.

Prospects for currency statecraft in the future, therefore, may be said to

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depend first and foremost on what sort of geopolitical environment we can anticipate. Borrowing from the language of conventional IR theory, we can put the issue in terms of polarity: concentrations of power ("poles") in the international system. The notion of polarity, we know, is a crude measure of the level of competition in any kind of system (Cohen and Benney 2014). The main difficulty is that it obscures the importance of inequalities among poles in terms of capabilities or influence. But for our purposes here, the approach will suffice to clarify the broad range of possible scenarios. Alternative environments can be contrasted in the starkest possible terms. Should we expect a unipolar world with one clearly dominant world power? A bipolar world with two main contenders? Or a more plural, multipolar world of many potential challengers?

Among free-world nations, a unipolar system is essentially what existed during the years of the Cold War, when all putative challenges to America's greenback came from countries that were allies or clients of the United States. The dollar standard may have been "unloved," but it endured, essentially because there was no other nation that could come close to matching Washington's broad range of economic and military capabilities. Direct currency conflict, accordingly, was minimal. Could such a scenario be reproduced in the twenty-first century? For the foreseeable future, there are arguably only two possible contenders for top geopolitical status: America and China. But neither seems likely to achieve the kind of disproportionate preponderance of power on a global scale that the United States enjoyed at the end of World War II. The postwar decades of US hegemony can be regarded as a unique period of history, unlikely to be repeated any time soon (short, perhaps, of another world war). The kind of unquestioned dominance that the greenback once enjoyed is not coming back.

A bipolar world, by contrast, is what many see approaching as a result of China's "peaceful rise" in recent decades. America and the Middle Kingdom together already account for some two-fifths of the global economy. Increasingly, they appear to loom over others like a pair of Gullivers in a universe of Lilliputians. Thus, it is suggested, the pair could come to dominate global politics in coming decades in much the same way that America and the Soviet Union did before the Iron Curtain fell. In such a world, the risk of currency collision would be much higher. The redback/greenback duel would persist. But that scenario, too, seems implausible, given the considerable growth in the lineup of other key geopolitical players as compared with the years of the Cold War. Emerging economies like India, Russia, and Brazil may never be able to match the overall capabilities of either the United States or China. But neither are they apt to acquiesce timidly to

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dominance by either Washington or Beijing. The kind of strict bipolarity that emerged after World War II between the free world and the Soviet bloc may also be regarded as historically unique.

Much more likely for the foreseeable future is a more plural world with a handful of contending poles of varying strength and reach. The United States and China may remain *primi inter pares*, but as the years go by a good number of other powers can also be expected to contend for political influence on a regional or global basis. A multipolar world need not be overtly conflictual. The probability of intense rivalries, however, is high. Sovereign governments will have an incentive to make use of whatever instruments of statecraft they have at their disposal—which, of course, includes their currency. The monetary counterpart of a multipolar world is a multicurrency system composed of several moneys competing for a place near the top of the currency pyramid with no single dominant money—what I have previously described as a "leaderless" currency system (Cohen 2009).

A multicurrency system would not necessarily be a bad thing. Indeed, an argument can be made that it might even turn out be an improvement over the present. For many, the greatest threat to monetary stability today is to be found in America's mammoth payments deficits. As the supplier of the world's most popular currency, the United States is in the position of an exploitative quasimonopolist that has frequently abused its "exorbitant privilege." But once the dollar's supremacy is eroded by emergent challengers, goes the argument, America would finally be forced to curb its appetite for foreign savings, thus lowering the risk of future crises. Competition would impose a discipline on US currency power.

Much depends, however, on the kind of relationships that develop among the system's currency suppliers. The last time the world was obliged to live without a clearly dominant money, during the interwar period, the outcome was—to say the least—dismal. A lack of cooperation between the British, with their weakened pound, and a self-consciously isolationist America was a critical cause of the financial calamities that followed the stock-market crash of 1929 (Kindleberger 1973). Can we expect better this time around?

In reality, it seems likely that as geopolitical rivalries intensify, more nations will become proactive in promoting or defending internationalization of their money, raising the risk of nasty and possibly costly interstate confrontations. Issuers increasingly could find themselves working at cross-purposes, provoking massive flows of investment funds from one currency to another. At a minimum this would mean greater volatility in financial markets. At worst it could mean fragmentation and closure of

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the monetary system on the order of what happened in the 1930s. In the words of Barry Eichengreen and colleagues (Eichengreen, Mehl, and Chiţu 2018, 199):

> The existence of several international currencies, all traded in liquid markets, will create additional scope for central banks, commercial banks, and other investors to alter the composition of their foreign balances and payments practices at the first sign of trouble. . . . One reason that no mass flight from the dollar has occurred in recent episodes of financial strain in the United States is the absence of other equally liquid assets and markets. Few other safe havens exist—there are only so many Swiss francs to go around. But this would no longer be true in a world of multiple international currencies.

Until recently, any suggestion of internationalization of national moneys below the top ranks of the currency pyramid might have been dismissed as implausible, if not delusional. But once China began to make progress with its campaign to promote the RMB, talk of an emerging multicurrency system quickly took off. "A world of multiple international currencies is coming," Eichengreen declared a few years ago (Eichengreen 2011, 150). Echoed the World Bank (2011, 125–26), "the most likely scenario for the international monetary system is a multicurrency system."

For some, the most credible candidate for internationalization is the Indian rupee. India is growing rapidly; it is increasingly becoming a force in global trade, and will soon have the largest population in the world. Moreover, the rupee already has a history as an international currency going back to colonial days, when India's money circulated widely in a number of other British dependencies, including Kuwait, Bahrain, Qatar, the United Arab Emirates (then known as the Trucial States), Oman, and Malaya. It was only in the 1960s that the rupee was replaced in these economies by newly minted national currencies. "All these factors . . . make the Indian rupee a natural candidate for being considered for greater internationalization," concluded a comprehensive study by the Reserve Bank of India (Ranjan and Prakash 2010, 14). Other currencies that have been considered as possible contenders include the Russian ruble (Johnson 2013), the South Korean won (Kim and Suh 2011), and even the South African rand (van den Heever 2010).

To be sure, enthusiasm for secondary currencies like these appears to have cooled more recently, as several of the larger emerging economies have run into strong headwinds. Russia, for instance, has been hobbled by sanctions and low oil prices, while South Korea has been distracted by cor-

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ruption scandals and a presidential impeachment. But such troubles will not last forever. Over the longer term, currency competition seems certain to escalate as more and more regional giants begin to assert themselves on the world stage. Where once duels like that between the redback and the greenback looked exceptional, outright collisions could increasingly become the rule. Monetary rivalries can be expected to multiply over time.

Conclusion

When currency statecrafts collide, sparks are bound to fly. But whether a conflagration follows is not at all assured, as the empirical record shows. Throughout the decades since World War II, outright confrontations between states have mostly been avoided, due largely to the special circumstances of the Cold War. The dollar reigned supreme among currencies because the United States reigned supreme among free-world allies. America's friends in Europe and Japan had no wish to allow monetary rivalries to threaten broader security relationships. Politicization of currency competition was rare. The one exception, coming more recently, has been China, which clearly has no compunction about challenging US global leadership.

The implication, therefore, is unambiguous. In essence, for years the world was lucky to avoid much serious currency conflict. But the duel triggered by China suggests that a new era may be dawning: an era of more open and potentially costly currency hostilities. A plural world means a risk of more monetary duels to come. It also means that if outright collisions are to be averted, solutions will have to be found well beyond the realm of money alone. Currency rivalries, ultimately, must be managed at the level of geopolitics, where clashes of grand national ambitions are resolved.

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EIGHT

Conclusion

Our subject has been currency statecraft—the policy strategies that nations adopt when their currencies gain some measure of international appeal. Through the preceding chapters, discussion has been framed by two central questions: What determines how governments choose to respond to internationalization of their currency (the use question), and what sets a limit to the effectiveness of currency statecraft (the utility question)? My aim has been to improve on our ability to assess prospects for rivalries among the world's leading monetary powers today and in the future. An international currency adds significantly to a state's overall capabilities, and is an important influence on the global balance of power. Our understanding of contemporary geopolitics would be incomplete without a firm grasp of the complexities of currency statecraft.

A good number of useful insights emerge from the discussion. These may be grouped under four headings: (1) first principles; (2) the use question; (3) the utility question; and (4) practical implications.

First Principles

To begin, it is clear that currency internationalization must be seen as a process, not a static condition. International currencies evolve through a life cycle, from youth to maturity to decline. Hence, currency statecraft can be expected to evolve as well. Our subject is not a destination but a journey.

In principle, as currencies evolve, governments have three broad policy options. Statecraft can be proactive in favor of internationalization; it can be proactive in opposition to internationalization; or it can be passive, declining to take action either for or against internationalization. Three options at each of three stages make for a total of nine options in all over

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the full length of a currency's life cycle. During the youthful stage, while the money's appeal is still being established, the challenge is existential: Is internationalization even wanted? The three possible choices are promotion, prevention, and permission. At maturity, where the challenge is learning to live with internationalization, the options are exploitation, evasion, or enjoyment. And once a currency goes into decline, as all international currencies in history have done, the challenge is how to cope. The choices are resistance, reinforcement, or relaxation.

Conventional wisdom would have us believe that, in practice, choices are strictly limited. Statecraft, it is commonly thought, is predictable and can be expected to be routinely proactive in favor of internationalization. An international currency, after all, offers a handy instrument to exercise leverage in the world. Why would governments not welcome the addition to their capabilities? Given the opportunity, observers assume, states will choose to promote foreign use of their currency, will exploit the power of an international money to the fullest, and will stubbornly resist any loss of authority. In short, a direct correlation between money and the pursuit of influence is taken as an article of faith. I call that the Immaculate Conception of Power.

Reality, however, is quite different. The Immaculate Conception of Power is seriously misleading. A review of the empirical record since World War II reveals that, in fact, many governments have chosen not to seek or defend internationalization of their currency. Indeed, some have been proactive in opposition, doing what they could to prevent or evade foreign use, while others have remained passive or ambivalent. The lesson of the past is clear. Any one of the nine possible options may be elected by one country or another at some time or other. All are genuine possibilities. The key questions are: What accounts for specific policy choices, and how effective are they likely to be?

The Use Question

The forces that drive currency statecraft are undoubtedly numerous, including both economic and political considerations. For precisely that reason, it is unlikely that governments will ever be faced in any given circumstance with just one unequivocal option. In practice, decision makers typically have some range of plausible strategies to choose from—some legitimate amount of policy space. An element of discretion is almost always available.

Within that policy space, historical evidence strongly suggests a cognitive explanation for the specific choices that we observe. Beyond the mate-

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rial factors addressed by traditional rationalist approaches, ideas seem to play an especially vital role in shaping the way currency issues are framed and decided. A credible theory of currency statecraft, set in this wider ideational context, is set out in chapter 3. The claims of the theory are well supported by the case studies examined in chapters 4 through 6.

At issue, it appears, is each society's sense of its underlying norms and priorities; in short, its sense of identity. Most critical in this context is how the nation views itself in relation to others—the degree of its geopolitical ambition. How eager is the society to build or sustain a prominent place in the community of nations? How driven is it to be a significant player in the broader game of global politics? How much does it seek to project power or control events outside its borders? Governments with relatively few geopolitical aspirations are unlikely to opt for currency policies that are proactive in favor of internationalization. Conversely, governments with more pronounced ambitions are unlikely to take a stand against extensive use of their money.

The pattern has been well illustrated in the modern era at each stage in the life cycle of international currencies. The years since World War II have seen a number of moneys begin to gain traction for cross-border use, including the West German Deutsche mark, Japan's yen, the euro, and the renminbi. Yet at this youthful stage, only the renminbi has been explicitly promoted by its issuing government. It is no accident that among the countries finding themselves in this position, China has shown by far the most pronounced desire for recognition as a great power. Likewise, among more mature currencies today, the US dollar alone is actively exploited by its issuing authority as a potent instrument of statecraft, reflecting America's still active leadership pretensions in world politics. The other members of the top-tier club, all less ambitious internationally, show correspondingly less interest in the prospect of an exorbitant privilege. And in the principal example we have of decline in the modern era, the pound sterling, we know that Britain's gradual loss of interest in defending its currency paralleled closely the slow-motion decay of its past imperial role. In all these examples, the salience of geopolitical ambition (its presence or absence) is palpable.

The Utility Question

What about effectiveness? Geopolitical ambition may be vital in explaining why governments choose the currency strategies that they do. But aspiration alone will not guarantee success. Governments may adopt all sorts of

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tactics to attain the goals they have in mind, whether to encourage or discourage use of their money. In currency matters, however, outcomes are determined not on the supply side of the market but on the demand side, where the decisions are made about what money to use. Directly or indirectly, currency statecraft is about influencing the terms of competition among moneys.

Effectiveness, therefore, will be most directly determined by the reactions of two sets of actors: currency users and competing governments. At the level of market relations, outcomes will reflect the preferences of those who actually deal in international currencies: traders, lenders, investors, and the like (including central banks, in their choices among reserve assets). Can currency users be persuaded to remain loyal to a particular money? Can they be induced to switch from one currency to another? Similarly, at the level of inter-state relations, much depends on the responses of other authorities that also happen to issue international currencies. Will competing suppliers accept or contest the choices of their peers? Either set of actors, currency users or issuing governments, could conceivably limit or even wholly block a nation's monetary strategy. As indicated in chapter 2, currency statecraft is not made in a vacuum.

In practice, the empirical record suggests two key lessons. The first has to do with the importance of congruence—the need for a good fit between an issuing nation's official policy and the preferences of currency users. No matter how well designed it may be, currency statecraft can fail if it ignores or seeks to defy demand-side sentiment. Neither West Germany nor Japan was able to counter the appetite of outsiders for the DM and yen; foreign taste for their currencies was simply too strong. Conversely, Britain was unable to reverse the world's growing aversion to sterling; distaste for the pound turned out to be much too pervasive. Nor will policy succeed if it runs afoul of the preferences of competing governments. Little risk of confrontation is involved if a state's strategy is passive or pro-active in opposition to internationalization. But matters get trickier if policy becomes more aggressive in favor of internationalization. Where statecrafts collide, a government may find its initiatives thwarted by the resistance of other suppliers.

History also suggests that the effectiveness of currency statecraft at either level must be evaluated in terms of the individual roles that a currency may play, rather than holistically. For each role, active efforts to either increase or decrease use of a currency are more likely to succeed if there is no dissent from either market sentiment on the demand side or other states on the supply side. Outcomes may vary considerably, depending on the

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role in question. West Germany, for instance, was far more effective in suppressing demand for the DM for investment purposes, which was in any event relatively weak, than it was in blocking use of its currency for trade invoicing and settlement, where the demand for internationalization was strong. Japan, conversely, could more easily discourage use of the yen for trade purposes than it could halt adoption by investors. And today it is clear that China is having much more success in promoting a trade role for the RMB than it is in boosting the money's use as a store of value. A government may succeed in achieving its goal for one role of its currency and yet fail markedly with respect to other roles.

Practical Implications

Finally, we come to practical implications. What does this discussion suggest about the outlook for global monetary rivalry in the present and future? Four key points suggest themselves.

First, it would appear that direct collisions of currency statecraft are by no means inevitable. The Immaculate Conception of Power suggests otherwise. If there were indeed a close correlation between money and the pursuit of influence, with multiple governments aggressively promoting or defending their respective currencies, market competition could easily degenerate into politicized confrontation. In fact, overt policy conflicts have been rare, and have been easily managed. In the modern era, most competitions between currencies have been settled without undue inter-state tensions. The reason, evidently, is that most monetary rivalries have been among friends or allies. Because the Europeans and Japanese were content to accept the geopolitical leadership of the United States, they were in turn disinclined to challenge the supremacy of the almighty dollar.

But, second, it would also appear that collisions can indeed occur to the extent that political relations between issuers are less than cordial, as demonstrated by today's duel between the greenback and China's redback. China sees itself as a natural rival to the United States as a great power. Hence it has no hesitation in promoting the RMB as a potential rival to the dollar. Washington has yet to respond in kind—primarily, it would seem, because of the grip of a deeply rooted complacency. But there seems little doubt that if the greenback does begin to slip noticeably from its long-held dominance, sparks could begin to fly between America and China.

Looking forward, therefore, there seems a good chance that collisions of currency statecraft will grow as world becomes increasingly multipolar. That is the third point. Gone are the days of Cold War US hegemony; and

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any notion of a coming bipolarity, based on a lasting Sino-American "bigemony," appears fanciful at best. Today, more and more nations are emerging as contenders for influence on the world stage. Hence, many more governments can be expected to become pro-active in promoting a higher rank for their money on the currency pyramid. Overall, we seem fated to witness a marked increase in the intensity of currency competition.

In turn, finally, this suggests that the challenge of managing monetary rivalry in the years to come will be more daunting than ever. What might be done to keep the peace? Formally, all sorts of technical initiatives could be imagined, from arrangements for regular consultations among the members of the top-tier club, on the model of the Group of Seven or Group of Twenty, to enhancement of the governance powers of an international institution like the IMF. But if the argument of this book is correct, no reform is likely to succeed if a collision of geopolitical ambitions is at stake. A peaceful resolution of currency conflicts is not outside the realm of possibility, but it will require negotiation and cooperation on a scale much broader than the domain of money alone.

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