Monetary wars and distrusts

Central bankers like to see their job as purely technical: as independent agencies, they are untrusted with the task of achieving one or several objectives through activating their various monetary instruments. Although the mandates vary across central banks, all of them include the objective of maintaining the internal and sometimes external value of the domestic currency. Central banks are also lenders of last resort for commercial banks. Hence they guarantee the liquidity of the banking sector, provided the latter remains solvent.

This technical view of central banking has recently encountered a number of complications:

- Political intrusion in national central banking through political declarations and appointments;
- The development of private, unregulated currencies;
- The temptation to develop alternative public currencies (eg. "minibots" in Italy);
- Acrimony about alleged "currency manipulation";
- The abuse of the power conferred to the key currency issuer country.

In this short paper, I will focus on the last two issues, hence on the International Monetary System (IMS).

Forty-six years after the end of the Bretton-Woods system, the US dollar remains the key currency of the international monetary system, although its share seems to have receded recently in official reserves, international loans and international deposits (ECB, 2019). The "exorbitant privilege" of issuing the international key currency comes along with three major duties:

- Playing the role of a global insurer (Gourinchas, Rey and Govillot, 2017): the United States issues liquid, riskless assets that are used in other countries as private and public reserves of liquidity. The counterpart on the asset side of the US balance sheet is investments in illiquid, risky assets. In normal times, this transformation yields a positive return – the exorbitant privilege. In times of crises, the liability side of the US balance sheet keeps a stable value or is even revalued (hence its qualification of "safe") whereas there is a loss on the asset side.
- Playing the role of an international lender-of-last-resort: since national central banks can only print their own currency, in general they cannot refinance commercial banks in US dollar.[1] During the GFC, the Federal Reserve extended swap lines to several central banks in advanced and emerging economies, in order to allow them to refinance their commercial banks not only in domestic currency but also in US dollar. In 2013, swap lines with central banks in advanced economies became permanent, whereas those with emerging countries were discontinued, incentivizing these countries to develop their own networks around the People's Bank of China (see Campagne et al. 2018).
- Refraining from having an exchange-rate policy: with N currencies in the world, there are only N-1 independent exchange rate. The key currency issuer is best place to "sacrifice" its exchange-rate policy since a large part of its foreign trade and investment is denominated in its own currency, hence it is less exposed to foreign-exchange risk.

[1] One exception is the People's Bank of China that may use its large official reserves in dollar for this purpose.

As famously noted by Charles Kindleberger, the "hegemonic" country will normally accept these three constraints since they are conditions for the system to continue: international monetary stability will convince foreign actors (whether private or public) to continue using the US dollar as the key international currency.

Recent evolutions however have introduced some doubts that the dollar-centered system can remain untouched:

- The American administration has started over-exploiting its monopoly rent (see Farhi and Maggiori, 2018): too much debt is issued, which eventually will lead to a lower dollar, hence to a form of soft default;
- Concerns about US unilateral sanctions may be prompting some diversification of official reserves and of banks assets in some countries (ECB, 2019). The uncertain access to swap lines in US dollar during the next crisis may also trigger some currency diversification especially in emerging market economies;
- The American administration has recently strengthened its threats vis-à-vis alleged "currency manipulators" (see US Treasury, 2019), suggesting that the value of the dollar is no longer a matter of "benign neglect".

More generally, foreign countries are gradually understanding the risks related to "weaponized interdependence" (Farrell and Newman, 2019): tight interdependence is no longer a stabilizing force when networks are organized around one dominant node, since the latter reaps an advantage both in terms of information and in terms of exclusion. The dominant country can then use this advantage for national or for geopolitical objectives.

Research on the history of the IMS suggests that several key currencies may coexist (Eichengreen and Flandreau, 2009, 2012; Chiţu et al. 2014). After possible instability during the transition, a diversified international monetary system would be stabilizing in that it would reduce the scope for the US over-exploiting its rent; it would also be stabilizing for exchange rates because it would distribute the impact of a given shock to several key exchange rates rather than concentrating it on the dollar (Bénassy-Quéré and Forouheshfar, 2015; Bénassy-Quéré, 2016). Recent threats to central bank independence and multilateralism have raised the case for a diversification of the IMS. As a matter of facts, internationalizing the euro has now become an official objective (see European Commission, 2018; ECB, 2019). However, it is difficult to see the euro becoming a key international currency equal to the dollar without the issuance of a common "safe asset" backed by a consolidated governance structure in the euro area. Unlocking major euro area reforms would surely be a surprising legacy of the Trump administration.

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