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How A Currency Dominates in World?

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Abstract

This study is done to seek the answer of question that why a particular currency such as US Dollar dominates in world as international currency. To understand the answer of that question, first the characteristics of international currency are discussed and analyzed that how US Dollar fulfill all these essential characteristics of international currency. Next question which is tried to solve in this paper is that which important factors a country should have to internationalize its currency. Next it is discussed that after internationalize its currency, which costs & benefits as well as positive & negative externalities a country would face. As there is continuous debate about the future of US Dollar, it has been tried to find out whether US Dollar can be replaced by another international currency in near future. To find the answer of all above questions, theoretical or conceptual approach is followed. After analyzing the literature and understanding the current position of US Dollar as international currency, it has been concluded that there is less chance that US Dollar can be completely replaced by another international currency in near future. But as the influence of Euro has increased in European region, Euro can replace the US Dollar in this region. Same way, Chinese Renminbi can become the powerful international currency in Asian region in future. So, in future we can see the multi international currency world, where a currency will dominate in a particular region only.

Keywords: International currency, US Dollar, Euro, Chinese Renminbi, Currency trade blocks.

Introduction

As we daily see in newspaper, Exchange rate of Indian Rupee and US Dollar is generally given. Same way most of the international Standardized goods such as oil, gas etc. are invoiced in Dollar. Even on online shopping sites, many goods and services like books, cosmetic items, international tour package, air tickets etc. are priced in Dollar. The reason of happening of that is because Dollar is world's most dominating currency and performs the role of international currency. International currency has some certain characteristics which differentiate it from other currencies. As explained by Blinder (1996), money has three main functions: Medium of exchange, Store of value, & Unit of account. An international currency performs these functions on international level. But Chinn & Frankel (2007) explained that international currency has different functions for official and private purposes. For official purposes (by government), international currency is used to invest official saving of nation, for intervention in exchange market, & for pegging local currency to international currency. Private uses (by trader and general public) of international currency are as follows: substitution of local currency or Dollarization, use for trade and other transactions (such as remittance), & invoicing of goods and services. International currency's characteristics are discussed in detail in fourth section.

A currency of particular nation can dominate in world as international currency if it fulfills at least certain conditions as explained by different scholars: Nation should have large economy and should have large share in world trade (Ranjan & Prakash,2010). Mundell (1999) explained that people's faith should be there for international currency. Already established international currency may have first mover advantages (Marc Aubion, 2012). People's belief will certainly high, in a currency which is already established as international currency; this provides first mover advantage to that currency. Papaioannou & Portes (2008) explained that openness of economy and financial market, political power of country, and less volatility of currency are also important factors for making a currency as international currency. Factors which are helpful in making a currency as international currency are discussed in detail in fifth section.

Currently, United State's Dollar (USD) is dominating in world as international currency. But this is not the first currency, which have become the international currency. In previous era, different currencies have dominated the world in different time periods. A brief history of previous dominating currencies is discussed here. Dwyer & Lothian (2002) explained that first currency which was used beyond its nation's local boundaries was silver Drachma. Silver Drachma (Greece) was first coined in fifth century B.C. After that so many currencies were used beyond their own nations' limits. Some of the main international currencies are as follows: Aureus (gold coin of Rome in 1st century), Denarius (silver coin of Rome in 2nd century), Solidus (gold coin of Rome in 4th century), Dinar (Silver coin of Syrian Dynasty in 12th century), & Florin (gold coin of Italy in 12th century) etc. Dwyer & Lothian (2002) analyzed that all international currencies of past history have some common characteristics as follows: Unitary of value in form of gold, Intrinsic stability in form of weight and fineness, & high economic power of issuing nations of those currencies. In 17th century Dutch Guilder become the main international currency. Bank of Amsterdam, which issue Dutch Guilder becomes the financial hub (Blinder, 1996). As explained by Dwyer & Lothian (2002), Dutch Guilder's development made the huge changes. Before Guilder, there were thousands of currencies, but Guilder becomes the currency of unit of account and transactions. There were two form of Guilder: Guilder Banco which was used as unit of account and Guilder coin which was used for transactions. In 18th century Guilder's influence was reduced and Pound sterling becomes the main international currency. Now trade and economic power were shifted to London and Paris (Blinder, 1996). England and other nearby European countries were the centre of world economy in 18th century and this continues until 19th century. After 1st world war, United State of America arisen as dominating economy and Dollar becomes the main international currency. As explained by Eichengreen(2014), in 1899 64% of foreign reserve were held in Sterling, & it reduced up to 48% in 1913. In 1920s, foreign reserve in Dollar and Sterling becomes almost equal. After 2nd world war, US Dollar finally won the race for international currency against Pound Sterling. Chinn & Frankel (2008) explained that fall of Pound Starling as international currency was due to big economic and political changes in economy of England. The main changes were that England lost its dominating military power, many colonies were become free, & reduced trade power etc. After Bretton Woods Conference in 1945, International Monetary Fund (IMF) was established. IMF established a fixed parity system, under which all countries fixed their currency's value in comparison to US Dollar. US Dollar's value was fixed against gold as 35 Dollar per troy ounce of gold. The fixed parity system continues up to mid 1970s. But because of difficulties of maintaining fixed parity system, IMF abandoned the fixed parity system (V. Sharan, 1992).

Since second war, US Dollar is the main international currency. But since then few financial crisis, especially after 2008 has create new debate that whether US Dollar will be able or should be continue as world's most dominating international currency. As Emily Merki (2015) argued that US economy is affecting due to Dollar's role of international currency. Current account deficit is continuously increasing. Same way Cohen (2009) explained that US current account deficit and financial crisis of 2008, has reduced confidence of people in US Dollar. So those countries (Russia, China etc.) which have large financial reserve holding in Dollar are worried about the affect if Dollar fails in future. So the main question is which currency can replace the Dollar as international currency. As explained by Eichgreen (2014) and Cohen (2009), that Japanese Yen showed some sign of rising currency in 1970s and 1980s, but after that its chance of becoming international currency is continuously falling. Another currency which seems to give competition to US Dollar is Euro. After the rise of Euro around in year 2000, and its adoption by many European countries show that it can become international currency. Chinn and Frankel (2008) examined that Euro can become the international currency and by pass the US Dollar, exactly the same way as US Dollar done with Pound Sterling. Same way Papaioannou & Portes (2008) explained that European Union has all necessary conditions which can make a currency international, so there is high chance that Euro will become an international currency. There are also some arguments that whether Chinese Renminbi can become international currency in future. As Eichengreen (2014) explained that past view is wrong which explains that it is difficult to replace already established currency due to first mover advantage. New view explains that more than one currency can become international currency at a time. So there is chance that Renminbi can become international currency with Dollar. But Marc Aubion (2012) explained that there is less possibility that Chinese Renminbi can replace the US Dollar & Euro as international currency. Same way (Ranjan & Prakash,2010) examined that Chinese Renminbi can become dominating currency only in Asia. At world level it cannot replace US Dollar.

In first section of this research paper, a brief introduction about international currency is given. Just a brief history of international currency is also discussed in this section. In second section, literature review on international currency, its characteristics, & nation's necessary factors to internationalize its currency, is explained. In third section, main objectives of this study are explained in simple terms. In fourth section, main characteristics of international currency are discussed. In fifth section, nation's those factors are discussed, which are helpful to make its currency international. In sixth section, costs and benefits of international currency are discussed. In seventh section, conclusion of the study is given.

Literature Review

Alan Blinder (1996) has explained that international currency has main four functions: 1. It is used as reserve currency by central banks of other countries. 2. It is used as currency for normal transactions in other countries. 3. It is used for invoicing and payment of international trade. 4. It is highly used in international finance market. He has pointed that US Dollar is currently performing these functions and no currency seems to replace the Dollar in near future. Chinn and Frankel (2007) analyzed that international currency performs three money functions (unit of account, store of value, & medium of exchange) for official or government and for private purposes (for particular persons). So, international currency has total six functions. Robert

Mundell (1999) has given seven important aspects which explain the international currency: 1. It is used on large scale. 2. It requires a stable monetary policy. 3. There should not be any control or economy should be open. 4. The nation should have economic and political power. 5. Past international currencies were backed by gold or silver. 6. People should have faith in currency. 7. Low interest rate. He predicted that world would again turn to fixed exchange rate.

Emily Merki (2015) argued that US Dollar cannot perform as international currency for long time because of its current account deficit and financial crisis. Further no other country's currency seems to become international currency. So, suggestion is that a common international currency should be developed and other currencies should have fixed exchange rate with this currency. Further, World Trade Organization (WTO) should regulate it, because it has more strict regulation than International Monetary Fund (IMF). Cohen (2009) has pointed that US Dollar cannot dominate the world in future; in fact future is unfavorable to US Dollar and favorable to new rising economies such as China and India. Eichengreen (2014) argued that US Dollar will not be able to take advantage of first mover advantage as explained by old view. New view explains that more than one currency can become international currency simultaneously. In 2009, foreign reserve holding in Euro was highest, but since then it is continuously reducing. So it is more likely that Chinese Renminbi and US Dollar both performs the role of international currency together.

Benjamin Cohen (2012) describes the benefits and costs of having an international currency. Both benefits and costs are non negligible. So, it depends on the nation whether that nation want to take costs with the benefits. Otherwise a nation can use its currency for only particular function of international currency such as only for trade and invoicing. Ranjan & Prakash (2010) has also discussed the cost and benefits of international currency. They also discussed the conditions which are necessary to make a currency international such as openness of economy and trade, high Growth Domestic Product (GDP), people's confidence in currency. On the basis of these conditions, they concluded that Chinese Renminbi cannot become international currency in near future, but it can play a big role in Asian region. Kenneth Rogoff (2001) suggested that no single currency can perform role of international currency in future because of complexity of economies. Developing of new common currency for international currency is not helpful because there is no clear cut rule of how to govern this currency. So, the main three or four currencies such as US Dollar, Euro, Yen etc. can perform as international currency.

Objectives of Study

The main aim of this paper is to understand the reason why a particular currency dominates in world as international currency. The circumstances in which, an international currency can be replaced by the other currency. The main objectives of this study are given below in more simplified form:

1. To understand the characteristics which an international currency should have.
2. To find out the main factors of a nation which help in making its currency as international currency.
3. To understand the merits and demerits of international currency to currency's home country.
4. To find out whether there is possibility that current international currency (US Dollar) can be replaced by any other currency.

Characteristics of International Currency

International currency's characteristics are the functions which it has to perform at international level and these functions make this currency different from other currencies. Level of internationalization of a currency is measured as how many monetary functions it performs at international level. Characteristics of international currency are as follows:

- Invoicing & Settlement of trade: International currency is used for invoicing imports and exports in international market. Dollar is used for invoicing purposes even when US is not the party in trade transactions. As Stephen Schulmeister (2000) explains that all standardized goods (oil, gas etc.) in international market are invoiced in Dollar.
- Use in International Finance Market: International currency is used heavily in international financial market. It is used for currency swap and for currency future and options in derivative market. Bonds, debentures and other securities denominated in international currency are issued in international financial market. As shown in Triennial Bank Survey Data 2013 (Bank of International Settlement), US Dollar and Euro are two main currencies which have high share in foreign exchange turnover.
- Reserve Currency for holding Official Capital: Central banks and governments of many countries invest their capital in international currency, because it is safe investment and provide more flexibility. Triennial Bank Survey Data 2013 (Bank of International Settlement) & IMF data shows that US Dollar is most used reserve currency for official capital and after that Euro is second most used currency.
- Hand to Hand Currency: It is also called as currency substitution. It is a situation in which people of a particular nation use the currency of other country in normal transactions like the local currency. So,

international currency is used by citizen of different countries in their own countries in transactions. As Marc Aubion (2012) explained that sixty percent of currency in Dollar is held outside US.

- Currency Pegging: Currency pegging means fixing the value of a currency with other currency. It is generally done with the major trade partner's currency or the major currency of the world (International currency). Countries in Caribbean islands, countries in Middle East (Jordon, Oman etc.), oil exporting countries (United Arab Emirates, Saudi Arabia etc.), Asian countries (Hong kong, Macau etc.) have pegged their currencies to Dollar. China unofficially manages its currency to US Dollar. (Wikipedia)

Helpful Factors for Internationalization of Currency

After understanding the characteristics of an international currency, the next important thing to know is the factors which are helpful to internationalization of a currency. These factors are related to the country, which contributes for making the country's currency as dominating currency at international level. Important factors are given below:

- Size of Economy: A currency can become international, from only that country which is large in size (in Gross Domestic Product terms) and have large influence on worlds' economy. As Chinn & Frankel (2008) explained that a nation with large size and has high proportion in world output, is more likely to be able to internationalization of its currency.
- Developed & Efficient financial Market: Financial market should be properly developed and efficient. If financial market of a country is not properly developed, then in financial crisis or in economic fluctuations it can be broke down. Papaioannou & Portes (2008) explained that after making the European Union, European Union combined economy is not less than US, and its financial market is also efficient. So, Euro can replace the Dollar as international currency.
- Trade Size: A country which has a large share in world's exports and imports can internationalize its currency. Because as the country's share in world trade is high, more nations will make trade transactions with that country. Because of large number of transactions, demand of that country's currency will increase, and there will be large active market for that currency. AS Dwyer & Lothian (2009) pointed out that size of trade matters for internationalization of a currency.
- Stability of Currency: Stability of exchange rate of international currency is necessary. If a currency's value fluctuates regularly, then holders of that currency have to take continuous exchange rate risk. In any crisis, holders of that currency may try to sell the currency quickly, & this may seriously affect the exchange rate of that currency. As Cohen (2009) has explained that after 2008 crisis, large holders (China, Russia etc.) of US Dollar are worried if US Dollar failed, their reserve will be affected.
- Openness of Economy: This is also one of the important conditions for internationalization of currency. For internationalization, both current account and capital account convertibility of currency is necessary. International currency should be available without restrictions for transactions purposes in international financial market. As Ranjan & Prakash (2010) described that Chinese Renminbi is still restricted by Chinese government, this reduces its chance to become international currency.
- Political Power: The dominance of a country in world's political & economic aspects helps its currency to become international currency. As Dwyer & Lothian (2002) examined that all international currencies in history, came from powerful nations. Marc Aubion (2012) argued that US political power is reducing and European Union is emerging as united political power, so in future Euro can emerge more important than US Dollar.
- Balance of trade & Balance of Payment: As international currency may be overvalued to other currency because of over demand, because of that country may face continuous current account deficit. To cover current account deficit, nation has to borrow from other nation. The high debt may become problem for the country. As Emily Merki (2015) explained that because of current account deficit, US debt is increasing. But because US received more investment, its capital account show surplus. Because of that situation is not much worst.
- Confidence in Currency: For internationalization of currency, people's confidence in currency is necessary. People will use a foreign currency for their transactions and for investment, only when they believe that a particular currency will stay as international currency for long time. They have to believe that international currency will have less fluctuation and it provides safe and stable option. As Robert Mundell (1999) described that people's belief in currency is important characteristics of an international currency.
- First mover Advantage: It is debatable whether first mover advantage of international currency provides an edge to already established currency. As Marc Aubion (2012) explained that it is hard to replace an established international currency. Because of high transactions in that currency, transaction cost of that currency is less (Because of active market), & people will not shift from

this currency to other currency because of less cost & less risk. On other hand Eichengreen (2014) argued that first mover advantage is an old view. According to new view, more than one currency can become international currencies.

Costs & Benefits of International Currency

International currency have both benefits and costs, because of that it is not easy decision for a country to decide whether try to make it currency international or not. There are so many positive and negative externalities for a country that run an international currency. The benefits of international currency are as follows:

- Low Transaction Cost: If a country's currency is used on high scale in international financial market, then it will have large trading market. There will be many buyers and sellers of that currency, because of that Bid-Ask rate difference will be less for that currency. So, people can make transactions at lower cost in that currency. As explained by Cohen (2012), international currency reduced the cost of transaction, both for home country and for outsider also.
- Low Exchange risk: International currency reduces the risk of exchange rate fluctuation for home country people. As most of the export and import of US is invoiced in Dollar, because of that US people do not have to worry about exchange rate movement. Ranjan & Prakash (2010) explained that because of no exchange rate risk of home country people of currency, they do not need to hedge their risk. So, they will be able to save transaction cost.
- Seigniorage: One of the most important benefits of having an international currency is seigniorage. Because international currency is desired by almost all other nations, home country can issue the international currency at almost negligible cost (cost is equal to using the paper for currency) and can purchase goods and services from other countries. That's why Papaioannou & Portes (2008) called it direct and quantifiable benefit of international currency.
- Competitive Advantage to Financial Market: International currency helps to provide competitive advantage to home country financial market. Financial market of home country can issue equity, bonds etc. in own currency, which is international currency. Because of the reputation of currency, there will not be any difficulty to find investor. Ranjan & Prakash (2010) described that international currency provide big edge to domestic financial market over the foreign financial markets.
- Reputation & Power: International currency provides huge reputation and power to the home country. US economy is world's most powerful economy and one of the biggest reasons of that because US Dollar is dominating international currency. Emily Merki (2015) explained that because of high reputation and power it get, US does not want to reduce international use of Dollar, even after having continuous current account deficit.

The main costs of having an international currency are given below:

- Currency Value Appreciation: Because an international currency is demanded all over the world, it can raise its value too high in comparison to other currencies. Because of continuous increase in value of currency, home country's export will reduce and import from other countries will increase. As Benjamin Cohen (2012) said that continuous increase in currency value may affect the trade balance badly.
- Fluctuation in Demand of Currency: As international currency is used at large scale in international finance market, large fluctuation of demand of currency may badly affect the home country economy. The situation can be worst in financial crisis situation. Ranjan & Prakash (2010) pointed that as China will further try to internationalize its currency, demand fluctuation can badly affect its economy.
- Global responsibility: Economic power of having an international currency comes with some responsibility at global level. Home country which is having international currency has to measure its economic policies affect on other economies. As Chinn & Frankel (2007) explained that US Federal Reserve has to make its policies after taking account of global market.

Conclusion

This study is done to understand the concept of international currency and to understand why a particular currency dominates in international transactions of world. International currency is a currency which is used by different people for different purposes in international transactions. Individual person uses this international currency for invoicing their export and import, payment for commercial transactions or such as remittance, and sometimes even in local transactions foreign international currency is used. Extreme situation of using international currency in local transactions is Dollarization. In this case, people of a particular nation, start using international currency in place of their local currency and almost replace the local currency with international currency even in local market. On the other hand, governments and central banks also use international currency as reserve currency for their investment capital, for pegging their currencies with international currency and also using international currency for intervention in exchange market. Currently US Dollar is used on large scale as international currency for different purposes by both individuals and officials (governments & central banks).

If a country wants the internationalization of its currency, then there are some conditions which it has to be fulfilled. First and most import conditions of a nation for internationalize its currency is that it should be dominating economy of the world and should have large proportion in worlds' trade. In the past, world's all international currencies have come from the powerful economic countries. Political power is also important with economic power. Country should have strong and stable macroeconomic policy, so that fluctuation will be less in the economy. Because of strong and stable policy, exchange rate fluctuation will be less for the currency, & people's faith will increase in that currency. If people from all over the world, start believing in economy and currency of a country, then its currency can be established as dominating international currency. Further country should have efficient and uncontrolled financial market, so that it can deal with the economic fluctuations. Country also has to open its economy and currency for outside world, so that outsider can use that country's currency in transactions.

The main benefit of international currency to the citizen of that country is that they have low transaction cost and low exchange rate risk. As the most of the international transactions are done in international currency, & this international currency is the local currency of citizen of that country, they will not face exchange rate risk. They also have not to pay transaction cost of converting one currency to another. The benefits of international currency to the nation are benefit of seigniorage and the reputation & power it gets because of international currency. The first cost of the international currency to the nation is that currency may have large fluctuation due to the effect of outsider's activities, because international currency is held by outsider from all over the world. Second cost is that because of over demand of currency, its value may rise against other currency, & this can negatively affect the trade. Third cost is that because of international currency, nation has to make it policy after measuring its affect on international financial market.

The next important thing to understand is that if Dollar can be replaced by other currency for performing the role of international currency. The debate has started that whether the Euro or Chinese Renminbi can replace the dollar. From the literature and data statistics, it can be concluded that still US Dollar dominates in every aspect of international currency. As Christian Thimann (2009), after analyzing the all aspects of global currency, has given 88.8 points to US Dollar and 38.7 points to Euro. All other currencies scored much less than this. So, it can be concluded that US Dollar still dominates the world as international currency. But the influence of Euro in European countries and Chinese Renminbi in Asian region is continuously increasing. So it is more likely that US Dollar will remain the world most powerful currency. But in Europe region, Euro is more likely to be intensively used in place of US Dollar in future. In Asian region, as the China's trade relation will increase with Asian countries, there is chance that Chinese Renminbi will become the dominate currency in Asia, and influence of US Dollar will reduce in Asia. In extreme case, the world may be divided in different groups (Dollar area, Euro area, Renminbi area etc.) on currency basis. This can happen because currently nations are trying to increase the local region trade by making regional trade groups, in place of increasing international trade on world level.

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