

# Will the U.S. Dollar Lose Its Place as the World's No. 1 Reserve Currency?

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U.S.

By Scott Reeves On 2/5/21 at 2:38 PM EST

U.S. Bitcoin U.S. Economy

Some fear stimulus spending to offset the worst of the economic shutdown during the COVID-19 pandemic and the Federal Reserve's injection of billions into the economy threaten the U.S. dollar's standing as the world's reserve currency.

Some investors have moved out of dollars and into gold. While it's hardly a stampede, it could be seen as further evidence of the dollar's increasing weakness. Others see Bitcoin as an inflation hedge, and last month investors drove the price of the cryptocurrency to \$41,973, an all-time high.

Relax, a Cornell University economics professor said, because the dollar's place in the world economy is secure.



A visual representation of cryptocurrency Bitcoin is placed on U.S. dollar bills in this photo illustration on Jan. 13, 2018, in The Hague, Netherlands. Yuriko Nakao/Getty

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"During this period of economic uncertainty and human loss during the global pandemic, the U.S. dollar's role as the reserve currency of the world has been reaffirmed," Andrew Karolyi, the Harold Bierman, Jr. Distinguished Professor of Management at Cornell University said in comments sent to *Newsweek*.

"There remains robust demand for U.S. Treasury securities at every auction, and approximately 40% of the world's debt is denominated in U.S. dollars," Karolyi said. "It is hard to see this reserve status being unseated as long as the size and core engine of the U.S. economy remains strong and the dominance of U.S. financial markets in the global system continues."

### **An 'Exorbitant Privilege'**

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Valery Giscard d'Estaing, French Finance Minister, in the 1960s, said the dollar's standing as the world's reserve currency gives the U.S. an "exorbitant privilege."

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Demand for dollars allows the U.S. to sell bonds at a lower cost, reducing the cost of borrowing. High demand means lower interest rates, because it's not necessary to pay more to entice buyers. As a result, some have said that U.S. bonds are actually the world's leading reserve asset. Two World Wars and a dynamic, innovative economy led to the dollar's dominance.



Pierre Trudeau, Princess Margaret, Takeo Fukuda, James Callaghan, Valéry Giscard d'Estaing, Queen Elizabeth II, Prince Philip, The Queen Mother, Jimmy Carter, Giulio Andreotti and Helmut Schmidt pose at Buckingham Palace on May 13, 1977 during the G7 summit. U.S. National Archives

Historians have noted that the American dollar surpassed the British pound as the world's de facto reserve currency in the 1920s, as England's economy struggled after World War I while the U.S. economy boomed in the Roaring '20s—at least, that is, until 1929.

The dollar's standing as the global reserve currency was formally established in 1944 at the Bretton Woods Conference, when 44 nations agreed to create the International Monetary Fund and the World Bank.

The Bretton Woods Agreement created a system of exchange rates. Signatories agreed to peg their currency to the dollar, which was at the time convertible to gold at \$35 an ounce.

But by the 1960s, the U.S. no longer had enough gold to back the dollars in circulation outside the country. This led to fear that a run on the dollar would deplete Uncle Sam's gold reserves. In response, President Richard Nixon took the dollar off the gold standard in 1971. About two years later, the current system of fluctuating exchange rates had replaced the Bretton Woods Agreement.



In May 2020, several crude oil traders said there was no current demand or storage space for May contract crude oil deliveries and that orders arriving in the Gulf, placed months previously, had nowhere to go. J PAT CARTER / Contributor/Getty Images  
The dollar remains the world's pre-eminent currency, and is widely used in international trade. Basic commodities such as oil and copper, which are produced worldwide, are generally priced in dollars.

The price of oil is a proxy for future economic activity. During the height of the COVID-19 pandemic last summer, the price briefly turned negative because demand had collapsed.

Copper is widely used in manufactured products and is a proxy for factory output, an indicator of consumer demand. Price tells the story, and pricing commodities in dollars provides a quick gauge of the economy.

But as the world's economy expands, the U.S. share of the pie grows smaller.

In 2016, Ben Bernanke, then chairman of the U.S. Federal Reserve, said the nation's declining share of a growing global economy and the rise of the euro and yen mean nations other than the U.S. could also borrow at low rates.

"The 'exorbitant privilege' is not so exorbitant any more," he wrote.

But the rising wealth of other nations doesn't spell doom for the U.S. It doesn't mean the U.S. is getting poorer—just that other nations are getting richer.



FBI Director Christopher Wray addresses the Council on Foreign Relations in Washington, D.C. on April 26, 2019. Photo by Alex Wong/Getty Images

"Absent a catastrophic U.S. policy error, I would expect the dollar to remain the most important reserve currency for the next several decades," Brad Setser, a senior fellow at the Council on Foreign Relations, a Washington-based think tank, said in a research paper.

The world's major reserve currencies are the U.S. dollar, euro, Japanese yen, British pound sterling and the Chinese yuan. Some reserves are also held in the Australian dollar, Canadian dollar and the Swiss franc.

About 60% of foreign exchange reserves are held in U.S. dollars, the International Monetary Fund reported. That suggests the greenback is likely to remain king—at least for the foreseeable future.

### **A Less Sanguine View**

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Gary Hufbauer, a nonresident senior fellow at the Washington-based Peterson Institute for International Economics, a Washington-based think tank, said the dollar faces four long-term threats to its standing as the world's key reserve currency.

The first is "profligate U.S. fiscal deficits," he said in comments sent to *Newsweek*.

Hufbauer called the second threat "the widespread use of dollar-based financial sanctions to punish China, Iran and other 'bad boys' which in turn call into question the sanctity of dollar assets."

His last two threats come from overseas, with the third originating in the largest global rival to the U.S., with the "probability that China will take necessary steps to make the yuan a true rival to the dollar: free convertibility, free capital flows, free floating, bank secrecy, cyber money."

Hufbauer's fourth threat is that the European Central Bank will take steps to make the euro an "attractive reserve currency" challenging the dollar's dominance.

### **The Dollar's Current Strength**

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The strength of the greenback increases when investors exchange other currencies for dollars, and when overseas investors buy American assets, including Treasury bonds and stocks.



Job seekers wait in line to enter a California job fair on Feb. 10, 2009 amid the Great Recession. Justin Sullivan/Getty Images

During the 2007-2009 recession sparked by the collapse of the subprime mortgage market, the U.S. economy recovered more quickly and more strongly than the rest of the world. As a result, U.S. Treasury bonds were considered a safe haven, boosting prices and pushing interest rates lower, since bond prices and yields move in opposite directions.

The dollar weakens when stagnant economy or heavy regulation leads investors to dump U.S. investments and look elsewhere. In March 2020, the U.S. Federal Reserve, the nation's central bank, cut interest rates to 0%-0.25% to encourage borrowing and consumer spending as the coronavirus pandemic hit.

But there may be trouble, or at least a few bumps, ahead.

The Fed has said it will tolerate inflation of about 2% annually. Adjusted for inflation, that reduces the interest paid on bonds and makes them less attractive to investors.

Tax revenue declined during the economic shutdown intended to curb spread of COVID-19, while Congress spent billions on stimulus and the Fed injected billions into the economy by purchasing mortgage-backed securities to keep credit markets working.



A woman wearing a mask walks past a wall bearing a graffiti asking for rent forgiveness on La Brea Ave on National May Day amid the Covid-19 pandemic, May 1, 2020, in Los Angeles, California. VALERIE MACON/AFP via Getty Images

The Dow Jones Industrial Average, a measure of 30 major U.S. stocks, plunged about 8,000 points between Feb. 12 and March 11, 2020 due to the COVID-19 pandemic. But stocks rebounded and the Dow recently reached 31,138.41, close to an all-time high.

A bull market increased the wealth of many because more than half the U.S. population owns stocks either directly or through a retirement plan. However, if the dollar loses its status as the world's reserve currency, interest rates would probably increase and that might limit government borrowing. That and a dose of inflation would drive up costs for consumers and businesses, increasing the price of cell phones, housing, new construction and foreign vacations, for example.

When compared with most other currencies, the U.S. dollar has remained stable or gained value recently. Some believe it's over-valued, but a minor decline wouldn't signal Armageddon.

However, the U.S. trade balance is worsening, especially with China, and the Federal Reserve continues its policy of easy money.

"In my opinion, in the short to medium terms, rumors of the dollar's demise as reserve currency are greatly exaggerated," Usha Haley, the W. Frank Barton Distinguished Chair in International Business and Director of the Center for International Business Advancement at Wichita State University, said in comments sent to *Newsweek*.

"Currently, no alternative safe havens exist for foreign investors," she said. Though gold has risen in popularity, it serves primarily as a hedge against volatility: The price of gold has stayed roughly the same over decades. Negative interest rates in Europe and Japan have made other major currencies unattractive investments as well."

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