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When did the dollar overtake sterling as the leading international currency? Evidence from the bond markets☆

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ABSTRACT

We offer new evidence on the emergence of the dollar as the leading international currency focusing on its role as currency of denomination in global bond markets. We show that the dollar overtook sterling much earlier than commonly supposed, as early as in 1929. Financial development appears to have been the main factor helping the dollar to overcome sterling's head start. The finding that a shift from a unipolar to a multipolar international monetary and financial system has happened before suggests that it can happen again. That the shift occurred earlier than commonly believed suggests that the advantages of incumbency are not insurmountable. And that financial deepening was a key determinant of the dollar's emergence points to the challenges facing currencies aspiring to international status.

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1. Introduction

The global economic and financial crisis has lent new impetus to discussions of the future of the international monetary and financial system. Policy makers in countries like China and Russia have openly questioned the viability of the current dollar-based global system.

Some advocate moving to a multipolar system in which the dollar shares its international currency role with the euro, the Chinese yuan and/or the IMF's Special Drawing Rights. At the Cannes Summit of November 2011, G20 Leaders committed to taking “concrete steps” to ensure that the international monetary system reflects “the changing equilibrium and the emergence of new international currencies”.[1]

Others expect this change to develop more spontaneously; they see it as a natural result of the declining economic and financial dominance of the United States and the increasingly multipolar nature of the global economy, together with the advent of the euro and rapid internationalization of the yuan (e.g. Angeloni et al., 2011; Bini Smaghi, 2011a, 2011b; Constâncio, 2011; Dorrucci and McKay, 2011; Eichengreen, 2011; Fratzscher and Mehl, 2011; Subramanian, 2011).

Sceptics object that prospect of a shift to a multipolar monetary and financial system is in fact remote; if it occurs, such a transition will take many decades to complete (Frankel, 2011; Kenen, 2011). The view that a shift to a multipolar system is unlikely to occur rapidly is rooted in theoretical models where international currency status is characterized by network externalities giving rise to lock-in and inertia, which benefit the incumbent (see e.g. Hartmann, 1998; Krugman, 1980; Krugman, 1984; Matsuyama et al., 1993; Rey, 2001; Zhou, 1997).[2]

These models rest, in turn, on a conventional historical narrative, epitomized by Triffin (1960), according to which it took between 30 and 70 years, depending on the aspects of economic and international currency status considered, from when the United States overtook Britain as the leading economic and commercial power and when the dollar overtook sterling as the dominant international currency. The US, it is

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[1] See the G20 Leaders' *Final declaration* at the Cannes Summit, 3–4 November 2011.

[2] In their calibrated model of international currency status, Portes and Rey (1998) show that a mixed equilibrium (i.e. multiple international currencies) is possible despite network externalities, however.

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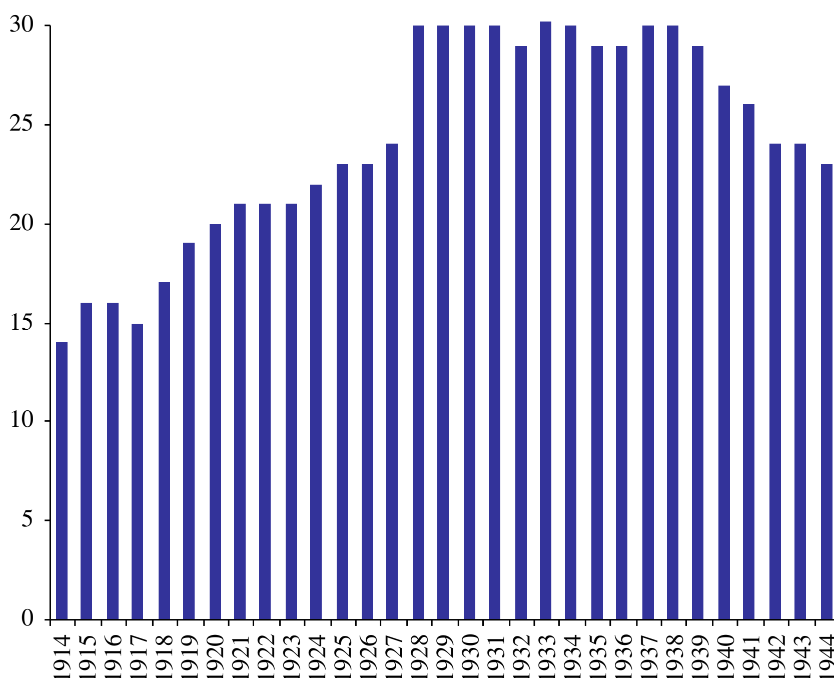

Fig. 1. Number of countries reporting data. *Note*: The figure shows for each year between 1914 and 1946 the number of countries reporting data on the currency composition of their foreign public debt, as available from United Nations (1948).

observed, surpassed Britain in terms of absolute economic size already in the 1870s. It became the leading commercial power, gauged by the value of foreign trade, already in 1913. It was the leading creditor nation by the conclusion of World War I. And yet sterling remained the dominant international currency, not simply during this period, but also throughout the interwar years, according to the conventional narrative, and even for a brief period after World War II.

Recent studies, referred to by Frankel (2011) as the "new view," have challenged this conventional account. Eichengreen and Flandreau (2009), relying on new data on the currency composition of global foreign exchange reserves, show that the dollar in fact overtook sterling as the leading reserve currency already in the mid-1920s — that is to say, more than two decades prior to the date assumed by previous scholars.

Eichengreen and Flandreau's "new view" also challenges broader implications of the conventional narrative. First, it suggests that inertia and the advantages of incumbency are not all they are cracked up to be. Second, it challenges the notion that there is room for only one international currency in the global system. Eichengreen and Flandreau show, to the contrary, that sterling and the dollar accounted for roughly equal shares of global foreign exchange reserves throughout the 1920s. Third, the new view challenges the presumption that dominance, once lost, is gone forever. Eichengreen and Flandreau's data indicate that sterling re-took the lead from the dollar for a brief period after 1931. This reinforces the point that the advantages of incumbency in the competition for reserve currency status may be less than commonly supposed.

In a companion piece, Eichengreen and Flandreau (2012) show that what was true of reserve currencies was true also of the use of currencies for financing international trade. The dollar overtook sterling as the leading form of trade credit (as the currency of denomination for what were known as "trade acceptances" or "bankers' acceptances") already in the mid-1920s, not only after World War II. The US achieved this from a standing start — that is to say, despite the fact that dollar-denominated trade credits had been virtually unknown as recently as 1914. Both market forces (financial market development) and policy support (with the Federal Reserve System as a market maker in the New York market for bankers' acceptances) were instrumental in helping the dollar rival and overtake sterling. That said, both New York and London, and both the dollar and sterling, remained consequential sources of trade credit in the 1920s. This again challenges the notion of international currency competition as a winner-take-all game.

Some critics have questioned the new view. Ghosh et al. (2011) suggest that the interwar gold standard was special in that gold, not foreign exchange, was the dominant reserve asset, accounting for some two-thirds of international reserves. The fact that gold played a large monetary role then but plays only a small one today may limit the inferences about prospective changes in international currency status that can be drawn from this earlier experience, in other words. Forbes (2012) suggests that, compared to the past, international financial transactions may play a larger role in driving the decision of which unit or units to use internationally. Merchandise transactions, and the importance of a currency and market as a source of trade credit, play a correspondingly smaller one. Thus, inferences about the future are less convincing insofar as they are drawn from the past behavior of trade credits and not from the use of currencies in international financial transactions.

In this paper we address these objections and complete the story. We provide new evidence from the interwar years on the use of the leading international currencies, sterling and the dollar, in international financial transactions. This sheds light on a third dimension of international currency status, namely the use of currencies as vehicles for international financing. We focus on the international bond market, bonds being the principal instrument for foreign lending and borrowing in this earlier era prior to the advent of syndicated bank lending.[3]

Looking at yet an additional aspect of international currency competition is useful for establishing the generality (or otherwise) of the so-called "new view" of international currency competition. In addition, because international bonds were typically denominated in national currencies and not gold, the earlier objection that evidence from reserves data is not insightful for today no longer applies.[4] Lastly, we try to go deeper than in previous studies in understanding the factors that helped the dollar surpass sterling. We provide a systematic empirical

[3] As explained in inter alia Eichengreen and Portes (1989).

[4] There were some so-called gold bonds (gold-indexed bonds or bonds containing clauses specifying that they were to be redeemed in national currencies of constant gold content). We discuss these further below.

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