

OUR
DOLLAR,
YOUR
PROBLEM

AN INSIDER'S VIEW OF SEVEN
TURBULENT DECADES OF GLOBAL FINANCE,
AND THE ROAD AHEAD

KENNETH
ROGOFF



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of Global Finance, and the Road Ahead

Kenneth Rogoff

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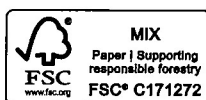
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To Natasha Lance Rogoff



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PREFACE

One never ceases to be amazed at the blasé complacency of modern-day perspectives on international macroeconomic and financial issues. It is not that I ever believed my ironically titled 2009 tome *This Time Is Different* (co-authored with Carmen Reinhart), which was seven years in the making, would permanently awaken the world to the risks of debt-fueled financial and spending excess. Countless readers enjoyed the book, and it became extremely well known, but that is a far cry from changing habits deeply rooted in human behavior. Still, it was surprising how quickly new “this time is different” stories replaced ones that had just crashed and burned in the global financial crisis: Now that economists understand inflation, it will never again be a concern. The speculative real estate boom in China is different thanks to superior state competence and booming growth, and so forth.

Academic economists also came up with one theory after another on why real (inflation-adjusted) interest rates will remain ultra-low forever, giving governments the green light to ignore any risks arising from very high debt. Anyone who doesn't believe that very high debt is a free lunch must be in favor of austerity. With cryptocurrencies, the nuttiness goes in both directions, including those who think they will supplant the dollar and those who think Bitcoin is a scam. Although for many years my own work pushing back on such ideas (and

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others) continued to be prominently published in the very top academic journals, my views were very much in the minority. That is perhaps a bit less so today.

Still, U.S. policymakers and smug economic commentators take on blind faith that we are in a pax dollar era that everyone should be grateful for and that can be relied on to produce stability and growth for the indefinite future. Most of the world, even America's friends, do not necessarily share this perspective, which will eventually be a problem, especially given the challenges that the United States faces in keeping its own macroeconomic house in order.

The title of this book is an allusion to the oft-cited retort of Treasury Secretary John Connally. In 1963, Connally, then the governor of Texas, was seriously wounded while riding in the presidential limousine when John F. Kennedy was assassinated. And he might have been most remembered for that but for a meeting in Rome in 1971, shortly after President Richard Nixon suspended the convertibility of U.S. dollars to gold. By then the Treasury secretary, Connally was confronted by furious European leaders whose countries were holding vast stores of U.S. Treasury bills. Even more importantly, they had built their entire post-war monetary and financial systems on the premise that the dollar was as good as gold. "Our dollar, your problem," Connally famously told them. As the reader of this book will come to understand, Connally was only half right. The inflation that Europeans feared would savage their dollar reserves was not very good for Americans either, a lesson that was painfully relearned in the early 2020s.

Today, the global financial system is at a critical inflection point not seen since the early 1970s, when the Bretton Woods fixed exchange rate system collapsed, or the late 1980s, when the Berlin Wall fell and China's meteoric rise began to accelerate. The United States no longer guarantees foreign central banks that they can exchange their dollars for gold. Instead, it promises to maintain low inflation and thereby preserve the purchasing power of the dollar, which is what the European finance ministers really cared about. The problem is that in a world in which the United States always looks out first and foremost for its own self-interests, that promise is getting harder to deliver on. The U.S. Federal Reserve, which manages America's monetary policy, is a great institution. Unfortunately, it is difficult to stand as an island of technocratic competence in a sea of political turmoil, both domestic and international. Delivering

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low inflation year in and year out in a world of burgeoning political and fiscal pressures is no simple task, especially when the occasional burst of inflation is the safety valve of first resort to avoid sudden excessive austerity, heavy-handed financial controls, or default. This will be particularly so if the world experiences a sustained period where investors demand higher inflation-adjusted interest rates and suddenly debt starts looking a lot less like the free lunch that many have thought it to be, especially since the 2008–2009 global financial crisis. And such a scenario may already be upon us.

Indeed, there are ample reasons to believe that over the coming decade, the world will experience higher interest rates and inflation than policymakers have gotten used to and that the dollar's unique borrowing privilege might be considerably less amid a considerably more fragmented global financial system. (Of course, interest rates will still be lower in recessions.) The era in which the dollar was utterly dominant and reliably stable may have passed its peak. The likely result will be a global rise in the number and intensity of debt, inflation, financial, and exchange rate crises – these won't happen all the time, but a lot more often than the world has gotten used to – especially when you look at the decade before the pandemic.

The prospect of rising instability may come as a surprise to those who have imbibed the “end of history” philosophy that permeates modern economics, whereby economists think they have it all (mostly) solved but for some refinements. In fact, an important part of the vaunted stability seemingly engineered by central banks over the last half century is an artifact of a period in which trade and financial globalization were rapidly increasing, great power conflict had faded, and populism had been suppressed. Needless to say, all these trends may be reversing.

Over the course of my five decades as a professional economist, I have observed that, although the financial system usually evolves glacially, the occasional dramatic turn is to be expected. Political upheavals, technological disruptions, wars, and other kinds of extreme duress have happened in the past, and they will happen again. The notion that we will almost always live in a world of ultra-low inflation and interest rates, and stable major currency exchange rates, is wishful thinking.

To put the remarkable evolution of today's dollar-centric global currency

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system in historical perspective, as well as to give the underlying analytical discussion texture and color, this book will frequently bring in my own professional and policy experiences. Perhaps reviewing real-time uncertainty about past changes and episodes will also provide a frame of reference for just how much uncertainty we face going forward right now and why the scenarios I will discuss later in the book, though perhaps outside the consensus, are hardly unrealistic.

It is true that the dollar has remained on top even though the United States has repeatedly been the epicenter of worldwide crises and recessions. Indeed, the 2008–2009 global financial crisis, much like the Great Depression of the 1930s, had its roots in U.S. policy blunders, yet it was the rest of the world that suffered the most. Ironically, the U.S. dollar emerged from that episode more dominant than ever. Don't count on that happening again, especially given U.S. political dysfunction and debt problems and China's zeal to break away from the dollar bloc. Although the dollar will likely stay on top for some time to come, its global footprint may shrink after decades of continual expansion; if so, the shift could further exacerbate the difficult fiscal adjustment the United States already faces.

If the United States wants to keep the dollar from dropping to a lower orbit, and encourage adherence to dollar rule, Americans need to appreciate that the rest of the world, even our friends, have mixed feeling about U.S. hegemony. As a teenager representing the United States in high-level chess tournaments across Europe in the late 1960s and early 1970s, I was constantly confronted with this paradox. People were steeped in American music and film. Inside at a crowded seedy bar in Sarajevo, the Jefferson Airplane song “White Rabbit” was booming out from the radio. It was stunning to hear half the people belting out every word even though almost none of them spoke English. It was embarrassing not to know the words myself as the lone American, and doubly so when I later learned that back in the states, my close and far cooler friend Kim Commons had been giving chess lessons to that band's lead singer, Grace Slick. Sometimes even the thinly disguised KGB agents who would accompany the Russian chess players couldn't hide their fascination with American culture. One “escort” I met couldn't stop talking (in perfect KGB English) about U.S. basketball star Wilt Chamberlain. Yet many of these same people would sit across

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from you at dinner and matter-of-factly denigrate the United States as a racist, war-mongering society.

These tensions and contradictions very much still exist today. The United States' allies and competitors alike enjoy the convenience of a quasi-global currency, much as English provides the common language of international trade and diplomacy. They bristle, however, at how exposed their economies are to the vicissitudes of self-absorbed U.S. macroeconomic policy. American financial officials typically pay little more than lip service to foreign concerns, sometimes leaving their foreign counterparts pining for Connally's directness so that they would at least know where things stand. Looking at the periodic financial turmoil of the past seventy-five years and the extreme divisiveness of the U.S. political situation today, not to mention the rise of China, the rest of the world is right to worry about what all of this implies for global macroeconomic stability in the coming decades.



CHAPTER 1

INTRODUCTION

The Making of a Dominant Currency

Before we dive into the odyssey of the dollar, and a bit of my own journey in trying to understand it, it is helpful to set the stage with a few key facts. Perhaps the single most important thing to know is that the mantle of the world's dominant currency does not change hands very often. One to two centuries is the norm, and the transition is typically marked by the co-existence of both the old dominant currency and the eventual new champion. In this sense, the era of dollar dominance, having lasted just over a century, may be regarded as late middle-aged. Conflict typically plays a major role in the changing of the guard, although innovation can also be a factor as, for example, in the case of the Dutch. The Netherlands held the mantle of dominant currency in the seventeenth century, thanks in no small part to the innovation of having silver-coin-backed bank paper notes, called “florin,” circulating alongside Dutch guilder coins.¹

Although the financial press regularly features articles about foreign leaders or Silicon Valley innovators who bluster about replacing the dollar, in reality the greenback rules the global financial system today like no currency before it – not the Spanish “pieces of eight” of the sixteenth century, or the Dutch guilder that came next, or even the British pound sterling at its peak from the end of the Napoleonic Wars through World War I, when the sun never set on the British

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Empire. The dollar is the undisputed lingua franca of today's highly globalized trade and financial markets. Indeed, what it means to be the dominant world currency has considerably expanded as the world has globalized and as the financial system has evolved; the Spanish peseta was of little significance in sixteenth-century India and China, whereas the dollar plays a central role throughout Asia—at least for now.

From the perspective of the rest of the world, the least attractive feature of the current regime is that although countries mostly trust the United States not to default (don't ask Russia or China), it still has wide berth to use inflation to decrease the real value of its debt. An unexpected burst of inflation is, after all, tantamount to partial default since the government gets to repay its debt in dollars that buy much less than originally expected when the debt was issued. This is exactly what happened in the 1970s, when European central banks saw the value of their dollar reserves wilt away. And, of course, the purchasing power of the dollar fell suddenly again after the pandemic.

For bond holders, inflation is the scourge of modern government-issued money. And the risk of high inflation remains the Achilles' heel of the system. Sure, the U.S. central bank—the Federal Reserve—can promise never to allow inflation to spike. If the Federal Reserve's inflation targets are treated as sacrosanct, however, what then is the safety valve for unsustainable debt or unexpected costs in the future (say, for emergency defense needs, the green transition, or a presidential administration gone off the rails)? Austerity? Financial repression (forced holdings of debt at low interest rates)? Outright default?

Mind you, there was inflation before the printing press; it was just much harder to do. When coins were made of precious metals, a government wanting to decrease the value of its currency—that is, to inflate—would have to call in its coins and then re-issue new ones with less silver content. Sometimes the old coins were just clipped and recirculated. Such debasement can be readily observed in exhibits at modern numismatic museums, such as those in Tokyo, Jerusalem, and Dresden: when one lines up a nation's coins over the decades and centuries, the shrinkage is typically manifest.

Henry VIII of England is famous for beheading two of his six wives: “divorced, beheaded, and died; divorced, beheaded, survived” is the old rhyme that English schoolchildren learn and that was most recently featured in the clever

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Broadway musical *SIX*.² In monetary economics, however, Henry VIII is just as famous for decapitating the United Kingdom's coinage: the silver content of the sterling shrunk by 50 percent in 1551.³ Of course, Henry VIII was a piker next to Robert Mugabe of Zimbabwe or Nicolás Maduro of Venezuela, who achieved hyperinflation this century with the aid of the modern printing press, as we shall come to later.

It was in part by not overindulging in shrinkage that Spain managed to have the dominant global currency in the 1500s. Spain was helped immensely by an influx of precious metals from mines in the New World, which were manned by native labor working under harsh conditions. Using mountains of silver plundered from the Potosí mines in the eastern Andes and the Zacatecas mines in Mexico, Spain was able to man armies, build ships, and deploy weapons on a scale far beyond its poorer European rivals; it became the foremost economic and military power of the sixteenth century. And when spoils from the colonies were not enough to satisfy the ambitions of the Spanish crown, Spain borrowed promiscuously, so much so that it defaulted on debt to foreign creditors six times from 1557 to 1647.⁴ The 1557 “Trinity Default,” in particular, marks one of the most significant global financial crises in history, with nearly simultaneous defaults in Spain, France, and the Netherlands.⁵

The Sea Hawk is a classic film that captures the ethos of the time from an unabashedly biased British American perspective. Set in the 1580s, the film stars Errol Flynn as the swashbuckling English privateer who had to overcome countless obstacles to warn England's Queen Elizabeth that a huge fleet was being readied by Spain's King Philip II for a surprise attack on England. The movie makes much of the fact that British captives were relegated to galley slaves in Spanish ships, whereas Flynn's character, upon seizing a Spanish ship, gives its surviving crew free run of his own pirate vessel, save for the weapons cache. The sinking of the invincible Spanish Armada, which was partly due to bad weather, was a turning point in dominant-currency history. By the nineteenth century, the pound sterling, and with it the U.K. banking system, had established the kind of global reach that King Philip II could scarcely have dreamed of.

The twentieth-century transition from the pound to the dollar also arose from conflict, even though the United States and United Kingdom fought as allies. As a result of two devastating world wars, the United Kingdom had ex-

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hausted a great deal of its wealth and lost part of its industrial base; it could no longer even hold on to its colonies. The United States, although suffering mightily, each time lost much less. After an interwar period in which the sterling and the dollar were co-dominant, the mantle passed definitively to the United States.

The global economic supremacy of the United States after World War II was breathtaking; in 1950, the U.S. economy accounted for an astounding 36 percent of global GDP.⁶ The post-war system of fixed exchange rates, hammered out in 1944 in Bretton Woods, New Hampshire, not only placed the U.S. dollar at the center but also gave the dollar extraordinary privileges by design.⁷ All other participating countries were required to fix their exchange rates to the dollar, and it was each country's responsibility to keep enough dollars on hand to achieve that end, subject to allowances for small fluctuations. The United States, on the other hand, was free to pursue whatever interest-rate and inflation-rate policy it wanted, with the main proviso that, in theory, the U.S. government had to stand ready to exchange dollars for gold for any government that wished to do so.

Thanks to network effects, international currency usage is a natural monopoly. So it should not be surprising that once a currency establishes itself in international transactions, the use of most other currencies falls by the wayside. Today, there are over 150 currencies in the world,⁸ world trade and finance would be a Tower of Babel if they were all used. A remarkable 90 percent of all foreign exchange transactions involve the dollar on one side or the other.⁹ That's because the market for most currency trades is so thin that it's cheaper to use the dollar as a "vehicle currency" for, say, converting Canadian dollars to Australian dollars than to swap the two directly. The transaction costs of the two trades (Canadian to U.S. dollars, then U.S. to Aussie dollars) are less than those of the direct trade. A mind-blowing fact is that the dollar, not the euro, is the dominant vehicle currency even for trades involving countries that border the eurozone (e.g., a trade from Turkish lira to Bulgarian lev).¹⁰

The dollar's position atop the currency food chain shows up across many quantitative metrics. For example, although the United States accounts for roughly a quarter of global output (measured at 2024 market exchange rates), almost 60 percent of foreign exchange reserves are held in U.S. dollars.¹¹

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The dollar also plays a central role in the pricing of international goods and financial assets. The share of the global oil trade priced in dollars remains around 80 percent, despite China's recent efforts to promote the renminbi; most other commodity trades are similarly dominated by dollar pricing.¹² Over 40 percent of global goods trade is priced in dollars, and that is an understatement because it counts trade between eurozone members as international trade. The dollar's share would be far higher otherwise; for example, over 85 percent of India's trade is in dollars.¹³ Global bond markets are even more dollar-centric.

Figure 1 offers perhaps the best and most nuanced summary measure of dollar dominance for the year 2019, before the pandemic.¹⁴ The map shows which countries' central banks either stabilize their currencies against the dollar or implicitly use the dollar as their main reference currency. Darkened areas show countries that have joined the dollar bloc since 1999. China, a charter member of the modern dollar bloc, is highlighted with striped lines because it has allowed a bit more exchange rate flexibility, especially since 2015. However, it is a borderline case, with the renminbi-dollar exchange rate in 2024 only slightly weaker than the exchange rate before the global financial crisis, and China could just as well have been included as a full member of the dollar bloc. Russia was forced to become less dollar-centric after the full-scale invasion of Ukraine in 2022, and the eastern former Soviet states followed in its wake. Nevertheless, the greenback remains in widespread circulation.

It is hardly surprising that so many of the world's central banks, especially in developing and emerging-market economies, care about stabilizing their dollar exchange rates given that such a large fraction of trade, and often a similarly large proportion of their international debt, is in dollars.¹⁵ In general, one can think of the exchange rate regime as a portmanteau measure of all the different ways the dollar matters for a country, since the central bank must take all of these into account in determining its exchange rate regime. If the central bank views the economy as highly sensitive to movements in the dollar exchange rate, it will be careful not to let that exchange rate move too much too fast.

A major factor in favor of the dollar is that the U.S. economy is the world's largest. Although its size advantage has been decreasing over time, this has happened far more slowly than most experts had predicted. Since 1950, the U.S. share of global GDP, measured at market exchange rates, has dropped to about

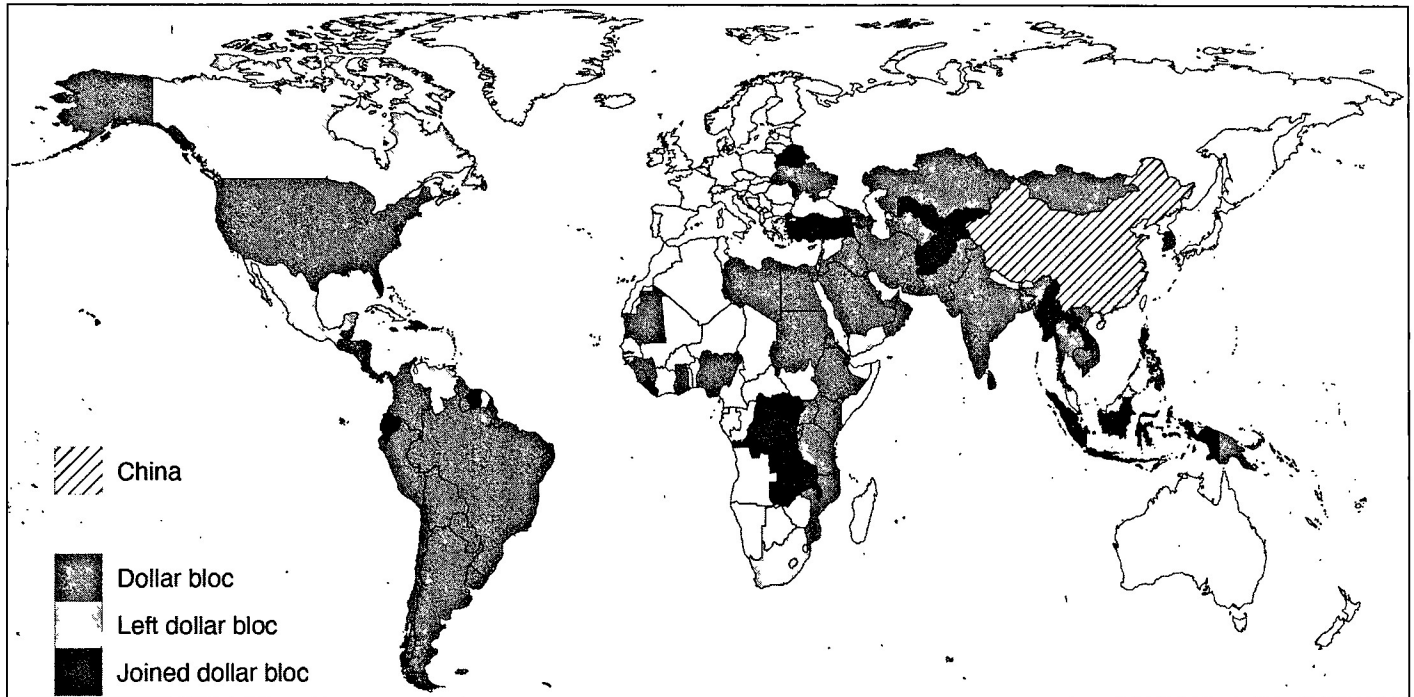


Figure 1. The dollar's vast footprint as an anchor or reference currency, 2019

Source: Updated from Iltetzki, Reinhart, and Rogoff, *Quarterly Journal of Economics*, 2019.

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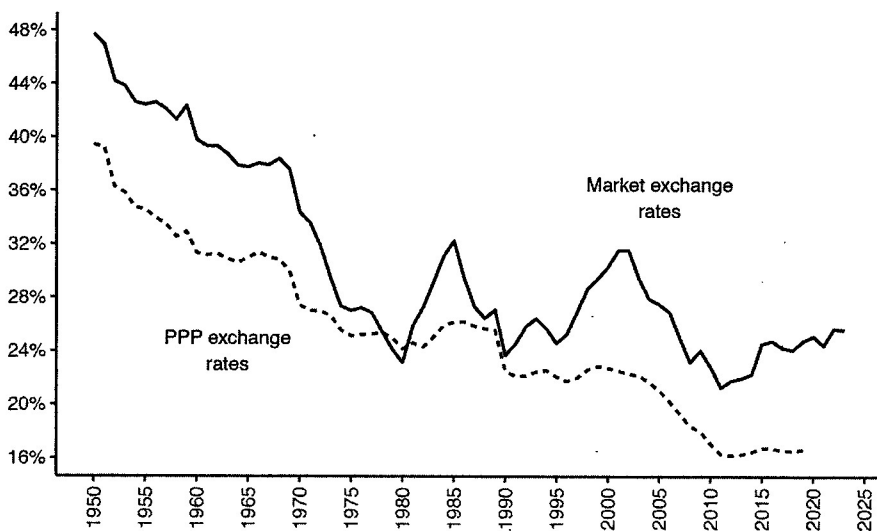


Figure 2. U.S. share of global GDP, 1950–2023

Data Source: Total Economy Database (market rates); Penn World Tables (PPP rates).

25 percent (as shown in figure 2).¹⁶ The decline came in two spurts: the first as the economies of Europe and Japan rebuilt from World War II; the second when China hit its peak growth period in the early 2000s.

Figure 2 also shows a second way to measure the size of the U.S. economy. That method uses artificially constructed purchasing power parity (PPP) exchange rates, which attempt to use a common set of prices to better compare living standards. The United States' decline is sharper by the PPP living-standard measure: under that measure, the U.S. share of global GDP has fallen to under 17 percent. However, for the purposes of understanding international trade and financial power, the market measure is more meaningful; a country cannot buy oil or Patriot missiles with PPP dollars.

In 2000, the economy of the European Union was roughly the same size as the U.S. economy and seemed on track to achieve co-equal status. Now it, too, has been left in the dust by the U.S. economy, mainly because of the technology sector. The Chinese juggernaut is impressive, but if one compares economies using market exchange rates to convert income to dollars, the Chinese economy

“Ken Rogoff is one of the world’s leading experts on international finance. In this book he combines his wide experience as a policymaker, academic, and observer of the global economy to provide a fascinating and accessible analysis of looming challenges to economic and financial stability.”

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