Money is Power:
The National-Security Impact of U.S. Financial Policy

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Money can't buy you love, or so the Beatles sang when they weren't belting out "Give me money, that's what I want." Money can indeed buy a great deal, especially for a nation that, loved or not, wishes to wield the economic power critical to military might and foreign-policy consequence. We know this from the historic evolution of hegemonic powers that is evident not only by the loss of critical battles or colonial empires, but also by what happens as nations gain or lose what is known as reserve-currency status.

As money accords otherwise ordinary mortals enormous market and political clout, so too does it grant nation-states powerful positions of diplomatic and military influence. It is, however, not just how much money a nation has that gives it clout, but also what other nations think of that money based on how that money – known as fiat-currency – is used within their borders and around the world. When one nation's fiat currency is the currency that is used around the world, then it's a "reserve currency," an asset conveying power well beyond a seemingly-wealthy nation's own borders.

This is clearly seen in the correlation of power and reserve-currency status in the transition from the Dutch florin in the 18th century to the British pound sterling in the 19th century to the U.S. dollar in the 20th and, at least so far, the 21st. As I'll discuss tonight, we know from history not just how fiat currencies become reserve currencies, but also what happens to a nation's security when a reserve currency is consigned to the global dust heap. This is a lesson of signal importance given attacks on the dollar's reserve currency status not just from abroad, but also and often unwittingly here at home.

What's a Reserve Currency

A reserve currency is the medium of exchange or store of value used around the world to a dominant extent in making payments, engaging in commerce or financial transactions, and investing or saving. As far back as 1965, the dollar's reserve-currency power reflected in these choices was dubbed an "exorbitant privilege" by a future president of France.[1] This phrase stuck because it was immediately understood as more than àpropos. This was of course a time in which one had to change dollars for francs in France or pounds in England or yen in Japan to pay for a day out and about, but it was also a time in which cross-border payments and dominant investment options were already mostly dollar-denominated due to the United States' unquestioned position as the bastion of global commerce, trade, and finance. Many transactions of the time were still executed in London and, later, Tokyo, but the majority of them were directly or indirectly dollar-denominated.

It's important here to remember that the exchange price of the dollar – i.e., how much a Japanese-produced car costs in the U.S. – is different from the reserve-currency power of the dollar. Trade in goods and services moves in response to exchange values and, when a nation manipulates its currency, trade in goods and services can move a lot. But this is foreign-exchange risk when one thinks about financial markets and FX risk can be managed. Day in, day out, a reserve currency is the one governments, bankers, and high-wealth individuals use at some point or another in virtually everything they do, hedging the risk of transforming other currencies into dollars through trillions in financial instruments on offer every day all the time.

The dollar is if anything even more dominant now than it was when Giscard d'Estaing called it an exorbitant privilege, now affording what might be called an extra-exorbitant privilege because economies have financialized over the intervening decades – that is, wealth increasingly accumulates from financial goods and services, not from those in physical goods or non-financial services. This extra-exorbitant status is evident most recently following the election of an anti-U.S. populist in Argentina who nonetheless plans quickly to transform that nation's currency into one pegged to the dollar.

Whatever else Javier Milei may be up to in Argentina, he's right about the dollar's almighty status. Nearly seventy percent of the world's countries weighted by GDP peg their currency to the U.S. dollar, at least in part.[2] The dollar is the dominant currency in foreign-exchange transactions (88 percent)[3] and it is used in more than 60 percent of global invoicing.[4] 58 percent of global central-bank assets are stored as dollars or dollar-denominated instruments[5] and U.S. Treasury bills and bonds are the go-to obligation for day-in, day-out trading and the havens for funds in "flights to safety" market stress events seen most recently in 2020.[6]

Using any of these dollar-denominated trillions of dollars requires what is called "dollar clearing," which is the ability to use your dollars to get something you want or turn an investment such as that in a Treasury obligation into the dollars needed for another investment, asset, or even a place to live where dollars matter. Financial institutions accepting dollars to convert into other currencies or do the reverse must have access to the dollar-clearing market to get or recycle dollars. Dollar-clearing is largely New York based and thus U.S. policy driven.

Where's the link between this economic power and national security? It's not hard to find, especially as the U.S. now seeks to exercise the "soft" power afforded by reserve-currency privilege to influence the Ukraine and Gaza wars.

Historically, primary and secondary sanctions were a nuclear-equivalent for nations such as North Korea wholly frozen out of dollar clearing and thus out of most of the global economy. However, as Russia, Hamas, and others have recently shown via the use of digital currencies, there are now ways around dollar clearing. The nation that controls these new ways has a strong shot at seeing its currency assume global reserve status.

What It Takes to Offer a Reserve Currency

The most significant and immediate threat to national security achieved by supplanting the dollar is most likely to accrue to China due to its clear ambitions to challenge the United States' reserve-currency soft power even as its cruisers roam the South China Sea. China's capital market is formidable – although its equity market is about a quarter of the U.S.'s,[7] but its growth and that of China's fixed-income market is two to three times faster over the past ten years.[8] Its sweep across the Global South and its new status as the world's leading sovereign creditor[9] – also speak to its ambitious reserve-currency objectives.

Nations that wish to adopt foreign policies different from those of the U.S. – most notably with regard to Russia or Iran – are not necessarily willing to align with China but nonetheless have to clear their transactions in and out of global markets somewhere. If China offers an alternative with enough scope, scale, and speed to challenge the U.S., then money will surely move and the dollar's reserve-currency status will erode, if not end.

Could China or another hopeful military hegemon really challenge or even supplant the U.S. by way of subverting the dollar's reserve currency status? The answer is that this would be hard were the U.S. not making it easier.

Military might is not the only criterion for extra-extraordinary privilege. The Dutch proved this in the 18th century, a time when Spain had more clout, but the Netherlands had one of the world's first central banks – vital for payment clearing – and perhaps the world's first joint stock company – a vital way to convert money into wealth. It also had a stable government, honored its sovereign-debt obligations, and governed finance and commerce under a transparent, predictable, and enforceable rule of law at least when compared to every other major nation of its time.

Still, the florin's exorbitant privilege ended about 1820 when the pound took over because England also had an early central bank, trustworthy sovereign obligations, joint stock companies, and a trusted rule of law.[10] It matched this with an empire that put others to shame and the pound sterling thus took over from the florin. Although the pound's reserve-currency status eroded after the gold standard broke during the Great Depression, England's reserve-currency status lasted even after the U.S. economy sped past it around 1870.

England's exorbitant privilege lasted until its remaining economic might was eviscerated by two world wars and its empire shrank and shrank some more as the U.S. emerged triumphant not only as the only major nation with a robust physical infrastructure after World War II, but a series of actions before the war that positioned it to take the reserve-currency scepter.

England in part held on so long because the U.S. finally established its central bank only in 1913. It also made clear that it had sound sovereign debt, and a series of laws largely after 1933 established a rule of law for U.S. capital markets and the banking system, at least for its time. The U.S. also had a mighty combination of hard post-war military power and adroit use of its soft power through the postwar network of multilateral financial institutions and global bodies it largely financed and thus controlled.

The Dollar's Danger

Will the exorbitant and even extra-exorbitant power of the dollar's reserve-currency status continue in the 21st century? It might, but this cannot be said with the unequivocal assurance of only a decade ago. The dollar's key role as the central-bank reserve asset is still strong, but it's also down 25 percent over the past two decades.[11]

First to the problems with our central bank. It is certainly the first among equals in terms of determining the fate of the global economy, power granted to it more by the dollar's reserve-currency status than the diminishing clout of the U.S. economy and trading system. But there are three cracks in the Federal Reserve's ability to retain this hegemonic power: the antiquated U.S. payment system, the rise of digital currencies, and plans by several major central banks to advance their fiat currency's hopes of becoming a reserve currency through new forms of central bank digital currency (CBDC).

Time doesn't permit in-depth discussion of these three phenomena, but recall one critical attribute of a reserve currency: it must be what is known as a frictionless – i.e., smooth and fast – medium of exchange. Money is power, but time is money. If I have to wait for payment in dollars in the U.S. – and one must increasingly wait far longer here than elsewhere – I will increasingly move my dollar-related payment transactions to alternative payment systems that in turn rely on other currencies. And, if digital dollars give me speed, anonymity, and protection from political risks – e.g., taxation or even sanctions – I'll go digital if these attributes are important as they are now to all too many rogue nations, conflict and combat entities, and those engaged in a wide range of illicit transactions that may also pose national-security risk. This threat is real – see for example provisions pending in the National Defense Appropriations Act attempting to bring cryptoasset transactions under the scope of U.S. anti-money laundering and sanctions law.

Nations setting up CBDCs want their central banks to run the digital-payment market and thus secure their national currencies' role in the home state and, even better, gain global status. It's not for nothing that the first and most widely used CBDC is to be found in China. There's a lot of opposition to a CBDC in the U.S. and the Federal Reserve is slow-walking this, in part because it's convinced that the U.S. is so dominant that nothing can threaten the dollar.

But the threat of new payment media isn't the only one confronting the dollar's reserve-currency status. Recall that history tells us that a reserve-currency hegemon must have sound sovereign obligations. One vital, vital aspect of dollar power is the fact that Treasury obligations are the globe's most liquid and trusted asset, far surpassing gold, the old reserve asset that backed the florin and the pound in their heyday, ensuring ready convertibility and clearing within the limits of technology at the time.[12]

I don't need to tell you that the U.S. Congress continues to flirt with turning the debt ceiling into a hard stop at which point Treasury-bond holders could lose access to payments due to them or even the principal value of Treasury obligations themselves. Even threatening not to honor the U.S. Government's obligations is a shocking dereliction of national duty to partisan politicking. The U.S. had so much economic power in 2011 that Congress's brief failure to raise the debt ceiling didn't hurt all that much – some, but not a lot because the debt stand-off was short-lived. Since then, the debt ceiling has always been lifted, but always only after prolonged struggles that sap global confidence that the U.S. somehow won't go over the fiscal-solvency edge. At a time of increasingly credible competitors for reserve-currency power, playing with the debt ceiling is a very dangerous game of chicken for U.S. national security.

The dollar so far still remains resilient because reserve-currency enemies are just beginning to mount their offense and, even as they do, the U.S. rule of law is sound even if our payment system is slow and our Congress heedless to the need to honor the obligations it authorizes. But how sound is our rule of law when a sitting president refuses to concede to the voters? How sound is our rule of law when essential provisions of law barely make it through Congress or when key military appointments are throttled by domestic political disputes? It was famously said in the 1950s that U.S. politics "stop at the water's edge."[13] As the high-risk games this evening with the National Defense Authorization Act make all too clear, partisan politics no longer knows any bounds in the name of national security.

One final point on the U.S. rule of law. Law is of course implemented via rule and the rules that govern the role of U.S.-domiciled financial institutions thus have direct influence on whether dollar-denominated finance and clearing are subject to U.S. law. SEC Chair Gary Gensler recently touted the depth and governance of U.S. capital markets as a key plank beneath the dollar's exorbitant privilege, and he's mostly right about that even as some of his rules try the securities industry's soul.[14]

The same cannot be said of the rules governing U.S. banking. Many payment-system modernizations outside the U.S. make it less important for dollar-based transactions to be conducted in the U.S. and, even though New York remains the key center for this vital activity, our open-banking system allows non-U.S. banks to engage in the same dollar-based activities as U.S.-regulated institutions. Sometimes the rules are the same for U.S. and non-U.S. banks; often, they aren't when a foreign bank's U.S. activities are consolidated with those of its parent bank outside the reach of U.S. law and rule. Dollar-based finance outside the U.S. may not directly affect reserve-currency status, but the diminished role of dominant financial entities subject to U.S. law and rule poses significant and near-term challenges to national security in areas such as adherence to sanctions and, over time, the depth and liquidity of the Treasury market – one critical attribute of reserve-currency status, as I've said. A nation with weak sovereign bonds is subject to attack that jeopardizes its national solvency and thus security.

The Florin, the Pound, and the Dollar?

Given all these threats, is the "almighty dollar" soon to join the Dutch florin and British pound in the reserve-currency scrap heap? I doubt it – the dollar is just too powerful, the U.S. remains the most important alternative to Russia and China, and the cracks in our own edifice do not yet threaten its foundations, or at least so I hope.

But these cracks are increasingly wide and there are those outside the fortress doing their best to blow them wide open. A nation that fails to ensure a privilege as exorbitant as that bestowed by a reserve currency is one that puts much else at risk.

[1] David Marsh, "Giscard d'Estaing: Architect of euro and sdr" (Dec. 3, 2020), https://www.omfif.org/2020/12/giscard-destaing-architect-of-euro-and-sdr/.

[2] Ethan Ilzetzki, Carmen M. Reinhart, and Kenneth S. Rogoff, "Exchange Arrangements Entering the 21st Century: Which Anchor Will Hold?" (2019), Figure 2, *available at* https://scholar.harvard.edu/sites/scholar.harvard.edu/files/rogoff/files/ilzetki_reinhart_rogoff_qje_2019_2.pdf.

[3] Carol Bertaut, Bastian von Beschwitz, and Stephanie Curcuru, "The International Role of the U.S. Dollar," *Board of Governors of the Federal Reserve System (FRB) FEDS Notes,* (June 23, 2023), Figure 9, *available at* https://www.federalreserve.gov/econres/notes/feds-notes/the-international-role-of-the-us-dollar-post-covid-edition-20230623.html.

[4] Ibid., Figure 5.

[5] Ibid., Figure 2., Accessible Version

[6] Financial Stability Board (FSB), "Holistic review of the March market turmoil," (November 17, 2023), https://www.fsb.org/wp-content/uploads/P171120-2.pdf.

[7] Securities Industry and Financial Markets Association (SIFMA), "2023 Capital Markets Fact Book" (July 2023), 7 and 13, *available at* https://www.sifma.org/wp-content/uploads/2022/07/2023-SIFMA-Capital-Markets-Factbook.pdf.

[8] SIFMA, "2023 Capital Markets Fact Book" (July 2023), 11 and 13, *available at* https://www.sifma.org/wp-content/uploads/2022/07/2023-SIFMA-Capital-Markets-Factbook.pdf.

[9] Keith Bradsher, "China Is Lending Billions to Countries in Financial Trouble," *New York Times*, (November 6, 2023) https://www.nytimes.com/2023/11/06/business/china-bri-aiddata.html.

[10] Antonio Coppola, Arvind Krishnamurthy, and Chenzi Xu "Liquidity, Debt Denomination, and Currency Dominance," *NBER,* (February 2023), 27, https://www.nber.org/system/files/working_papers/w30984/w30984.pdf.

[11] Carol Bertaut, Bastian von Beschwitz, and Stephanie Curcuru, "The International Role of the U.S. Dollar," *op. cit.*

[12] See World Gold Council, "Gold Market Primer: Market size and structure," (April 27, 2023) https://www.gold.org/goldhub/research/market-primer/gold-market-primer-market-size-and-structure; and SIFMA, " US Treasury Securities Statistics," (December 7, 2023) https://www.sifma.org/resources/research/us-treasury-securities-statistics/.

[13] United States Senate, "The 'Famous Five'," (accessed on December 12, 2023) https://www.senate.gov/artandhistory/history/common/briefing/Famous_Five_Seven.htm#:~:text=Asserting%20that%20%22politics%20stops%20at,bipartisanship%20in%20American%20foreign%20policy.

[14] SEC Chair Gary Gensler, "Prepared Remarks Before the Council on Foreign Relations," (speech, Washington, D.C., December 4, 2023) https://www.sec.gov/news/speech/gensler-prepared-remarks-council-foreign-relations-12042023#_ftn11.