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OUTLOOK Economic Data and Commentary

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The U.S. Dollar in the Global Economy

The U.S. dollar has long enjoyed its status as the primary reserve currency of the global economy. It has served as an international safe haven and lubricated the operation of financial markets around the world.

Yet, the international role of the dollar also has been consistently questioned, most recently in the wake of the 2008 financial crisis. And with China on the rise – and Russia's recent threat to abandon the dollar – some wonder just how long the dollar will be the primary global reserve currency.

Former French President and Finance Minister Valéry Giscard d'Estaing once coined a phrase – *exorbitant privilege* – to describe the extraordinary benefits reaped by the United States for having the world's foremost currency. Those privileges, according to d'Estaing, included the reduced risk of a sudden devaluation, lower borrowing costs for the federal government, and U.S. companies reducing the trouble and cost of dealing in multiple currencies.

"Exorbitant Privilege" is also the name of a 2012 book by Barry Eichengreen, Professor of Economics and Professor of Political Science at the University of California, Berkeley, where he has taught since 1987. In his book, Dr. Eichengreen describes his belief that while the dollar may not be as dominant as it has been in the global economy over the past 50 years, it is not necessarily destined to lose its international status either. The dollar's future, he says, depends more on avoiding the mistakes of the recent past and making sound economic policy decisions here in the U.S. rather than on the actions of any foreign government.

OUTLOOK recently sat down with Dr. Eichengreen to understand how the U.S. dollar is currently faring in the global economy and what we might expect to see in the future.

> The U.S. accounts for 20 to 25 percent of the global economy ... but the dollar accounts for the majority of foreign government and central bank foreign exchange reserves.

About this article

Barry Eichengreen is the George C. Pardee and Helen N. Pardee Professor of Economics and Professor of Political Science at the University of California, Berkeley, where he has taught since 1987. He is the author of "From Miracle to Maturity: The Growth of the Korean Economy" with Dwight H. Perkins and Kwanho Shin and "Exorbitant Privilege: The Rise and Fall of the Dollar and the Future of the International Monetary System."

Dr. Eichengreen is also a research associate for the National Bureau of Economic Research and research fellow of the Centre for Economic Policy Research in London. Previously, he has served as a senior policy advisor at the International Monetary Fund.

He was named one of *Foreign Policy* magazine's 100 Leading Global Thinkers in 2011. He is a past president of the Economic History Association.

OUTLOOK: Remind us of the importance of the U.S. dollar in the global financial system. What does it mean to be the primary global reserve currency?

Barry Eichengreen: It means the dollar plays a role internationally that is out of proportion to the role of the United States in the world economy. The U.S. accounts for 20 to 25 percent of the global economy depending on how one measures and values different kinds of transactions. But the dollar accounts for the majority of foreign government and central bank foreign exchange reserves. It is used in the majority of foreign exchange market transactions. It is the dominant currency in which international bonds – bonds marketed and sold to investors outside of the issuing country – are denominated. It's the primary international unit of account, means of payment and store of value.

OUTLOOK: Give us a brief history of the dollar in the global context.

BE: The dollar really became the dominant international currency twice – first after World War I and then a second time after World War II.

The Pound Sterling had been the leading international currency prior to World War I, but Britain's position was challenged by the disruptions of the war. That coincided with passage of the U.S. Federal Reserve Act in late 1913 and creation of the Federal Reserve System the following year. The Federal Reserve Act permitted U.S. banks to set up foreign branches so they could provide financial services in dollars to foreigners. The Federal Reserve System actively encouraged them to do so. By the middle of the 1920s, the dollar had overtaken the Pound Sterling as the leading international currency.

Then, the Great Depression caused foreigners to grow disenchanted with the dollar, erasing the progress it had made earlier in the century. It took from the end of World War II until the mid-1950s – at which point the U.S. was far and away the largest economy in the world – for the dollar to regain its position as the dominant international currency. At that point, of course, the greenback had few rivals, since the U.S. was the only country with liquid financial markets that were open to people in other countries.

"The world is a big place, and for a currency to be attractive to foreigners there has to be an ample supply, which the dollar certainly has.

OUTLOOK: What is it that makes the dollar such a safe haven or desirable currency?

BE: Three things – size, stability and liquidity.

The world is a big place, and for a currency to be attractive to foreigners there has to be an ample supply, which the dollar certainly has. Also, the United States engages in a lot of international transactions, so there is a natural market or demand for our currency.

Stability means that investors are reasonably confident that the currency will hold its value compared to the alternatives.

The third factor is liquidity. The main thing the dollar possesses that rival currencies do not is that you can buy and sell the dollar – or bonds denominated in dollars – at a low cost in large amounts without moving the market price against yourself. For example, if the People's Bank of China wants more dollars, its purchases are not going to drive the price up dramatically. And if the People's Bank wants fewer dollars, it's not going to inflict large losses upon itself by selling some of its U.S. Treasury bonds in return for other assets. Transaction costs are low, and there are lots of other willing buyers and sellers. Market liquidity is something that portfolio managers and central bankers value, and it is something that the dollar possesses.

OUTLOOK: How has the dollar fared recently – especially during and now after the financial crisis?

BE: Overall, not much has changed, which is contrary to widespread predictions. Many people said the dollar would become less attractive and foreign investors – especially central banks – would flee because of the disorderly closure of Lehman Brothers and the 2008 financial crisis. Then with the debt ceiling fiasco, the dollar skeptics warned that Congress was undermining confidence in the U.S. Treasury bond market. None of that happened. Those consequences never materialized.

Indeed, there have been claims and forecasts that the dollar would lose its dominance going back to the 1960s. Despite all of this, the share of the dollar in the currency composition of global foreign exchange reserves is currently about 61 percent, which is only very marginally below where it was five, 10 or even 20 years ago.

OUTLOOK: Are you surprised by the continuing stability of the dollar in the aftermath of the financial crisis? Were you worried about the dollar losing value or status globally, or were you confident all along?

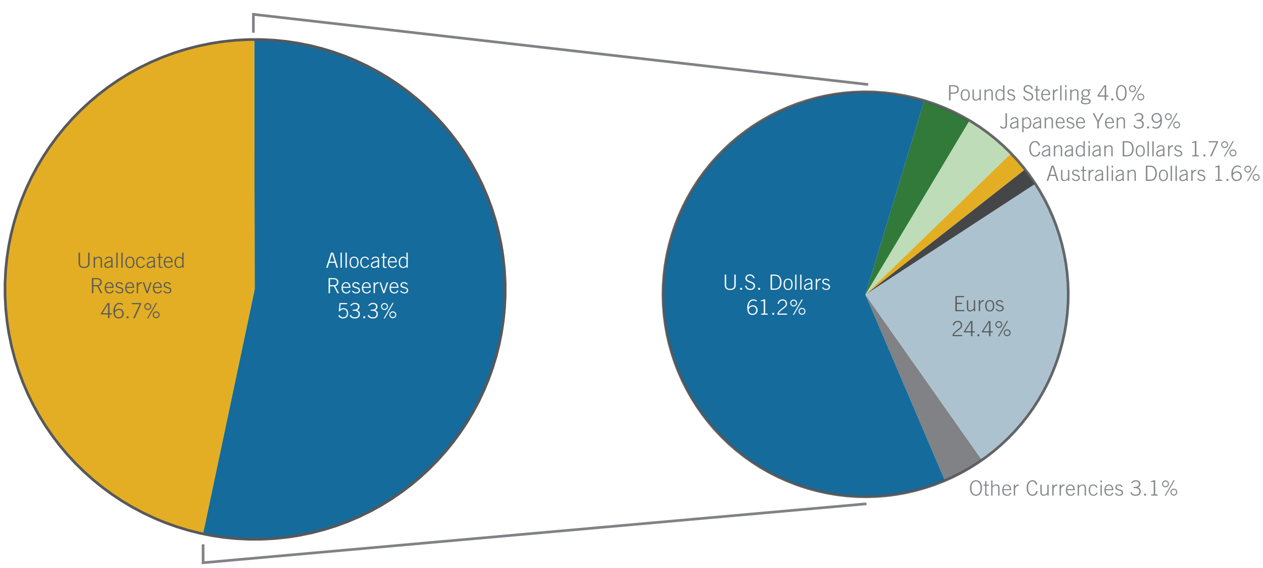
BE: I have been surprised by the strength of the dollar's safe-haven effect. International investors value stability, including financial stability, and the United States was not exactly a paragon of financial stability in the 2008-2009 time frame. What we learned is that in a crisis, international investors attach even higher value to liquidity. Given that the market in U.S. Treasuries is the single most liquid market in the world, that's where they fled.

OUTLOOK: How is U.S. monetary policy affecting the dollar in the global economy?

BE: First, it's important to separate weekly or monthly fluctuations in the value of the dollar on foreign exchange markets – which is not something that economists' models have much success in predicting, or even explaining – from the broader question: *Is the Fed doing anything to undermine the dollar's international role over time?* My answer to this broader question is: no, it is not.

With regard to Fed policy, we hear widespread warnings about inflation. If high inflation did, in fact, materialize, that clearly would be bad news for the dollar. No one wants to hold the currency of a country about to experience high inflation. But inflation is not an issue at the moment. In fact, the problem

WORLD FOREIGN EXCHANGE RESERVES 2013



Source: International Monetary Fund

For the dollar to remain the leading international currency, the U.S. has to grow its economic platform. If we don't grow, the U.S. will become a progressively smaller share of the global economy.

right now is, if anything, too little inflation. And, looking to the future, the Fed is already thinking about how to smoothly exit from its low interest rate policies if and when higher inflation materializes.

More broadly, the Fed and U.S. policymakers are clearly more concerned than before the crisis with financial stability, which I regard as a positive for the dollar. Were we to again become what we were in 2008 – the country at the center of a financial crisis – where nobody knows which assets are going to be liquid and which ones are going to hold their value, investors are not going to be attracted to our currency.

My view is that the Fed is serious about financial stability. It is paying closer attention to the risks than prior to 2008. U.S. officials have made progress in holding the banks to higher capital standards, and they have indicated that they will mandate even higher capital requirements for large, systemically significant banks. Their approach to tapering is focused on supporting stability and economic growth while returning as soon as possible to a normal monetary policy. These policies are not consciously designed to support the dollar's international role, but they have that effect.

OUTLOOK: What will Fed Chair Janet Yellen's approach be to the dollar in the global marketplace?

BE: It's going to be a balancing act – a focus on financial stability, on price stability and also on economic growth, the last of which will also be important in shaping the dollar's role going forward. For the dollar to remain the leading international currency, the U.S. has to grow its economic platform. If we don't grow, the U.S. will become a progressively smaller share of the global economy and the dollar can't play the same international role.

Take the case of the Swiss franc. While the franc is an international currency, people certainly don't talk about it in the same breath as the dollar. Why is no mystery. Switzerland is too small and the number of francs in circulation is too small relative to the world economy to make a much of a difference.

I think Yellen will pursue price stability, financial stability and economic growth. Her challenge will be to hit three birds with one stone.

OUTLOOK: Many agricultural producers are involved in export markets and are directly affected by foreign exchange rates. What do you expect to see over the next five years with respect to specific currencies?

BE: If the U.S. grows strongly, relative to its potential, the Fed will be quicker to raise rates and that will be a positive for the dollar. If the Eurozone grows strongly relative to its potential – and its potential growth is lower because of its less favorable demographics – then the European Central Bank will be quicker to raise rates, which will be a positive for the euro. My forecast for the euro/dollar exchange rate is heavily dependent on one's forecast for U.S. and Eurozone growth.

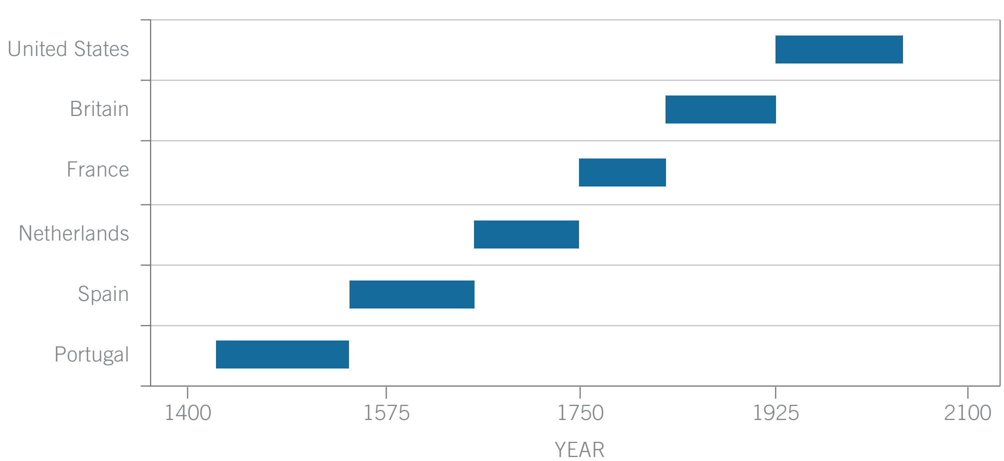
The renminbi is the wild card. Sustained growth in China in the 6 to 7 percent range will mean continued appreciation of the renminbi against the dollar. But a sharp growth slowdown or crisis in the shadow banking system there would mean the opposite. And there is no telling what will unfold in China in the next five years.

The one sure bet is that the dollar will strengthen further against the yen. The Bank of Japan will have to double down on its expansionary policies to succeed in ending Japanese deflation.

OUTLOOK: Over the past few years, it was suggested that the dollar's status as the global reserve currency was in question. Why?

BE: It goes to the peculiar disjuncture between the size and weight of the U.S. in the world economy and the weight of the U.S. dollar in international finance.

GLOBAL RESERVE CURRENCY STATUS FROM 1400 TO PRESENT



Source: JP Morgan

The pre-eminent status of the dollar isn't going to change in the short-term, but, that said, its future isn't assured either. Challenges to the dollar can come from two places, from abroad and from the U.S. itself.

In terms of output of goods and services, the U.S. is only a quarter of the world economy. But in terms of the weight in financial markets, for many decades, deep and liquid financial markets open to the rest of the world only existed in the U.S. Many people were uncomfortable about this disproportion and wondered whether it was sustainable.

Secondly, there were individuals who thought this situation was somehow unfair. Charles de Gaulle and his Finance Minister, Valerie Giscard d'Estaing, referred to benefits garnered by the U.S. for having the preeminent international currency as exorbitant privilege, "exorbitant," of course, being an unflattering characterization. The implication was that if it was unfair, it wasn't going to last forever. In some circles, that sentiment persists.

There was also skepticism and suspicion of U.S. economic policies. When the U.S. experienced relatively high inflation in the 1970s, it was sensible to predict that investors in other countries would intensify their search for alternatives to dollar reserves. However, that high inflation came to an end after Paul Volcker became chair of the Fed. And it turned out that there were no attractive alternatives to the dollar on offer.

OUTLOOK: What is the dollar's current status in the global economy?

BE: The pre-eminent status of the dollar isn't going to change in the short-term, but, that said, its future isn't assured either. Challenges to the dollar can come from two places, from abroad and from the U.S. itself.

Domestically, were we to have another deadlock over the debt ceiling and experience a technical default on our debt – if the government had to prioritize treasury payments and, in the worst case, not pay the bond holders – that would certainly encourage foreign governments and commercial banks to look for alternatives. We are entirely capable of shooting ourselves in the foot.

Internationally, if other potential suppliers of international currencies – primarily Europe and China – restore and maintain economic and financial stability, and build deep and liquid financial markets, holding euros or Chinese renminbi will become more attractive. That wouldn't automatically spell the demise of the dollar as an international unit, but it would mean that alternatives would exist; there would be rivals. The dollar wouldn't have the monopoly in the international sphere that it enjoyed in the second half of the 20th century.

OUTLOOK: What advantages does the dollar's status as the global reserve currency provide to the U.S. economy?

BE: I think the dollar's unique status does give us significant advantages. For one, it's an automatic form of insurance against financial disasters. When something bad happens financially, people rush into dollars rather than out of them, and that behavior tends to stabilize U.S. financial markets. We reaped returns on that insurance when the sub-prime crisis hit in 2007 and the dollar strengthened. And, again, when Lehman Brothers declared bankruptcy in 2008, investors rushed into dollars, causing the currency to strengthen at a convenient time.

In normal, non-crisis times, the fact that there is this additional source of demand for U.S. Treasury bonds from foreign central banks, sovereign wealth funds and others means that the U.S. government can borrow at a lower cost to the U.S. taxpayer. Making it easy for the government to borrow can be a mixed blessing, but the dollar's exorbitant privilege means that our debt servicing costs are lower than they would be otherwise.

And finally, the dollar's status as international unit of account and means of payment is a source of convenience and competitiveness for U.S. banks and firms, which can do cross-border business in their own currency. They don't have to worry about changing money and converting prices, which are already expressed in dollars. Their own local banks can conduct transactions for them; they don't have to line up a foreign bank to help.

OUTLOOK: The growth of the Chinese economy – the world's second largest – has fueled discussion that the Chinese renminbi may eventually take the dollar's place as the primary global reserve currency. What are your thoughts?

BE: At some point the renminbi is going to play a much more important international role. While I do not believe the renminbi will dominate the dollar in international markets in our lifetime, we may live long enough to see the Chinese economy overtake the U.S. economy in terms of sheer size. But economic growth is not enough by itself for a country's money to become an international currency. This requires also developing deep and liquid financial markets and strengthening contract enforcement and rule of law, which China still needs to do.

> There will have to be significant changes in China's political environment and system before the renminbi will begin to rival the dollar. China will have to strengthen its rule of law and political accountability and make its central bank independent.

The United States has an independent central bank. The People's Bank of China, in contrast, is not independent. It takes its marching orders from the Central Committee. Until that changes, people are going to wonder about the conduct of Chinese monetary policy and the motives of its makers. As a result, they will have hesitations about holding China's currency.

When I go to China, I often observe that every reserve currency in history has been the currency of a political democracy or a republic. Admittedly, the sample of such currencies is small, but it points to the fact that foreigners want to see political checks and balances, and limits on arbitrary action by the government before they are willing to put many eggs in the renminbi basket.

Does this mean China has to become a democracy in order for the renminbi to become a consequential international currency? Maybe not. But China will have to strengthen rule of law and political accountability. It will have to make its central bank independent. There will have to be significant changes in China's political environment and system before the renminbi will begin to rival the dollar.

OUTLOOK: The renminbi is closely controlled by the Chinese government. Do you see them taking steps to participate in more liberal trading of their currency?

BE: In order to make their currency attractive to international investors, the Chinese authorities have to build deeper and more liquid financial markets. They have to open those markets to foreign central banks and foreign investors. They have to create confidence in the stability, reliability and transparency of those markets. Those are challenging tasks.

They are making very significant progress in terms of developing those markets and gradually opening them to the rest of the world. But there are also those other questions related to confidence in rule of law and the Chinese political environment.

There's another important consideration, which is a point of disagreement among many economists – *Should you complete the process of developing world-class financial markets before you open them to the rest of the world? Or, should you open them sooner rather than later, as a way of introducing world-class technology and foreign competition?*

Sometimes I worry that China has adopted a risky strategy in which they're moving too quickly in terms of opening their markets to the rest of the world while allowing the financial development side to lag behind.

OUTLOOK: How are other currencies – the euro, the pound, and the yen – doing in the global economy?

BE: The pound and the yen are the currencies of countries that are too small to make much of a difference. Japan has a declining population and labor force, and the country doesn't welcome immigration. So the yen is a shrinking country with a currency that even now accounts for only 3 or 4 percent of global foreign exchange reserves. It's not going to make much of a difference globally.

Over the next decade or so, the only economy that can make much of a difference is the Eurozone. However, Europe needs to start growing again. International investors need to be reassured about the stability of the region's banks. In any case, European financial markets leave much to be desired in terms of liquidity. There isn't much trading in their bond and bill markets by U.S. standards because the European system is still so heavily bank-based.

The Europeans do have the scale – in terms of output of goods and services, the Eurozone is about the same size as the United States. Its financial markets are relatively well developed. But the single currency's unresolved crisis remains an issue. I also question the ability of the EU to create fixes in a reasonably short amount of time. It will take time for Europe to definitely draw a line under its crisis and for the euro to gain significant ground as an international currency

Looking further ahead – 30 years or so – I think we'll be talking about the appearance of the Indian rupee and the Brazilian real on the global stage. India and Brazil are big economies with favorable demographics that are capable of growing by at least mid-single digit rates. They have relatively well-regulated financial markets that will develop further. But that's a story for the mid-21st century, not for today.

OUTLOOK: How does the continuing increase in U.S. debt play into the global reserve currency discussion?

BE: U.S. debt dynamics are relatively benign for the moment. The federal government's debt-to-GDP ratio, not the absolute amount of debt, is what matters, and the debt-to-GDP ratio is on a path to stabilize at around 75 percent, or slightly higher, according to the Congressional Budget Office. Seventy-five percent is high, but it is not going to undermine confidence in the dollar.

Certainly, there are things to think about and monitor going forward – such as the deficit widening because of political problems or exploding health care costs that none of us can anticipate. But I think the markets are reassured by these credible non-partisan projections of the debt-to-GDP ratio, which is reflected in what remain record low 10-year U.S. Treasury yields. I worry about lots of economic and financial issues, but not about the debt-to-GDP ratio at the moment.

OUTLOOK: The U.S. has implemented some economic sanctions to penalize Russia for its aggression in Ukraine. In response, Russia has threatened to abandon the dollar. How could this affect the dollar and the global economy? Is it likely to happen?

BE: Serious conflict with Russia would be quite disruptive to the global economy. Russia is a consequential supplier of energy to Western Europe. But at the same time, there are more Russian financial assets in the West for us to freeze than there are U.S financial assets for them to sell.

Russia is a small economy in terms of output with a declining population and labor force. And, it relies on a commodity, energy, which we have recently discovered how to extract by fracking. For all these reasons, I don't see them as being in a position to issue credible financial threats. But no one should welcome the idea of economic and financial conflict between Russia and the rest of the world. That wouldn't do anyone any good.

Interest Rates and Economic Indicators

The interest rate and economic data on this page were updated as of 3/31/14. They are intended to provide rate or cost indications only and are for notional amounts in excess of $5 million except for forward fixed rates.

KEY ECONOMIC INDICATORS

Gross Domestic Product (GDP) measures the change in total output of the U.S. economy. The Consumer Price Index (CPI) is a measure of consumer inflation. The federal funds rate is the rate charged by banks to one another on overnight funds. The target federal funds rate is set by the Federal Reserve as one of the tools of monetary policy. The interest rate on the 10-year U.S. Treasury Note is considered a reflection of the market's view of longer-term macroeconomic performance; the 2-year projection provides a view of more near-term economic performance.

ECONOMIC AND INTEREST RATE PROJECTIONS

Source: Insight Economics, LLC and Blue Chip Economic Indicators

				US Treasury Securities	
2014	**GDP**	**CPI**	**Funds**	**2-year**	**10-year**
Q1	1.90%	1.90%	0.07%	0.42%	2.72%
Q2	2.80%	1.90%	0.08%	0.49%	3.05%
Q3	3.00%	2.20%	0.10%	0.65%	3.21%
Q4	3.10%	2.00%	0.13%	0.82%	3.36%
2015	**GDP**	**CPI**	**Funds**	**2-year**	**10-year**
Q1	3.00%	2.10%	0.21%	0.98%	3.48%

PROJECTIONS OF FUTURE INTEREST RATES

The table below reflects current market expectations about interest rates at given points in the future. Implied forward rates are the most commonly used measure of the outlook for interest rates. The forward rates listed are derived from the current interest rate curve using a mathematical formula to project future interest rate levels.

IMPLIED FORWARD SWAP RATES

Years Forward	3-month LIBOR	1-year Swap	3-year Swap	5-year Swap	7-year Swap	10-year Swap
Today	0.23%	0.27%	1.00%	1.82%	2.38%	2.88%
0.25	0.25%	0.33%	1.20%	1.98%	2.52%	2.98%
0.50	0.27%	0.44%	1.40%	2.16%	2.65%	3.09%
0.75	0.33%	0.61%	1.62%	2.34%	2.80%	3.20%
1.00	0.47%	0.83%	1.85%	2.53%	2.94%	3.31%
1.50	0.94%	1.37%	2.29%	2.87%	3.21%	3.52%
2.00	1.50%	1.94%	2.71%	3.18%	3.42%	3.70%
2.50	2.03%	2.37%	3.03%	3.41%	3.61%	3.83%
3.00	2.56%	2.81%	3.34%	3.63%	3.81%	3.97%
4.00	3.14%	3.42%	3.76%	3.93%	4.05%	4.15%
5.00	3.58%	3.82%	4.01%	4.13%	4.21%	4.27%

HEDGING THE COST OF FUTURE LOANS

A forward fixed rate is a fixed loan rate on a specified balance that can be drawn on or before a predetermined future date. The table below lists the additional cost incurred today to fix a loan at a future date.

FORWARD FIXED RATES

Cost of Forward Funds

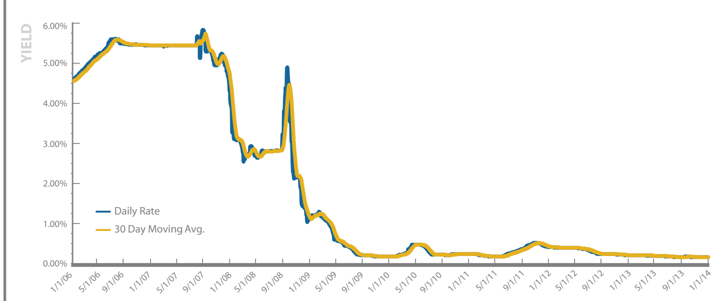
Forward Period (Days)	Average Life of Loan			
	2-yr	3-yr	5-yr	10-yr
30	8	9	8	6
90	21	22	21	14
180	38	42	40	27
365	91	87	81	53

Costs are stated in basis points per year.

SHORT-TERM INTEREST RATES

This graph depicts the recent history of the cost to fund floating rate loans. Three-month LIBOR is the most commonly used index for short-term financing.

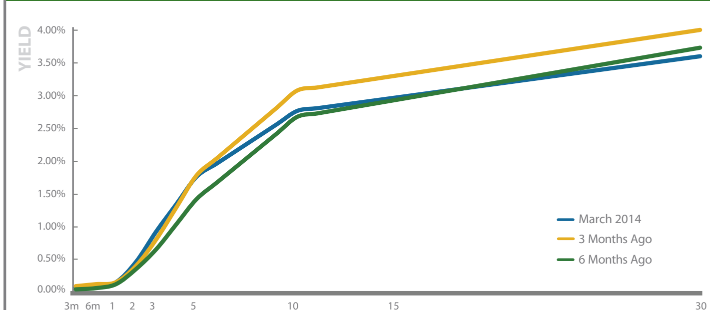
3-MONTH LIBOR



RELATION OF INTEREST RATE TO MATURITY

The yield curve is the relation between the cost of borrowing and the time to maturity of debt for a given borrower in a given currency. Typically, interest rates on long-term securities are higher than rates on short-term securities. Long-term securities generally require a risk premium for inflation uncertainty, for liquidity, and for potential default risk.

TREASURY YIELD CURVE



CoBank Invests in New $150 Million Rural Economic Development Fund

CoBank recently announced that it is a founding investor in a new fund that will promote job growth and economic development through equity investments in rural businesses.

U.S. Secretary of Agriculture Tom Vilsack unveiled the $150 million fund at a press conference in Iowa earlier this month. Formed under the U.S. Department of Agriculture's Rural Business Investment Program, the fund will focus on investments that help rural communities and industries, with an emphasis on supporting businesses involved in production agriculture, processing and marketing of agricultural products, farm supply, input suppliers and rural infrastructure providers.

"This new fund will allow innovative small businesses throughout rural America to access the capital they need to grow and create jobs," Vilsack said. "One of USDA's top priorities is to help reenergize the rural economy, and we now have a powerful new tool available to help achieve that goal. This new partnership will allow us to facilitate private investment in businesses working in bio-manufacturing, advanced energy production, local and regional food systems, improved farming technologies and other cutting-edge fields."

CoBank has committed to invest $20 million in the fund. Seven other Farm Credit institutions are contributing the balance, including AgStar Financial Services (Mankato, Minn.), AgriBank (St. Paul, Minn.), Capital Farm Credit (Bryan, Texas), Farm Credit Bank of Texas (Austin, Texas), Farm Credit Services of America (Omaha, Neb.), Farm Credit Mid-America (Louisville, Ky.) and United Farm Credit (Willmar, Minn.)

"We're enormously proud to serve as a founding investor in this important new venture," said Robert B. Engel, CoBank's chief executive officer. "The Farm Credit System is an essential provider of credit to agriculture and rural America. However, it's critical that rural businesses have access to equity forms of capital as well, which is why the Rural Business Investment Program was created. We see this fund as another way that CoBank can fulfill its mission and support the continued development of the U.S. rural economy."

About CoBank

CoBank is a $98 billion cooperative bank serving vital industries across rural America. The bank provides loans, leases, export financing and other financial services to agribusinesses and rural power, water and communications providers in all 50 states. The bank also provides wholesale loans and other financial services to affiliated Farm Credit associations serving farmers, ranchers and other rural borrowers in 23 states around the country.

CoBank is a member of the Farm Credit System, a nationwide network of banks and retail lending associations chartered to support the borrowing needs of U.S. agriculture and the nation's rural economy.

Headquartered outside Denver, Colorado, CoBank serves customers from regional banking centers across the U.S. and also maintains an international representative office in Singapore.

For more information about CoBank, visit the bank's web site at www.cobank.com.

Advantage Capital Partners, a leading growth capital and small business finance firm, will serve as general partner of the fund. Based in New Orleans and with offices throughout the U.S., Advantage Capital has invested more than $1.6 billion since 1992. The firm invests in small businesses across a wide range of industries that are located in geographic areas underserved by traditional sources of capital.

USDA has conditionally licensed the new fund. Final approval is pending based primarily on execution of formation documents and investor capital commitments.