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The International Monetary System: Time for a Change?

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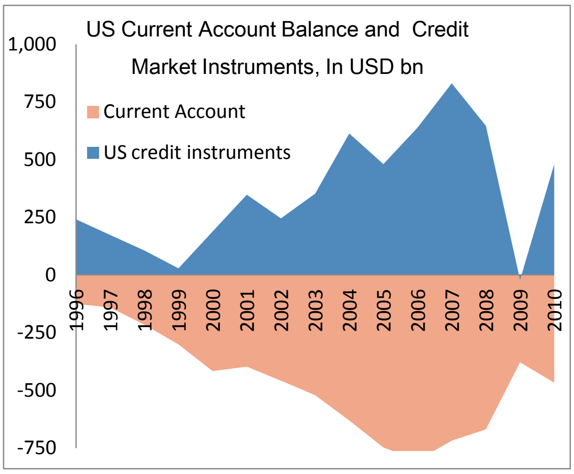
The debates regarding the weakness of the international monetary system (IMS) have often surfaced following financial stresses in the global economy. The latest episode took place following the 2008 global financial crisis; it questioned the desirability of the current IMS that relies heavily on the US dollar (USD). The debate was particularly acute as the financial crisis originated from the United States, traditionally a reliable economy and the issuer of the currency the rest of the world uses to settle a large portion of cross border transactions and holds as a store of value.

The convenience of using the USD comes with a price tag. Under the current IMS, US monetary conditions are imposed on everyone else that do not necessarily share cyclical shocks. Choi and Lee (2010), for example, found a significant pass-through of the global monetary policy stance (mainly the US) on 20 Asian countries for 1980-2008. In particular, to the extent that emerging markets (EMs) fix the value of their currency to the USD—often an optimal policy response from individual country's perspective—the IMS has facilitated bouts of global imbalances. Moreover, it also exposes countries with non-convertible currency to foreign exchange crisis risks in times of USD market tightening such as was the case during the 2008 crisis.

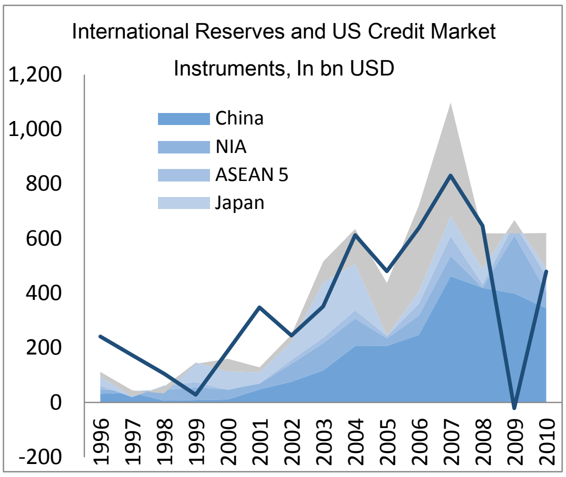
For the United States, it is a mixed blessing. On the positive side, it has benefitted from a sizable seigniorage. Demand for the USD as "store of value" and for "precautionary motive" surged during the 2000s, partly in response to the Asian financial crisis, creating a huge base for actual and potential seigniorage. On the negative side, the increase in international reserves under fixed exchange rates by emerging economies, as noted above, exposed the US to reverse spillover of its own policies. US expansionary monetary policy contributed to growing current account deficit and thus capital outflows, which in turn was invested in US assets by surplus countries, facilitating global imbalance.

Figure 1



Sources: World Economic Outlook, IMF, and Flow of Fund, US Fed.

Figure 2



Sources: World Economic Outlook, IMF, and Flow of Fund, US Fed.

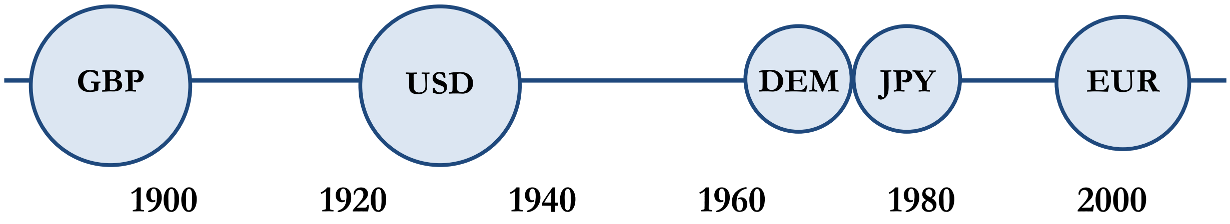
Too much focus on the global imbalance tends exert peer pressure on countries to target a certain level of current account balance that may not be optimal from its long-term equilibrium when taking into account individual country's aging profile. For example, an analysis by Lee et al (2013) based on demography alone shows that the United States should have had a current account surplus during most of the 2000s and a deficit during the 2010s while China should have had a current account deficit and a surplus during these two periods, respectively. The gap between the actual vs. the optimal long-term equilibrium may arise either due to savings or investment or both (e.g., Lee and Yang, 2013).

Demand for a Currency as a Reserve Currency

Despite the short comings of the current IMS, the US dollar is likely to remain as the main reserve currency for the foreseeable future. Ultimately, it will depend on the market, namely on the confidence that the currency can be converted into goods and services at minimum cost and short notice. This in turn requires that the governance that underpins the credibility of the government of the currency issuing country is sound and sustainable (equivalent to "superpower" in Mundell's (1997) argument where he notes that "the currency of a superpower would always play a central role in the international monetary system"), the currency has a deep and liquid market, and is supported by a financial infrastructure that enables easy conversion (e.g., clearing, storage, and settlement system). Moreover, the value of the currency has to be stable relative to the price of goods and services, i.e., inflation of the currency issuing country has to be durably low.

These economic aspects in turn are underpinned by the size of the economy including GDP, trade, and capital flows. Non-economic factors are often equally important and include military and political influence in global affairs. Political system also matter as it is key to the governance structure of any monetary system. A shift from one reserve currency to another could take place rather rapidly, triggered by global incidences such as war or major economic shocks. For example, the change from the pound to the dollar as the world's reserve currency took place relatively fast with the rise of the United States before World War II as the world's dominant political superpower, building on its economic size that overtook the UK about four decades earlier.

Figure 3



The current global political and economic prospects suggest that the market confidence on the US dollar will not likely wane anytime soon. The United States will remain as the dominant military and economic power over the next few decades; demand for US assets and their attractiveness as the most sought after "store of value" across the globe will remain strong. Moreover, the US dollar has a deep market with ample liquidity that provides convenience to traders.

Time for a Change to the IMS?

Nevertheless, the supremacy of the USD as the main global reserve currency is being challenged. The 2008 global financial crisis that undermined market confidence on the US financial market, unconventional monetary policy that is now being normalized, large public/private debt that has yet to be addressed, and the difficult fiscal outlook over the the next decade or two are some of the sources of the doubt. In parallel, the emergence of China as an economic power is affecting the currency landscape in Asia and beyond. For example, the RMB already has established the first trading center outside Asia in London. Total amount used for trade settlement amounted to USD 1.7 trillion at end 2013.

Despite these early successes, it is true that The RMB has its own share of challenges to overcome. In terms of daily turnover, the RMB still has a long way to go before becoming a meaningful player. Moreover, China's capital account is relatively closed (Lee 2012 and 2013), and the RMB does not have enough market liquidity to cater for large volumes of transactions of financial flows. The euro will not likely increase its influence in the global currency market either in the foreseeable future given existing economic challenges in Europe.

While the market will ultimately decide which currency it will use, one should not undermine the important role played by governments in shaping the framework of the market. With this in mind, governments should coordinate to set the rule to the best interest of all parties concerned. While history testifies that global coordination for a change in the IMS is hardly possible, as eloquently argued by Eichengreen (2013), progress has been made at the regional level, e.g., the Euro. This suggests that changes are possible and can be initiated at the regional level and in the direction that the market has already taken.

Table 1

Global Foreign Exchange Market Turnover

(% of average daily turnover in April of each year)

	1989	1992	1995	1998	2001	2004	2007	2010	2013
US dollar	90.0	82.0	83.0	86.8	89.8	88.0	85.6	84.8	87.0
euro	...	...	...	...	38.0	37.4	37.0	39.0	33.4
Deutsche mark[1]	27.0	40.0	37.0	30.0	...	...	...	...	...
ECU and other EMS currencies	4.0	12.0	15.0	17.0	...	...	...	...	...
Japanese yen	27.0	23.0	24.0	21.8	23.6	20.8	17.2	19.0	23.0
Pound sterling	15.0	14.0	10.0	11.0	13.0	16.4	14.8	12.8	11.8
Chinese yuan	0.0	0.0	0.0	0.0	0.0	0.1	0.5	0.9	2.2
other currencies	37.0	29.0	31.0	33.4	35.6	37.1	44.7	43.3	42.4
Total	200.0	200.0	200.0	200.0	200.0	200.0	200.0	200.0	200.0

Note: 1. Data for April 1989 exclude domestic trading involving the Deutsche mark in Germany.
Source: BIS, Triennial Central Bank Survey of Foreign Exchange and Derivatives Market Activity.

To address the global imbalance as well as to ride on the growing use of the RMB, Asian economies could agree on an arrangement that will enhance the use of a few key Asian currencies for trade (and services) settlements within the region. As argued by Lee and Park (2013), such an approach would not require opening the capital account prematurely nor waiting until the Asian bond market deepens sufficiently. It will also help promote the use of the RMB among Asian economies and beyond before capital account convertibility is attained.

The benefits of such a system are many. First, it will allow countries involved to reduce the share of the USD in their reserves to the extent that they will be able to finance their intra-Asia trade with their own currencies. Second, as countries start using their currencies directly for settlements, policy efforts will be directed toward reducing the volatility between bilateral exchange rates that hitherto used to be determined as cross exchange rates. Greater stability among Asian currencies in turn promotes intra-Asia trade and greater use of global value chain within Asia. Finally, it will also benefit the United States as these currencies collectively will become more flexible vis-à-vis the dollar, breaking the reverse spillover of its own monetary policy. The corollary is that this will also dampen monetary policy transmission from the US to the EMs.

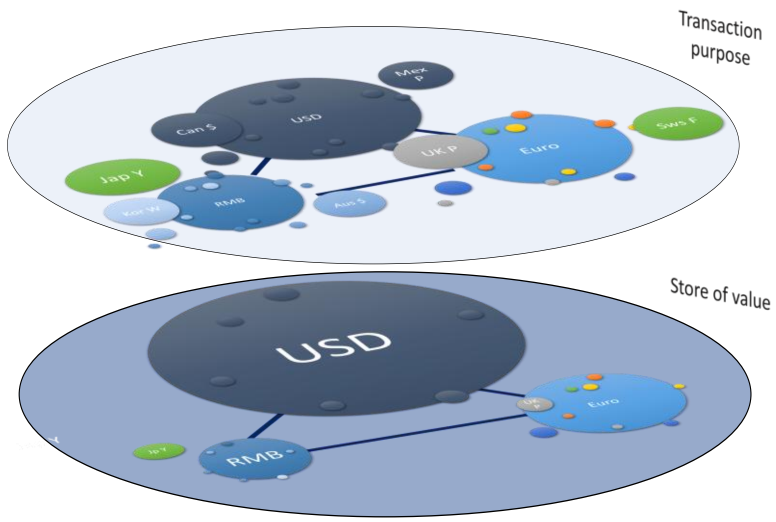
Possible Shape of a New IMS

An Asian currency arrangement can promote the use of the RMB along with a few other key Asian currencies for the settlement of regional cross border transactions of goods and services. The growth of the RMB use in Asia could also provide further impetus on its use beyond Asia. If this happens, then the global currency map could be shaped on a tri-polar currency cluster system. The US dollar, the euro, and the RMB will be the main trading currencies, with the British pound and the Japanese yen each playing a minor role at the global level. Other smaller currencies will play part at the regional level, but it is doubtful whether the market would use them significantly beyond their respective geographical region. Rather, smaller currencies will likely gravitate around one of these three major currencies.

While a single world currency would be a more efficient system, or at least a global unit of account such as the SDR, it is hardly feasible. Even if such an agreement were to be concluded, active promotion by governments would be required to move the market to use such a world currency—likely with no prevail. The tri-polar currency cluster system, on the other hand, will be something that the market will shape with only a limited support from governments once a currency arrangement is set up in Asia.

The system should be developed first to facilitate the use for "settlement" of trade and services, and then gradually expanded for financial flows. As store of value, it will be some time before the non-USD currencies in the tri-polar cluster can catch up to even partly replace the currently US dollar dominated assets. Even then, this hybrid system will be able to overcome current shortcomings, including global imbalance, without unduly disrupting the current order.

Figure 4



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