think piece

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The End of Dollar Dominance? Signs of Change in the International Financial System

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Summary

- The last decade has been one of marked change in both the world economic order and the financial system, primarily promoting the large emerging market economies. These trends have been rocked but not reversed by the global crisis, which centred on the "North Atlantic" developed nations.
- The rising powers have led a decade of massive expansion in trade, global industry and investment while their currencies and fast developing financial markets are starting to play an increasing role in global wealth and the international financial system.
- However, the international monetary system and related institutions continue to be dominated by the US and Europe, by the dollar and, to a lesser extent, the euro. This is a growing source of tension and also of instability in the system.
- Doubts about the dollar's ability to continue as the lynchpin of the global monetary system, together with difficulties managing the euro in tandem with the dollar, have coincided with the rising potential of other currencies to take a leading role, with the focus especially on the Chinese renminbi (RMB).
- Looking at the steps being taken by China, notably its policy goal of making the RMB fully convertible by 2020, if not before, there is a gathering impression that this decade will be one of significant transition for what will become the world's largest economy.
- Whatever eventually emerges as the new international monetary system, it will be shaped not just by the views, interests and requirements of the advanced economies, as it was in the past, but also by the rising powers of the developing world, which have good reason to feel that the existing world order was set up by the old powers with little reference to them.

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CII Introduction: various changes are emerging in the international financial arena which could challenge the West's dominance in for example the global monetary system. In this latest addition in our special series of thinkpieces on global themes, Vanessa Rossi of Chatham House explores these changes. Effectively tensions derive from the broader, long-term trends: the US dollar, the key reserve currency at the heart of the present system, has been struggling to cope with the growing and multiple demands arising from the rapid expansion of the world economy, financial markets and foreign exchange (FX) reserves.

While many see the dollar's status as a huge advantage for the US - the "exorbitant privilege" - it also imposes demands on US policy that are increasingly hard to satisfy as they encompass everything from meeting national priorities and tackling global imbalances to satisfying international monetary objectives. Change may be underway but this is likely to take the form of a gradual development over time, increasing the use of a multi-currency system, rather than a brutal demotion of the dollar. The rising powers of the developing world will be the primary beneficiaries of this inevitable but genteel decline of the old order.

Pressures on monetary system as world economy, trade and wealth expand

The US has coped for many years with the pressures, and sometimes conflicting policy requirements, imposed by its role as the issuer of the world's key reserve currency. By and large, US economic policy objectives, primarily steady GDP growth with moderate inflation, proved acceptable and compatible with maintaining international stability in the past. Even today, the dollar still represents some 60% of global FX reserves as well as serving as a safe haven, for example, in the financial storm of 2008-2009.

However, the last decade has seen repeated bouts of dollar weakness, responding to worries about the US's growing trade deficit but at the same time encouraging the portrayal of the dollar as a currency under threat. These episodes point to an inherent dilemma for the dollar: it cannot be used as a mechanism for adjusting trade balances without jeopardising confidence in its role as a store of value, thus putting its reserve currency status at risk. In late 2009, critics even suggested that the dollar might be on the brink of a dramatic demotion from its position as the world's reserve currency. Such predictions were wide of the mark partly because they ignore the other roles of a reserve currency (such as provision of liquidity) as well as the lack of a viable alternative to displace the dollar. But they have provided a wake up call, a catalyst for change.

What options are there? While the euro now accounts for almost 30% of FX reserve holdings, the ECB has no intention of strengthening its role as a global reserve currency, as the ECB's President Trichet stressed in an interview to the press as recently as November 2009. In fact, the dollar rebounded in early 2010, due to a weak European economy and the Greek debt crisis driving down the euro. However, even though Europe has taken some of the heat off the dollar in the short run, dollar-euro volatility only highlights just how inadequate a bi-polar monetary system based on these two key currencies would be for the task of maintaining a stable international monetary system, indeed it may even exacerbate instability rather than contain it. Growing the role of the euro therefore offers no solution to the dollar dilemma.

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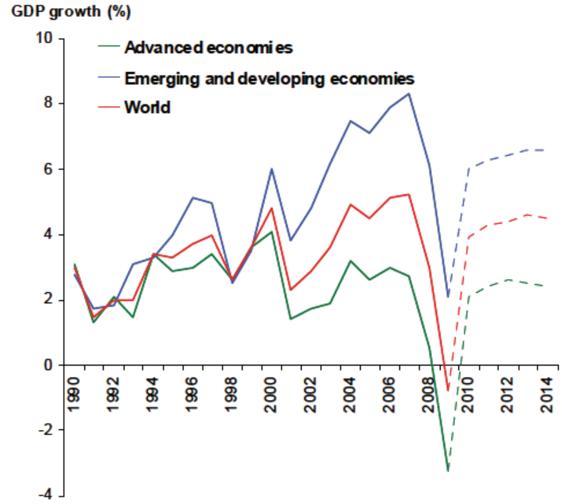
The answer can be found by returning to the fundamental question: why has stress in the international monetary system, on the dollar in particular, mounted over the last decade?

Increasing pressure derives from the sheer scale and impact of growth in global business and finance, affecting not only world trade and capital flows, the typical drivers of international demand for dollars to service transactions and manage liquidity, but also the requirements of the big emerging market economies. These newly important economies have tended to be far more intensive holders of FX reserves than would have been the case in the past, even allowing for the scale of countries being far greater than the original Asian tigers, and they are entering the global financial arena at a rapid rate.

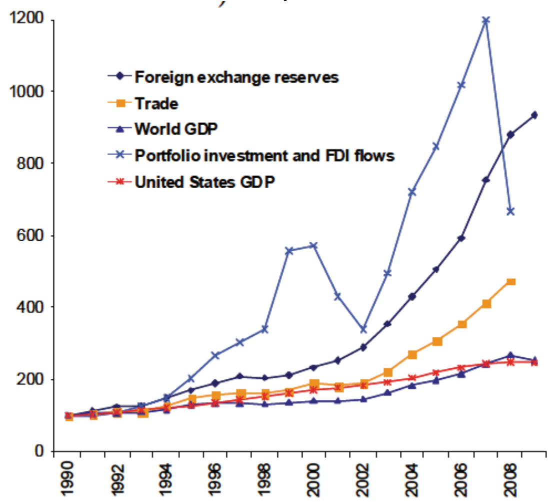
The scale of change is illustrated in Figure 2, which depicts the rapid rise in global financial flows and trade relative to world and US GDP. This is important as the implied international demand for US dollars (related to growth in international liquidity, transactions and investment) will also have risen rapidly and increased as a share of US GDP, putting strain on the US in the form of encouraging the rise in its trade deficit.

Figure 1: GDP growth still shows signs of decoupling



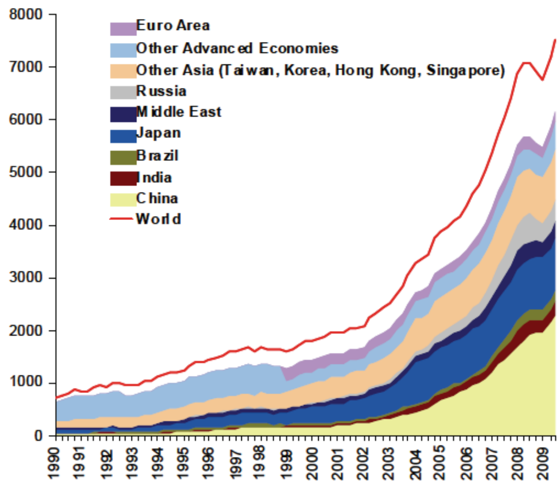
Source: calculations of IMF data

Figure 2: Expansion in world trade, foreign exchange reserves, capital flows outstrips rise in World and US GDP (all indices 1990 = 100)



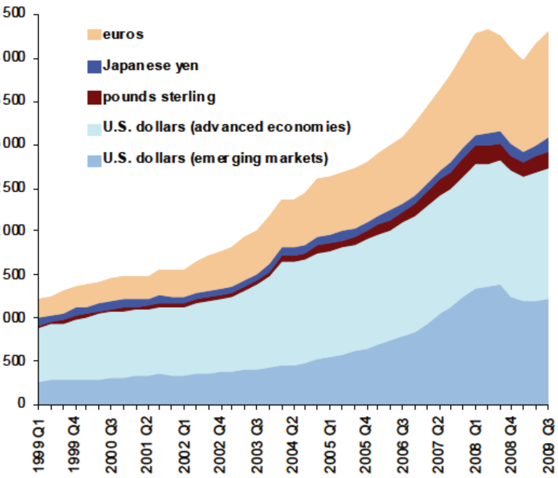
Source: calculations of IMF data

Figure 3: Holders of foreign exchange reserves ($ billions)



Source: IMF

Figure 4: Currency composition of known allocated reserves ($ billions)



Source: IMF

Although it is often argued that the build up of FX reserves is the consequence of pegging or managing exchange rates, effectively attempts to suppress revaluation against the dollar, this cannot fully explain the motives for many countries, often relatively poor, deliberately seeking to build up such substantial FX reserves (or Sovereign Wealth Funds, to take the alternative form of holding this national wealth) as a form of security measure – a safety buffer - and store of national wealth.

Building large FX reserves to protect the balance of payments was a form of insurance policy that was far preferable to […] limiting export dependence to avoid repercussions from global shocks and cycles.

An increasing appetite for FX holdings became particularly noticeable after the Asian crisis, which fed already growing dislike and distrust of the IMF and other forms of international intervention and control. Countries affected were keen to restore autonomy over economic affairs and building reserves undoubtedly appealed as a relatively simple way of ensuring they could remain autonomous even in the event of unexpected shocks and turbulence in the local or international economy. In fact, for countries keen to benefit from international trade and productivity growth, building large FX reserves to protect the balance of payments was a form of insurance policy that was far preferable to restricting the opening up to trade and limiting export dependence to avoid repercussions from global shocks and cycles.

This process was encouraged by the example of China's self-financing model of growth that successfully delivered both strong and steady economic growth. China's model compares favourably with the old textbook template for accelerating developing country growth through the use of capital inflows - which all too often proved dangerously unreliable, increasing instability in economies struggling to emerge. China has notably maintained autonomy over economic policy and relative stability in spite of the active pursuit of international trade and development of its financial markets. Provided domestic savings can be mobilised, the policy mix of “closed finance but open to trade” appears to work better for countries at this stage of development than “closed trade, open finance” or even “open trade, open finance” as it promotes the growth in productivity and world linkages that come from trade while avoiding the risk of instability and loss of control in financial flows. But it does depend on the initial ability and willingness of the population to save and postpone consumption in order to achieve the lift off into growth.

Ready access to a now large equity market (roughly in line with China’s GDP) together with a tradable currency will open up opportunities for international investors.

By now, China itself is preparing to move on to fully opening up both trade and capital accounts and floating the currency. While the bedrock should be strong enough to take the strain, change will nevertheless cause some sense of trepidation, and not only in China. There is scope here for yet another dramatic effect from China – this time from surging capital flows and the internationalisation of both China’s financial markets and its currency. Ready access to a now large equity market (roughly in line with China’s GDP) together with a tradable currency will open up opportunities for international investors. But there will also be capital outflows as Chinese investors diversify abroad.

Opening up of the capital account makes predictions for the future trend of China’s FX reserves hard to assess, however, over the next few years before this kicks in, annual increases in FX holdings are likely to remain in the $200-400 billion range.

Clearly, whatever the drivers, worldwide holdings of FX reserves (Figures 3 and 4) have shot up dramatically, from around $1 trillion in the early 1990s to $7.5 trillion by late 2009, and are still rising. This growth has served to make the holding countries feel more secure and less threatened by international intervention. Certainly many countries found reserves a useful safety buffer to take some of the strain of the capital flow turmoil that broke out when the world economy hit the skids in 2008-2009 (as shown in Table 1).

Ironically, at the same time as their holdings of dollar reserves have increased, many of the same countries have complained heartily about the US’s “exorbitant privilege” as the issuer of the key reserve currency. What changes could realistically be expected over the next decade? Are early signs of a shift away from the dollar towards a multi-currency system, as Beijing seems to favour, a harbinger of change to come?

Table 1: Change in foreign exchange reserves, July 2008-March 2009 ($ billions)

	Peak	Trough	Loss	(% loss)	*Latest*
Developing Asia (excl. China)	640	583	57	-8.9%	**660**
China	1,906	1,885	21	-1.1%	**2,328**
Latin America	513	464	49	-9.6%	**513**
Central and Eastern Europe	338	288	49	-14.6%	**349**
Russia	582	367	215	-37.0%	**414**

Source: IMF – IFS

Gradually moving towards a multi-currency system - evolution not revolution?

Periods of exchange rate turbulence have typically drawn attention to shortcomings in the international monetary system and criticism of the US and the role of the dollar. As seasoned commentators might say, haven’t we have been here before? The history of the monetary system is punctuated by attempts at reform, however, the world economy has recently undergone such rapid and radical change that this makes the arguments for change far more cogent.

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The speed and magnitude of the recent crisis – greater than all previous crises in the post-war years – have added to international tensions and highlighted shortfalls in the present dollar based system, even in terms of providing liquidity for trade and capital markets to function. For example, during the worst phase of the crisis, in late 2008 and early 2009, leading central banks had to rapidly respond with currency swaps to provide finance to countries running short of dollars. This eased tensions but only after energetic action not only by the US but increasingly by China as well (Table 2).

This participation by China together with moves such as the bilateral agreement with Brazil to settle trade in their own currencies rather than dollars and the expanding use of the RMB through Hong Kong all suggest that China and the other major emerging market economies are now big enough, financially sound enough and sufficiently prepared politically to take on a wider role in global finance.

Table 2: Currency swap lines, October 2008-March 2009 ($ bn)

USA		China		Japan		Total
Brazil	30	Belarus	2.9	Indonesia	10	
Mexico	30	Hong Kong	31.9	Korea	20	
Korea	30	Indonesia	14.6			
Singapore	30	Argentina	10.2			
		Malaysia	11.7			
		Korea	28.4			
Total	120		99.7		30	249.7

Source: Bloomberg, Reuters

This does not herald a dramatic exit for the dollar - the changes underway simply point to the gradual use of other currencies to settle transactions and manage financial affairs, side-stepping the need for a dominant reserve currency. Whereas the last decade has been one of sharply rising international demand for dollars – with all the complaints this has brought – the next decade could be one of weakening international demand for dollars, not because of a sudden loss of faith in the US and dollar or weakening growth in international activity but simply because the payments system itself is starting to shift away from the need for such a dominant reserve currency. This is partly due to confidence in the use of other units and bilateral settlements but may also be related to technological advances that make this shift easier to organise than was the case a decade ago. Of course, concern over the US may speed up the transition to a new order, but it would be wrong to think that this is the only reason for change to occur.

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What may be the deciding factors in establishing a broader range of reserve currencies? Not all currencies fulfil the criteria, meeting responsibilities as well as gaining privileges. To acquire reserve status, a currency should be backed by a strong economy with a sound financial system that includes a deep and liquid short-term debt market – these are technical requirements – but clearly it must also be able to command international confidence and respect, whatever this entails. It has to be trusted. In turn, a reserve country must be willing to supply liquidity to the rest of the world – expanding its money supply for the use of others as well as itself. This leads to reserve countries running balance of payments deficits: they must be able to withstand such a position without becoming unstable or reneging on the agreement to supply liquidity. These demands raise various tensions, such as we see today for the dollar. Sharing the burden could help.

Of the new currencies that could meet the criteria, clearly China is identified as the front runner – although it firstly needs to promote rapid growth in the RMB short term debt market in order to offer suitable investment vehicles for potential holders of its currency. Beijing also seems to favour a gradual shift to a multi-polar reserve system with a key role for China and, in any case, is pursuing the internationalisation of the RMB.

If it can perform the mechanical roles required, then a newly evolving multi-currency system will readily serve as a sustainable alternative to the dollar-dominated order.

Other currencies will also be able to develop a role provided they meet the criteria for acceptability, although scope for a large role will probably be limited compared with China. This implies that the medium term alternative to the US dominated system will be increasing reliance on a US-Europe-Asia tripod, with China quickly taking on a significant role along with Japan in Asia, and other major Asian economies, such as Korea and India, gradually raising their profiles. An alternative would be development of a synthetic Asian unit, which has been much discussed, although current difficulties in managing the Euro area may reduce enthusiasm for such a venture. And the more inclusive and neutral proposal would be to encourage use of the SDR, although it too would need formal mechanisms put in place in order to to develop. The great advantage of the gradual multi-currency option is that it can progress with little need for formal arrangements. Such organic development may be described as good money naturally replacing the bad.

However, the important question to address, whatever the precise formula for a new monetary system, is whether this change will be able to meet the need for international finance and stability or not. Resolving global macroeconomic problems and imbalances is a very complex task, and has to involve far more than exchange rate adjustment – this almost intractable debate cannot be allowed to stand in the way of a balanced and orderly international payments system.

Demands placed on this must be realistic and practical. If it can perform the mechanical roles required, chiefly supplying the liquidity necessary to facilitate international trade and investment while also offering globally recognised stores of value, then a newly evolving multi-currency system will readily serve as a sustainable alternative to the dollar dominated order – to paraphrase the famous quote from China's Chairman Deng, if it catches mice, then it will serve as a cat.

Chatham House and the ESRC World Economy and Finance Programme have just completed a joint project on the International Monetary System, the conclusions of which are detailed in a report launched on 17 March 2010.

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