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Currency uncertainties and the future of the IMS

The world has been living without an International Monetary System (IMS) since August 15, 1971 when U.S. President Richard Nixon terminated the convertibility of the U.S. Dollar into gold, thereby ending the Bretton Woods agreement.* Since that action – often referred to as the Nixon shock – was taken, the IMS lives under the reign of the Dollar as the U.S. economy remains the largest and the most dynamic. The last decade has been harsh on the U.S. economy however, as it dipped, in 2008, into its deepest recession since 1929. "The Great Recession" weakened the U.S. economy and its currency and opened the door to a multipolar monetary system based not only on the Dollar, but also on the Euro and the Yuan, as the combined Gross Domestic Product (GDP) of the European Monetary Union (EMU), the USA and China makes up 60 percent of global GDP.

Conditions for an international currency

The essential characteristics of domestic and international currencies are a medium of exchange, unit of account and store of value. To perform an international function, a currency must be available beyond its borders and should be fully convertible. For an international currency to be considered reserve, it should have a creditor status, issued by a large economy with a developed financial system and should be heavily used. Clearly, the U.S. Dollar fulfills these criteria, the Euro to a lesser extent and the Chinese currency not. The fact that Central Banks and private investors consider U.S. T-Bills as safe assets allows the U.S. to finance its current account deficit easily. Some call it "exorbitant privilege" or the ability to print money and receive goods and services in exchange. The current situation requires countries to have faith in the Dollar even as the Fed prints, which actually weakens it. This is known as the Triffin Paradox.

* The **Bretton Woods** agreement established the rules for commercial and financial relations among the world's major industrial states, intended to govern a post-second World War economy. The chief features of the Bretton Woods system, signed in July 1944 by 44 allied states, were an obligation for each country to adopt a monetary policy that maintained the exchange rate by tying its currency to the U.S. Dollar.

Economic foundations for the multipolar system

A currency cannot have the reserve quality if it is not based on a strong economy with a solid potential. The tables below show selected and relevant economic and financial data given and computed by international organizations such as the World Bank and the International Monetary Fund for 2011 (actual), 2012 and 2013 (estimated):

	2011	2012	2013
USA			
Real GDP Growth	1.7%	2.0%	2.3%
Current Account Balance (% of GDP)	-3.1	-3.1	-2.9
Budget Balance (% of GDP)	-9.0	-7.5	-6.0
Gross Public Debt (%of GDP)	102.8	106.7	110.7
EMU			
Real GDP Growth	1.6%	-0.6%	-0.4%
Current Account Balance (% of GDP)	0.1	0.9	1.4
Budget Balance (% of GDP)	-4.0	-3.3	-2.6
Gross Public Debt (% of GDP)	89	91.2	93.2
China			
Real GDP Growth	9.2%	8%	8.5%
Current Account Balance (% of GDP)	2.8	2.3	2.5
Budget Balance (% of GDP)	-1.2	-1.3	-1.0
Gross Public Debt (% of GDP)	25.8	22	19.4

Source: IMF, World Bank

Data from these tables demonstrate clearly that the Chinese economy is strongest and soon will become the largest, although indicators remain weak on per capita basis due to the size of the population. Chinese growth rates are now weakening as the society shifts towards consumerism (and less savings) and the West is urging consumption of its own products to combat recession. The USA and the EMU have different strengths and weaknesses but strong similarities in institutions, legal foundations and culture. As such, future economic competition will be broadly between them on the one hand and China on the other.

Future of the Dollar

The easy monetary policy of the Federal Reserve Board adopted since January 2001 contributed to the housing bubble, to the crisis and to a loss of confidence in the Dollar. The policy was possible due to savings inflow from the Gulf Cooperation Council (GCC) countries and Asia, especially China. The Dollar can probably keep its status as the prime reserve currency if the U.S. can stabilize its current account deficit to around 3% of GDP along with a low budget deficit and a higher savings rate. The U.S. financial policy should change towards a strong and stable Dollar that attracts investment and promotes growth.

Future of the Euro

The crisis in the Euro-zone is severe but Europeans are succeeding in getting their act together. If austerity measures continue however, voters are likely to revolt and political extremists could take over. Financial discipline and the implementation of the Maastricht criteria are needed but not at the expense of social and political stability. The Euro-zone is heterogeneous but can improve outcomes by increasing the common central budget so transfers happen easily in times of crisis. The Euro-zone should shift slowly into an Optimum Currency Area* as defined by Nobel Prize-winning economist Robert Mundell. The Euro could therefore improve its chances of becoming a real competitor to the Dollar as a reserve currency.

* A geographical region in which it would maximize economic efficiency to have the entire region share a single currency.

Future of the Yuan

China has witnessed an impressive growth in output and exports. The country is intervening in markets to prevent an appreciation of the Renminbi against the Dollar. It seems that Chinese leaders are not eager to transform the currency from a local or regional currency to an international reserve. China's lack of open, deep and broad financial markets means that its currency cannot as of yet play a reserve role. When leadership aims for that role, it should float the currency along with full convertibility which will raise its exchange value and lower exports. Is China ready for that transformation? There is no indication of that yet.

Future of the IMS

Quantitative easing is leading to currency competition among those adopting it. Left unchecked, it could lead to a crisis of instability. The IMF should play a crucial role of coordination among central banks and surveillance of the markets to avoid potential conflicts. The Dollar will remain the most important reserve currency with a secondary but growing role for the Euro. The Yuan is not a competitor yet. Fred Bergsten and Joseph Gagnon of the Peterson Institute for International Economics estimate that if currency intervention ceases, the U.S. trade deficit would decline by USD150 bn or 1 - 2 percent of GDP. Between 1 and 2 million jobs will be created. The Euro zone will gain significantly, but less.

Impact on MENA

The world economy undergoes a shift in the balance of power as Justin Yifu Lin and Mansoor Dailami of the World Bank expect that by 2025 six emerging economies – Brazil, China, India, Indonesia, South Korea and Russia – will collectively account for half of global growth. The Middle East North Africa region still relies heavily on oil, which is denominated in the Dollar. The region favors and benefits from a strong Dollar policy that will improve the standard of living for all. It is also safer for MENA to have, over time, an IMS based on three reserve currencies to diversify choice and lower risk. MENA should deepen its relationship with Europe and China to be prepared for the multipolar system whenever it happens.

by **Dr. Louis Hobeika**, economist

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Endnotes

1 C. Fred Bergsten and Joseph E. Gagnon, "Time for a Fight back in the Currency Wars," PIIE, 2012.

2 Justin Yifu Lin and Mansoor Dailami, "The Coming Multipolar World Economy: Is the Developed World Prepared?" The International Economy, Summer 2011, pp. 30-31.

3 Lanchard Olivier, David Romer, Michael Spence and Joseph Stiglitz, In the Wake of the Crisis, MIT Press, 2012.

4 Hale David and Lyric Hughes Hale, "What's Next?" Unconventional Wisdom on the Future of the World Economy, Yale, 2011.