China, the Eurozone and Global Reserve Currencies

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Introduction

Until recently, the U.S. Dollar was unquestioned in its position as global reserve currency. However, the financial crisis and relative Dollar weakness has put the Dollar position in question. Should there be an alternative to the current reserve currency system? A two-currency reserve system such as U.S. Dollar and Euro would potentially be even more unstable than the existing one, because of speculation moves in and out of the U.S. Dollar and the Euro depending on their return, increasing volatility. U.S. policymakers have started to realize that large external deficits, the dominance of the Dollar, and the large capital inflows that necessarily accompany deficits and currency dominance are no longer in the U.S. national interest. The U.S. has to consider initiatives put forward over the past year by China and others to begin a serious discussion of reforming the international monetary system.

This paper will examine four scenarios regarding the global currency regime of the future. It will focus on the U.S. Dollar decline as the Reserve Currency, on the Euro and its recent problems questioning its potential strength in a turbulent world, on the potential of the Renminbi to become a Reserve Currency, and on the future of the Super-Sovereign Reserve Currency, the IMF's Special Drawing Rights (SDRs).

2. Potential Currency Scenarios for China and the Eurozone

Each single scenario is a stylised simplification and even if there are probably more scenarios to consider because of the interrelation and combination between the variables used, this approach is very helpful to draw the main trend we will have to face in the future.

The U.S. and the global community have an interest in continued globalization and efficient international financial markets, and so neither has any interest in entirely eliminating the international role of the Dollar. The U.S. should consider practical changes in the current international monetary order. Despite its recent problems with Greece, the Euro based on a collective European economy as large as the United States' and with capital markets as extensive in most respects, is the most obvious candidate. The Euro already rivals the Dollar in some domains, such as currency holdings and private bond placements, and will become a full competitor whenever the Eurozone countries adopt a more integrated fiscal policy. The Chinese Renminbi is likely to acquire a significant international role once China allows it to be converted for financial as well as current account transactions and eases capital controls.

Scenario 1: The U.S. Dollar decline as the Reserve Currency

"The dollar may be our currency, but it's your problem", a phrase that John Connally, U.S. Treasury Secretary under President Nixon, used to a delegation of European visitors in 1971. John Connally statement still has a ring to it but the Dollar is gradually losing its status as the world's reserve currency. A reserve currency has to be stable to be effective, and for some time now, it has been clear that the U.S. Dollar is gradually losing the confidence of global markets (Chinn and Frankel 2008, Posen 2008, Duncan 2005).

Confidence in the health of the U.S. economy, and therefore the U.S. Dollar, could plunge because of continued large U.S. current-account deficits, an unstable banking sector, expansionist monetary policy and a Financial Regulation system that is lacking in credibility. In late March 2009, U.S. Treasury Secretary Timothy Geithner sent the Dollar tumbling when he said he was "actually quite open" (Bloomberg, 2009) to China's proposal for a greater role for SDRs. The U.S. Dollar lost 1.3% against the Euro within 10 minutes of Geithner's unexpected comment.

Chinn and Frankel (2007) claim that rankings of international currencies change only very slowly, but when they change they do so with a bang. Although the United States surpassed the United Kingdom in economic size very early (between 1860 and 1875 depending on estimates), the U.S. Dollar did not surpass the Pound as the major international currency until 1945.

The potential geopolitical implications of such a projected shift are immense. First, the U.S. would lose its privileged/seigniorage position- the ability to achieve permanently higher returns on foreign assets than the returns paid to foreigners who invest in the U.S.

The current economic crisis has revealed that the U.S. legal framework for the regulation of financial markets and institutions has been captured by Wall Street interests. Even given the dismal state of the legal framework, the actual performance of key regulators like the Federal Reserve and the Securities and Exchange Commission has been appalling, with astonishing examples of incompetence and regulatory capture (Buiter 2008, Eichengreen 2009, Markopolos 2010).

The U.S. Federal government has taken on massive additional contingent liabilities through its bail out/underwriting of the U.S. financial system. Together with the foreseeable increase in actual Federal government liabilities because of vastly increased future Federal deficits, this implies the need for a future private to public sector resource transfer that is most unlikely to be politically feasible without recourse to inflation. The only alternative is default on the Federal debt. There is little doubt that the Federal authorities will choose the inflation and currency depreciation route over the default route.

China has been keeping the U.S. afloat for the best part of a decade, buying up vast quantities of Treasury bills to fund America's enormous budget and trade deficits. At any point, China could seriously damage the world's largest economy – by refusing to lend more money, China could spark an instant run on the Dollar. The Chinese have not done that as it would harm their Dollar-based holdings given the interdependencies existing between the two economies (Cooper 2009).

China's influence on U.S. policy faces two big constraints. The U.S. Dollar's status as the world's reserve currency gives the U.S. huge flexibility that other countries with large deficits do not enjoy, much to the frustration of many Chinese officials. China's unwillingness to let its currency appreciate more also limits its leverage. Secondly, the Chinese-U.S. relationship in the past was dominated by lectures from Washington D.C. about China's undervalued currency and its closed financial markets. Over the last year the discussion has been about Chinese warnings on the risks of inflation in the U.S. economy and Dollar weakness (Halligan 2009).

There are four reasons why China might worry about a decline in the value of the Dollar that would depreciate the value of their Treasury bill holdings. First, the U.S. government is racking up huge debts in its efforts to climb out of recession and purge the financial system of toxic assets. Massive government debt is a sure-fire means to put downward pressure on a nation's currency value. Second, printing money is a means to relieve temporarily some of the debt problems. However, this always leads to an inflation problem in the long term, which again places a declining bias on a nation's monetary unit. Third, U.S. interest rates are at exceptionally low levels. This will reduce the attraction for international investors of holding U.S. Treasury bills, bonds and notes once the need for "safety" is deemed to be less pressing. Fourth, there are already signs that the "safety" effect may be waning. It appears that China is preparing to take a diversification and risk minimizing strategy by purchasing other assets such as gold (Waldmeir 2009).

A much cheaper Dollar will make the U.S. poorer, since Americans will pay higher prices for everything they buy from abroad – such as clothes, computers, cars, toys, food. It will make the U.S. military presence abroad more expensive, since the cost of contractors and local suppliers will escalate in Dollar terms. It will slow imports, removing competition that is essential to hold down the general price level in America, thereby making inflation more likely. It will send the wrong price signals for a country that prides itself on creating sophisticated, highly valuable products, for a low Dollar will encourage producers to compete on price more than quality. It will diminish the political influence and prestige that the U.S. has had while the Dollar has been dominant.

The U.S. has at least three assets that don't exist in the Eurozone countries. First, it prints the currency in which its liabilities are denominated, and can monetise further, if needs be. Second, it can depreciate its currency. Third, it offers significant and sought after capital market opportunities to its foreign creditors.

The poor quality of U.S assets that was suddenly revealed in 2007 led to the loss of credibility of its financial institutions in the 2008 crisis. Although arguments about the uniquely high quality of U.S. private assets have been tarnished, the basic idea of American exorbitant privilege is still

alive: the Dollar is the world's reserve currency, by virtue of U.S. size and history. The question then becomes whether the Dollar's unique role is eternal, or whether a sufficiently long record of deficits and depreciation could induce investors to turn elsewhere.

Sophisticated investors have also been exploiting America's interest rate to borrow cheaply in Dollars, switch these borrowings in currencies where returns are higher, then pocket the difference. This so-called "carry trade" has flooded foreign exchange markets with the U.S. currency. The reality is that U.S. "weak dollar" policy – its long-standing practice of allowing its currency to depreciate in order to lower the value of its foreign debts – amounts to the biggest currency manipulation in human history. At the same time, the U.S. has, for years, shamefully stalled on various rulings passed by the World Trade Organisation that show the U.S. to be breaching global trade rules (Halligan, 2010).

If the markets thought China would buy less Dollar-denominated debt going forward, the U.S. currency would weaken further, compounding China's loss. U.S. financial diplomacy has complacently relied on this for some time because China is in so deep it has no choice but to carry on buying U.S. debt. But China has become so worried about U.S. expansionary monetary policy that it is speaking out, despite the damage that does to the value of China's currency reserves. The U.S. Dollar is now being used as a "carry" currency. Currency traders are using low Federal Reserve rates to take out cheap U.S. Dollar loans, and then converting the money into currencies generating higher yields. "Carrying" credit in this way is currently the source of huge gains. No one knows the true scale, but the global economy has been flooded with cheap U.S. Dollars.

This presents serious global systemic danger. The U.S. Dollar is weighed down by Chinese divestment, and then suppressed further by carry-trading. Those who had borrowed in Dollars would owe more, while their Dollar-funded investments would be worth less. This "unwinding" could send financial shock around the globe.

Ten years on, the People's Bank of China (PBOC) has an extraordinary stock of U.S. Dollars, and one pressing question: "What to do out of them?" Increasing political tensions have given rise to fears that it might get rid of this huge bulk of securities and precipitate a Dollar crash. In August 2007 a Chinese official indeed reminded that Beijing was in a position to provoke a "mass depreciation" of the Dollar if it decided to do so (Accominotti 2009). China's authorities have shown few signs of attempting to weaken the Dollar. The reason for this seems straightforward. After all, China is the world's largest Dollar investor, and no one else would have less interest in seeing the value of the U.S. currency plummet. The People's Bank of China might be the promptest to support the Dollar, not least because it would suffer a huge capital loss in the event of Dollar depreciation.

Scenario 2: Euro and its recent problems questioning its potential strength in a turbulent world

Chinese and Russian concerns that the U.S. can flood the world with Dollars and finance rising budget deficits at little cost, enhancing the U.S. Dollar's global status and crowding out the borrowing efforts of other countries, echo earlier critiques from Europe. Since the 1960s, France has been a critic of U.S. alleged "exorbitant privilege" of international reserve asset power. One of the many reasons for the creation of the Euro was indeed to fulfil the Europeans' long-held wish to create a reserve asset that could counter the Dollar's global dominance. Today, large countries such as China and Russia could start to buy into the Euro on a grand scale instead of Dollar, or switch large quantities of the present reserves (Portes 2007 & 2008).

In its assessment of the first 10 years experience of EMU (Directorate General Economics and Finance 2008), the European Commission claimed a success. The European Central Bank successfully brought down interest rates and anchored inflation within the Eurozone to an average of just over 2 per cent. Externally, the Euro became increasingly important as a world currency in trade and financial services. It is now the second largest global reserve currency after the U.S. Dollar.

The introduction of the synthetic Euro in 1999 and then physically in 2002 was the most far-reaching change in the international monetary system since the changeover to floating exchange rates in the early 1970s. Where the Deutsche Mark and the Yen failed in the 1970s and 1980s, the Euro now appears to have succeeded, namely in challenging the U.S. Dollar as the undisputed leading international currency. The Euro has gained considerable clout as an international trade, investment, anchor and reserve currency over recent years and has firmly established itself as the second most important currency behind the U.S. Dollar. That is why, for the first time in many decades, there is serious debate about whether the U.S. Dollar will remain the premier international currency going forward (Galati and Wooldridge 2006).

It is revealing that, even in the midst of the worst financial crisis in 70 years, one widely and somewhat justifiably believed to have begun in the U.S. economy, the flight to safety of world savings was to U.S. Treasury bonds and not noticeably to the Euro currency. For the Eurozone to pose a serious challenge to the U.S. Dollar it needs to address some areas of weakness. European banking and financial supervision is still too largely under national control. There is no single market for government bonds (Galati and Wooldridge 2006). The Eurozone does not have effective representation at global level in fora such as the International Monetary Fund (Pisani-Ferry and Posen 2009). The Eurozone response to the 2008 emergency in the financial sector was slow and driven by national considerations. The de Larosiere report was adopted in 2009 and seen as an important contribution to providing a blueprint for the future global financial architecture. It takes several important steps forward, especially on its proposals for reform of the supervisory role in the European Union regulation. The Euro already has effectively displaced the Dollar as the key reserve currency of Europe. Eastern European countries, the Nordic countries and Switzerland hold most of their reserves in Euro. Russia is moving that way as well (ECB 2009).

During the financial crisis and Greek debt problems, the Euro came under pressure.
The Greek crisis has generated many misguided comments and reactions by journalists, financiers and policymakers. Greece is not bankrupt. Countries cannot be bankrupt; their governments can only default on their debts. In the absence of internationally recognised resolution mechanisms, government defaults open up a messy situation as governments negotiate with their creditors. There is no reason for the Greek government to default. It is not in its

interest and it can service its debt, whose size is half that of the Japanese government and the same order of magnitude as that of many other governments, including soon the UK and the U.S. Yet, markets can force the government to default if they refuse to refinance the parts of the debt that reach maturity. This is a pure case of self-fulfilling crisis.

There is no mechanism for transforming the Greek debt crisis into a Eurozone breakup. No country can be forced out and it is in no country's interest to leave. Had Greece not been part of the Eurozone, it would have long undergone major currency depreciation, like in Hungary in November 2008. The Euro protects Greece. A debt default by the Greek government, on its own, would be a non-event. Greece's GDP amounts to less than 3% of Eurozone's GDP. Contagion to Portugal, which is even smaller, would also be a non-event. Moving on to Spain and Italy is another matter (Münchau, 2010).

Contagion, already under way, could be destructive but would not destroy European Monetary Union. The contagion has brought the value of the Euro down – but this is mostly good news for the Eurozone as it is suffering from an overvalued exchange rate at a time of anaemic domestic demand. The real worry is the banking system. Some European banks hold part of the Greek debt and, if still saddled with unrecognised losses from the subprime crisis, some might go bankrupt. Many governments have simply not pushed their banks to straighten up their accounts, and they are now discovering some of the unforeseen consequences of supervisory forbearance.

This crisis is a proof that the Eurozone needs a more integrated decision making structure that would at the minimum coordinate fiscal policies and could intervene in such a situation. It is true that this arrangement would nicely complement the common currency but it is politically difficult. The Maastricht Treaty called for a sovereignty transfer in the area of monetary policy. A sovereignty transfer in the area of fiscal policy would not have been accepted by a large majority of citizens.

The solution to that “missing element” is the Stability and Growth Pact (SGP), which was intended to impose fiscal discipline on Eurozone members. The SGP has failed whenever a recession has hit Europe and it has failed to prevent the current situation because in each case it was perceived as a threat to sovereignty.

Greece’s problems are not only a result of the financial crisis. Greece has run unsustainable deficits for decades, finally turning to accounting chicanery. Greece has had do-little public sector jobs as buy-offs for social peace, too many jobs, and these wealth-transfer posts can’t be funded, now. The political counterweight for those jobs was a tax system which more or less allowed there significant domestic wealthy elite to live in a domestic tax haven, paying virtually nothing. All of this was possible while fraudulent ‘growth’ was happening due to the credit bubble making Greece’s sovereign debt fundable on capital markets without qualm—once it was Euro-denominated. Greece had financial crises in the recent past before the currency union. How the Euro develops as a reserve currency will depend on its handling of the Greek financial crisis and evolution of the Eurozone fiscal co-ordination especially the Stability and Growth Pact.

Scenario 3: Will the Renminbi become a Reserve Currency

Helmut Reisen, head of research at the development centre of the Organisation for Economic Co-operation and Development, says that using the last switch in reserve currency as a guide, the Renminbi can be expected to replace the Dollar as a reserve currency in about 2050. Reisen believes that, in purchasing power parity terms at least, the Chinese economy should surpass the U.S. economy in about six years’ time, while China is also well on its way to becoming the world’s largest exporter. “These historic parallels imply a switch in the reserve currency by the mid-21st century” (Reisen, 2009).

Although it would take substantial development and opening of China’s financial markets, the Renminbi could become an international currency within a decade and possibly one of the most important in 30 years. But it would be part of a system of multiple reserve currencies—one that would also include the Dollar, the Euro, the Yen, Pound, Swiss franc, and SDRs, and perhaps even gold as well.

The role of the Chinese currency in the global financial market can be defined and some conclusions on Chinese exchange rate policy can be drawn. First, the Chinese government favours prudential financial management. It has demonstrated a willingness to succumb to international pressure, but only on its terms, with the Chinese economy as its priority. Second, the Asian financial crisis exposed weaknesses in neighbouring economies and lessons learnt from that episode seem to have been implemented. Third, China's capital account is becoming more open over time in both de jure and de facto terms, with the easing of capital controls and the inexorable rise in cross-border financial flows. This exposes the economy to volatile capital flows—tighter exchange rate management is seen as essential to control this process. But exchange rate flexibility by itself will not lead to greater capital account openness, a common misconception. Fourth, China's economy is becoming a leading global player which has many similarities with Japan in the 1960s and 1970s, thus Japan's experience of market liberalization might provide a test case (Goldstein and Lardy 2009).

At this juncture, it is pertinent to answer some important questions, such as: what role will the Renminbi play in the global financial markets in the future? Will it ever become a reserve currency? To be eligible for reserve status, several prerequisites have to be fulfilled:

- The currency should be fully convertible and widely accepted;
- Its financial markets should be broad and liquid;
- Its value should be reasonably stable;
- Large amounts of trade should be transacted in it (Thimann 2009).

Beijing has already stated its intentions to have a convertible currency; assuming there are no deviations from its exchange rate policy, this is a point worth pondering (García-Herrero, and Koivu 2009). An ensuing concern is that although heavy-handed government meddling may be more effective than market-based tools to pull an economy out of a deep downturn, it comes at a cost. The Chinese monetary authorities have simultaneously been taking cautious steps to make their currency more internationally relevant. China signed a Renminbi 70bn currency swap deal with Argentina, designed to allow the Latin American nation to settle some trade bills in

Renminbi. China is staking out a responsible position whereby it seeks a multilateral alternative monitored by a multilateral body (The China Analyst 2009).

On 13 March 2009 China's Premier Wen Jiabao expressed concerns about the future of the U.S. Dollar, the currency in which most of his country's official reserves are denominated; his remarks provoked contrasting reactions among U.S. economists. Some, like Fred Bergsten (2009) of the Institute of International Economics, exhorted the U.S. government to take Mr. Wen's concerns seriously and listen to Beijing's suggestion to create a substitution account in the IMF, which would allow Fund members to exchange unwanted Dollar balances for SDRs, as part of a gradual process to replace the Dollar with a supra-national reserve currency over the long run.

In his New York Times column, Krugman (2009) argues that China has "driven itself into a Dollar trap and that it can neither get itself out nor change the policies that put it in that trap in the first place." Since any attempt by China or any other country to diversify away from the Dollar too much or too quickly would be self-defeating, there was no immediate threat to U.S. or world financial stability.

In the event of protracted Dollar depreciation, it is highly unlikely that the central banks of Europe, Japan, and the UK would stay put and let their currencies appreciate. More likely, these countries would resist appreciation by engaging in a process of competitive devaluations, the end result of which would be an increase in global inflation. Over the last three decades there have been five coordinated interventions in major currencies. In 1985 the G7 signed the Plaza Accord to weaken the Dollar. In 1987 the G7 changed stance at Louvre and pledged to support the falling Dollar. Similarly, in 1995 the G7 again decided to intervene to help the U.S. currency. In 1998 the U.S. and Japan sold Dollars to prop up the Yen. In 2000 the European Central Bank persuaded the Federal Reserve and the Banks of Japan, United Kingdom and Canada to support the Euro.

Four of these five interventions were ultimately successful in changing the trend of the currency markets. In 1985 the U.S. Dollar stopped overshooting against the Yen and Deutsche Mark. In 1995 the Dollar began a sustained rally that lasted throughout the late 1990s. In 1998 the "yen carry trade" reversed sharply to the benefit of Japan's currency and in the early 2000s the Euro rarely traded below the levels where the G7 central banks had intervened to support it.
The Louvre Accord is the one exception here. Though the G7 agreed in February 1987 to help the greenback, the Dollar continued to slide as the German Bundesbank increased interest rates in the summer.

China continues to raise questions about the dominance of the U.S. Dollar and the need for an alternative monetary system; other countries have also raised concerns about the Dollars viability. An eclipse of the Dollar would be mirrored by a rise in the use of the Renminbi (Garten 2009).

A country's exchange rate cannot be a concern for it alone, since it must also affect its trading partners. But this is particularly true for big economies. So, whether China likes it or not, it's heavily managed exchange rate regime is a legitimate concern of its trading partners. Its exports are now larger than those of any other country. The liberty of insignificance has vanished. Naturally, the Chinese resent the pressure. Wen Jiabao, the Chinese premier, has complained about demands for Beijing to allow its currency to appreciate. He protested that "some countries on the one hand want the Renminbi to appreciate, but on the other hand engage in brazen trade protectionism against China. This is unfair. Their measures are a restriction on China's development." The premier also repeated the traditional mantra: "We will maintain the stability of the Renminbi at a reasonable and balanced level." (Wolf 2009)

There are four obvious replies to Mr Wen. First, whatever the Chinese may feel, the degree of protectionism directed at their exports has been astonishingly small, given the depth of the recession. Second, the policy of keeping the exchange rate down is equivalent to an export subsidy and tariff, at a uniform rate – in other words, to protectionism. Third, having accumulated $2,273bn in foreign currency reserves by September 2009, China has kept its exchange rate down, to a degree unmatched in world economic history. Finally, China has, as a

result, distorted its own economy and that of the rest of the world. Its real exchange rate is, for example, no higher than in early 1998 and has depreciated by 12 per cent over the past seven months, even though China has the world's fastest-growing economy and largest current account surplus.

China's exchange rate regime and structural policies are, indeed, of concern to the world. So, too, are the policies of other significant powers. What would happen if the deficit countries did slash spending relative to incomes while their trading partners were determined to sustain their own excess of output over incomes and export the difference? Answer: a depression. What would happen if deficit countries sustained domestic demand with massive and open-ended fiscal deficits? Answer: a wave of fiscal crises.

Neither answer is acceptable; and co-operative adjustment is needed. Without it, protectionism in deficit countries is inevitable. An estimate by the Peterson Institute of International Economics that the Chinese currency is undervalued by 41 per cent against the Dollar was widely picked up in the U.S. adding to the popular view that China has a large and unfair advantage coming out of the crisis (Goldstein and Lardy 2009).

If China were to end its intervention, the Renminbi would appreciate substantially - likely in the region of 20-40 percent. China would also stop accumulating Dollars (and other foreign assets). The primary effect would therefore be an effective depreciation of the U.S. Dollar against the Chinese Renminbi -- and against all other countries' currencies that are implicitly pegged to the Renminbi (more precisely, to the Dollar rate with an eye on China's competitiveness). On a trade-weighted basis -- and in real effective terms (despite the fact that the currencies of other major trading partners float freely) -- the Dollar would also likely fall in value.
The Renminbi will continue to strengthen its role, but challenges for reserve currency status are likely to take ten years or more.

Scenario 4: Super-Sovereign Reserve Currency: A Nice Theoretical Debate

An alternative to a global monetary system that has been centered on the Dollar is now imperative. That means a multi-currency framework including the Euro, the Yen, the Renminbi and significant issuance of an IMF-backed currency called "special drawing rights". International assets have begun to show up in central bank reserve acquisitions as well as the Euro. First is the SDR. It was born at the end of the 1960s as a medicine prescribed too late for the rapidly deteriorating Bretton Woods patient. The SDRs issued in the early 1970s established their claim as an international reserve asset, but the quantities were far too small to matter. By the 1990s the unit had all but disappeared from the world monetary system (Eichengreen and Frankel, 1996).

The SDR accomplished a stunning return from the dead at the G-20 meeting in April 2009, when leaders decided not only to triple the size of the IMF but also to issue a new batch for the first time in years. Subsequently China suggested replacing the Dollar as international currency with the SDR. Without a major region or country using the SDR as its home currency it does not stand much chance of competing with the Euro or the Yen, let alone the Dollar. Nevertheless, it seems likely that the SDR will now rejoin the list of serious alternative assets in a multiple reserve currency system, especially if the IMF were to adopt "substitution account" proposals to allow members to swap unwanted Dollars for SDRs.

On 3 March 2009, the Governor of China's Central Bank called for a "Super-Sovereign Reserve Currency" that would be run by the (IMF) International Monetary Fund, an idea that has been backed by Russia, Brazil and India. Losing the global reserve currency status might be healthier for the global economy in the long run, but it would not be a very comfortable adjustment for the U.S. (Zhou, 2009).

The idea of the Super-Sovereign Reserve Currency would be to create a reserve currency that is disconnected from individual nations and is able to remain stable in the long run, thus removing the inherent deficiencies caused by using credit-based national currencies. This is a clear sign that China, as the largest holder of U.S. Dollar financial assets, is concerned about the potential inflationary risk of the U.S. Federal Reserve printing money (Eichengreen and Frankel 1996).

China has over-exposed itself to the U.S. Dollar-denominated securities. The U.S. puts domestic economic needs before its creditors; the Beijing authorities now worry that possible future inflation could cost them dearly. As the Bank of China's Governor says, a reserve super currency could be created through further issuance of the International Monetary Fund's Special Drawing Rights – the IMF's in-house reserve asset.

The value of SDRs is based on a basket of four currencies – the U.S. Dollar, Yen, Euro and Sterling – and they are used largely as a unit of account by the IMF and some other international organisations. But the SDR is unlikely to become a reserve currency any time soon. It would take years if not decades to develop SDR money markets that are liquid enough to be a reserve asset.

China's proposal would expand the basket of currencies forming the basis of SDR valuation to all major economies and set up a settlement system between SDRs and other currencies so they could be used in international trade and financial transactions. The People's Bank of China governor's proposal March 3, 2009 was China's way of making clear that it is worried that the Fed's response to the crisis—printing of money—will hurt the Dollar and hence the value of China's huge foreign reserves. The current international financial system, which is based on a single currency, has two main flaws. First, the reserve-currency status of the U.S. Dollar helped to create global imbalances. Second, the country that issues the reserve currency faces a trade-off between domestic and international stability. Massive money-printing by the Fed to support the economy makes sense from a national perspective, but it may harm the Dollar's value (Zhou, 2009).

Some specific steps are needed to improve the role of the SDR as a global reserve asset.
In order to make the SDR the principal reserve asset via allocation, close to $3 trillion in SDRs would need to be created. Wijnholds (2009) has thus suggested a so-called SDR Substitution Account. The idea is to permit countries whose official Dollar holdings are larger than they desire to convert Dollars into Special Drawing Rights. Conversion would occur outside the market and thus would not put downward pressure on the Dollar. This suggestion, however,

requires settling who will bear the exchange (Dollar) risk as the SDR Substitution Account is likely to mostly hold Dollars as assets.

The SDR is unlikely to be a practical alternative to the Dollar. In theory, countries can purchase liabilities issued by the International Monetary Fund that are linked to the SDR. If the objective is to diversify out of Dollars, reserve managers can achieve it more efficiently by directly increasing their holdings of Euro, Yen and Sterling (the other currencies to which the SDR is linked).

China has suggested the Renminbi be included in the SDR. While this may help other nations gain exposure to the Renminbi, China may need to accept a further increase in its own exposure to the Dollar. China's proposal would have members surrender part of their reserves to the Fund in exchange for SDRs, effectively making the IMF a global vault. The benefit here would be simply one of diversification—the IMF would have no enforcement authority in the management of global liquidity beyond its current one (Bergsten 2009). But how would that help China in its current problem? If everyone expects the Dollar to decline in value, reserve managers would only be willing to change their Dollars for SDRs, not their Euro holdings. This would drive the Dollar weaker in the same way it would if China went and sold Dollars for Euros outright in the Foreign Exchange market (Aiyar 2009*)*. Chinn and Frankel (2008) estimated that a similar tipping point could be reached between the Dollar and the Euro, with the Euro pulling ahead by 2022. This two-currency simulation should not be taken too literally. A possible successor to the era of unipolar dollar domination is a multiple reserve system like SDR.

Conclusions

Both the SDR plan and measures to internationalise the Renminbi seem to assume that China's problem is simply that too many of its reserves are in Dollars. But China's real problem is that it is running a persistent current-account surplus; in order to keep the Renminbi closely tied to the Dollar it has to keep buying more Dollar assets. If China really wants to reduce its exposure to the greenback it must allow the Renminbi to rise. It would incur a loss on its existing reserves but stem future losses. But so long as China maintains its current exchange-rate policy, it is, ironically, helping keep the Dollar dominant.

There are two reasons for the decline in the international role of the U.S. Dollar. The first is persistent current account deficits combined with a long-term decline in the Dollar's exchange rate – and perhaps imperial overreach, too. The second is the emergence of a genuine alternative to the Dollar. Neither the Yen nor the Deutsche Mark had a realistic chance of replacing the greenback. But the Euro is a real alternative. The Eurozone economy is almost as large as that of the U.S. and may surpass it as it continues to enlarge. London is the Eurozone's de facto financial centre, even though the UK itself has not adopted the Euro.

The projected speed at which the Dollar will lose its predominant position as a global reserve currency obviously depends on the U.S. Treasury fiscal policy. The reckless monetary policy of the Federal Reserve has speeded up the Dollar's decline and caused a rise in inflationary expectations. U.S. inflation could pick up significantly once the present recession ends. Future inflation will weigh heavily on the global role of the U.S. Dollar. Another factor that pushes in the same direction is the weakening of the U.S. financial sector.

Chinese leaders frequently emphasise the U.S. responsibilities for the stability of the Dollar as the premier reserve currency. The Chinese central bank, the guardian of the proceeds from Beijing's massive current account surpluses, warns obliquely that turning its back on the greenback would risk a monetary catastrophe. It is time, though, for a more balanced debate.

During the height of the crisis, the Dollar's volatility was comparable to that of Sterling and the Euro and lower than that of other advanced countries. Second, to the extent that a country's external obligations remain largely denominated in U.S. Dollars, the Dollar's volatility does no undermine the ability to cover $-denominated obligations.

Importantly, it is unclear whether the diversification benefit would be enough to make reserve managers willing to hold SDRs instead of Dollars (or Euros), unless the SDR takes a prominent role as unit of account or medium of exchange in global trade and financial transactions. The use of an SDR in international trade and finance would be painfully slow. Geographical, historic and cultural ties create inertia in the currencies chosen as units of account in international trade and finance.

China's huge volume of Dollar reserves is now at the centre of serious concerns about the future of the U.S. currency. The origin of this situation dates back to the early 2000s, after the Asian and Russian crises. At that time, accumulating foreign reserves was considered benign policy. Developing and emerging countries were encouraged in this way in order to insure against sudden reversals of capital inflows. China was pegging its currency against the Dollar and, due to the U.S. trade deficits, started acquiring U.S. assets.

Are the Dollar's Days as Reserve Currency Over? No. They aren't. But they are numbered. They aren't over because other nations still need the U.S. consumer. Until the Chinese manage to create a domestic consumer society, both they and other countries can't cut themselves lose from the U.S. consumer. What they will do, and what they are doing, is trying to manage how much the U.S. borrows and to take away the U.S. ability to control the world's money supply. They will still have to keep the U.S. propped up for the time being, because in so doing they are propping up themselves. The key break point, the end of the Dollar hegemony, will come when the Chinese are able to move to a consumer economy. At that point, the Chinese will no longer need the U.S. as consumers, and they will let the Renminbi float.

There has been a great deal of gloom about Europe since the Greek debt crisis began. This has diverted attention from good news about the European economy. The clouds over Greece have been obscuring some fundamentally positive developments favouring European financial markets. The Euro has been falling rapidly against the Dollar because of Greek debt worries – an enormous boost to export-orientated companies across Europe, especially in Germany.

The Eurozone has had a crisis – after 10 years of waiting for one to happen. This is just what is needed to galvanise government leaders in countries such as Greece into action to correct policy shortcomings. Europe always responds best when it is in a tight spot. The European Central Bank is highly unlikely to raise interest rates in the near future. A continuation of easy money will be good for equities. The sense of impending doom surrounding Greece has acted as a useful reminder to other European governments of the dangers of Greek-style profligacy. This portends downward pressure on wages and government spending across Europe – great news for the corporate sector.

Germany seems likely to secure the presidency of the European Central Bank 2011 for Axel Weber, currently head of the Bundesbank. With a German at the ECB helm for an eight-year term, Germany will remain a full-hearted member of the single currency at least until 2019 – giving Europe a 10-year-stretch of Bundesbank-style discipline and predictability, from which investors and consumers in Europe will surely benefit. The key issue that will remain for years to come is whether Greece is willing to undertake the huge domestic effort required to achieve a sustainable fiscal position. As long as doubts remain on this account, the spreads on Greek debt will remain elevated irrespective of the exact terms of international rescue packages. The fate of Greece will be decided in Athens, not in Brussels, Berlin or Washington.

The U.S. Treasury has put off a decision on whether to label China a currency manipulator for a few months, pending negotiations with China. Declaring China a currency manipulator and then following through with various trade restrictions would hurt China much more than the U.S. (after all, the U.S. needs to get its economy into a better balance of savings and consumption, and weaning itself off unduly cheap imports is one starting point). The reality is the U.S. has made a tactical error: China's cheap currency is a problem for not just the U.S., but for the EU,

India, and other countries. This should be a multi-lateral, not a bi-lateral discussion. But the Chinese leadership may not have many degrees of freedom.

If Chinese foreign policy has been (on many levels) counterproductive, that may be because its intended audience isn't in Washington or Brussels. That is, its international strategy is increasingly driven by undercurrents at home. The Chinese leadership seems uneasy about losing control. The U.S. and China need to restructure their economies so as to become dependent on each other. That means, among other things, China having to shift to a consumption-led economy. That is a ten to twenty year project, when the U.S. and the rest of the world need a faster adjustment as in they are no longer willing or able to keep accumulating debt at the level needed to sustain a high level of Chinese exports.

If the U.S.Treasury was really serious about China's currency intervention, it would have taken real action already. The Treasury can force China to end the Renminbi's peg on the Dollar by stopping the sale of its bonds to China. The fact that it has not done so suggests it cares more about financing the budget deficit and the federal government's spending programmes.
At this point, to keep its accounts balanced, the central bank can either allow the Renminbi to appreciate against the Dollar so it needs to spend fewer Renminbi to buy Dollars, or to stop issuing sterilising bonds and allow domestic inflation. As domestic prices increase in China, Chinese goods will cost more Dollars. Either way, the Renminbi will appreciate.

Stopping the sale of Treasury bonds to China would benefit the U.S. First, it would prevent Chinese savings depressing demand for American goods. Second, it would discourage the U.S. government from deficit spending and prevent skyrocketing government debts. Third, it would avoid a trade war, which would benefit no one. The inconvenient truth, however, is that the Treasury needs cheap Chinese savings to finance many more urgent spending needs, including the new healthcare plan.

The U.S. wants to have it both ways - they want the Renminbi to appreciate and they want China's continuous supply of cheap money. But even if China is somehow able to do both and revalue the Renminbi, will that help the U.S. economy?

Between July 2005 and June 2008, the Renminbi appreciated against the Dollar by 21 per cent on nominal terms, but China's exports to the US still increased and trade surplus surged from $100bn in 2005 to $300bn in 2008. A sharper appreciation of another 20 per cent, as some have suggested, will probably have a stronger effect on the trade deficit but that will also kill growth of the Chinese economy, and China will never agree to that.

Often overlooked is the fact that the Renminbi is only pegged to the U.S. Dollar, so its undervaluation against other currencies, if it exists, is the direct result of the Dollar's own devaluation. If the U.S. really wants to help other countries, it should not devalue the Dollar. The Renminbi's peg prevents a freefall in the Dollar, so helps countries that earned and saved the currency while it was strong.

The trade imbalance between China and the U.S. cannot be cured simply by adjusting the exchange rate. There are more fundamental concerns, such as labour market flexibility and the strengths of the two economies. The focus should be on those concerns and the exchange rate should be treated as something to be negotiated.

To resolve these problems over the longer term, the Chinese themselves will have to take action to reduce reliance on the Dollar as the world’s No. 1 currency and promote international use of the Renminbi. Chinese companies are being encouraged to persuade their foreign export customers to switch to Renminbi invoicing instead of Dollars. Use of the Renminbi as a transaction currency in international bond issuance is being expanded. None of this means that the Dollar will be replaced any time soon by a new Asian upstart. But the international markets need an alternative to the Dollar and the Euro. Slowly but surely, their country’s own interests and those of the outside world are pushing the Chinese to take on a more active reserve currency role.

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