Towards a Global Currency for a Global Economy: Proposals for the G20 Summits

The necessity for a global currency for the global economy was recognized as early as in 1944 at the Bretton Woods Conference and after an over 60-year experimenting with various settings, the issue is on the policy agenda again. The recent global crisis highlighted the limitations of the use of a national currency as global reserve currency and there is a call for a new international currency with a stable value and supply to secure global financial stability. The Stiglitz Report by the United Nations proposes a new global monetary framework with an international reserve currency and a global issuer and this proposal could serve as a basis for discussions on the global financial architecture at G20 meetings.

Tensions in the dollar reserve system

At the beginning of the United Nations Monetary and Financial Conference (popularly known as the Bretton Woods Conference) in 1944, there was a broad agreement among the top officials of the two key players - the UK and the US - that a global economy would need a global currency, distinct from a national currency. However, the technical consensus among experts was superseded by the US authorities who wanted the US dollar to play the role of global currency. In order to facilitate the use of the US dollar as the global currency, the US government made a commitment to exchange US dollars for gold at $35 an ounce. With this commitment to convertibility, the dollar was accepted as the international currency of choice following the establishment of Bretton Woods institutions.

The problems of having a national currency as a global currency, however, soon became evident. Robert Triffin - in what came to be called the ‘Triffin Dilemma’ - pointed out that in order to provide sufficient liquidity for international transactions, the supply of dollars would have to increase steadily through US current account deficits. Indeed, as the world economy recovered rapidly in the post-war years, the international supply of dollars (and gold) proved inadequate for supporting the expansion of world trade and financial development that took place in the post-war world.

By 1969, the international community had recognised the need for, and agreed to create, a new international reserve asset called the SDR (Special Drawing Right) under the auspices of the IMF to boost international liquidity. The IMF Articles of Agreement were modified to provide explicitly for the SDR as a global reserve currency "making the special drawing right the principal reserve asset in the international monetary system" (Article VIII, Section 7 and Article XXII). But now there were fears that there was an excess of dollars in the global economy and that the US might not be able to redeem them all at $35 an ounce. The fears of a steady depletion of gold from US reserves led to the creation of the Substitution Account in the IMF which would accept deposits of foreign exchange, primarily US dollars, from Fund Members in exchange for an equivalent amount of claims denominated in SDRs. The incentive for the holders of dollars was that SDRs were as good as gold (paper gold) and would in addition earn an interest rate. J. J. Polak, in his seminal paper explained how the balance sheet of the IMF would evolve under the SDR-based system.

Meanwhile, as had been widely predicted, the US announced on August 15, 1971 the end of convertibility of dollars into gold. Thus began what is often called Bretton Woods II, where the dollar remained a key reserve currency but without being backed by gold. It was also allowed to float freely against other currencies. The US was thus able to enjoy seigniorage gains given the international status of the dollar. Holders of dollars could convert their holdings into gold but at market prices prevailing at the time. In general, however, other than occasional and brief episodes of purchases of gold, holders of dollars remained satisfied with the huge range and depth of opportunities for investment that the United States economy provided to them.

An excess of dollars

Between 1972 and 1991, the US current account deficits averaged about 1% of GDP. But, the annual current account deficit of the US doubled to about 2% of GDP between 1992 and 2000 and was as much as 4% of GDP in 2000. Such deficits would have had adverse economic impacts, had the US dollar not been the reserve currency.

With the ending of the dot.com boom in 2000, there were concerns about recession and these were markedly reinforced after 9/11 when fear gripped the nation. There was a sharp decline in the Dow Jones industrial average of 18% between August 2001 and December 2002 and in NASDAQ by 29% over the same period. To check any recessionary fallout, interest rates were brought down in

a series of steps with the Federal Funds rate declining from 3.8% in July 2001 to 1.8% in December 2001 and below 1% in December 2003. Households were encouraged to increase spending and wider home ownership became a key component of the prevailing political agenda. The financial system including institutions tacitly supported by the Federal Government, such as Freddie Mac and Fannie Mae, expanded lending to promote home ownership. This was also an era of tax cuts and the Federal fiscal balance changed from +1.3% GDP in 2001 to -4.5% of GDP in 2004. Simultaneously, the US current account deficit widened from 3.8% of GDP in 2001 to 5.1% in 2007, a level at which it was effectively using up a major portion of global savings mostly on domestic housing investment and consumption.

There were of course warnings about these widening current account deficits of the US from reknown individuals. For example, Larry Summers, the former US Treasury Secretary in a speech in Mumbai in 2006 had stated: “the American current account deficit is unprecedented in our economic history or that of any other major economic power... Most of the classic indicators for deciding how serious a current account deficit are worrying”. In a similar vein, writing in the Financial Times (December 11, 2007), Fred Bergsten, Director of the Peterson Institute, Washington DC opined: “the world economy faces an acute policy dilemma that, if mishandled, could bring on the mother of all monetary crises. Many dollar holders, including central banks and sovereign wealth funds as well as private investors, clearly want to diversify into other currencies. Since foreign dollar holdings total at least $20,000 billion, even a modest realization of these desires could produce a free fall of the US currency and huge disruptions to markets and the world economy. Fears of such an outcome have risen sharply in both the official circles and the markets.” He went on to argue for the use of the substitution account of the IMF through which a portion of the dollars held in reserves could be converted into SDRs.

**Weaknesses in the dollar reserve system**

Warnings about the dangers of US fiscal and balance of payments deficits and creation of excessive private sector indebtedness proved to be right. The US economy was pushed into an unprecedented financial crisis in 2008 as a result of defaults on mortgage-backed securities, the so-called CDOs or collateralized debt obligations. In the world outside the US, there was recognition that the international dollar reserve system, the global interconnectedness of major financial institutions and a mispricing of risk by private financial institutions in the US would have international repercussions. This led to calls from several European leaders for a fundamental reform of the international financial system.

However, given the absence of any obvious alternatives, enthusiasm for reform remained lukewarm. Indeed, in the first meeting of G20 Leaders’ Summit on Financial Markets and the World Economy held on November 15, 2008 in Washington D.C. under the leadership of the U.S., the focus was on the reform of the regulatory system for financial institutions and a review of actions to be taken to address the immediate crisis and strengthen growth. Moreover, there was a reluctance to pin the blame for the crisis on market failure, especially asymmetrical information and skewed incentives within the financial sector, to be corrected by official intervention. In fact, the G20 “reaffirmed their commitment to free market principles.”

With the global financial crisis deepening in 2009, there was greater willingness among some members of G20 countries to face up to the dangers of the unfettered role of markets and of the dollar reserve system. Gordon Brown, the Prime Minister of the UK, the host country for the G20 Summit in April declared “the old Washington Consensus is over”. Before the Summit, the Russian President Dmitry Medvedev declared that the world economy needed a new global currency. The Chinese authorities, too, expressed their preference for a global currency in an essay in the webpage of the People’s Bank of China. The essay stated that “the outbreak of the current crisis and its spillover in the world have confronted us with a long-existing but still unanswered question, i.e. what kind of international reserve currency do we need to secure global financial stability and facilitate world economic growth, which was one of the purposes for establishing the IMF? ... The acceptance of credit-based national currencies as major international reserve currencies, as is the case in the current system, is a rare special case in history. The crisis again calls for creative reform of the existing international monetary system towards an international reserve currency with a stable value, rule-based issuance and manageable supply, so as to achieve the objective of safeguarding global economic and financial stability...Special consideration should be given to giving the SDR a greater role.”

In the subsequent London Summit, the issue of a global currency was, however, not explicitly considered. Instead, it was agreed to make available an additional $850 billion through the IMF and the multilateral development banks to support growth in emerging markets and developing countries by debt rollovers and by helping to finance counter-cyclical spending, bank recapitalisation, infrastructure investment, trade, balance of payments deficits and social protection.

**The dollar problem beyond the Great Recession**

With the immediate crisis more or less under control, the issue of US fiscal and balance of payments deficits receded into the background. However, according to IMF projections (IMF, World Economic Outlook 2010) the current account deficits of the US are expected to remain high for some time, increasing from $378.4 billion in 2009 to $601.7 billion in 2015. The risks of these imbalances have been highlighted by Fred Bergsten. “It has long been known that large external deficits pose substantial risks to the US economy because foreign investors might at some point refuse to finance these deficits on..."
terms compatible with US prosperity. Any sudden stop in lending to the United States would drive the dollar down, push inflation and interest rates up, and perhaps bring on a hard landing for the United States—and the world economy at large. But it is now evident that it can be equally or even more damaging if foreign investors do finance large US deficits for prolonged periods. US policymakers, therefore, must recognize 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 United States’ national interest. The US should now welcome initiatives to begin a serious discussion of reforming the international monetary system.

The Peterson Institute for International Economics projects that the international position of the United States is likely to weaken further, with the current account deficit rising from a previous record of six percent of GDP to over 15 percent (more than $5 trillion annually) by 2030 and net debt climbing from $3.5 trillion today to $50 trillion (the equivalent of 140 percent of GDP and more than 700 percent of exports) by 2030. If no corrective action is taken, the United States would then be transferring a full seven percent ($2.5 trillion) of its entire economic output to foreigners every year in order to service its external debt.

This untenable scenario highlights the gravity of the situation. If the rest of the world continues to finance the United States’ external deficits, the conditions that brought on the current crisis are likely to be replicated and the risk of a new crisis increased. At the same time, foreign financing of US deficits would probably become unsustainable and produce a sharp drop in the value of the dollar well before 2030. Furthermore, even if the United States were able to avoid another financial crisis, the steadily rising transfer of US income to the rest of the world to service its external debt.

However, notwithstanding these warnings, the US authorities appear instead to be putting their faith in the growth of the economy being able to resolve their problems. To this end, the Federal Reserve is attempting to stimulate lending and investment in the economy by further loosening monetary policy. Most observers are of the view that far from improving US growth and employment looser monetary policies are likely to lead to increased short term outflows, primarily to developing economies, with serious risks of exchange rate instability, currency wars, currency controls and protectionism. Indeed, the signs are that a new financial crisis could occur sooner or later, with grave consequences both for the US as well as the world economy. Can such a scenario be prevented?

The UN system to the rescue?

The UN report on the Reform of the International Monetary and Financial System7 (the Stiglitz Report) was a landmark event and has the potential to improve the management of the global economy and prevent a new financial crisis. A path-breaking contribution of the Stiglitz Report was to make a detailed and compelling case for moving toward a global reserve currency system including the creation of a new institution, the Global Reserve Bank. Among the important points it makes are the following:

- The current crisis may be an opportunity to overcome political resistance to a new global monetary system. A new system may be of interest to both the US and China, the two major players in the world economy today. The new system may help the US correct its external imbalances and the increasing cost of being the main reserve currency. Likewise, it may be helpful for China to avoid the risk of a steady depreciation in the value of its dollar reserve assets.

- If the international agency responsible for creating global reserves is to issue the global currency there is no need for any additional backing for the global currency, except the commitment of central banks to accept it in exchange for their own currencies.

- The technical issues concerning the operations of the new system with regard to the size of annual creations/additions of the currency, the method of allocation among member countries, uses to which the new currency might be put and how it could create incentives for avoiding excessive imbalances in reserve holdings are all important issues but none of them present inherently insurmountable problems.

- Part of the annual creations could be used for buying bonds of multilateral development banks and thus expand the resources available for development, in a way similar to the proposal of the “development link” made by the UNCTAD panel of experts in the 1960s.

The Stiglitz Report by the United Nations is a significant contribution to the cause of stable and sustainable growth of the world economy in the future. The next meeting of the G20 provides an opportunity to consider calling upon the UN Secretary-General to convene another United Nations Monetary and Financial Conference (the official name of the first Bretton Woods Conference) involving all members of the UN to examine the proposals of the Stiglitz Report, as well as any other proposals, for the reform of the international financial architecture in line with and reflecting the needs of the 21st century.