

Future of the International Monetary and Financial Order

Central Reserve Bank of Peru

Julio Velarde
Governor



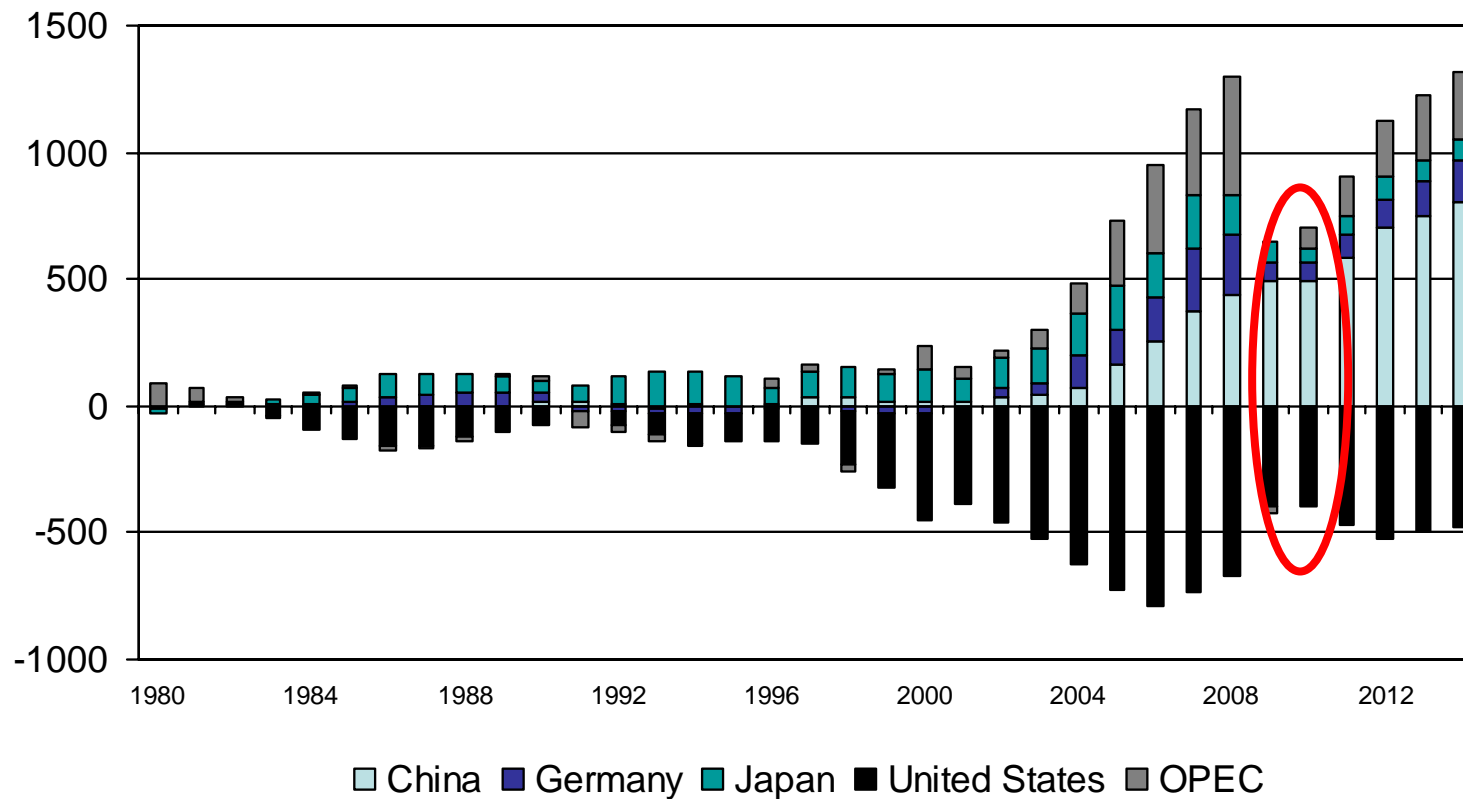
Outline

- a. Global imbalances have not decreased significantly during the crisis. The dollar has remained a “safe” asset.
 - Global imbalances will likely continue in the medium term.
 - Emerging economies are greatly involved in global imbalances.
- b. What are the main macroeconomic options against global imbalances?
 - Currency appreciation of BRIC currencies, yen, and euro.
 - Increase in domestic demand outside the U.S.
- c. Since global imbalances will likely not be corrected in the short term, is it possible to change the international monetary system?
- d. Emerging economies, global imbalances, and the current global financial infrastructure: is there a need for change?



The reduction in the U.S. current account deficit does not seem to be enough to correct global imbalances.

Current account (US\$ billions)

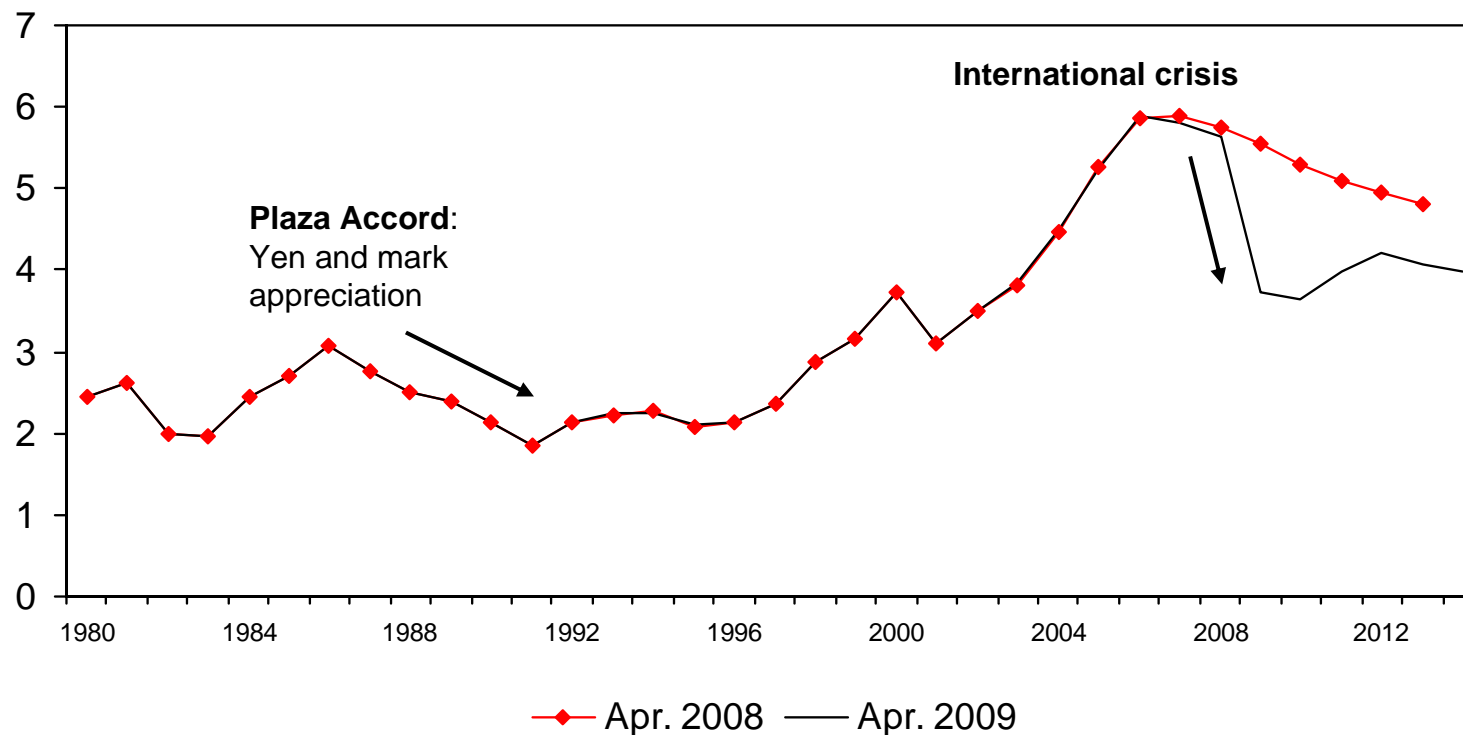


Source: IMF



From a historical perspective, global imbalances remain high, despite the recent correction.

Global imbalances (absolute value of current accounts as a % of GDP)

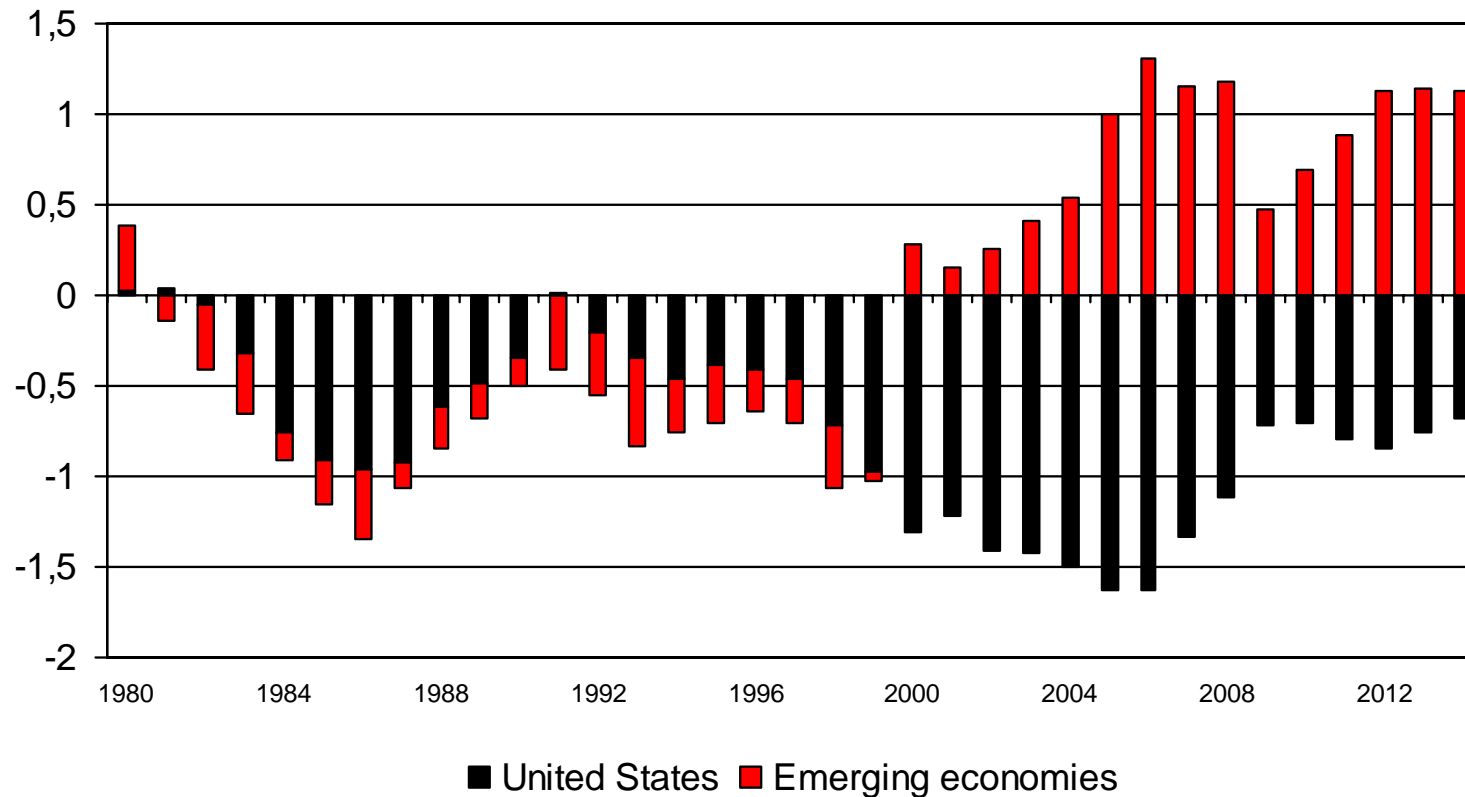


Source: IMF



Unlike the 1980s, emerging economies are greatly involved in global imbalances.

Current account (as a percentage of global GDP)

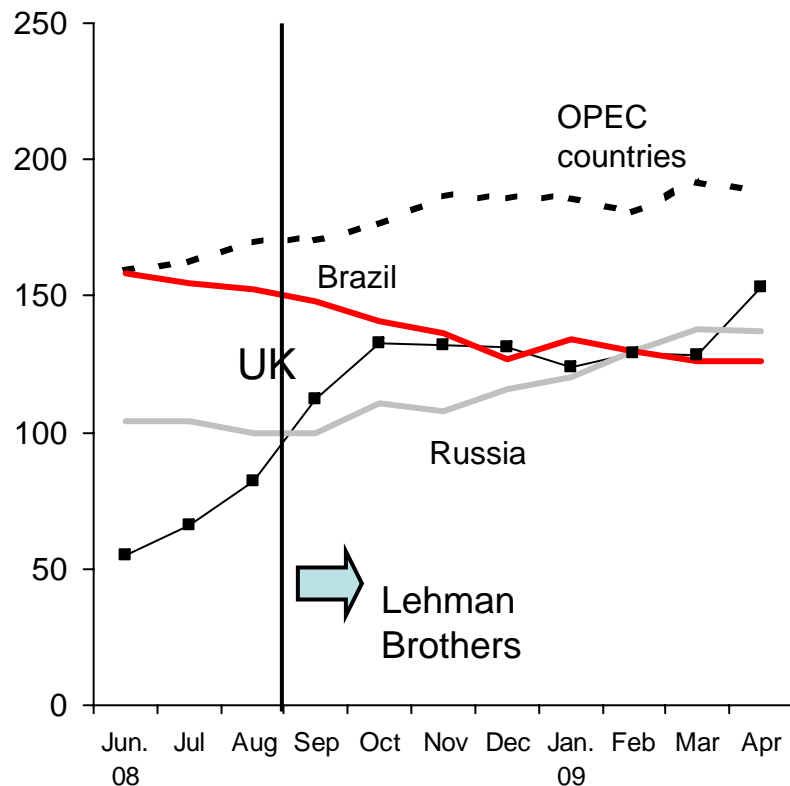


Source: IMF

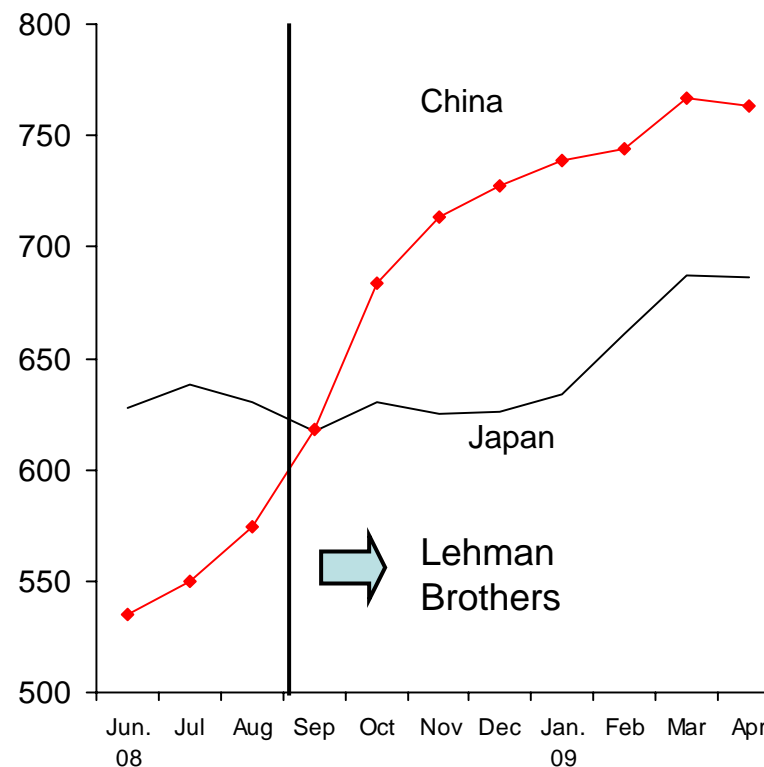


Emerging economies have built up dollar assets during the crisis.

Holdings of US Treasuries (US\$ billions)



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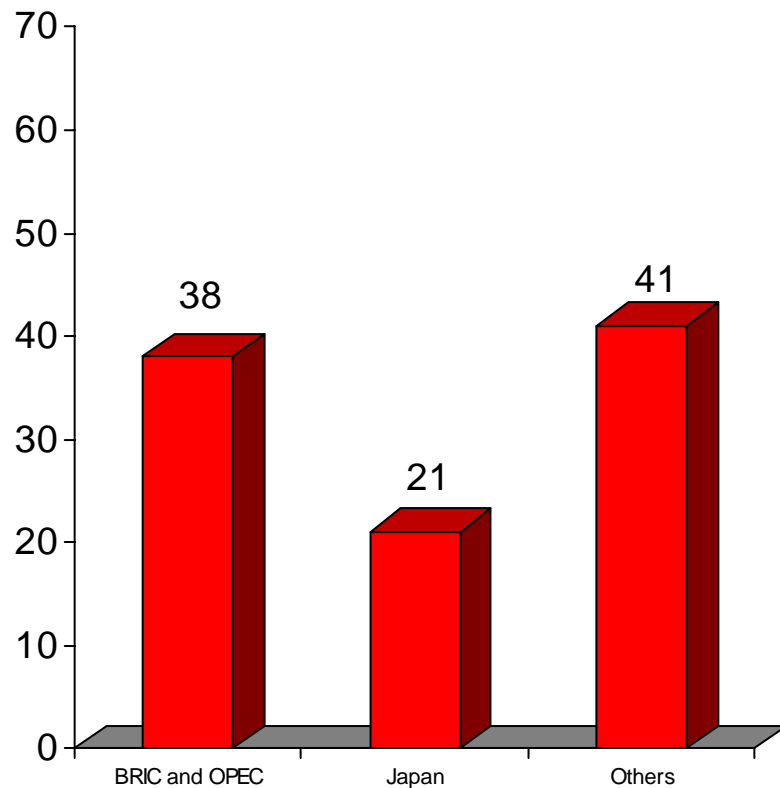


Source: US Treasury.

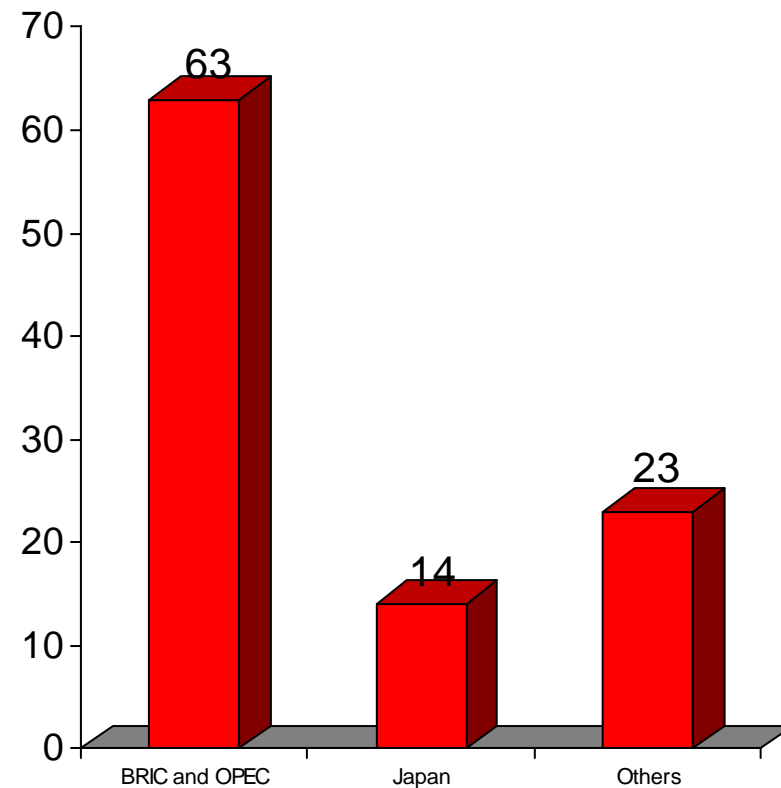


Emerging economies have built up dollar assets during the crisis.

Foreign holding of US Treasury by countries
US (as % of total foreign holdings) April 2009



Foreign holding of US Treasury by countries
US (as % of annual variation april 2008-april 2009)



Source: US Treasury.



Can BW2 last longer? Similarities and differences with BW1

Similarities:

- U.S. fiscal deficit is a key driver of external deficit (twin deficits).
- Capital controls in countries with high intervention in FX markets.

Differences:

- New Bretton Woods regime is not global. Eurozone allows its currency to float and the euro has faced excessive pressures.
- BW1 was the result of an explicit institutional arrangement. BW2 is an implicit one (therefore more fragile).
- The current financial crisis stopped the expected adjustment: currency appreciation of Asian currencies is less likely now because of declining inflationary pressures, lower external demand, and high risk aversion.



Correction of global imbalances: some mechanisms

Higher consumption in China:

- Difficulties in changing growth pattern (from outward to inward oriented) in the short term.
- Consumption in China is seven times lower than in the U.S.

Higher growth in surplus countries (Germany and Japan):

- In the short term, consumption and investment will remain constrained.
- Edwards (2007): Impact of higher growth in Europe and Japan will improve U.S. external balance modestly.



Since global imbalances will likely not be corrected in the short term, how feasible is a change in the international monetary system?

- Replacement of the dollar with another strong currency.
- Greater role for BRIC currencies.
- Issuance of non-dollar assets (SDR-denominated bonds).



Replacing the dollar with another strong currency?

**Currency Composition of Official Foreign Exchange Reserve
(Percentage share)**

	1999	2002	2005	2008
World	100	100	100	100
Advanced economies	72	69	62	51
US dollars	51	47	44	35
Euros	12	15	13	11
Yenes	5	4	3	2
Others	4	3	3	3
Emerging economies	28	31	38	49
US dollars	20	20	23	29
Euros	5	8	11	15
Yen	1	1	1	1
Others	1	1	2	4

Source : IMF

The introduction of the euro has not yet resulted in a significant change in the currency composition of official reserve holdings.

The U.S. dollar has maintained its place as the dominant reserve currency, supported perhaps by the edge that dollar financial markets still have over euro markets in terms of size, credit quality and liquidity, as well as inertia in the use of international currencies.

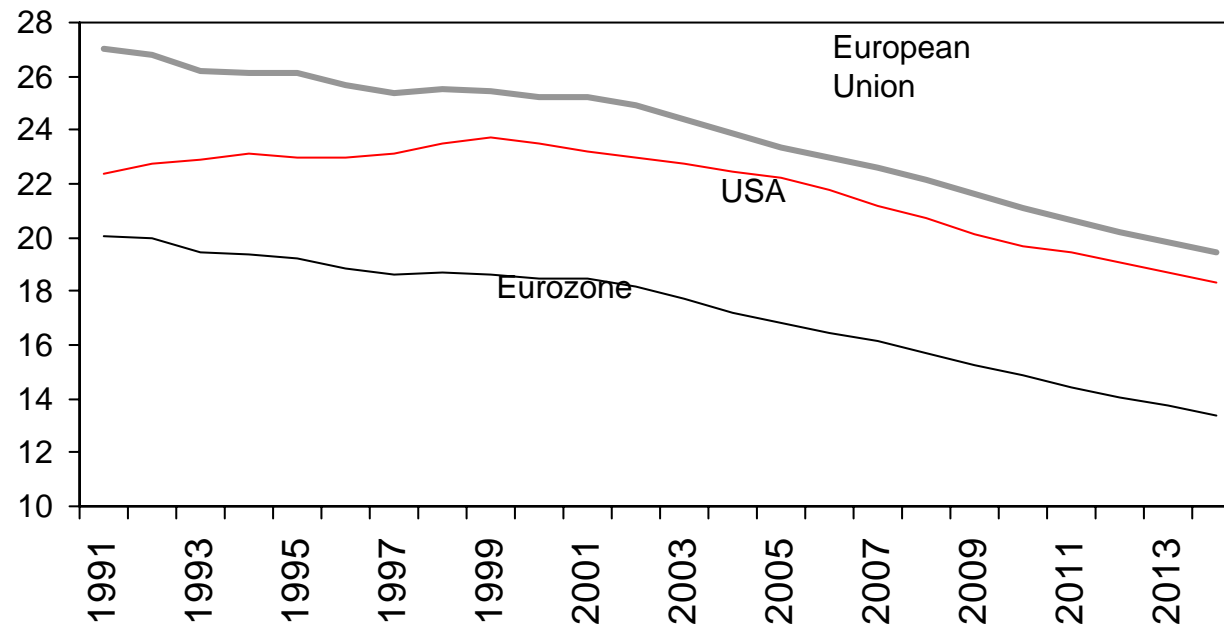
**Galati and Wooldridge (2008) The euro as a reserve currency: a challenge to the pre-eminence of the US dollar?*



Replacing the dollar with another strong currency?

- Relatively more optimistic growth expectations in the U.S. (more flexible markets and higher productivity).
- However, in terms of global output, the euro should play an increasing role in line with Eurozone enlargement.

GDP (share on global output)



Source: IMF

— Eurozone — European Union — USA



Replacing the dollar with another strong currency?

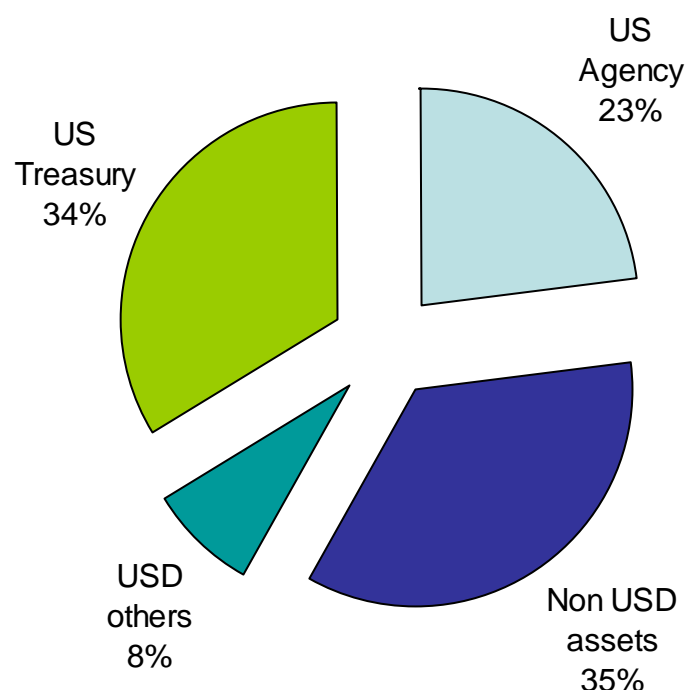
- Risk of exchange rate losses in countries with high dollar holdings (BRICs and other emerging economies). However, the current accumulation of U.S. dollars can magnify future losses.
- The euro improved the functioning of European financial markets. Even though the liquidity and breadth of euro financial markets are fast approaching those of dollar markets, banking and capital markets in the euro area remain segmented.
- U.S. governance (federal system) differs from the Eurozone. The European single currency is governed by a single monetary policy, but leaves fiscal policy with member states.

Galati and Wooldridge (2008). *The euro as a reserve currency: a challenge to the pre-eminence of the U.S. dollar?*



The BRIC economies, greatly involved in global imbalances, could reduce the share of dollar assets only gradually. A sharp shift does not seem possible in the short run.

China's foreign assets



Source: UBS

Few alternatives to dollar assets in the short term:

- Shortage of safe assets.
- Other government bonds not so liquid.
- Gold market relatively small compared to China's assets: 5% of its reserves equals one year of world gold production.

“Dollar trap”:

- Risk of exchange rate losses.
- Lower demand from U.S.

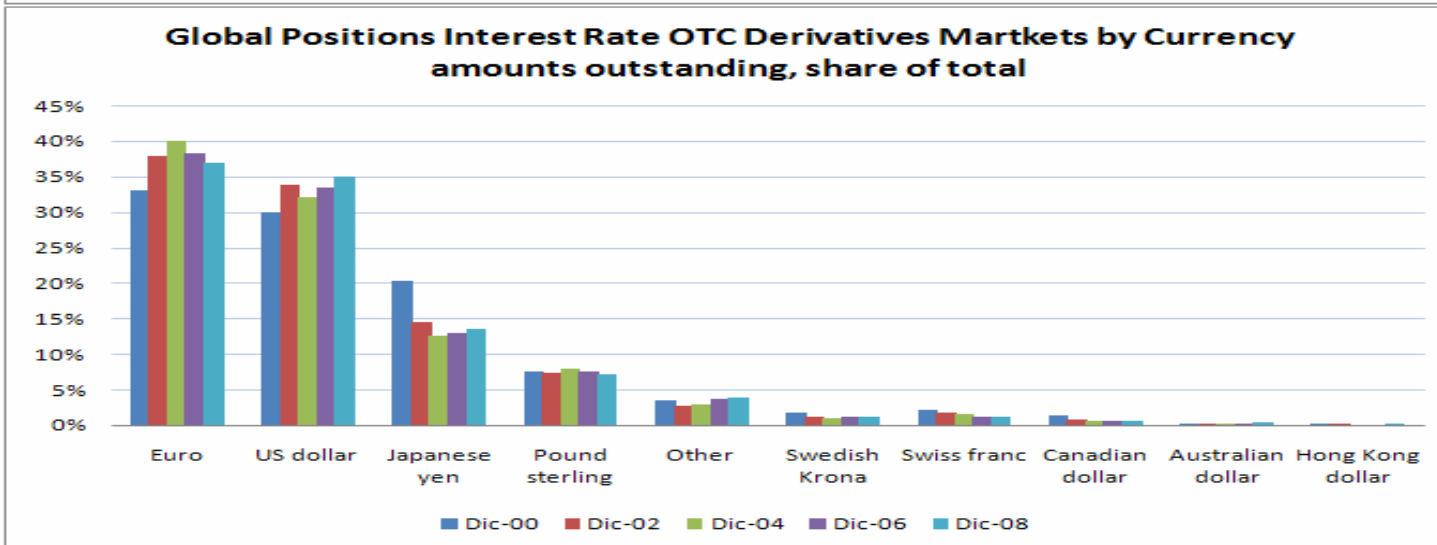
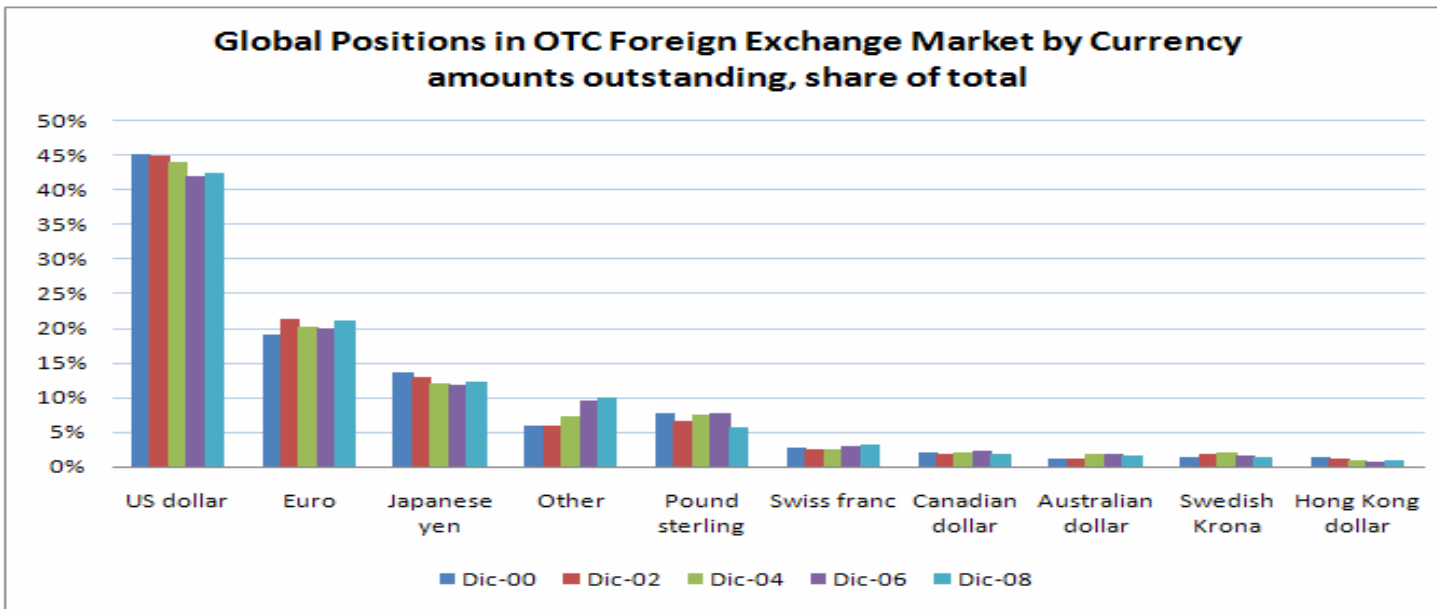


Dollar versus Euro in Trade transactions

- a. Exports of homogeneous primary goods (commodities) tend to be traded in dollars with worldwide formation in a centralized exchange.
- b. Export of manufactured goods tend to be in the home industrialized currencies.
 - Before the establishment of the Euro Area, more than 75 percent of German export were invoiced in marks and more than 50 percent of French export were invoiced in francs. Nowadays, continental European countries invoice their net exports outside the European Union mainly in euros.
 - Japan only invoiced about 36 percent of its exports in its own currency because the U.S. is its main export market.

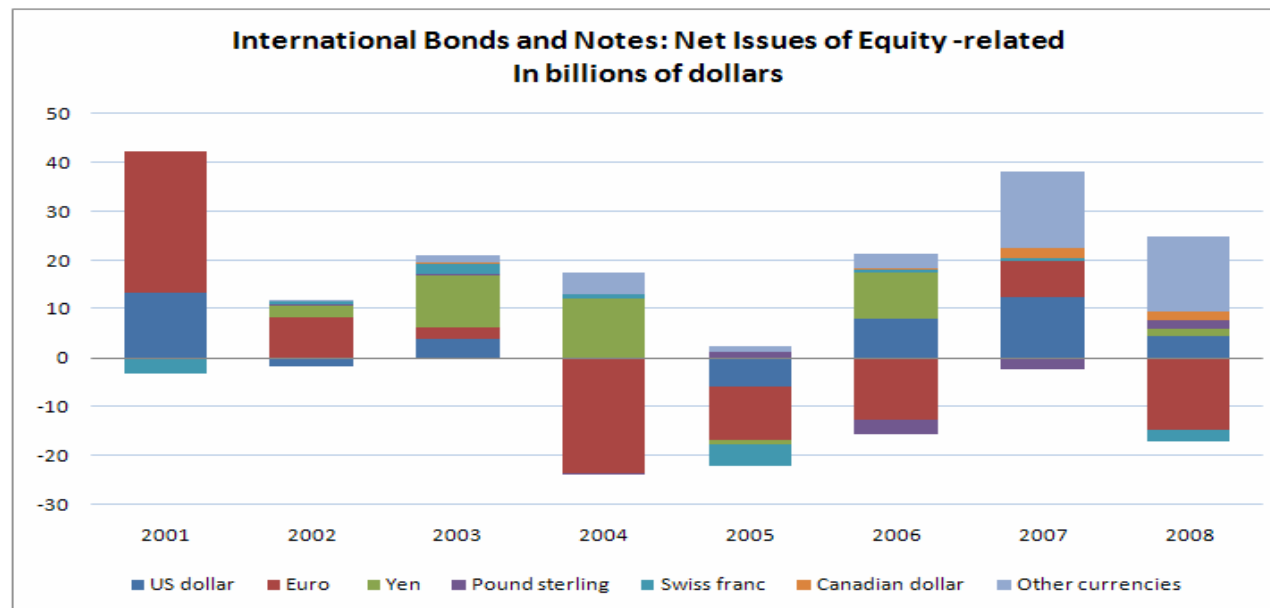
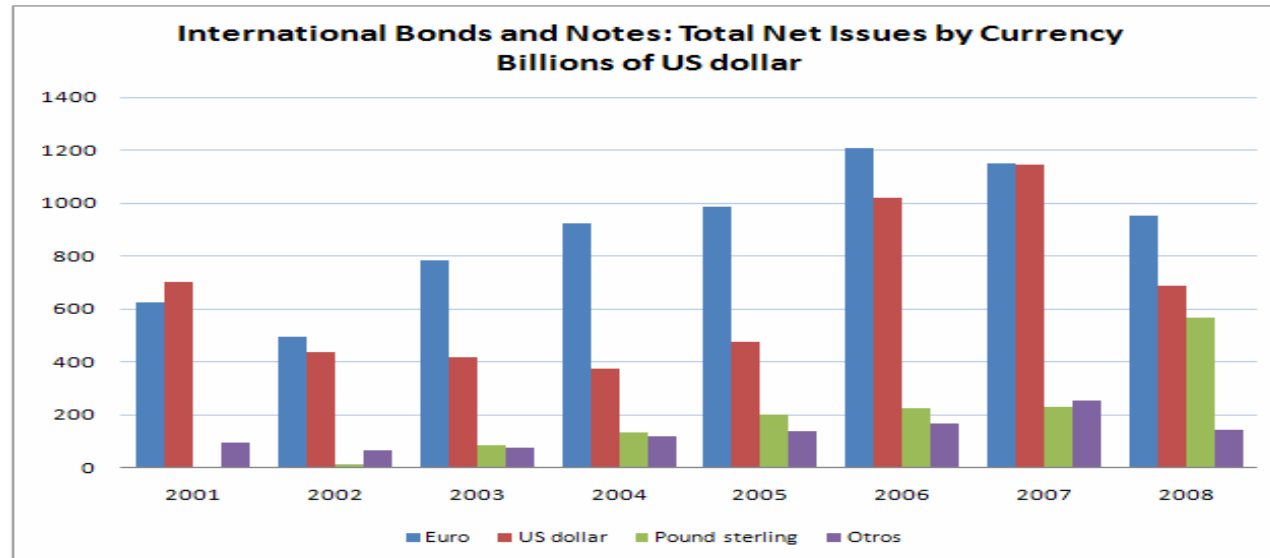
Mc. Kinnon. *Euroland and East Asia in a Dollar-Based International Monetary System*





Source: BIS





Source: BIS



BANCO CENTRAL DE RESERVA DEL PERÚ



Replacing the dollar with another strong currency?

1. The dollar took over as dominant reserve currency in the mid-1920s, four decades after the U.S. became the world's main industrial economy.
2. There is room for more than one dominant reserve currency:
 - The dollar and sterling shared dominance during most of the inter-war period (more than 97% of world international reserves together).
 - Investors pooled risks by placing reserves in London and New York, both deep and liquid financial centers.
 - The dollar-sterling duopoly replaced the previous sterling-franc-mark oligopoly. Therefore the real anomaly is the dominance of one currency.

Eichengreen & Flandreau (2008). *The Rise and Fall of the Dollar, or When did the Dollar Replace Sterling as the Leading Reserve Currency?*



Conditions for a replacement of the dollar by the euro in the medium term.

- The major pay-off of the paper is predictions about scenarios under which the euro might in the future rival or surpass the dollar as the world's leading international reserve currency. That question appears to depend most importantly on two things:
 1. Whether enough other EU members join euroland so that it becomes larger than the U.S. economy and, in particular, whether the UK comes in, with its large financial markets.
 2. Whether U.S. macroeconomic policies eventually undermine confidence in the value of the dollar through inflation and depreciation. Whatever value this exercise has probably consists of estimating, contingent on those two things happening, how quickly the euro might rise to challenge the dollar.
- We find that if all 13 EU members who are not currently in EMU join it by 2020, including the United Kingdom, then the euro overtakes the dollar a few years later. We also find that even if some of these countries do not join, a continuation of the recent trend depreciation of the dollar, were it to occur for whatever reason, could bring about the tipping point even sooner.

Frankel and Chin (2009). *Will the euro eventually surpass the dollar as leading international reserve currency?*



Greater role for BRIC currencies?



Source: UBS

Greater role for BRIC currencies? Some limitations.

1. Several capital controls on BRIC currencies.
2. Limited scope as tradable currencies:
 - Trade between BRICs and other emerging economies still lower than with developed economies.
 - Developed economies account for more than 50 percent of exports from China.

Exports by Region, 2007
Percentage Share

	North America	S/C America	Europe	África	Middle East	CIS	Asia, exc. Japan	Japan
Brazil	20%	24%	27%	6%	4%	3%	13%	4%
Russia	4%	1%	60%	1%	2%	15%	13%	3%
India	15%	3%	23%	9%	17%	1%	29%	3%
China	22%	3%	22%	3%	4%	4%	32%	11%

Source: International Trade Statistics 2008, WTO



Greater role for BRIC currencies: Some limitations

International Debt Securities by Nationality Issuer Amounts outstanding (In billions of US\$ dollars)								
	Financial Institutions				Corporate Issuers			
	2006	2007	2008	2009 *	2006	2007	2008	2009 *
All countries	14,367	17,974	18,900	18,770	1,843	2,220	2,427	2,549
Developed countries	13,845	17,306	18,211	18,107	1,681	2,021	2,222	2,346
Developing countries	381	505	521	505	163	199	205	203
China	23	28	33	32	1	5	7	7
India	7	16	17	16	13	22	24	23
Russia	51	87	90	86	11	15	23	22
Brazil	45	53	57	56	14	14	12	12

* March

International Money Market Instruments by Currency and Region Amounts outstanding (In billions of US dollars)			
	2007	2008	2009 *
Total by Currency	1137	1132	1031
Euro	477	511	487
Pound sterling	154	149	138
US\$ dollar	383	370	319
Yen	34	33	25
Otros	89	69	62
Total by region	1137	1132	1031
Developed countries	1125	1126	1024
Developing countries	12	6	7

* March

Source : BIS

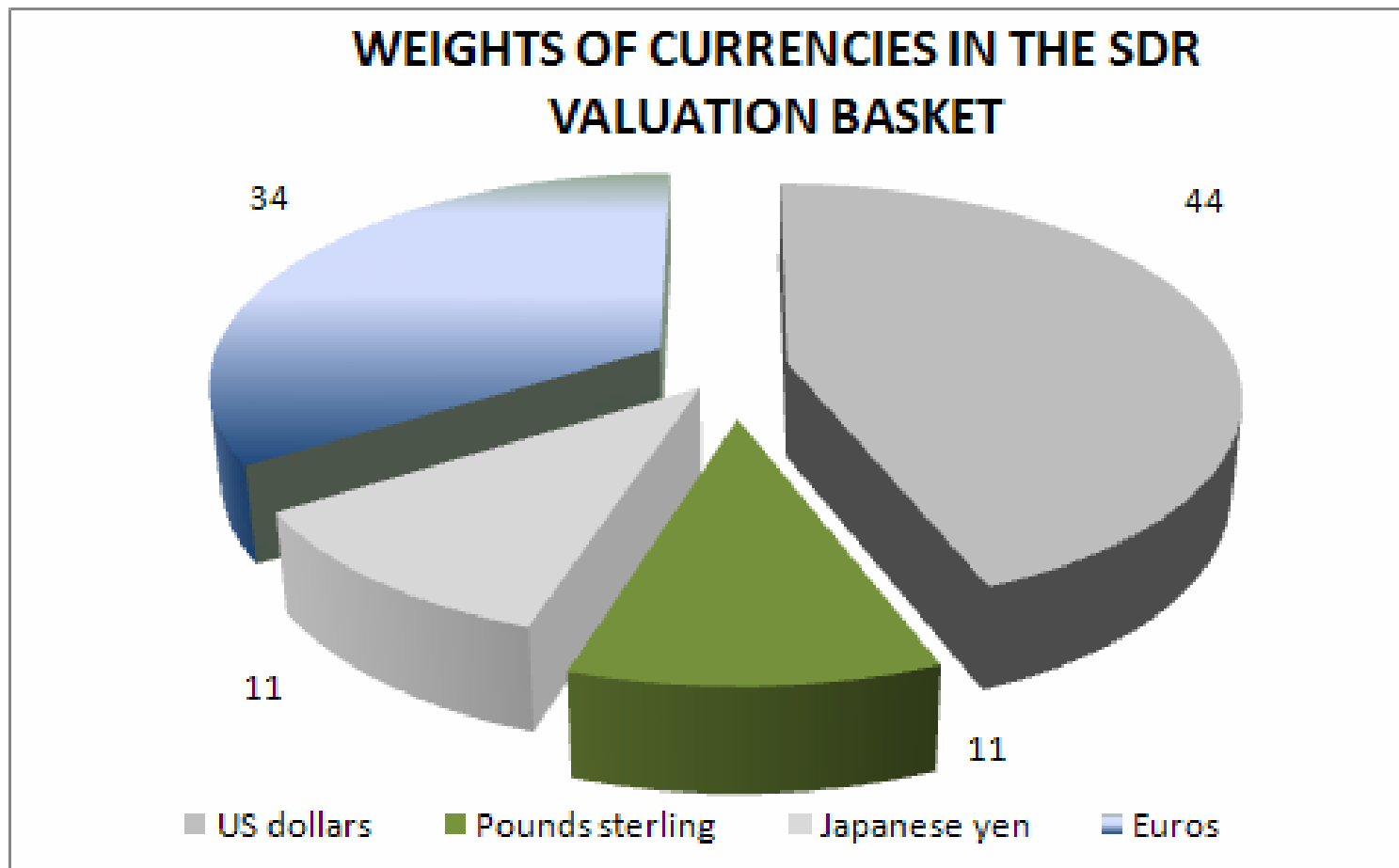


Scale of RMB business in the financial system still low, but increasing.

- In recent months, the Chinese mainland has completed bilateral currency swap deals with several countries:
 - Korea (CNY 180bn, December 2008)
 - Hong Kong (CNY 200bn, January 2009)
 - Malaysia (CNY 80bn, February 2009)
 - Belarus (CNY 20 bn, March 2009)
 - Indonesia (CNY 100bn, March 2009)
 - Argentina (CNY 70bn, March 2009)
- April 2009: a scheme of allowing settlement in CNY in the trade of Shanghai, Shenzhen, Guangzhou, Zhuhai, and Dongguan with Hong Kong and Macau, and in the trade of Yunnan and Guangxi with South East Asian Nations.
- June 2009: Malaysia's Central Bank is allowed to purchase and hold Chinese government debt as part of its foreign reserves and as possible hedge against the weakening of the U.S. dollar.



An alternative asset (SDR denominated bonds) would ultimately rely on the U.S. dollar.



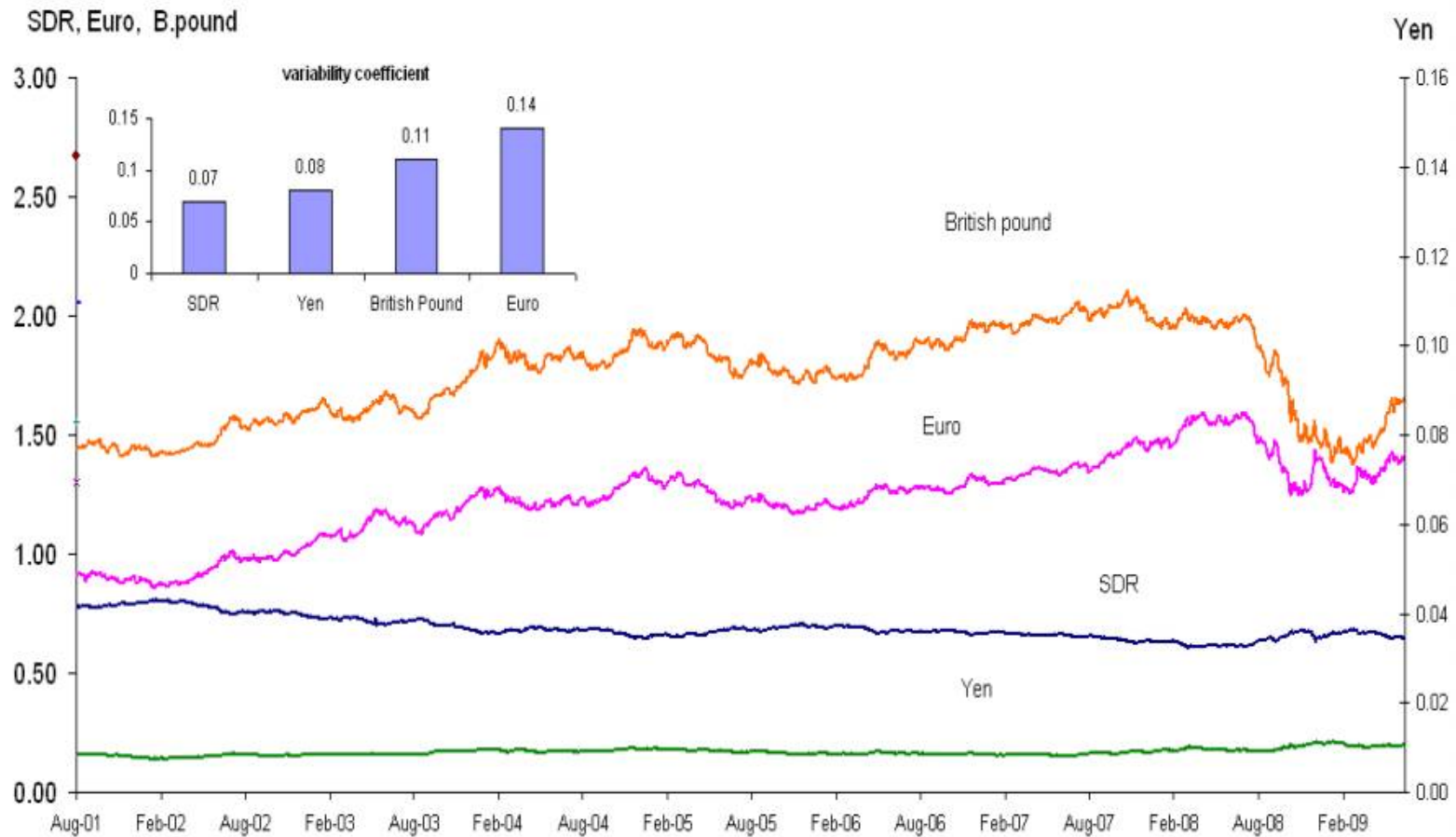
Source: IMF

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SDR volatility.

Nominal exchange rate: SDR, euro, British Pound and yen



Source: Bloomberg



BRICs economies has a lower share in the IMF than in the world economy

The BRIC in the International Financial System						
(in millions)						
	IMF Quotas		World GDP 2008			
	SDR	%	PPP USD	%	Market Exchange Rate	%
World	217,373	100	68,996,849	100	60,689,812	100
Developed	135,623	62	38,106,903	55	42,099,544	69
Emerging Markets	81,749	38	30,889,946	45	18,590,268	31
BRIC	21,230	10	15,446,888	22	8,860,725	15
Brazil	3,036	1	1,981,207	3	1,572,839	3
Russia	5,945	3	2,260,907	3	1,676,586	3
India	4,158	2	3,288,345	5	1,209,686	2
China	8,090	4	7,916,429	11	4,401,614	7

PPP= Purchasing Power Parity.
Source: FMI, WEO e IFS

Emerging economies could surpass the advanced economies as early as 2014 in terms of their share of world GDP.



IFIs' response to the crisis

- Access limits raised significantly.
- Additional bilateral financing.
- Increase in lending capacity for low- income countries.
- Proposed general SDR allocation to enhance international liquidity.
- A new credit line (FCL) for countries with strong fundamentals.
- Proposed capital increases in regional development banks.
- Actions to leverage private capital.
- Support to trade liquidity.



IFIs' response to the crisis

Four key areas where global architecture needs to be enhanced:

- Surveillance: (i) follow-up of global economic developments and policies; (ii) early warning mechanism and specific policy response.
- Multilateral coordination: (i) coordination of macroeconomic policies across governments; (ii) rebalancing of quotas in multilateral agencies.
- Regulation and supervision of internationally active financial institutions.
- Arrangements to ensure adequate international liquidity; loans to support adjustment.



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