The emerging market agenda for international monetary system reform

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Key judgements

- China's increasingly assertive posture in international financial discussions is driven by efforts to escape a dollar trap that severely limits its policy freedom of action.
- A quick resolution of the G2 (China-US) savings-investment imbalances looks unlikely. As a result, volatility in currency markets and global capital flows is liable to increase.
- A "dollar trap" scenario implies persistent upward pressure on emerging market currencies, so offsetting policy responses will be needed.
- To be viable, China's proposal to make the SDR an international reserve currency requires the creation of a world central bank with the authority to issue a new international reserve currency.
- Emerging economies are left depending on China and the US to take the lead in policy adjustment. Neither the existing international dollar standard nor the proposed Chinese alternative gives confidence that they will foster such an adjustment.

China rocks the currency boat ...

China's huge FX reserves and increasingly assertive posture in international financial discussions have been unsettling for markets. Debates on the implications of the dollar's declining role in official reserve holdings and its eventual displacement by the Chinese yuan are all the rage.

While such an outcome appears plausible in the long run, popularising such views obscures what matters in the here and now: the dollar may or may not end up as toast, but what matters for investors and emerging market policymakers is how such an outcome might come about.

... because it is caught in a dollar trap

The starting point is to recognise that China is in a dollar trap that severely limits its freedom of action in managing its FX reserves. This predicament is the result of its explicit policies since 2000 that provided incentives and subsidies to support investment-led growth in manufacturing industries. These policies generated:

- a boom in corporate savings that financed rising investment;
- rapid export expansion that fuelled rising current account surpluses.

China's savings-investment imbalances are policy-driven. Chinese personal consumption has lagged GDP growth in recent years because the distribution of

national income has been skewed towards capital (industry) and away from labour; low consumption is due to low personal incomes, not to precautionary savings on the part of households.

A revaluation of the yuan by itself is unlikely to lead to the needed changes in China's industrial policies that are essential to correcting its savings-investment imbalances. Boosting consumption requires no grandiose social welfare programmes but policy changes to increase labour's share of national income and reduce that of industry.

Many among the top Chinese leadership and their advisers know this but there appears to be a reluctance to act. Some policymakers may be betting that a recovery in US and EU consumption will provide a new boost to growth once the fiscal stimulus winds down. Others are probably simply loath to confront the industrial lobbies that would have to bear the lion's share of the adjustment.

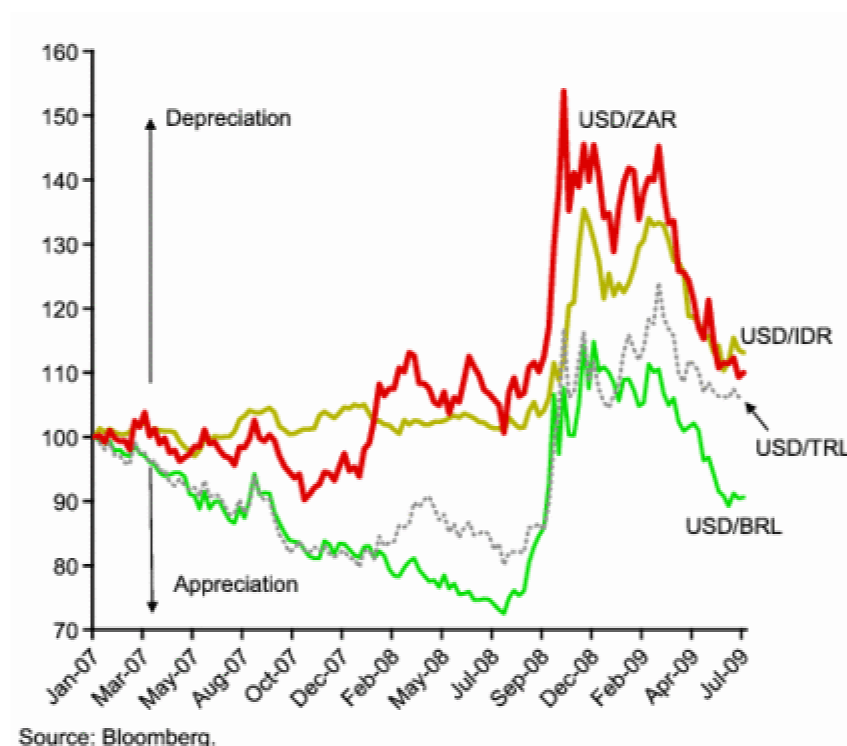
Back to the bad old days?

A quick resolution to China's dollar trap looks unlikely unless the all-too-evident addictions of the G2 economies to running surpluses (China) and deficits (US) are corrected. In the absence of a rebalancing of economic policies in both countries it will be exceedingly difficult to gain international agreement on reforms of the international financial architecture.

Moreover, this unhealthy symbiosis possesses significant scope for injecting volatility into currency markets and global capital flows. In emerging markets this volatility is evident in wide swings in currency rates, from overvaluation to undervaluation and back again. These swings are driven in turn by sudden surges in capital, in and out of emerging economies that maintain open capital markets.

In today's volatile world floating exchange rates are increasingly driven by capital flows, not economic fundamentals as many economists would have us believe. Flexible exchange rates do influence changes in domestic spending and investment, but the recent 30-40 per cent up and down movements in emerging market currencies such as the Brazilian Real and South African rand (Chart 1) are excessive. Such volatility does little to foster economic growth and stability.

Chart 1: Emerging market currencies vs the US dollar, January 2007 - July 2009 (index January 2007 = 100)



Note: ZAR = South African rand, IDR = Indonesian rupiah, TRL = Turkish lira, BRL = Brazilian Real.

With the dollar likely to remain under pressure in the "dollar trap" scenario, policymakers in many emerging economies will face persistent upward pressure on their currencies, necessitating offsetting policy responses including FX intervention and restrictions on capital inflows. And if even a fraction of the cash that reputedly is sitting in US investment accounts earmarked for emerging market investments starts moving, then EM policymakers' headaches will intensify.

Such portfolio inflows into emerging economies will increasingly be supplemented by official capital movements as major reserve-holding countries seek alternatives to investments in the dollar, euro and yen. Although some have predicted that the Chinese yuan could become a reserve currency in the next decade, it is far more probable that such official flows will seek countries with relatively deep domestic capital markets and minimal capital restrictions.

The Brazilian Real is the obvious candidate for such reserve accumulation, followed by the South African rand, but any emerging economy running sound economic policies will also feel the effects of this coming wave of global reserve diversification. For investors the simple rule is to buy currencies of any well-

managed emerging economy, so what starts as a trickle could quickly turn into a flood.

Reform? Fix the savings-investment imbalances first

The emerging markets therefore have a significant stake both in a resolution of these imbalances and in broader international monetary reform. But in their absence the global economy will backtrack to the bad old days of dirty floating, rising protectionism and political restrictions on foreign direct investment. In fact global economic policy has already moved a considerable way down this path.

A corollary of this state of affairs is that non-G2 countries - mostly innocent bystanders - have little incentive or ability to get involved in easing these two countries' predicament. They have to wait for the G2 to act, but still risk suffering the consequences if these two countries fail to begin correcting their imbalances. The challenge for policymakers in emerging economies will be to prepare defensive policy game plans in case external shocks begin to threaten domestic economic stability.

One specific example concerns the rising volatility in EM currencies and in capital flows, mostly inflows of portfolio investment. What China says about the dollar and what it does with its dollar investments are frequently quite divergent. China's very public pronouncements about displacing the dollar are belied by the reality that the dollar trap has locked it into positions where the only option is either to lengthen or to shorten duration in its Treasury holdings. This "disconnect" between appearance and reality can and does generate volatility in capital movements with significant implications for monetary policy in other economies.

Who holds the effective leverage?

Many quickly jump to the conclusion that China holds all the trump cards in this G2 poker match by virtue of its huge pile of dollar reserves. But real life is seldom so accommodating.

For example, in talking openly about alternatives to today's dollar reserve system China has opened a Pandora's Box that could easily boomerang. The country's proposal to elevate the SDR unit of account to the status of an international reserve currency has been seen by some countries as an attempt to have the world community bear the burden of providing an escape from the dollar trap China so willingly embraced.

Most would argue that this burden should fall on China and the US, not other countries. Mid-1980s IMF proposals for an SDR substitution account (to convert an earlier "dollar overhang" into SDRs) foundered on disagreements over how and by whom potential valuation shortfalls in running such a composite unit of account would be compensated. Today the practical difficulties of implementing such an SDR substitution account dwarf what was ultimately rejected back then.

A global central bank with its own currency?

Commenting in June on the Chinese SDR proposal, John Lipsky, the Fund's Deputy Managing Director, said the new SDRs would have to be delinked from other currencies and be issued by an international organisation with equivalent authority to a central bank. In other words, such SDRs would not be SDRs as we know them today, but a full-fledged international currency, backed by a newly created global central bank or agency.

At this stage China's SDR proposal lacks any clear conception of how it actually might be achieved and how it would be backed. Lipsky's comments, however, highlight the precondition for making the Chinese proposal viable: the creation of a world central bank with the authority to issue its own currency. Modifying the existing SDR to include other currencies such as the Chinese yuan and Brazilian Real cannot turn what is a unit of account into a viable international reserve currency. A completely new institutional structure is required, either outside the IMF or within a radically transformed IMF.

The creation of a world central bank, issuing what would become the world's international reserve currency, raises a host of issues that have not even been identified, let alone debated. Much would have to be clarified in order to judge whether a new global currency could be created with adequate liquidity and confidence as a store of value.

Without prejudging the likely outcome, it is a discussion whose time has come.

The unanswered question: How will economic adjustment be assured?

Even if technical aspects about a radically reformed role for the IMF as a global central bank could be addressed, a more important question is how such a new currency system would assure international adjustment.

Today's international dollar standard (Bretton Woods II) owes its longevity to its tolerance of all kinds of undesirable behaviour, ranging from reckless lending and ineffective regulation of financial markets to outsize reserve accumulation. This is hardly a ringing endorsement for its further preservation. But you cannot replace a far-from-perfect system with a non-system, so change is probably not just around the corner.

Most emerging economies would welcome a more stable international monetary system. But their narrow national interests would be better served by China taking the lead in rebalancing its fundamental economic development strategies away from investment and exports towards domestic-led growth.

To put it bluntly, helping China escape its dollar trap or perpetuating the US addiction to debt is not a top priority for most emerging economies, particularly if this would perpetuate the very policies that gave us the global imbalances in the

first place. In other words, correcting the G2 imbalances is a lot more important for most emerging economies than reform of the international monetary system.

Summing up

The bottom line for emerging economies is to guarantee that discussions of monetary reform are not separated from a focus on how adjustment of existing imbalances can be achieved.

Neither today's existing international dollar standard nor the proposed Chinese alternative gives much confidence that they have a solution to this challenge. We are left depending on China and the US to take the lead in policy adjustment. This predicament could turn into a replay of Samuel Beckett's "Waiting for Godot", described by one wag as an evening when nothing happens twice. Change in such a world would be driven by crisis rather than effective policy implementation.

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