LA LETTRE DU CEPII

CENTRE D'ÉTUDES PROSPECTIVES ET D'INFORMATIONS INTERNATIONALES

No 308 - 16 February 2011

The long march towards a multipolar monetary regime*

International monetary reform is back on the agenda after two decades during which it has been hardly discussed. Controversies about the macroeconomic and monetary factors at the root of the financial crisis, China's exchange rate regime, the reasons why emerging countries accumulated about five trillion dollars of international reserves over the last ten years, and more recently the risk of currency wars all explain this renewed attention. Yet the key question is what monetary regime will best suit the world economy in the XXI[st] century. An evolution towards a multipolar system, with the dollar, the renminbi and the euro as its key likely pillars may mitigate some flaws of the present regime, such as the rigidity of key exchange rates, the asymmetry of balance-of-payments adjustments or what remains of the Triffin dilemma. However it may exacerbate other problems, such as short-run exchange rate volatility or the scope for 'currency wars', while leaving key questions unresolved, such as the response to global liquidity provision. Hence, in itself, a multipolar regime can be both the best and the worst of all regimes, depending on the degree of cooperation within a multilateral framework. In the short term, policymakers should concentrate on feasible reforms, while opening the way for more fundamental changes.

The current situation

The present international monetary system (IMS) is characterised by:

- Almost universal current-account convertibility and a high degree of capital mobility between advanced and emerging countries (with the major exception of China);
- Mostly free floating amongst advanced economies or zones, and a variety of 'fear of floating'[1] behaviours in emerging and developing countries;
- Liquidity provision in case of emergencies based on IMF facilities as well as bilateral swaps and regional agreements; however, since the Asian crisis at the end of the 1990s, self-insurance through official reserve accumulation has been prevalent, especially in Asia;
- Monetary surveillance and cooperation at regional (EU) or multilateral (G20, IMF) levels, the effectiveness of which is disputable.

In this context the US dollar remains dominant. Especially its share in international reserves and its role as an anchor currency remain unchallenged – they have even been increased by the economic dynamism of the countries of the de facto dollar zone in East Asia. It is true that the advanced economies and a group of emerging countries, most of which adopted in the 2000s some variant of inflation targeting strategies, have severed the direct links with the US dollar they once had. But at the height of the crisis even these countries also proved dependent on the Federal Reserve for liquidity provision: when monetary markets were clogged, the Fed swap lines brought much-needed oxygen to national banking systems. The dollar thus reclaimed its position during the crisis, proving that it was still the keystone in the IMS.

This still-central role of the dollar contrasts strongly with the emergence of a tripolar economy in which North America

*. This Letter is based on research prepared by Bruegel and CEPII for DG ECFIN of the European Commission and on a forthcoming report for the French Conseil d'Analyse Economique (A. Bénassy-Quéré & J. Pisani-Ferry, (2011), "Quel système monétaire international pour une économie mondiale en mutation rapide ?"). Views expressed in this paper are those of the authors alone.

1. See G. Calvo & C. Renhart (2002), "Fear of Floating", *Quarterly Journal of Economics*, Vol. CXVII No. 2, May, 379-408..

weighs no more than either Europe or East Asia (Figure 1). The persistence of dollar pegs is also inconsistent with the need for emerging countries to run independent monetary policies focused on domestic inflation and financial stability at a time when their economic conditions differ markedly from those of the US – something that became obvious in the fall of 2010 when the US decided to engage in another round of quantitative easing.

The debate on the pros and cons of monetary systems focuses on a five key issues:

♦ *Exchange rate misalignments*. Research has shown that for financially developed countries, short-term exchange-rate volatility has no significant disadvantages. However, persistent currency misalignments have serious consequences because they lead to distortions in economic decisions. This argument has long been used against floating exchange rates, but while these can lastingly depart from balance, they usually end up reverting to the long-term trend. Misalignments are now regarded more often as an argument against fixed exchange rates, especially in the case of China;

♦ *The global allocation of saving*. Financial liberalization has not led to capital flowing from rich to poor countries. The poor countries' large-scale investment into low-yielding reserve assets and the associated net savings flows from South to North involve significant macroeconomic costs (although they also reflect the success of export-led growth models);

♦ *The volatility of capital flows, reserves and the provision international liquidity*. Instead of playing a stabilizing role, capital flows have exhibited high volatility and they have often caused macroeconomic instability in emerging countries.[2] When faced with sudden capital outflows, emerging market countries must either draw on their reserves, or benefit from an outside injection of liquidity. Uncertainty over access to liquidity is an important factor in the accumulation of reserves, which serve as self-insurance. A growing number of emerging countries are also reintroducing capital controls to cope with short-term capital inflows;

♦ *International adjustment, discipline and coordination*. The burden of adjustment is unevenly distributed. The current regime does not provide incentives to countries in external surplus to adjust, and the demand for dollar-denominated assets acts as an incentive for the US not to reduce its external deficit either;

♦ *The global monetary stance*. A major role of an IMS is to ensure that the global monetary stance is delivering overall price stability. This role is of renewed importance in a world subject to resource constraints.

Economic power and international monetary arrangements

Figure 2 provides a bird eye's view of the evolution of the world economy and the distribution of economic power from 1870 to 2050.[3] For most of the gold standard period (1879-1913), the sterling area composed of the UK and its colonies was either the dominant power in terms of GDP or a close second to the US. Throughout the Bretton Woods period (1945-1973), the US was the undisputed dominant power. But according to long-term projections, China's weight (at 2005 prices and exchange rates) should exceed that of the euro area in 2025 and that of the US in 2035. The change of guard is even faster if measured in purchasing power parity exchange rates.

The world that is taking shape is therefore likely to be characterised for a few decades by a more even distribution of economic power between the three main currency-issuing zones than at any time in recent history. Implications for monetary arrangements should however be discussed with caution. Historical experience suggests (1) that the impact of economic power on monetary power is likely to be delayed; (2) that two international currencies can coexist for extended periods of time, with even possible reversals of fortune;[4] and (3) that economic size is only one determinant of international currency status alongside financial development and openness, the existence of a liquid and deep bond market, price stability and the predictability of monetary policy, or the ability of the system to cope with shocks. In addition, non-economic factors such as political cohesion and sheer power play a role. The example of Japan in the 1980s and the 1990s is indicative of the fact that, in spite of economic ascendency, no currency can acquire international status if such important conditions are not met.

Table 1 summarises the respective strengths and weaknesses of the euro and the renminbi with respect to these criteria. It shows that the euro has many of the attributes that could make it a good candidate for internationalisation, but that it is still handicapped by its incomplete governance and the lack of political cohesion. Although already important in normal times, these factors matter considerably in times of crisis. As far as the renminbi is concerned, its short-term handicaps are due to the limited openness and development of China's financial markets, as well as to a weaker policy record, but provided financial reforms are carried out in China, it could gradually become a major challenger, and ultimately the main challenger to the dollar.

2. A. Kose, E. Prasad, K. Rogoff & S.-J. Wei (2006), "Financial Globalisation: A Reappraisal", *IMF Working Paper* 186/2006, August.
3. The figure is based on Angus Maddison's historical statistics (www.ggdc.net) and long-term economic projections prepared by CEPII: J. Fouré, A. Bénassy-Quéré & L. Fontagné (2010), "The World Economy in 2050: a Tentative Picture", *CEPII Working Papier*, no 2010-27, December.
4. See B. Eichengreen & M. Flandreau (2008), "The Rise and Fall of the Dollar, or When Did the Dollar Replace Sterling as the Leading International Currency?", *NBER working paper* No. 14154. The historical example of the Sterling and the dollar suggests however that a multipolar system may not be a stable equilibrium in the long run.

Barring a severe dollar crisis, the evolution towards a multipolar system will likely take time. Moreover, genuine multipolarity can only develop if each pole allows its currency to play an international role. In the current context of open markets for trade in goods and financial assets, this requires allowing non-residents to hold domestic and offshore financial assets in the home currency, and enabling them to convert assets into other currencies without restriction at any time. For the market to work smoothly, this would also require residents to be allowed to buy and sell foreign-denominated assets without constraints.[5]

The pros and cons of a multipolar system

A major question for today's policymakers is whether evolution towards a multipolar system is desirable. Still, assessing IMS is a difficult task. One of the reasons is that there are few opportunities for genuine comparison. Another reason is that an IMS is rarely a pure one, so one can only observe hybrid regimes. It is however useful to contrast schematic systems to gauge the pros and cons of moving in a particular direction. In the following we compare two polar systems:

1) A system in which one international currency is used by all countries as an anchor for pegging purposes and as a store of value – hence something at world level close to the so-called 'Bretton Woods 2 system;[6]

2) A system with a few key currencies with free capital mobility and floating exchange rates between them. These currencies can in turn serve as anchor and reserve currencies at regional level, with corresponding restrictions on capital flows when monetary sovereignty is not given up altogether (through dollarization or monetary union).

The current regime borrows from both polar systems: it involves more exchange-rate floating than the first system but less symmetry than the second. Here we compare the two polar regimes while assuming evenly-distributed economic weights between the key players as suggested by Figure 2 and relying on three straightforward criteria: efficiency, stability and equity.

- As regards economic *efficiency*, to the extent that monetary blocks would match economic ones (with floating exchange rates between the blocks but not necessarily within them) the loss, in terms of transaction costs, of having several key currencies rather than a single one should remain limited. At the same time there would be some gains in terms of capital allocation through a lesser accumulation of costly official reserves, greater incentives to allocate capital within each currency block, and less scope for real exchange-rate misalignments (although short-term exchange-rate volatility could actually be magnified).
- As regards *economic and financial stability*, multipolarity could help mitigate the Triffin dilemma,[7] or what remains of it, and limit the risk of lasting imbalances and their eventual unwinding through crises. Spillovers onto bilateral exchange rates of third-country policies (for example, the effect of China's policy on the euro-dollar exchange rate) would also be reduced. However, short-term volatility could be increased due to the increased substitutability of key currencies in international portfolios. Additionally, the management of global liquidity would require strong cooperation among key countries, and the move to multipolarity would not fundamentally change the problem of liquidity provision in times of crisis (to the extent that the Federal Reserve would no longer feel in charge, it may even worsen it).
- As regards *equity*, provided all key currencies are truly allowed to float, a multipolar system would reduce the asymmetry of adjustments and the 'exorbitant privilege' of issuing reserve assets would be more widely shared.

The move towards a multipolar system would thus yield improvements in terms of efficiency and equity, while its impact on stability could be more ambiguous. The gain from a lesser scope for imbalances would likely overcome the loss in terms of higher volatility, given the availability of affordable hedging products, but instability arising from lack or excess of liquidity at the global level would still need to be addressed.

On the whole, a case can be made for moving from hegemony to multipolarity. However, gains would be conditional on free floating and capital mobility between key currencies, and on a move of the third countries currently pegged on the dollar towards more flexibility or regional pegs. Many emerging countries will likely continue to value exchange-rate stability. To the extent that each country tries to monitor its competitiveness through foreign-exchange interventions, this could trigger more frequent "currency wars" that are a direct consequence of failures of collective action. This risk would be mitigated if key currencies truly float among themselves, but it will not be eliminated.

5. One-way financial opening would not allow the internationalisation of a currency, as it limits exchanges to the balance of the financial account (as opposed to gross flows). Consider, for example, that non-residents are allowed to acquire assets in China without residents of China being able to purchase assets abroad. Unless the central bank compensates for all capital inflows, the internationalisation of the renminbi would not be possible. Note that it is free movement of capital that is key here, not the existence of a current account deficit.

6. M. Dooley, D. Folkerts-Landau & P. Garber (2004), "The Revived Bretton Woods System", *International Journal of Finance and Economics* 9, pp 307-313.

7. Robert Triffin exposed in 1960 that the US had to run a balance-of-payment deficit to meet the foreign demand for dollar reserve assets, but that these deficits and the resulting deterioration of the gold backing of the dollar were undermining confidence in the stability of the US currency. The relevance of the Triffin dilemma is diminished with the end of convertibility in gold and the advent of free capital mobility, because the US can simultaneously (and during a long time) provide the world with liquid, dollar assets, and invest in foreign, less liquid ones. he Triffin dilemma then arises more from the transformation risk than from the accumulation of deficits. Note that in a multipolar system the Triffin dilemma would be spread across the key countries or areas. Only a supra-national currency could fully eliminate the Triffin dilemma.

Multipolarity per se is therefore not a sufficient response to international monetary challenges. Although it is not the responsibility of the international community to decide which currency should be internationalized, it should work to make the benefits of multipolarity materialize. This involves exerting supervision on national exchange-rate policies, which is a mission of the IMF.

The policy agenda

The transition towards a multipolar system is most likely to take decades and to be driven by a series of individual choices by governments[8] and investors rather than international organisations. However, the international community does have a role to play in assisting and anticipating the evolutions in order to avoid unnecessary disturbances. In particular, abrupt diversification of public and private portfolios could be destabilising. One of the readings of the financial crisis of 2007-2009 is that, along the decade before the crisis, the global demand for liquid assets excessively focused on US assets. One of the challenges of the transition period will be of a similar nature: to ensure a smooth diversification of reserves into other currencies through a simultaneous expansion of supply and demand for renminbi and/or euro assets. The US, China and euro area all have a stake in avoiding a disruptive transition. Cooperation between central banks will thus be key. At regional level, cooperation will also be required to ease the transition, especially in Asia where, until now, the dollar peg has served as a substitute for genuine monetary coordination.

In this spirit, the immediate priorities should be:

(1) *To move towards greater flexibility of the exchange rates of the main currencies*. Increased flexibility of the renminbi exchange rate is consistent with an evolution towards multipolarity. However, it should go hand-in-hand with the recognition that exchange rates can be subject to mis-adjustments and that this can justify limited currency interventions, preferably coordinated, and/or capital controls.

(2) *To create a framework for surveillance of capital controls*. As capital controls are making their comeback into the legitimate policy toolkit, there is a need to define when and how they can be used. In order to avoid them being used in mercantilist or beggar-thy-neighbour fashions, the international community could agree on a code of conduct on capital controls and the IMF could exercise surveillance. This implies extending the IMF's mandate to include surveillance of the financial account[9] and enhancing the effectiveness of exchange-rate policy surveillance.

(3) *To enhance existing facilities for the provision of global liquidity in times of crisis*. This would imply going a step further than existing facilities, and in particular making the provision of liquidity explicitly counter-cyclical. Multilateral arrangements are essential and they can be complemented by regional and bilateral facilities. This would reduce the self-insurance motive for reserve accumulation and thereby bring more transparency to the discussion on exchange rates.

(4) *To create a venue for cooperation in managing global liquidity*. Although projects aiming to give a more important role to the Special Drawing Rights (SDR) are remote, a more modest objective could be to institutionalise cooperation and dialogue between the governors of the central banks whose currencies belong to the SDR basket, so that the global monetary stance and global liquidity are taken into account in national monetary policies. The SDR is a natural candidate for this because the central banks of the key currencies already have the ability to create money when SDRs are swapped for their own currencies. Inclusion of the renminbi in this basket (conditional on gradual internationalisation) would give more weight to such an initiative. This could lead to the emergence of a G5 consisting of the US, the euro area, the UK, Japan and China, which would be tasked with addressing those monetary and exchange rate issues that cannot realistically be tackled within the G20 framework.

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8. Chinese authorities have already announced their intention to internationalize the renminbi and have taken a few steps in this direction, even though the path will still be long. Concerning the euro, internationalisation will require some form of unified market for European riskless assets, the so-called (and controversial) Eurobonds. For a proposal see J. Delpla & J. von Weizsäcker (2010), "The Blue Bond Proposal", Bruegel Policy Brief, 6 May.
9. IMF member states have to comply with Art. VIII-2 rules for current-account transactions. They are free to impose restrictions on capital flows.

LA LETTRE DU CEPII

PUBLISHER:
Agnès Bénassy-Quéré
Director of CEPII

CHIEF EDITOR:
Gunther Capelle-Blancard

DTP:
Laure Boivin

DIFFUSION :
La Documentation française.

SUBSCRIPTION only to the original, French version
(11 issues per year)
France 60 € VAT
Europe 62 € VAT
DOM-TOM (NET, econ. air mail) 60,80 € NET
Other countries (NET, econ. air mail) 61,90 € HT

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La Documentation française
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75007 Paris
Tél. : 01 40 15 70 00

WEB site: **www.cepii.fr**
ISSN 0243-1947

CCP n° 1462 AD
16 February 2011

Imp. Centre d'analyse stratégique
Imprimé en France

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et d'informations internationales
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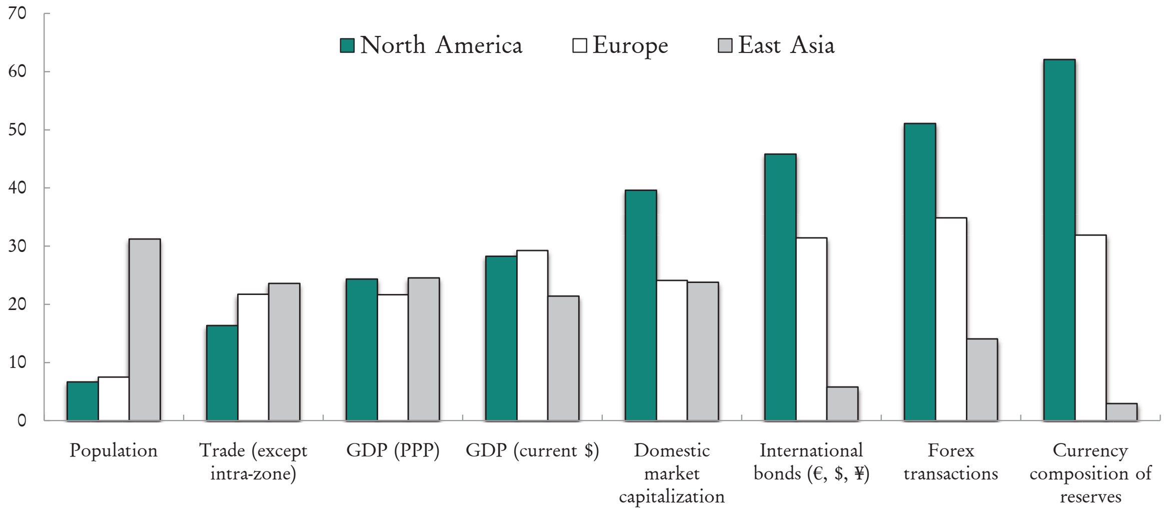
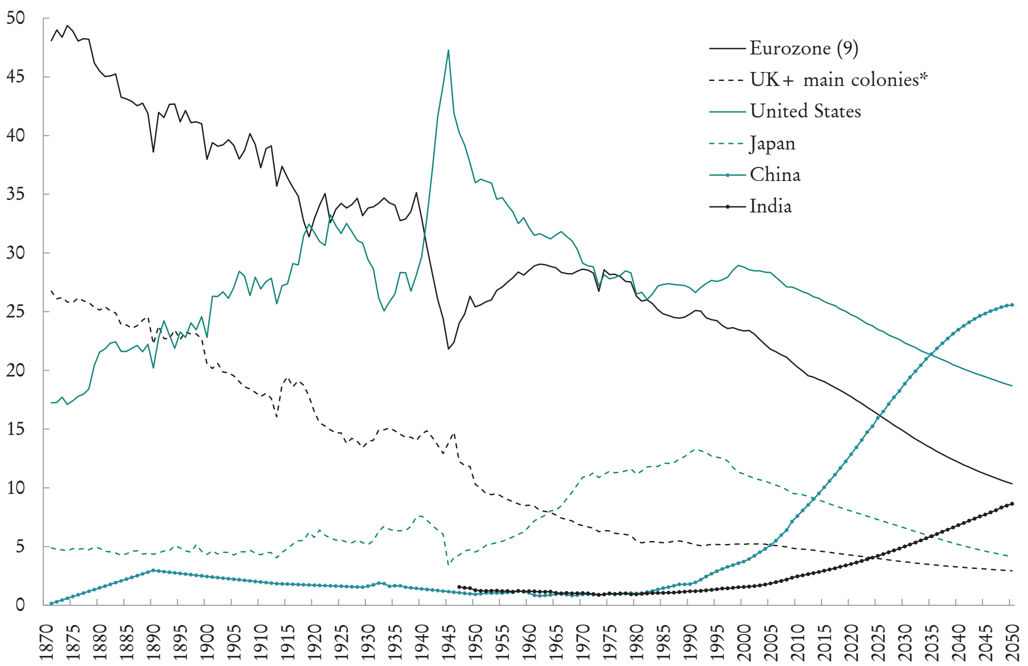
Figure 1 – Economic tripolarity vs. monetary unipolarity
share of world total in percentage



North America = NAFTA Europe = UE + Switzerland East Asia = ASEAN + 3

Source: WEO-IMF 2009 (population, trade and GDP), WFE end 2009 (domestic market capitalization), ECB 2009 (international bonds - narrow definition), BIS triennal survey 2010 (forex transactions), COFER-IMF 2009 (international reserves).

Figure 2 – Percentage shares of selected countries and areas in world GDP, 1870-2050
(at 2005 prices and exchange rates)



* Australia (up to 1900), New Zealand (up to 1939), India (up to 1946). Canada is not included as it was already nearly independent in 1870.

Sources: Authors' calculations based on Angus Maddison's historical statistics and CEPII projections.

Table 1 – Potential for internationalisation: the euro and the renminbi, in 2010

	Euro	Renminbi
Size	20% of world GDP, decreasing	7.6% of world GDP, increasing
Financial openness	Full capital mobility	Restricted capital mobility
Financial markets	Second after the US, but bond markets remain fragmented in the absence of unified Eurobonds	Underdeveloped compared to country size
Price stability and monetary policy predictability	Very good track record	Good track record but at risk, in part because of currency peg, in part because the resilience of the financial system to openness remains untested
Ability of policy system to cope with shocks	Limited by institutional arrangements	Strong
Power and cohesion	Limited by political fragmentation	Strong

Source: authors.