New world currency order starts to unfold

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The US dollar still retains a disproportionately large representation in international trade transactions, official reserves and exchange rate regimes.

This is largely due to the many institutional arrangements and incumbencies which remain from the Bretton Woods era of 1944 to 1971 when the gold-linked dollar provided the formal anchor for the world monetary system.

Now, though, this privileged, inherited status of the paper dollar is under threat from the falling relative economic size of the US and its cyclical influence and the scale of the excesses that very privilege has allowed.

Appropriately straddling the turn of the 21st century, the "borrowed" consumer decade of 1997–2007 may come to be regarded as the fin de siecle, marking a critical juncture in the drift away from the US dollar hegemony that has dominated the international financial system since the Bretton Woods regime ended in 1971.

Instead, we are on the road to a new, multilateral currency order.

As far back as the 1970s, in the earliest years of the floating rate regime when the US dollar declined rapidly in value after its link with gold was formally broken, its hegemony was under threat. But, back then, the US was still a net creditor nation and there was no obvious liquid alternative.

Today, after almost 25 years of deficits, the US is the world's largest debtor with little chance of shrinking that debt without significant further real depreciation of its currency.

Moreover, while the US financial system is in crisis with increasing public intervention in the system, liquidity and transparency in both industrialised and emerging currency and financial markets, while still imperfect, has greatly increased.

Finally, there is a credible, liquid alternative currency which can at least share the role of global numeraire; the euro.

This backdrop of cyclical and structural pressures presents a challenging environment for even the most established and rigid dollar-peggers such as Hong Kong and the Gulf states. Their pegs have resulted in unprecedented foreign currency reserve accumulation, as warranted exchange rate adjustments are prevented via intervention and capital control.

Before the crisis in the US financial system, higher inflation was also a natural consequence of having to keep monetary policy linked to the US Federal Reserve.

The credit crisis has distracted attention from the disequilibrium of many dollar-pegged currencies around the world, not least as the dollar has recovered significantly in value over the past year. But, as the world emerges from the crisis, US monetary policy may stay expansive for a prolonged period and the dollar may become significantly weakened again.

This could drive a new wedge between the appropriate monetary policy of the dollar-pegged states and the policy of the US, especially as expansive monetary policy may eventually drive up global commodity prices upon which the economic performance of many dollar-pegged states depends.

Domestic price adjustments, in imports, housing, wages and ultimately all goods and services, will be part of the equilibrating costs of a currency peg during such phases as long as the peg is maintained.

If the currency cannot adjust, then prices must do so. Is the cost of ever-increasing phases of inflation or, in other circumstances, potential deflation, worth sustaining unilateral pegs?

In a world of more diversified trade, fading US dominance and ever-larger capital flows, the answer is, increasingly, no.

Boom-bust cycles, redistributions and inequalities of income and purchasing power, damage to non-US export markets and disincentives for investment are all likely to be prevalent.

Economic considerations would thus argue that adjustment of these regimes is justified, not just cyclically but structurally, too.

But what is the alternative? Given the typically high trade dependence and relatively low liquidity of the currencies in question and the ever greater scale of international capital flows it is unlikely the volatility of a perfectly free float, or “benign neglect” of the exchange rate, will be desirable.

Political considerations may dictate simple revaluation of the dollar peg rate as the only viable option to regain control of inflation in the short to medium term.

However, this may invite yet larger scale speculation because any change in these long-established regimes would be likely to weaken their credibility.

A switch to a peg with the only liquid alternative to the dollar – the euro – may be more inappropriate unless the country in question has highly concentrated trade with Europe alone. The appealing alternative in a more diversified world economy is a multilateral currency regime consisting of a blend of major currencies such as the euro and dollar or a much broader trade-weighted basket. This approach is already favoured by several countries which have moved away recently from unilateral pegs including Russia and Kuwait and, with great success, Singapore since 1981. While China has maintained tight control of the yuan’s exchange rate versus the dollar since the unilateral peg was abandoned in 2005, it is ostensibly managed with reference to an unpublished, broader exchange rate basket. Such a multilateral currency world should be a natural consequence of economic growth over time.

But the pace at which the shift takes place will depend, critically, upon the stability of the US and its economic policies. For the first time in modern history, many of today’s largest foreign currency reserve holders are not part of the Group of Seven (G7) industrialised countries. This is important because the G7 has traditionally acted as a co-operative stabilising influence dampening major currency swings with intervention at times of greatest stress and illiquidity and maintaining confidence in the dollar. Today’s largest currency reserve holders may act as stabilisers to preserve their own self interest but no more than that.

As almost 100 countries still use currency pegs in varying forms, mainly versus the US dollar, the procession to a more multilateral exchange rate regime is expected to continue. With increasing diversity of central bank reserve assets and an increasingly diverse range of reserve holders themselves, a tri-polar world with shared primary reserve status between the principal currencies of the Americas, Asia and Europe is likely to take shape.

The euro is increasingly posing that challenge and can expect to see further increases in its global currency reserve share from about 30 per cent now.

And, in the much longer run, China’s yuan may well be both liquid and flexible enough to represent Asia’s primary role in the multilateral system.

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