# THE INTERNATIONAL MONETARY SYSTEM IS CHANGING: WHAT OPPORTUNITIES AND RISKS FOR THE EURO?

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## Highlights

- After a thirty-year pause, discussions on the future of the international monetary system (IMS) have restarted. This is partly due to the fact that the IMS has facilitated, or at least not prevented, the economic and financial imbalances that led to the recent crisis.
- This paper argues that the international position of the US dollar is likely to erode in the coming years, though the speed of the process is uncertain. This will create a demand for other currencies to be used internationally as means of payment and store of value. The most likely candidates for filling the partial vacuum created by the dollar's decline are the euro and the Chinese renminbi. The probability that the renminbi will eventually become one of the world's key currencies is very high, but the speed of the process is uncertain.
- As far as the euro is concerned, much will depend on if and how the sovereign debt crisis is resolved. Our view is that the crisis will be dealt with and that it will result in radical steps towards fiscal and financial integration. If such steps are taken, the euro will secure both internal stabilisation and a growing international role.

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## 1. At the crossroads

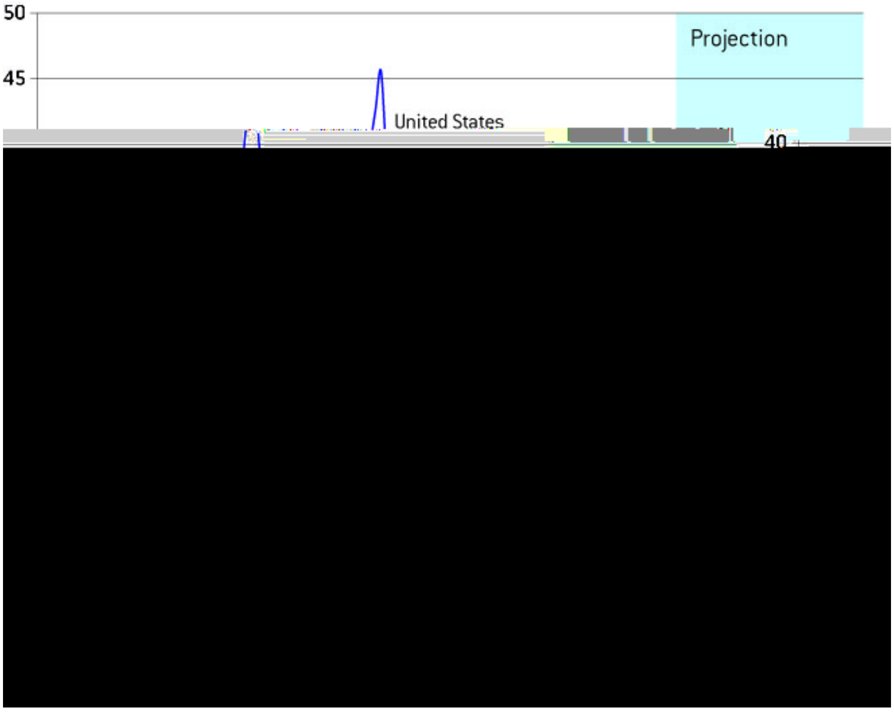
After a thirty-year pause, discussions about the future of the international monetary system are likely in the near future. The aim of this paper is to outline some of these developments and to discuss foreseeable implications for Europe.

Before 2007, some had already noted the peculiar configuration that the post-Bretton Woods system had assumed, with China and the US increasingly unbalanced in their external positions and with a common interest on their part to postpone or even avoid adjustment (Dooley, Folkerts Landau and Garber, 2004). With the crisis, concerns about this situation have increased. Three things happened. First, analyses of the mechanisms driving the supply and demand for risky assets in th prospects are not necessarily as grim as they appear at present. Our focus is on the

Gradually, however, this hope dissipated as the two assumptions on which it rested became untenable. First, macroeconomic policies by the key players were meant to remain disciplined and consistent with maintaining the system in balance. This was obviously not the case for the United States whose currency retained a central role in the system giving it the 'exorbitant privilege' of easy external deficit financing and seignorage extraction. Second, countries outside the advanced world, often unable or unwilling to abide by the system of generalised floating and flexible inflation-targeting with full capital mobility and were once a relatively a

Furthermore, dissatisfaction with capital flows volatility has revived the debate about the costs and benefits of free capital mobility. The general consensus established in the 1990s about the benefits of financial globalisation is difficult to predict. Sceptics point out that agreements on overhauls of the IMS were only reached in exceptional circumsta meantime – say, in the next 10 to 20 years – there will be an interregnum during which economic power will be much more evenly distributed amongst a core group of countries.

Figure 1: Percentage shares of selected countries and areas in world GDP, 1870-2050 (at 2005 exchange rates)




Sources: see Angeloni *et al* (2011).

The second factor has to do with the ability of a country or a group of countries to exercise monetary leadership. Beyond economic size, this ability depends on financial development, on the quality of economic and financial institutions, on the nature and effectiveness of governance, and on an economic power's political might and commitment to global leadership. Table 1 summarises the respective situations of the US dollar, the euro and the renminbi with respect to these elements.

Table 1: The incumbent and the challengers: state of play in 2011

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defensive than offensive; they convey a more cautious approach to liberalisation by emerging and developing countries rather than an irreversible U-turn. Meanwhile, Asian financial centres have continued to strengthen, and their openness and integration have increased.

A separate issue concerns the direction of capital flows. A striking characteristic of the last decade is that, in net terms, while private capital has been flowing 'downhill', from relatively richer to relatively poorer countries, official reserve hoarding has reversed the direction of total net flows 'uphill'. Although they abated somewhat in the aftermath of the global crisis, there are reasons to believe that 'South-North' capital flows are going to remain strong and that the world saving-investment balance pattern is not going to reverse dramatically over the next 10-15 years[4].

Based on these observations, there seems to be three scenarios for the IMS in the foreseeable future, say the next 10-15 years:

1. A repair-and-improve scenario whereby changes to current arrangements are introduced through incremental reforms. These are *inter alia* enhanced surveillance, a voluntary reform of exchange-rate arrangements, especially in Asia; improved international liquidity facilities; accompanying domestic reforms such as the development of home-currency financial markets; and regional initiatives to complement current IMF facilities. Under this scenario, the international role of key currencies remains broadly constant and the US dollar retains its dominant role, the euro's role remains broadly unchanged, and the one of the Chinese renminbi increases, but remains marginal in comparison to the dollar and the euro.
2. A multipolar scenario in which a system structured around two or three international currencies - the dollar and, presumably, the euro and/or the renminbi – emerges over a 10-15 year horizon. Although a move to a multipolar system is generally viewed as a remote prospect, especially in the case of the renminbi, it would be entirely consistent with the long-run evolution of the world economy. Moreover, the Chinese authorities have taken significant steps in this direction through various schemes and their currency has a strong potential for internationalisation. As for the euro, it has already developed as a diversification currency and in this scenario the euro area overcomes its current difficulties and the euro graduates from a mainly regional to a truly global currency. Yet an alternative bipolar scenario with the dollar and the renminbi could occur if the euro remains handicapped economically and politically.
3. A multilateral scenario in which participants agree to take steps towards a strengthened international monetary order. In contrast with the multipolar scenario, which will largely rely on market forces and national policies, renewed multilateralism would require a fairly intense degree of international coordination and the development of new instruments to help escape the pitfalls of regimes based on the dominant role of one or a few national currencies, foster macroeconomic discipline and provide for international liquidity management. A system of this sort could build on the existing SDR or rely on other, new vehicles.

Compared with the current regime, each of these three scenarios has advantages and disadvantages in terms of efficiency, stability and equity. It has also its own specificity in

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terms of feasibility. Table 2 provides an assessment of the three scenarios in terms of these four criteria.

Table 2: Assessing the three scenarios

| Criterion | Scenario 1<br>Repair and improve | Scenario 2<br>Multipolarity | Scenario 3<br>Renewed multilateralism |
|---|---|---|---|
| Efficiency | | | |
| Economies of scale | 0 | - | 0/- |
| Espillov-10.5(e)-422(irs]TJ10.894611.1497 TD0.8(752-3 T[a++]987426 +665.6(o+688 026 +6987426 +6TJ/F211 Tf-00.8946112.6343 | | | |
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More extreme multilateral scenarios involving the creation of an 'outside' international currency in a proper sense (modelled for example on Keynes' bancor) rather than simply the SDR – a scenario envisaged recently by Padoa-Schioppa (2010) would be preferable in our view, at least theoretically, as they would guarantee a fully symmetric adjustment mechanism and full control of global reserves. Admittedly, however, they are even far less realistic than the more modest multilateral scenario considered here.

If feasibility in the medium term is the main guiding principle, then the multipolar scenario is clearly the most interesting to explore since it best corresponds to the structural changes in the world economy discussed earlier, in particular the role of China.

It should be emphasised, though, that the gains from multipolarity can only materialise if key currencies are truly allowed to float (although maybe in a managed way), and if third countries move towards more flexibility or regional pegs. Here the key question concerns the internationalisation of the renminbi and whether it will make exchange rate flexibility more acceptable for both China and its regional partners.

## 4. A key question: the role of China

There are several reasons to assume that the renminbi will become a major international currency. As the second largest economy in the world, China already has the scale necessary to create deep and liquid financial markets. The huge size of its foreign trade and foreign direct investment volume forms the basis for renminbi-denominated transactions. In addition, the People's Bank of China (PBC) and the State Administration of Foreign Exchange (SAFE) have large balance sheets and already actively intervene in on- and off-shore financial markets. Moreover, importantly, as Eichengreen (2010) argues, the rise of the renminbi to a fuller international status will be advantageous to China. Besides the extraction of seignorage, domestic firms would be able to limit their foreign exchange exposures by transacting internationally in their own currency, the PBC will be able to follow an independent monetary policy and China's financial sector will become more competitive.

At the moment, however, the internationalisation of the renminbi remains very limited, even compared to currencies of other emerging countries. Cheung, Ma and McCauley (2010) show that, in 2007, daily trading of the renminbi barely surpassed the sum of daily imports and exports from China, whereas foreign exchange turnover in relation to foreign trade was around 10 for the Indian rupee or the Korean won and roughly 100 for international currencies such as the Swiss franc or the US dollar.

There are, clearly, formidable obstacles that must be overcome before China's currency gains international status, which presupposes capital account convertibility – the ability to freely convert domestic into foreign financial assets at market determined exchange rates. They include the quality of financial regulation and supervision, the degree of the rule of law, the exchange rate policy and the strong reliance on exports. These obstacles are all interrelated and overcoming them will amount to a fundamental change in China's economic model. Barry Eichengreen argues that *"these kinds of changes are coming. While one can question the timing – whether Shanghai will have become a true international financial centre by 2020 [as China's State Council has announced] and whether the renminbi will be a first-rank* *international currency by that date – one cannot question the direction"* (Eichengreen, 2010, pp. 6-7).

Indeed the central question about the internationalisation of the renminbi is one of timing, which is a key factor behind the different scenarios for the evolution of the IMS over the next 10-15 years discussed in the previous section.

In scenario 1, it is assumed that China gradually aligns its monetary regime on those of other Asian emerging countries, which can be characterised by 'dirty' float and a limited use of capital controls. Building on its experience with the creation of an offshore market for the renminbi, it continues to foster the international role of its currency, but at a gradual pace.

By contrast, scenario 2 assumes that China moves at a more sustained pace towards the internationalisation of its currency. Changes are initially gradual (for example, we suppose an extension of the 'pilot' project of renminbi internationalisation launched in 2009, the promotion of one or several active financial centres and initiatives towards increased financial account openness), but they create a momentum and trigger enough two-way capital mobility for a degree of internationalisation of the renminbi to take place despite remaining limitations to capital mobility. Further internationalisation would require greater capital account liberalisation and a freely floati81 0 .185 e e9is c

The stance of European policymakers towards the phenomenon has been ambivalent. In 1999, the ECB formulated a doctrine that can be labelled "watchful neglect". According to it, the internationalisation of the euro is a market driven process that should be monitored, not pursued ('neither fostered nor hampered' is the expression used in the ECB, 1999); it is a by-product of other goals (price stability, financial integration), not a goal in itself. This view arose partly from the consideration of the potential costs and risk of an international currency, in terms of added volatility and vulnerability to external influe the eventual outcome, more market turbulence is likely. While there is no statistical evidence yet that the euro debt crisis has altered the portfolio shares of global private and official asset holders, or has affected other indicators measuring the international use of the euro, the present uncertainties are enough to discourage anybody from venturing into conjectures on further advancements of the euro's cross border presence in the years to come.

While agreeing that caution is

international investors (bank deposits, Treasury paper, etc) and financing, via trade credit, the vast international trade between the UK and its empire (Eichengreen, 2011, chapter 3).

The question arises of whether

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