
NY
Tokyo
London
FTSE
4.83
-0.54
0.01
1.34
27%
0.03%
0.00%
0.17%
5.63
0.23%
-6.89
0.06%

Third global currency

The economic rise of Asia and the need for an alternative to the US dollar as the world's reserve currency produces a parallel broad-basket Asian Currency Unit.

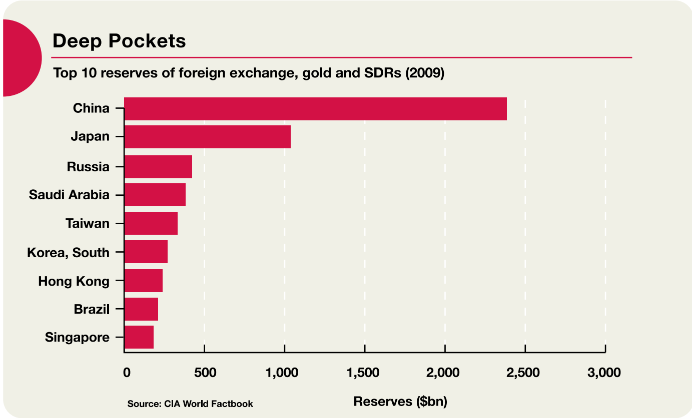
Alongside individual national currencies and regional currencies such as the East Caribbean dollar and the West African franc, today there are essentially two key currencies that can be considered as global reserve currencies: the US dollar and the euro. These are the currencies in which key commodities such as oil, gold, steel and so on are priced; they are the primary currencies against which all others are compared; and they are the currencies that most national governments and central banks hold as part of their national reserves. By implication, they are therefore seen as the currencies of greatest stability and the ones that keep the world's trade systems flowing.

However, things change and global reserve currencies are not immune from this. Going back a century or so, UK sterling was the default global currency, the US dollar was increasing in influence and the euro had not even been conceived. Today, although they are clearly the current leaders, both the dollar and the euro are under increasing pressure. Momentum is building up for a change, or at least the addition of a third, alternative global reserve currency – one that is less dependent on the West and one that more readily supports the future needs of the global financial system. As the G20 has superseded the G7, many have recognised that financial management of the global system must become more equable. Robert Zoellick, President of the World Bank, recently said that the US must 'brace itself' for the dollar to be replaced as the world's reserve currency.

The fundamental drivers of this are the clear shift in the centre of economic gravity towards Asia, the associated growing economic importance of China and the increased risk stemming from growing levels of debt in the US. In addition, the recent problems in the eurozone have raised increasing concern over the long-term credibility and viability of the euro as a common currency across hence many economically varying countries, and so its credibility as a stable global reserve currency.

Given that US public debt has already passed 60% of GDP and could hit 80% in the next decade, many argue that 'the US may require a more flexible fiscal policy than currently exists given its status as the now default primary currency'. With China and others continuing to prosper by lending the US money to buy more of their products and services and so increasing debt and dependency and with the continued rise of the cost of alternative stores of value such as gold, one option for the US government is to devalue the dollar. This would help rebalance the system both domestically and locally, support export growth and also give more economic flexibility. However, at this time, due to its global position as a reserve currency and China's resistance to free-floating the renminbi, this option is not available.

At the same time, many high-growth Asian economies are keen to move on from needing to trade with each other via the dollar. Not only do they want to avoid having to use the dollar as the de facto intermediary for many international trades, they also want to keep their



money within their own control with less dependency on the strength of the US economy and the highly US-orientated global financial institutions. 'Why should Asian savings make the round trip to the US?' was a typical comment we encountered. China, India and Japan as well as many others such as Thailand, Vietnam and Malaysia are keen to have an alternative option to the dollar, but this is increasingly seen as not being the euro. The evident weakness in the eurozone, where strong economies like Germany have clearly been carrying weak ones like Greece, creates instability and, besides that, the euro can also be seen to be just as much linked to Western financial imperatives as the dollar.

"Over the next decade, we will move unmistakably towards a multi-polar world which will be characterized by a much broader consultative process that extends to a larger number of jurisdictions. Greater coordination amongst major economies on financial sector regulation will be needed, and this can be facilitated by the newly enlarged Financial Stability Board based in Basle. At its core, the coordination will have to be aimed at achieving greater trust in the transparent and universally applicable working of the financial system. This will especially need to dispel the fear that the global financial system has a bias in favour of any one country or group of countries or group of dominant institutions."

During the course of the Future Agenda programme, there was much discussion on this topic. Rajiv Kumar of ICRIER in Delhi authored a challenging initial perspective on the future of currency that was debated in workshops in Europe and Asia. In addition, talk of the decline of the dollar, the US–China exchange rate and the potential for alternatives was increasingly reported in much of the mainstream financial press. All agreed that change is on the horizon but the options and timescales for a third global currency to have an impact were hotly debated. Effectively, most experts see that three alternatives are available.

The China option is one that is seen as increasingly possible, but not the right answer: the rise of China's economic power creates a case for the renminbi revaluation to make it a global reserve currency but there are several fundamental barriers to this. Firstly, the controls exerted by the Chinese government on its currency mean that it is devalued against the rest of the world's currencies, and especially the dollar, to give it export advantage. As Niall Ferguson points out:

"Because Beijing keeps the exchange rate fixed, the dollar cannot devalue against China (and other parts of Asia) despite the large US trade deficits."

Although the Chinese government started to relax the pegging to the dollar in June 2010, the variation being allowed is marginal: analysts at Credit Suisse reckon that the renminbi is undervalued by 50%. These controls prevent the renminbi from having capital account convertibility and so don't allow it to float freely in sync with other currencies; the removal of these controls would be a prerequisite for the renminbi to become

Why should Asian savings make the round trip to the US?

more influential on the world stage. In addition, some argue that, even if the Chinese government allowed their currency to become fully convertible, China may not be prepared politically to assume such a position of global financial leadership and associated responsibility.

A second option is for all countries to adopt what are termed 'special drawing rights' as a parallel reserve currency for international trade. SDRs are the international reserve assets managed by the IMF. They were used to boost global liquidity in 2009, but it is argued that ongoing applications should be made more practical. Several advisers in the US are keen on this approach because it provides an alternative to the dollar but does not give away too much influence as long as the US is still part of the pool. But many suggest that this could constitute a true single world currency and therefore is simply not practical: differential interest rates and selective monetary policies make it impossible and currency harmonisation cannot readily be implemented across countries at different stages of economic development. The considered view is that the IMF is not a super central bank and turning SDRs into a world currency is neither politically possible nor practical. In addition the likes of Martin Feldstein, Professor of Economics at Harvard University, have pointed out that the costs of such a single currency are greater than the benefits of the existence of hedging.

The third option for the third global reserve currency is the creation of what has been termed the Asian Currency Unit or the ACU. This is a basket of Asian currencies that are used not as the primary currency in each country but as a secondary parallel currency for trade. Given the similarities to what happened in Europe in the late 1990s, many see that the ACU could be a precursor to a common future currency, just as the ECU was for the euro. However, this is not necessarily the case. The ACU is not implicitly linked to Asian monetary union, nor requires it, but is rather a means by which the Asian economies can take greater control of their world:

"If the Asian Development Bank takes the European model forward and creates a parallel currency that is a plural basket of national currencies, the Asian region as a whole will gain some decoupling from the US dollar. This will allow economic agents in the region to invoice financial and trade transactions in a common currency and reduce exchange rate risks as well as channel Asia's savings more efficiently within the region. As a regional benchmark, the ACU will help share the degree of divergence of each participating country's' currencies, which will improve the understanding of generic problems in a particular currency's market and in pursuing macroeconomic policies."

A key question here is whether the ACU would require all nineteen ASEAN countries to participate from the start, or whether it would be more pragmatic to begin with the four big economies – China, India, Japan and South Korea – and then add in more as others gain stability. This would essentially copy the good aspects of the ECU, beginning with the strongest economies without trying to include everyone too soon. It is clear that the concept of the ACU has wide-ranging appeal and benefit, but is also evident that politics could get in the way – especially between China and the other major regional economies. However, given that the alternative is to maintain the dollar as the global currency, with ever-rising pressure on the system, some, but not all, see that by 2020 a more equable model, like the ACU, could well be in play.

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