Illustration by BINAY SINHA

A new international monetary system?

The current monetary 'non-system' is the only way to deal with the turmoil in the world economy, says DEEPAK LAL

As China's foreign exchange reserves passed $2 trillion, its calls for a new international monetary system are becoming more strident. Is there a case for changing the current floating rate international monetary 'non-system' with the dollar as its core?

Any international monetary system faces the 'trilateral dilemma'. One can have two, but not all three, among fixed exchange rates, monetary independence and free international mobility of capital. Under the Gold Standard (which perished in the Great Depression) there were fixed exchange rates and free capital mobility but no monetary independence. Under the Bretton Woods quasi-fixed exchange rate system which replaced it (and perished in the Great Inflation generated by the Vietnam War), there were fixed exchange rates and monetary independence but not free capital mobility, with capital controls restricting short-term capital movements. In the current floating rate 'non-system' there is capital mobility and monetary independence but no fixed exchange rates.

The Chinese, who have run a Bretton Woods-type quasi-fixed exchange rate system — with an undervalued renminbi pegged to the dollar — want to extend it to the world, with an expanded form of SDRs replacing the dollar as the global reserve currency. This desire is based on China's reluctance to freely float its currency, and its mounting fear that US fiscal and monetary expansion will lead to a fall in the value of its massive holdings of US government debt, as US interest rates rise and the dollar depreciates. This is a consequence of its foolish exchange rate policies, which in effect have converted a large part of China's massive savings into relatively low-yielding US government debt. But, should the world accede to the former Chinese desire (as also that of Russia and Brazil) to dethrone the dollar, and is it likely to succeed?

Any quasi-exchange rate system is subject to a fundamental flaw. It depends upon control of short-term capital movements, which could lead to speculative attacks on the currency. But, these controls become increasingly leaky as foreign trade is liberalised, as short-term capital can be moved through the 'leads and lags' in foreign trade: with exporters 'under-invoicing' exports, and importers 'over-invoicing' imports, keeping the difference in whatever foreign currency they choose.

Despite draconian capital control, China has not been able to control such 'hot money' flows. Its latest increase in reserves of $178 billion (in the second quarter of 2009) is not based on the traditional drivers of the trade surplus and foreign direct investment which, at about $60 billion, were the lowest in three years. The increase was due to 'hot money' inflows of between $30 billion and $70 billion ("Lex", FT, July 15). To prevent any currency appreciation, the Chinese have (as in the past) sterilised these inflows. But with the domestic money supply, nevertheless, rising rapidly with the growing credit made available to stem the slide in output caused by the global financial crisis, a serious housing and stock market bubble is developing. With non-traded goods prices rising, whilst those of traded goods are kept constant through the relatively fixed nominal exchange rate, the real exchange rate must be appreciating. China, because of its continuing attachment to the Bretton Woods Mark II system, is likely to find its current distorted recovery unsustainable. Why then should the rest of the world follow it by embracing another Bretton Woods type system for the international monetary system?

China's desire for an enhanced SDR (with the BRIC currencies having a greater weight) is also likely to be unfulfilled. Central banks have had the opportunity to diversify their reserves into non-dollar assets, including SDRs, but have not chosen to do so. Instead, dollar holdings in central bank reserves have risen to about 75 per cent of total reserves in the first quarter of 2009. Nor is the Chinese move to finance its growing bilateral trade with emerging markets in renminbi likely to make its inconvertible currency a potential reserve currency. It is more like the creation of a 'rouble area' under Comecon.

Nor is the proposal being floated by a Brazilian economist for four competing currency unions, with four alternative reserve currencies, likely to succeed. Ricardo Amaral ("Brazil, China, and the New Asian currency", *www.rgemonitor.com*) has proposed an Asian currency union (modelled on the euro) centred around the renminbi, which would also include Brazil. Russia should join the euro, and the Gulf countries should have a common currency centred on the Saudi rial. But, currency unions require some political common ground amongst the participating countries ideally, as in the US—currency union is a political union. The euro still remains fragile, because the hoped-for European political union has not yet emerged. A stable political union is necessary if 30-year bonds issued in the common currency are to be widely held. Without a political union there can be no guarantee that the common currency will be around when the bonds come to be redeemed.

Though a Gulf currency union with a political union seems more feasible, there is no chance of an Asian currency union comprising, I presume, India, Japan and the southeast Asian countries with such divergent polities being formed. Who would be willing to hold the bonds of an authoritarian country whose currency remains inconvertible for its citizens and foreign holders?

Finally, though the dollar may be in trouble, it remains the currency of the sole superpower. The sterling remained the world reserve currency even after British hegemony was beginning to slip. So, I do not expect the dollar to cease to be the world's reserve currency for a long time to come. The current international monetary 'non-system' remains the only desirable one to deal with the continuing turmoil in the world economy.