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New Global Currency Proposal: Good Diplomatic Theater but Bad Policy

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Recently, both China and Russia have called for the replacement of the dollar as the international reserve currency of choice, suggesting use of IMF Special Drawing Rights (SDRs) instead. Don't rush to sell your greenbacks, however: The proposal has far more to do with the theater of international diplomacy than the workings of the world economy.

Even as he made the proposal, Chinese central banker Zhou Xiaochun acknowledged that it would require "extraordinary political vision and courage." That is diplomatic speak for "We know this is impossible." The fact that Zhou and his Russian counterpart in proposing the idea, Finance Minister Alexei Kudrin, placed the timeline for the change far in the future—30 years in the case of Kudrin—offers an additional strong clue that the proposal is politically motivated rather than intended to address a real and pressing economic problem.

For both Zhou and Kudrin, an attack on the dollar just before the G-20 economic summit is a great theatrical device with which to express displeasure at U.S. dominance of the international financial system. It is also a marker of their unhappiness with the ineffective U.S. approach to restoring world growth and protecting international trade and financial flows, sending a clear signal that they have no intention of rubber-stamping U.S. proposals at the summit.

The Dollar Works for Everybody. The U.S. dollar is currently the principal international reserve currency, a role it assumed following the collapse of the gold standard and the dissolution of the British Empire in the second half of the 20th century. The U.S. gains significant advantages from the use by others of the dollar as a reserve currency: Worldwide demand for dollars helps keep the value of the dollar high, meaning imported goods—including basic commodities like oil—are cheaper for Americans. The willingness of foreigners to hold dollar stocks (or dollar-denominated assets such as U.S. Treasury securities) makes possible the long-running U.S. trade deficit, to the benefit of American consumers.

Some assert that there is a corresponding cost to U.S. producers, who lose export opportunities or even jobs to foreign producers because of the high value of the dollar—a logical idea that holds true for countries whose currency is not held as a reserve. In most countries, if its currency appreciates in value, its exports become more expensive and demand for them decreases. However, demand for U.S. exports has consistently risen, even as the value of the dollar remained high. The reason is that the value to other countries of the dollar as a reserve currency creates additional demand for the dollar over and above what would be generated by normal trade flows. Thus people are willing to sell Americans more goods than they otherwise would in order to get

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extra dollars to hold as reserves. But they still want to buy U.S. goods and services, too.

The benefits for other countries are substantial as well. The utility of the reserve currency function—having a stable and readily convertible commodity (the dollar in this case) in which to hold wealth—is self-evident. The dollar provides a readily available medium of exchange; it can be used to pay for almost anything. Furthermore, consumers can also be confident that the dollar will buy about as much tomorrow as it buys today. It is hard to imagine international trade without some medium of exchange like the dollar.

Even more important, however, is the additional demand created in the United States for exports from other countries—a byproduct of strong global desire for dollars. This U.S. consumer demand has served as the primary engine of growth for the world economy. Worldwide, that growth has lifted millions of people out of poverty over the last decade. For China, this export-led growth has fueled job creation that promotes social stability and raises incomes, at least in certain sectors and geographic areas that have been permitted by the authoritarian Chinese government to link to the global economy.

An Unrealistic Solution to a Non-Existent Problem. The creation of a new international reserve currency to replace the dollar is a solution looking for a problem. So far, the dollar is working just fine as a reserve currency. The continued strength of the dollar testifies to its continued utility as a reserve currency and the confidence of the markets in its future value. That confidence extends, by the way, to the Russian and Chinese governments, both of which continue to hold large stocks of dollars.

In contrast, there are many reasons why moving to an SDR makes no sense:

- *The SDR has no intrinsic value.* The SDR is backed by nothing other than the good faith and credit, if you will, of the IMF. It has no intrinsic value and, at the moment at least, can't be used to purchase anything. It is true that people like to say that the dollar is backed only by the good faith and credit of the U.S. government. In reality, however, the dollar is backed by the goods and services produced by the American people and their willingness to trade those goods and services for dollars. With this willingness to trade real things for dollars extending to people around the world, the value of the dollar becomes backed not just by the U.S. people or the U.S. government but by literally all the world's producers and consumers interconnected through global supply chains: Arab oil traders, Bangladeshi textile producers, Japanese and Korean auto manufacturers, and, yes, even Russian finance ministers and Chinese central bankers. The IMF, by contrast, produces nothing.
- *A one-size-fits-all international currency will not meet diverse world needs.* Countries growing at different rates have different monetary policy needs. Faster-growing countries need a more rapidly increasing supply of money. Slower-growing countries must have less in order to prevent inflation. The SDR could not accommodate these differing needs. Its value is set by the policies of the IMF, which in turn are subject to the competing political and economic interests of international diplomats.
- *Embracing the SDR will result in a loss of transparency.* The process of setting the supply and value of the dollar is highly transparent. People around the world know exactly what the Federal Reserve is doing as it adds dollars to the system or adjusts interest rates. Even the rationale for the changes is quickly apparent from Fed statements and the open grilling to which the U.S. subjects Fed governors. The IMF is far more opaque: Each country's representative would likely tell a different story about what was done and why.
- *The SDR will create new financial complexities and opportunities for corruption.* Use of the SDR would add an additional step to every international transaction. Buyers and sellers would have to convert their local currency into SDRs. Some would have to change first into a convertible currency and then into SDRs. This would create new opportunities for arbitrage and corruption or, at the very least, make the process more expensive with an additional transaction fee. Fans of derivatives will love the SDR: Like derivatives, SDRs

are an additional layer away from anything of real value. They will provide wonderful opportunities for manipulation and skimming of value by currency traders and financial speculators. They will also be less transparent and harder for normal people to understand. And they will be controlled by an international organization that has little if any democratic legitimacy or accountability.

A Silly Idea from Serious People. Why would the Russians and Chinese propose such a thing? They are serious people, and serious people do not usually propose silly ideas. The easy answer would be resentment toward the U.S. for its unique and dominant role in the system. This may be an element especially for the Russians. Far more likely, however, is that the Chinese and Russians are motivated instead by fear that the U.S. is not doing a very good job of managing its economy and its international economic role right now. Floating an unrealistic but provocative proposal is precisely the way to diplomatically express that concern without actually threatening the current system on which they depend just as does the rest of the world.

One would have to guess that the U.S. response—categorical defense of the dollar and its role as a reserve currency by both Treasury Secretary Geithner and Fed Chairman Bernanke[1]—was exactly what the Chinese and Russians were trying to inspire. It is a diplomatic coup for them as well as a warning to the U.S. that what this nation does right and what it does wrong has major implications for other nations as well as itself. America should not expect other countries to remain idle if U.S. policies begin hurting their economic growth as well as its own.

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1. Geithner, in either a huge mistake or (hopefully) a simple misunderstanding of a reporter's question, initially gave a positive response to the idea of expanding the role of SDRs, but he, the President, and FED Chairman Bernanke quickly set things straight. See "Geithner and Bernanke Reject New Global Currency Idea," Reuters, March 24, 2009, at *http://uk.news.yahoo.com/22/20090324/tpl-uk-forex-usa-geithner-sb-d1a0d5d.html* (March 26, 2009).