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INTERNATIONAL MONETARY SYSTEM: HEADED TOWARDS A STRUCTURAL CHANGE?

by Vivekanand Jayakumar, Ph.D.

Persistent global imbalances and exchange rate misalignments have attracted considerable attention in recent years. In particular, large U.S. current account deficits and China's renminbi exchange rate policy have been at the forefront of discussions surrounding the current international monetary system (IMS). In order to comprehend key global economic challenges, it is essential to consider the inherent flaws and the archaic nature of the current dollar-centric global monetary order, and to examine the likely future evolution of the IMS.

Since unseating the British sterling as the world's principal reserve currency during the Inter-War period, the dollar has been widely used as the chief vehicle currency for carrying out currency transactions, as the leading currency for settling international trade transactions, and as the central currency for undertaking international financial transactions. The dollar's de facto status as the pre-eminent reserve currency was formalized under the Bretton Woods (BW) System, which lasted between 1945 and 1971. Under the BW system, the dollar was tied to gold, and, most other major currencies were pegged (on an adjustable basis) to the dollar. The U.S. possessed three-quarters of the world's monetary gold stock in 1945, which made the establishment of dollar convertibility into gold at a fixed parity — set at $35 an ounce of gold — feasible. However, there were built-in flaws in the BW system that made its ultimate collapse inevitable.

In 1960, economist Robert Triffin presciently observed the inherent dilemma in having a global monetary order centered on a national sovereign currency. According to the aptly named Triffin Dilemma, the reserve issuing country needs to run persistent balance of payments (BOP) deficits to satisfy the demand for liquidity that naturally arises in a growing world economy, yet, sustained BOP deficits ultimately reduces the confidence in the reserve currency.

Concerns regarding the BW system rose in the late 1950s, as Western European countries shifted towards current account convertibility and began to experience a buildup of official dollar reserves. In the 1960s, the then French finance minister, Valéry Giscard d'Estaing, famously observed that the U.S. enjoyed an exorbitant privilege because of its ability to achieve global seignorage. Surplus countries, such as West Germany, feared inflationary consequences arising from the dollar glut. In theory, the U.S. could have undertaken a devaluation of the dollar relative to gold (and other major currencies) in the early 1960s to correct the rise of overseas official dollar liabilities. Alternatively, it could have considered domestic deflation to restore the dollar value of U.S. gold stocks in real terms and to boost U.S. export competitiveness. However, neither option was palatable to U.S. policymakers. Instead, they attempted various forms of controls on capital and gold flows, which were largely ineffective.

From the surplus countries side, necessary adjustments would have entailed currency revaluation, and some form of domestic monetary easing (ideally, with concomitant fiscal restraint). West Germany, in particular, was averse to frequent demands for revaluation and considered calls for monetary easing dangerously inflationary. Expansionary U.S. fiscal policy, and accommodative monetary policy, associated with the Vietnam War finally led many to believe that the existing dollar-gold parity rate was increasingly untenable. U.S. gold reserves steadily declined during the 1960s (see figure 1.1 on page 4) and its foreign liabilities rose (as shown in table 1.1 on page 4), the total official dollar liabilities

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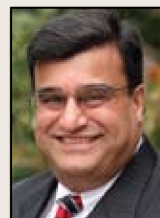

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THE TAMPA BAY ECONOMY: DECEMBER UPDATE

By Brian T. Kench, Ph.D.

For over three years, the Tampa Bay metropolitan statistical area (Hernando, Hillsborough, Pasco and Pinellas counties) has been recovering from the great recession. Through October 2012, economic data for Tampa Bay continues to move in a positive direction.

Gross sales in Tampa Bay totaled $8.9 billion in August 2012, a 10 percent increase from August 2012 (see figure 2.1). In part, the acceleration in August 2012 gross sales is because of the Republican National Convention held in Tampa Bay. However, the year-on-year change in gross sales averaged 5.7 percent per month for the first eight months of 2012, which was slower than the first eight months of 2011 by 0.7 of a percentage point. Since March 2010, the year-on-year change in gross sales has averaged 6.7 percent per month.

Data in figure 2.2 reveals that beginning September 2010 nonfarm payroll jobs in Tampa Bay have increased for 25 months, on a year-on-year basis. A similar trend exists for Florida and the U.S. Over the last year, however, the pace of year-on-year job growth has been 1.7 percent per month in Tampa Bay, but only 1.4 percent in the U.S. and only 1 percent in Florida.

Figure 2.3 illustrates the duration of job loss in Tampa Bay in the 2007-2009 recession relative to the last two U.S. recessions. The figure illustrates how the recession has impacted the labor force in Tampa Bay. As of September 2012, 57 months have passed since the recession began in December 2007 and the area remains net negative 94,900 jobs, which is 7.6 percent of December 2007 employment level. Although Tampa Bay is slowly adding nonfarm payroll jobs, many more months, if not years, will pass before Tampa Bay observes the number of nonfarm payroll jobs that existed prior to the recession.

Figure 2.1: Gross Sales in Tampa Bay: January 2007 – September 2012
Source: Florida Department of Revenue

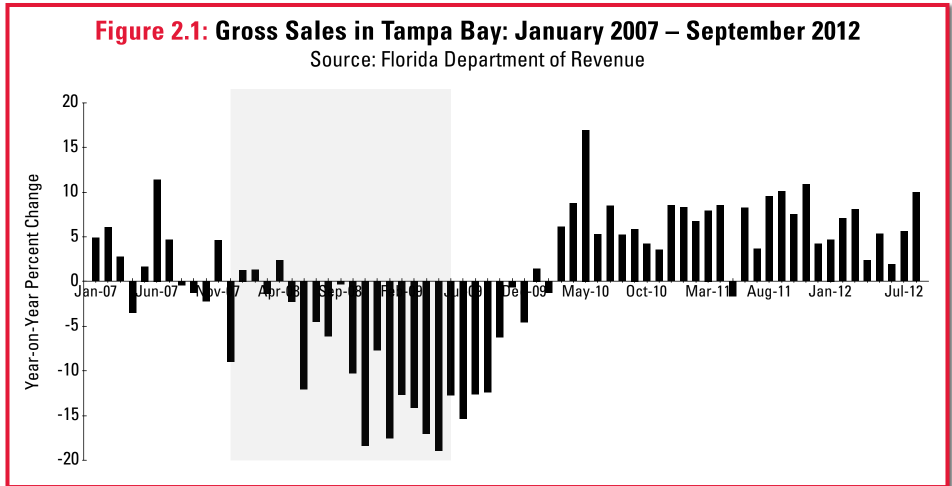


Figure 2.2: Nonfarm Payroll Jobs: January 2000 – October 2012
Source: Bureau of Labor Statistics

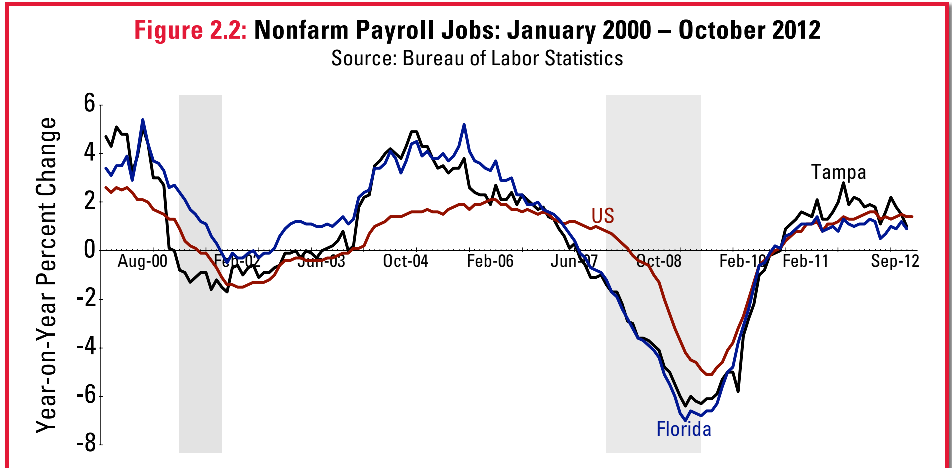
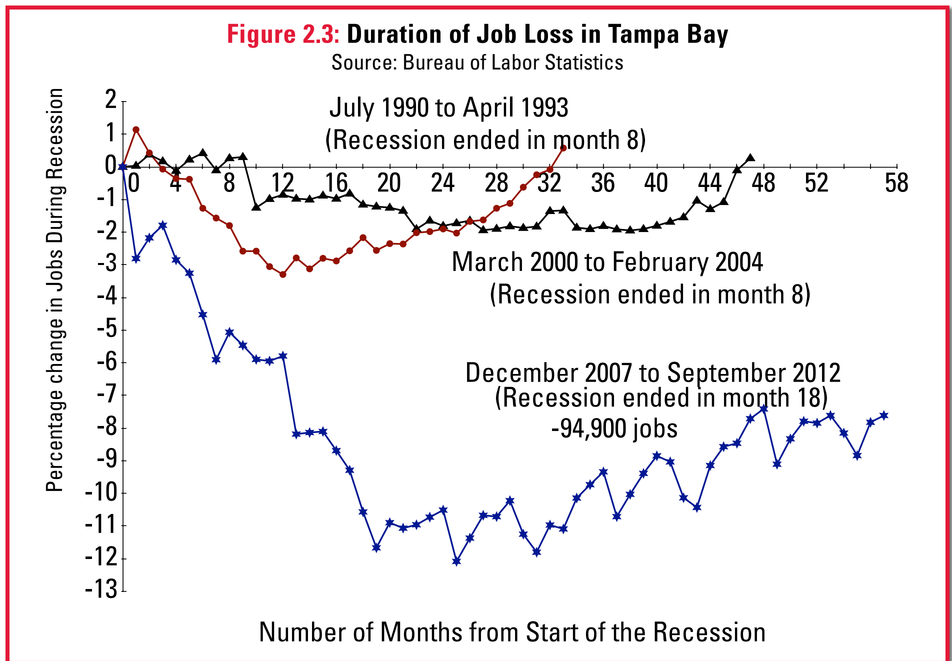


Figure 2.3: Duration of Job Loss in Tampa Bay
Source: Bureau of Labor Statistics



The unemployment rate measures the ratio of those unemployed and looking for work divided by the labor force. In Tampa Bay, the unemployment rate (NSA) was 8.2 percent in October 2012, which is higher than the national unemployment rate (NSA)

by 0.7 percentage points, and it was equal to the unemployment rate (NSA) for the state of Florida. Despite its elevated level, the Tampa Bay unemployment rate fell in October 2012 relative to both September 2012 (8.8 percent) and October 2011 (10.5 percent). Lastly, in Octomer 2012, the unemployment rate (NSA) was 9.8 percent in Hernando County, 8.0 percent in Hillsborough County, 9.1 percent in Pasco County and 7.9 percent in Pinellas County.

The S&P's Case-Shiller housing price index (HPI) for Tampa Bay is based on observed changes in home prices in the area. Tampa Bay's seasonally adjusted HPI hit its maximum value of 239.05 in May 2006. Since that time, the HPI fell 47.7 percent over 5 years to its lowest post-bubble reading of 125 in September 2011. Over the subsequent year the Tampa Bay HPI has increased 6.04 percent to its August 2012 reading of 132.55.

The Price-Rent Index (PRI) for Tampa Bay measures the price of area homes relative to their implicit rental value. The price component of the PRI is the S&P's Case-Shiller HPI for Tampa Bay. The rent component of the PRI is the owner's equivalent rent index (OWRI) for Tampa Bay, published by the Bureau of Labor Statistics. Each series is adjusted to one in 1987 and the PRI computes the HPI/OWRI ratio. A PRI greater than one means that home prices are high relative to rents in Tampa Bay, while a PRI less than one means that home prices are low relative to rents in the Tampa Bay. Figure 2.4 informs the reader that from 2003 to 2007 home prices were high relative to rents — in retrospect, a clear sign of a housing bubble. During the great recession, the PRI declined dramatically. By the end of 2011, the price-rent ratio reached a level not seen over the period of study. Although, off its low point, the estimated 2012 PRI reveals that in Tampa Bay an individual could purchase a home and maintain a monthly payment for less than what would be required to rent the same home.

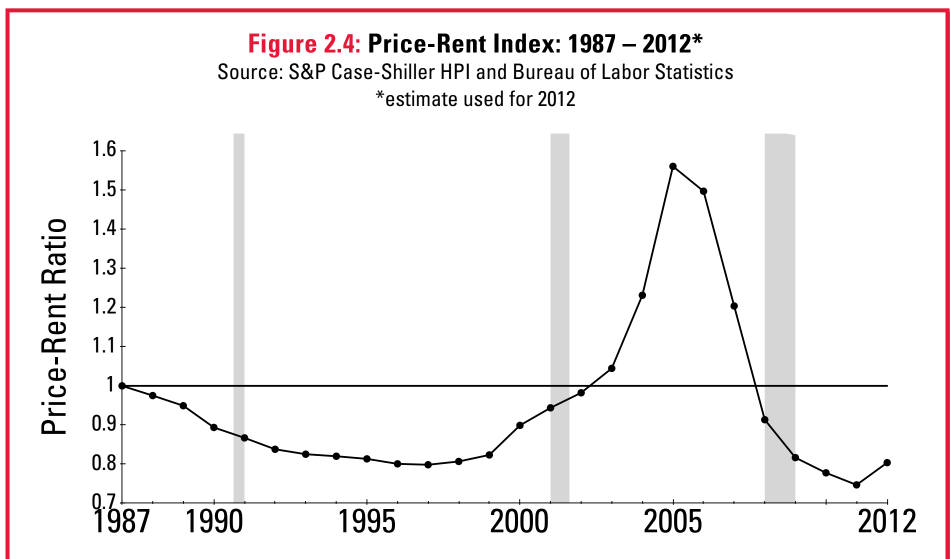


Figure 2.4: Price-Rent Index: 1987 – 2012*
Source: S&P Case-Shiller HPI and Bureau of Labor Statistics
*estimate used for 2012

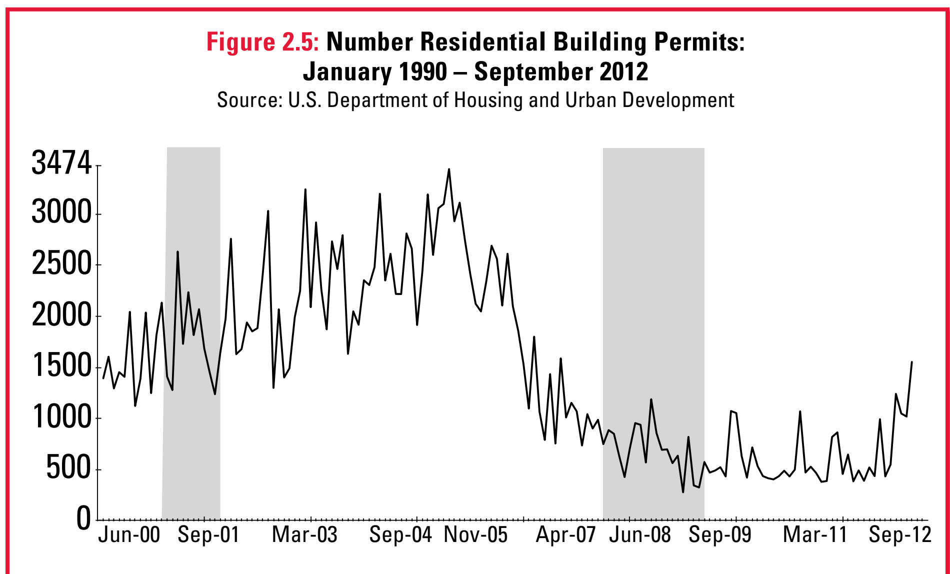


Figure 2.5: Number Residential Building Permits: January 1990 – September 2012
Source: U.S. Department of Housing and Urban Development

Figure 2.5 shows the absolute number of privately owned one-unit residential permits for new homes in the Tampa Bay area. New permits for September 2012 totaled 1554 — a level last observed in July 2006. The number of new permits in the first nine months of 2012 exceeded those issued in the first nine months of 2011 by 55 percent. The acceleration in new building permits in Tampa Bay, since June 2012, strongly suggests that the bottom the housing market has passed.

In summary, recent data continue to point in a positive direction. Gross sales in Tampa Bay continue to grow on a year-on-year basis. The area is adding nonfarm payroll jobs — the year-on-year change in nonfarm payroll jobs has been positive for 25 months. Unemployment rates are falling. And the housing market is strengthening. The Case-Shiller HPI has risen 6.04 percent between September 2011 and August 2012, purchasing a home costs less than renting the same sized home, and one-unit residential permits for new homes are accelerating. Despite these very positive telltales, it will continue to take years for Tampa Bay to recover from the damage left behind by the great recession.

Write to Prof. Kench at
bkench@ut.edu.

Figure 1.1: Key Bretton Woods Era Developments
Sources: NBER Macrohistory Database; Federal Reserve Bank at St. Louis

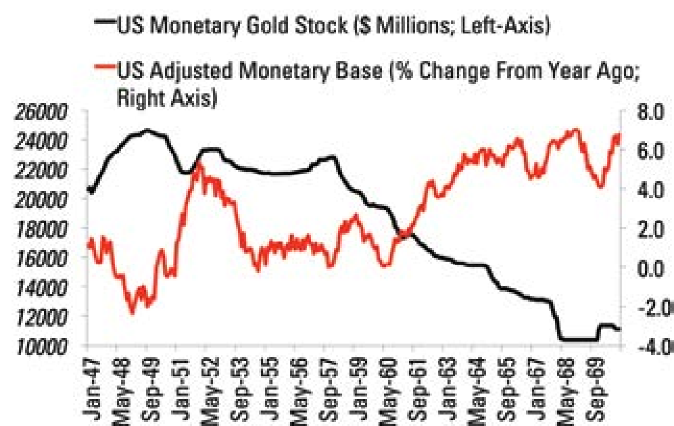
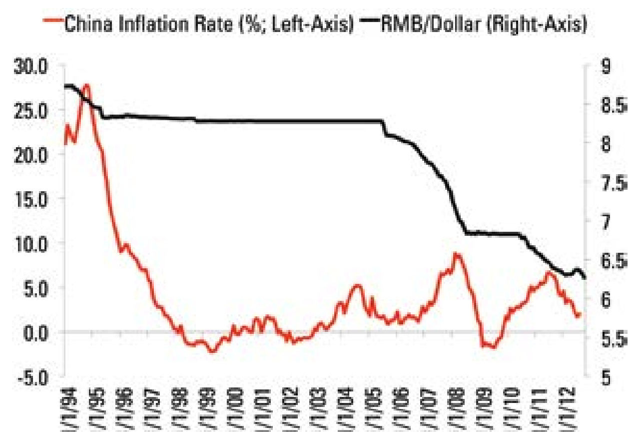


Figure 1.2: China Exchange Rate and Inflation Rate
Data Source: Federal Reserve Bank at St. Louis



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rose sharply between 1969 and 1972). Growth in U.S. monetary base (see figure 1.1) and money supply in the 1960s also eroded the real purchasing power of the dollar. President Nixon's unilateral closure of the official gold exchange window in August 1971 triggered the collapse of the BW arrangement. After a few futile attempts at restructuring the BW arrangement, the U.S. and most major economies adopted flexible exchange rates in 1973 and abandoned currency ties to gold.

Despite the demise of the BW system in the early 1970s, the U.S. dollar has maintained its status as the world's pre-eminent reserve currency due to inertia, lack of genuine competitors, and relative domestic stability. A traditional Triffin Dilemma might be less relevant in a world of fiat monies and flexible exchange rates, as international liquidity can be provided by the reserve issuers without, in theory, creating large external imbalances. For instance, financial globalization should enable sustainable maturity transformation — reserve issuers supply safe and liquid assets to the rest of world and offset it with purchase of long term and less liquid foreign securities — that satisfies the needs of a

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Table 1.1: US Liquid Liabilities ($ MILLIONS)
Source: BEA's Survey of Current Business – Various Issues

	To Foreign Official Agencies	To Foreign Central Banks & Governments	To IMF
31-Dec-64	$15,148	$14,348	$800
31-Dec-65	16,177	15,343	834
31-Dec-66	14,688	13,677	1,011
31-Dec-67	16,738	15,705	1,033
31-Dec-68	13,569	12,539	1,030
31-Dec-69	13,001	11,982	1,019
31-Dec-70	20,626	20,060	566
31-Dec-71	47,593	47,049	544
31-Dec-72	57,286	57,286	0

Table 1.2: U.S.-China Comparison
Sources: IMF WEO Database – Oct 2012; World Bank WDI Database (Forex Reserves Data); OMB/Treasury (U.S. Budget Balance Data)

	China's Share of World GDP (%; PPP Basis)	U.S. Share of World GDP (%; PPP Basis)	U.S. Federal Budget Balance (% of GDP)	U.S. Gross Debt (% of GDP)	U.S. CA Balance (% of GDP)	China CA Balance (% of GDP)	China Forex Reserves ($ Bil.)
1984	2.9	25.2	-4.8	50.9	-2.4	0.6	$21.3
1994	5.3	23.1	-2.9	71.6	-1.7	1.4	57.8
2004	8.9	22.5	-3.5	68.3	-5.3	3.6	622.9
2005	9.4	22.2	-2.6	67.9	-5.9	5.9	831.4
2006	10.1	21.7	-1.9	66.6	-6.0	8.6	1,080.8
2007	11.0	21.0	-1.2	67.2	-5.1	10.1	1,546.4
2008	11.7	20.4	-3.2	76.1	-4.7	9.1	1,966.0
2009	12.9	19.9	-10.1	89.7	-2.7	5.2	2,452.9
2010	13.6	19.4	-9	98.6	-3.0	4.0	2,913.7
2011	14.3	19.1	-8.7	102.9	-3.1	2.8	3,254.7
2012f	15.0	18.9	-7	107.2	-3.1	2.3	
2017f	18.3	17.9	-3	114.0	-3.5	4.3	

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growing global economy without creating serious external imbalances. In reality, however, global imbalances, characterized by large and persistent U.S. current account deficits, have become a dominant feature of the contemporary global economic landscape. In fact, a different form of Triffin Dilemma has taken hold in the modern era. High international demand for dollar assets has meant that the U.S. rarely encounters internal or external market disciplinary mechanisms. This has often resulted in twin U.S. budgetary and current account deficits during most of the past three decades (see table 1.2).

More recently, with ever increasing cross-border capital mobility, many nations in the emerging world are subject to intermittent hot money flows and sudden stops. To insure themselves from potential turbulence resulting from unexpected swings in capital flows, many emerging market central banks have resorted to building foreign reserve holdings — often held in dollar denominated securities. Large commodity producers, seeking to recycle dollar inflows arising from strong export sales, are also generating demand for safe and liquid dollar assets. This ready demand abroad for dollar assets — especially Treasury securities, and until recently, bonds issued by government sponsored enterprises (GSEs) — has made the U.S. too reliant on a consumption dependent growth model. Easy credit stance during normal times and aggressively expansionary stance during economic slowdowns or recessions has become the de rigueur policy choice. In addition, 'flight to safety' often reinforces dollar demand during periods of economic turbulence, thus furthering the ability of U.S. policymakers to conduct expansionary policies.

Two developments on the horizon are, however, likely to fundamentally shake the existing dollar-centric global monetary order. First, continued attractiveness of low-yielding U.S. dollar denominated assets to foreigners well into the future is questionable because of ultra-loose monetary policy and exploding deficits and gross debt levels (see table 1.2). Second, China's gradual push to internationalize the renminbi is likely to provide genuine longer-term competition to the dollar's status as the pre-eminent reserve currency.

Currently, according to the IMF, U.S. dollar reserves still account for around 62 percent of official allocated foreign reserve holdings. While the Euro has achieved some success as a reserve currency since its introduction in 1999, its scope is somewhat limited by intra-regional imbalances and by relatively low growth prospects. China's rapid economic progress has made the renminbi a realistic long-term challenger to the dollar, and it is likely that the future global monetary order will be more multipolar in nature—with the dollar, the renminbi and the euro sharing duties as reserve currencies.

To understand the renminbi's long-term prospects and its likely role in the future IMS, it is worth highlighting two relevant issues: recent evolution of China's exchange rate policy and China's long-term economic trends. After more than a decade during which the dollar was tightly pegged to the renminbi, the People's Bank of China (PBOC) has pursued a carefully managed strategy of gradual appreciation of the Chinese currency since July 2005 (see figure 1.2). In fact, the renminbi and the yen have been the two best performing major currencies since 2005. If one considers the fact that China's inflation rate has consistently been higher than U.S. inflation rates during this period, the real exchange rate appreciation involving the renminbi has exceeded 30 percent.

However, in attempting to manage the pace of appreciation, the PBOC triggered one-way speculative bets by investors (despite the presence of capital controls), especially during the summer-2005 to summer-2008 period. In order to slowdown the pace of appreciation, the PBOC had to directly intervene in foreign exchange markets and sell renminbi and acquire dollars to satiate some of the excess demand for the Chinese currency. Such interventions led to a sharp increase in foreign reserve holdings and an increase in the monetary base (MB). The rise in MB proved to be inflationary, and as a consequence, the PBOC attempted to sterilize its foreign exchange market intervention by undertaking open market sales of renminbi denominated bonds in the domestic market — to soak up some of the excess renminbi. The extent of the foreign exchange market intervention meant that the sterilization was only partially successful. Consequently, domestic inflation in China rose sharply.

There was another cost as the yield that the PBOC had to offer on the renminbi bonds it sold often exceeded the low yields it received from the dollar securities it held as foreign reserves. More significantly, the buildup of foreign exchange reserves (see table 1.2) implied that China was exposed to massive capital losses in the event of a sharp dollar decline. Given the overexposure to low yielding dollar assets, and the inflation and sterilization costs arising out of foreign exchange interventions, Chinese authorities have realized that it is in their long-term interest to shift away from a dollar peg and towards greater renminbi internationalization. As a result, the past few years have seen China gradually encourage the use of renminbi for international trade settlements, for reserve holding purposes, and for denominating international bond sales. China's long-term trends (see table 1.2) are likely to favor the internationalization of the renminbi. In particular, it is soon expected to overtake

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the U.S. as the world's largest economy and as the world's largest trader. It is also likely, given its persistent current account surpluses, to overtake Japan as the world's largest net creditor in the near future. Financial sector and capital liberalization along with the growth of Chinese equity and bond markets are like to generate overseas demand for liquid renminbi denominated securities.

The gradual switch from the dollar-centric international monetary order to a multipolar currency order is likely to reduce the persistence of large imbalances. External market discipline will make it challenging for any single country to consistently experience large current account deficits. From the U.S. perspective, the evolution of the IMS is likely to encourage a reorientation of the economy towards a more export and investment led — and less consumption based — growth path. For China, the shift will encourage a more consumer driven — and less export and investment dependent — growth path. Such rebalancing should prove to be beneficial for the long-term health of the global economy.

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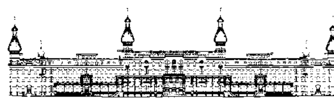

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