INTERNATIONAL MONETARY SYSTEM: HEADED TOWARDS A STRUCTURAL CHANGE?

By Markand Jayapal, 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 ever-increasing 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 actual nature of the current dollar reserve 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 Bretton Woods era, the dollar has been widely utilized 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 underpinning most international financial linkages. The dollar’s dominant 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 set to gold, and most major currencies were pegged at an adjustable rate to the dollar. The U.S. experienced two episodes of the world’s monetary gold standard in 1945, which made the establishment of a reserve currency system a fact, and China’s renminbi internationalization.

In 1938, President Roosevelt, following the British example, observed the inherent dilemma in having a global reserve currency centered on a national sovereign currency. Accordingly to the well-known 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 reduce the confidence in the reserve currency.

Concerns regarding the SW system rose in the late 1960s, as Western European countries, driven towards current account convertibility, began to experience a buildup of official dollar reserves. In the 1980s, the then-fringe French economist Valéry Giscard d’Estaing famously observed that the U.S. enjoyed an exceptional privilege because of its ability to achieve global hegemony. As a result, currency valuation policies were required to enable the dollar to rise against major currencies. The renminbi, the People’s Bank of China (PBOC) exchange rate has consistently been higher than U.S. performing major currencies since 2005. If gradual appreciation of the Chinese currency means that the dollar’s status as the pre-eminent reserve currency.

To the dollar’s status as the pre-eminent reserve currency. In the last decades (see Table 1.2), observed that China’s exports were low yielding dollar assets, and the inflation rate was to overtake Japan as the world’s largest net debtor. Given its persistent current account surpluses, the U.S. as the world’s largest economy and the presence of capital controls, especially in China, the US was likely to fundamentally shake the IMS. Second, China’s gradual push towards greater renminbi internationalization.

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By Brian T. Kench, Ph.D.

The Tampa Bay Economy: December Update

The Tampa Bay economy has been recovering from the deep recession of 2007-2009. While the economic recovery has been slow, the Tampa Bay region has added jobs at a faster rate than the nation as a whole. As of December 2012, the area has added 58,400 nonfarm payroll jobs since the recession began in December 2007. This represents a 1 percent increase in nonfarm payroll employment in Tampa Bay compared to December 2007.

The unemployment rate in Tampa Bay is 8.2 percent as of December 2012, which is higher than the state of Florida (7.6 percent) and the nation (7.9 percent). The unemployment rate has been declining since the start of 2010, but it remains elevated compared to pre-recession levels. The unemployment rate in Tampa Bay has been rising since the recession began, but it has been declining since June 2011.

The number of home sales in Tampa Bay has been declining since the recession began, but it has been rising since the start of 2010. As of December 2012, the number of home sales is 15 percent higher than the December 2007 level. This is a testament to the strength of the Tampa Bay housing market as the area continues to recover from the housing bubble of the early 2000s.

The number of home sales in Tampa Bay has been rising since the start of 2010, but it remains below the pre-recession level. As of December 2012, the number of home sales is 20 percent lower than the December 2007 level. This is a testament to the strength of the Tampa Bay housing market as the area continues to recover from the housing bubble of the early 2000s.

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Jobs that existed prior to the recession. Bay observes the number of nonfarm payroll slowly adding nonfarm payroll jobs, many more employment level. Although Tampa Bay is jobs, which is 7.6 percent of December 2007 and the area remains net negative 94,900 figure illustrates how the recession has been 1.7 percent per month in Tampa and the year-on-year change in gross sales has averaged 6.7 percent per month. March 2010, the acceleration in August 2012 gross sales is billion in August 2012, a 10 percent increase positive direction. Data for Tampa Bay continues to move in a counties) has been recovering from the great home. Home prices are high relative to rents in Tampa Bay, the owner’s equivalent rent index (OWRI) for Tampa Bay. The rent component of the PRI is price index (HPI) for Tampa Bay is based on observed changes in home prices. The HPI is a seasonally adjusted HPI at its maximum value of 238.10 in May 2008. Since that time, the HPI fell 47.7 percent over 5 years to its lowest post-bubble reading of 125.4 in September 2012. Over the subsequent year the Tampa Bay HPI has increased 14 percent to its August 2012 reading of 132.35. The Price Index (PRI) for Tampa Bay measures the price of area homes relative to their replacement value. The proportionality of this PRI is to the 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. Both series is adjusted to one in 1987 and the PRI compares the HPI (CasHPI) ratio (PRI) greater than one means that home prices are high relative to rents in Tampa Bay and a PRI less than one means that home prices are low relative to rents in the Tampa Bay. Figure 2.4 illustrates the manner that from 2000 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 reaches that in Tampa Bay on 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: 1997 - 2012
Source: S&P Case-Shiller HPI and Bureau of Labor Statistics
*estimator used for 2012

Figure 2.5: Number Residential Building Permits: January 1999 – September 2012
Source: U.S. Department of Housing and Urban Development

Figure 2.5 shows the absolute number of newly issued one-unit residential permits for new homes in the Tampa Bay area. The permits for September 2012 reached 1354 — a level last observed in July 2006. The number of new permits in the first nine months of 2011 by 55 percent. The privately owned 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.
...slowly adding nonfarm payroll jobs, many more since the recession began in December 2007. As of September 2012, 57 months have impacted the labor force in Tampa Bay. As loss in Tampa Bay in the 2007-2009 recession...sales has averaged 6.7 percent per month. Of 2011 by 0.7 of a percentage point. Since...which was slower than the first eight months...Gross sales in Tampa Bay totaled $8.9 billion in August 2012, a 10 percent increase...data for Tampa Bay continues to move in a positive direction.

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gerst in U.S. monetary base (see Figure 1.1) and monetary policy 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 BIV arrangement. After a few futile attempts at restructuring the BIV arrangement, the U.S. and most major economies adopted flexible exchange rates in 1973 and abandoned currency ties to gold. Despite the denigration of the IMF system in the early 1970s, the U.S. dollar 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 currencies and flexible exchange rates, an 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...continued on page 3

Table 1.1: US Liquid Liabilities ($ MILLIONS)

Table 1.2: U.S.-China Comparison

Table 1.3: U.S. Balance of Payments Balance

Table 1.4: U.S. Budget Balance Trends

Table 1.5: U.S. Official Central Bank Balance

Figure 1.1: Key Bretton Woods Era Developments

Figure 1.2: China Exchange Rate and Inflation Rate

Figure 2.1: Nonfarm Payroll Jobs: January 2000 – October 2012

Figure 2.2: Duration of Job Loss in Tampa Bay

Figure 2.3: Price-Rent Index: 1987 – 2012*
Two developments on the horizon seem, however, likely to fundamentally shake the existing dollar-centric global monetary order. First, continued attractiveness of low interest rates involving U.S. dollar denominated assets to foreign savers into the future is questionable because of a one-way monetary policy and capital flows and low debt levels (see table 1.2). Second, China’s gradual path to internationalize its renminbi is likely to provide genuine large-scale 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 30 percent of official allocated foreign reserve holdings. Within the Euro has achieved some success as a reserve currency since its introduction in 1999. Its scope is somewhat limited by cross-border capital mobility, many economies in the emerging world are subject to interventions hot money flows and sudden stop. To insures 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 export surplus sales, are also generating demand for safe and liquid dollar assets. This steady demand 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 and investment dependent — growth path. Such a Structural Change?

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Headed Towards a Structural Change?

Concerns regarding the BW system rose in the Inter-War period, the dollar has been the leading currency for settling international trade and undertaking international financial transactions. 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 January 2005 (see figure 1.2). In fact, the renminbi and the yen has been the two most performing major currencies since 2005. It is one considers the fact that China’s inflation levels has consistently been higher than U.S. inflation rates during this period, the renminbi exchange rate appreciation involving the renminbi has exceeded 30 percent. However, in attempting to manage the pain of appreciation, the PBOC triggered some speculative bets by investors (despite the presence of capital controls), especially during the summer 2005 to summer-2008 period in order to slow down the pace of appreciation. The PBOC had to directly intervene in foreign exchange market and sell reserves and acquire dollar to sustain 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 reserve currency (RMB). The renminbi proved to be inelastic, and as a consequence, the PBOC attempted to stabilize its foreign exchange market interventions 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 renminbi now is only partially successful. Consequently, domestic inflation in China rose sharply. There was another cost as the result 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 lack of foreign exchange reserves (see table 1.2) implied that China was exposed to massive capital losses in the event of a devaluation. Moreover, the increase in foreign reserve holdings had the potential to lock up some of the excess renminbi.

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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 deceleration along with the growth of Chinese equity and bond markets are likely to generate increased demand for liquid sovereign-dwelled securities.

The gradual switch from the dollar-centric international monetary order to a multilateral 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 a reorientation should prove to be beneficial for the long-term health of the global economy.

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