

Future Stance of Currencies in the International Monetary System

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ABSTRACT – The current global crisis is a manifestation of global imbalance. Higher creation of savings in emerging economies compared to developed countries; higher investments of developed economies in comparison with developing countries; the current account deficit of the balance of payments in developed countries as opposed to the current account surplus of the balance of payments in emerging economies create new conditions for future stance of currencies in the international monetary system.

The future aspect of the international monetary system is, at present, a major topic of discussion for monetary authorities as well as supranational institutions. The intention of this contribution is to highlight the main trends in its development

KEY WORDS: global imbalance, savings, investment, foreign exchange reserves, balance of payment, importance of currencies for the international market, international monetary system

Introduction

We are in the fourth year of existence of the current global crisis, whereby the claim that it is in its final stage, is delivered with great prudence. According to the World Economic Outlook of the International Monetary Fund in October 2009 “after contracting by about 1 % in 2009, global activity is forecast to expand by about 3 percent in 2010, which is well below the rates achieved before the crisis”.

Global imbalance

The global economy has been transformed from the so-called bipolar world, where countries were explicitly divided into rich and poor, and global economic growth was determined by developments in the USA and Europe, into a world that can be described as multipolar, in which emerging and developing economies have been assigned a significant role from a global perspective. Menbere Tiruneh Workie (2007, 29)

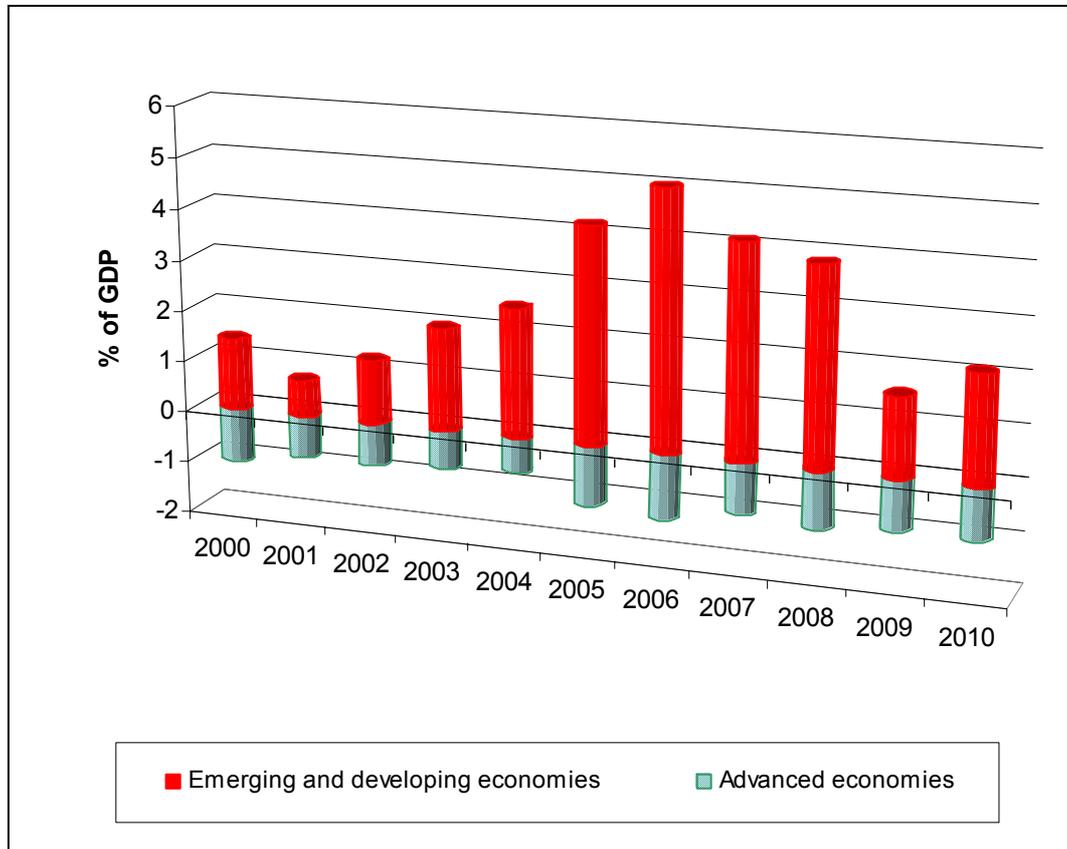
Since 2004 the global economy has vaulted to the current account surplus of the balance of payments thanks to developing countries. Developed economies demonstrate a current account deficit of the balance of payments. The graph outlines the IMF forecasts, which indicate the time at which the current account of the balance of payments in the aftermath of

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the global financial crisis should gradually decrease in the advanced economies, whereas further export growth is expected in emerging and developing economies.

Graph 1. Development of the current account of balance of payments in major country groups (% of GDP)



Source: author's own processing, data from www.imf.org
(2009 and 2010 – forecast of IMF)

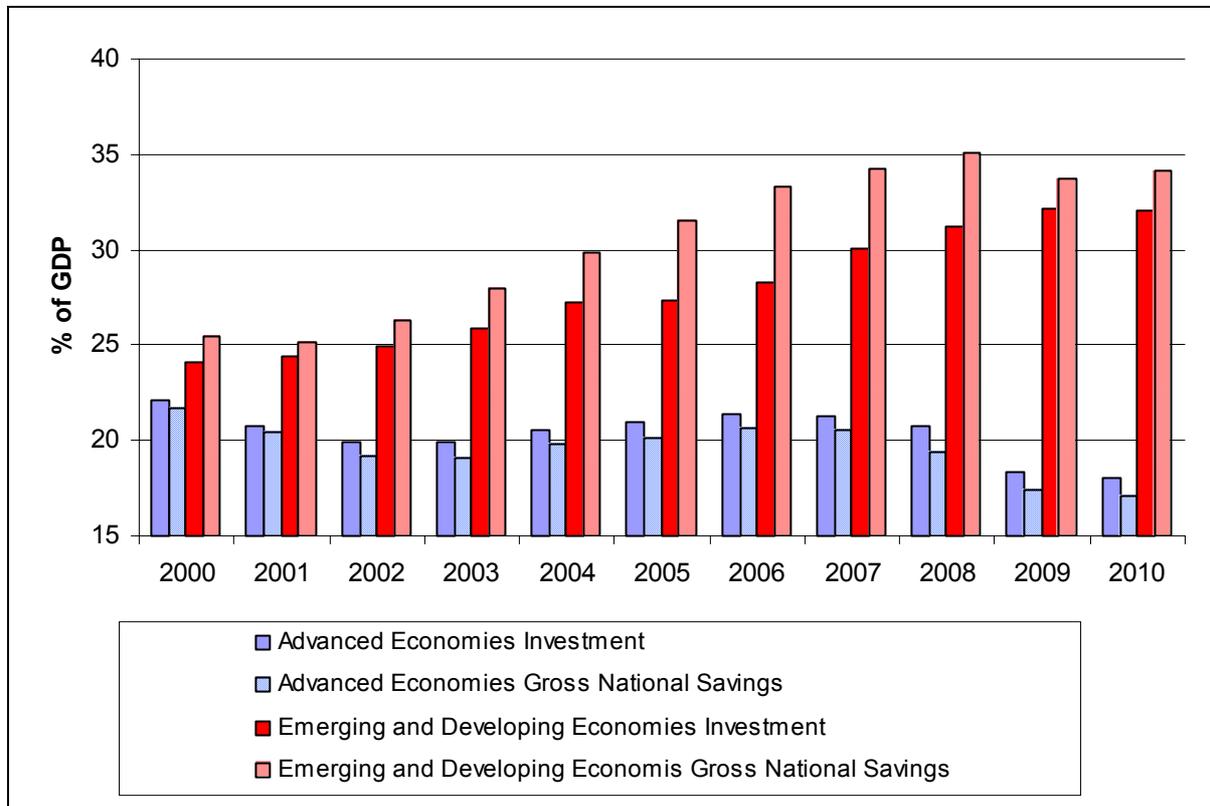
If we compare savings and investment in the major country groups of the world, we can notice, that investments in advanced economies are not covered by the creation of savings; on the contrary, in the case of emerging economies and developing economies savings exceed investments. The basic breakdown of countries into two groups can thus indicate the fact that investments in more developed parts of the world are created because of the savings of less developed parts of the world. If we look at the global data, we can notice that investments and savings stand almost on the same level, which could testify to the maintenance of global equilibrium; however, a detailed analysis of these data, according to other subgroups, can lead to interesting facts.

The unambiguous conclusion of the analysis of the relationship between savings and investment is that the driving force of the current global economy is the savings in the developing world and the newly industrialized Asian economies. This tendency should be supported in the future by the fact that in these countries there is a strong population



growth, which creates space for the future growth of consumption and demand, which creates the prerequisites for their further economic growth.

Graph 2. The development of savings and investments in developed and emerging economies as % of GDP



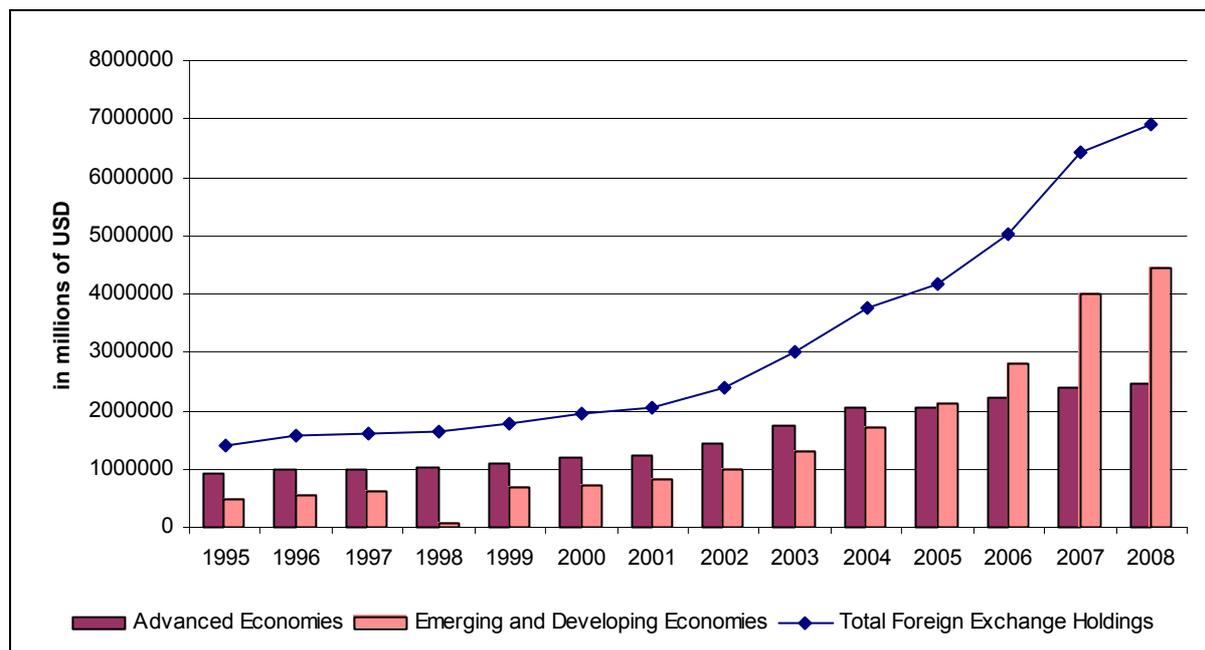
Source: author's own processing, data from www.imf.org
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Foreign Exchange Reserves

Since 2005, it has been possible to monitor the higher creation of foreign exchange reserves in emerging and developing economies rather than in developed economies. The largest foreign exchange reserves (data to June 2008) are held by China (1.7 billion USD), Japan (0.97 billion U.S. dollars), Russia (0.55 billion USD).



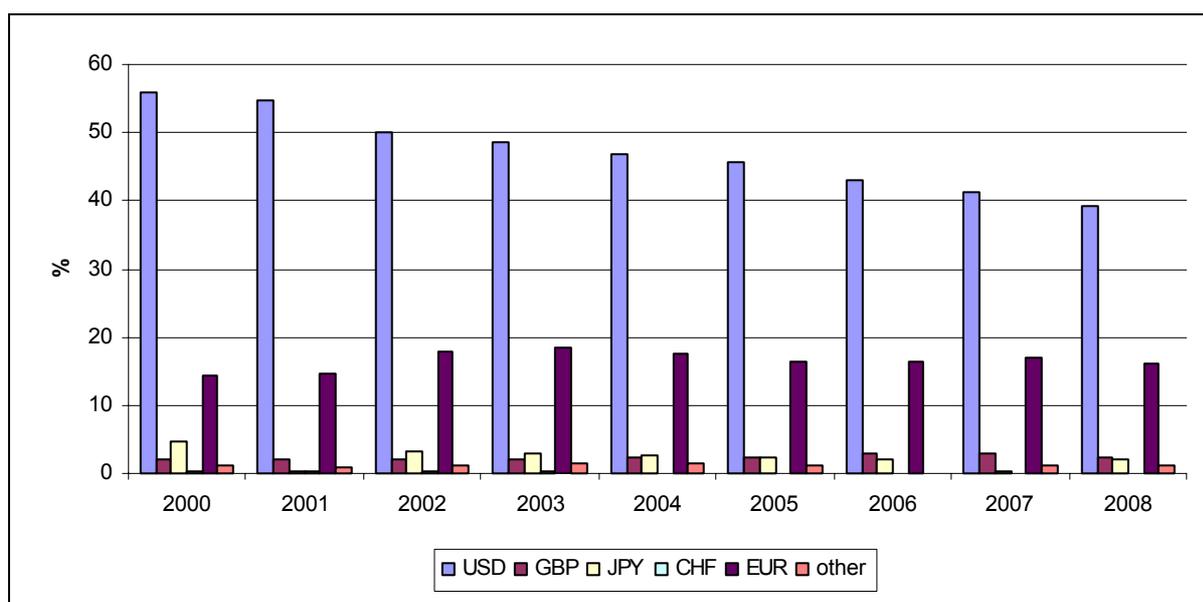
Graph 3. Development of foreign exchange reserves in the world since 1995 to present



Source: author's own processing, data from www.imf.org

Foreign exchange reserves are used to cover imports, foreign exchange interventions and balancing the movements in the capital and financial accounts of the balance of payments. As a result of more frequent financial crises in emerging economies, these incentives have been completed in order to protect the economy from the threat of loss of international liquidity (mainly due to a sudden outflow of capital). The main source of foreign exchange reserves in these countries is the net income from international trade and capital movements.

Graph 4. Structure of global foreign exchange reserves from 2000 to present



Source: author's own processing, data from www.imf.org



After the launch of EMU, there has been a visible increase of the EUR in the foreign exchange portfolio and a drop in dollars. However, the U.S. dollar still continues to hold a strong position in the currency structure of the foreign exchange portfolio (about 65%).

Importance of currencies for the international market

When talking about international currencies, we are interested in the extent to which a certain currency is used outside the domestic economy (the place of its issuance). Some authors, for example, E. G. Lim, refer to it as a currency that is used "outside the domestic economy by non-residents for transactions with residents of the domestic economy or with residents of third countries" E. G. Lim (2006). Another approach attributes an international attribute to the currency based on its scope of usage as a currency of debt denomination issued by non-residents on the capital market.

The European Central Bank assesses the international role of a particular currency based on the extent to which this currency is used as denomination for various financial assets and liabilities outside the area of its issuance, as a nominal anchor, reserve and intervention currency for central banks in certain third countries and as a parallel currency used by private agents in some geographically adjacent economies. At the same time, it assesses its importance as a currency (vehicle currency) in some segments of the global foreign exchange market. Therefore, it assesses two major aspects:

- a) the importance of the currency for the international bond market, foreign exchange market and the international market for goods and services,
- b) the importance of the currency for third countries.

The largest issuers in the international bond market are the globally operating financial institutions and corporations. As foreign currency denomination, they mainly use USD, EUR or GBP. The international debt securities in USD are issued by European banks and corporations, whereas these securities in EUR are issued by investment banks and corporations from the United States, Great Britain and some European countries outside the euro area. The importance of the international bond market in total activities of the international global capital market has fallen due to the development of further financial markets that are open to foreign investors. Therefore, the international bond market is becoming a less significant indicator of a currency of international importance. Central banks in emerging economies and sovereign wealth funds have become large global investors, and have become increasingly active in the issuance of government bonds, corporate bonds and shares in third countries. The stock market has gained a considerable market share and therefore, it dictates the denomination of its own assets, and the international role of currencies.

For example, Ch. Thimann (2009, 10) in his study argues that:

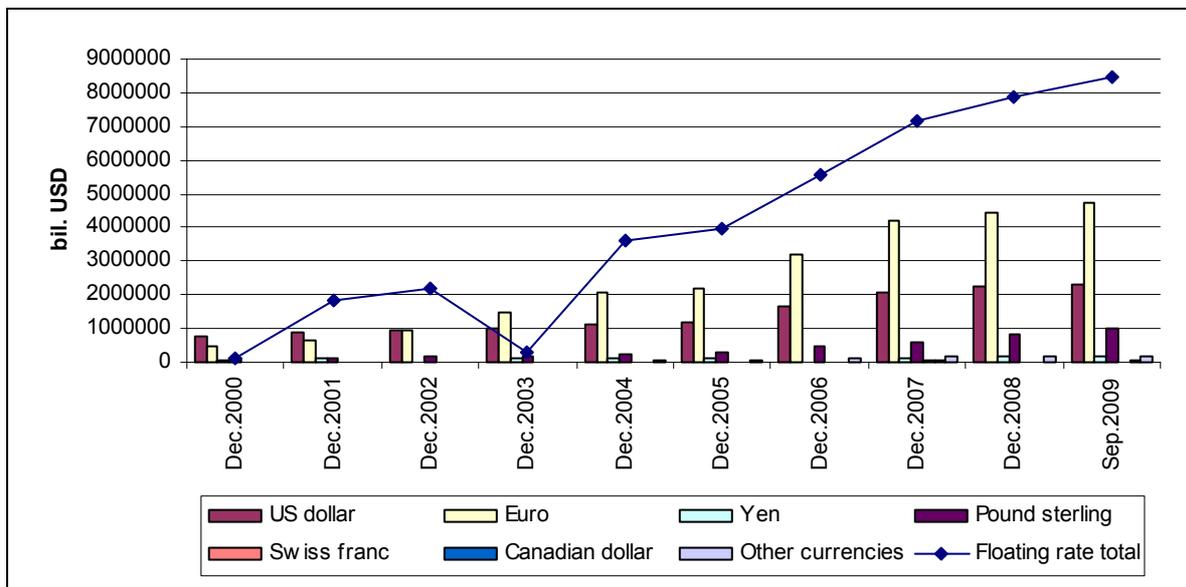
- a) the international bond market is excessively denominated in USD and EUR, and accounts for about 80% of the market, while on the dollar market segment EUR emissions account for 60%, on the EUR market the emissions from the USA and non-euro area countries account for 70% of emissions,



- b) the international bond market is relatively narrowly structured, financial institutions constitute 80% of the market, businesses, governments or international institutions account for the rest 20%,
- c) the choice of currency has been significantly influenced by entrepreneurial motives (control of balance, project financing, taxes) and by short-term cyclical factors (exchange rate predictions and interest rate differential).

The international bond market, from the perspective of the narrow supply of debt instruments, does not have such a significant impact on the evaluation of the currency position as on the international currency. In a broader definition of supply of debt instruments, however, its impact on the role of currency in an international context is more significant, according to the IMF data; up to 11.2 trillion USD bonds are held abroad out of the total volume of bonds (18.4 trillion U.S. dollars), whereas in the narrow definition, it is only 7.8 trillion USD. In comparison, foreign holdings of shares account for 8.8 trillion USD.

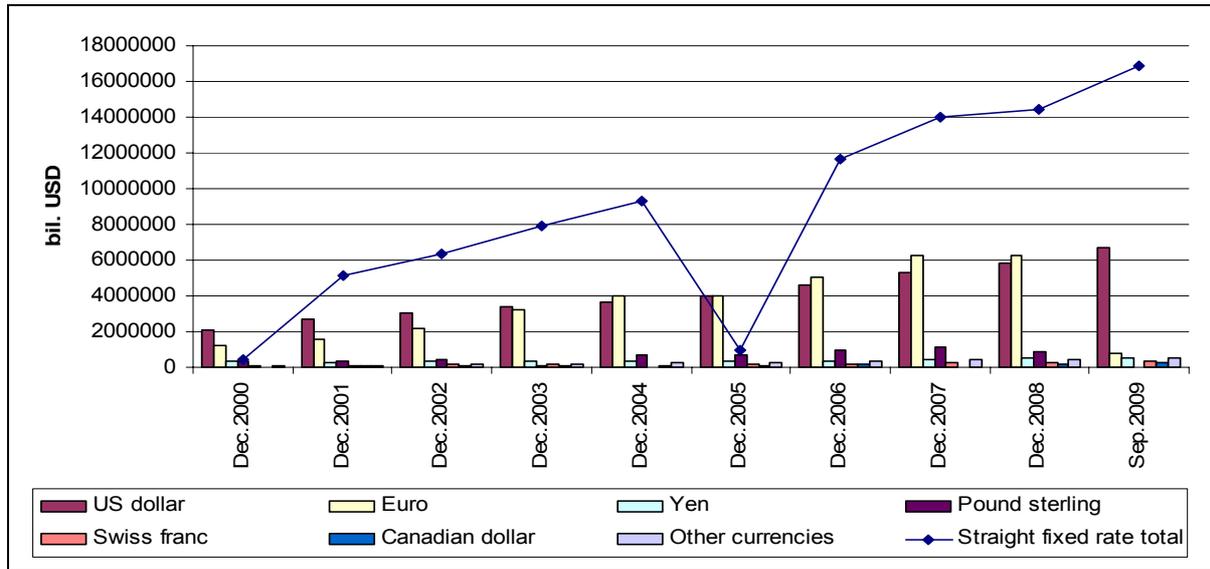
Graph 5. Issuance of Bonds with variable rates of interest by Currency Denominations



Source: author's own processing, data from www.bis.org



Graph 6. Issuance of Bonds with fixed rates of interest by Currency Denominations

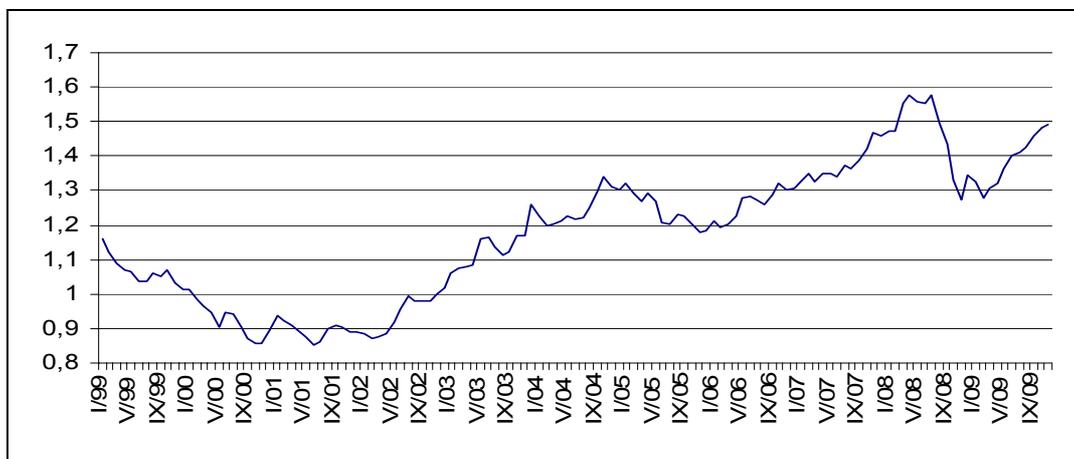


Source: author's own processing, data from www.bis.org

The previous graphs can be used to monitor that the euro is used as a currency denomination of bonds to a much greater extent than the USD. This tendency in the world started to create the euro in 2002 (commercial papers and bonds with floating interest rates), in the case of other debt securities, two years later, in 2004. The biggest difference with the preference of the euro as denomination against the USD has been recorded in bonds with variable interest rate.

A few years ago, there were concerns about a tripolar monetary system in which three currencies were to play a key role - USD, EUR and the Japanese yen. The current approach to the usage of currencies in the bond, foreign exchange and commodity markets in the world, however, suggests an entirely different trend.

Graph 7. Development of the main pair USD/EUR



Source: author's own processing, data from www.ecb.int



If we were to comment upon the first question, then, for example, M. D. Chinn and J. A. Frankel(2008, 4) argue that the USD will lose its position as the main currency due to the fact that the EUR is a much more serious rival than the mark or yen used to be in the past, and the USA have already had a chronic current account deficit of the balance of payments for 25 years and 35 years of USD depreciation. It is assumed that this will happen in 2015.

Conclusion

All the previously mentioned factors indicate the fact that the future development of the international monetary system will not continue in its conventional manner, but it will be fully affected by the approach of developed countries to developing world.

On the question of the relationship between the USD and the euro there have been several discussions. Jean-Claude Trichet (President of the ECB) has said that the further depreciation of the USD is unacceptable for the euro area since it would mean the artificial overvaluation of the euro, whose exchange rate would not reflect the real economic development of the euro area, which would cause additional risks to maintain its stability in the future.

Of course, it is necessary to take into account the further progress of economic integration in other regions of the world. For example, the countries of the Gulf in 2010 are planning to launch a monetary union with a common currency. At present, the composition of a common currency basket is being analysed. The risk is that these countries are major oil exporters, and they have already joined the trade in this commodity in a currency other than USD, which in the future could mean a further depreciation of USD.

Similar integration schemes can also be observed in Africa and Asia, but their implementation is a matter of the distant future.

As for the Chinese yuan, China is among the economies with the highest foreign exchange reserves, increasing exports and high savings creation. Moreover, in the past, they purchased large amounts of bonds denominated in USD, much of which is approaching maturity.

Moreover, the recovery of the U.S. economy is not realised in such a pace as it was planned by an optimistic scenario.

The G20 requested, for example, the European Commission to accelerate a further expansion of the euro area countries, which would protect their economies against the excessive volatility of exchange rates due to the financial crisis. The answer by the EC, however, to this proposal was unequivocal; the euro area would not abandon its enlargement strategy based on the fulfilment of the Maastricht criteria, since it considers price and financial stability as its main priority.

Commenting upon the future outlook of the international monetary system there have been several discussions. Perhaps, the proposal of France and Great Britain on the creation of the Bretton Woods II system, which would again mean a return to the gold standard, whereas the main currency should be the IMF's special drawing rights (SDRs). Although this proposal is more or less criticized. Major opponents argue that the IMF membership (185 countries) is very different today than it was at its birth, since emerging and developing countries are more represented than developed ones, while those given the growing debts



can be a threat to the restoration of international stability. Moreover, the Triffin paradox, which is well known for the BWS I failure, should be remembered. The increase in current account deficits of the balance of payments associated with the growth of public debt does not guarantee the basis for the international monetary system, which must meet the stability and other features such as liquidity and symmetry in international monetary relations.

In regard to foreign trade in goods and services, the dominant currency denomination of transactions is still the American dollar, but here we can see a downward trend. Changes in the exchange rate alternate the value of mutual obligations and claims of the parties entering into business.

The future international monetary system has to meet three basic functions - liquidity, symmetry and stability in the international monetary relations, which requires a unique management style. It is necessary to revisit the basic principles of the functioning of market mechanism in conditions of a globalizing economy, since the latest trends such as liberalization, both economic and financial integration point to the fact that the market is not always able to regulate shocks, to which the global economy is exposed.

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