UN-DESA Policy Brief No. 27

Can we Avert the Next Dollar Crisis?

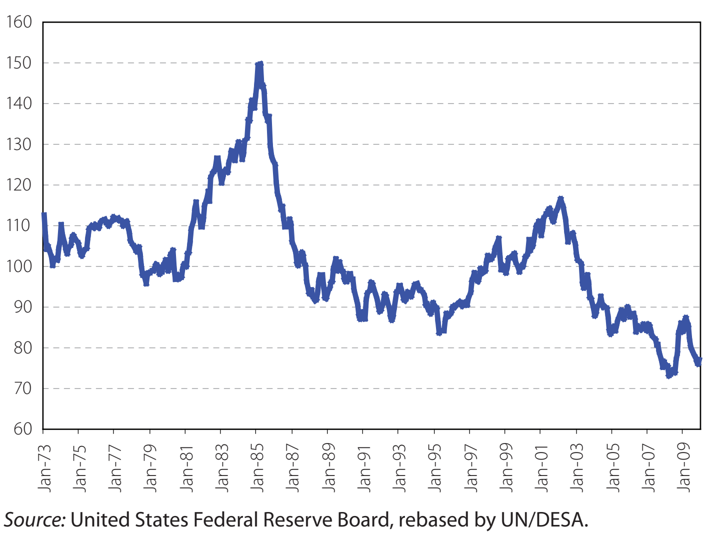
Global recovery at risk of a dollar collapse

Are we heading towards a hard landing of the United States dollar? In recent months, the value of the dollar approached another historic low vis-à-vis other major currencies (figure 1). This contrasts with the increased strength of the dollar during the deepest part of the global financial crisis between August 2008 and March 2009. Since then, the dollar has resumed the downward trend it had been on since 2002. As the United States has been running large external deficits, a weakening dollar could be seen as a normal adjustment to restore the imbalance. However, the dollar is not just any currency. It is the world's reserve currency and, as such, is expected to be a safe storage of wealth. An unstable dollar could trigger renewed financial turmoil. Stimulus measures in response to the crisis have led to a substantial widening of the United States fiscal and external deficits, heightening the risk of further erosion of dollar confidence and, as argued in the ***World Economic Situation and Prospects 2010***, posing a serious risk to the recovery of the world economy. Reducing this risk to the global financial system requires urgent and fundamental changes to the global currency reserve system.

The dollar's rise and fall during the crisis

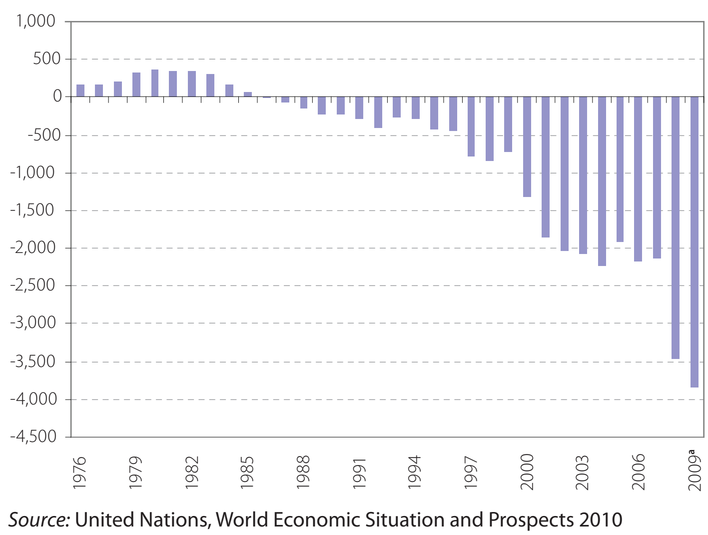
The sharp appreciation of the dollar during the first eight months of the global recession was mainly driven by flight-to-safety effects as the global financial crisis heightened risk aversion, in general, and caused a massive move of financial assets worldwide into United States Treasury bills. Since March 2009, however, the dollar has resumed its downward trend as a result of the stabilizing conditions in global financial markets which have moderated the increased demand for dollars associated with the deleveraging of major financial institutions and the flight to safety by investors. In addition, investors have started to become increasingly concerned with the sharp increase in the budget deficit and the continued worsening of the net foreign investment position of the United States, which has reached an estimated $3.8 trillion (figure 2). The twin deficits will maintain downward pressure on the dollar, and a hard landing is anything but a remote possibility.

Figure 1:
Dollar exchange-rate index against other major currencies
(January 2000=100)



Source: United States Federal Reserve Board, rebased by UN/DESA.
The major currencies index contains currencies of most developed countries.
A decline in the index represents a depreciation of the dollar.

Figure 2:
Net international investment position of the United States, 1976-2009 (billions of dollars)



Source: United Nations, World Economic Situation and Prospects 2010 (http://www.un.org/esa/policy/wess/wesp2010files/wesp2010.pdf).
a Estimation by UN/DESA

Systemic flaws of the global reserve system

The present currency reserve arrangement, centred on the dollar, suffers from a number of systemic flaws that have been well documented since its creation. This includes, in particular, the risk of instability associated with the use of a national currency as the dominant international reserve currency. For other countries to accumulate reserves, the reserve currency country must run an external deficit. Over time, this may lead to an undesirable level of external indebtedness of the reserve-currency country, followed by an erosion of confidence in the value of that currency. The risk of a strongly weakening dollar in the outlook results from this systemic flaw.

This prognosis also underscores the fact that the self-insurance sought by developing countries by accumulating vast amounts of foreign-exchange reserves to protect themselves against shocks in financial and commodity markets is far from an optimal strategy. The reserve accumulation, undertaken by many countries in the aftermath of the Asian crisis, was a logical response in the absence of more adequate collective insurance mechanisms to manage balance-of-payments crises. However, at the same time, this response contributed to the problem of significantly widening global imbalances, related volatility and weakening of the value of the major reserve currency, and itself became a factor leading to the present crisis and the instability of the system.

A further deficiency of the current system lies in its inherent deflationary bias. This stems from the pressure on countries with balance-of-payments deficits to take the brunt of macroeconomic adjustment in view of higher debt ratios or a lack of external financing. While this downward pressure on demand in deficit countries can be accompanied by the need to control the inflationary effects in surplus countries, the latter remains more of an option than a necessity, producing a contractionary effect on demand in the aggregate.

Is a multi-currency reserve system a better option?

The present system could, of course, evolve naturally into one in which several reserve currencies are important. Countries already tend to hold reserves in more than one single currency, but at present other currencies remain a secondary feature in a system where, by far, most reserve assets are held in dollars and where most of the world's trade and financial transactions are effected in the major reserve currency. The advantage of a multi-reserve currency arrangement is that it would provide countries with the benefit of diversifying their foreign-exchange reserve assets, thereby addressing the risk of instability in exchange rates. However, this would not fix any of the other deficiencies in the present system. Most notably, it would not resolve the problem of the deflationary bias inherent in the adjustment to global imbalances.

A reserve system built on an international currency would be more stable

A more viable option would be to pursue the transition to a reserve system based on a true form of international liquidity by expanding the role of special drawing rights (SDRs). Doing so would, in fact, fulfil the objective included in the IMF Articles of Agreement of "making the special drawing right the principal reserve asset in the international monetary system" (Article VIII, Section 7, and Article XXII). The G20 decided in April 2009 on a general SDR allocation equivalent to $250 billion in recognition of the need to boost international liquidity using an international reserve unit. A further step forward could be to make SDR issuance automatic and regular and to link it to the demand for foreign-exchange reserves and the growth of the world economy. A key criterion for SDR issuance, withdrawal and allocation would be to provide counter-cyclical finance. In this way, the two key deficiencies of the present system, its deflationary bias and the inherent instability of the value of the reserve currency, could be overcome. An SDR-based reserve system would furthermore provide a basis for a better pooling of international reserves, as international liquidity would be made available on a counter-cyclical basis, thus reducing the need for individual countries to hold costly amounts of reserves on their own. ■

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