We should listen to Beijing's currency idea

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Zhou Xiaochuan, governor of China's central bank, has suggested creating a "super-sovereign reserve currency" to replace the dollar over the long run. He would sharply enhance the global role of special drawing rights, the international asset created by the **International Monetary Fund** in the late 1960s and just given an enormous boost by the decision of the Group of 20 to expand its issuance by $250bn (€189bn, £171bn). These are the first big proposals for international monetary reform from China or indeed any emerging market economy and deserve to be taken seriously for that reason alone.

Several other Asian countries, Brazil and Russia have expressed support for Mr Zhou's ideas. The US and several other governments, however, have been quick to reject them, reaffirming their confidence in the central global role of the dollar. They apparently fear that serious discussion of this issue could shake confidence in the dollar, driving down its value and prompting a sharp rise in the euro and other currencies. Such instability and consequent rise in global interest rates would severely complicate US, European and global recovery from the crisis.

But there is a more immediate threat to financial stability from the global role of the dollar that could be significantly reduced by pursuing a more limited proposal made by Mr Zhou. The risk is that China and perhaps other monetary authorities, together holding more than $5,000bn in dollar reserves, will lose confidence in the dollar owing to the prospects for huge and sustained budget deficits in the US. Premier **Wen Jiabao** recently expressed such concerns in a highly unusual public statement, asking for "guarantees" of China's dollar holdings that recall the British demand for a guarantee in 1971 that triggered the US decision to break the dollar's link to gold.

These worried dollar holders have refrained from dumping Treasury securities only because the dollar has strengthened over the past year – which is almost certainly a temporary phenomenon – and because of the adverse global repercussions. We ignore at our peril the prospect that they may feel compelled to do so, especially if the US were to provoke the Chinese by taking aggressive trade policy actions against them. Big conversions by China or another large holder, or even market fears thereof, could trigger a massive run on the dollar.

Mr Zhou proposes to alleviate this problem by creating "an open-ended SDR-denominated fund" at the IMF into which dollar balances could be exchanged for SDRs. This is essentially the substitution account idea negotiated in the IMF in the late 1970s and for which detailed blueprints were developed. Similar anxieties about the dollar at that time prompted its sharpest plunge in the postwar period, intensifying the double-digit inflation and soaring interest rates that brought on the deepest US slowdown since the 1930s, until now.

I set out how the idea would work in an article on these pages in December 2007, in which Chinese officials displayed considerable interest. Instead of converting unwanted dollars through the market, official holders would deposit them in a separate IMF account for **SDR**. Their new asset would be liquid and pay a market rate of return. It would offer the desired diversification as the SDR is denominated in a basket of currencies – 44 per cent dollars, 34 per cent euro and 11 per cent each of yen and sterling.

The substitution account would be a winning proposition for all concerned. The dollar holders would obtain instant diversification. The US would avoid the risk of a free fall of the dollar. Europe would prevent a sharp rise in the euro. The global system would eliminate a potential source of great instability. These benefits call for the use of a global asset to make up any losses to the account from future falls in the dollar, such as creation of additional SDR or the IMF's gold holdings (including the sizeable US share of them).

The main argument against such an account is that China has accumulated its dollar hoard of more than $1,000bn by keeping its currency substantially undervalued, through massive intervention in the foreign exchange markets, and thus deserves no sympathy if it takes losses on those dollars. One might even suspect that the Chinese have mentally booked such losses as the implicit cost of the subsidy to exports and jobs achieved through their currency manipulation. But there is no sign that China will stop intervening, or that its surpluses will abate, even though the US external deficit has declined sharply, and its reserve build-up is thus likely to become even more threatening.

Moreover, this is an ideal issue for China and the US to develop the informal "G2" partnership that is needed to provide global economic leadership to pass needed reforms at the existing multilateral institutions. Since China advocates currency consolidation, the US could insist that it contribute substantially to the IMF's new lending facilities as a *quid pro quo*. The Europeans would have to concur, since the agreement would include a large increase in China's voting rights at the IMF, where Europe is so heavily over-represented, but China-US agreement would go far to seal the deal.

The writer is director of the Peterson Institute for International Economics. He was assistant secretary of the Treasury for international affairs in 1977-1981 and led the substitution account negotiations for the US in 1980