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Dollar's Last Days?

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CAMBRIDGE — Zhou Xiaochuan, the governor of the People's Bank of China, recently suggested that replacing the dollar with the International Monetary Fund's Special Drawing Rights (SDR) as the dominant reserve currency would bring greater stability to the global financial system.

The idea of reforming the system by introducing a supranational reserve currency is also, it appears, supported by Russia and other emerging markets. And a United Nations advisory committee chaired by the Nobel laureate Joseph Stiglitz has argued for a new global reserve currency, possibly one based on the SDR.

Transforming the dollar standard into an SDR-based system would be a major break with a policy that has lasted more than 60 years.

The SDR was introduced 40 years ago to supplement what was then seen as an inadequate level of global reserves, and was subsequently enshrined in the IMF's amended Articles of Agreement as the future principal reserve asset.

But the world soon became awash in dollars. So, instead of becoming the principal reserve asset of the global system, the proportion of SDRs in global reserves shrank to a tiny fraction, rendering the SDR the monetary equivalent of Esperanto.

Although the euro, created in 1999, turned out to be a more serious competitor to the dollar, its share in total international reserves has probably remained below 30 percent, compared to 65 percent for the dollar (these shares are in part estimates, as China, the world's largest holder of reserves, does not report the currency composition of its holdings).

There are two ways in which the dollar's role in the international monetary system can be reduced. One possibility is a gradual, market-determined erosion of the dollar as a reserve currency in favor of the euro.

But, while the euro's international role — especially its use in financial markets — has increased since its inception, it is hard to envisage it overtaking the dollar as the dominant reserve currency in the foreseeable future.

Such an outcome is probably only possible if two conditions are met: first, the United Kingdom joins the euro area, and, second, the United States makes serious, confidence-sapping mistakes.

The latter condition may already have been partially met, but U.S. policies to stabilize its financial system should help avoid a major dollar slide. Moreover, the European Central Bank has repeatedly stated that it neither encourages nor discourages the euro's international role.

With the dollar's hegemony unlikely to be seriously undermined by market forces, at least in the short and medium-term, the only way to bring about a major reduction in its role as a reserve currency is by international agreement. The Chinese proposal falls into this category.

One way to make the SDR the major reserve currency relatively soon would be to create and allocate a massive amount of new SDRs to the IMF's members.

While the G20 leaders have decided to support an SDR allocation of $250 billion, this will increase the share of SDRs in total international reserves to no more than 4 percent.

In order to make the SDR the principal reserve asset via the allocation route, close to $3 trillion in SDRs would need to be created, an unrealistic proposition.

But there is a more realistic way for the SDR's importance to grow. Back in 1980, the IMF came close to adopting a so-called SDR Substitution Account. The idea was to permit countries whose official dollar holdings were larger than they were comfortable with to convert dollars into SDRs.
Conversion would occur outside the market, and thus would not put downward pressure on the dollar. Member countries would receive an asset that was more stable than the dollar, as it was based on a basket of currencies, thereby providing better protection against losses.

The plan fell apart when some major IMF shareholders could not accept the burden-sharing arrangements that would be necessary in case of losses due to exchange-rate movements. The U.S. also lost interest in the scheme as the dollar strengthened.

What are the chances of adopting a scheme of this kind today? Is the U.S. prepared to go along with a reform of the international monetary system that reduces the dollar's role?

Until recently, I would have considered this unlikely. But the changed international climate, and the possibility of a bout of severe dollar weakness, could convince the U.S. to go along with a conversion scheme that would alleviate excessive pressure on the dollar.

And, apart from possible political considerations, large holders of dollars would find a substitution account attractive as a form of protection against strong fluctuations in the dollar's value. What about possible losses suffered by the Substitution Account? This can be dealt with by setting aside part of the IMF's large gold stock.

Even if an SDR Substitution Account is established, it is unlikely that the dollar's share in international reserves would fall to an insignificant level. The dollar will remain important for many countries as a vehicle for intervention in foreign-exchange markets, as well as for invoicing and for denominating internationally traded securities.

But one can envisage a system in which international reserves are held each in roughly equal shares of dollars, euros (assuming a further gradual increase in its share), and SDRs.

While there are currently other priorities, it would be useful for the IMF to study anew an SDR substitution account and similar schemes. If it does not, the debate will take place elsewhere.

Onno de Beaufort Wijnholds is a former executive director of the International Monetary Fund and a former permanent representative of the European Central Bank in the U.S. For more stories visit Project Syndicate (www.project-syndicate.org).