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## **Global Currencies**

In light of the global financial and euro area crises there has been an active debate about the dominance of the U.S. dollar and the euro in the International Monetary System (IMS). Indeed, there are signs that the system is evolving toward a greater role for emerging market (EM) currencies, some of which have achieved varying degrees of internationalization. A recent IMF paper surveys the evolving landscape of international currencies and examines the potential for moving from the current, de-facto, two “global currencies” system towards a multi-polar system (available at: <http://www.imf.org/external/pubs/ft/sdn/2011/sdn1117.pdf>).

Currency internationalization refers to a currency’s use outside the issuer’s borders, including for purchases of goods, services, and financial assets in transactions by nonresidents. Having an international currency offers a number of benefits, including lower transactions costs and exchange rate risk, greater impetus for financial market development, and lower cost of funding. However, there are also risks and costs as it complicates monetary management and potentially can cause a loss of competitiveness as the exchange rate of the reserve currency issuer is higher than it would be otherwise because of the increased demand for assets denominated in that currency.

Common measures of international use of a currency include a currency’s use as an international reserve asset; its use in invoicing and settlement of international transactions; and trading volumes in foreign exchange markets. By these metrics, today’s system is characterized by the dominance of the U.S. dollar, followed by the euro, sterling, and yen and more marginal use of a handful of other advanced economy currencies. For example, these four currencies make up more than 95 percent of global international reserves. The U.S. dollar dominates the pricing of commodities, as well as the issuance of international debt and equities. The four currencies comprise about 75 percent of global foreign exchange turnover.

EM currencies, by contrast, are hardly used internationally, even though these economies are increasingly more integrated into the global economy and their contribution to global growth, trade, and financial flows is growing fast. This raises a number of issues. The concentration of many functions of the IMS in one or two currencies, while efficient, does not reflect the increasingly multi-polar structure of the global economy. Further, such concentration may increase systemic vulnerability stemming from shocks in global currency issuers or from policy decisions that may not be appropriate for the rest of the world. It also leads to uneven sharing of currency risk among international currency issuers and others (who face the bulk of the risks). In addition, the global financial crisis and debt sustainability concerns have raised questions over the long-term store of value properties of the main global currencies.

No single factor determines successful internationalization; rather, wide use of a currency outside the issuer’s borders is due to the combination of economic size and centrality to

global trade, as well as capital account openness and the depth of financial markets, which provide global investors with safe stores of value. Aside from wide trade networks, which support the use of the currency both as a unit of account and medium of exchange, and invoicing practices, high GDP growth rates (and potential future growth), low and stable inflation, and financial stability are key for the global demand for a currency.

On the supply side, the attractiveness of the currency is strengthened by greater domestic financial market depth as it provides borrowers and investors access to a range of financial instruments. Importantly, access to deep and liquid financial markets onshore is essential to allow hedging of currency and credit risks required by participants in international markets. Offshore market development is also important and should be pursued in tandem with financial deepening onshore. Currency convertibility and capital account liberalization are also essential as limits on the convertibility of a currency for capital account transactions are likely to raise the costs of transactions denominated in the currency, and limit foreign access to domestic stores of value.

Based on the considerations above, the potential for internationalization of key EM currencies is clear, although to varying degrees. Higher rates of growth in many emerging market countries relative to advanced economies, in particular over the last decade, has meant that emerging market countries now account for nearly half of global output, up from just over a quarter in 1971. This trend is expected to continue. The increased economic weight of EMs is complemented by a significant rise in trade centrality and trade flows, particularly in the case of China. Furthermore, EMs credit ratings have improved markedly and EM countries have made progress in deepening their financial markets, with China and Brazil standing out for the rapid expansion of domestic bond markets. In contrast, having a large share of commodities in trade flows may present headwinds to currency internationalization in Brazil, India, and Russia. Also, with the exception of China, inflation has been consistently higher in EMs, with negative implications for the stable store of value characteristic. While Brazil and Russia have made significant progress toward liberalizing their capital accounts, China, India, and South Africa still lag behind.

China has made the most progress in promoting cross-border use of the RMB, in particular since the start of the pilot scheme in early 2010, suggesting that rapid change in the actual use of international currencies is quite possible. Policymakers from EM countries that wish to promote internationalization of their currencies would need to focus on maintaining macroeconomic stability and market-determined interest and exchange rates, pursue capital account liberalization, and show a willingness to act as a provider of global liquidity at times of financial stress. As such, currency internationalization may even be viewed to some extent as a by-product of economic reforms that are worth pursuing in their own right.

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