



# INTERNATIONAL MONETARY FUND

**Questioning the Possible Establishment of an Official World  
Reserve Currency to Replace the US Dollar**

**BACKGROUND PAPER**

Hamdi Aden  
Stacey Coe

In the absence of a world currency backed by effective governance, foreign trade and investment relies on national currencies playing international roles. Without leadership to oversee macroeconomic policy compatibility, global financial relations will continue to suffer under constant risk of instability, or worse.<sup>1</sup>

The recent global financial crisis has highlighted criticism of the current global monetary system, and raised questions as to the future of global reserves. For nearly a century the US dollar has reigned supreme, however, in recent decades confidence in the greenback has been undermined by persistent US current account deficit (CAD) and growing foreign debt.<sup>2</sup> For many, the dollar's fate seemed sealed following the collapse of the US housing market in mid-2007, triggering the greatest upheaval in US financial markets since the Great Depression.<sup>3</sup> However, the crisis proved anything but fatal for the dollar.

The premise of this Committee's debate is to question *the possible establishment of an official world reserve currency to replace the US dollar* similar to the global currency reforms advocated by some policymakers and economics literature. This could be through a single reserve currency, a basket of existing national currencies, or as a new international currency. A common international currency would ease adverse effects associated with using national currencies, but its regulation would prove difficult.



IMF Board of Governors (2006) – source: ninemsn<sup>4</sup>

## A Brief Introduction to the IMF

The International Monetary Fund, or IMF, is one of the key institutions in the architecture of international finance and trade – two others being the World Bank and Bank for International Settlements, each with separate mandates and delineated functions within the global financial system. Conceived on July 22, 1944 at the United Nations Monetary and Financial Conference at Bretton

---

<sup>1</sup> Montecillo, Paolo Luis G, 'Dollar uncontested as reserve currency', Business World, Manila Nov 5. 2009

<sup>2</sup> Carbaugh, Robert and David Hedrick 'Losing Faith in the Dollar', *Challenge*, vol. 51, no. 3, May/June 2008, pp. 93

<sup>3</sup> Cohen, Benjamin J, 'The future of reserve currencies', Finance & Development, Washington, Vol. 46, Iss. 3; Sept 2009, pg. 26

<sup>4</sup> Image: <http://seeker401.files.wordpress.com/2009/09/imf-board-of-governors-circa-20061.jpg>

Woods, New Hampshire, the IMF came into effect December 27, 1945 when 29 founding members signed its Articles of Agreement.<sup>5</sup>

Today membership has grown to 186 countries. The IMF aims to foster monetary competition, stabilise exchange rates, facilitate international trade, development and macroeconomic stability amongst member states, provide policy advice (see *The Washington Consensus*), and reduce poverty. The IMF also acts as a lender of last resort for financially distressed members, offering highly leveraged loans, often to poorer nations.<sup>6</sup> Membership and voting is based on a quota system relative to members' contributions to IMF reserves, and each state's role in the international trading system. This quota system sets the subscription, voting weight, allocation of Special Drawing Rights (SDR) – “an international reserve asset, created by the IMF in 1969 to supplement its member countries' official reserves”<sup>7</sup> – and access to IMF currency reserves.<sup>8</sup> During BrizMUN 2010, the IMF will operate on a one vote, one voice system.

## **A Brief Introduction to the History of Global Currency Reserves**

A reserve, or anchor, currency is a currency held in significant stocks by governments and central banks. The US Dollar forms the majority of current global currency reserves, and is used as the anchor-point against which commodities are traded on international markets.<sup>9</sup> However, before delegates will be able to debate the merits for and against the establishment of a new global currency, consideration must be given to key events in the history of currency reserves and international trade.

The International Gold Standard was a monetary system first implemented by Great Britain in 1821, replacing the previously favoured metal of silver over the following 50 years, of fixed exchange rates between currency and gold. Under this system, gold or a currency freely convertible to gold (USD) was the primary medium for international payments. The fixing of the primary currency's value against gold insured the value of USD. Currencies of other countries were then adjusted based on the gold standard. Trigger points of devaluing in currencies against the gold standard resulted in large inflows and outflows of gold as markets self-corrected,<sup>10</sup> causing liquidity shortfall – an inability to meet demand for liquid currency.

Liquidity shortfall was a key criticism levelled against the gold standard, ultimately leading to its disbandment in favour of USD. The superiority of a fiat (paper) money system as a flexible instrument for trade was seen in WWI, when central banks experienced a scarcity of gold reserves and had to find other means (paper money) to fund the war. In the years following the end of WWI, gold supply fell behind the growth of the global economy and highlighted the need to implement a different system for currency reserves.<sup>11</sup> During the Great

---

<sup>5</sup> The International Monetary Fund: <http://www.imf.org/external/pubs/ft/aa/>

<sup>6</sup> The International Monetary Fund: <http://www.imf.org/external/about.htm>

<sup>7</sup> The International Monetary Fund: <http://www.imf.org/external/np/exr/facts/sdr.htm>

<sup>8</sup> Wikipedia: [http://en.wikipedia.org/wiki/International\\_Monetary\\_Fund](http://en.wikipedia.org/wiki/International_Monetary_Fund)

<sup>9</sup> Wikipedia: [http://en.wikipedia.org/wiki/Reserve\\_currency](http://en.wikipedia.org/wiki/Reserve_currency)

<sup>10</sup> Encyclopedia Britannica: <http://www.britannica.com/EBchecked/topic/237431/gold-standard#>

<sup>11</sup> Investopedia: <http://www.investopedia.com/articles/05/030705.asp>

Depression, the gold standard drew further criticism for being too rigid a measure of international currency exchange, preventing the Federal Reserve of America from implementing monetary policy to help alleviate the effects of macroeconomic contraction. Due to events following the Great Depression, WWII and high inflation during the 1960s, by 1971 the US abandoned the gold standard completely in favour of fiat currency, bringing to an end the era of the gold standard.<sup>12</sup>

Despite the advantages the gold standard provided – limiting the powers of central financial institutions to induce inflation of their currency, and providing certainty through fixed exchange rates – the disadvantages far outweighed them – lack of flexibility in supply, emerging liquidity shortfall, and limiting governments' and central banks' abilities to implement corrective fiscal policies.<sup>13</sup>

### **Why is the current system of global currency reserves being called into question?**

In the 1960s and 1970s, the global financial system suffered setbacks identified by the research of Robert Triffin as *the Triffin dilemma* – the use of national currency to serve as an international financial instrument in international jurisdictions causes supply of reserves to be subject to the domestic fiscal policy of the issuing nation. Under Triffin's analysis, any domestic currency is an inherent de-stabiliser in the global system. The advantages to the nation issuing the currency are seen in the trade imbalances this, the Bretton Woods, system creates. With the recent global financial crisis, particularly the mid-2007 crash of the US housing market, dependence on the dollar has prompted speculation about the limitations, benefits and costs of using a national currency in international trade.<sup>14</sup>

Further to the Triffin dilemma, economic theory also levels criticism of the dollar's reserve-currency status (and US hegemony) at its right to seigniorage – the US government's ability to finance and accumulate debt in its own national currency, supply the fiat system with reserve currency, and invoice international trade (at manipulated, favourable exchange rates).<sup>15</sup> Despite increasing trade deficits through the use of, and heavy dependence on, imports and foreign capital to support high government spending and huge levels of public consumption, the US continues to accumulate debt unabated – becoming one of the world's greatest debtors, where once it was one of the greatest creditors. Furthermore, the US economy composition has changed from production-led hegemony to finance-led hegemony. The absence of many

---

<sup>12</sup> Wikipedia: [http://en.wikipedia.org/wiki/Gold\\_standard](http://en.wikipedia.org/wiki/Gold_standard)

<sup>13</sup> Encyclopedia Britannica: <http://www.britannica.com/EBchecked/topic/237431/gold-standard#>

<sup>14</sup> Mandeng, Ousméne Jacques. 2009. Reserve currencies and solving the new Triffin dilemma. *Central Banking*. February 2009, 19 (3), pp. 27-32. London, UK.

<sup>15</sup> Ivanova, M. N. 26 March 2008 "*Hegemony and Seigniorage: The Planned Spontaneity of the US Current Account Deficit*". Paper presented at the annual meeting of the ISA's 49<sup>th</sup> Annual Convention Bridging Multiple Divides, Hilton, San Francisco, CA. Accessed from USA Online: [http://www.allacademic.com/meta/p252978\\_index.html](http://www.allacademic.com/meta/p252978_index.html)

negative effects of ongoing CAD has been seen as an *exorbitant privilege* for the US.

The UNCTAD Trade & Development Report 2009 has pointed to dominance of the dollar as the reason for current global trade imbalances, and called for the establishment of a new global currency based on the SDR, managed by a newly established global currency reserve bank. The natural monopoly of the dollar has developed over the past 100 years as the result of the 'lock in' effect of network externalities, whereby the dollar gained value as more nations stockpiled it in reserve, encouraging further purchasing of reserves and 'buy in' by other nations, resulting in widespread dependence and entrenchment in global finance. The US dollar accounts for approximately two-thirds of global currency reserves.<sup>16</sup>

In an attempt to decrease reliance on the dollar, Chinese officials, led by Dr Zhou Xiaochan (Governor of the People's Bank of China), have called for the establishment of a new international currency to replace the dollar, and establishment of a fund denominated in the SDR. In an experiment aimed at reducing China's reliance on the dollar, three China-based companies invoiced using the renminbi ('people's currency') in cross-border trade.<sup>17</sup> Similarly, Russian officials have indicated their desire to decrease their dependence on the dollar, focusing their investment on the currencies of their BRIC partners, with Russia and Brazil recording significant volumes of sales of US Treasuries during 2009. Notably, China remains the largest net purchaser of USD, while advocating use of SDR for international payments. Despite China's desire to move away from the dollar, the panoply of capital controls exercised by the Chinese government is one of many obstacles to the renminbi challenging the dollar's reserve currency status. Analysts agree there is no viable option amongst existing *national currencies* to replace the dollar.<sup>18</sup>

For proponents of a new global currency reserve the single greatest concern for fiscal stability is the current and ongoing US deficit. While meeting with the US for the regular US-China Strategic and Economic Dialogue, Chinese officials expressed concern about US CAD. As the biggest buyer of US reserve currency (\$1.2 trillion dollars<sup>19</sup>) China is well founded in its fears that record US budget deficits could undermine its holdings.<sup>20</sup> In acknowledging this, US officials pledged to reduce deficits and increase private savings. This example demonstrates central banks' willingness to hold the dollar in reserve – based on its 'unit of account', 'medium for exchange', and 'store of value' properties – while being wary of the large accumulation of US Treasuries jeopardising the mobility of currency reserves. That is, another case of potentially disastrous liquidity shortfall. While the dollar may have declined in value (reducing its *store of value*), its *unit of account* and *medium of exchange* properties are unchallenged. That is, the dollar is highly usable.

Apart from gold, Special Drawing Rights (SDRs) allocated by the IMF, aimed at

---


<sup>16</sup> IMF, 2009

<sup>17</sup> Platt, Gordon. 2009. "Dollar secure in its role as world's key reserve currency, analysts say". *Global Finance*. September 2009, 23 (8), pp. 46-48. New York, USA.

<sup>18</sup> Reuters: <http://www.reuters.com/article/idUSLJ93633020090319>

<sup>19</sup> [http://www.imf.org/Foreign\\_reserves.htm](http://www.imf.org/Foreign_reserves.htm)

<sup>20</sup> <http://online.wsj.com/article/SB123780272456212885.html> ---china



providing additional reserve assets to supplement global liquidity, has come closest to creating an alternative international reserve currency. While the SDR may be a more stable currency than the dollar, it still poses problems when used in international trade.<sup>21</sup> Invoicing in SDR requires parties to settle in all currencies comprising the SDR basket, proving highly complex – creating a nexus of complexity in governance and uniform macroeconomic policies of common currency, and the undue privileges of the Triffin dilemma.<sup>22</sup>

## The Need for Coordination

However you, the Delegates of the IMF, agree to best address the identified problematic elements of existing currency reserves, thought should be given to the need for macroeconomic coordination and management as vital to the success, or failure, of changes to the global monetary system. The elements of the current market structure that are of greatest concern are: the effects official holdings of US Treasuries (rather than the absolute supply of fiat currency),<sup>23</sup> the ‘exorbitant privilege’<sup>24</sup> of the US in international trade, and the emergence of a new Triffin dilemma. That is, the asymmetrical privilege of the US’ ability to finance trade deficit’s in its currency. Some critics of the dollar argue this points to a need for reserve diversification to foster stability through diffusing risk across multiple currencies.<sup>25</sup>

If modelled on the SDR, a new global currency would include a basket of dollar, euro, pound sterling, and yen. The support of central banks in transitioning away from dollar-dependence is critical to the campaign for global currency reserve reform. According to some authors, any efforts to create an international currency for reserve, or to change its sourcing to a diversified basket of major currencies, must be insured against failure through the coordination, management and implementation of a global central reserve bank acting separately to national governments.<sup>26</sup> For without coordination and leadership to manage a guaranteed minimum level of fiscal policy compatibility between nations, the global financial system would risk instability. Others add that the political and economic implications of a fragmented system of a mixed basket of currencies are significant. Given the disjuncture between national currencies and the power imbalance they create at the international level (Triffin dilemma), it follows that the political economy must be considered, not purely economics alone.

Central bankers and governments will not opt for currency that is not in wide use in the private sector, central bankers in particular have shown sensitivity to

---

<sup>21</sup> Platt, Gordan, ‘Dollar secure in its role as world’s key reserve currency’, *Global Finance*, Vol. 23, Iss. 8; Sept 2009 pg. 47


<sup>22</sup> [http://en.wikipedia.org/wiki/Triffin\\_dilemma](http://en.wikipedia.org/wiki/Triffin_dilemma)

<sup>23</sup> Mandeng, Ousméne Jacques. 2009. Reserve currencies and solving the new Triffin dilemma. *Central Banking*. February 2009, 19 (3), pp. 27-32. London, UK.

<sup>24</sup> Cohen, Benjamin J. 2009. The future of reserve currencies. *Finance & Development*. September 2009, 46 (3), pp. 26-29. Washington, USA.

<sup>25</sup> Ivanova, Maria N. March 26, 2008. “Hegemony and seigniorage: the planned spontaneity of the US current deficit”. Paper presented at the annual meeting of the ISA’s 49<sup>th</sup> Annual Convention “*Bridging Multiple Divides*”, Hilton, San Francisco, CA, USA.

<sup>26</sup> Montecillo, Paolo Luis G. 2009. Dollar uncontested as reserve currency. *Business World*. November 5, 2009. Manilla, Philippines



liquidity shortfall, exchange convenience, and rates of return.<sup>27</sup> The political advantage of reserve currencies is seen in the “soft” and “hard” power it delivers – status, prestige, military pursuits, and trade negotiations. The euro, though considered the natural rival to the dollar, suffers from a lack of stable governance; the EU area’s structures remain unclear, its fiscal policies equally so. What does emerge as fundamental from this debate is, for any currency to achieve global reserve status, it is vital to consider both political and economic factors, in concert with the need for strong and clear governance, centralised organisation, and coordinated macroeconomic policy.

### **Where to From Here?**

A host of alternatives to the dollar have been suggested, including: energy-based commodities, a mixed basket of major currencies (yen, pound sterling, dollar, and euro), and existing Special Drawing Rights.<sup>28</sup>

At a recent G8 summit, the BRIC countries’ (Brazil, Russia, India and China) call for reform of the international monetary system through the establishment of a supranational reserve currency was rejected. Supporters of monetary reform cite the recent US housing market crash as an example of the potential threat dollar-dependence poses to global reserves. However, G8 nations have deflected this criticism in calling for countries to refrain from competitive currency devaluations<sup>29</sup>. Another offering to resolve tension in global reserves is the use of a mixed basket of major global currencies. However, the lack of options for assets with ‘reserve-type’ properties (such as the dollar) imposes limits on the feasibility of a mixed-basket system. The stability and usability of a currency is a key consideration: the former pertains to the political and economic environments of the issuing country, the latter to economic development and network externalities, including the economy’s size, low inflation, exchange-rate stability and geopolitical considerations.<sup>30</sup>

However, today the effects of such large accumulations of holdings of US Treasuries, rather than the absolute supply of reserve assets, is of great concern. The emergence of a new Triffin dilemma may cause reserve holdings to be less effective due to increasing illiquidity. This implies the feasibility of the current financial system has reached a point of exhaustion. The diversification of assets therefore seems a necessary condition to accommodate today's stock of international reserves, and restore objective and viability of international reserves. Market structure effects suggest that the expansion of existing reserve currencies is not viable. The transition to such a regime would need to be orderly, but the allocation out of US securities remains a risk if undertaken through uncoordinated actions of central banks.

Industrialised countries are projected to contribute a less dominant share of


---

<sup>27</sup> Carbaugh, Robert, and David Hedrick. 2008. “Losing faith in the dollar: Can it remain the world’s dominant reserve currency?” *Challenge*, vol 51 (3), pp. 93-114.

<sup>28</sup> UN Conference on Trade and Development:  
<http://www.unctad.org/Templates/Webflyer.asp?intItemID=1397&docID=11867>

<sup>29</sup> Platt, Gordan, ‘Dollar secure in its role as world’s key reserve currency’, *Global Finance*, Vol. 23, Iss. 8; Sept 2009 pg. 46

<sup>30</sup> Mandeng, Ousméne Jacques, ‘Reserve currencies and solving the new Triffin dilemma’, *Central Banking*, Vol. 19, Iss. 3; Feb 2009, p. 28



total global output and trade, while emerging markets' assets and currencies will increasingly possess characteristics of reserve currencies. Additional reserve brackets could thus include a secondary section of major emerging markets currencies and an investment portion comprising emerging markets sovereign debt.<sup>31</sup> While the adoption of emerging-market currencies in central bank reserve portfolios may seem daunting under current market conditions, currency performance is at least in part endogenous to central bank allocation patterns, an issue to which Delegates should give due consideration.

**In considering your country's position in this discussion, keep the following points in mind:**

- Purpose/objective: why change the current system? Cost/benefit analysis for making a change
- For new currency: setting of its value, liquidity (shortfall), flexibility, and governance
- For reform: mechanics/logistics of transition, member opposition, and risks to existing reserves
- Policy: macroeconomic coordination and cooperation, and transfer of holdings of US Treasuries
- IMF: US largest donor to reserves (two-thirds), only member able to over-rule majority decisions

**Further Reading**

Mateos y Lago, Isabelle, Rupa Duttgupta, and Rishi Goyal. November 11, 2009 (SPN/09/06). IMF - *The Debate on the International Monetary System*; <http://www.imf.org/external/pubs/ft/spn/2009/spn0926.pdf>

---

<sup>31</sup> Montecillo, Paolo Luis G, 'Dollar uncontested as reserve currency', Business World, Manila Nov 5. 2009