China’s Proposal for a Super-sovereign Reserve Currency System

Reform the International Monetary System

By Zhou Xiaochuan
Global Research, April 09, 2009
People's Bank of China 9 April 2009

Region: Asia
Theme: Global Economy

Proposal of the Governor of the People’s Bank of China
presented to the G20 Meetings

The outbreak of the current crisis and its spillover in the world have confronted us with a long-existing but still unanswered question,i.e., what kind of international reserve currency do we need to secure global financial stability and facilitate world economic growth, which was one of the purposes for establishing the IMF? There were various institutional arrangements in an attempt to find a solution, including the Silver Standard, the Gold Standard, the Gold Exchange Standard and the Bretton Woods system. The above question, however, as the ongoing financial crisis demonstrates, is far from being solved, and has become even more severe due to the inherent weaknesses of the current international monetary system.

Theoretically, an international reserve currency should first be anchored to a stable benchmark and issued according to a clear set of rules, therefore to ensure orderly supply; second, its supply should be flexible enough to allow timely adjustment according to the changing demand; third, such adjustments should be disconnected from economic conditions and sovereign interests of any single country. The acceptance of credit-based national currencies as major international reserve currencies, as is the case in the current system, is a rare special case in history. The crisis again calls for creative reform of the existing international monetary system towards an international reserve currency with a stable value, rule-based issuance and manageable supply, so as to achieve the objective of safeguarding global economic and financial stability.

I. The outbreak of the crisis and its spillover to the entire world reflect the inherent vulnerabilities and systemic risks in the existing international monetary system.

Issuing countries of reserve currencies are constantly confronted with the dilemma between achieving their domestic monetary policy goals and meeting other countries’ demand for reserve currencies. On the one hand,the monetary authorities cannot simply focus on domestic goals without carrying out their international responsibilities��on the other hand,they cannot pursue different domestic and international objectives at the same time. They may either fail to adequately meet the demand of a growing global economy for liquidity as they try to ease inflation pressures at home, or create excess liquidity in the global markets by overly stimulating domestic demand. The Triffin Dilemma, i.e., the issuing countries of reserve currencies cannot maintain the value of the reserve currencies while providing liquidity to the world, still exists.

When a national currency is used in pricing primary commodities, trade settlements and is adopted as a reserve currency globally, efforts of the monetary authority issuing such a currency to address its economic imbalances by adjusting exchange rate would be made in vain, as its currency serves as a benchmark for many other currencies. While benefiting from a widely accepted reserve currency, the globalization also suffers from the flaws of such a system. The frequency and increasing intensity of financial crises following the collapse of the Bretton Woods system suggests the costs of such a system to the world may have exceeded its benefits. The price is becoming increasingly higher, not only for the users, but also for the issuers of the reserve currencies. Although crisis may not necessarily be an intended result of the issuing authorities, it is an inevitable outcome of the institutional flaws.

II. The desirable goal of reforming the international monetary system, therefore, is to create an international reserve currency that is disconnected from individual nations and is able to remain stable in the long run, thus removing the inherent deficiencies caused by using credit-based national currencies.

1. Though the super-sovereign reserve currency has long since been proposed, yet no substantive progress has been achieved to date. Back in the 1940s, Keynes had already proposed to introduce an international currency unit named “Bancor”, based on the value of 30 representative commodities. Unfortunately, the proposal was not accepted. The collapse of the Bretton Woods system, which was based on the White approach, indicates that the Keynesian approach may have been more farsighted. The IMF also created the SDR in 1969, when the defects of the Bretton Woods system initially emerged, to mitigate the inherent risks sovereign reserve currencies caused. Yet, the role of the SDR has not been put into full play due to limitations on its allocation and the scope of its uses. However, it serves as the light in the tunnel for the reform of the international monetary system.

2. A super-sovereign reserve currency not only eliminates the inherent risks of credit-based sovereign currency, but also makes it possible to manage global liquidity. A super-sovereign reserve currency managed by a global institution could be used to both create and control the global liquidity. And when a country’s currency is no longer used as the yardstick for global trade and as the benchmark for other currencies, the exchange rate policy of the country would be far more effective in adjusting economic imbalances. This will significantly reduce the risks of a future crisis and enhance crisis management capability.

III. The reform should be guided by a grand vision and begin with specific deliverables. It should be a gradual process that yields win-win results for all

The reestablishment of a new and widely accepted reserve currency with a stable valuation benchmark may take a long time. The creation of an international currency unit, based on the Keynesian proposal, is a bold initiative that requires extraordinary political vision and courage. In the short run, the international community, particularly the IMF, should at least recognize and face up to the risks resulting from the existing system, conduct regular monitoring and assessment and issue timely early warnings.

Special consideration should be given to giving the SDR a greater role. The SDR has the features and potential to act as a super-sovereign reserve currency. Moreover, an increase in SDR allocation would help the Fund address its resources problem and the difficulties in the voice and representation reform. Therefore, efforts should be made to push forward a

SDR allocation. This will require political cooperation among member countries. Specifically, the Fourth Amendment to the Articles of Agreement and relevant resolution on SDR allocation proposed in 1997 should be approved as soon as possible so that members joined the Fund after 1981 could also share the benefits of the SDR. On the basis of this, considerations could be given to further increase SDR allocation.

The scope of using the SDR should be broadened, so as to enable it to fully satisfy the member countries' demand for a reserve currency.

Set up a settlement system between the SDR and other currencies. Therefore, the SDR, which is now only used between governments and international institutions, could become a widely accepted means of payment in international trade and financial transactions.

Actively promote the use of the SDR in international trade, commodities pricing, investment and corporate book-keeping. This will help enhance the role of the SDR, and will effectively reduce the fluctuation of prices of assets denominated in national currencies and related risks.

Create financial assets denominated in the SDR to increase its appeal. The introduction of SDR-denominated securities, which is being studied by the IMF, will be a good start.

Further improve the valuation and allocation of the SDR. The basket of currencies forming the basis for SDR valuation should be expanded to include currencies of all major economies, and the GDP may also be included as a weight. The allocation of the SDR can be shifted from a purely calculation-based system to a system backed by real assets, such as a reserve pool, to further boost market confidence in its value.

IV. Entrusting part of the member countries' reserve to the centralized management of the IMF will not only enhance the international community's ability to address the crisis and maintain the stability of the international monetary and financial system, but also significantly strengthen the role of the SDR.

1. Compared with separate management of reserves by individual countries, the centralized management of part of the global reserve by a trustworthy international institution with a reasonable return to encourage participation will be more effective in deterring speculation and stabilizing financial markets. The participating countries can also save some reserve for domestic development and economic growth. With its universal membership, its unique mandate of maintaining monetary and financial stability, and as an international "supervisor" on the macroeconomic policies of its member countries, the IMF, equipped with its expertise, is endowed with a natural advantage to act as the manager of its member countries' reserves.

2. The centralized management of its member countries' reserves by the Fund will be an effective measure to promote a greater role of the SDR as a reserve currency. To achieve this, the IMF can set up an open-ended SDR-denominated fund based on the market practice, allowing subscription and redemption in the existing reserve currencies by various investors as desired. This arrangement will not only promote the development of SDR-denominated assets, but will also partially allow management of the liquidity in the form of the existing reserve currencies. It can even lay a foundation for increasing SDR allocation to gradually replace existing reserve currencies with the SDR.

Comment on Global Research Articles on our Facebook page

Become a Member of Global Research

Articles by: Zhou Xiaochuan