

Global currencies for tomorrow: A European perspective

A report on options for, and implications of, reforms of the international monetary system prepared for the European Commission in the context of Contract No. ECFIN/220/2010/573686

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This report examines possible scenarios for the evolution of the international monetary system (IMS) and their implications for the euro area, within a 15-year perspective.

After the Bretton Woods system ended forty years ago, the IMS gradually developed into its present state, a hybrid mix in terms of exchange-rate flexibility, capital mobility and monetary independence. The US dollar retains a dominant, but not exclusive, role in it and its system of governance blends regional and multilateral surveillance. It combines IMF-based and ad-hoc liquidity provision. Although it has proved resilient during the crisis, partly thanks to ad-hoc arrangements, the IMS has serious flaws, which are likely to get magnified by the rapid transformation of the global economy and the rising economic power of emerging economies.

The report begins by taking stock of two major lessons of history:

- Since the beginning of the XXth century emphasis in most countries has shifted towards internal rather than external stability. This priority is likely to remain pivotal in the coming decades;
- Although the dollar has eventually succeeded the pound as the dominant international currency, history demonstrates that multipolar systems based on more than one key currency not only can exist, but can also persist for several decades.

The report assesses the implications for the IMS of the ongoing shift in the world balance of economic power. It points out that by 2020-2030 economic power is likely to be more evenly distributed among key players – the US, the euro area and China – that at any point in time in recent history. It discusses what makes a currency able to play an international role and concludes that neither the euro nor the renminbi are likely to be in a position to challenge the supremacy of the dollar, but that they are likely to come to play a meaningful international role, under certain conditions.

The report then outlines three possible scenarios for the IMS:

- a repair-and-improve scenario where changes to current arrangements are introduced through incremental reforms,
- a multipolar scenario in which a system structured around two or three international currencies emerges,
- a multilateral scenario in which participants agree to take steps towards a strengthened international monetary order.

The first scenario is the least demanding in terms of both domestic policies and international coordination and the most likely to prevail in the short run, while the last one is the most demanding and the least likely of the three scenarios. Though limited in ambition, the first scenario would be an important stepping-stone towards further development of the IMS. The second scenario relies on market forces and domestic policies rather than on international cooperation and its probability, although fairly low in the short run, is significant within the 10-15 year horizon. The third scenario has a low probability, but can gain likelihood in case of major international financial crises.

Assessment of the three scenarios on the basis of efficiency, stability and equity criteria suggests that:

- all three would offer improvements compared to the current system,
- their feasibility negatively correlates to their desirability,
- the multipolar scenario would best correspond to structural changes in the world economy and mitigate some (albeit not all) flaws of the current IMS.

The deeper transformation of the IMS is likely to take a long time. The report analyses three specific issues for the transition and concludes that:

- the Chinese renminbi can reach a moderate international role without major changes to Chinese policies, but deeper reforms will be needed to rival the euro and the dollar,
- in the absence of a major overhaul of the IMS, the “repair-and-improve” scenario (that includes lower incentives to accumulate reserves), together with significant domestic policy shifts, can be powerful in reducing global imbalances,
- concerning exchange-rate misalignments and asymmetries in the run-up to the multipolar and multilateral scenarios, (i) Chinese developments are not neutral for the euro/dollar exchange rate if China keeps a fixed exchange rate to the dollar, (ii) move from a dollar-centred to a multi-currency system and more flexibility of the renminbi exchange rate could create more short-term exchange-rate volatility, but reduce the potential for medium-term exchange-rate misalignments, (iii) the internationalisation of the renminbi would be stabilising for the euro/dollar exchange rate.

From the viewpoint of the euro area:

- the multilateral scenario not only stands out as the most desirable one, but is also particularly congruent with the euro area’s intrinsic principles,
- the multipolar scenario would be preferable to the repair-and-improve scenario,
- in comparison to the current dollar-dominated system, the euro area could benefit from a move to a bipolar system around the dollar and the renminbi;
- the capacity of the euro to increase its international status requires key decisions by the euro area, such as further governance reform, the creation of a Eurobond market, and the streamlining of external representation,
- issuing a fully-fledged international currency involves both privileges and duties; it is a political choice whether to increase the euro’s role.