

## Special Feature A

# The Fall in the US Dollar and its Status as a Reserve Currency

## Introduction

Since its most recent peak in early 2002, the US\$ has weakened significantly against the major currencies, including the euro, Swiss franc and the Canadian dollar. Together with the sizeable US current account deficit, this has raised issues concerning the continued role of the greenback as the world's leading reserve currency and the stability of the global monetary system. Key parallel structural developments that have occurred in the global economy have also had an impact on the international monetary system in recent years. These include persistent saving-investment imbalances, the creation of the euro, and the rise of large emerging market economies, such as China and India. The views and research on all these important developments are reviewed in this Special Feature.

There are signs of a gradual transition of the global monetary system towards generalised floating exchange rates, which suggest that the somewhat popular "Bretton Woods II" label currently being applied to the international monetary system may now be a little out of date. As countries develop and experience the benefits of fewer capital controls and more flexible exchange rates, and as financial markets mature in terms of depth and liquidity, other currencies may gain acceptance as reserve currencies. If this happens, then we might indeed witness a gradual decline in the importance of the dollar as a reserve currency. That said, given the extensive network externalities and the entrenched position of the US as default banker to the world, the greenback's position as a leading reserve currency and as a "vehicle" currency for global transactions is unlikely to be dislodged anytime soon.

## The US Dollar Adjustment Process

### Broad-based, Gradual Depreciation

Since the beginning of 2002, the dollar has depreciated significantly, particularly against the major currencies such as the euro, Australian dollar and Canadian dollar. Moreover, Asian currencies have also started to appreciate against the US\$ at a faster pace in the last few years. (Chart 1)

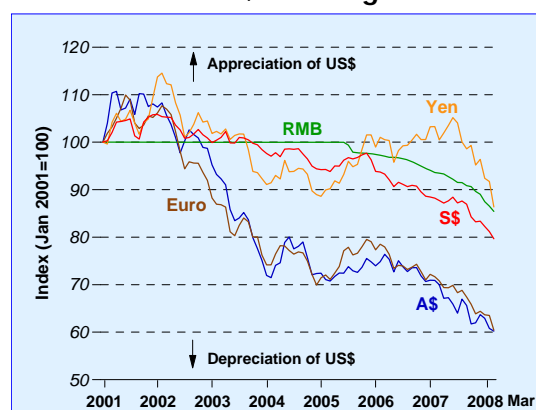
On a trade-weighted basis, the nominal US\$ is now at a level which prevailed thirteen years ago, according to Federal Reserve computations and, as at end-March 2008, has declined by 26% relative to its peak in February 2002. Against the major currencies, the dollar has declined even further, by 37%, over the same period, and is now at its lowest level since the start of its free-float in 1973. (Chart 2)

In real terms, i.e. adjusted for differences in inflation rates across countries, the US\$ has fallen to near historic lows of the post-Bretton Woods period. (Chart 3) A key difference in the current adjustment phase, however, is that the decline in the dollar has occurred over a much longer time span. At the time of the Plaza Accord in the mid-1980s, the real trade-weighted US\$ exchange rate fell by 29% over a three year period between March 1985 and April 1988, or about 9% per year. By contrast, it fell by only 25% over a much longer six-year period between February 2002 and March 2008, or 3-4% per year.

Table 1 shows that, since its peak in February 2002, the US\$ has depreciated most against the Australian dollar, followed by the euro and the Canadian dollar.

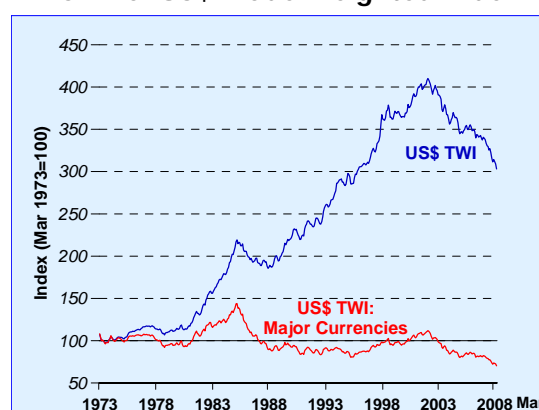
Figure 1 documents the key developments over the decades that have had an influence on the value of the US\$ (taking the Yen/US\$ exchange rate as a proxy).

**Chart 1**  
Selected US\$ Exchange Rates



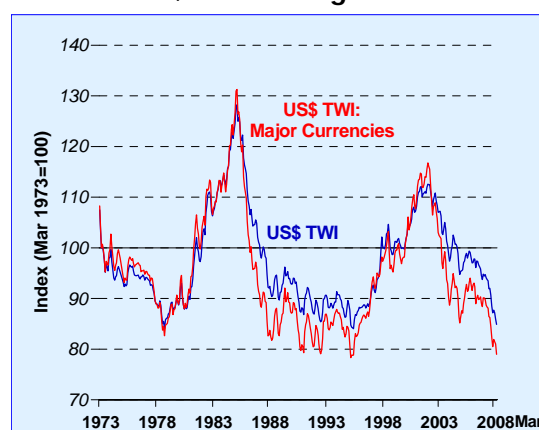
Source: CEIC

**Chart 2**  
Nominal US\$ Trade-weighted Index



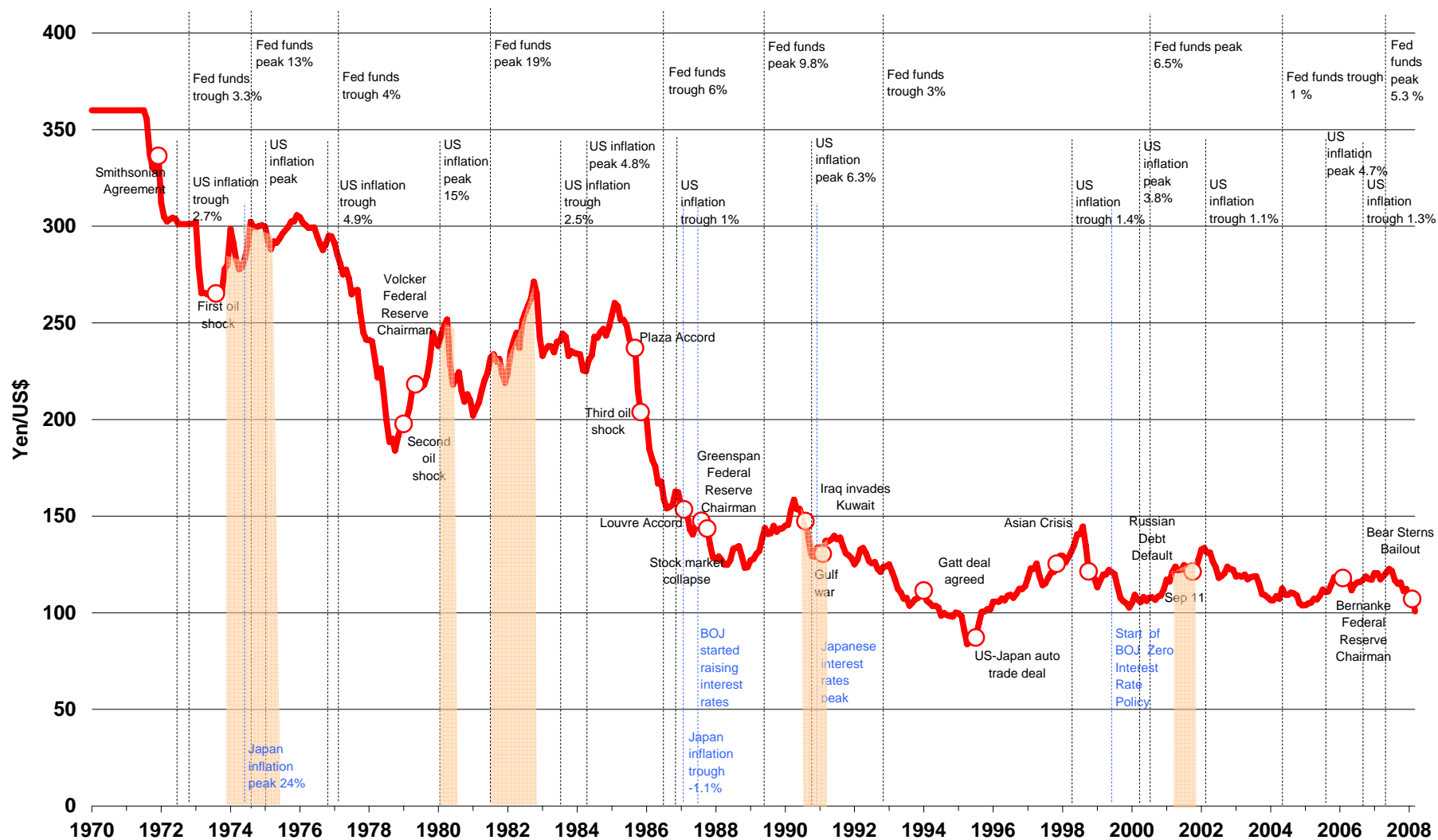
Source: CEIC

**Chart 3**  
Real US\$ Trade-weighted Index



Source: CEIC

Figure 1: Yen/US\$ Exchange Rate (1970-2008)



Note: Shaded area indicates US recession

**Table 1**  
**Exchange Rate Movements against the US\$**

	% Appreciation against the US\$ (as at end-March 2008)	
	Since Jan 2005	Since Feb 2002
<b>Euro</b>	18.3	78.3
<b>Sterling pound</b>	6.5	40.7
<b>Japanese yen</b>	2.6	32.6
<b>Canadian dollar</b>	22.1	59.2
<b>Australian dollar</b>	20.2	79.8
<b>Chinese renminbi</b>	17.0	17.0
<b>Korean won</b>	5.7	34.5
<b>Indonesian rupiah</b>	-0.6	10.5
<b>Malaysian ringgit</b>	19.3	19.3
<b>Philippine peso</b>	31.6	22.7
<b>Thai baht</b>	23.4	39.6
<b>Singapore dollar</b>	18.3	32.3
<b>Nominal US\$ TWI: Broad</b>	-12.5	-26.1
<b>Nominal US\$ TWI: Major Currencies</b>	-13.2	-37.2

Source: CEIC

The fall in the US\$, together with a concurrent decline in the US current account deficit more recently, has eased tensions over what the IMF calls “global imbalances”. From a record high of US\$217 billion in Q3 2006 (or 6.5% of GDP), the seasonally-adjusted deficit has narrowed to US\$173 billion in Q4 2007 (4.9%). US real exports of goods and services, which rose by 6.5% q-o-q SAAR in Q4 2007, expanded at a faster pace than imports, which contracted by 1.4%. (See Chart 4 for longer-term trends in y-o-y terms.)

The orderly adjustment of the US\$ has lessened the sense of impending crisis in the global economy and has permitted economic agents to adapt to the changes without major or abrupt disruption of normal activities. Indeed, Simon Johnson, chief economist at the IMF, has recently characterised the dollar decline as “reassuring” and “not disorderly” because it has not led to a widespread loss of confidence in the dollar as a reserve currency, nor has it required a rise in US interest rates.

**Chart 4**  
**Growth in US Exports and Imports of Goods**



Source: CEIC

## The Contemporary International Monetary “Non-System”

This section reviews some of the salient features of the post-Bretton Woods monetary system in the light of recent developments, including the adoption of inflation targeting regimes by many central banks around the world.

The present adjustment to the value of the dollar and global imbalances is best viewed in the context of the gradual evolution of the international monetary system. Under the original Bretton Woods system, the US\$ performed the role of a nominal anchor for the international monetary system, with its value fixed at US\$35 per troy ounce of gold. Other currencies were pegged to the dollar, and thus to the base price of gold.<sup>1</sup>

Although official exchange rates were fixed under Bretton Woods, the reality was somewhat different, according to a seminal study by Reinhart and Rogoff (2002). Taking into account the incidence of dual or parallel markets (legal or otherwise) and multiple exchange rate practices in the post-war period, the authors found that more than 50% of the cases of pegged exchange rate regimes had in fact two or more exchange rates. The existence of these parallel and more market-based exchange rates – on which a significant amount of transactions were based – suggests that Bretton Woods was not entirely a pure, fixed exchange rate system. Thus, on a de facto basis, the number of pegged exchange rate regimes under Bretton Woods was significantly less than reported to the IMF.

Further, the authors found that the number of de facto managed floating and freely floating exchange rates post-Bretton Woods was also fewer than what was reported on a de jure basis. These findings have significantly narrowed the actual differences between the system of exchange rates during Bretton Woods and the post-Bretton Woods environment.

Notwithstanding these caveats, when the dollar was unpegged to gold and floated in March 1973, it marked the beginning of the “generalised floating era” for major currencies. Theoretically, if all currencies are freely floating, there would be little need for currency intervention and no need for countries to maintain substantial foreign exchange reserves. Balance of payments disequilibria would be corrected automatically by movements in the nominal exchange rate, which, in turn, would function as a “shock absorber” for the domestic economy. However, many developing countries have continued to peg their currencies, de facto, to “hard” currencies, especially the dollar, on the grounds that their financial systems are insufficiently mature to deal with large currency fluctuations.

Borrowing from the Bretton Woods framework, some economists have characterised the present monetary system as a “Bretton Woods II” arrangement,<sup>2</sup> or simply as an extension of the Bretton Woods fixed exchange rate system. According to this hypothesis, the core of the arrangement comprises the major G3 economies (the US, Europe and Japan), where exchange rates are largely determined by market forces. By contrast, the periphery consists of the large and rapidly growing Asian region (excluding Japan) and the Middle East, where currencies remain closely tied to the US\$. Thus, Bretton Woods II is a “shared development” model that provides an incentive for peripheral countries to keep their exchange rates stable against the US\$. This attempt to keep exchange rates relatively stable has been termed “fear of floating” by Calvo and Reinhart (2002).

Given that the present international monetary system comprises a mixed bag of freely floating currencies, managed floats and more tightly pegged exchange rates, a number of

<sup>1</sup> Or pegged to a major currency such as the pound sterling, which was itself pegged to the US\$.

<sup>2</sup> The idea of Bretton Woods II was initiated and popularised by a group of economists at Deutsche Bank.

commentators have pointed out that this represents a major “fault-line” in the system. Recognising in part the wide divergences in countries’ exchange rate regimes and practices, Williamson (1977), for example, famously characterised post-Bretton Woods as a “non-system”. Corden (1994) also observed that the essential feature of the system is that it is “unplanned and uncoordinated”.

Referring more specifically to the Bretton Woods II characterisation, Eichengreen (2007) pointed to the fact that under the original Bretton Woods system there were formal arrangements, such as the Gold Pool<sup>3</sup>, that provided incentives for countries to play by the rules. By contrast, no such binding arrangements hold Bretton Woods II together. Apart from the shared (export-driven) development model, there is also an absence of an effective surveillance and enforcement mechanism that prevents Bretton Woods II countries from curtailing their accumulation of dollars and diversifying their reserves. The ultimate collapse of the Gold Pool thus serves as a useful reminder that “when institutional support is weak, when information is imperfect, when a fringe of non-participating countries exists, then it would be difficult to achieve sustainable cooperation.”

### **Towards a More Flexible International Monetary System?**

Indeed, recent developments have given greater credence to some of these concerns. As developing countries have grown in importance in the world economy, and financial globalisation has become more entrenched, global imbalances appear more protracted and difficult to resolve. In addition, the substantial increase in private cross-

border financial flows has allowed some countries to sustain external disequilibria for extended periods of time.

As long as the key countries involved, especially the US, run reasonably balanced external positions, the global system can function smoothly – deficit countries merely need to devalue against the dollar. Other things being equal, devaluation would be tantamount to a depreciation against all currencies, and this would help to promote the necessary shifts in expenditures away from tradeables (imports) while encouraging increased domestic production and exports.

However, when the anchor country, in this case the US, runs persistent and sizeable current account deficits, then the problem becomes one of identifying those countries which will bear most of the burden of adjustment. Clearly, no single country would want to be the primary counterparty to a weak dollar.

As it turned out, the persistence of the US current account deficit since the early 1990s (and its large size) has led to some fairly significant changes to the asymmetry in global exchange rate arrangements, particularly in Asia. There has been considerable pressure on Asian currencies to rise relative to the dollar. Contemporary developments in the global economy suggest that Bretton Woods II may be no more than a transitional phase. The loosening of the peg between the renminbi and the US\$ since July 2005 has removed a key pillar of the Bretton Woods II argument. Subsequently, as the renminbi appreciated, most other Asian currencies followed suit, further de-coupling these currencies from the dollar.<sup>4</sup> In the Middle East, Kuwait recently became the first Gulf country to delink its currency from the US\$.

<sup>3</sup> The Gold Pool was an American initiative in 1961 to stabilise the market price of gold by pooling the gold reserves of the US and the major European countries. This collective effort reduced the burden on the US to singlehandedly maintain the market price of gold at US\$35 a troy ounce.

<sup>4</sup> Acknowledging the significant appreciation of Asian and other emerging market currencies against the US\$, Peter Hooper of Deutsche Bank recently conceded that there have been “some signs of a loosening of the dollar peg in several emerging market economies” which represented a gradual “unwinding” of the Bretton Woods II arrangement and is similar to the unwinding process that took place under the original Bretton Woods system.

Based on the IMF's classification of de facto exchange rate regimes, there appears to be an increase in the number of emerging market countries that have moved towards a floating arrangement over the past 10-15 years.<sup>5</sup> Indeed, about half of the emerging market economies are classified to have such a regime in 2006. (Chart 5)

Some of the broad shifts in de facto exchange rate regimes are highlighted below:

### Greater Asian Currency Flexibility

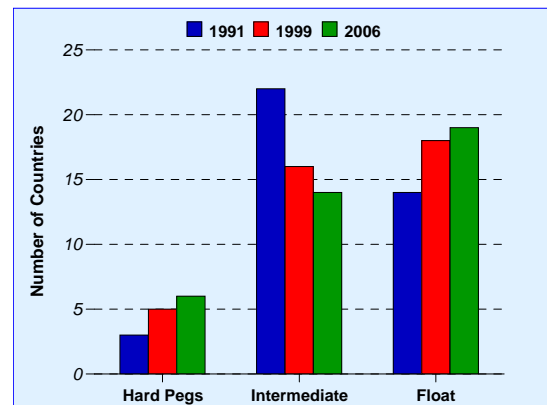
In the aftermath of the Asian Crisis, many commentators called for greater exchange rate flexibility in Asia. Following the loosening of the renminbi peg in 2005, it is generally recognised that Asian currencies have indeed become more flexible vis-à-vis the US\$. Many have appreciated significantly against the greenback, particularly in the past few years. A number of central banks have also adopted an inflation targeting framework.

Thus far, the Asian currency adjustment process has proceeded in an uncoordinated manner. Regional central banks have intervened where necessary to prevent their exchange rates from rising too sharply and most have also been sterilising their interventions so as to mitigate the liquidity impact on the domestic economy. Over the last few years, there has been a tendency for Asian currencies to rise in tandem. Between January 2005 and March 2008, for instance, the renminbi, Malaysian ringgit and Thai baht rose by 17%, 19% and 23% respectively, against the US\$.

### Pressure on Middle East Currency Pegs

With the fall of the US\$, there has been increased speculation as to whether Middle Eastern countries will abandon their dollar pegs. The debate has intensified since May 2007 when Kuwait became the first Gulf State to drop its rigid exchange rate peg to the US\$ in favour of a more flexible peg to a basket of currencies. By shifting to a basket peg, the Kuwaiti monetary authorities have gained a measure of domestic monetary policy independence, which allows them to pursue a

**Chart 5**  
**Emerging Market Economies: Shifts in de facto Exchange Rate Regimes**



Source: Fischer (2007)

<sup>5</sup> This is based on Fischer (2007) and the IMF's annual reports on Exchange Arrangements and Exchange Restrictions. Fischer re-grouped the IMF's exchange rate classifications into three categories, namely: a hard peg, which consists of currency boards and countries with no separate legal tender; an intermediate regime that comprises currencies pegged in a horizontal band, crawling pegs, rates within crawling bands and other fixed pegs; and a floating exchange rate arrangement that comprises managed floats and independent floats.

different (tighter) monetary policy stance to that of the US. While a more flexible basket peg arrangement might be a useful idea, some have argued that the Gulf States are not quite prepared, in terms of financial infrastructure, to cope with greater exchange rate volatility.

### Inflation Targeting and Currency Flexibility in Latin America

Many Latin American countries have adopted an inflation targeting framework,<sup>6</sup> which has been credited with helping to bring inflation down, and anchoring it at low levels. Moreover, macroeconomic stability in the region has allowed the monetary authorities to adopt a more “benign neglect” attitude towards exchange rate movements.

As Federal Reserve Chairman (at that time Governor) Bernanke (2005) said: “Inflation targeting and flexible exchange rates together serve to reduce the conflict between domestic economic stability and the free movement of capital across borders that is inherent in some other arrangements, most obviously the fixed exchange rate regimes favoured by these countries in the past.” Bernanke also cites reforms in fiscal policy and banking regulation, and central bank independence as key changes in the policy environment that have contributed to the success in containing inflation in Latin America. As inflation expectations become entrenched at moderate levels, monetary authorities are likely to become more comfortable with greater exchange rate flexibility.

## Challenges to the Dollar’s Pre-eminent Global Position

The fall in the US\$ over the last six years has renewed speculation about its longer-term status as a leading reserve currency. The dollar, like any other domestic or international currency, can be characterised by its primary functions: a medium of exchange, a unit of account and a store of value. In an international context, as a medium of exchange the dollar is widely used in cross-border trade and financial transactions, even in transactions that do not involve the US directly. As a unit of account, the dollar is commonly used as an invoicing currency for a wide variety of commodities, high-tech products and services. As a store of value, the dollar has generally held up well against most other currencies over the longer term. At the official level, the dollar also functions as a reserve and intervention medium and as a peg for exchange rates.

Clearly, the widespread use and acceptance of the dollar all over the world is tied to the status of the United States as the world’s dominant superpower with the most advanced economy. More specifically, the continued dominance of the dollar

will depend on a number of factors, including its strong incumbent position dating back to the Bretton Woods system, the size of the US economy and trade and capital movements, the depth of US financial markets and the credibility enjoyed by the Federal Reserve.<sup>7</sup> Lastly, economies of scale suggest that it would be very difficult for another currency to quickly replace the dollar as the major reserve currency. Thus, although the dollar has no special status post-Bretton Woods, it continues to occupy a central position in the global financial system.

Cohen (1998) notes that the key to the widespread acceptance of a currency – particularly when it is used outside of its own territorial domain – is simply *trust*. He adds that “money has no meaning at all except with reference to the mutual confidence that makes its use possible.” Hence, the dollar’s leading position reflects the fact that people all over the world believe and trust that it will continue to be accepted as a medium of exchange and that it will retain its real purchasing power.

<sup>6</sup> These include Brazil, Mexico, Chile, Colombia and Peru. Argentina has also expressed an interest in moving towards such a regime.

<sup>7</sup> In the words of Former Federal Reserve Chairman Paul Volcker (2008): “As custodian of the nation’s money, the Federal Reserve has the basic responsibility to protect its value and resist chronic pressures toward inflation.”

Two factors, in particular, will be important in the ongoing debate about the fall in the dollar and its continued role as a leading reserve currency.

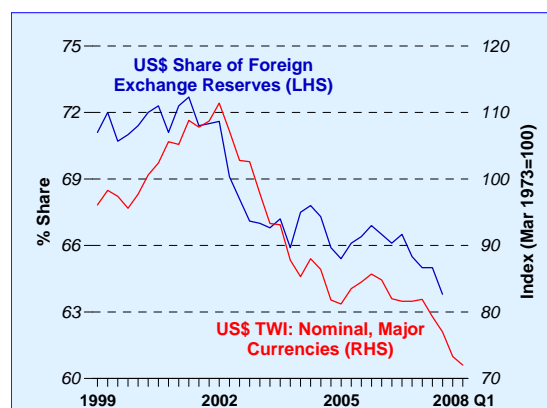
### **(i) Portfolio Adjustment by Central Banks**

First, is a major sell-off of the US\$ by foreign central banks likely? On the assumption that some central banks have recently become “buyers of last resort” of the US\$, some analysts have expressed concern that should central banks stop their dollar purchases, for whatever reason, the greenback would fall sharply.

In his book *The Age of Turbulence*, former Federal Reserve Chairman Alan Greenspan (2007) has played down this possibility. He suggests that the world’s financial markets are sufficiently deep to cope with official selling pressures or reduced demand. However, noting that China and Japan have accumulated some US\$2.5 trillion of reserves between them (of which, four-fifths appear to be dollar claims), Greenspan agrees that there will be some modest downward pressure on the dollar and upward pressure on US long-term interest rates if central banks sell dollar reserves. Nonetheless, he notes that the “foreign exchange markets for the major currencies have become so liquid that the currency transactions required to implement large international transfers of US\$ deposits can be accomplished with only modest disturbance to markets. As for interest rates, the extent of a rise is likely to be less than many analysts fear, certainly less than a percentage point and conceivably much less.” He reasons that liquidation of US Treasury securities by central banks (or any other market participant) is merely an asset swap which affects the spread between two securities but need not affect the overall level of interest rates.

Recent data from the IMF indicate that global official foreign exchange reserves (OFR) rose to US\$6.39 trillion in December 2007, the highest on record, and an almost four-fold increase over the past ten years. The IMF’s Currency Composition of Official Foreign Exchange Reserves (COFER) data suggests that the dollar may have lost ground as the currency of choice for foreign exchange reserves. The dollar’s share of countries’ official reserve assets slipped to 63.9% as at end-2007, compared with 65.5% in 2006, and 66.9% in 2005.<sup>8</sup> (Chart 6) Thus, it appears that official asset

**Chart 6**  
**US\$ Share of Official Foreign Exchange Reserves and the US\$ TWI**



Source: IMF COFER database and CEIC

<sup>8</sup> These figures are based on data pertaining to “allocated reserves”, in which the currency composition can be identified (or reported to the IMF). Unallocated reserves (in which there is no information on the currency composition of the reserves) amounted to a significant US\$2.33 trillion in December 2007 (or equivalent to 36% of total global OFR).

allocation has begun to favour non-dollar instruments in order to reduce foreign exchange losses in the event of a continued dollar correction.

However, it is also plausible that the decline in the US\$ share of OFR simply reflects the fall in the value of the US\$ against other major currencies and translation losses as the currency reserves are marked to market, i.e. valued at the latest exchange rates. Assets held in euros, for instance, will have gained in value with the fall in the dollar. Since OFR statistics are denominated in US\$ and the US\$ has fallen by some 37% against the major currencies, it would be reasonable to expect a reduction in the share of US\$-denominated assets in countries' OFR. Indeed, Chart 6 suggests that there is a fairly strong correlation between the dollar share of OFR and movements in the US\$ exchange rate.

Furthermore, in a recent IMF working paper Lim (2007) found some evidence of "portfolio rebalancing" behaviour among reserve asset managers over the period 1999 to 2007. A portfolio rebalancing strategy involves purchasing a currency when it depreciates, and selling a currency when it appreciates – a sort of "contrarian" asset management strategy. Such a strategy tends to offset the direction of movement of a currency. For example, when the US\$ falls, the value of dollar assets in a portfolio will decline, causing its share to shrink relative to other currency assets in the portfolio. In order to "rebalance" or maintain a certain desired share of the dollar in the portfolio, this calls for the purchase of more dollar assets in order to boost its relative share. Lim concludes that "portfolio rebalancing is likely the dominant dynamic allocation strategy in the management of reserves." This implies that the fear of central banks selling dollars as a source of instability in the foreign exchange markets has been somewhat exaggerated.

### (ii) Declining Use of the US\$ as an Invoice Currency

The second factor pertains to the continued role of the dollar as a vehicle currency for international trade and finance. According to a recent paper by

Goldberg (2008) from the Federal Reserve, the use of the US\$ as an invoice currency for both exports and imports remains very popular among "dollar bloc" countries in Asia. For countries such as Korea and Thailand, some 80% of their trade is reportedly invoiced in dollars even though direct trade with the US accounts for only 10-20% of their total trade. The use of the US\$ has fallen for other more developed countries in the region. Official Japanese data, for example, show that the proportion of exports invoiced in yen has risen from near zero in 1970 to some 40% since the early 1980s. Slightly more than half of Japanese exports to Asia are now denominated in yen.

Further, following the advent of the euro and the growing number of countries lining up to join the EU (and perhaps eventually the eurozone), the use of the euro has also expanded significantly. Slightly more than half of all exports from France, Germany, Italy and Spain are now invoiced in euros. For many of the EU-accession countries, the proportion of exports invoiced in euros is considerably higher, at some 50-85%, as these countries trade predominantly with EU countries. So the expansion of the EU is likely to lead to an increased role for the euro over time.

Thus, while there is still considerable inertia in the use of other major currencies in international transactions, these trends, together with the rise of large emerging market economies, such as China and India, suggest that the use of the US\$ as an invoice currency is likely to decline gradually over time.

It is worth remembering that seven hundred years ago, China led the world in terms of technology and per capita income. It then fell into relative decline before embarking on a rapid catch-up phase at the end of the 1970s. According to long term projections by Maddison (2007), China's economy should grow at twice the rate of the US (5% versus 2.5%) between 2003 and 2030, and will probably overtake the US as the world's biggest economy by 2030 in Purchasing Power Parity (PPP) terms. By then, the combined GDP of China and India is projected to approach that of the group of rich countries comprising Western Europe, the US and Japan. (Table 2)

In addition, technology and highly liquid foreign exchange markets make it much easier to convert from one currency to another. As Eichengreen (2007) explains, “financial innovation will continue to reduce the costs of converting currencies, further weakening the incentive to hold reserves in

the same form that other countries hold reserves simply to minimise transaction costs”. This argument holds for both private and public sector holdings of dollars. Reduced transaction costs could lead to reduced demand to hold US\$ balances solely for settlement purposes.

**Table 2**  
**Global GDP, 1950-2030**

	Levels in Billions of 1990 PPP Dollars					Average Annual Rate of Change (%)	
	1950	1973	1990	2003	2030	1990- 2003	2003- 2030
W. Europe	1,396	4,097	6,033	7,857	12,556	2.05	1.75
USA	1,456	3,537	5,803	8,431	16,662	2.91	2.56
Japan	161	1,243	2,321	2,699	3,488	1.17	0.95
Other Industrial	180	522	862	1,277	2,414	3.07	2.39
<b>Industrial Countries</b>	<b>3,193</b>	<b>9,398</b>	<b>15,020</b>	<b>20,265</b>	<b>35,120</b>	<b>2.33</b>	<b>2.06</b>
E. Europe	185	551	663	786	1,269	1.33	1.79
Russia	315	872	1,151	914	2,017	-1.76	2.98
Other Former USSR	199	641	837	638	1,222	-2.17	2.43
Latin America	416	1,389	2,240	3,132	6,074	2.61	2.48
China	245	739	2,124	6,188	22,983	8.56	4.98
India	222	495	1,098	2,267	10,074	5.73	5.68
Other Asia	363	1,387	3,099	5,401	14,884	4.36	3.83
Africa	203	550	905	1,322	2,937	2.96	3.00
<b>Rest of the World</b>	<b>2,144</b>	<b>6,625</b>	<b>12,117</b>	<b>20,649</b>	<b>61,460</b>	<b>4.19</b>	<b>4.12</b>
<b>World</b>	<b>5,337</b>	<b>16,022</b>	<b>27,136</b>	<b>40,913</b>	<b>96,580</b>	<b>3.21</b>	<b>3.23</b>

Source: Maddison (2007)

## Sum Up

After the collapse of the Bretton Woods fixed exchange rate system in the early 1970s, world trade and payments relied on an unplanned and uncoordinated monetary “system” that included a wide variety of fixed and flexible exchange rate regimes. This arrangement, though imperfect, proved manageable provided the core country (the US) was largely in balance – from a balance of payments perspective. However, strains began to emerge in the early 1990s following the rise in the US current account deficit.

Up until recently, the “Bretton Woods II” hypothesis was a popular characterisation of the post-Bretton Woods arrangement. However, following the un-pegging of the renminbi and

increased currency flexibility in emerging market economies, Bretton Woods II may prove to be a transitional phase in the evolution of the global monetary system.

The current environment in which the anchor currency (US\$) experiences increased volatility could pose a risk to the health of the global economy and financial system. That said, the relative ease with which the US trade deficits have thus far been financed suggests that there is no shortage of international lenders to the US (or demand for US assets) – otherwise, US interest rates would have been somewhat higher. Clearly, the credibility enjoyed by the Federal Reserve in maintaining low inflation is fundamental to

preserving investors' confidence in the dollar. However, as the Federal Reserve lowers interest rates to deal with the fallout from the subprime crisis, there is the obvious risk that inflation expectations could rise, which could undermine confidence in the currency.

From a portfolio perspective, an important long-term risk to the dollar emanates from the continued build-up of the US' net international liabilities. The US presently needs to borrow some US\$700-800 billion a year from abroad to meet its domestic savings shortfall. Kenneth Rogoff, former chief economist at the IMF, has recently stated that Americans will find global hegemony a lot more expensive if the dollar falls off its perch.

More recently, the persistent fall in the dollar, the rise in global commodity prices, growing inflationary pressures and wealth accumulation outside of the US may well be signs of a world in which the dollar plays a less strategic role and the US shares more of its economic power with the rest of the world.

At this juncture, there is considerable uncertainty with regard to the trajectory of the US economy and the dollar. Nonetheless, it seems safe to say, given the significant structural changes in the global economy in recent years – the successful creation of the euro, the rise of China and India, the adoption of more flexible exchange rate regimes – that the dollar is likely to share its reserve currency status with some other currencies over the longer term which, in itself, need not be an undesirable outcome. To some extent, it reflects a natural by-product of a more broad-based global economy with reduced dependence on the US as a primary engine of growth.

The stability of the global monetary system should also be enhanced by the increased flexibility of exchange rates in many parts of the world, including the "dollar bloc" countries in the Asia-Pacific region. To fully benefit from increased currency flexibility and at the same time be shielded from some of the adverse effects of more volatile exchange rates, emerging market economies should therefore strengthen their financial infrastructure and supporting institutions.

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