Bratislava Model United Nations 2011

UN ECONOMIC AND FINANCIAL COMMITTEE

THE DOLLAR CRISIS

Study Guide

Chairs: Trung Dang Quoc & Dávid Žitňanský

Table of Contents

Letter from the chair

Dear Delegates,

As Chair of the UN Economic and Financial Committee it is my pleasure and privilege to welcome you to the Bratislava Model United Nations Conference 2011.

Since economics and finance are the areas I'm particularly interested in, I would like to introduce you to this year's ECOFIN topic: the Dollar crisis. If you are interested in politics, economics and finance, you must be surely aware of the hot issue going on not only in United States, but also in the rest of the world. Recent economic and financial instability in the world forecasts another global financial crisis, which is considered by many economists to be much more severe than the one between WWI and WWII. It would have not only economical but also political impact on every future decision of the global community. Therefore, I considered this topic to be a really exciting and challenging one to discuss.

As of now, I'm a graduating student of the IB programme in Bratislava. As I mentioned before, economics, politics and finance are one of my interests, ones in which I would like to pursue my further studies at university. Apart from that, I enjoy guitar playing and all kinds of sport in my free time. My friends also know me as a guy who enjoys having fun and parties (There will surely be one at least one at the time of BratMUN, so don't miss the chance to experience Bratislava nightlife!).

I look forward to meeting you in November to discuss this important issue and hope that you will enjoy this topic as much as I do. This study guide serves only as the first source of your information, so you will be motivated to gather as much information as possible. In case of any inquires do not hesitate to contact us.

Trung Dang Quoc

Co-chair of the ECOFIN

Introduction

Under the terms of the Bretton Woods Agreement, signed in July 1944, the United States agreed to exchange U.S. dollars for gold at a fixed rate of $35 per ounce. Currencies of signatory nations were pegged to the U.S. dollar within a 1% deviation limit. Central banks would buy or sell U.S. dollars to keep their currency within the permitted fluctuation band. Thus, the U.S. dollar became the world's official reserve currency.

More recently, a prolonged period of U.S. dollar weakness against the currencies of its major trading partners, persistent current account and budget deficits, and a policy of quantitative easing by the U.S. Federal Reserve have led investors to question how much longer the dollar's status as the world's de facto reserve currency will remain unchallenged. This question has important implications for the U.S. economy since worldwide reserves held as foreign exchange total $6.5 trillion. The bill is coming due and the table is being set for the biggest currency crisis ever.

Here is the summary of key factors why value of US dollar has yet lost 27% against other currencies for the last decade:

- The U.S. debt is over $14 trillion (14.3 exactly).
- Foreign holders of this debt are concerned that the U.S. will let the dollar value decline so the relative value of its debt is less.
- The large debt could force the U.S. to raise taxes to pay it off, which would slow economic growth.
- As more countries join or trade with the European Union, demand for the euro increases.
- Foreign investors are diversifying their portfolios with more non-dollar denominated assets.
- As the dollar loses value, investors are less likely to hold assets in dollars as they wait for the decline to stop.

The situation in world is becoming more strengthened and investors are worried about their investments not only to US Treasuries but also possible financial crisis that may arise if US will be no longer able to meet its obligations. All trade is happening in dollars, commodities are valued in dollars, currency rates are tied to US dollar and the US is the most important trading partner for many economies, especially developing economies such as China, Brazil and India. If dollar collapsed, $6.5 trillion in foreign reserves all over the world would significantly lose its value. Such amount of Money devaluation would have not only economical and financial impacts, but may also trigger riots, uncontrollable inflation and significant increase in the rate of unemployment, especially in the US, but also rest of the world. UN ECOFIN Committee faces one of the most serious challenges ever. Exact measures and solutions are inevitable. And they are essential now.

Reserve currency and the international monetary system

The International monetary system

International monetary systems are sets of internationally agreed rules, conventions and supporting institutions that facilitate international trade, cross border investment and generally the reallocation of capital between nation states. They provide means of payment acceptable between buyers and sellers of different nationality, including deferred payment. To operate successfully, they need to inspire confidence, to provide sufficient liquidity for fluctuating levels of trade and to provide means by which global imbalances can be corrected. The systems can grow organically as the collective result of numerous individual agreements between international economic actors spread over several decades. Alternatively, they can arise from a single architectural vision as happened at Bretton Woods in 1944.

Pre-WWI order: 1870-1914

From the 1870s to the outbreak of World War I in 1914, the world benefited from a well integrated financial order, sometimes known as the *First age of Globalisation*. Money unions were operating which effectively allowed members to accept each others currency as legal tender including the Latin Monetary Union(Belgium, Italy, Switzerland, France) and Scandinavian monetary union(Denmark, Norway and Sweden). In the absence of shared membership of a union, transactions were facilitated by widespread participation in the gold standard by both independent nations and their colonies. Great Britain was at the time the world's pre-eminent financial, imperial, and industrial power, ruling more of the world and exporting more capital as a percentage of her national income than any other creditor nation has since.

Between the Wars: 1914-1939

The years between the world wars have been described as a period of *de-globalisation*, as both international trade and capital flows shrank compared to the period before World War I. During World War I countries had abandoned the gold standard and, except for the United States, returned to it only briefly. By the early 30's the prevailing order was essentially a fragmented system of floating exchange rates .In this era, the experience of Great Britain and others was that the gold standard ran counter to the need to retain domestic policy autonomy. To protect their reserves of gold countries would sometimes need to raise interest rates and generally follow a deflationary policy. The greatest need for this could arise in a downturn, just when leaders would have preferred to lower rates to encourage growth.

The Bretton Woods Era: 1945-1971

British and American policy makers began to plan the post war international monetary system in the early 1940s. The objective was to create an order that combined the benefits of an integrated and relatively liberal international system with the freedom for governments to pursue domestic policies aimed at promoting full employment and social wellbeing. The principal architects of the new system, John Maynard Keynes and Harry Dexter White, created a plan which was endorsed by the 42 countries attending the 1944 Bretton Woods Conference. The plan involved nations agreeing to a **system of fixed but adjustable exchange rates where the currencies were pegged against the dollar**, with the dollar itself convertible into gold. **So in effect this was a gold-dollar exchange standard**. There were a number of improvements on the old gold standard. Two international institutions, the **International Monetary Funds (IMF)** and the **World Bank** were created; A key part of their function was to replace private finance as more reliable source of lending for investment projects in developing states.

The Post-Bretton Woods Era: 1971-present

An alternative name for the post-Bretton Woods system is the **Washington Consensus**. The transition away from Bretton Woods was marked by a switch from a **state led to a market led system**. The Bretton Wood system is considered by economic historians to have broken down in the 1970s: crucial events being Nixon suspending the dollar's convertibility into gold in 1971, the United States' abandonment of Capital Controls in 1974, and Great Britain's ending of capital controls in 1979 which was swiftly copied by most other major economies.

Generally the industrial nations experienced much slower growth and higher unemployment than in the previous era, and according to Professor Gordon Fletcher in retrospect the 1950s and 60s when the Bretton Woods system was operating came to be seen as a golden age. **Financial crises have been more intense and have increased in frequency by about 300%** – with the damaging effects prior to 2008 being chiefly felt in the emerging economies. On the positive side, at least until 2008 investors have frequently achieved very high rates of return, with salaries and bonuses in the financial sector reaching record levels.

Proposal of a new Bretton Woods system

"We must have a new Bretton Woods, building a new international financial architecture for the years ahead." Gordon Brown.

Leading financial journalist Martin Wolf has reported that all financial crises since 1971 have been preceded by large capital inflows into affected regions. While ever since the seventies there have been numerous calls from the global justice movement for a revamped international system to tackle the problem of unfettered capital flows, it wasn't until late 2008 that this idea began to receive substantial support from leading politicians. On September 26, 2008, French President Nicolas Sarkozy, then also the President of the

European Union, said: "*We must rethink the financial system from scratch, as at Bretton Woods.*"

World currency

The Spanish Dollar

The **Spanish dollar** (also known as the **piece of eight**, the **real de a ocho** or the **eight-real coin**) that was minted in the Spanish Empire after a Spanish currency reform in 1497. Its purpose was to correspond to the German thaler. In Australia, in the colony of New South Wales, Spanish dollars were sent by the British government, with holes punched out of the centres of the coins to create a new Australian Currency. It was the coin upon which the original United States Dollar was based, and it remained legal tender in the United States until the Coinage Act of 1857 discontinued the practice. Because it was widely used in Europe, the Americas, and the Far East, it became the first world currency by the late 18th century. Aside from the U.S. dollar, several other existing currencies, such as the Canadian dollar and the Chinese yuan, as well as several currencies in Latin America and the Philippine peso, were initially based on the Spanish dollar and other 8-reales coins.

The Golden Standard

The most stable "reserve currency" was the gold rate. Gold rate or gold standard is a monetary system which was standardizing economy. It was bounding the amount of money being in trade by the amount of gold in national deposits.

Similarly, the *gold exchange standard* typically involves the circulation of only coins made of silver or other metals, but where the authorities guarantee a fixed exchange rate with another country that is on the gold standard. This creates a de facto gold standard, in that the value of the silver coins has a fixed external value in terms of gold that is independent of the inherent silver value. Finally, the gold bullion standard is a system in which gold coins do not circulate, but in which the authorities have agreed to sell gold bullion on demand at a fixed price in exchange for the circulating currency. Its advantages were, among others:

- Long-term price stability has been described as the great virtue of the gold standard. Under the gold standard, high levels of inflation are rare, and hyperinflation is nearly impossible as the money supply can only grow at the rate that the gold supply increases. Economy-wide price increases caused by ever-increasing amounts of currency chasing a constant supply of goods are rare, as gold supply for monetary use is limited by the available gold that can be minted into coin.

- The gold standard limits the power of governments to inflate prices through excessive issuance of paper currency. It provides fixed international exchange rates between those countries that have adopted it, and thus reduces uncertainty in international trade.

- The gold standard makes chronic deficit spending by governments more difficult, as it prevents governments from inflating away the real value of their debts. A central bank cannot be an unlimited buyer of last resort of government debt. A central bank could not create unlimited quantities of money at will, as there is a limited supply of gold.

On the other hand, the golden standard had its disadvantages:

- The total amount of gold that has ever been mined has been estimated at around 142,000 metric tonnes. This is less than the value of circulating money in the U.S. alone, where more than $8.3 trillion is in circulation or in deposit. Therefore, a return to the gold standard, if also combined with a mandated end to fractional reserve banking, would result in a significant increase in the current value of gold, which may limit its use in current applications.
- Deflation rewards savers and punishes debtors. Real debt burdens therefore rise, causing borrowers to cut spending to service their debts or to default. Lenders become wealthier, but may choose to save some of their additional wealth rather than spending it all. The overall amount of expenditure is therefore likely to fall
- Following a gold standard would mean that the amount of money would be determined by the supply of gold, and hence monetary policy could no longer be used to stabilize the economy in times of economic recession. Such reason is often employed to partially blame the gold standard for the Great Depression, citing that the Federal Reserve couldn't expand credit enough to offset the deflationary forces at work in the market.
- Monetary policy would essentially be determined by the rate of gold production. Fluctuations in the amount of gold that is mined could cause inflation if there is an increase or deflation if there is a decrease.
- Although the gold standard gives long-run price stability, it does in the short run bring high price volatility.

Reserve currency

Reserve Currency is a currency that is held in significant quantities by many governments and institutions as part of their foreign exchange reserves. It works easily: governments are buying the most important goods in this currency. Currently the global reserve currency is US Dollar.

In history reserve currencies were changing, we can say according to which empire was in the rule of the most trade.

From Chinese Liang to Pound Sterling in 1944

After World War 2 United States was placed as the anchor of the Bretton Woods System (a system which established rules for financial relations among the economical strongest countries) US government guaranteed for other central banks that they could sell their US dollar reserves for gold at fixed rate. In late 60s and 70s first problems have begun.

US Dollar – end of another global currency?

"Frankly, I think we're at a tipping point. What's my biggest single financial concern is the loss of the dollar as the reserve currency," (***Sam Zell***, *real-estate magnate)*

"We need reserves that are surer and more stable than the dollar." (***Christine Lagarde***, *French Minister of finance)*

Recently, a long period of U.S. dollar weakness against the currencies of its major trading partners, rising current account and budget deficits, and easy monetary policy of the U.S. Federal Reserve have led investors to worry about the dollar's status as the world's reserve currency. This question has important implications for the U.S. economy since worldwide reserves of US dollars held as foreign exchange total $6.5 trillion. The bill is coming due and the table is being set for the biggest currency crisis ever.

China, IMF, UN calling for new reserve currency

"The world economy faces the looming risk of a collapse of the dollar together with the dangers of rising commodity prices, continued high unemployment and the risk of sovereign debt default."

(UN report on world economy and financial stability, 2010)

The International Monetary Fund expressed their concerns about future of status of US dollar to remain the world currency on 10 February 2011 . It proposed SDR – Special Drawing Rights as a possible replacement for dollar.

In 2009, The UN Conference on Trade and Development (UNCTAD) report has stated that the current system of currencies is not working properly and the US dollar's status of world reserve currency should be put into serious reconsideration.

As the reaction to Standard & Poor's US credit downgrading Chinese official, Xinhua, stated: *"The US government has to come to terms with the painful fact that the good old days when it could just borrow its way out of messes of its own making are finally gone. International supervision over the issue of US dollars should be introduced and a new, stable and secured global reserve currency may also be an option to avert a catastrophe caused by any single country."*

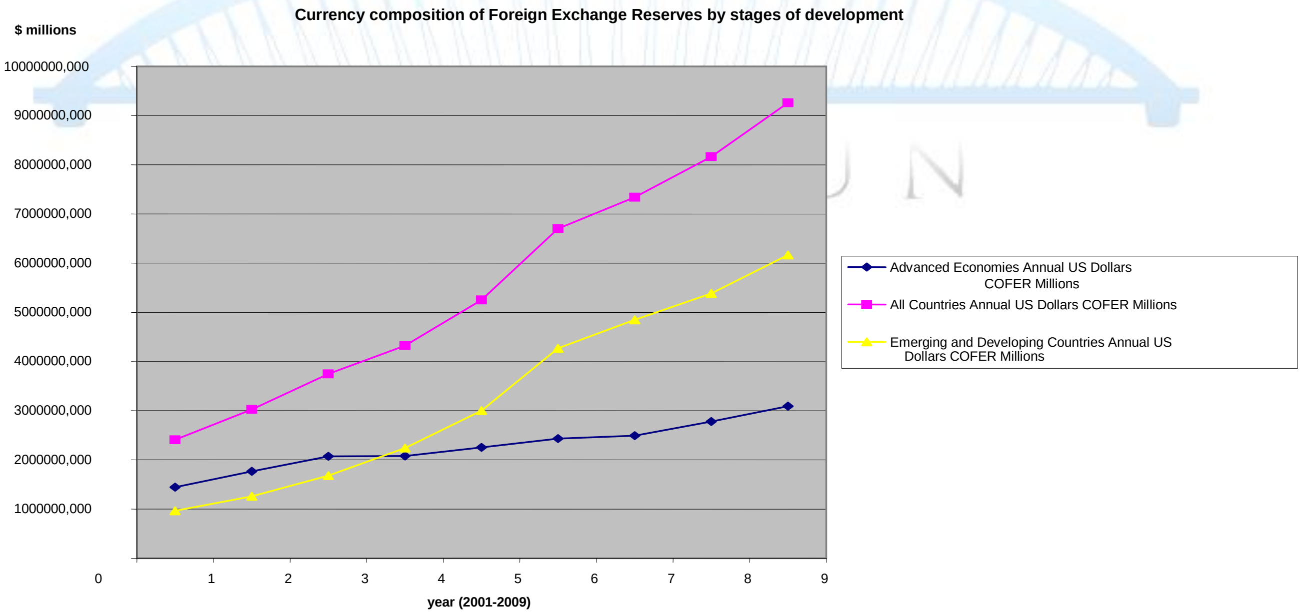
It seems that the times when investors put their money into US Treasuries considered to be the safest investment are inevitably over. Due to irresponsible fiscal policy and quantitative easing of dollars, US dollar has been on decline for couple of years and UN role in solving this difficult issue is inevitable.

Reasons

The U.S. dollar has had periods of strength and weakness since we entered the floating rate period. There have been two periods of great dollar strength in the post-Bretton Woods era. The first episode, from 1981–85, corresponded with the tight monetary and loose fiscal policy adopted during the first Reagan administration. The second period of dollar strength, from 1997–2001, roughly coincided with the technology bubble. As shown in exhibit 1, the dollar entered a persistent downtrend in early 2002. As of August 2009, the U.S. dollar stood only 7% above its all-time low and 23% below its average level since January 1973, according to the Federal Reserve's dollar index.

Why are there such concerns now?

Some of the trends we have discussed so far have been in place for several years. Why has the rather arcane issue of international reserve management been in the news so much recently? As we'll show in the next section, reserve managers have already been diversifying out of the dollar for 10 years. However, since the fourth quarter of 2005, the majority of global reserves have been held by the central banks of emerging economies as can be seen on the chart below.

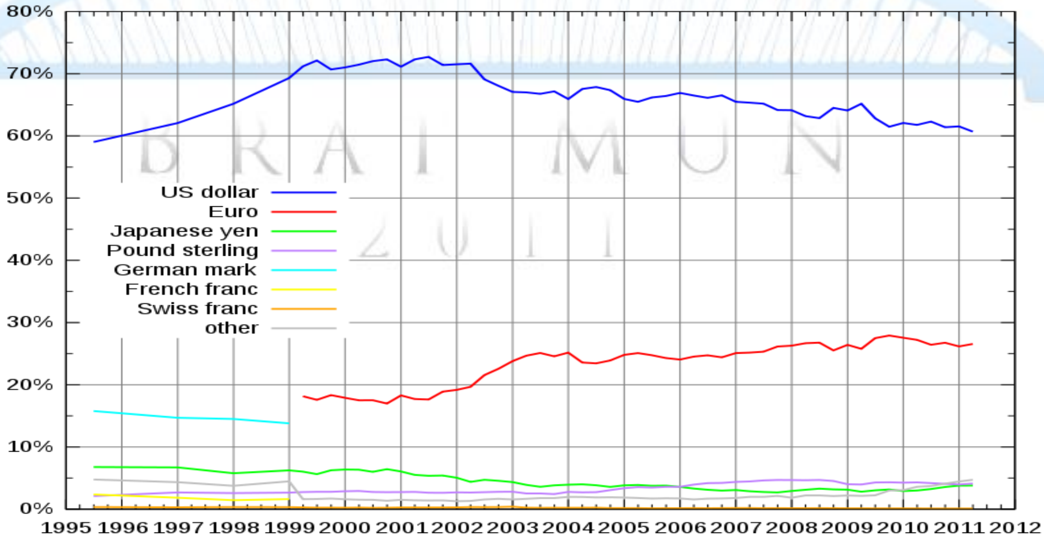


Developing countries now hold a much larger share of their GDP as foreign exchange reserves than advanced economies do. According to the IMF, advanced economies held reserves equivalent to 5.5% of GDP in 2008. For developing economies, the figure was 21.9%. As such, they have a correspondingly higher incentive to preserve the purchasing power of their reserves. In fact, much of the "noise" surrounding the dollar's status has come from developing countries with large reserve balances.

Emerging economies hold a larger share of GDP as reserves for two reasons. The first is mercantilism. Lacking a domestic consumer base, some countries have pursued a policy of export-led growth. Maintaining an undervalued exchange rate keeps export products competitive on international markets. The second reason emerging economies have high reserve/GDP ratios is self-insurance. During past financial crises, the IMF played a key role as lender of last resort. However, IMF loans come with strings attached, such as budgetary constraints. By holding reserves against foreign liabilities, countries reduce their reliance on the IMF.

Some reserve diversification has already occurred

As seen in chart below, some diversification of foreign exchange reserves out of the U.S. dollar has already occurred. Since 1999, the U.S. dollar’s share of global reserves excluding gold has fallen steadily from about 72% to 63%, according to the IMF. Central bank holdings of Euros and British pounds have risen accordingly. Informatively, central bank holdings of the Japanese yen and the Swiss franc have actually fallen by more, in percentage terms, than their holdings of U.S. dollar denominated assets. This reflects the sensitivity of central bank reserve managers to the nominal yields available on currency deposits and short-term government debt. It also suggests that higher short-term interest rates might temporarily halt or slow diversification out of the dollar.



Source: Wikipedia

Fiat Money – Nixon Shock

Fiat money is money that has value only because of government regulation or law. The term derives from the Latin *fiat,* meaning "let it be done", as such money is established by government decree. Where fiat money is used as currency, the term **fiat currency** is used.

Fiat money originated in 11th century China, and its use became widespread during the Yuan and Ming dynasties. The Nixon Shock of 1971 ended the direct convertibility of the United States dollar to gold. Since then all reserve currencies have been fiat currencies, including the dollar and the euro.

The term fiat money has been defined variously as:

- Any money declared by a government to be legal tender
- State-issued money which is neither convertible by law to any other thing, nor fixed in value in terms of any objective standard
- Money without intrinsic value

While specie-backed representative money entails the legal requirement that the bank of issue redeem it in fixed weights of specie, fiat money's value is unrelated to the value of any physical quantity. A feature of all fiat money is its acceptability to the government for payment of taxes and charges. Fiat money is not essential for large countries, nor is it always used. An economy may function on banknotes issued by commercial banks, which are not legal tender, and hence not fiat money. This was the situation in the United States during periods prior to 1862, before the first United States Notes were created and declared by the government to be legal tender.

As described above, according to the Bretton Woods Agreement the US agreed to exchange US dollars for gold at fixed rate $35 per ounce of gold. However, this arrangement continued only till 1971 when due to finance-demanding Vietnam War the US run out of sufficient gold reserves to back dollars.

By the early 1970s, as the Vietnam War accelerated inflation, the United States as a whole began running a trade deficit. The crucial turning point was 1970, which saw U.S. gold coverage deteriorate from 55% to 22%. This, in the view of neoclassical economists, represented the point where holders of the dollar had lost faith in the ability of the U.S. to cut budget and trade deficits.

In 1971 more and more dollars were being printed in Washington, then being pumped overseas, to pay for government expenditure on the military and social programs. In the first six months of 1971, assets for $22 billion fled the U.S. In response, on August 15, 1971, Nixon unilaterally imposed 90-day wage and price controls, a 10% import surcharge, and most importantly "closed the gold window", making the dollar inconvertible to gold directly, except on the open market. Unusually, this decision was made without consulting members of the international monetary system or even his own State Department, and was soon dubbed the ***Nixon Shock***.

US debt crisis

For more than thirty years, the U.S. has resisted the restructuring, austerity and market forces required to restore the health, competitiveness and potential of its economy.

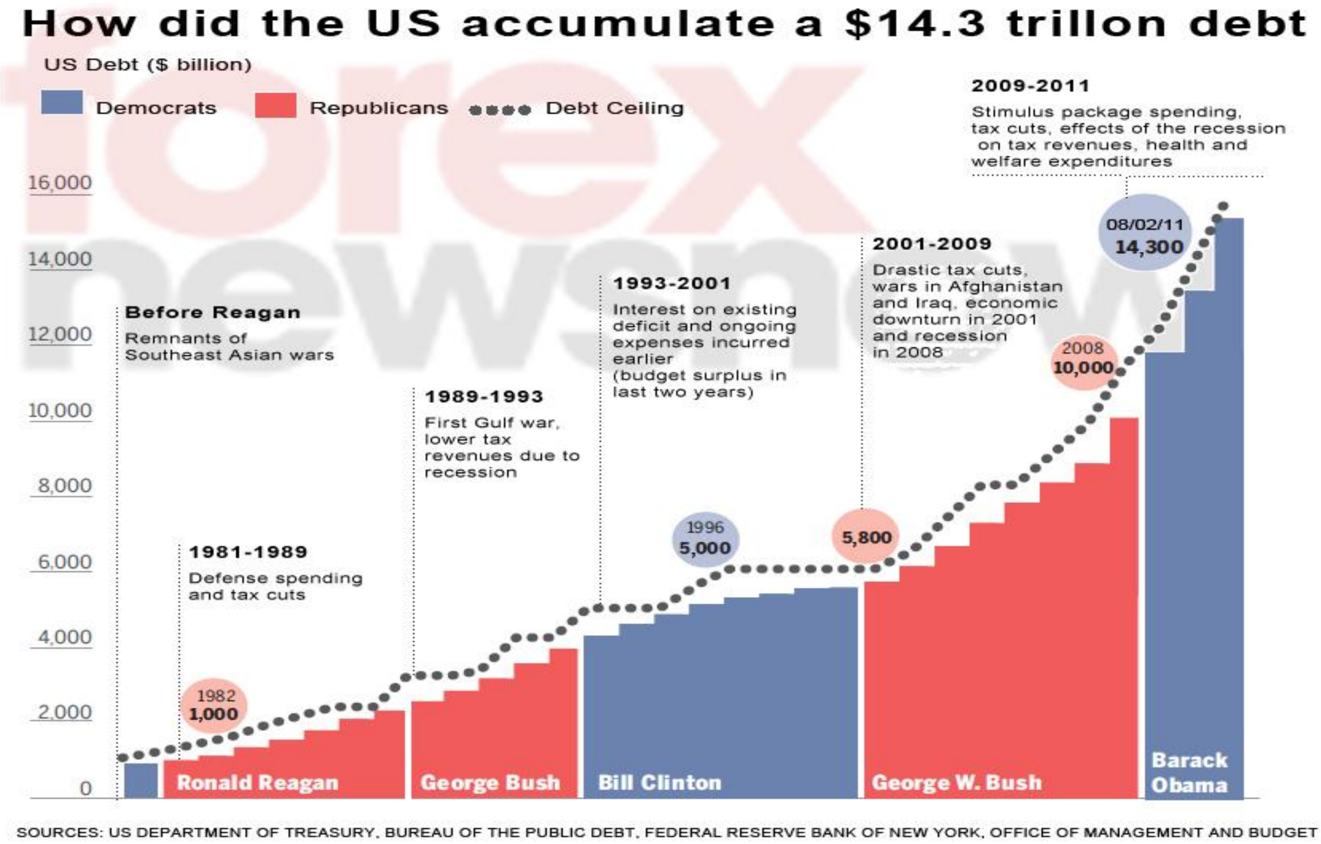
Extending a long-running policy of neglect, denial, short-sightedness, political expediency and corruption, for the past two years, the Federal Reserve has tried to prop up the increasingly uncompetitive and defective U.S. economy with what amounts to unprecedented amounts of money printing -- still in effect and slated to expand. The government as a whole has increasingly spent beyond its means, doubled down on debt and pushed the limits of inflation risks.

US debt ceiling

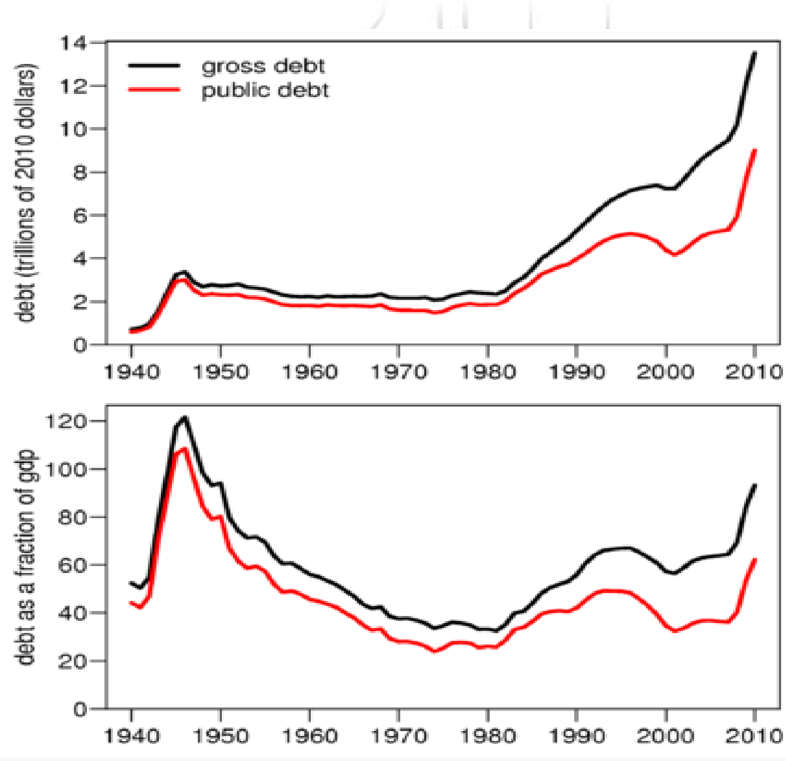
Under US law, the administration can spend only if it has sufficient funds to pay for it. Congress has set a debt ceiling, beyond which Treasury cannot borrow. In the absence of sufficient revenue, a failure to raise the debt ceiling would result in the administration being unable to fund all the spending. At that point, the government must cancel or delay some spending, a situation sometimes referred as a partial government shut down. However, the problem is that this debt limit has been raised 72 times since WWII and there are questions, whether it is meaningful at all. This allowed both US citizens and government to spend Money beyond their means, running bigger and bigger account and budget deficits, thus accumulating huge debt for half of the century. Recently, Congress is raising the debt ceiling not for greater spending but rather for being able to pay its interest payments.

As a consequence of running huge debt, the late debt-ceiling crisis in August 2011 was about raising the debt limit to be able to pay its interest payments not for larger spending. This shows that if US Congress hadn't allowed this raising, US would have entered sovereign default which would have had catastrophic impact on the whole world.

The following chart shows how the United States increased debt ceiling and got into such a huge debt:



U.S. debt from 1940 to 2010. Red lines indicate the Debt Held by the Public (net public debt) and black lines indicate the Total Public Debt Outstanding (gross public debt), the difference being that the gross debt includes that held by the federal government itself. The second panel shows the two debt figures as a percentage of U.S. GDP (dollar value of U.S. economic production for that year):



Source: Wikipedia

Here is the summary of key factors which may trigger a dollar crisis:

1) **Financial excess:** Key measures of financial excess -- a U.S. budget deficit at 10% of GDP, overall credit amounting to as much as 350% of GDP, a projected $100 trillion more in entitlement obligations than the federal government can currently cover, and more than $1 trillion in state pension underfunding -- are now well into the levels that undermined other countries during currency crises and rendered them insolvent, bankrupt or close to it.

2) **Diminishing competitiveness:** The gift of hindsight now shows that outside of housing and finance, the U.S. economy was hollowing out over the past 30 years. A withering export base and increasingly lopsided growth (as opposed to broad-based, diversified growth across multiple industries) were telltale signs in Mexico, Russia, Thailand and elsewhere that a country would have trouble paying its bills to creditors abroad.

3) **Pre-existing economic pain:** A high unemployment rate -- roughly 10% and as much as 20% under broader measures -- will limit the willingness of policymakers to make the tough choices needed to get the country's house in order. As they've already demonstrated, politicians are more likely to continue trying to limit the pain and take the easy way out in the short run -- borrowing more and printing more money -- instead of taking real steps to demonstrate the country will be able to pay its bills to creditors abroad without devaluing the dollar (in other words, cut back on spending, raise taxes, reform the economy in a way that bolsters export receipts).

4) **Heightened political risk:** Ahead of the November midterm elections, the U.S. faces a degree of policy uncertainty we haven't seen since the 1930's and arguably since the years leading up to the Civil War (maybe even further back, the currency chaos after the Revolutionary War). The two parties are both historically weak and want to take the U.S. economy in radically different directions -- Democrats, led by President Obama, toward more government control, greater intervention in the economy and higher taxes and Republicans, increasingly pressured by the Tea Party, toward sharply less government, lower taxes and less intervention in the economy. Unusually critical midterm election this November may set a permanent course or lead to policy paralysis. This is the kind of political uncertainty that formed the backdrop to multiple currency crises, including Mexico's 1994 crisis, which preceded presidential elections.

5) **Rising rates abroad:** Real, stronger growth outside the U.S. is prompting central banks in Canada, Australia, Latin America, China and elsewhere to tighten credit, while the Fed loosens, inflates and all but signals it **wants** to let her rip and weaken the currency. That means growing downward pressure on the U.S. dollar. It was the raising of short-term rates in the U.S. through the late 1990's that put Mexico, Asia (particularly Thailand) and Russia under pressure to allow their currencies to collapse.

6) **Weak and defective financial system:** Large numbers of U.S. banks continue to fail on a monthly basis across the U.S. The federal government recently announced a stealth

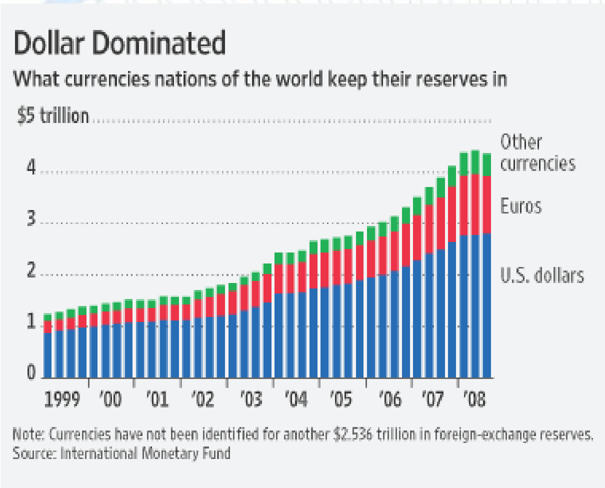
$30 billion bailout of credit unions highlights lingering problems. It continues to bankroll massive losses at Fannie Mae and Freddie Mac and has effectively nationalized mortgage finance. We still have inadequate disclosure on the true extent of bad loans -- a key wildcard that led to loss of confidence in Asian and other financial crises. We still don't know the full extent of the black hole. Banking Guru Meredith Witney expects a new round of top-line pressure on all the big banks over the coming year.

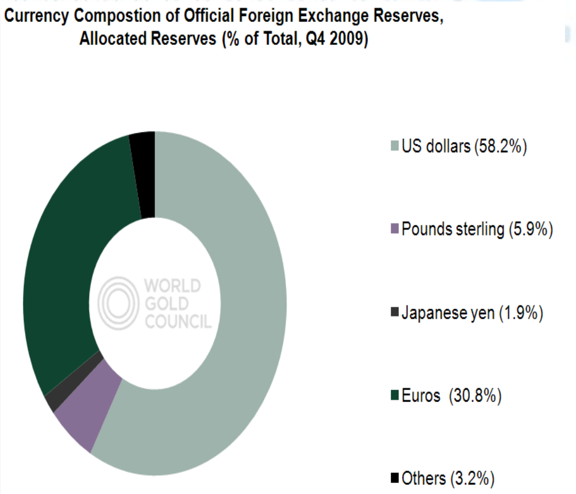
7) Capital flight: From elites, top investment funds and banks. The sharp drop of trading volume on U.S. equity markets, heavy inflows into commodity funds, hedges such as gold and even farmland and outflows into overseas markets funds and ETFs may be early omens. There is also growing evidence of human capital flight from the U.S., as the business climate continues to deteriorate and high-skill individuals seek higher after-tax returns from themselves abroad.

8) Violent conflict: The Chiapas Rebellion in Mexico intensified anxiety of the country's management in 1994. Current potential flash points include Iran/Israel/The Middle East, North Korea, the South China Sea and China-Japan.

Possible alternatives to dollar

The Euro

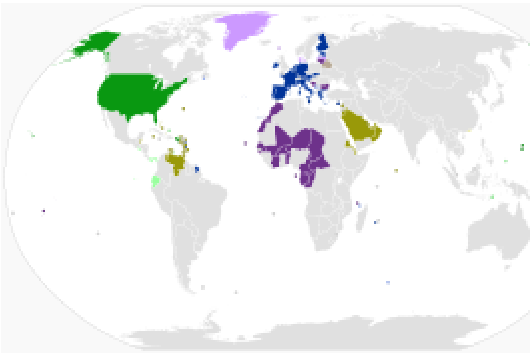




The euro is currently the second most commonly held reserve currency, comprising approximately a quarter of allocated holdings. After World War II and the rebuilding of the German economy, the German Deutsche Mark gained the status of the second most important reserve currency after the US dollar. When the euro was launched on January 1, 1999, replacing the Mark, French Franc and ten other European currencies, it inherited the status of a major reserve currency from the Mark. Since then, its contribution to official reserves has risen continually as banks seek to diversify their reserves and trade in the euro-zone continues to expand.

Former US Federal Reserve Chairman Alan Greenspan said in September 2007 that the euro could replace the U.S. dollar as the world's primary reserve currency. It is "*absolutely conceivable that the euro will replace the US dollar as reserve currency, or will be traded as an equally important reserve currency*."

However, the European sovereign-debt crisis, which is going on in the old continent, discourages investors from exchanging to euro and also raises concerns if euro currency even survives the crisis.



Worldwide use of the euro and the US$

United States

External adopters of the US dollar

Currencies pegged to the US dollar

Currencies pegged to the US dollar w/ narrow band

Eurozone

Source: Wikipedia

Pound Sterling

The United Kingdom's pound sterling was the primary reserve currency of much of the world in the 19th century. U.S. and German economic dominance from the second half of the 20th century onward, the emergence of the USA as an economic superpower (and, importantly, the establishment of the U.S. Federal Reserve System in 1913) as well as economic weakness in the UK at various intervals during the second half of the 20th century resulted in Sterling losing its status as the world's most reserved currency.

Since mid-2006 it is the third most widely held reserve currency, having seen resurgence in popularity in recent years, but growing from about 2.5% to just around 4% of all currency reserves. Analysts say this resurgence is caused by carry-trade investors considering the pound as a stable high-yield proxy to the euro, as well as the position of London in world financial affairs.

Japanese yen

Japan's yen is part of the IMF Special Drawing Rights (SDR) valuation. The SDR currency value is determined daily by the IMF, based on the exchange rates of the currencies making up the basket, as quoted at noon at the London market. The valuation basket is reviewed and adjusted every five years.

Renmibi – Chinese yuan

The Chinese yuan or renminbi (RMB) cannot be used as a reserve currency as long as the Chinese government maintains capital controls on the conversion of its currency. The currency would not be attractive to central banks for holding unless China developed a strong open bond market. Chinese President Hu Jintao has said that it would be a long process before the yuan was accepted as a global currency.

However, Chinese officials, concerned about the situation in the US, also called for the consideration of a new international currency (SDR). Recently, deputy central bank governor Yi Gang said that Chinese yuan could potentially become a world reserve currency as the country gears up to boost its global clout. The People's Bank of China said on Wednesday 2 March 2011 that it would allow importers and exporters across the nation to settle trades in the yuan this year, a move that would give yuan a bigger role in the global financial markets (Source: Reuters).

China needs time to push through difficult economic reforms at home before it can allow its currency to float freely against the dollar:

"China needs a benchmark so that the price can be compared to the global price, to the price structure, compatible with efficiency. That's why price reform is more important than exchange-rate change... Exchange-rate change would not really change the inefficiencies ... [as] the internal subsidies are still there." (Gieng Xiao, *director of the Brookings-Tsinghua Center for Public Policy*)

Although there are many challenges which China has to overcome to make yuan the global reserve currency, its reasons for doing so may be found here:

http://articles.businessinsider.com/2011-03-07/markets/29997670_1_rmb-china-financial-system-michael-pettis

SDR – Special Drawing Rights

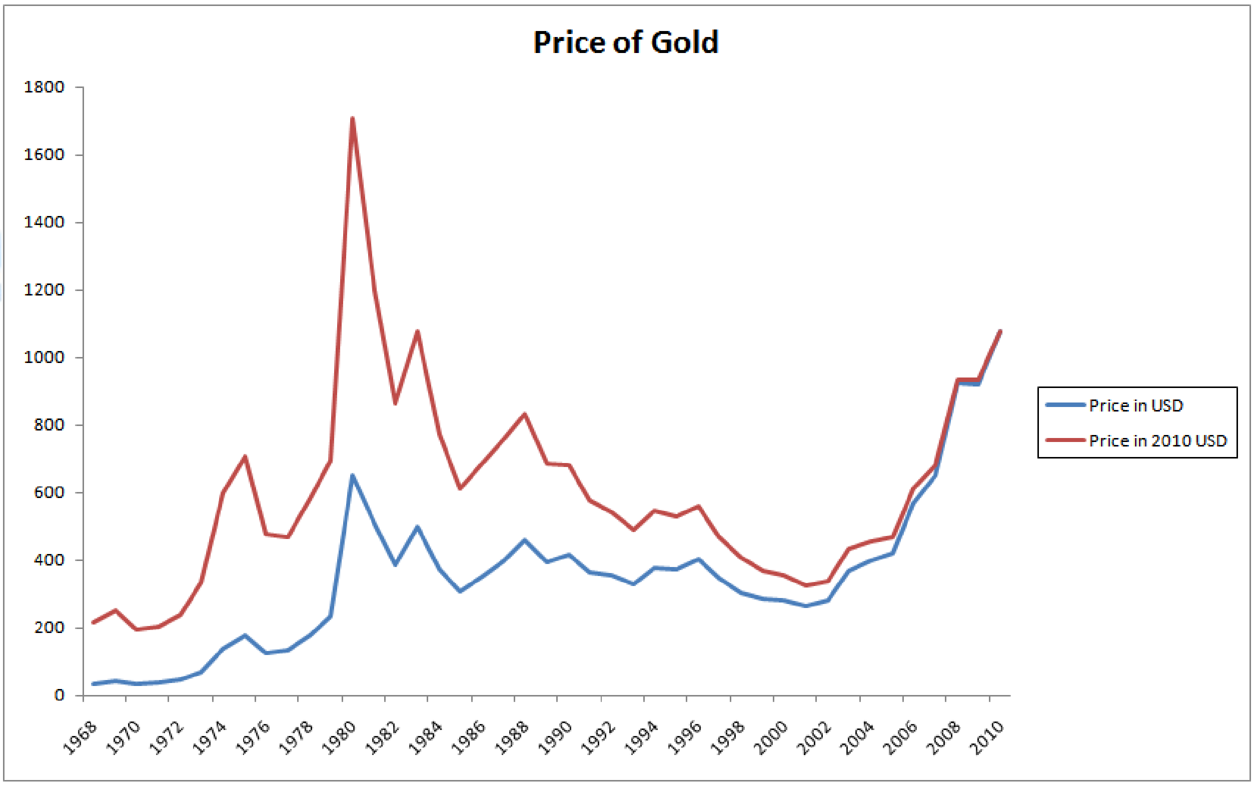
Special Drawing Rights (SDRs) are supplementary foreign exchange reserve assets defined and maintained by the International Monetary Fund (IMF). Not a currency, SDR instead represents a claim to currency held by IMF member countries for which they may be exchanged. As they can only be exchanged for Euros, Japanese yen, UK pounds, or US dollars, SDR may actually represent a potential claim on IMF member countries' non-gold foreign exchange reserve assets, which are usually held in those currencies. While they may appear to have a far more important part to play, or, perhaps, an important future role, being the unit of account for the IMF has long been the main function of the SDR.

Created in 1969 to supplement a shortfall of preferred foreign exchange reserve assets, namely gold and the US dollar, the SDR's value is defined by a weighted currency basket of four major currencies: the Euro, the US dollar, the British pound, and the Japanese yen.

The Gold Standard?

The **gold standard** is a monetary system in which the standard economic unit of account is a fixed mass of gold. Today, gold reserves are almost exclusively, albeit rarely, used in the settlement of international transactions. At the end of 2004, central banks and investment funds held 19% of all above-ground gold as bank reserve assets.

However, due to contemporary devaluation of US dollar, Gold reserves are held in significant quantity by many nations as a means of defending their currency, and hedging against the U.S. Dollar, which forms the bulk of liquid currency reserves. In 1999, to protect the value of gold as a reserve, European Central Bankers signed the Washington Agreement on Gold, which stated that they would not allow gold leasing for speculative purposes, nor would they enter the market as sellers except for sales that had already been agreed upon.



It has been estimated that all the gold mined by the end of 2009 totalled 165,000 tonnes. At a price of US$1900/oz., reached in September 2011, one ton of gold has a value of approximately US$60.8 million. The total value of all gold ever mined would exceed US$9.2 trillion at that valuation.

However there are not only advantages, but also disadvantages of returning to gold standard as written in *Gold Standard* section.

Is the dollar's collapse imminent or not?

Why should the U.S. dollar remain the largest component of international reserves? The dollar holds several advantages compared with other currencies.

1) Nearly all commodities are priced and settled in dollars. Much international trade is invoiced in U.S. dollars, even when the United States is not the source or destination of the goods or services involved in the transaction.

2) The United States has the largest, most liquid and most transparent financial markets in the world.

3) Many countries, including several with significant international reserves, rely on the U.S. for military protection.

4) Certain mercantilist economies (China, Brazil, India, Japan...) rely on the U.S. as a destination for their exports. These countries manage their exchange rates against the U.S. dollar in order to keep domestic costs low, thereby accumulating large dollar reserve balances. Developing countries such as China, India but also developed countries such as Japan are dependent on US consumers. They know that if they sell their dollars, their products will cost more in the U.S., and their economies will suffer. Right now, it's still in their best interest to hold onto their dollar reserves. China and Japan are selling more to other Asian countries, who are gradually becoming wealthier. However, the U.S. is still the best market in the world.

Issue: China's influence on US dollar

China's Economy Depends on Exports to U.S. China exports $1.5 trillion of its production, making it the world's second largest exporter after the EU. China ships 20% of its exports to the U.S., which created a $252 billion trade deficit in 2010. While China needs the U.S., it's increasing its trade with Hong Kong (12%) and Japan (8%). It's encouraging trade with African nations, investing in their infrastructure in return for oil. Finally, China is increasing trade agreements with other Southeast Asian nations, and with many Latin American countries.

China Is the Largest Foreign Owner of U.S. Treasuries. As of May 2011, China owned $1.16 trillion in U.S. Treasury bills, bonds and notes. This is 26% of the total of $4.5 trillion held by the public. China does this to support the value of the dollar. China pegs its currency (the yuan) lower than the U.S. dollar to keep its export prices competitive. (Source: U.S. Treasury, Major Foreign Holders) China is America's largest banker, giving it leverage. For example, China threatens to sell part of its holdings whenever the U.S. pressures it to raise the yuan's value. China counters by saying it did raise the yuan's value by 20% between 2005 and 2010.

China keeps buying U.S. Treasury's bonds in order to maintain strong dollar, thus supporting its own export. China has fixed the value of its currency, the yuan, to the dollar. Currently, a dollar is worth 6.8 yuan. Many analysts think it is artificially low. If China allowed its currency to float freely, it would be more valuable than the dollar because of China's strong economy, and it would rise. China does this to keep its products cheaper than U.S. products, thus increasing its exports to the U.S.

The only way China can keep the yuan artificially low is to promise to redeem dollars for yuan at the fixed rate. To do so, it must keep a good supply of dollars in reserve. Instead of holding dollar bills, it holds U.S. Treasuries, which it can quickly sell for dollars. As China's economy grows, it must buy more and more U.S. currency to meet the growing number of yuan. Finally, since a high proportion of the external liabilities of many countries are U.S. dollar-denominated, holding reserves as dollars is a form of asset-liability matching.

What consequences would there be if the dollar collapsed?

Even though the dollar collapse is unlikely to happen, we should at least know what to expect if so; a sudden dollar collapse would create global economic turmoil as investors rush to other currencies, such as the euro, or other assets, such as gold or other commodities. Demand for Treasuries would plummet, driving up interest rates. Import prices would skyrocket, causing inflation. U.S. exports would be dirt cheap, boosting the economy briefly. Unfortunately, uncertainty, inflation and high interest rates would strangle possible business growth. Unemployment would worsen, sending the U.S. back into recession or even creating a depression.

In this new monetary world, moreover, the U.S. government will not be able to finance its budget deficits so cheaply, since there will no longer be as big an appetite for U.S. Treasury securities on the part of foreign central banks. Nor will the U.S. be able to run such large trade and current-account deficits, since financing them will become more expensive. Narrowing the current-account deficit will require exporting more, which will mean making U.S. goods more competitive on foreign markets. That in turn means that the dollar will have to fall on foreign-exchange markets—helping U.S. exporters and hurting those companies that export to the U.S.

Abroad, the cheap dollar would make it harder for other nations to export to the U.S., hurting their growth. China could face social unrest. Trade wars could break out. And there could be blowups at overexposed banks whose risk managers were sure no such dollar bust could happen. As investor Warren Buffett once said: "You only find out who is swimming naked when the tide goes out."

One obvious change will be to the foreign-exchange markets. There will no longer be an automatic jump up in the value of the dollar, and corresponding decline in the value of other major currencies, when financial volatility surges. With the dollar, euro and yuan all trading in liquid markets and all seen as safe havens, there will be movement into all three of them in periods of financial distress. No one currency will rise as strongly as did the dollar following the failure of Lehman Bros. There will be no reason for the rates between them to move sharply, something that would potentially upend investors.

Conversely, life will become easier for European and Chinese banks and companies, which will be able to do more of their international business in their own currencies. The same will be true of companies in other countries that do most of their business with China or Europe. It will be a considerable convenience—and competitive advantage—for them to be able to do that business in yuan or euro rather than having to go through the dollar.

Questions to be considered

As a delegate of UN ECOFIN Committee you are required to write a policy statement. It should be written in the form of a short speech and you are required to address to these three criteria - your country's background on the topics, its current positions, and what it hopes to achieve in relation to the topics. Each delegate will present their country's policy statement during one of the committee sessions. When listening to the standpoints of other countries you will be able to find possible allies in future resolutions, which means that they are a vital and important part of your preparation.

Following questions are recommended to take into account in order to create a final resolution. However, there are much more questions arising, therefore, delegates are recommended to make a good research of all issues related to this complex topic:

1) How to solve debt-crisis situation in the US in order to avoid dollar collapse, hence economical, social and financial instability? How to deal with its current and account budget deficit? US fiscal and monetary policy should be also discussed (role of the US is inevitably essential in solving this issue).

2) Is the US dollar's status of world reserve currency still strong to bear this burden any longer? Many strong economies hold large dollar reserves and further devaluation of dollar would also lower their fortune (China, Japan, Europe, OPEC countries). Hence, long term solutions are needed.

3) As a consequence of dollar instability, the current Bretton Woods system with adoption of 1971 fiat money is considered to be very dangerous as this system let all other currencies tied to US dollar. Hence, UN should suggest a proposal of a new Bretton Woods system that will resolve this.

4) Possible alternatives to US dollar are essential to discuss. If dollar were no longer the world currency, what alternative should be proposed?

5) After series of events that proved instability in fluctuating and countries, influencing of value of currencies, gold standard is on the table again. Should we again return to gold standard? If so, how to do so and to avoid such crisis as Great Depression in 1930s (this is also a key question to be considered, so proper preparation for this issue is more than necessary)?

6) Huge investments to gold due to currencies crisis take place, which may cause "gold bubble", because there is not enough of gold stock. How to deal with this problem?

7) There has been a significant diversification in foreign exchange reserves from the dollar to other currencies in recent years. How to make this process smooth in order to avoid *sudden currency devaluations and property value depreciation, hence riots associated with rising inflation and unemployment?*

8) Emerging economies such as China or Brazil are becoming stronger and stronger. Their role in influence of world trade and economy is far more significant than ever before. However, they are artificially maintaining strong dollar in order to boost their exports. With huge deficits and debts on US side and surplus on the side of developing countries, this can't last long. UN should also discuss issues related to irresponsible fiscal and monetary policies, harmful trade strategies and indebtedness of governments.

Suggestions for further reading and sources

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