My Views on the International Monetary System

(Updated on August 30, 2002)

On the future of the dollar as reserve currency

Since the end of the war, the world has grown used to the dollar's dominant role as the most widely used hard currency. By the late 1990s, more than 80% of all foreign-exchange transactions involved the dollar. The DM featured in 30% of foreign-exchange transactions, and other euro-member currencies in only 24%. Nearly half of world exports were denominated in dollars. The proportion of official reserves held in dollars rose from about half in 1990 to two-thirds in 1999.

Many factors determine a currency's international role: stability, which reduces the risk of holding assets in that currency; a strong exchange rate to minimise capital losses for investors; deep and liquid financial markets, which enable holders to diversify or liquidate their holdings; and strong regulatory backing that acts as a guarantee against crises. On all these counts, the dollar is far ahead of the Euro and the Yen.

Looking back, it is clear that the Euro, when it was introduced, created more hype than justified. Prior to the launch of the Euro, the enthusiasts reckoned that the euro would be a strong and stable currency that would rapidly challenge the dollar's predominance, largely because investors would diversify their portfolios into euros. They felt this would happen quickly—in line with the speed of today's international capital markets. The Economist (Nov 12, 1998) predicted, "The one certainty is that the euro will immediately be a major international currency, second only to the dollar." The magazine argued that, in economic and financial terms, the euro-11 countries were a close match for the United States, their combined GDP (in 1997) $6.5 trillion, comparing favourably with America's $8.1 trillion. Moreover, their share of international trade outside the euro area (19%) was in fact larger than that of the United States (17%). But the Economist admitted that the dollar's role in international finance was, however, far bigger than America's relative weight would suggest. The skeptics felt that the euro would need to establish a track record before investors moved into it. They also reckoned that inertia of central bankers in reserve diversification, could benefit the dollar for several decades. The view of the skeptics certainly seems to have been correct.

On recent currency movements

At the beginning of 2002, the dollar was trading at about 1.11 Euros and 132. Yen. The dollar's descent began in early April. By mid July, the dollar had reached 0.99 Euro and 116. Yen. Currently, the dollar is trading at about 1.03 Euros and 119 Yen. The fortunes of the dollar in the immediate past have been influenced by movements in the equity markets. The dollar's push higher in recent weeks owes much to the rebound in US equities from their lows in July.

Before its rebound, the dollar was hit hard by the outlook for weaker U.S. growth and the U.S. corporate scandals. Now speculators are taking profits and covering their short positions.

Japanese intervention has also boosted the greenback, sending it from around 116 yen to about 121 over a two-week period. At the same time, U.S. investors, worried about everything from a possible war with Iraq to global growth prospects, are bringing money home, leading to big dollar purchases.

How long will the dollar's strength last? Many forecasters predict another fall in the dollar, but they generally expect it to be gradual and relatively painless. Indeed, despite the current market jitters, the dollar has some strong props under it. The productivity of the U.S. economy continues to improve, rising at an annualised rate of 4.3% in the first quarter of 2002. Eventually, the economic recovery should revive profits and stocks. If that happens, the dollar is bound to strengthen.

I personally would bet on a strong dollar revival. There are clear signs that the worst of the corporate scams is already over. The US has consistently demonstrated its ability to reinvent itself from time to time. So, it is only a matter of time before the markets rediscover the dollar's fundamental strengths.

Long term outlook for the dollar

Although the dollar has declined sharply against other major currencies during the past few months, it is not low by historical standards. The real trade-weighted exchange rate of the dollar was 108.7 in July, compared with an average of 92.1 for the 1990s (1990 as the baseline). And even at its recent lows in relation to the Japanese yen, the dollar was actually a little higher than its average exchange rate for the past ten years.

The fall of the dollar against the Euro is not all that significant. When the euro was launched on Jan. 1, 1999, it fetched $1.17. Even at a rate of $1, it still has a long way to go before it can be considered to be giving the dollar a run for its money.

The long term outlook for the dollar has to be judged in relation to that for the Euro. From time to time, the Economist has argued that America's superior economic performance in recent years has been exaggerated. During 1996-2001, America's growth averaged almost 4%, compared with only 2.7% in the euro area. But the magazine has argued that taking GDP per head, a better measure of comparative performance in raising living standards, the gap in growth rate is small: 3% in America, against 2.6% in the euro area. It also feels that for all the talk about America's productivity miracle, productivity growth in manufacturing had been almost as fast over the past decade in the euro area as it has in America. It has also argued that the productivity gap will further fall as Europe learns to make better use of IT as American companies have already done. If that indeed happens the euro is bound to strengthen.

The pessimism of the Economist has not subsided in recent times. In a recent issue,(June 8, 2002) it argued that America's large current-account deficit, at more than 4% of GDP and growing, looks unsustainable. If the dollar stays roughly where it is as the economy rebounds, then the deficit will grow. The Economist has pointed out, on the basis of past evidence, that once a country's external deficit approaches 5% of GDP, its currency tends to fall.

But despite these arguments and the recent scandals in the US corporate sector, the fact remains that innovation, productivity, and economic growth over the next decade are likely to be higher in the U.S than in Europe. On the other hand, the Europeans are struggling to inject flexibility into their economy. Moreover, the macroeconomic statistics in the Euro are not all that encouraging as they looked at one point of time. Portugal has become the first country to plead guilty to violation of the stability pact. Its budget deficit in 2001 was 3.9% of GDP, well outside the pact's 3% limit, and much higher than any previous official figures. Germany, France and Italy, the three biggest economies in the Eurozone, are all likely to face problems in staying within the Maastricht Treaty limit. Moreover, the best brainpower in the world still wants to work in the US and not in Europe. So, I do feel that the outlook for US competitiveness in the long run is bright and talk of the dollar nosediving is meaningless.

The dollar has fallen every few years, but it has hardly ever gone into a tailspin. Because the dollar floats freely, there isn't the kind of pent-up selling pressure that afflicts currencies pegged to the dollar. Moreover, even if global investors are skeptical about the dollar, they have few better options. We must keep in mind that the dollar's decline to date has been modest. It has dropped about 8% since February 2002 against a basket of rich-country currencies. Measured against a trade-weighted index of the 26 most important currencies, it's off less than 2% this year, after adjusting for inflation.