COUNCIL *on* FOREIGN RELATIONS

POLICY INNOVATION MEMORANDUM NO. 1

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From: Moritz Schularick

Re: Managing the World's Dollar Dependency

The global financial crisis has exposed a weakness in the international monetary (non-)system. Desired levels of currency reserves in emerging markets have jumped over the past decade. The dollar's unique reserve-currency status has caused the bulk of these reserves to be parked in the United States, and the resulting capital flows have contributed to the under-pricing of risks in the world's leading financial center. This underpricing formed part of the backdrop for the global financial crisis and may set the stage for the next one. To prevent a repeat of the past, policymakers must establish mechanisms to avoid excess reserve accumulation in surplus nations. In the early 1970s, U.S. treasury secretary John Connally could tell Europeans that the dollar was "our currency, but your problem." Today the world's dollar dependency is a problem for the United States, too.

The strategy proposed here rests on two pillars. First, a novel policy tool called the excessive reserve procedure (ERP) should be implemented to discourage reserve accumulation beyond prudent levels. Second, the need for precautionary reserve holdings should be reduced via unremunerated reserve requirements (URRs). Such a dual strategy would go a long way toward stabilizing and ultimately reducing the ratio of foreign exchange reserves to global GDP.

THE PROBLEM

As emerging markets have integrated into the world economy, they have opened themselves up to foreign capital inflows and hence rendered themselves vulnerable to capital flight. To insure against this risk, they have accumulated large stockpiles of dollar reserves to maintain liquidity and exchange-rate stability. In many respects, this has proved a wise policy. Countries with large reserve buffers weathered the financial storm of 2007–2009 relatively well.

But precautionary reserve accumulation has a cost. It can make individual economies safer, but it contributes to macroeconomic imbalances and the mispricing of financial risks on a global level. Moreover, many observers believe that some portion of recent reserve accumulation is motivated by factors other than precaution. By persistently selling their own currencies and buying dollars, countries seek to keep their currencies competitive, benefiting their exporters. Resentment over such export subsidies could spark retaliatory tariffs, disrupting the global trading system.

The pace of reserve accumulation has far outstripped GDP growth in emerging economies. China now holds more than 50 percent of GDP in foreign currency reserves–up from less than 10 percent fifteen years ago. In South Korea and Russia, the ratio stands at around 35 percent; in India and Brazil it is above 20 percent. This appetite for reserve accumulation clearly distinguishes the latest round of catching up in the global economy from previous ones. Germany and Japan in the 1960s and 1970s grew their reserve holdings at approximately the same rate as output, so that reserve levels remained constant at about 5 percent of GDP, or one-tenth of China's current levels.

For the foreseeable future, this reserve accumulation is likely to be channeled into dollars because there are no real alternatives to the dollar as the world's leading reserve currency. The eurozone's problems demonstrate that not all European countries can provide financial assets that can be relied on as a store of value. The German government bond market is too small to satisfy the hunger of emerging markets for risk-free reserves. China lacks deep capital markets and may also face doubts about its long-term political stability. The notion of a world currency managed jointly by a world authority seems far-fetched for the time being. As a consequence, the world's dependence on the U.S. dollar will continue.

THE NEED FOR NEW POLICIES

Managing the world's dollar dependency requires sanctioning excess reserve accumulation and decreasing the need for precautionary holdings of reserves. The goal must be to stabilize and then slowly reduce the amount of reserves relative to world GDP.

Reserve Monitoring and an "Excessive Reserve Procedure"

The International Monetary Fund (IMF) must be tasked to establish benchmarks for adequate reserve holdings—adequate being the level that reflects legitimate precautionary concern rather than an export subsidy. The definition of adequate reserve levels should account for country-specific factors such as openness to trade and capital flows, as well as the health of the banking sector and the quality of financial regulation: A country that is very open to foreign capital flows and has weak banks will legitimately want to hold more reserves than others. In light of the recent crisis, 30 percent of GDP would seem to constitute a realistic upper limit for most countries.

If the IMF determines that a country has accumulated reserves in excess of its adequate level, it should discuss the issue with the government during its regular annual consultations. Policies to slow reserve accumulation should then be considered. To give this consultation teeth, there must be a credible threat of sanctions. The IMF should therefore have the right to initiate an excess reserve procedure against noncompliant countries.

If the ERP consultation does not yield results, the IMF could formally authorize the countries issuing the global reserve currency (i.e., the United States and possibly some others) to decrease the attractiveness of additional purchases of government securities. This could be achieved by means of a financial stability duty levied on bond purchases, or by imposing outright restrictions on bond sales to residents of the offending country. But the most easily implemented option is to reduce interest payments on newly purchased bonds.

The mechanism proposed here would be similar to the dispute settlement procedure at the World Trade Organization (WTO). An international organization would determine the legitimacy of sanctions, but sovereign governments would implement them. In the case of the new ERP, the IMF, after consultation with the parties, would authorize individual countries to take measures to safeguard financial stability. The U.S. Treasury would then announce a date after which interest payments on newly purchased Treasury securities by residents of country X would be reduced to zero. To receive interest payments on Treasury securities purchased in primary and secondary markets after that date, the custodian banks would have to ensure that the beneficiary was not a resident of the country in question.

This approach would require cooperation from the major custodian banks. Because of their location and the focus of their business, they are highly motivated to remain on good terms with prominent governments in the international system. Indeed, more than half of the emerging economies' reserve assets are held in custody at the New York Federal Reserve, giving U.S. policymakers a significant advantage in administering this sanction.

If it is to sanction excess reserve accumulators, the United States must be willing to reduce the attractiveness of Treasury securities to foreign buyers despite its large budget deficits. Since medium- and long-term U.S. budget discipline is desirable in itself, this is a price the United States should be willing to pay. Moreover, lower foreign demand for treasuries would be coupled with less currency intervention and hence a weaker dollar, which should boost U.S. growth and make necessary deficit reduction less painful.

Reduce the Need for Precautionary Reserve Holdings

As well as sanctioning reserve accumulation that goes beyond the level needed for precautionary reasons, policymakers must work to lower the level of reserves that countries feel safe with. To this end, the private sector should be discouraged from borrowing in foreign currency, particularly when the loans are short-term and easily recalled in a crisis. Private sector borrowers should be made to deposit 20 percent of short-term inflows at the central bank, which will pay no interest on them.

Emerging economies have successfully experimented with such unremunerated reserve requirements, and their effect on central banks' desired foreign exchange reserve holdings is twofold. First, the need for precautionary dollar reserves is reduced by a corresponding amount as the private sector has been forced to self-insure against a sudden reversal of short-term flows. Second, foreign investors and domestic borrowers face incentives to choose longer-dated financial instruments not subject to reserve requirements. This diminishes the risk of a reversal in capital inflows and reduces the need for precautionary reserve accumulation.

THE CASE FOR ACTION

The dependence of global trade and finance on one or two primary reserve currencies is a well-known market imperfection. Throughout the period of the dollar's ascendancy, statesmen have opted simply to live with it. But the severity of the financial crisis, together with the risk that imbalances will grow as emerging economies account for a larger share of global GDP, makes continued passivity an unattractive option.

The measures outlined above would protect the global trading system. Frustrated by the extraordinary level of Chinese reserves, members of the U.S. Congress have recommended retaliatory trade sanctions, a policy that would risk opening the door to generalized trade protectionism. While the proposed ERP will undoubtedly be controversial, it entails a clear commitment to ring-fence monetary tensions.

The approach proposed here would be preferable to current account targets, which have been supported by the U.S. Treasury. Such targets have been suggested as a way of reducing imbalances. But as an accountability mechanism, current account targets are ineffective. Even large current account surpluses may not reflect currency interventions or excess reserve accumulation, and a country that exceeds its target can blame policy distortions on the part of trading partners. Moreover, current account targets bring monetary conflict into the trade arena.

As a first step toward implementation, the United States should initiate discussions within the G20 and at the IMF board. Opposition to the ERP can be expected from surplus countries, with China the most likely critic. But appropriate transition periods could help soften resistance, and the ERP would be flexible enough to allow foreign exchange reserves to continue to grow in absolute terms, if not as a share of GDP. Individual country targets, agreed upon by the IMF and taking into account specific weaknesses (i.e., in the banking system), could create the space for necessary diplomatic compromise and help overcome resistance. *cfr*

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