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Demise of the Dollar With Nothing to Replace It

By Yevgeny Gavrilenkov

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Although Standard & Poor's downgrade of the U.S. rating outlook to negative caused nothing more than slight and short-lived turbulence on the markets, it very well may have long-lasting serious consequences. Indeed, no new information was released since everybody was aware of the persistent U.S. budget deficit and mounting debt. Hence, the market reaction was very moderate, the dollar continuing its gradual slide, driven by fundamental factors, which also helped inflate commodity prices.

It looks as though markets that are awash with liquidity have developed immunity against such shocks. Even Japan's nuclear disaster and political instability in the Middle East and North Africa were unable to undermine market confidence as much as last year's debt crisis in Greece. The fact that the markets are now less sensitive to negative news clearly illustrates that they are in bubble territory, even though the bubble is not as significant as it was before the 2008 crisis. Consistently loose macroeconomic policy in the United States and euro zone, which results in permanent liquidity injections, is helping to inflate it to a greater extent than it is helping to stimulate growth.

When growth is organic, it does not need any artificial stimulus.

A very volatile but gradually falling dollar has become very inconvenient as a global reserve currency. Indeed, holding reserves in currencies that represent a negative real interest rate environment, such as the United States, is not the most efficient way to save.

The problem for the majority of reserve holders is that the dollar has no real alternative at the moment. Although the euro was able to acquire some credibility in the past decade, many analysts — mostly in the United States, as would be expected — challenge the reliability of a single European currency. Their chief arguments are that the euro zone is equally overburdened by debt problems, it is accompanied by sluggish economic growth, and there is little flexibility in decision making.

Unsurprisingly, faster-growing emerging economies, such as Brazil and China, are trying to protect themselves against external volatility by either introducing various forms of capital controls or targeting the exchange rate. This is true, although to a lesser extent, in some other large emerging economies, such as India and Russia. (The term "emerging" cannot be fully applied to Russia, however, as its per capita gross domestic product is higher than in the other BRIC countries.)

While many emerging economies have attempted to limit local currency appreciation in nominal terms — sometimes unsuccessfully, as with the Brazilian real, which has gained 17 percent against the dollar since May 2010 — it was and will be virtually impossible to withstand real appreciation against major reserve currencies like the dollar, euro, pound and yen. This is another argument against holding your reserves in currencies that are depreciating against your own. Hence, the share of advanced economies in global GDP will keep shrinking.

The combined GDP of the BRICS, which now includes South Africa, in 2010 was comparable with that of the United States and the combined GDP of the 17 countries using the single European currency, including Estonia, which joined the euro zone on Jan. 1. Moreover, the combined GDP of the BRICS countries is expected to exceed the combined GDP of the euro zone already this year or next.

The recent BRICS summit demonstrated that this union is becoming increasingly institutionalized. After South Africa formally joined the group, it now represents four continents. Despite obvious political differences and varying geopolitical interests, there has been increasing political cooperation among member countries, as seen in the case of Russia and China, which have often coordinated their efforts in the United Nations and on various other occasions. As a result, we now have three roughly equal major economic formations by size of GDP, but only two currencies that can be treated as global.

What also unites the BRICS nations is that they hold about $4 trillion in international reserves and are quite uncomfortable with ongoing market instability and expectations of either potential weakening of the dollar or problems in the euro zone. Hence, the idea of replacing the dollar with some synthetic currency, such as the International Monetary Fund's special drawing rights, or SDR, which has gained support within the BRICS. But the idea is facing strong opposition from developed countries, making it rather unlikely that SDRs will become a new reserve currency any time soon.

Moreover, the entire concept of a synthetic reserve currency is rather questionable and faces a number of technical aspects, such as capital controls and exchange-rate targeting in some countries and a lack of coordination of macroeconomic policies among potential founding members of the future currency union. Nonetheless, in the current environment of growing dissatisfaction with existing reserve currencies, creating some synthetic currency might garner more support, especially if it is established by the five BRICS members and even if initially aimed at a limited number of mutual transactions.

Indeed, in this case, the new reserve currency may be backed not only by the economic potential of the BRICS countries, but by their international reserves and low leverage as well. The latter is a stark contrast to the United States and euro zone, where mounting debt problems are making investors from emerging countries nervous and suspicious about the future of the currency issued by a country with a debt-to-GDP ratio of about 100 percent.

The gap between the idea of any synthetic currency and its materialization can clearly be quite broad, but the longer macroeconomic policy remains unsustainable in the United States and major European countries, the greater the chance that policymakers will start more actively thinking about better synthetic substitutes to the dollar and euro.

If some action is taken in this direction, it would further weaken existing reserve currencies, as often happened in the past when not the value alone, but also the importance of the currency diminished as debt problems mounted, such as with the British pound after World War II.

Yevgeny Gavrilenkov is chief economist at Troika Dialog.