Amity Business Journal
2013, Vol. 2, No. 2

Copyright 2013 by ABS,
Amity University Uttar Pradesh, Lucknow Campus (ISSN 2278-0904)

Revisiting Global Financial Architecture: Some Strategic Issues

Dr. R. K. Raul*

Institutions of global, political and economic governance, created more than six decades ago are apparently not infusing fresh momentum into the changing world. The mismatch of demand and supply of dollar, inter-alia, triggered the liquidity contraction in almost all parts of the globe. World's anchor currency, dollar, is believed to have implanted the seed of the financial tsunami. Despite criticism, it will remain 'bloodied but unbowed' and countries will go on biting the bullet and lurching into crisis to crisis too. The process, perhaps, will continue unless availability of structural alternative that would work any better than the current framework. The world has noticed single currency (Euro) is not the answer. This has called for multilateral efforts to combat the crisis and overhauling the fiscal mismanagement of the individual countries in the line of ensuring global financial liquidity. BRICS countries are in the threshold of coordinating their reflexes on both economic and political issues and emerged as a force to combat the deficiencies of global governance. The economic tie ups among the regional groupings SAARC, NAFTA etc would strengthen through intra trade and perhaps pave the way for insulating local currency from global financial mess boosting to revisiting global financial architecture.

Key words: global financial mess, world anchor currency, regional groupings, BRICS

Introduction

The role of more than six decade old institutions of global, political and economic governance seems inadequate in accommodating themselves in the changing milieu where the philosophy of global trade is under the threshold of transformation. The west have messed up finances and successfully exported their crisis to everywhere which is stubbornly immune to concerted withering efforts. It is well documented that mismatch of demand and supply of dollar, inter-alia, triggered the liquidity contraction in almost all parts of the globe. The equilibrium of real dollar rate is indeed positively affected by high trend growth in the US, whereas it is negatively affected by a positive output gap (Vlaar, 2007). Besides, the world's anchor currency, the dollar, was alleged to implant the seed of the financial tsunami. The world has significantly observed transmutation in the power domain. China and India, two Asian giants, emerged as manufacturing hub and economic power house of Asia in the context of shifting of geo-political and geo-economic power from North to South and West to East. Significant multilateral efforts from emerging countries, BRICS in particular, gained momentum for combating crisis of the century and insulating own currencies from the dollar dilemma (Raul, 2011).

With this backdrop the paper attempts to:

- examine the interrelationship between international reserve currency (US Dollar) and global financial stability, and
- explore alternative strategy in the present global financial architecture for overhauling global financial imbalances.

The relevant discourse presented hereafter encompasses: fiscal predicaments of the US over the years, financial woes of dollarized zone in the context of declining value of dollar followed by an alternative strategy in resolving global financial impasse.

Dollar dominance in the international financial system

The history of international financial system aptly portraits the way in which the economic predominance of the British Empire gradually went into oblivion. The war burden (WW-I&II) and Suez Canal fiasco leading to burgeoning and prolonged current account deficit had turned the status of the UK net creditor to the rest of the world to net debtor. Panics among investors; bondholders across the globe mounted up and consequently British Sterling came under the attack and Bank of England drawn its reserve to defend sterling but ended with devaluation (Subramanian, 2011). Moreover, it was agreed in the Bretton Woods conference 1944 that countries would hold their reserves in dollars as well as gold. As a result, the international monetary system thereafter had fallen into dollar trap

* *Professor in Finance Area, Department of Business Administration, Assam University Silchar, Silchar-788011, Assam, India. Email: rkraul@yahoo.com*

(www.cciee.org.in, 2010) and world's gold reserves ended up in the hands of the US (Johnson, 2011), which became undisputed leader amongst the market based economies.

Linkage between Dollar and US economy

Since December 7, 1941, with collapse of Bretton Woods, world has been relying on the America, somewhat competent hyper power, in respect of global governance. It is seen that the fundamentals of economic model of America are based on consumption glut backed by credits. Its share in the world GDP has significantly fallen since the mid 1960s. In 1980, US federal receipts were 19pc of GDP and debts was USD 0.9 trillion. The situation has completely reversed; share of federal receipts to GDP is nearly 5 percent points lower and debts nearly 15 percent higher. The public debt to GDP ratio has substantially increased. In one estimate, the ratio of outstanding federal debt to GDP is expected to increase to 87 percent in 2020 and 146 percent in 2030. Moreover, the budget deficit would likely to touch 6.5 pc and 13pc of GDP respectively during the aforesaid period (Khedekar, 2011). The reasons of ballooning fiscal deficit are attributed to weak tax revenues owing to poor economic performance, continuous fall in housing prices, stubbornly high unemployment, fragility of the US banking system and its role in non transparent credit default swaps (CDS), and above all America's financial mismanagement (Stiglitz, 2011). Besides, decaying infrastructure, weakening educational systems and dysfunctional healthcare system (Delong, 2011) are worrying phenomenon. They slash job and never moved out of recovery into expansion. The debt as on end March2011 accounted 100pc of GDP amounting to about USD15 trillion out of which USD 4.5 trillion to the foreign countries holding US debt securities. The economy, thus, despite its bigness seems to be declining not just in a fiscal sense, but also in the sense that its growth prospects look somewhat dim (Subramanian, 2011). Thus, there is ample evidence that the US economy is affected by earlier British Syndrome. On the other hand the emerging markets are growing and China in particular has been running current account surpluses and building up foreign exchange reserves about USD3 trillion (Olivier, 2009)

Another significant development took place in the context of unilateral sanctioned imposed by the US and EU banning involvement of any banks dealing with American and European counterparts in the oil trade with the Iran. Indian government followed by the China agreed to settle oil bills of Tehran in gold, which a departure from the international payment mechanism.

Is Dollar fading away?

The Dollar is international reserve currency and only medium of exchange for the central banks around the globe for invoicing trade, borrowing and lending currency. The continuous decline in the value of dollar has a cascading effect on the whole world. The dollar pegged zone Hong- Kong, UAE in particular received boost from booming US economy. On the contrary, when anchor currency passes through bad phase their currency weakened and economy jolted too. Besides, ripples of dollar predicaments spread across the countries affecting the world stock market. Further, the emerging countries which depend on cheap loans from abroad and FIIs inflows from the Dollar zone became worst affected. Thus, no country in the IT enabled globalize ambience could escape from dollar trap. The Indian currency (INR) has bottomed up in relation to dollar due to export contraction in both euro zone and the US as well as trade deficit arose particularly due to oil import bill. The RBI and public sector banks are forcibly resorting to selling dollar to rescue rupee from its mess ultimately leading to depletion in country's forex reserve.

Why do we rush to America's Dollar?

The US government treasuries being unrivalled to any currency in respect of safety and liquidity are most sought after assets and despite weakness dollar remains as international reserve currency. S&P's downgrade on sovereign US debt to AA+ from AAA and A-1+ for her short term debts resulted in huge loss to holders of the US treasury, particularly, investors who had lent cash against treasuries and also loan for more bonds as collateral. The market has reacted sharply to this contagion resulting in deterioration in value of dollar, landslide in global stock market, slashing employment rate and insurance businesses (Kewalramani, 2011). But very significant fact is that, leaving all speculations at bay, the yield of long term US Govt Bond has not increased which was supposed to be. Actually, 10 years US bond yield fell from 2.75pc to 2.34pc during August1-4, 2011 further ended 2011 at 1.87pc and finished the third quarter of 2012 at 1.64pc (Schawel,2012).

The global investors have exited emerging markets and rushed into dollar as a safe haven as no other country looks safer heaven than the US. Besides, US remain unrivalled in the context of innovation and academic pursuits. The central banks across the

globe increased their exposure because US debt bonds were one of the most secure from default risk though its yield is minuscule. So investors keep buying treasury bills and driving up prices. Over the decades Asian currencies were pegged to dollar and countries pursued export oriented growth strategies. The system allowed the peripheral economy (like china) to grow rapidly even as the anchor economy (US) enjoyed cheap financing. It may be noted that the rise of china did not diminish the role of dollar and may even have enhanced it.

Dollar supremacy in portfolio construction

The central banks' preference around the world for parking their currency in US treasury bills (T Bills) perhaps lies in the basic philosophy of constructing portfolio. Generally portfolio consisting of financial assets including the foreign currencies is constructed on the basis of three criteria; return, risk and liquidity. In this respect US T Bills fulfill all such criteria of high liquidity, with low risk and low return. Moreover, holding of US T Bills serves twin purposes.

- Country (buyer) builds up its forex reserve facilitating its international transaction, and
- The US issues T Bills to mitigate its trade deficit and keep fuelling the pace of its domestic consumption and indirectly ensuring worldwide demand intact. Further, it enables US to reduce exchange rate risk and lower borrowing costs.

Yuan has lack of dual convertibility which is pre-requisite of attaining the feat of global reserve currency and the central banks across the globe hesitate to hold it too. According to Bank of International Settlement (BIS) Renminbi's (RMB) share in the global foreign exchange turnovers was only 0.25 percent in 2007 and RMB ranked 20th in the world and 5th among Asian emerging market currencies. Besides, in most of export-driven nations such as Russia, Brazil, and Argentina, RMB is non-convertible currency. On the contrary, Euro, an imperfectly constructed currency, is also not the alternative to USD as entire euro zone is suffering under the financial strains over the years. The rest of the countries are following free floating rate. Thus, Dollar remains unrivalled. The US is big economy and possesses huge critical mass which sets the tune of pace of development of the world. The relevant statistics exhibit that the US has just 1.5pc of GDP accounting about USD 225bn as interest bill, as on end March 2011, in comparison to its annual revenue of about 14.5pc of GDP which is nearly 10 times higher than that of interest payment.

At different forum, however, role of dollar is suspected in the context of present global financial crisis and validity of accepting single nation's currency as medium of exchange in international monetary transaction is also raised. Dominique Strauss Kahn holds that "the country might be called upon IMF to provide global reserve currency as an alternative to the US dollar. Though time has not come, but I think it is intellectually wealthy to explore these kinds of ideas now. Such asset could be similar to but distinctly different from IMF's SDR and will be based upon a basket of major currency" (Strauss-Kahn, 2010).

Alternatives to present global financial architecture:

In the context of global currency woes, US dollar is considered to be the key player. However, the reality is, besides criticism, US Dollar, the anchor currency, will remain 'bloodied but unbowed' and

Annexure

Table 1: Foreign creditors of US (as on April30 2012) in bn dollar

Major holders of the US treasury securities	As on Feb.2012	As on March 2011	% Change over the previous period
Total	5100.3	4477.6	13.907
a. China	1178.9 (23.11)	1144.9 (25.57)	2.97
b. Japan	1095.9 (21.49)	908.1 (20.28)	20.68
c. Brazil	225.5 (4.41)	193.5 (4.32)	16.54
d. Taiwan	178.1 (3.49)	156.1 (3.49)	14.09
e. Switzerland	148.1 (2.90)	108.(2.41)	37.13
f. Russia	142.1 (2.79)	127.8 (2.85)	11.19
g. India	40.6 (0.80)	39.8 (.89)	2.01

Source: Department of Federal Reserve Board, 2012

countries will go on biting the bullet and also lurching into crisis to crisis. The process will continue unless availability of structural alternative that would work any better than the current framework. This has called for multilateral efforts to combat the crisis and overhauling fiscal mismanagement of the individual countries in the line of ensuring global financial liquidity. At the individual country level strategies in this regard would be to sort out domestic imbalances and reining over twin deficits; fiscal and account.

As stated earlier, Euro has not yielded covetable results in boosting the pace of growth in the region rather fuelled the financial crisis because it was created on the basis of political gimmick rather than fiscal unification. On the other hand, nations especially; BRICS; Brazil, Russia, India, China and South Africa, which share 25 percent in the world GDP, is in the threshold of coordinating their reflexes on both economic and political issues and emerged as a force to combat the deficiencies of global governance. The BRICS nations are expected to play a major role as growth drivers of the post-crisis global economy and deliver something above the talk shop to translate its collective economic clout into instrument of global policy change.

The core issues behind such efforts are that when participant countries will trade vigorously an intra currency market will automatically be created leading to breaking down the dollar peg spurring further opening up of intra trade and investment. This would pave the way for, deepening demand of local currencies, greater convertibility and exchange rate flexibility. Besides, it would strengthen the trade relationship and cultural bondage amongst the partners and finally leading to effortless mobility of resources and overall socio-politico growth.

The New Delhi summit, March 29, 2012 adopted the idea of conducting trade among themselves in their own currencies and endorsed the agreements:

- The local currencies will be used as medium of trade, and
- The BRICS development Banks (modus operandi still unavailable) will give local currency loans for accelerating the momentum of growth of trade among the countries. The basic aim of establishing such a bank is to mobilise resources for infrastructure and sustainable development projects in BRICS countries and also for other emerging economies and developing countries to supplement the existing efforts of multilateral and regional financial institutions for global growth and development (World Bank).

  Besides, a stock exchange will be established exclusive for trading in the equity derivative segment for facilitating the investors of the group countries. Once these are materialized the member countries will get a hold plethora of benefits;
- The currency reserve of each countries will be diversified with INR, RMB, Brazilian Real, Rubble and South African Rand, instead of only major currencies (USD,€,£,¥).
- The participant countries can hedge their currency with any liquid currencies; dollar, euro etc

Conclusion

History shows that once the anchor currency has established itself, it can be very resilient and often ensure the economic and geopolitical dominance of the country of origin. Dollar will therefore continue to enjoy world anchor currency status and any immediate disruption would lead to catastrophe severe than that of great depression 1930. However, economic partnership in an amiable political milieu amongst countries perhaps has a solution regarding global financial impasse. The local currency might replace dollar when the countries involve in vigorous intra-trade and special purpose financial institutions including banks, stock exchanges and the like take care of such transaction ensuring liquidity in the financial system. The recent efforts of BRICS countries which enormously increased intra-trade during 1995-2007 than that of with rest of the world to trade in local currency is a significant development in the international financial arena. The regional groupings like SAARC though emerged based on regional securities rather than economic gain have improved substantially economic cooperation among India, Pakistan, Bangladesh, Maldives and Srilanka. Further, NAFTA; extension of US-Canada free trade agreement to Mexico, EU 27 extension of EU 15 under Maastricht treaty and similar other groups in Latin America and Africa were formed on the basis of diversified reasons like political needs, ensuring human rights, environmental safeguards etc. The economic tie ups will be strengthened through the development of trade among these regional groupings in the line of BRICS efforts in vogue. Perhaps these efforts would boost revisiting global financial architecture and insulate the local currencies from global financial mess.

References

Delong, J. B. (2011, August 21), "America's Locast Years", The Economic Times.

Department of Federal Reserve Board. (2012, April 30), "Foreign Creditors of US", The US Treasury.

Johnson, S. (2011, September 21), "Who will Eclipse America?", The Economic Times.

Kewalramani, S. (2011, August 8), "Perils of US credit downgrade", The Economic Times.

Khedekar, S. (2011, September 5-18), "US Economy the TINA factor", Capital market, 15-17.

Olivier, J. B. (2009, August 31), "Sustaining a global recovery", Finance and Development, 46 (3), 8-12.

Raul, R. K. (2011), "World's Anchor Currency: Losing Ground?", Indian Journal of Accounting, Vol. XLII, No. I, pp. 80-85.

Schawel, D. (2012), "Bill Gross Assertion that the US could resemble Greece is nonsense", Retrieved September 16, 2012, from www.businessinsider.com/will-bonds-be.

Stiglitz, J. (2011, August 10), "A contagion of bad ideas", The Economic Times.

Strauss-Kahn, D. (2010, February 26), "An IMF for 21st century. Bretton Woods Committee Annual Meeting", IMF, Washington DC.

Subramanian, A. (2011), "Eclipse: Living in the Shadow of China's Dominance", New York: Peterson Institute for International Economics. NW.

Vlaar, P. J. (2007, December), "GDP growth and currency valuation: the case of the dollar", Journal of International Money and Finance, 26(8), 1424-1449.

www.cciee.org.in. (2010, September), Retrieved August 19,2011, from Return of the international monetary system under the G 20 framework.