

# Future Prospects for the World's Foreign Exchange Rate System: Political Design vs. Evolution

**Otmar Issing**

CFS, Goethe University Frankfurt



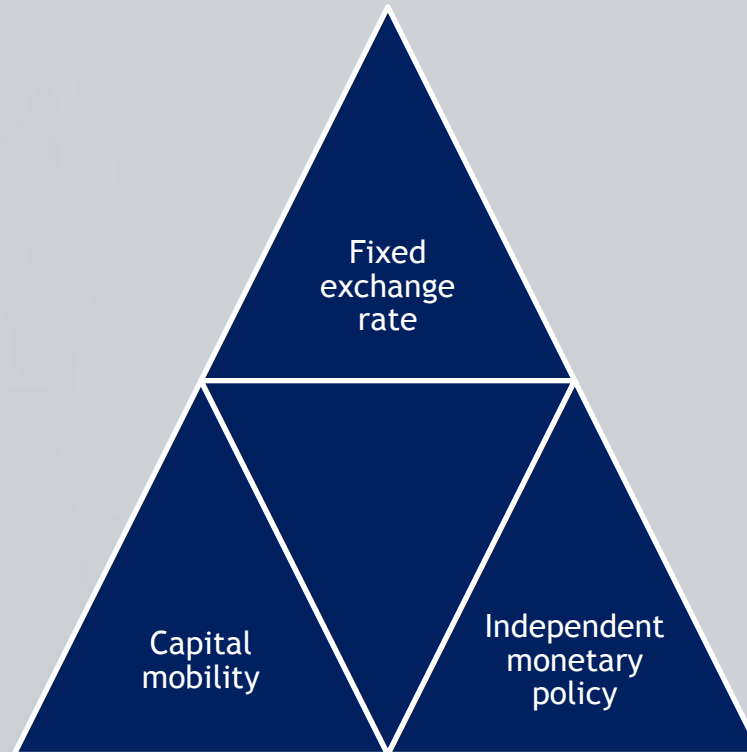
- Past and present
  - Bretton Woods 1944
  - Monetary and financial trilemma
- Choice of exchange rate system
  - Current situation
  - Corner solutions: Free float vs. Hard peg
- Future
  - International currency requirements
  - Options
    - New Bretton Woods?
    - Evolution rather than revolution

## Bretton Woods 1944

- US vs. UK - White vs. Keynes
- The result of US dominance
  - Dollar Standard
  - Fixed exchange rates - adjustable peg
  - IMF
  - World Bank

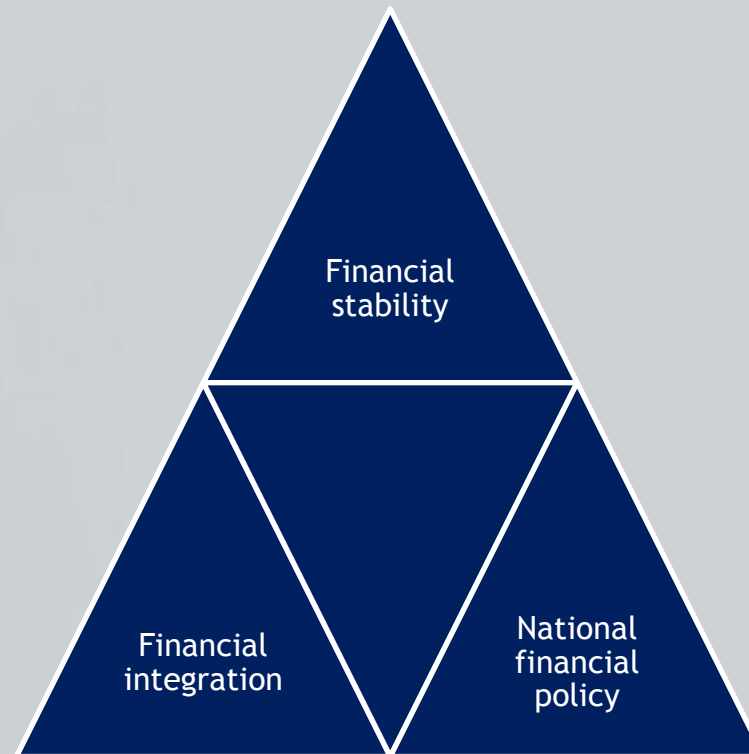
# Result of liberalizing capital movements

## The monetary trilemma



# With further financial integration

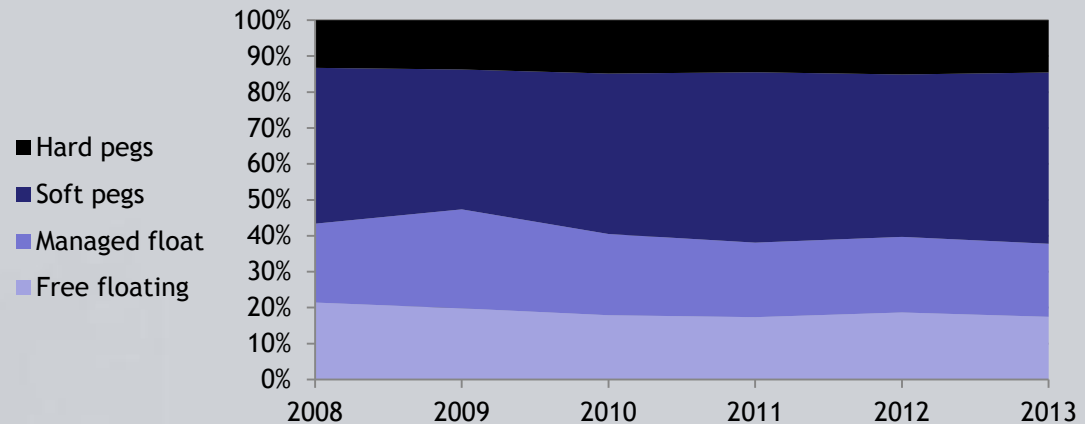
A financial trilemma?



## Choice of an exchange rate system

- Hard pegs
- Soft pegs
- Managed float
- Free Floating

# The current situation (de facto)



	2008	2009	2010	2011	2012	2013
<b>Hard pegs</b>	<b>12.2</b>	<b>12.2</b>	<b>13.2</b>	<b>13.2</b>	<b>13.2</b>	<b>13.1</b>
- No separate legal tender	5.3	5.3	6.3	6.8	6.8	6.8
- Currency board	6.9	6.9	6.9	6.3	6.3	6.3
<b>Soft pegs</b>	<b>39.9</b>	<b>34.6</b>	<b>39.7</b>	<b>43.2</b>	<b>39.5</b>	<b>42.9</b>
- Conventional peg	22.3	22.3	23.3	22.6	22.6	23.6
- Stabilized arrangement	12.8	6.9	12.7	12.1	8.4	9.9
- Crawling peg	2.7	2.7	1.6	1.6	1.6	1
- Crawl-like arrangement	1.1	0.5	1.1	6.3	6.3	7.9
- Pegged ER within horizontal bands	1.1	2.1	1.1	0.5	0.5	0.5
<b>Floating</b>	<b>39.9</b>	<b>42</b>	<b>36</b>	<b>34.7</b>	<b>34.7</b>	<b>34</b>
- Managed float	20.2	24.5	20.1	18.9	18.4	18.3
- Free floating	19.7	17.6	15.9	15.8	16.3	15.7
Residual/Other managed arrangement	8	11.2	11.1	8.9	12.6	9.9

Note: Percent of IMF members as of April 30 each year.  
Source: IMF.

## Corner solution 1: Free floating

- Monetary stability
- Financial stability
- The role of capital controls
  - Large economies
  - Small economies



## Corner solution 1: Free floating (cont'd)

- US dollar
- Yen, Pound, AUD, CAD etc.
- Euro
  - Free floating to RoW
  - But: Hard peg inside Euro area (corner solution 2)

## Corner solution 2: Hard peg

- No separate legal tender (“dollarization”)
  - e.g. Ecuador, Kosovo
- Currency board
  - e.g. East Carribean states, Hong Kong
- Monetary union: The case of the Euro area
  - One currency - one central bank
  - 18 sovereign states
  - No-bail-out clause

## Excursus: The Eurozone crisis

- Causes
  - Diverging competitiveness
  - Macroeconomic imbalances
  - Private and public sector debt
  - Failure of the Stability and Growth Pact
- EMU: From crisis to political union?
  - Economic union
  - Banking union
  - Fiscal union
  - Political union

# Characteristics of an international currency

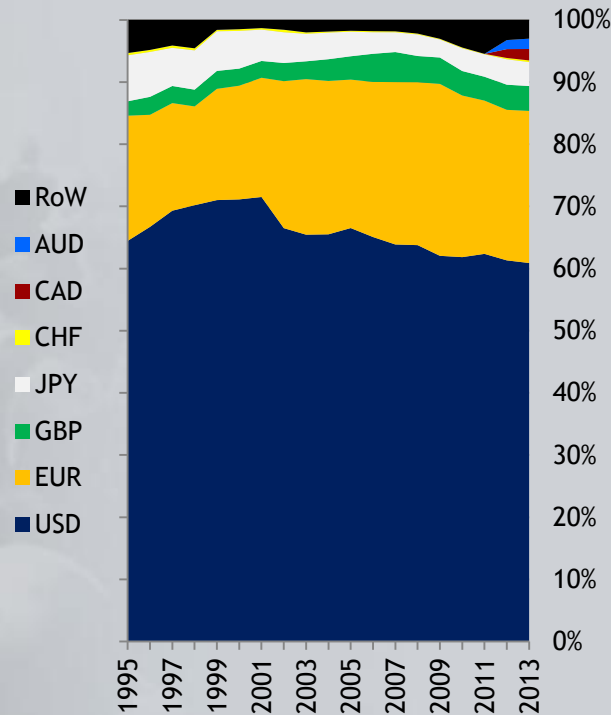
- Domestic financial markets
  - Depth
  - Breadth
  - Openness
- Stability of currency and confidence in its future stability
- Domestic real economy
  - Size
  - Strength
  - International linkages
- Previous use of currency (inertia)

## The international role of the ...

- US dollar: Declining, but still dominant
  - Reserves
  - Trade finance
  - FX
- Euro: leading role in some markets (bonds, OTC derivatives)
- Renminbi: rising importance (e.g. trade finance)

# 1. US dollar

## Reserves

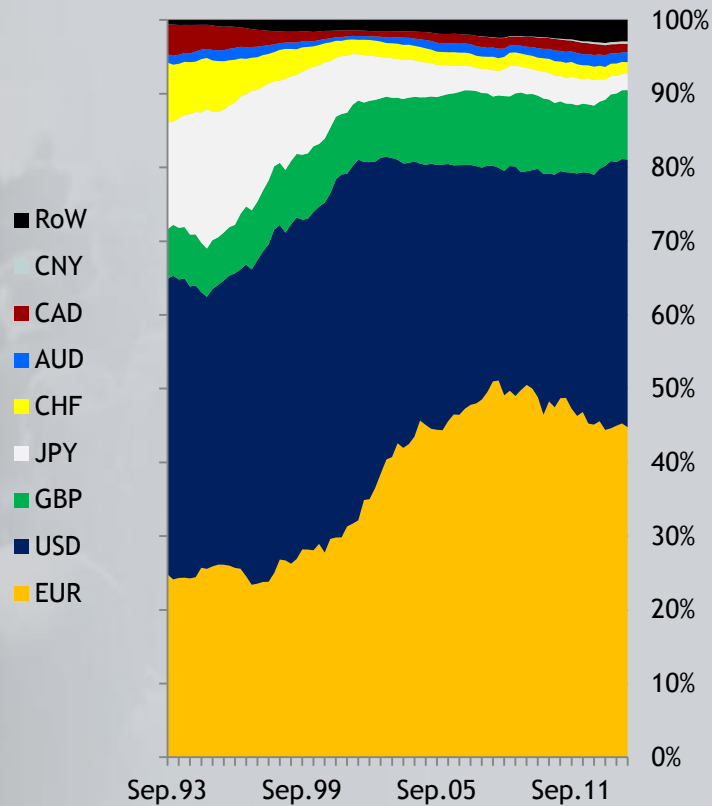


	1995	1998	2001	2004	2007	2010	2013
USD	58.96	69.28	71.51	65.51	63.88	61.84	60.89
EUR	18.43	15.69	19.18	24.68	26.12	26.00	24.47
GBP	2.11	2.66	2.70	3.49	4.83	3.94	4.00
JPY	6.77	6.24	5.05	4.28	3.18	3.66	3.85

Note: Data according to the Currency Composition of Official Foreign Exchange Reserves (COFER) reported by the IMF and based on allocated reserves only, unallocated reserves includes foreign exchange holdings of those countries/territories that currently report to IMF International Financial Statistics (IFS) but do not report to COFER. Reserves consist of the monetary authorities' claims on nonresidents in the form of: foreign banknotes, bank deposits, treasury bills, short- and long-term government securities and other claims usable in the event of balance of payments needs. For Euro data between 1995 and 1998 claims in Deutsche mark, French franc and Dutch guilder were totaled.  
Source: IMF (COFER and IFS).

## 2. Euro

### Bonds and notes



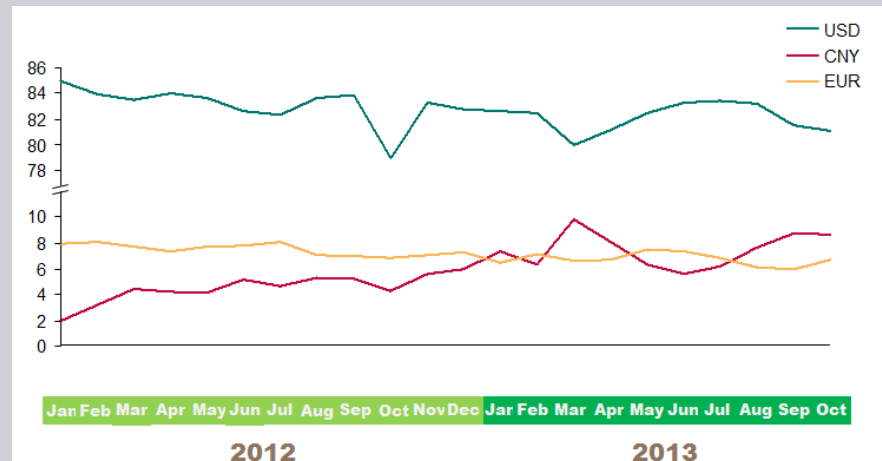
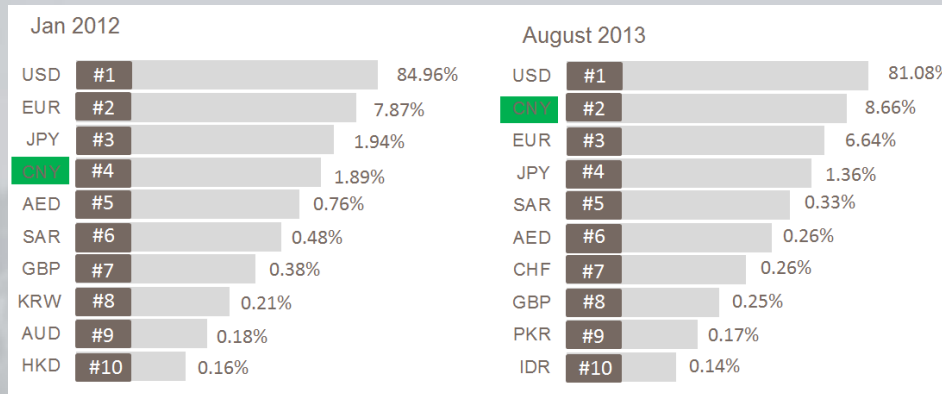
(March)	1996	1999	2002	2005	2008	2011	2014
EUR	26.12	26.26	32.15	45.08	50.99	48.70	44.78
USD	38.56	46.03	48.91	35.27	29.25	30.81	36.30
GBP	6.50	8.58	8.02	9.17	9.40	9.45	9.41
JPY	16.68	11.49	6.27	4.70	3.57	3.47	2.20

Note: Amounts outstanding, total issues, in billions of US dollars. For Euro data between 1993 and 1998 bonds denominated in national currencies of Euro area countries was totaled.

Source: BIS (Quarterly Review, June 2014).

# 3. Renminbi

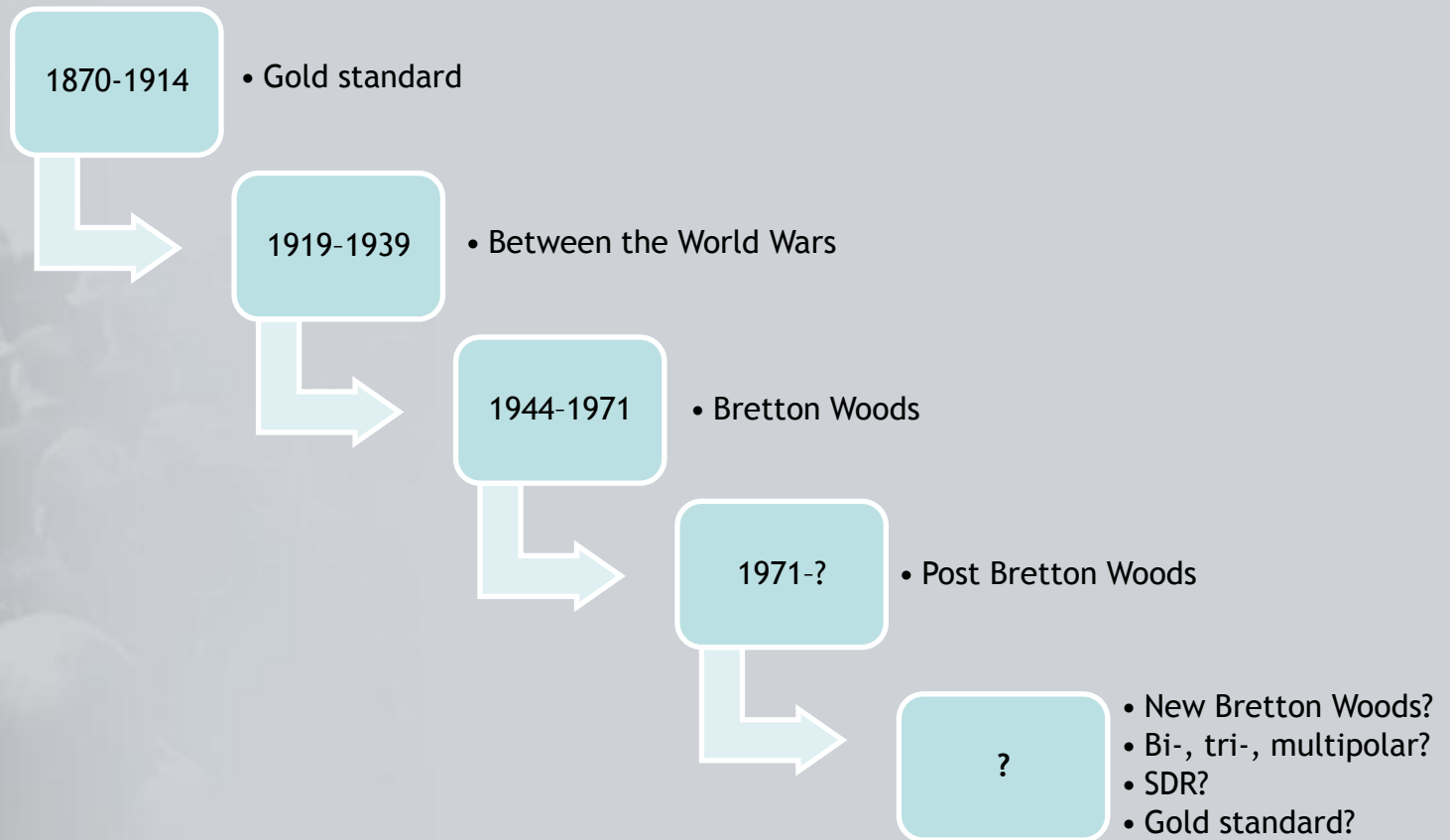
## World trade finance



Note: Sent and received with the RoW.  
Source: SWIFT Watch.



# The future exchange rate system



→ Evolution rather than revolution

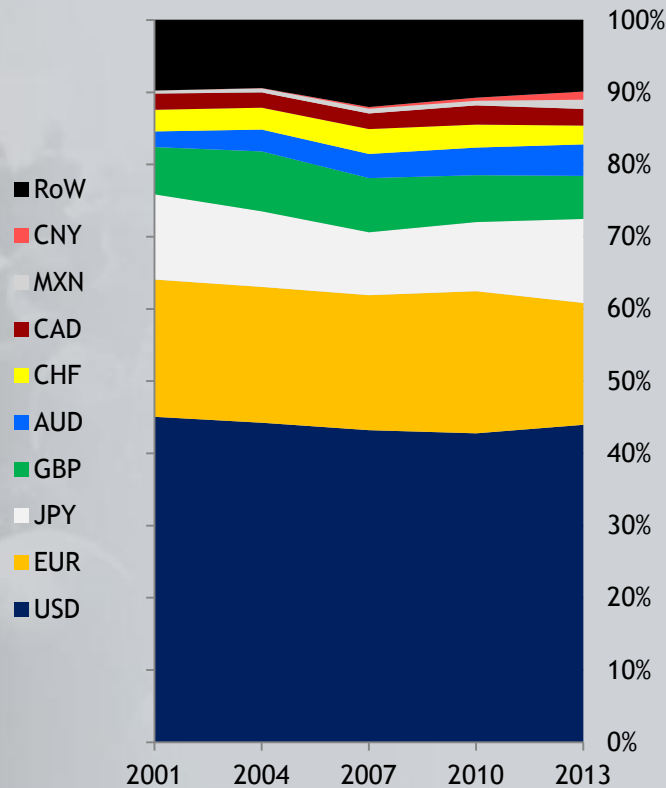
## The prospects for evolution

- The end of the „exorbitant privilege“?
- A bipolar, tripolar or multipolar system?
  - Formation of currency zones?
  - The future of £, ¥, SFR etc.



# 1. US dollar

## Foreign exchange market turnover

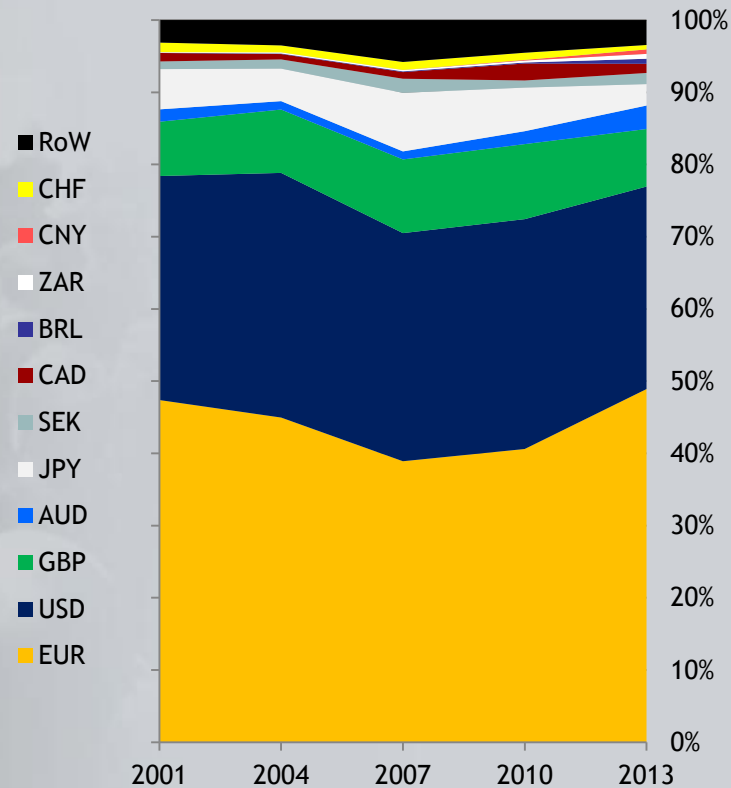


	1998	2001	2004	2007	2010	2013	
USD	43.40	44.93	44.00	42.80	42.43	43.52	1
EUR	...	18.96	18.70	18.52	19.53	16.71	2
JPY	10.86	11.77	10.42	8.62	9.50	11.52	3
GBP	5.51	6.52	8.25	7.43	6.44	5.90	4
CNY	0.01	0.00	0.05	0.23	0.43	1.12	9

Note: Adjusted for local and cross-border inter-dealer double-counting (i.e. "net-net" basis), 1 percentage shares of average daily turnover in April.  
Source: BIS.

## 2. Euro

### OTC interest rate derivatives market turnover

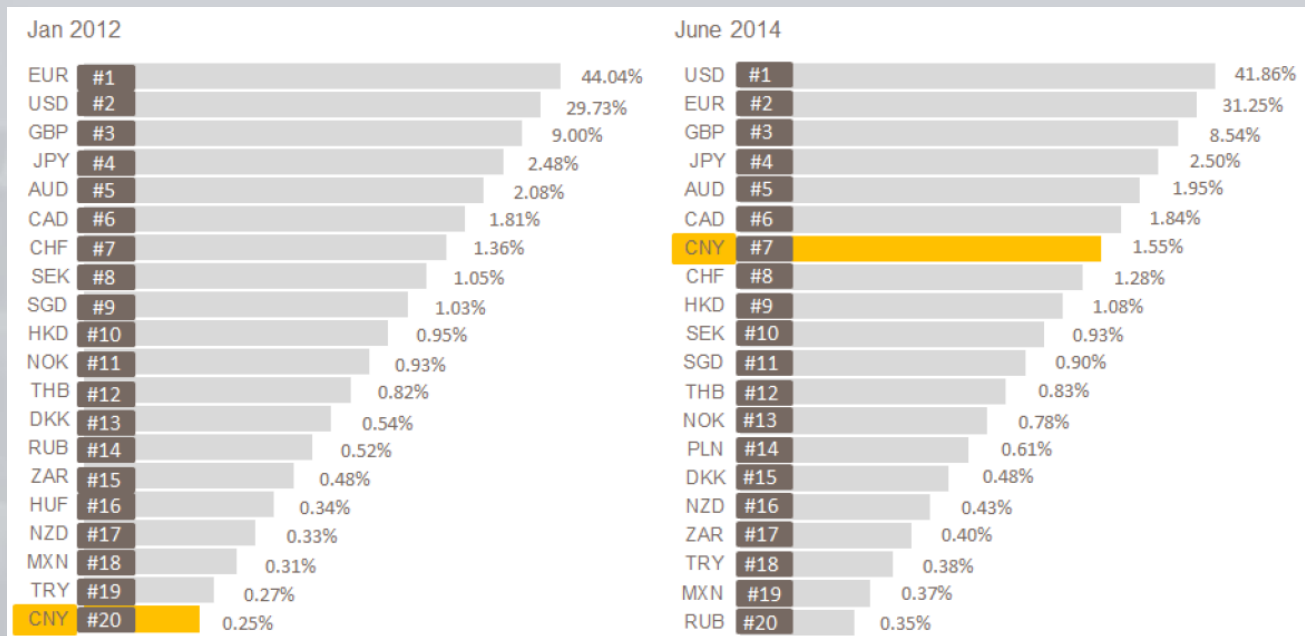


	1998	2001	2004	2007	2010	2013	
EUR	...	47.38	44.96	38.91	40.60	48.90	1
USD	26.68	31.02	33.88	31.59	31.83	28.04	2
GBP	6.26	7.52	8.77	10.20	10.39	7.97	3
AUD	1.14	1.71	1.16	1.11	1.78	3.25	4
CNY	0.66	1.06	1.28	1.95	0.98	1.54	10

Note: Adjusted for local and cross-border inter-dealer double-counting (i.e. "net-net" basis), 2 daily averages in April, in billions of US dollars.  
Source: BIS.

### 3. Renminbi

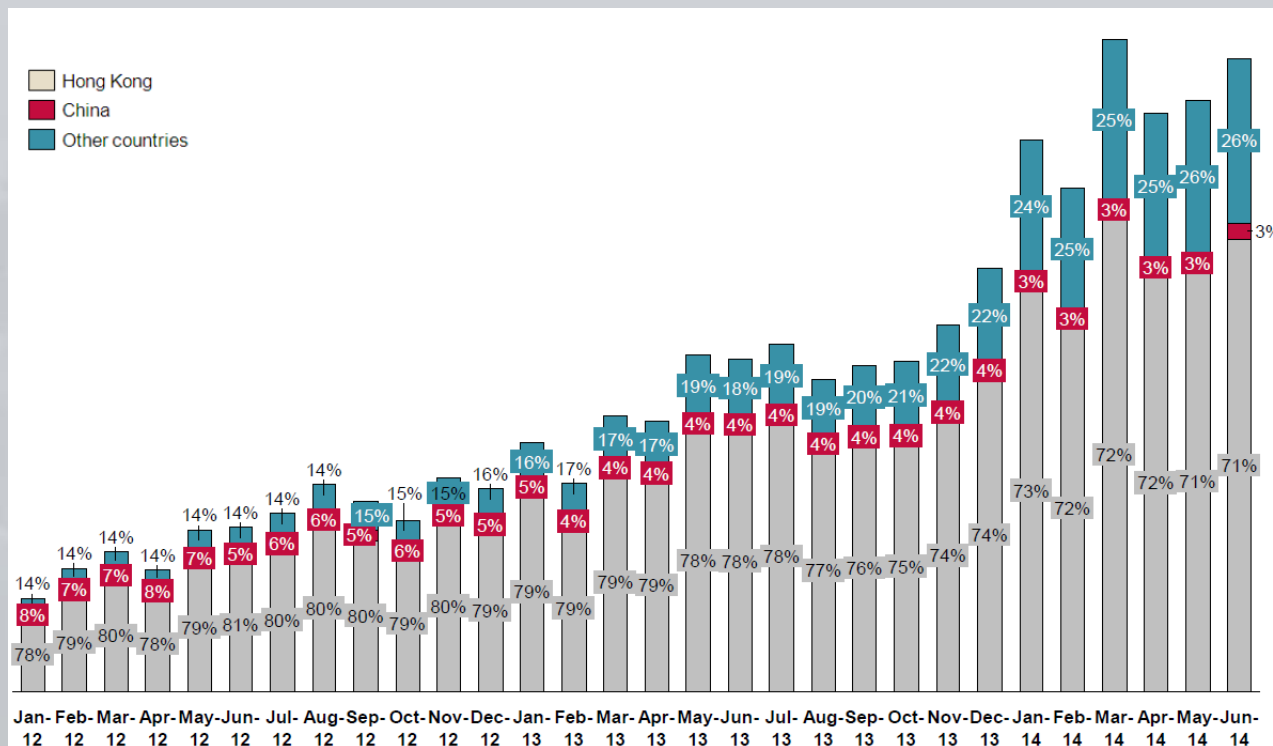
#### World payments currency



Note: Customer initiated and institutional payments. Inbound + Outbound traffic. Based on value.  
Source: SWIFT Watch.

### 3. Renminbi

#### Payments evolution



Note: Customer initiated and institutional payments. Inbound + Outbound traffic. Based on value.  
Source: SWIFT Watch.