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THE REQUIREMENTS OF A NEW RESERVE CURRENCY REGIME

There has been much demand of late for a new reserve currency to replace the US dollar. The arguments in favour of such a demand are quite powerful: if one nation's currency plays the role of a reserve currency in the world economy, then this confers enormous advantages upon that nation, which is not fair. It can, in effect, print money which other countries are more or less obliged to hold.

What is more, the obligation to hold this currency is not a result of external pressures alone; it arises from each nation's concern with its own self-interest. In so far as countries already hold significant amounts of reserves in this currency, or in assets denominated in it, and their nationals hold significant amounts of wealth in such assets, they can not afford to rock the boat by refusing to hold more of this currency, since any such refusal, leading to a fall in its relative value, would entail a loss of wealth for them.

The reserve currency country therefore can afford to run current account deficits with impunity. Not only would such deficits be "automatically" financed, but this very fact would also prevent any speculative attacks on its currency. The reserve currency country, consequently, can afford to live beyond its means; it can, when the world economy is not demand-constrained, suck goods away from other countries to their detriment; and it can even finance wars by implicitly forcing loans out of other countries. What is more, the actions of its government and people determine the magnitude of newly created reserves in the world economy.

The denial of such powers to a single country, through the replacement of the current regime by an alternative one, where the reserve currency is the liability of an international body, constitutes a step towards a more democratic global order. It also has the advantage that additions to the stock of this new reserve currency, and the distribution across countries of such additions, can be decided upon collectively and consciously, in keeping with criteria of fairness and even other considerations such as potential counter-cyclicality.

There are, however, several problems with this suggestion. One relates to the *relative value of such a new reserve currency*. Even if its relative value is officially pegged to a basket of currencies, maintaining it at that level, against the activities of speculators, may well prove to be a task beyond the capacity of the international body whose liability it is. The second problem relates to the *possible adverse effect on world aggregate demand of the introduction of such a new reserve currency*; and this is what the present note is concerned with.

The reserve currency country's being in a position where it can spend beyond its means is what actually makes it undertake substantial expenditure that boosts the level of world aggregate demand. If this ability to spend beyond its means is undermined through the introduction of an alternative reserve currency, then its actual expenditure will be adversely affected and, together with it, the level of world aggregate demand. *With the introduction of an alternative reserve currency therefore, an alternative arrangement for boosting world aggregate demand must be simultaneously introduced.*

This point relates to the question of the leadership role in the world economy. The reserve currency country is typically the leading country of the world economy, such as Britain was during the pre-first world war years, and the U.S. has been in the post-second world war years. Its currency, being the reserve currency, confers it the *ability* to run current account deficits with impunity.

Its leadership role, however, consists in the fact that, because of this *ability*, it is also *willing* to run current account deficits vis a vis at least the other major economies, especially the newly industrializing economies, of its time. Britain, while running such a deficit vis a vis the newly industrializing countries of its time, did not have an overall current account deficit, because of its economic relationship with the colonies and its near monopoly over shipping.

The U.S., the leading country in the post-colonial world, does not enjoy such advantages: while running a deficit vis a vis the other major countries, especially the newly industrializing ones, it is forced to have an overall current account deficit that makes it the largest borrowing economy of the world. While this is a major source of potential problems for the world economy, the fact remains that any effort on the part of the U.S. to curtail its current account deficit within the prevailing trade regime would reduce the level of aggregate demand in the world economy.

Boosting world aggregate demand

Hence, while overcoming the unfairness associated with one country assuming the leadership role, the need for an alternative, more collective, arrangement for discharging this leadership role, cannot be overlooked. If one aspect of the leadership role, namely providing the reserve currency, is to be differently organized, then the other, related, aspect of the leadership role, namely boosting world demand, has also got to be differently organized, but organized nonetheless.

In a world with an alternative reserve currency arrangement, there are two basic ways in which the level of aggregate demand can be maintained. One is to boost the value of the Keynesian multiplier at the world level, so that even if the original demand stimulus – arising from expenditures undertaken in the U.S. economy – weakens, its adverse effects on the world output and employment are counterbalanced. A simple way of increasing the value of this "world multiplier" is to force surplus countries to either reduce their surpluses by boosting domestic absorption, or recycle these surpluses as grants to the less developed economies.[i] After all, *any recycling of surplus*, whether total surplus or incremental surplus, *boosts the value of the Keynes-Kahn multiplier at the level of the world economy,* in the sense that for any given vector of autonomous expenditures undertaken by countries, it raises world output and employment.

The other way to boost world aggregate demand against the adverse impact of the introduction of a new reserve currency is to increase the original stimulus itself, upon which the Keynes-Kahn multiplier operates. This can be done by giving purchasing power *gratis* to the less developed countries of the world through a system of grants. These can be an earmarked portion, each year, of the addition to the stock of the new reserve currency. Of course, this earmarked portion will need back-up in the form of extra holdings of the major currencies of the world; but the international body creating this new reserve currency can obtain the requisite extra amounts of major currencies for providing this back-up.

Thus, along with the new reserve currency arrangement, purchasing power should be handed over *gratis* to the poor countries, either by recycling the surpluses of the surplus countries, or by the printing of additional money by the international body issuing the new reserve currency, or both.

The rules to be followed with regard to both these ways of boosting world demand should be revised with experience. But the need to boost aggregate demand with the introduction of a new reserve regime remains paramount.

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[i] A suggestion for doing so with regard to *incremental* surpluses, arising from fiscal stimuli in the context of the crisis, was discussed in G24 Policy Brief 43.