Emerging Markets: New Reserve Currencies and Spillovers from Advanced Economies

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All of today's reserve currencies are based on trust. They are forms of debt, since they are no longer backed by gold or any other commodity. These currencies are demanded because they are trusted and they are convertible in each other without any legal restriction.

The Dollar is the most important reserve currency. During the interwar period, the Sterling competed with it. In more recent times, the Euro and the Yen have started to gain importance. Other currencies, like the Canadian and the Australian Dollars are also slowly acquiring the status of reserve currencies, but represent still a very small proportion of global reserves.

The main advantage of getting the status of reserve currency is the fact that then the country can issue all its debt in local currency. That is why more and more countries will continue to try to make their currencies eligible for reserve.

Today there should be no global shortage of liquidity, except for a deliberate monetary contraction in a big supplier of a reserve currency, as it happened in the early eighties when the FED suddenly decided to strongly fight inflation. The appearance of new reserve currencies should reduce the risks of global illiquidity events.

The US and the countries that issue reserve currencies, manage their macroeconomic policies trying to reach domestic targets on inflation and employment.

In spite of the existence of the G20 and the IMF, that could help to coordinate macro-economic policies of the advanced economies, it is fair to say that, since the collapse of the Bretton Woods system until now, no individual country, or group of countries, take responsibility for spillover effects of its economic policies on the rest of the world. In that sense, there is no such a thing as an International Monetary System that pursues global stability.

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Emerging markets have a double curse. Their currencies are not trustworthy enough to be reserve currencies. And they suffer from spillover effects from the domestic policies of the advanced countries.

The spillover effects cause on emerging markets the same problems that the macro-policy mismanagement cause in their own advanced economies: Recession and Deflation; Over-heating and Inflation; Stagflation; Financial Crisis and Sovereign Debt Crisis.

The difference is that if a reserve country wants to solve these problems, they have just to correct the mismanagement of their policies. Emerging markets, instead, have much limited room for maneuvering with domestic policies in order to fix the problems that imported from abroad.

In most countries, advanced and emerging, the risks of recession and deflation and over-heating and inflation, as well as stagflation, are still associated with mistakes in monetary and fiscal policies of each country, as they were in the less financially globalized world of the period 1914-1973.

But since the globalization of finance, which started with the recycling of the petrodollars and expanded very rapidly during the nineties and the two thousands, most macroeconomic disorders in the emerging markets arouse from financial crisis and sovereign debt crisis very influenced by spillover effects of macro-policies of the advanced countries.

Financial Crisis and Sovereign Debt Crisis are always the consequence of excessive indebtness: sometimes of firms, sometimes of households, sometimes of financial intermediaries and sometimes of governments; and, at time of crisis, excessive indebtness of all of them.

In the advanced world, as they can issue large amounts of reserve currency denominated debt, there is always the temptation to bail out debts. Such a strategy creates the risk of negative interest rates to inflate debts away. This strategy would create inflationary problems, immediately in the emerging world and eventually in their own economies.

To cope with the debt problems created by financial crisis in advanced economies, the solutions should not be “bail-outs” that simply transform private debts into public debts but “bail-ins” through orderly processes of debt restructuring. Governments and International Financial Institutions should concentrate their interventions in the financial field, primarily on facilitating the debt restructuring processes and not bailing out creditors that took excessive risks. This is particularly important to minimize the negative spillover effects on the emerging economies.

For the emerging economies, financial globalization means an increasing degree of currency substitution and competition between the domestic money and foreign currencies. As a consequence emerging economies import instability whenever there is ample reserve currency volatility.

The antidotes used by non-dollarized emerging market economies are: active use of fiscal policy, inflation targeting monetary policy and imposition of some capital movement restrictions while building trust for the national currency to become fully convertible.

The negative spillover effects of reserve currency volatility are larger and more dangerous on highly “dollarized” economies. Highly dollarized economies are normally those that during the 80s suffered hyperinflation or went through regime change that destroyed the old monetary system. In order to stabilize their economies, some of these countries decided to adopt bi-monetary regimes, allowing the dollar to compete freely with the domestic currency; other fully dollarized their economies; other adopted currency board regimes and the european economies found convenient to enter in the Eurozone.

Even though “dollarization” makes those economies more vulnerable to negative spillover effects of reserve currency volatility, forced de-dollarization has not provided a solution but has just worsen the problems. The best solution for these emerging economies is to accept the competition of foreign currencies and manage monetary policy as to increase the trust on their local currency.

A future International Monetary System should include: improved bank resolution mechanisms, a Sovereign Debt Restructuring Mechanism or, at least, improved Collective Action Clauses in new bond issues and a Lender of Last Resort for nations, not only for financial intermediaries.