SRM MUN 2013

ECONOMIC AND SOCIAL COUNCIL

EXPLORING THE POSSIBILITY OF ESTABLISHING OF AN INDEPENDENT AND INTERNATIONAL RESERVE CURRENCY AS AN ALTERNATIVE TO US DOLLAR

A WORD FROM THE EXECUTIVE BOARD

Dear Delegates

It is indeed a great honour to welcome you to the Economic and Social Council of SRM Model United Nations Conference 2013.

To the veterans of MUN, we promise you a very enriching debate that you've never experienced before and to the newcomers, we are really excited to be a part of your maiden voyage.

The following pages intend to guide you with the nuances of the agenda as well as the Council. The Guide chronologically touches upon all the different aspects that are relevant and will lead to fruitful debate in the Council. It will provide you with a bird's eye view of the gist of the issue.

However, it has to be noted that the background guide only contains certain basic information which may form the basis for the debate and your research.

You are the representative of your allotted country and it is our hope that you put in wholehearted efforts to research and comprehensively grasp all important facets of the diverse agenda. All the delegates should be prepared well in order to make the council's direction and debate productive. After all, only then will you truly be able to represent your country in the best possible way.

Our aim in the council would be to urge you, the delegates to put your best foot forward and take back an unforgettable experience.

We encourage you to go beyond this background guide and delve into the extremities of the agenda to further enhance your knowledge of a burning global issue.

This may be a fairly technical committee for the ones with no background of economics. We have tried our best to make the economic terms very simple to understand. For any further assistance, we would be happy to help you understand the concepts.

For any further assistance feel free to contact us at

bangaprerna@gmail.com

vidya.bhaskar93@yahoo.in

Research Ahoy!

The Executive Board

DESCRIPTION OF THE COMMITTEE:

The United Nations Economic and Social Council is one of the six principal organs of the UN, established under the United Nations Charter in 1945. It coordinates the economic, social, and related work of the 14 UN specialized agencies, functional commissions and five regional commissions. In addition, it receives reports from 11 UN funds and programmes. It consists of 54 members which are elected by the General Assembly.

ECOSOC is the central forum for discussing international economic and social issues. It also formulates policy recommendations addressed to Member States and the United Nations system. Its main objectives are:

1. Promote higher standards of living, full employment, and economic and social progress;

2. Identify solutions to international economic, social and health problems;

3. Facilitate international cultural and educational cooperation; and

4. Encourage universal respect for human rights and fundamental freedoms.

The ECOSOC can make or initiate studies and reports on these issues. It also has the power to assist the preparations and organization of major international conferences in the economic, social and related fields. Further, the ECOSOC can facilitate a coordinated follow-up to these conferences. The Council's purview extends to over 70 per cent of the human and financial resources of the entire UN system.

EXPLORING THE POSSIBILITY OF ESTABLISHING OF AN INDEPENDENT AND INTERNATIONAL RESERVE CURRENCY AS AN ALTERNATIVE TO US DOLLAR

1. RESERVE CURRENCY:

A reserve currency is a national currency held by many other governments around the world as part of their foreign exchange reserves. Reserve currency status indicates a powerful economy as other governments depend on the reserve currency's stability to manage their own monetary policies. A reserve currency provides many advantages to the country that issues it.

2. IMPORTANCE OF RESERVE CURRENCY:

Reserve currency allows for a country to pay for imports and other needs by printing more money. It allows that country to 'export inflation'; because when it prints money it circulates outside its own economy, keeping the local money supply much more stable than non-reserve currencies that print money. Having a reserve currency gives a country much more flexibility in international affairs, both economic and political. Governments aren't the only ones who benefit from a reserve currency. Traders prefer working in a reserve currency because it minimizes costly exchanges when buying or selling. International commodities are priced in Dollars, so you can sell Mongolian copper to China and use the money to buy Saudi oil without having to shift between Tugriks, Renminbi and Riyals. Reserve currencies give traders what they need most: efficiency. That attracts investors to the currency, and the governments and traders give the nation that owns the currency vast amounts of economic power.

It is not a compulsion for any country to follow any specific currency to keep it as their reserve currency. The percentage in which they hold their reserve differs from country to country. The exact scenario which pops up here is that a country keeps a certain reserve to maintain its foreign exchange reserve and as the maximum international trade all over the world occurs in Dollars so the countries prefer keeping maximum of their reserves in Dollars.

So essentially there is no official requirement that the US Dollar is to be held as the reserve currency for every country but it depends on the global belief and faith in the US economy and that is why countries prefer to hold US Dollars over any other national currencies.

If, however a country's majority of trading happens with for instance, China, the country may decide to keep the reserves of Renmimbi, in addition to keeping reserves of US Dollars.

3. US DOLLAR AS THE RESERVE CURRENCY:

The Dollar has been the cornerstone of the international monetary system since the Second World War. The dominance of the US Dollar emerged only after the Second World War after the Bretton Woods System was established and the Pound Sterling lost its balance. The US Dollar was made the essential anchor by the Bretton Woods System.

After this, until the formation of the Monetary Union of the European Union in 1999 the Duetshe Mark was the second largest reserve currency used worldwide. After this, these properties of the German Mark were inherited by the Euro and now Euro has a quarter of the share as a reserve currency worldwide. It is the most important reserve currency, accounting for at least two-thirds of reserve assets, according to the IMF's Composition of Foreign Exchange Reserves database. The bulk of foreign exchange transactions involve Dollars, and significantly more trade gets settled in Dollars that involves the United States. The formation of the Monetary European Union led to great changes in the market. Countries like Italy which had rates of 1000 Lira to a Dollar ratio now traded at 0.86 Lira to a Dollar. This led to an extreme change in the market of countries like Italy, Spain etc. whose economies were based on exporting olives, oils etc. and due to this change an overvaluation of assets took place. This bubble which now burst has in turn acted as oil to the spark leading the Eurozone into an ember. However, the recent crisis has prompted an abundance of commentary on the future of the international monetary system and potential alternative reserve currencies. What does all this mean for the future of the international monetary system and the role of the Dollar?

4. WHY IS THE US DOLLAR A RESERVE CURRENCY?

First, let's recall that while under the Bretton Woods system, the Dollar's primacy was rooted in law, this has not been the case for the past 30 years: Dollar usage has continued as a matter of choice. Its widespread acceptance is partly the consequence of the dominant position of the U.S. economy, but has also been sustained by the following factors:

- The depth and liquidity of the United States' financial and foreign exchange markets, which remained robust, even during the multiple financial turmoils the US faced.
- Network effects—the more a currency is used and held, the more useful it becomes, which in turn increases demand for it even more.
- The U.S. economy's track record of macroeconomic stability, which boosts confidence in the Dollar's long term purchasing power.
- The willingness of the U.S. fiscal and monetary authorities to allow the Dollar to be used in international transactions and to generate sufficient high quality liabilities to meet international demand for assets denominated in Dollars.

Further, many countries have heavily invested in the U.S. Treasury. China's economy is dependent on exports to the U.S. and investing here helps fuel demand for those goods.

However, the slip of the Dollar during the 2007 crisis also saw coming up of China and the proposal of Renmenbi to be included as a currency to the basket of currencies used by the IMF called the SDRs.

But the acceptance of Dollar primarily created an impact when Saudi Arabia agreed to trade all its oil in terms of Dollars. This made a huge impact on the international market as oil is something which has always been in demand.

5. ALTERNATIVES TO US DOLLAR:

Based on economic size, there are potential competitors to the Dollar. Looking further ahead, China's dynamic growth may lead to the Renminbi becoming more widely accepted internationally. Potentially better would be a system where multiple currencies operate on a par. It is unclear, however, whether such a system could emerge on its own—given network effects—and, how stable it would be. In fact, the increased scope for arbitrage among the major reserve currencies could potentially make such a system unstable, unless tight policy coordination among reserve issuers could be achieved. Some say it will be the Euro; others, perhaps the Japanese Yen or China's Renminbi. And some call for a new world reserve currency, possibly based on the IMF's Special Drawing Right or SDR, a reserve asset. None of these proposals, however, is without flaws.

- **EURO:**

Consider the Euro, for instance, widely considered being the most natural rival to the Dollar. The Euro is also handicapped by several critical shortcomings. Among these is a strong antigrowth bias built into the Euro area's provisions for monetary and fiscal policy, compounding other factors that tend to weaken Europe's output potential (for instance, ageing populations, rigid labour markets, and strict government regulations). A sluggish European economy can hardly be expected to make the Euro attractive for trading or investment purposes. And the familiar ambiguities of the Euro area's governance structure are bound to give outsiders pause. Thus, Euro which was initially considered to be a powerful contender to be the number one currency is now itself in crisis where further deterioration in the situation would lead to markets flushing with Euro and mass-dumping of the currency.

- **JAPAN'S YEN:**

Japan's Yen was once thought to be the Dollar's apparent heir but now looks more like a sad, faded also-ran. During the 1970s and 1980s, when the fast-growing Japanese economy seemed destined for superpower status, international use of the Yen accelerated swiftly, particularly in global bond markets. But, at the end of the 1980s, the bursting of Japan's "bubble economy" abruptly halted the currency's upward trajectory. Today, after years of domestic stagnation, the Yen appears to face a gradual erosion of market standing not unlike sterling's long decline in an earlier era.

- **CHINA'S YUAN:**

Could China's Yuan rise? The currency of one of the world's largest economies, the Renminbi certainly has much going for it. International use, however, remains rudimentary despite recent efforts by Beijing to broaden the currency's appeal. Acceptance is discouraged by obstacles far more severe than even anything blocking the Euro or Yen, including full panoply of capital controls and a severely underdeveloped financial system.

- **RETURN TO GOLD:**

While central banks have displayed a willingness to increase gold holdings to diversify their international reserves, this is driven by concerns over the stability of the Dollar and Euro; the purpose of holding gold is to maintain the value of a country's assets. The actual volume of gold being held is relatively small as a percentage of assets held.

- **CANADIAN DOLLAR AND THE SWISS FRANC:**

The Canadian Dollar has come out as a very viable choice for the countries as the Canadian Dollar has shown utmost stability in its nature. The banking system of Canada has always been appreciated for its brilliant functioning. Some countries have actually shown interest in adopting the Canadian Dollar as their currency after suffering a period of crises.

The Swiss Franc has always been stable but on the foreign exchange reserve graph it has shown a decline. In fact Lichtenstein has actually adopted the Swiss Franc as its currency.

6. ECONOMIC INTERESTS:

In the absence of a world currency backed by an effective global government, foreign trade and investment must rely on acceptable national currencies to play international roles. A disconnect therefore exists between the jurisdictions that are the source of international monies and the domains of the markets in which they operate, which introduces a political dimension that is often overlooked in purely economic analysis.

The conventional framework for the study of international currencies separates out the three standard functions of money—medium of exchange, unit of account, and store of

value—at two levels of analysis: the private market and government policy. In markets, an international currency plays a role in foreign exchange trading, trade invoicing, and financial investments. For governments, the functions of international money are as an exchange rate anchor and as a reserve currency. At the market level, economic considerations typically dominate in determining preferences. At the government level, the additional ingredient of politics is unavoidable.

Politics enters because an international currency offers unique advantages for the nation that issues it—political as well as economic. Economists naturally tend to focus on the economic benefits involved, such as international seigniorage—the gain of real resources that results when a country's currency is acquired and held abroad.

There may also be disadvantages for the issuer, of course, especially once a substantial overhang of its currency accumulates in foreign hands. Interest rates might have to be raised to sustain the money's value in exchange markets. Ultimately, policy autonomy may be seriously compromised by the need to avert a flight to other assets.

All these matters are at issue when governments choose what money to use as a reserve currency. The preferences of market actors, based essentially on economic calculus, also play a role; no government will opt for a currency that is not already widely used by the private sector. Central bankers are clearly sensitive to issues of liquidity, exchange convenience, and comparative rates of return. But when choices are made from the small pool of alternatives favoured at the market level, political factors are sure to intervene, too. Key considerations include both the quality of governance in a currency's home economy and the nature of relationships between states.

7. THE ISSUE OF SUSTAINANCE OF DOLLAR:

China and Japan have unveiled plans to promote direct exchange of their currencies in a bid to cut costs for companies and boost bilateral trade. The deal will allow firms to convert the Chinese and Japanese currencies directly into each other. (instead of converting them through the US Dollar). [(1)]

The five major emerging economies of BRICS — Brazil, Russia, India, China and South Africa — are set to inject greater economic momentum into their grouping by signing two pacts for promoting intra-BRICS trade. The two agreements will enable credit facility in local currency for businesses of BRICS countries which is expected to scale up intra-BRICS trade.

Iran has been one of the most aggressive nations when it comes to moving away from the U.S. Dollar in international trade. For example, it has been reported that India will begin to use gold to buy oil from Iran.

(1) http://www.bbc.co.uk/news/business-16330574

Leaders from both Russia and China have been strongly advocating for a new global reserve currency for several years, and both nations seem determined to break the power that the U.S. Dollar has over international trade. Russia and China have been using their own national currencies when trading with each other for more than a year now.

Saudi Arabia and China have teamed up to construct a massive new oil refinery in Saudi Arabia. It would be a matter of concern if Saudi Arabia reconsiders it decision to trade through the petrodollar, given that China is one of its most important customer.

8. IMF SPECIAL DRAWING RIGHTS:

The SDR is an international reserve asset, created by the IMF in 1969 to supplement its member countries' official reserves. Its value is based on a basket of four key international currencies, and SDRs can be exchanged for freely usable currencies. [(2)] To combine the advantages of multiple and single currency systems, a basket-based reserve system, perhaps built on the IMF's Special Drawing Rights (SDRs) is being debated. The SDR is not a currency; it takes its value from its constituent currencies (currently, the US Dollar, Euro, Pound Sterling and Yen, but the basket is periodically reviewed), and this makes it more stable: if one of its constituent currencies depreciates, the share of the others in the basket rises proportionately, dampening the volatility of the basket. However, for the SDR to take on such a significant role, its liquidity would need to increase massively.

The main problem with the SDR is that the institution that issues it, the IMF, is not a bank. This implies that the IMF can ONLY lend and provide SDRs to governments and NOT to private markets. Using SDRs to buy anything in the private market involves a lot of time and expense because you first need to convert them back to the domestic currencies. However, without an effective government to back it, a world reserve currency of any kind—whether based on the SDR or invented de novo—would have difficulty attaining even a minimal level of credibility.

Can enough be created to make a significant difference? Can supply be provided more flexibly? And most critically, who would have the authority to manage it?

CONCLUSION:

While it is interesting to speculate about the future of the international monetary system, and the Dollar's role in it, the reality is that the current system has proved its resilience while the alternatives have not; and though change is likely over time, it will not happen overnight, or by decree. The key challenge for policy makers is to continuously nudge the system toward stability along the way.

(2) http://www.imf.org/external/np/exr/facts/sdr.htm/

SOME IMPORTANT TERMS

1. **Balance of Payments (BOP)** - A statement summarizing the economic transactions between the residents of a country and non-residents during a specific period, usually a year. The BOP includes transactions in goods, services, income, transfers and financial assets and liabilities. Generally, the BOP is divided into two major components: the current account and the capital and financial account.

2. **Exchange Rate**-The price of one currency in terms of another. Most commonly, exchange rates are expressed as the number of units of domestic currency that will purchase one unit of foreign currency.

3. **Liquidity Ratio**-A measure used to gauge the IMF's capacity to provide financial assistance to members and meet members' claims on the IMF. It is the ratio of the IMF's net uncommitted usable resources to its liquid liabilities.

4. **SDR Interest Rate**-Weighted average of interest rates on short-term financial instruments in the markets of the currencies included in the SDR valuation basket. It is determined on a weekly basis.

5. **Currency depreciation/ appreciation** – Depreciation refers to the loss of value of a country's currency with respect to one or more foreign reference currencies. The appreciation of a country's currency refers to an increase in the value of that country's currency. These fluctuations are typically experienced in a floating exchange rate system.

6. **Devaluation/Revaluation**- Devaluation is the deliberate downward adjustment to a country's official exchange rate relative to other currencies. Revaluation is a calculated upward adjustment to a country's official exchange rate relative to a chosen baseline. This kind of behaviour is a characteristic of a fixed exchange rate system.

7. **Fixed exchange rate**-a type of exchange rate regime where a currency's value is fixed against the value of another single currency or to a basket of other currencies, or to another measure of value, such as gold.

8. **Floating exchange rate** -a type of exchange rate regime wherein a currency's value is allowed to fluctuate according to the foreign exchange market.

9. **Seigniorage**-the economic cost of producing a currency within a given economy or country. If the seigniorage is positive, then the government will make an economic profit; a negative seigniorage will result in an economic loss.

10. **Gold Standard**- A monetary system in which a country's government allows its currency unit to be freely converted into fixed amounts of gold and vice versa.

11. **Currency war (competitive devaluation)** - a situation in which countries compete against each other to achieve a relatively low exchange rate for their own currency.

QUESTIONS TO BE ADDRESSED:

1. What are the alternatives to the US Dollars? What are their advantages and drawbacks?
2. Through what process can the US Dollar be replaced by an alternative currency?
3. Should a basket of currencies or an independent currency be proposed as an alternative?
4. What would be the impact of a change in the reserve currency on the global economy?
5. Is the SDR a viable option?
6. Should the countries hold gold and use that as a reserve?
7. In the light of the recent scams that have occurred in manipulation of trade of Silver, do you feel that precious metal manipulation can cause a problem?
8. What should be the main features of the alternative currency?

LINKS FOR FURTHER RESEARCH:

1. http://www.imf.org/external/pubs/ft/sdn/2011/sdn1116.pdf - Financial deepening and international monetary stability
2. http://www.imf.org/external/np/exr/facts/sdr.htm/ - Special drawing rights
3. http://www.reuters.com/article/2012/07/27/markets-forex-idUSL2E8IRAYN20120727
4. http://www.imf.org/external/pubs/ft/GFSR/index.htm - Global Financial Stability report
5. http://www.reuters.com/article/2012/03/18/us-china-currency-imf-idUSBRE82H02L20120318
6. http://www.imf.org/external/pubs/ft/weo/2012/update/01/pdf/0112.pdf - World Economic Outlook