

Sustainable Developments

Rethink the Global Money Supply

Less reliance on the U.S. dollar by international reserves would be widely beneficial

BY JEFFREY D. SACHS



The People's Bank of China jolted the financial world in March with a proposal for a new global monetary arrangement. The proposal initially attracted attention mostly for its signal of China's rising global economic power, but its content also has much to commend it.

A century ago almost all the world's currencies were linked to gold and most of the rest to silver. Currencies were readily interchangeable, gold anchored exchange rates and the physical supply of gold stabilized the money supply over the long term.

The gold standard collapsed in the wake of World War I. Wartime financing with unbacked paper currency led to widespread inflation. European nations tried to resume the gold standard in the 1920s, but the gold supply was insufficient and inelastic. A ferocious monetary squeeze and competition across countries for limited gold reserves followed and contributed to the Great Depression. After World War II, nations adopted the dollar-exchange standard. The U.S. dollar was backed by gold at \$35 per ounce, while the rest of the world's currencies were backed by dollars. The global money stock could expand through dollar reserves.

President Richard Nixon delinked the dollar from gold in 1971 (to offset the U.S.'s expansionary monetary policies in the Vietnam era), and major currencies began to float against one another in value. But most global trade and financial transactions remained dollar-denominated, as did most foreign exchange reserves held by the world's central banks. The exchange rates of many currencies also remained tightly tied to the dollar.

This special role of the dollar in the international monetary system has contributed to the global scale of the current crisis, which is rooted in a combination of overly expansionary monetary policies by the Federal Reserve and lax financial regulations. Easy money fed an unprecedented surge in bank credits, first in the U.S. and then elsewhere, as international banks funded themselves in the U.S. money markets. As bank loans flowed into other economies, many foreign central banks intervened to maintain currency stability with the dollar. The surge in the U.S. money supply was thus matched by a surge in the money supplies of countries linked to the U.S. dollar. The result was a temporary worldwide credit

bubble, followed by a wave of loan defaults, falling housing prices, banking losses and a dramatic tightening of bank lending.

China has now proposed that the world move to a more symmetrical monetary system, in which nations peg their currencies to a representative basket of others rather than to the dollar alone. The "special drawing rights" of the International Monetary Fund is such a basket of four currencies (the dollar, pound, yen and euro), although the Chinese rightly suggest that it should be re-based to reflect a broader range of them, including China's yuan. U.S. monetary policy would accordingly lose its excessive global influence over money supplies and credit conditions. On average, the dollar should depreciate against Asian currencies to encourage more U.S. net exports to Asia. The euro should probably strengthen against the dollar but weaken against Asian currencies.

The U.S. response to the Chinese proposal was revealing. Treasury Secretary Timothy Geithner initially described himself as open to exploring the idea; his candor quickly caused the dollar to weaken in value—which it needs to do for the good of the U.S. economy. That weakening, however, led Geithner to reverse himself within minutes by underscoring that the U.S. dollar would remain the world's reserve currency for the foreseeable future.

Geithner's first reaction was right. The Chinese proposal requires study but seems consistent with the long-term shift to a more balanced world economy in which the U.S. plays a monetary role more coequal with Europe and Asia. No change of global monetary system will happen abruptly, but the changes ahead are not under the sole control of the U.S. We will probably move over time to a world of greater monetary cooperation within Asia, a rising role for the Chinese yuan, and greater symmetry in overall world monetary and financial relations. ■

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