

Edge Weekly

# My Say: Regional currency arrangements come with huge challenges

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24 May 2023, 11:30 am



This article first appeared in Forum, The Edge Malaysia Weekly on May 22, 2023 - May 28, 2023

De-dollarising seems to be in vogue these days. China, Russia and their BRICS (Brazil, Russia, India, China and South Africa) partners may have initiated the narrative but the desire to remove or at least reduce the US dollar's hegemony has spread. Many nations, including Malaysia, have openly articulated their desire to move away from US dollar dependence for their trade.

Though it has been a long time coming, the rising disdain of the US dollar is in no small part due to American policy hubris and abuse of its reserve currency status. As the only country that can repay its foreign debt in its own currency, it has run years of current account deficits, created a mountain of debt surpassing US\$30 trillion (RM136 trillion) and effectively piggybacks on the rest of the world with its autarchic monetary policies.

Like the proverbial big borrower who worries less about a default than his banker, the current brinkmanship being played out in the US Congress over the debt ceiling and potential default causes stress and sleepless nights not in Washington but in Beijing, Tokyo, Seoul and the other Asian capitals — these being the nations that have provided the debt funding, accumulated huge dollar reserves and now have massive exposure to both the US dollar and American policy vicissitudes.

Some months earlier, the dollar had caused a different headache — the rapid rise in US interest rates from near zero to 5% saw every other currency depreciating. Dollar-based commodity prices rose, and the interest rate hike altered the terms of trade of emerging markets, increased the burden of their foreign liabilities and induced volatility in global financial markets.

That despite all these, the dollar remains dominant is testimony to the lack of an alternative. The dollar's dominance began with the Bretton Woods system in 1945 under which it was the anchor currency. However, even the system's collapse in 1972, caused by American profligacy that eroded the dollar's gold parity, appears to have done little to reduce its dominance as a global currency. Even now, 60% of global trade is dollar denominated.

There were two reasons for this supremacy. First, despite its problems, the dollar has over the years played relatively well the three key roles of a well-functioning currency — as a medium of exchange, store of value and unit of account. The second and perhaps more important reason is the lack of an alternative currency that can replace the dollar. The euro is far too small, lacks the liquidity and capital market depth and, as the events of 2011 with Greece had shown, has its own set of problems. The Chinese yuan, though increasingly popular in trade settlement, is not fully convertible, being hobbled with capital controls, opaqueness in policy and effectively subject to one-man rule. Thus, as in the world of the blind where the one-eyed man is king, the dollar continues to reign supreme despite its inadequacies.

For US policymakers, the dollar's supremacy is taken for granted as nothing can threaten it, at least not in the foreseeable future. Thus, the weaponisation of the dollar, the unilateral imposition of sanctions, the liberal use of prohibiting access to SWIFT and effectively cutting off countries from the global financial system can all continue for a while as no other currency comes close to dethroning the dollar.

So, where does this leave the rest of the world that seeks to de-dollarise? The bilateral trade agreements to settle payments in local currency are really a non-starter. For countries like Malaysia, it may be effective with some currencies but not with others. For example, it could work for the Chinese yuan as Malaysian exporters who receive the yuan could use it to either pay for their imports from China or other parties with trade links to China who would want the yuan.

However, this may not be the case with other bilateral arrangements, for example, with India. It is hard to imagine how the Malaysian exporter who previously received payment in US dollars for his exports to India is better off getting paid in rupees. Where he could previously use his US dollar revenue to source anything from anywhere in the world, with rupees he is severely limited. The same limitation applies to the Indian exporter who now gets paid in ringgit. The difference here is as a medium of exchange. Whereas the US dollar is highly liquid and efficient as a medium of exchange, the yuan is less so and the rupee much less so.

Thus, before pushing for more bilateral arrangements, there are two factors that need to be considered. First, with currencies deemed more volatile and not a good store of value, bid-ask spreads or transactions costs would be higher. Second, the price quotes one receives is often dependent on the currency you would pay with. Even in India, you get a better deal if you pay in US dollars than in rupees. So, let's not get too excited about arrangements that will allow for local currency settlement of trade. Their only benefit may be less reliance on the US dollar, but at a potentially huge cost.

Regional currency arrangements (RCAs) may be a more sensible route, not just to de-dollarise but for its other benefits like enhanced trade and economic integration, exchange rate stability and reserves management. Where no one currency can now challenge the US dollar, a composite regional currency could.

Broadly speaking, RCAs could range from a common currency area (CCA) or currency union with fixed pegs to looser target zone type arrangements. The euro area and WAMU (West African Monetary Union) would be examples of the former while the

EMS (European Monetary System), forerunner to the euro, is an example of a target zone arrangement.

The EMS, established in 1979, enabled the 12 participating countries to reduce inflation, stabilise their currencies and enhance trade and economic integration. Yes, it had its problems but over the 20 years until 1999, it enabled the countries to integrate and evolve into a single currency area. At the heart of the EMS was the European Currency Unit (ECU), which was simply a statistical GDP-weighted composite currency. Under the exchange-rate mechanism, each participating currency was linked to the ECU at a fixed rate. However, to avoid a fixed peg and the policy restrictions that come with fixed pegs, currencies were allowed to fluctuate within a band. The band, first set at 2.25%, was later raised to 6% and then 15%. The flexible bands enabled participating countries to benefit from the stability afforded by the RCA without sacrificing economic sovereignty.

It is such flexible arrangements designed on the EMS template that emerging nations aspiring for RCAs should aim for. Fixed peg, monetary union type arrangements would certainly provide more currency stability but the policy restrictions they require can be debilitating. Unless the needs of participating countries are in sync and aligned congruently as with the EU nations or WAMU, a CCA can be notoriously difficult to operationalise. More than the economics, it is in the politics that the real hurdles lie. Imagine the BRICS negotiating a common currency arrangement. How much of its economic sovereignty do you think China would be willing to sacrifice for India's benefit? And how much would India be willing to sacrifice for China's benefit? Therein lies the problem. And so long as such problems exist, the dollar will continue to reign supreme.

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