Internationale Politikanalyse
International Policy Analysis

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What comes after the dollar?

- The US dollar is at risk of losing its status as the world's prime reserve currency. The "hard landing" of the US currency therefore holds the potential to change the parameters of the world economy.
- The euro could emerge as the new world reserve currency – with all the associated costs and benefits.
- The euro comes after the dollar. But in addition to the growing importance of the euro, the trend toward monetary regionalization will be reinforced. This raises the specter of a resurgence of protectionism in the world economy.
- The article discusses the scenarios of "euroization" and regionalization of the world's monetary system against the backdrop of sustained US dollar weakness. The authors advise Europe to leverage its emerging new role to push for a multilateral institutionalization of the global monetary order.

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1 The end of the global deal

From Frankfurt to New York, from London to Washington, from Davos to Tokyo, for months now the US credit crisis has been the no.1 topic on the world economic circuit. Understandably, the day-to-day political debate is dominated by questions of a short-term nature: can recession be averted in the US; how will the downward trend in world financial markets be stopped; how can the negative consequences for Europe, Asia and other regions of the world best be contained? But the present situation also gives rise to some weighty long-term questions. One of the most important of these for the global economy concerns the future of the world monetary system.

Since the end of the Second World War the US dollar has been the world's dominant commercial and reserve currency. The US has managed to hold on to its monetary supremacy through a good number of economic and political upheavals. After the US, under President Richard Nixon, abandoned gold convertibility in 1971 this supremacy has thrived on nothing but trust – the trust of international economic agents (from central banks and financial investors to oil-producing countries) in the size and the growth prospects of the US economy, as well as in the ability of the US Federal Reserve to safeguard long-term price stability.

Since the early days of the rise of China and other second-generation Asian tigers, the status of the US dollar has been closely linked with the US' role as the "consumer of last resort." In the wake of the painful experience of the 1997–98 Asian financial crisis, in which a headlong exodus of capital induced Indonesia, South Korea, Malaysia, and Thailand to sell off more than a quarter of their foreign-exchange reserves before they were finally forced to abandon their fixed exchange rates to the dollar, the region adopted an aggressively export-led growth model. This model was based on fixed, undervalued national currencies coupled with targeted efforts to accumulate foreign-exchange reserves. As Dooley, Folkerts-Landau, and Garber (2003) have pointedly observed, the implicit global economic and monetary arrangement was that the US would buy consumer goods manufactured in East Asia, thus supporting the development of productive capacities there, while in turn the Asian countries would "recycle" their export surpluses in US government bonds, ultimately financing US consumption. The mechanism works as follows: foreign central banks purchase US government bonds, in this way supporting the US dollar; the high foreign demand for US bonds keeps US interest rates at low levels (in the government bond market in the first instance, but indirectly also for mortgage loans, business loans, and consumer credit); business profits rise, together with equity and house prices; this in turn sustains business confidence and a high propensity to consume in the US.

With oil prices rising constantly since 2002, the oil-exporting countries have also signed up to this implicit global deal. Like China and other emerging markets, they have built up huge current-account surpluses and invested (at least part of) these foreign-exchange earnings in the US securities market.

What back in 2003 looked like a viable long-term functional specialization in the world economy to Dooley et al. appears today, five years later, more like a model doomed to extinction. China alone has been so fast in expanding its productive capacities (by double-digit annual growth rates) that its current-account surplus grew more than sevenfold in the years between 2002 and 2006 (to a level of US$ 250 billion, or 9.5 % of its annual economic output). This we find mirrored in the US current-account deficit, which swelled in the same period from US$ 459 billion to US$ 811 billion (6.2 % of US GDP for 2006).

Against the background of this external deficit (and the simultaneous fiscal expansion pursued by the Bush administration, which pushed the public budget deep into the red), the US dollar began to spiral downward, losing over 50 % of its value against the euro and a sizeable 15 % in trade-weighted terms between 2002 and 2004 (see Fig. 1). Since 2006, following a one-year recovery phase, this decline has continued apace, even accelerating in connection with the subprime mortgage crisis that broke out in 2007.

All of this points clearly to the dual dilemma faced by the Federal Reserve. First, its task is twofold in nature. Unlike the European Central Bank (ECB), whose paramount priority under the EU treaties is containment of inflation, the Fed's task is to work for both price stability and full employment, and this, in the short term, inevitably means a trade-off. By aggressively lowering its policy rate in early 2008, the Fed has – despite continuing inflation risks due not least to rising oil and food prices – opted unambiguously for measures designed to stimulate the economy and protect jobs.

Second, the Fed is simultaneously faced with both a turndown in domestic business activity and a decline in the external value of the US currency. In this connection the Fed's hasty interest rate cuts can be interpreted only as a clear-cut prioritization of the domestic sphere. All the Fed could wish for regarding the US dollar exchange rate is that it might be possible to repeat the double success achieved in 2001, when a series of drastic interest-rate cuts (from 6.50 % at the

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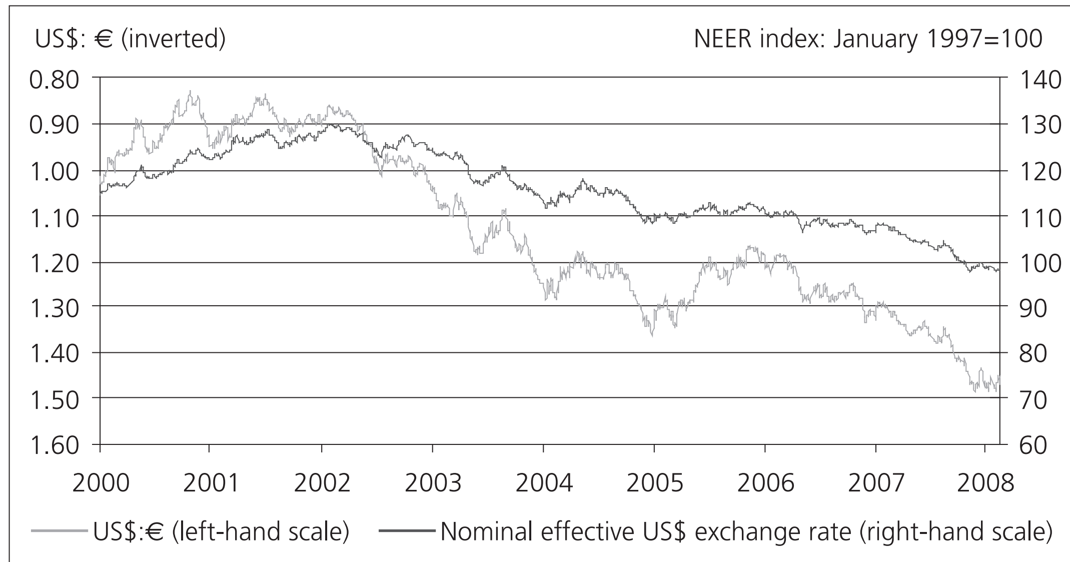
Figure 1: US dollar exchange rates, 1 January 2000–15 February 2008



Source: Federal Reserve

beginning of the year to 1.75 % in mid-December) not only prevented a recession in the US, but also, counter-intuitively, bolstered the US dollar in foreign-exchange markets. The first success was accomplished by creating more favorable conditions for credit in the US, sparking a real-estate boom that boosted consumption. The second can only be explained by a confidence effect in foreign-exchange markets, as it flew in the face of all economic theory, which sees the interest rate as the return on a currency and would thus have predicted a precipitous downturn for the dollar in response to interest-rate cuts.

However, it seems more than doubtful that this could work again today in view of the US' current external deficit, government shortfall and level of private household debt, to say nothing of the structural problems emerging in the financial markets.[1] Viewed in connection with the decline in the value of the US dollar during recent months, all these factors indicate that the confidence foreign investors and central banks have shown for many years in the US' ability to link economic growth with price stability is gradually eroding.

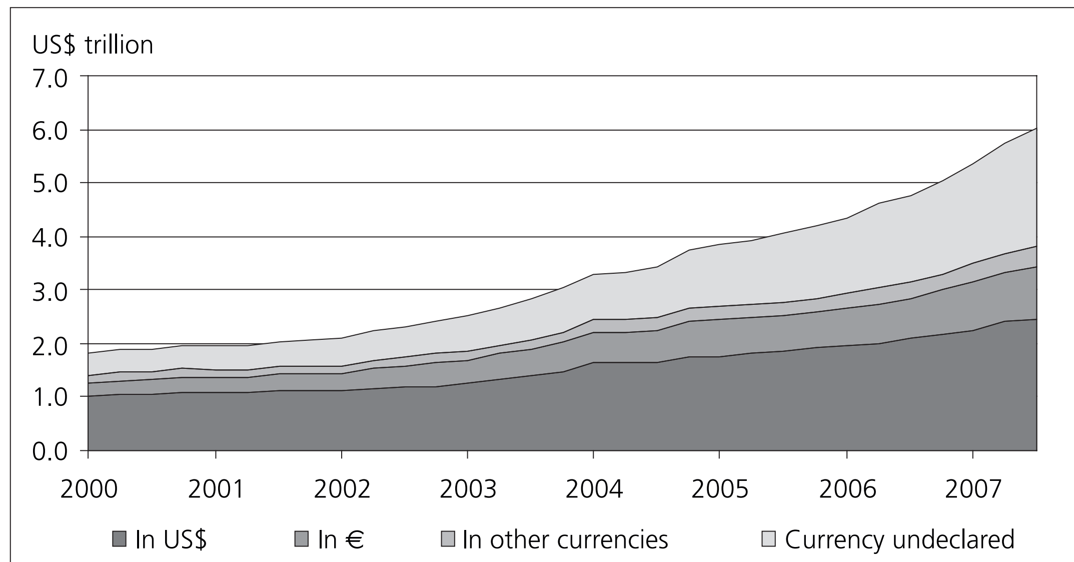
But since the dollar is the primary global reserve currency (see Fig. 2), a weak dollar translates into a de facto devaluation of the foreign-exchange reserves that central banks around the world have accumulated in recent years. In fact, exchange-rate fluctuations explain much of the decline observed in the proportion of US dollars in the world's foreign-exchange reserves with known currency composition (roughly two thirds of total reserves). At least at present, the available figures do not suggest that a systematic policy of moving reserves out of the US dollar is being pursued by the world's central banks.

This statement is, though, in need of two provisos:

1. In recent years various countries with high foreign-trade surpluses have diverted substantial sums into sovereign wealth funds (SWF). Compared with traditional foreign-exchange reserves, these SWFs can not only earn higher returns (on account of their riskier investment strategies), they are also not subject to the same multilateral reporting requirements in effect for official currency reserves. However, as far as the external value of the US dollar

1 In converting mortgage loans into securities which were then sold in the capital market, US banks largely passed on to other creditors the repayment risk always associated with lending. This blurred banks' incentives to carefully check the creditworthiness of their borrowers, and this in turn played a key role in the massive expansion of lending to households lacking a good credit rating. In conjunction with an institutionalized conflict of interests on the part of rating agencies (which are paid by issuers of these bonds and thus have an incentive to underestimate the level of the risk they bear), the complexity of the family of mortgage-backed loans served to conceal the actual risk associated with these securities. Worse still, banks sold these mortgage-backed bonds in the capital market through unregulated subsidiaries in order to ensure that these claims would not appear on their balance sheets, undermining their core capital buffer. This lack of transparency concerning what credit risks had been assumed by which financial institutions was an important factor in the drying-up of lending activity in the interbank market, thus contributing to the international spread of the crisis (see Kellermann 2007).

Figure 2: Global reserves by currency, Q1 2000–Q3 2007



Source: IMF, Currency composition of official foreign exchange reserves (COFER)

is concerned, their function is quite similar to that of reserves.

2. States are required to report regularly to the IMF on the level of their total reserves, but not on the latter's currency composition – which many countries treat as a state secret. This trend toward secrecy has even increased in recent years: since 2004 the sum of those reserves whose currency composition remains undeclared has risen at rates in excess of 20 % p.a. (see Fig. 3). Between 2000 and 2007 the share of these undeclared reserves worldwide rose from 22 % to 36 % (see Fig. 2). This is mainly due to the fact that in recent years countries with restrictive information policies have accounted for a large part of the increase in total world reserves.

On account of these two large unknowns (investment activities of SWFs and currency composition of reserves) we would be likely to perceive a reshuffling of official funds (e.g. out of the US dollar) only indirectly and belatedly (e.g. on the basis of a declining US dollar exchange rate or US balance-of-payments statistics – see Munchnau 2007).

In any event, in view of the high percentage of currency reserves held in US dollars (still over 60 % of the reserves with known composition, i.e. at least 40 % of total reserves), the world has a collective interest in supporting the US dollar. Individually, however, foreign central banks have a constantly growing incentive to diversify their own reserves before the dollar falls any further. This entails the risk of a massive and abrupt downward spiral.

While the East Asian emerging markets need the US as a consumer in the framework of the export-driven growth model for which they have opted, and thus have an additional interest in supporting the dollar's external purchasing power, the oil-producing countries have a much lesser interest in supporting the US' role as a consumer of last resort. True, a US economic turndown would tend to depress oil prices, but not only has US oil consumption been relatively unresponsive to fluctuations in US domestic growth, global demand for oil (and thus rises in its price) has been driven mainly by the ongoing expansion in Asia, not primarily by the US economy.

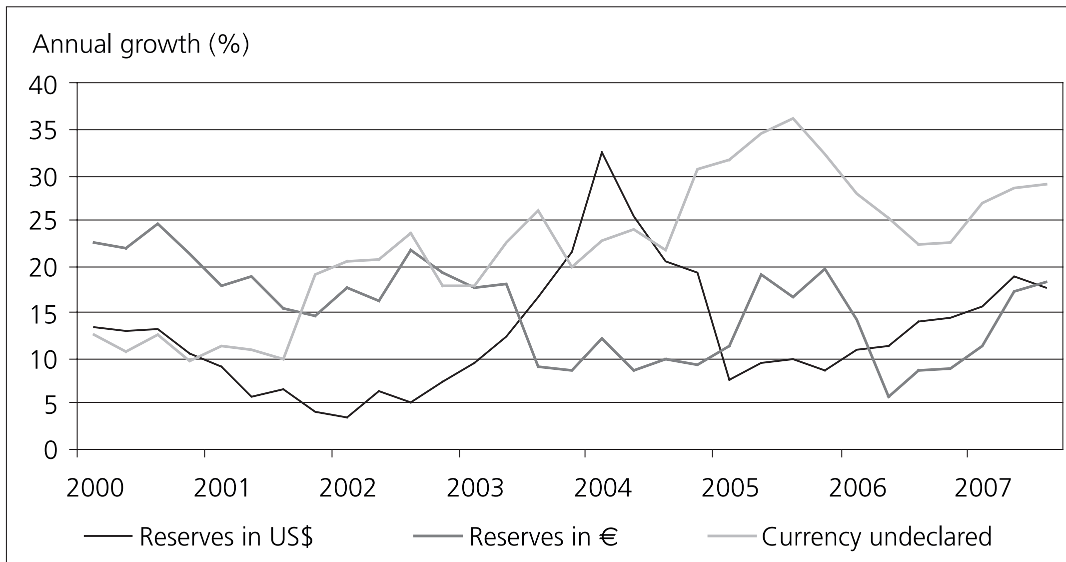
2 Scenarios for the future of the world monetary system

As noted at length in Part 1 above, there may be some serious upheavals in store for the US-centered world economic and monetary system. The following section discusses three relevant scenarios.

2.1 Continuing dominance of the US dollar

Of course it is impossible to rule out that the subprime mortgage crisis will turn out to be a tempest in a teapot. International investors might regain confidence in the ability of the US economy to deliver sizable returns over the medium to longer term, even if interest rates remain low for a time. Should the Fed's

Figure 3: Growth of global reserves by currency, Q1 2000-Q3 2007



Source: IMF, Currency composition of official foreign exchange reserves (COFER)

rate-cutting strategy, in conjunction with the economic stimulus package from the US federal budget, succeed in boosting demand in the world's largest economy, and should the present downturn in the value of the US dollar help to redress the US current-account deficit, confidence might well return. In a situation of this kind, Asian central banks would likely come to the conclusion that the US will be able and willing to continue to play the part of the consumer of last resort and, consequently, seek to prolong the status quo.

But this scenario appears implausible to us for three reasons:

1. China and some of its neighbors (though not Japan) have experienced, since the third quarter of 2007, a surge in inflation that raises the question of whether and to what extent Asian central banks will continue to be in a position to neutralize the inflationary pressure stemming from massive inflows of foreign exchange without allowing their currencies to rise significantly, a strategy they have pursued with considerable success in recent years. If this so-called sterilization policy runs up against limits, it is at least conceivable that the countries concerned would allow the value of their currencies to drift upward in the name of price stability. The direct effect of this would be to weaken the US dollar further. If a decision of this kind was coupled with a general flexibilization of exchange rates, this would create yet another incentive to rebalance currency reserves out of the US dollar.
2. One central element of any national or international monetary system that depends solely on confidence, and no longer on an external anchor (e.g. gold in the 1950s and 1960s), is the credibility of the commitment of central banks to guarantee price stability. This is because one effect of inflation is to undermine a currency's real value – to the disadvantage of all those who hold this currency. With its radical interest-rate cuts (timed in a way that suggested obedience to Wall Street interests alongside concerns about the wider economy), the Fed is squandering the credibility of its commitment to fight inflation. In other words, cuts in interest rates (the return on the US currency) are now joined by the prospect of higher inflation. Together, these two factors cannot help but undercut the attractiveness of the US dollar, and their combined effect would likely be to place the dollar under growing pressure.
3. Another peculiarity of the present situation is that a weak phase of the US economy coincides with a number of structural imbalances. For years now the US has been consuming far more than it produces, financing this overconsumption with cheap credit provided by the rest of the world merely on account of the US dollar's status as the world's primary reserve currency. Deeply rooted doubts as to the sustainability of a world economic system based largely on a task-sharing arrangement that translates into consumption for the US and saving and/or production for East Asia are increasingly gaining weight in the world's markets. In view of

this fact any attempt simply to muddle on would appear to be implausible in that this would only exacerbate the existing global external-trade imbalances, further increasing the risk of an abrupt dollar crash, as outlined above; for once a critical mass of economic agents is convinced that a given arrangement is unsustainable in the long run, its days are usually numbered.

Even if, under the framework conditions given at present, a soft landing seems unlikely for the US economy, this does not imply that the US dollar will automatically lose its position as the world's key reserve currency. Indeed, one conceivable approach would be for the US to alter its interest-rate policy once it has become evident that structural adjustment is inevitable. Should the present strategy of interest-rate cuts prove ineffective as a means of reviving the economy (as we expect), the US would most likely be headed into a phase of "stagflation." In the late 1970s, when the US found itself faced with a phase of simultaneous economic stagnation and inflation, the Fed – ideologically motivated by monetarism – ultimately changed course: it reprioritized the fight against inflation and drastically raised interest rates. Both in the US and other parts of the world this prompted a phase of weak growth (with disastrous impacts on developing countries: this policy was instrumental in triggering the 1980s Latin American debt crisis). But this tight-money policy was successful to the extent that it restored confidence in the US dollar as an international reserve currency. It may well be justified to expect a similar reversal in monetary policy today too if the present strategy proves unable to avert a hard landing for the US economy.

If the US changes its policy stance in this sense, it would again be conceivable for Washington to (re) turn to a course of multilateralism, or at least one of cooperative currency management. Instead of basing its support for the US dollar exclusively on its national interest-rate policy, the US could seek to win the support of other countries for an action to rescue the US dollar as the key world reserve currency. In so doing, the US would be banking on a reflex widespread in Asia, but also in Europe, namely to keep the value of one's own national currency – mindful of the export industry – as low as possible.

2.2 The euro as the new world currency

Unlike other periods of dollar weakness, all of which the US currency survived without losing its position as a reserve medium, the world today has an alternative currency, and one with comparable liquidity in bond and foreign-exchange markets: the euro. If we compare the size of the two economies, we find that in the coming years the balance is likely to tip in favor of the eurozone. Not only did the European economy outperform the US economy in 2007, the stage is also set for further enlargement of the European Monetary Union. A dozen EU member states still have currencies of their own, and at least half of them have good chances of joining the monetary union in the course of the coming five years, including the sizable economies of Poland, the Czech Republic and Denmark. Thus, for the first time in post-war history, there is another currency area large enough to stand a realistic chance of supplanting the US dollar as the world's key reserve currency (see Dauderstädt/Kellermann 2007).

If the euro develops into the world's central reserve currency, this would no doubt entail major change for the eurozone. On the economic side, the eurozone would enjoy a number of advantages that at present accrue mainly to the US:

- Structurally greater demand for the euro would serve to lower the market rate of interest. This reduction in the cost of credit would in turn ease budget pressures in Europe and foster investment and consumption.
- Eurozone bond issuers (be they governments or firms) would be able to borrow without incurring exchange-rate risk because the euro's status as the main reserve currency would induce external investors to grant loans denominated in euros.[2]
- In economically uncertain times investors prefer to put their funds in assets denominated in the reserve currency. This "flight to safety" works in favor of anticyclical currency movements, i.e. tends to lower the risk of a currency slump induced by temporary cyclical weaknesses.
- A rise of the euro to become the world's key reserve currency would also work in favor of a shift in international trade out of the dollar and into the euro. Viewed from the standpoint of eurozone consumers (e.g. of raw materials), but also of producers (e.g. of passenger aircraft), the establishment of the euro as a key medium of world trade would serve to eliminate one potential factor behind price volatility, namely the exchange rate

2 While this is largely already the case (only roughly 10 % of all outstanding bonds issued by euro-area agents are denominated in currencies other than the euro), we can nevertheless assume that external agents are still less willing to buy euro bonds if the eurozone's external economic situation was to worsen substantially than this has until now been the case with the US.

between the domestic currency and the currency used for world trade.

On the other hand, though, if the euro developed into the world's primary reserve currency, the eurozone would be deprived of the option of using the euro as an instrument of export promotion. Even today the euro is actually not used this way, as the ECB has generally shown restraint when it comes to monetary intervention so as not to jeopardize the credibility of its efforts to fight inflation, its paramount goal. However, the frequent complaints expressed by eurozone governments (above all by Italy and France, but every now and then by Germany as well) about the euro's strength and the negative effects this has on exports raises doubts about these countries' willingness to tolerate any development of the euro into the world reserve currency.

This would require a political-cultural paradigm shift in Europe. The central economic advantage of an economic area whose currency is accepted internationally as a reserve medium is that this area would be able to afford to consume – albeit within limits – more than it produces, since other countries would be prepared to grant the issuer of the reserve currency long-term credit on favorable terms and in the issuer's own currency. To recognize this as an advantage, it would first be essential to make it generally clear in the eurozone that economic success should be measured in terms of consumption, rather than just in terms of output – and that a country benefits economically from its imports, not its exports.

As long as this insight has not found general acceptance, there is a danger of Europe falling back to protectionist policies as a means of counteracting any decline in European exports (resulting from euro appreciation) or the growing trade deficit with China and other weak-currency countries that would inevitably ensue. There can be no doubt that imposing punitive tariffs or erecting other (non-tariff) import barriers would send a fatal signal concerning the euro's readiness to serve as the key world currency: it would indicate that the eurozone was more intent on short-term protection of its export-oriented jobs than on taking advantage of the structural economic advantages that the key currency offers its issuer.

If the EU and the eurozone succeeded in withstanding the – probably mounting – political pressure in favor of protectionism, in this way supporting the euro's rise to the world's key reserve currency, this would then make it possible to adopt a second, similarly important action strategy: Europe could and should push to place the world monetary system on a multilateral footing. On the one hand, this would serve to avert the persistent use of competition-distorting undervaluation strategies that China and Japan have adopted. On the other hand, it would prevent Europe from incurring too much debt in response to its newly gained international credibility as the issuer of the world's reserve currency that could, theoretically, afford to consume more than it produces. Simply continuing what Dooley et al. refer to as the post Bretton Woods System, now with an institutionalized European supremacy, would certainly not be the right multilateral approach. Instead, a set of fundamental institutional reforms would be called for (see Kellermann 2006).

2.3 Monetary regionalization

A third possibility, and one wholly compatible with the two scenarios outlined above, consists in a more pronounced tendency toward monetary regionalization. Like the European Union, the countries of other regions could intensify their efforts to join forces to create free-trade areas and currency zones, engaging in a kind of regional external economic policy. The beginnings of such tendencies are already observable in Asia and Latin America, but also in the Gulf states, though the extent of these efforts differs substantially from one region to another.

The projects particularly relevant to the future of the world monetary system are those geared to monetary regionalism, i.e. to currency unions or looser cooperative mechanisms. Depending on the extent of cooperation of this kind, the countries involved will see themselves forced to relinquish part of their sovereignty, a politically sensitive undertaking. The first central advantage of monetary cooperation is that it serves to contain exchange-rate fluctuations, a fact that, on its own, has positive implications for trade. Many countries have until now sought, for the most part unilaterally, currency stability in relation to the US dollar, a state of affairs that has much to do with the US' position as an important worldwide trading partner. Should a recession appreciably weaken US demand for imports, other countries would have less of an incentive to gear their currency-stability policy to the US, quite aside from the inflation risk posed by a declining US dollar for countries with a dollar peg. As geographic proximity fosters trade flows between the countries in a given region, regional monetary cooperation offers an interesting option for countries interested in counteracting destabilizing exchange-rate fluctuations not only vis-à-vis *one* important trading partner but in relation to an entire economic region. In addition, if countries in a region pool their currency reserves, and in particular if they take the step of cre-

ating a common currency, they will be in a far better position to shield themselves from financial crisis and/or speculative attacks on their currency than they would be each on their own. However, in view of the multifarious obstacles that need to be overcome before any more far-reaching regional monetary agreements can be effectively enforced (such as acceptance of limitations on the scope for national fiscal action), the chances that projects of this kind will be realized are relatively slim in the short to medium term.

Outside Europe it is mainly the countries of East Asia that are seeking closer monetary cooperation, and have in part even already achieved it. At the height of the Asian financial crisis the Japanese government proposed the creation of an Asian Monetary Fund. In the case of a renewed crisis, this fund was supposed to make liquidity available, albeit without imposing the economic-policy conditionalities typically required for IMF loans at that time. However, the Japanese plans failed in the face of the resistance put up by the US government, but also in view of China's reservations concerning the special role that Japan aspired to play in the arrangement. Once this relatively far-reaching initiative had failed, the ASEAN countries joined forces with China, Japan, and South Korea to create a liquidity pool – in the form of a network of bilateral swap arrangements covering the exchange of national currency against other currencies.

This arrangement – known as the Chiang Mai Initiative – presently has an overall volume of US$ 83 billion. Since its creation in 2000 there have been ongoing discussions about an institutionalization of monetary cooperation – thus far, though, without much success. The initiative has therefore not advanced beyond the status of a de facto regional liquidity fund that – much like the IMF – for the most part attaches conditions to the loans it provides. Another interesting step is the Asian Bond Markets Initiative (ABMI), which was created to develop efficient and liquid bond markets in Asia. Both of these instruments show that there has been a real interest in monetary cooperation since the Asian crisis, not least because the countries in the region have little confidence in the multilateral regime under the auspices of the IMF (a fact also signaled by the size of the currency reserves held in Asia).

While the financial requirements for a credible regional cooperation are given in Asia, largely due to the volume of the foreign-exchange reserves held there (see Dieter 2003), no further-reaching regional integration, e.g. in the form of a regional monetary system, is expected for the near future. Firstly, East Asian countries, including Japan and China, are engaged in competitive exchange-rate policy not only vis-à-vis the US and the eurozone but among one another as well. If, as is to be expected, the export environment deteriorates for East Asia as a result of weak growth in the US, the undervaluation strategies pursued in the region are likely to grow in importance. Use of a national currency as a national export-promotion instrument is, however, in no way compatible with the aim of creating a regional monetary union. Secondly, a monetary union would call for some form of monetary and fiscal policy coordination. This is, for political reasons, not an option at the present juncture. Indeed, in Asia all forms of regional (political or economic) institutionalization, wich where already given in Europe when the monetary union was established, are still in their infancy. In summary, from today's perspective, outside the EU, Asia is the region that has made the most progress on the road to a deepened monetary regionalism, but this progress has still been modest, and there are clear-cut limits to its further development.

Regionalization tendencies on other continents are less advanced, even though they have similarly high ambitions. Latin America, for instance, has long been pondering a closer monetary cooperation modeled on the European monetary system. And recently Argentina, Bolivia, Brazil, Ecuador, Paraguay, Uruguay and Venezuela even went as far as to establish the so-called Banco del Sur. Latin America thus has a new development bank in addition to the Mercosur customs union, whose members include Argentina, Brazil, Paraguay, and Uruguay (Venezuela has membership only on paper, since it has yet to adopt Mercosur external tariff rates). The Banco del Sur is – much like the Asian initiatives outlined above – largely a product of dissatisfaction with the US-dominated IMF. Unlike the Asian Chiang Mai Initiative, though, the South American project has been given the form of a development bank, and its capital endowment is accordingly small (US$ 7 billion). Furthermore, the bank is reliant on Venezuela's oil revenues, which are, by their nature, quite volatile. For these reasons, the Banco del Sur would be unable to assume the role of a liquidity fund for member countries in times of crisis. While the possibility that the Banco del Sur may serve to advance regional integration cannot be ruled out, at present it does not offer any realistic prospects for monetary regionalism.

Monetary-regionalism fantasies are also to be observed among the member countries of the Gulf Cooperation Council (Bahrain, Qatar, Kuwait, Oman, Saudi Arabia, and the United Arab Emirates). But thus far the efforts of these countries have not gone beyond declarations of intent, even though they might

well have good reasons to adopt a common currency: their currencies' traditional dollar peg has entailed some acute problems with inflation in connection with US dollar depreciation and the interest-rate policies pursued by the Fed. Sufficient liquidity for monetary integration would certainly not constitute a problem. However, these countries appear to be shifting more in the direction of a euro peg or alignment with a euro-heavy currency basket, a step that Kuwait has already initiated unilaterally, thus pouring cold water on the project of closer currency cooperation. The region therefore seems to be headed into a phase involving unilateral separation from the US dollar. A common currency or closer monetary cooperation is still a long way off.

On the whole, a tendency toward monetary regionalism in response to (regional) financial crises exists and might well continue, and even intensify, should the US economy be in for a hard landing, with the value of the US dollar heading into a downward spiral. Thus far, though, regional cooperation initiatives have been restricted to instruments that do not require the countries involved to relinquish any of their national sovereignty; no further-reaching political steps toward integration – of the kind taken by the EU – have to date been taken anywhere. One of the major factors at work here is that none of the regions concerned can look back on a tradition of trust-based regional cooperation. However, regional monetary blocs can only work in the long term if the countries involved are willing, at least in principle, to respect a set of rules they have set themselves; a culture of respect for international agreements is a central prerequisite for successful regional monetary cooperation. On the whole, monetary regionalization is thus a scenario that seems rather unrealistic, with a certain potential discernible only in Asia, if at all.

3 Conclusion

Our analysis indicates that the US dollar is in for a hard landing. In the current environment, this may lead to a shift in the present global monetary system. Two tendencies are already taking on visible shape, and they are likely to be intensified by a weakening US dollar. One is the trend toward a strengthening euro, which is potentially in a position to assume the role of the key world currency. The other is a trend toward monetary regionalization, which is becoming more and more attractive in regions in which there is (a) a high level of liquidity, (b) dissatisfaction with the status quo of the multilateral financial regime, and (c) a will to engage in cooperation based on a set of projected long-term benefits. Today the only region where this situation is given, at least in part, is Asia. However, the fact that the euro is likely to emerge as a winner from the present situation of dollar weakness could serve to induce other regions to try their hand at initiating similar steps on the road to monetary integration.

One crucial question will be how Europe deals with the rise of the euro to the role of the world reserve currency – a scenario that appears entirely realistic in view of the situation given today. On the one hand, the eurozone would have to retain a certain measure of openness and should not opt for protectionist means to shield itself from the current (and likely continuing) upward trend in the euro's value and the inflows of goods that this will entail. On the other hand, Europe should work resolutely for a multilateral framework for the new monetary system, even though this would mean having to relinquish or share some of its newly acquired power. In this context the best approach would be to seek to win over the US as a partner for a balanced and universal reinstitutionalization of the world monetary system. Considering the present geopolitical constellation of power, the eurozone would probably have to accept the coexistence of two reserve currencies (US dollar and euro), with discretionary currency management serving as the most likely option to avert any excessive fluctuations in the exchange rates of the two reserve currencies. With a European strategy along those lines, multilateralism could emerge as the winner from the current financial crisis.

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