

A key Currency View of Global Imbalances

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Abstract

This study divides the world into currency zones according to the co-movement of each currency with the key currencies. The dollar zone groups economies that produce well over half of global GDP. The euro zone now includes almost all of Europe and some commodity producers, but remains less than half the size of the dollar zone. The dollar zone share has shown striking stability despite big shifts across zones over time. These include the demise of the sterling zone and the expansion of the DM/euro from northwestern Europe to Europe and beyond.

Global imbalances look very different from a currency perspective. In the 2000s, the dollar zone's current account improved as the dollar depreciated, even as the US current account plumbed all-time lows. Thus, the Mundell-Fleming relationship between the exchange rate and the current account held up for the dollar zone but not the US economy. The dollar zone NIIP showed net wealth in ?????. Thus, neither flow nor stock readings support widespread predictions in the early 2000s of an imminent dollar crash. In fact, most of the secular widening of current accounts occurred within currency zones, where by definition investors bear limited currency risk.

Our account of the dollar's dominance rests not on the US economy's size but rather on the size of the zone with limited currency risk vis-a-vis the dollar. In such a world, the rise of another large economy poses the question not of relative size but rather of re-alignment of third currencies. What if the renminbi becomes a key currency alongside the dollar and the euro? Already some emerging market currencies are co-moving with the renminbi against the dollar. On current evidence, a renminbi zone would shrink the dollar zone, widen its current account deficit and leave it with a negative NIIP.

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