



Press Release

Scenarios for the Global Monetary System

How is Covid-19 affecting the global economic order?

Supply chains collapse, companies are facing bankruptcy, and mass unemployment ensues. Covid-19 has triggered a global financial crisis and is forcing states to develop rescue packages on a scale not seen before. In addition, the crisis has called into question the US dollar's hegemony and could redefine the global monetary system. A team of researchers from the Institute for Advanced Sustainability Studies (IASS) has developed four scenarios that show how political decisions will shape the post-Corona world.

Scientific scenarios have become an important tool for political decision-makers as they tackle the Covid-19 pandemic. Models of the Corona Crisis developed by researchers, and predicting shocking infection and death rates, have persuaded governments around the world to adopt strict lockdown measures and reduce economic activities to a minimum. The magnitude of this decision is now becoming increasingly apparent. The measures adopted have triggered a global economic and financial crisis that is affecting both industrialized and – even more so – developing nations, jeopardizing efforts to achieve the United Nations Sustainable Development Goals. Governments tackling this crisis face unprecedented challenges. Their task is made all the more difficult by the dearth of economic scenarios and models that could support decision-making in this situation.

In a collaboration between the IASS, Harvard University and Boston University, a team of researchers led by Steffen Murau, Joe Rini and Armin Haas has developed an innovative political-economic methodology to study the impact of global economic and financial crises precipitated by events such as the Covid-19 pandemic on the global monetary and financial systems. Their findings were recently published in the *Journal of Institutional Economics*.

The Covid-19 pandemic: A turning point in the global economic order?

At the outset of their study, the researchers examined the dynamics underpinning the development of the global monetary and financial system in recent decades. The team identified two trends that are of central importance in this context: First, while the US dollar is the centrepiece of the global financial system, a substantial share of this currency is now created by private financial institutions outside the USA, and thus outside the control of the United States' central bank, the Federal Reserve (Fed). This happens, for example, when



banks outside the United States create deposits by issuing loans in US dollars to finance trade within global supply chains. The researchers refer to this as "offshore dollar creation". Second, shadow banks have become systemically relevant entities and are creating novel forms of credit instruments that researchers now refer to as "shadow money".

In the case of complex and privatized structures such as the offshore dollar-based monetary and financial system, crises are key drivers of change. It is in these moments that political decision-makers lay the groundwork for future developments. The global financial crisis of 2007 – 2009, which escalated following the collapse of US investment bank Lehman Brothers, was one such moment. That crisis began in the shadow banking system and was essentially a bank run on offshore dollars and shadow money. The massive loss of confidence driving that crisis could only be mitigated through the introduction of an institutional innovation: a new form of cooperation between the central banks of the G7 countries – so-called "swap lines" – through which central banks outside the USA could borrow US dollars from the Federal Reserve to support domestic banks.

"In today's global dollar system, the Federal Reserve's US dollar swap lines are the ultimate safety net," explains Steffen Murau, who has researched this issue first at the IASS and then at Harvard University and Boston University. "The European Central Bank is the Federal Reserve's most important partner in this area. In times of crisis, the ECB can borrow US dollars from the Fed and then pass them on as loans to euro zone banks. The crucial issue for the future of the global US dollar system is how robust this safety net will prove to be."

"The Covid-19 pandemic has triggered a new global crisis, the scale of which we still cannot foresee," says Armin Haas, who leads the research team at the IASS. "How political decision-makers respond to this crisis is crucial for the future development of the global economic order. Covid-19 is also a crisis of the global monetary and financial system based on offshore dollars".

This aspect has been the focus of research at the IASS since 2017: "In our research project, we studied scenarios both with and without systemic crises and developed four alternative scenarios," explains Haas. "The scenarios explore possible developments over the next two decades and, in light of the unfolding Covid-19 pandemic, are already proving to be highly relevant for policymakers."

Four scenarios for the global financial system in 2040

The researchers explore four possible development pathways in their analysis. The first two presuppose that the financial system continues to evolve – resolving crises with the instruments of the existing system, much as occurred in 2008. The other two explore possible developments resulting from a collapse of the system that the Fed failed to prevent.

The analyses explore the following four scenarios:

1. a continuation of the current US dollar hegemony;
2. the co-existence of competing monetary blocks;
3. the emergence of an international monetary federation; or
4. international monetary anarchy.

In the "business as usual" scenario (1), US dollar hegemony persists, with the USA maintaining its role as the central stabilizing factor in the financial system. In this scenario, Trumpism and its policy of "America First" prove to be passing fads. The Eurozone, meanwhile, remains mired in a backlog of much-needed reforms and China fails to establish itself as a rival financial centre.

"The current Covid-19 crisis is putting extreme pressure on the global privatized US dollar system. But the Federal Reserve's interventions in March and April have stabilized the system for the time being, allowing it to continue along its current development path. In doing so, the Federal Reserve is acting as the de facto global central bank," says Steffen Murau. "The eurozone, on the other hand, is in troubled waters. Once again, the issue of Eurobonds is putting the EU to the test and revealing the gulf between reality and European aspirations to strengthen the euro's international role."

In contrast, the second scenario sees the establishment of competing monetary blocs, with the EU and China emerging as two significant rivals to the USA. In this scenario the latter no longer stands as the guarantor of global stability, while the Eurozone successfully overcomes its deficits and China succeeds in internationalizing its currency, the renminbi. These developments result in the further regionalism of world trade and the financial system.

"The pandemic is exposing the failings of America's welfare state. The collapse of the US economy could weaken the geopolitical position of the United States in the medium term. China, on the other hand, has a head-start when it comes to overcoming the effects of the pandemic and could use this to its advantage in the trade war opened by Trump," Murau explains.

In the third (revolutionary) scenario the Federal Reserve proves unable to withstand the global crisis and the global US dollar system implodes in a series of defaults and bankruptcies of leading private financial institutions. However, the scenario assumes that the G20 succeeds in creating an alternative global monetary system at the height of the crisis; a system built not around a single national currency, but around an international organization. In this scenario, the international monetary hierarchy has shifted, with national currency areas now operating alongside each other. In the EU, the Member States reintroduce their former currencies, but retain the euro as a regional supranational unit of account. Offshore credit money creation is completely abolished. While shadow banks continue to operate in some states, elsewhere governments push for tougher regulation aimed at eliminating shadow money.

"The Federal Reserve's rescue efforts run counter to the policies of the Trump Administration, which has probably not yet grasped the scope of these interventions. The question is whether the Fed can maintain this level of commitment in the medium term, especially in the event of Trump's re-election. It is not impossible that a chain of circumstances could take the Fed's swap network to breaking point – an event that would be comparable to the Bank of England's cancellation of the gold standard in 1931," says Armin Haas. "Naturally, there's a touch of liberal utopia to our third scenario. However, proposals for this kind of system have been around in various forms for at least 150 years."

In the fourth scenario, following the collapse of the existing system based on private offshore dollar creation, efforts by the G20 to establish an alternative monetary and financial system founder and eventually fail. Instead, international monetary anarchy reigns. As a consequence, the international payments system grows increasingly unreliable, international value chains break down and barter arrangements become commonplace in international trade. The result: a hard-hitting global depression that compels states to experiment with different institutional arrangements in order to tackle the challenges. These experiments lay the foundations for the development of a new system at some point in the future.

"This is the only scenario in which crypto-currencies are of more than marginal importance," says Joe Rini, who has previously worked in the fintech sector. "In our view, the strong path dependency of the global dollar system makes it unlikely that crypto will emerge as a genuine alternative – unless, of course, the current system implodes. Crypto currencies have been largely ignored in the context of the Covid-19 Crisis and have failed to profit from it so far. But this could quickly change in the event of an uncontrolled systemic collapse."



Charting a course for the transformation towards sustainability

"Our scenarios are not intended to be exact predictions of the future, nor are they normative assessments or institutional blueprints," explains Armin Haas. "What they do is extrapolate existing trends and create a space of possibility in which we can explore the development of the international monetary system along different development pathways through to 2040."

"The ideas presented in these scenarios are already being discussed in expert circles. What we have done is to link these ideas to political and economic development pathways and to highlight the central role of shadow banks and offshore money creation," says Haas. "These scenarios emphasize the decisive role of the US Federal Reserve as the creditor of last resort for the global dollar system and its ability to tackle the crisis."

The development of scenarios to explore the future of the international monetary and financial system dovetails with the mission of the IASS to analyse and support global transformations towards sustainability. "Exploring the implications of different scenarios for the ecological transformation of our societies is integral to our research programme." After all, "financing for transitions towards sustainability will either be provided through the global financial system – or they will not take place," says Armin Haas. "Efforts to create a sustainable and climate-friendly global economy cannot succeed in the absence of a functioning global monetary and finance system."

Publication

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