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Will the U.S. Dollar Remain the Global Reserve Currency?

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The U.S. economy's rapidly growing trade and current account deficits (2003-2007) and systematic weakening of the dollar against the Euro and other currencies raised several concerns about its future as the global reserve currency. The global financial crisis of 2007-2009, while reinforcing the U.S. dollar's role as the most liquid and in demand currency (especially during periods of increased risk aversion) triggered a political debate on how the future global reserve currency system should be shaped. Skeptics of the U.S.'s enduring economic and political power proposed a new global reserve currency. This idea was presented, among others, by the Governor of the People's Bank of China, the Government of the Russian Federation, and even elaborated in detail by the so-called Stiglitz Commission. Although changes in the global reserve currency system are possible they will not happen rapidly. Even if they do take place, they will be driven by market rather than political choices[1].

The Definition of Reserve Currency

The popular notion of a "reserve currency" centers around a currency which is held in large amounts by central banks as part of their foreign exchange reserves. The latter are defined by the IMF as "*…the monetary authorities' claims on nonresidents in the form of foreign banknotes, bank deposits, treasury bills, short- and long-term government securities, and other claims usable in the event of balance of payments needs*" [2].

In order to be able to play its role a reserve currency must be freely convertible for both current and capital account transactions, relatively stable in terms of its purchasing power, and enjoy the confidence of market participants.

Central Banks vs. Private Sector Choices

The demand for reserve currencies is determined by both political and institutional choices in respect to monetary/exchange rate regimes on both a national and international level as well as market preferences. Historically, the dominant international monetary regimes based on fixed exchange rates (gold standard until 1914, gold exchange standard in the interwar period, and Bretton Woods system between 1944 and 1971) were the main factors determining choice of reserve currency (monetary gold, British pound, U.S. dollar), but private sector demand also played an important role.

With the collapse of the Bretton Woods system in 1971, adoption of flexible exchange rates as well as rapid expansion and integration of global financial markets, the role of market forces became more important. In a world of predominantly open capital accounts and strong financial market integration there is growing competition between currencies as a medium of exchange, unit of account, store of value and means of deferred payments. Private sector choices are determined not only by a perceived stability or strength of individual currencies, but also by the size and reputation of the economies standing behind them. Another important factor relates to so-called network externalities, i.e. to dominant currency choices of other market participants (to decrease the transaction costs) and availability of various kinds of financial instruments in a given currency. Thus, private sector choices have a strong impact on central bank preferences.

Still, non-floating monetary/exchange rate regimes have an impact regarding central banks' decisions on the size and currency structure of their holdings and, therefore, on their demand for individual reserve currencies. For example, this pertains to currency boards and other forms of fixed pegs which increase a central bank's demand for a particular anchor currency.

Importance of Liquidity Considerations

As mentioned earlier, the role of foreign exchange reserves (backing current and capital account

[1] The author wants to thank Susan Schadler, Marianne Schultze-Ghattas, Charles Wyplosz and Maciej Krzak for their comments to the earlier version of this paper.

[2] See Composition of Official Foreign Exchange Reserves (COFER) http://www.imf.org/external/np/sta/cofer/eng/

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convertibility of national currencies) and the multiple tasks performed by contemporary central banks (as lender of last resort as well as providing price/exchange rate and financial sector stability) determine, to a large extent, the choice of reserve currencies. They must be widely used and accepted by the private sector. In addition, the prudential rules of foreign exchange management by central banks themselves require a high level of liquidity. In fact, liquidity considerations are one of the key determinants of private sector demand for specific currencies.

Thus, reserve currencies must be those which are used internationally for trade, financial transaction, and saving purposes by a sufficiently large number of private agents, and represent relatively stable purchasing power. They must be underpinned by deep financial markets that facilitate financial investment and risk hedging.

These are exactly the liquidity considerations which explain why the U.S. dollar continues to hold a dominant position in the global reserve currency system, in spite of growing uncertainty regarding its stability. The money markets of USD-denominated financial instruments still represent the largest size, depth, and liquidity compared to other major currencies, including the Euro. This is also the reason why other currencies such as the Chinese renminbi or any new global currency (see below) still have a long way to go in challenging the dominance of the U.S. dollar.

The Role of Systemic Inertia

Historical experience demonstrates that fundamental changes in the global reserve currency system proceed rather slowly. This was the case when gold was abandoned (the departure from the gold standard lasted from the 1920s until the collapse of the Bretton Woods system in 1972) and when the move from a sterling to U.S. dollar standard occurred. The same slow shift was observed during the 2000s between the U.S. dollar and Euro (the share of Euro-denominated assets in the global reserve holdings has increased at a relatively slow pace – see Figure 1), even in the presence of sizeable external shocks.

The systemic inertia has been determined by a number of factors, including the slow pace of change of private sector preferences and central banks' fear of negative impacts of large scale changes in their assets composition on market value. The observed inertia is an important constraint which must be taken into account while thinking about far-reaching changes in the global reserve system.

Issuing a Global Currency-Blessing or Curse?

Issuing a global currency brings both costs and benefits. On the one hand, the issuing country or region enjoys seigniorage revenues coming from increased external demand for its currency, it has the opportunity to borrow in its own currency at a relatively low cost, and it faces less balance-of-payments constraints than other economies (the so-called exorbitant privilege, a term coined in the 1960s by then French Minister of Finance Valéry Giscard d'Estaing in respect to U.S. dollar dominance). On the other hand, it also faces certain costs and risks.

For example, external demand for a global currency may lead to a large current account deficit for the issuing country or region which, subsequently, undermines the stability of the reserve currency. This phenomenon was observed in the U.S. under the Bretton Woods system and has been referred to in academic literature as the Triffin dilemma. More recently, large current account deficits in the U.S. matched by large current account surpluses in a number of Asian as well as oil economies has triggered a debate on the source of global imbalances. One of the hypotheses referred to the so-called global savings glut built up in China, India, Japan and several oil exporting economies which had to be accommodated by expansionary monetary policy of the major issuing center, i.e. the U.S. Federal Reserve System, in order to avoid global deflation.

Global vs. National Goals

Whatever the sources of rising global imbalances during the 1990s and 2000s where they indicated the potential conflict of interest between national and global policy goals that any central bank faces, especially when it issues a global currency.

Looking from a global perspective the monetary authority which issues a global reserve currency should be able to ensure that global liquidity keeps pace with long-term global economic activity, while at the same time safeguarding long-term price stability and fair distribution of income between regions and countries. More specifically, the reserve currency's supply should be equal to global demand for this currency in order to avoid both deflationary and inflationary biases. It should also limit other kinds of nominal shocks like excessive volatility of exchange and interest rates.

It is quite clear that these kinds of global macroeconomic management expectations go well beyond the institutional mandate of any national or regional central bank, like the U.S. Federal Reserve (Fed) or European Central Bank (ECB). Even if they are institutionally independent and take into consideration external consequences of their monetary policy decisions, eventually they are accountable to their domestic constituencies and are expected to address, in

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first instance, domestic economic challenges.

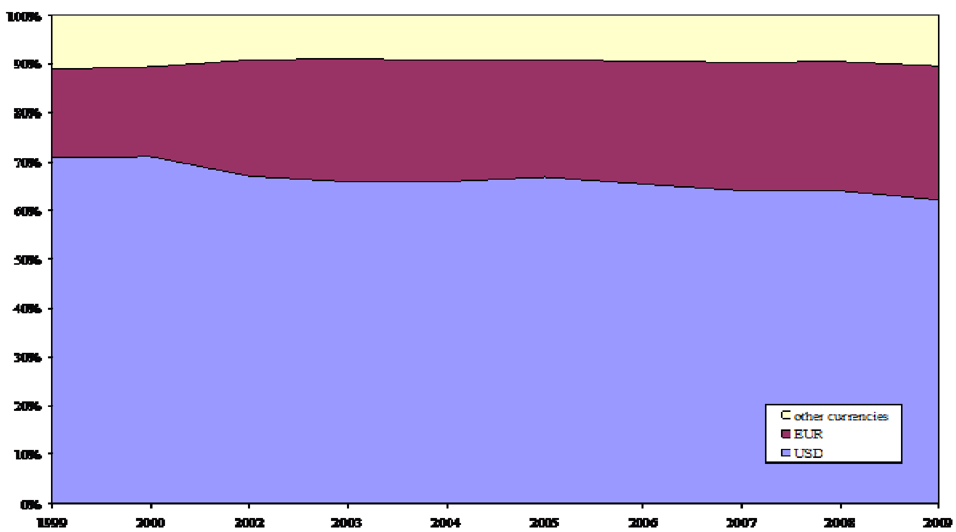
Is a New Global Reserve Currency the Solution?

Could a new global reserve currency (for example, based on the SDR) solve the above described conflict of interest? Potentially yes, but too many political and institutional conditions would have to be met to make such an option realistic.

The global reserve currency would require the creation of a global monetary institution. Whether this takes the form of a Global Reserve Bank, as suggested by the Stiglitz Commission, or a reformed IMF, it will take both a lot of time and political bargaining. The history behind a common European currency (within the bloc of relatively homogenous countries strongly committed to economic and political integration) provides a good lesson of how difficult and time-consuming such a process can be.

The list of potential political and economic controversies may relate to global monetary policy goals and instruments, voting patterns in the global monetary institution and guarantees of its independence, distribution of seigniorage, analytical and forecasting models related to global output, inflation, demand for money, monetary transmission mechanisms, etc. Last but not least, various measures to promote private sector demand for a new currency would be required. Otherwise, it would not differ from the current SDR, which is accepted only to the extent that it can be converted into a "real" reserve currency.

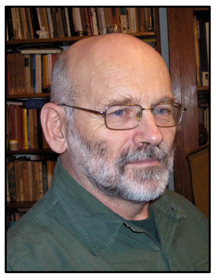
FIGURE 1: CURRENCY COMPOSITION OF OFFICIAL FOREIGN EXCHANGE RESERVES, IN %, 1999-2009



SOURCE: http://www.imf.org/external/np/sta/cofer/eng/cofer.pdf and author's calculations

Gradual Evolution Rather Than "Big Bang"

Taking into consideration all potential obstacles in creating a hypothetical international reserve currency and the systemic inertia of the current system, continuation of the current multiple currency system with a dominant U.S. dollar seems to be the most plausible scenario in the short-to-medium term. In the medium-to-long term one may consider a gradual evolution towards a greater role for the Euro. However, this will depend greatly on the development of financial markets for Euro-denominated assets (especially the highly liquid ones) as well as the ability of the Euro area to resolve their fiscal problems without compromising the reputation of both the Euro and ECB. In the longer-term perspective one can even imagine an increasing role for the Chinese renminbi, particularly if China manages to overcome the underdevelopment of its financial markets and ensures its full integration with the global market.



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