International reserves and reserve currencies

From Wikipedia, the free encyclopedia

The US dollar and the euro are the most used currencies in terms of global reserves, together making up 90% of all reserves globally.

A reserve currency, or anchor currency, is a currency which is held in significant quantities by many governments and institutions as part of their foreign exchange reserves. It also tends to be the international pricing currency for products traded on a global market, and commodities such as oil, gold, etc.

This permits the issuing country to purchase the commodities at a marginally lower rate than other nations, which must exchange their currencies with each purchase and pay a transaction cost. For major currencies, this transaction cost is negligible with respect to the price of the commodity. It also permits the government issuing the currency to borrow money at a better rate, as there will always be a larger market for that currency than others.

Global currency reserves

| Currency            | '95  | '96  | '97  | '98  | '99  | '00  | '01  | '02  | '03  | '04  | '05  | '06  | '07  | '08  | '09  |
|---------------------|------|------|------|------|------|------|------|------|------|------|------|------|------|------|
| US dollar           | 59.0 | 62.1 | 65.2 | 69.3 | 70.9 | 70.5 | 70.7 | 66.5 | 65.8 | 65.9 | 66.4 | 65.7 | 64.1 | 64.1 |
| Euro                | 17.9 | 18.8 | 19.8 | 24.2 | 25.3 | 24.9 | 24.3 | 25.2 | 26.3 | 26.4 | 27.3 |     |     |     |
| Pound sterling      | 2.1% | 2.7% | 2.6% | 2.7% | 2.9% | 2.8% | 2.7% | 2.9% | 2.6% | 3.3% | 3.6% | 4.2% | 4.7% | 4.0% | 4.3% |
| Japanese yen        | 6.8% | 6.7% | 6.2% | 6.4% | 6.3% | 5.2% | 4.5% | 4.1% | 3.9% | 3.7% | 3.2% | 2.9% | 3.1% | 3.0% |
| German mark         | 15.8 | 14.7 | 14.5 | 13.8 |      |      |      |      |      |      |      |      |      |      |      |
| French franc        | 2.4% | 1.8% | 1.4% | 1.6% |      |      |      |      |      |      |      |      |      |      |      |
| Swiss franc         | 0.3% | 0.2% | 0.4% | 0.3% | 0.2% | 0.3% | 0.3% | 0.4% | 0.2% | 0.2% | 0.2% | 0.1% | 0.2% | 0.1% | 0.1% |
| Other               | 13.6 | 11.7 | 10.2 |     | 6.1% | 1.6% | 1.4% | 1.2% | 1.4% | 1.9% | 1.8% | 1.9% | 1.5% | 1.8% | 2.2% |

Reserve currencies are widely recognized and used for international transactions. The fact that money in those times consisted of precious metals and was not printed on notes supports this. In the 1800s a similar picture was in place with the US dollar, Russian ruble, and the unified German Reichmark, being added to the list in the very late 19th century.

However, the modern conception of an international currency as a store of value for the international reserves of central banks and governments is a relatively recent development, arising only in the 19th century coinciding with the emergence of the international gold standard in the decades leading up to the First World War.

After World War II, the international financial system was governed by a formal agreement, the Bretton Woods System. Under this system the US dollar was placed deliberately as the anchor of the system, with the US government guaranteeing other central banks that they could sell their US dollar reserves at a fixed rate for gold. European countries and Japan deliberately devalued their currencies against the dollar in order to boost exports and development.

In the late 1960s and early 70s the system suffered setbacks due to problems pointed out by the Triffin dilemma, a general problem with any fiat currency under a fixed exchange regimen, as the dollar was in the Bretton Woods system.

**Theory**

Economists debate whether or not a single reserve currency will always dominate the global economy. Many have recently argued that one currency will almost always dominate due to network externalities, especially in the field of invoicing trade and denominated foreign debt securities, meaning that there are strong incentives to conform to the choice that dominates the marketplace. The argument is that, in the absence of sufficiently large shocks, a currency that dominates the marketplace will not lose much ground to challengers.
However, some economists, such as Barry Eichengreen argue that this is not as true when it comes to the denomination of official reserves because the network externalities are not strong. As long as the currency's market is sufficiently liquid, the benefits of reserve diversification are strong, as it insures against large capital losses. The implication is that the world may well soon begin to move away from a financial system dominated uniquely by the dollar. In the first half of the 20th century multiple currencies did share the status as primary reserve currencies. Although Sterling was the largest currency, both francs and marks shared large portions of the market until the First World War, after which the mark was replaced by dollars. Since the Second World War, the dollar has dominated official reserves, but this is likely a reflection of the unusual domination of the American economy during this period, as well as official discouragement of reserve status from the potential rivals, Germany and Japan.

The top reserve currency is generally selected by the banking community for the strength and stability of the economy in which it is used. Thus, as a currency becomes less stable, or its economy becomes less dominant, bankers may over time abandon it for a currency issued by a larger or more stable economy. This can take a relatively long time, as recognition is important in determining a reserve currency. For example, it took many years after the United States overtook the UK as the world's largest economy before the dollar overtook Sterling as the dominant global reserve currency.

The G8 also frequently issues public statements as to exchange rates. In the past its predecessor bodies could directly manipulate rates to reverse large trade deficits (see Plaza Accord).

**United States dollar**

The **United States dollar** is the most widely held reserve currency in the world today. Throughout the last decade, an average of two thirds of the total allocated foreign exchange reserves of countries have been in U.S. dollars. For this reason, the U.S. dollar is said to have "reserve-currency status," making it somewhat easier for the United States to run higher trade deficits with greatly postponed economic impact (see currency crisis). Central bank reserves held in dollar-denominated debt, however, are small compared to private holdings of such debt. In the event that non-United States holders of dollar-denominated assets decided to shift holdings to assets denominated in other currencies, there could be serious consequences for the U.S. economy. Changes of this kind are rare, and typically change takes place gradually over time; the markets involved adjust accordingly.

However the dollar remains the favorite reserve currency because it has stability along with assets such as **United States Treasury security** that have both scale and liquidity. [2]

**Euro**

The **euro** is currently the second most commonly held reserve currency, comprising approximately a quarter of allocated holdings. After World War II and the rebuilding of the German economy (see the Wirtschaftswunder), the German **Deutsche Mark** gained the status of
the second most important reserve currency after the US dollar. When the euro was launched on January 1, 1999, replacing the Mark, French Franc and ten other European currencies, it inherited the status of a major reserve currency from the Mark. Since then, its contribution to official reserves has risen continually as banks seek to diversify their reserves and trade in the eurozone continues to expand.\[13\] The New York Times Book Review also referred to the euro as the "Deutsch-Mark by another name".

Former Federal Reserve Chairman Alan Greenspan said in September 2007 that the euro could replace the U.S. dollar as the world's primary reserve currency. It is "absolutely conceivable that the euro will replace the dollar as reserve currency, or will be traded as an equally important reserve currency."\[14\] Econometric analysis by Jeffery Frankel and Menzie Chinn suggests the euro may replace the U.S. dollar as the major reserve currency by 2020 if: (1) the remaining EU members, including the UK, adopt the Euro by 2020 or (2) the recent depreciation trend of the dollar persists into the future.\[5\][6] In contrast to Greenspan's 2007 assessment the euro's increase in the share of the worldwide currency reserve basket has slowed considerably since the year 2007 and since the beginning of the worldwide credit crunch related recession and sovereign debt crisis.\[12\]

**Pound sterling**

The United Kingdom's pound sterling was the primary reserve currency of much of the world in the 18th and 19th centuries. The dire economic cost of fighting the First and Second World Wars, the increasing dominance of the USA in world economics (and, importantly, the establishment of the U.S. Federal Reserve System in 1913) as well as economic weakness in the UK at various intervals during the second half of the 20th century resulted in Sterling losing its status as the world's most reserved currency.

Since mid-2006 it is the third most widely held reserve currency, having seen a resurgence in popularity in recent years, but growing from about 2.5% to just below 5% of all currency reserves.\[8\] Analysts say this resurgence is caused by carry-trade investors considering the pound as a stable high-yield proxy to the Euro.\[9\]

**Japanese yen**

Japan's yen is part of the IMF's Special Drawing Rights Valuation. The SDR currency value is determined daily by the IMF, based on the exchange rates of the currencies making up the basket, as quoted at noon at the London market. The valuation basket is reviewed and adjusted every five years.

The SDR Values and yen conversion for government procurement are used by Japan’s JETRO for Japan's official procurement in international trade.
Swiss franc

The Swiss franc is often considered a reserve currency, because of the perceived stability of the currency and the Swiss banking system. However, the share of all foreign exchange reserves held in Swiss francs has historically been well below 0.5%. The daily trading market turnover of the franc however, ranked fifth, or about 3.4%, among all currencies in a 2007 survey by the Bank for International Settlements.

Call for new major reserve currency

Other nations, such as Russia and the People's Republic of China, central banks, and economic analysts and groups, such as the Gulf Cooperation Council, have expressed a desire to see an independent new currency replace the dollar as the reserve currency. China has proposed using the Special Drawing Rights, calculated daily from a basket of U.S. dollar, euro, Japanese yen and British pound, used by the International Monetary Fund for international payments.

On 3 September 2009, UNCTAD issued a report calling for a new reserve currency based on the SDR, managed by a new global reserve bank.

The Chinese yuan or renminbi (RMB) cannot be used as a reserve currency as long as the PRC maintains capital controls on the conversion of its currency. The currency would not be attractive to central banks for holding unless China developed a strong open bond market.

Russian president Medvedev has offered the Russian Ruble as one of six worldwide reserve currencies.

See also

- Exorbitant privilege
- Foreign exchange reserves
- Hard currency
- Triffin dilemma
- World currency

References – See Wikepedia site
### International Reserves, 2006, All Countries (in billions of SDRs*)

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreign Exchange</td>
<td>3,348.3</td>
<td>98.1%</td>
</tr>
<tr>
<td>IMF reserve positions</td>
<td>17.5</td>
<td>0.5</td>
</tr>
<tr>
<td>Gold**</td>
<td>30.4</td>
<td>0.9</td>
</tr>
<tr>
<td>SDRs</td>
<td>18.2</td>
<td>0.5</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>3,414.4</td>
<td><strong>100.0%</strong></td>
</tr>
</tbody>
</table>