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# ON THE FUTURE OF THE GLOBAL FOREIGN EXCHANGE RESERVE' SYSTEM

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ORĂȘTEAN Ramona

**Abstract:**

*US dollar is currently the most important currency in which foreign exchange reserves of different countries are set up, it being found both at the central banks and international financial institutions. Only very liquid currencies, stable and acceptable as a means of payment in a large economic area have the potential to become major currencies in which are maintained foreign exchange reserves. Ten years after the euro was launched, the US dollar' share in foreign exchange reserves decreased by 7%, that don't point to a significant diversification away from the US dollar in central bank assets over the past decade. But now, the US dollar's position is no longer so secure. This paper explores different views on reserve currencies and tries to answer the question what kind of reserve currency do we need in order to ensure the stability of the global financial system.*

**Keywords:** *reserve currency, US dollar, euro, currency basket*

The main reasons of maintaining official reserves are: transactions (to finance imports and foreign debt, the authorities having regard to include in their reserves the currencies in which imports and liabilities are denominated), interventions in foreign exchange markets (the authorities vision is for those currencies which are related to national currencies), investments (to diversify portfolios and optimize risk), caution (to cope with exceptional events - wars, financial crisis, embargo - and to prevent possible speculative attacks against national currency).

The share of US dollar holdings in foreign exchange reserves was 71.5% at the end of 2001 - the largest share during the period 1987-2008 - coinciding with the dollar peak in March 2002. It has since declined to 64% in 2008, because of a depreciation of the US dollar against other reserve currencies over the same period, which offset robust purchases of dollar assets until 2007. In 2008 purchases of dollar assets by countries reporting their reserve composition declined to their lowest level in a decade. With a share of 26.5% of the total reserve assets at the end of 2008, the euro is the second reserve currency, behind the US dollar (64.0%) and before the Japanese yen (3.3%). The share of the euro increased sharply between 1999 and 2003 and after a period of relative stability it raised further to over 26% of total foreign exchange reserves at the end of 2008.

Table 1. Share of the national currencies in foreign exchange reserves (%)

	'95	'96	'97	'98	'99	'00	'01	'02	'03	'04	'05	'06	'07	'08
USD	59.0	62.1	65.2	69.4	71.0	71.1	71.5	67.1	65.9	65.9	66.9	65.5	64.1	64.0
EUR	-	-	-	-	17.9	18.3	19.2	23.8	25.2	24.8	24.0	25.1	26.3	26.5
JPY	6.8	6.7	5.8	6.2	6.4	6.1	5.0	4.4	3.9	3.8	3.6	3.1	2.9	3.3
GBP	2.1	2.7	2.6	2.7	2.9	2.8	2.7	2.8	2.8	3.4	3.6	4.4	4.7	4.1
DEM	15.8	14.7	14.5	13.8	-	-	-	-	-	-	-	-	-	-
FRF	2.4	1.8	1.4	1.6	-	-	-	-	-	-	-	-	-	-
ECU	8.5	7.1	6.0	1.2	-	-	-	-	-	-	-	-	-	-
CHF	0.3	0.3	0.3	0.3	0.2	0.3	0.3	0.4	0.2	0.2	0.1	0.2	0.2	0.1
Other currencies	5.1	4.5	4.2	4.8	1.6	1.5	1.3	1.6	2.0	1.9	1.7	1.8	1.8	2.0
<b>Advanced economies</b>														
USD	52.3	57.4	59.1	67.6	70.5	70.5	71.3	67.5	68.1	68.2	70.1	68.9	66.9	68.1
EUR	-	-	-	-	17.3	17.5	18.1	22.1	22.1	21.9	20.2	21.2	23.1	22.1
JPY	6.7	5.7	5.9	7.0	7.3	7.4	6.2	5.3	5.0	4.9	4.7	4.3	4.1	4.6
GBP	2.1	2.1	2.0	2.9	3.1	2.8	2.7	2.9	2.4	2.7	2.8	3.3	3.6	2.9
DEM	16.6	15.9	16.2	13.6	-	-	-	-	-	-	-	-	-	-
FRF	2.3	1.7	0.9	1.4	-	-	-	-	-	-	-	-	-	-
ECU	13.6	12.3	11.2	1.7	-	-	-	-	-	-	-	-	-	-
CHF	0.1	0.1	0.1	0.2	0.1	0.3	0.3	0.5	0.3	0.2	0.2	0.2	0.2	0.2
Other currencies	6.2	4.9	4.6	5.6	1.7	1.5	1.4	1.6	2.1	2.2	1.9	2.0	2.2	2.1
<b>Developing and emerging economies</b>														
USD	70.3	68.5	72.4	73.7	72.3	72.9	72.1	66.0	61.3	61.4	61.5	60.7	61.3	59.8
EUR	-	-	-	-	19.4	20.2	21.6	27.6	31.7	30.8	30.4	30.5	29.6	31.1
JPY	7.0	8.1	5.7	4.4	4.0	2.7	2.3	2.2	1.6	1.7	1.7	1.3	1.7	1.9
GBP	2.2	3.5	3.3	2.2	2.4	2.5	2.7	2.6	3.6	4.7	4.9	5.8	5.8	5.3
DEM	14.4	13.0	12.5	14.3	-	-	-	-	-	-	-	-	-	-
FRF	2.4	2.0	2.1	2.1	-	-	-	-	-	-	-	-	-	-
ECU	0	0	0	0	-	-	-	-	-	-	-	-	-	-
CHF	0.7	0.6	0.6	0.5	0.5	0.2	0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Other currencies	3.1	4.2	3.5	2.8	1.4	1.5	1.0	1.4	1.7	1.3	1.4	1.6	1.5	1.9

Source: IMF, Annual Report, 2006-2009

The share of US dollar holdings by advanced economies moved higher from 66.9% in 2007 to 68.1% in 2008, while the share of euro holdings fell by 1% point to 22.1% in the same period. The share of Japanese yen holdings increased to 4.6%, while the share of British pound declined to 2.9% and Swiss franc holdings remained stable.

In emerging and developing economies' foreign exchange reserves the share of US dollar holdings declined by 1.5%, from 61.3% in 2007 to 59.8% in 2008, significantly lower than in earlier years. The share of euro holdings increased with 1.5% to 31.1% in 2008.

Ten years before the introduction of the euro the dollar' share in international reserves increased by 20%, taking into account the central banks interest in accumulation of reserves in US dollars in the years '90. Ten years after the euro was launched, the US dollar' share in foreign exchange reserves decreased by 7%, that don't point to a significant diversification away from the US dollar in central bank assets over the past decade.

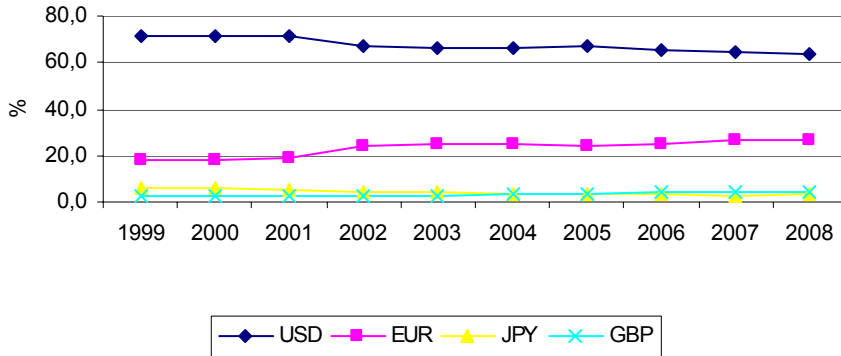
Eichengreen (2005) argues that network externalities may be strong in other areas but are less obviously valid for the currency of denomination of reserves and that market liquidity is not all that matters. He considers that it may be worth tolerating a bit less market liquidity in return for the benefits of greater diversification.

In the last years, developments in reserves data have tended to support Bergsten, Mundell and Eichengreen view on diversification effects, although the tendency of the dollar area to accumulate dollars (stressed by the McKinnon, Kenen and Cooper view) has limited the size of the diversification and preserved the dollar's status as the dominant reserve currency (Lim, E.G., 2006).

The most striking feature of the currency composition of international reserves through 2008 was its stability. The dollar's share of their combined total declined only very gradually, to USD 2.4 trillion of dollar reserves and USD 0.9 trillion of euro reserves in the second quarter of 2007 (Eichengreen, B., 2009).

In the last ten years it can be observed an increase in official holdings of foreign exchange in British pound, a currency of a country with large current account deficits, in parallel with a decline of foreign exchange reserves in Japanese yen, the currency of a country with large current account surpluses in the same period.

**Figure 1. Currency composition of central bank foreign exchange reserves (%)**



Euro' share in total foreign exchange reserves remained relatively stable and much lower than the US dollar, even if the authorities from countries like South Korea, Pakistan and Russia have adopted in 2002 a series of regulations to increase the share of euro in their official reserves. The same trend is evident in China, which ranks first worldwide in terms of foreign reserves, with a volume of USD 2272.6 billion in September 2009.

Chinn and Frankel (2008) consider that the euro has arisen as a credible eventual competitor to the dollar as leading international currency, much as the dollar rose to challenge the British pound 70 years ago. The euro area expansion in the new EU member states created the possibility that Eurozone might surpass the USA as international trader and as the world's largest financial market. Their conclusion is that the euro may surpass the dollar as leading international reserve currency as early as 2015.

Central banks increasingly give up of the US dollar for euro and Japanese yen in foreign exchange reserves, intensifying the pressure so high on the dollar. Current period is characterized by record levels of foreign reserves in central banks that reached USD 7300 billion in the third quarter of 2009, the biggest increase since 2003. According to Barclays Capital, 63% of new reserves in the countries that report in the same period are in euro and Japanese yen.

The diversification of the currencies preferred by central banks in their foreign exchange reserves announces a further depreciation of the US dollar, which lost 10.3% in quarters two and three from 2009, the biggest decline since 1991.

The idea that the US dollar is not a good reserve currency is not new.

Negotiations between a number of states in the Middle East with Chinese, Russian, Japanese, Brazilian and French officials have the final aim to trade oil in Japanese yen, Chinese renminbi, euro, gold or even in a new single currency on which to join Saudi Arabia, United Arab Emirates, Kuwait and Qatar.

In the longer run, OPEC will shift to pricing petroleum in a basket of currencies. It sells its oil to the United States, Europe, Japan and emerging markets and it is comfortable to denominate oil prices in the currency of only one of its customers. Central banks would have to show care when deciding what to hold as reserves, with some fear regarding the structure of the dollar basket.

Bergsten (2009) links the role of the US dollar as reserve currency by massive capital inflows that charged the credit bubble and residential markets in the United States.

In the Report of the Commission of Experts of the President of the United Nations General Assembly on Reforms of the International Monetary and Financial System (2009) is specify that the reform of the global reserve system could take place through a global agreement or regional initiatives. A regional or a global reserve system could be established if a group of countries agreed to create and to hold a common reserve currency which they would stand ready to exchange for their own currencies and also to reduce, over time, their holdings of other reserve currencies.

The Commission has suggested a gradual move from the US dollar to the Special Drawing Rights (SDR). After the G20 Summit in London in April 2009, the IMF decided in August 2009 to distribute to its members SDR in a value of USD 250 billion that increased the share of SDR in total international reserves to 4%. Countries whose official dollar holdings are larger than they were comfortable with would convert dollars into SDR through a mechanism called "SDR Substitution Account". In such way the role of the SDR will increase, representing an important step because any significant diversification of China's, Japan's, Middle Eastern countries' or Russia's dollar holdings could adversely impact both the United States and the Eurozone countries (Bergsten, C.F., 2009).

This proposal comes in response of China's fears about the potential inflationary risk of the US Federal Reserve' issue of currency. According with "Triffin Dilemma", as long as the US dollar is the only global reserve currency the US external deficits are required. This will determine inflows of capital to the United States and push up the dollar's exchange rate, so that the US' competitiveness will be affected and external deficits will be even larger. Bergsten (2009) find that both international monetary reform and a lesser role for the US dollar are very much in the interest of the United States.

The share of US dollar in global foreign exchange reserves remains almost three times that of euro. Bruegel and Posen (2009) fear the euro area's reticence to take on a global currency role could lead to instability in the future, similar to that which happened in period 1920-1930 between the British pound and the US dollar.

According to International Monetary Fund, total international reserves, including gold, stood at SDR 4.9 trillion at the end of 2008. They grew by 7.7% during the year, a much slower pace than the average annual growth rate of nearly 17% they registered during the previous five years. This slowdown in the evolution of international reserves was related to the sharp deterioration in the global economic environment, particularly in late 2008, which was accompanied by a sharp decline in

cross-border capital flows. Foreign exchange reserves (90% of total international reserves) increased by 7.6% to SDR 4.4 trillion in 2008, with a share of over 50% of China.

**Table 2. Countries with the largest foreign exchange reserves (September 2009)**

No.	Country	Billion USD
1.	China <sup>1</sup>	2272.6
2.	Japan	1052.6
3.	Eurozone	610.8
4.	Russia	413.4
5.	Taiwan <sup>2</sup>	325.4
6.	India	277.3
7.	South Korea <sup>3</sup>	254.2
8.	Hong Kong	223.3
9.	Brazil	221.6
10.	Singapore	176.3
11.	Germany	171.0

Source: IMF, *Data Template on International Reserves and Foreign Currency Liquidity*, October 2009

<sup>1</sup> State Administration of Foreign Exchange, China - *Monthly Foreign Exchange Reserves*, 2009

<sup>2</sup> <http://www.cbc.gov.tw/ct.asp?xItem=35200&ctNode=448&mp=2>

<sup>3</sup> [http://koreatimes.co.kr/www/news/biz/2009/10/123\\_53032.html](http://koreatimes.co.kr/www/news/biz/2009/10/123_53032.html)

In September 2009 China held foreign exchange reserves amounting to USD 2272.6 billion, the top foreign exchange reserve in the world. An estimated two-thirds of these reserves are held in dollar-denominated assets. The foreign exchange reserve of the People's Republic of China is mainly composed of US dollar in the forms of US government bonds and institutional bonds. Even if China reduced the share of its portfolio in dollars, the great increase of its reserve in 2007 meant that it clearly added more dollar assets to its portfolio than ever before.

Nouriel Roubini (2009), professor of economics at the New York University Stern School of Business, has suggested that the Chinese renminbi may supplant the US dollar's role.

China has proposed replacing the US dollar as the international reserve currency with a global reserve currency, disconnected from individual nations and able to remain stable in the long run, a basket of significant currencies and commodities, possibly an extended version of the SDR. Even if Zhou Xiaochuan, governor of the People's Bank of China, did not mention the US dollar, the essay posted on the central bank's website gave a pointed critique of the current dollar-dominated monetary system.

While the Russians would like to bring on ruble, the British are caught in the middle, because they are aware that the US dollar is becoming increasingly dangerous

as the reference currency, but on the other hand can not back behind the United States, their ally always. Furthermore, China considers the United State persuaded the United Kingdom remain outside the Eurozone to prevent a weakening of the US dollar's role.

**Conclusions:**

Questions about the US dollar's reserve currency status have intensified after the global financial crisis' effects started to show in the middle of 2007. The US dollar may be challenged by other currencies, especially the euro and the Chinese renminbi. The British pound, the Japanese yen and the Swiss franc remain minor reserve currencies.

The entry of the United Kingdom into the Eurozone, taking into account the London financial centre liquidity and financial depth, and the Eurozone expansion to the other new EU member states would increase the share of the euro in central bank holdings.

The changing of the US dollar's role will be accompanied by deeper changes related to model of economic activity worldwide. They are already under way in financial crisis, with an accelerated shift of activity by emerging economies, especially Asia and above all China. It is known that some of the large holders of foreign exchange reserves have their currencies pegged to the US dollar (China, Saudi Arabia and other Gulf countries, excluding Kuwait).

China proposed in March 2009 to give the SDR a greater role, with a new global system controlled by International Monetary Fund, idea that was accepted by Russia. The renminbi is now a serious contender for SDR inclusion, China representing the world's largest creditor, but the Chinese currency is far from becoming a global reserve currency. The Chinese renminbi will share the international stage with the US dollar, euro, British pound and Japanese yen.

A global solution could be a supranational reserve currency based on Special Drawing Rights or another currency basket formed by US dollar, euro, British pound, Japanese yen, Swiss franc and Chinese renminbi.

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