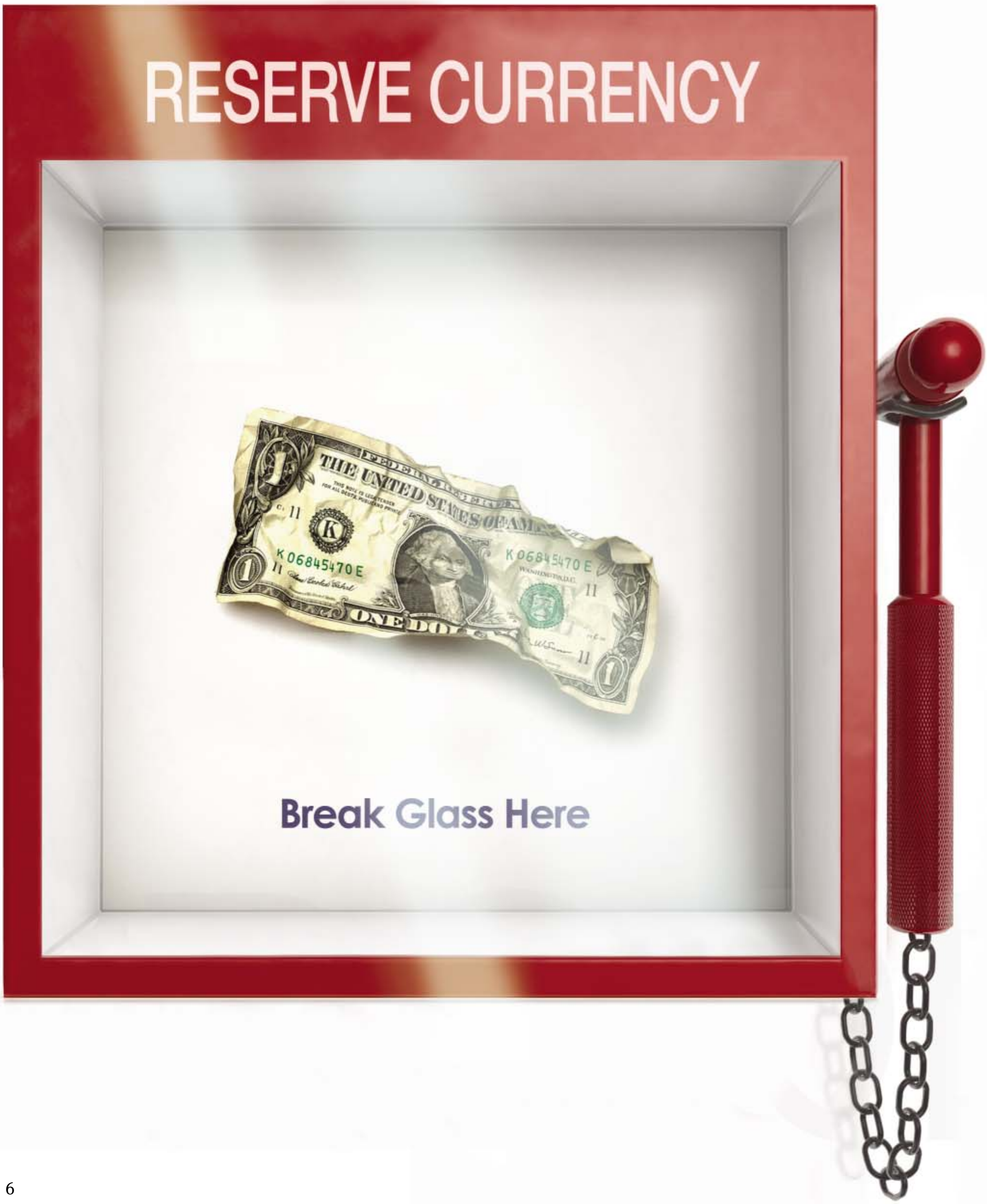
To what extent has the financial crisis undermined the dollar's pre-eminence as the world's reserve currency? **Gianluca Benigno** explores shifting demand for dollar assets and outlines some scenarios for the future international role of the currency.



Challenges for the dollar as a reserve currency

The financial crisis and its economic consequences have renewed debate about the status of the dollar as most governments' first choice of currency to hold in their foreign exchange reserves. One key reason relates to the build-up of substantial global macroeconomic imbalances over the past decade, notably the US current account deficit and the country's swelling burden of public debt. Maintaining the dollar's reserve currency status is vitally important for the United States, allowing the country to finance its deficits more easily.

Historically, shifts in reserve status between currencies are not abrupt events but occur slowly, reflecting changes in such factors as national economic and political influence, use in trade and investment transactions and the deepness of domestic financial markets. Discussions about the dollar's reserve status have emerged before, following the convertibility of West European countries' currencies in the 1960s, the introduction of the Special Drawing Right (SDR)* in 1969 and the introduction of the euro in 1999.

What might be different now? Given that the world economy has suffered its most severe crisis since the Great Depression, it is reasonable to ask to what extent such an event might lead to structural changes in the international monetary system. These could arise as policy authorities redesign the global financial architecture or as a consequence of events that lead to a reshaping of the economic and political forces that determine the world's leading reserve currencies.

* SDRs are International Monetary Fund (IMF) assets, originally created to supplement US dollars within the Bretton Woods fixed exchange rate system

Demand for dollars

So have dollars become less desirable assets in recent years? In fact, data on the currency composition of global foreign exchange reserves show that there has been very little change in the shares that countries allocate to dollar reserves (see Figure 1). The dollar accounts for more than 60% of total reserves now, a higher proportion than in 1995.

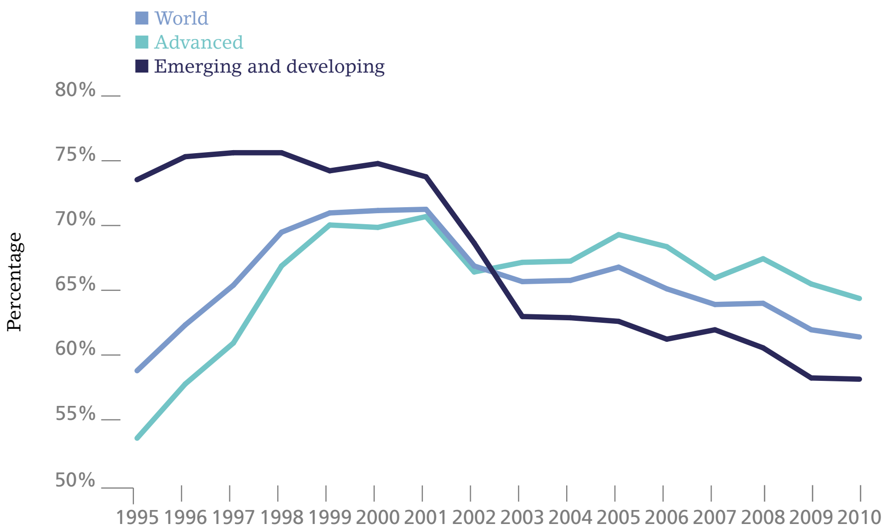
Even looking at how this share has changed for different groups of countries, there is no evidence of any systematic trend in dollar claims. At most there has been a slow decline in dollar claims by emerging and developing economies over the past five years, but the dollar share remains above 58%. The only notable trend in the past decade has been the rapid rise of the euro as a reserve currency, but this has been more at the expense of other currencies (notably the yen) than the dollar.

More indirect evidence on the desirability of dollar assets comes from data on the holdings of US Treasury securities by China and oil-exporting countries (see Figure 2). These show that despite recent events, holdings of US Treasuries have actually increased markedly.

The dollar in the financial crisis

What happened to the dollar during the crisis? Data for the period from August 2007 to June 2009 show that despite being at the epicentre of the turmoil at a time when the solidity and stability of the US financial system were questioned, the

Figure 1:
The dollar's share of total foreign exchange reserves



dollar strengthened in value. The dollar was on a downward trend until July 2008 as the crisis began to become a global phenomenon. After that, the dollar started appreciating, with peaks occurring at times of high tension in financial markets as its role as a 'safe haven' currency was reaffirmed (see Figure 3).

This pattern has continued during the sovereign debt crisis in the euro area, which began in early 2010. Peaks in market tensions arising from the funding needs of European countries have been associated with shifts towards safe haven assets.

The preference for dollar-denominated assets at times of high tension has also been demonstrated by measures of the perceived credit risk in the economy and risk and liquidity in the money market, as reflected in the returns on short-term US and German bonds. During the most acute episodes of the financial crisis, these measures mirrored the behaviour of the dollar, indicating that investors were shifting towards short-term dollar assets.

The impact of current US policies

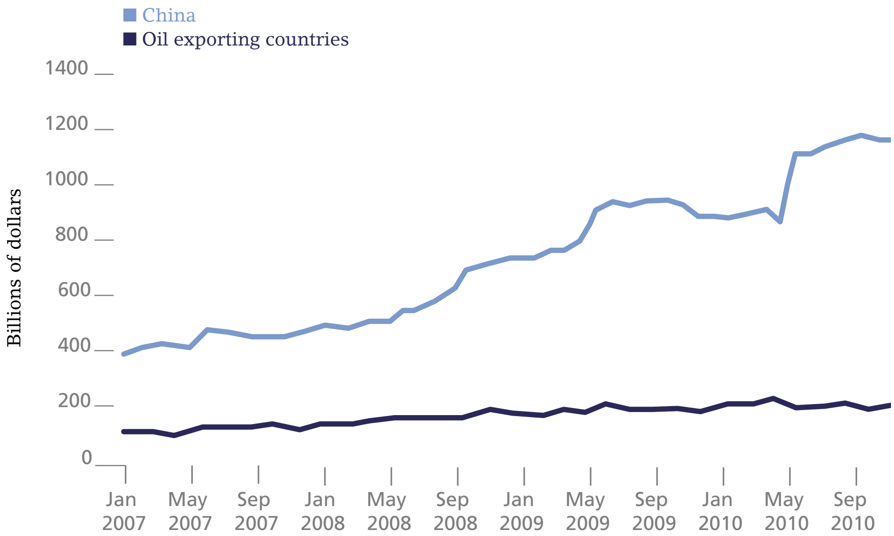
As financial market conditions have improved, the sustainability of the role of the dollar as a reserve currency has been questioned because of concerns about the possible consequences of current monetary and fiscal policies for the value of the dollar.

From a monetary policy perspective, the Federal Reserve has implemented rate cuts, liquidity measures, outright asset purchases and bailouts to mitigate a credit crunch and avoid deflation. But now there are worries that its actions may lead to higher inflation. So far though, the increase in base money that has followed the quantitative easing programme has not been inflationary: monetary aggregates have not increased (money velocity has decreased) as banks have deposited their excess reserves with the Fed rather than expanding credit.

From a fiscal policy perspective, the substantial increase in the US fiscal deficit has raised concerns about the sustainability of the fiscal position and repercussions for the value of the dollar and its role as a reserve currency. According to the Congressional Budget Office, the fiscal deficit will amount to about $7 trillion over the period 2012-21 with public debt rising from 53% of GDP in 2009 to 75% in 2014. The risks associated with the US fiscal position (at least from the market perspective) seem to be consistent with the weakening of the dollar since the end of March 2009.

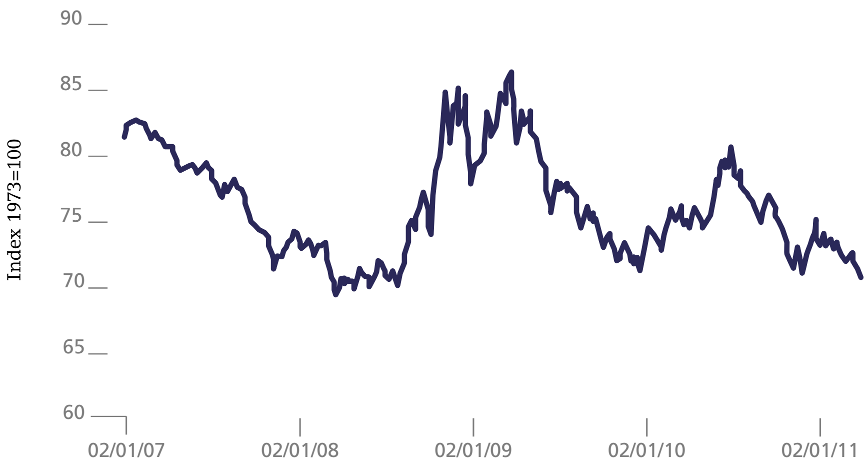
Nevertheless, the extent to which fiscal factors might affect the dollar's value will depend on the currencies against which the dollar could weaken. As many other advanced countries are running comparably large budget deficits, the

Figure 2:
Major foreign holdings of US Treasury securities in billions of dollars, 2007-10



Source: US Treasury TIC System

Figure 3:
Trade-weighted dollar exchange rate (upward movement correlates to an appreciation of the currency)



Source: Bloomberg

The crisis may have advanced the date when the dollar is no longer the leading reserve currency currencies against which the dollar might depreciate are those of the emerging market countries.

In general, therefore, despite the fact that signs of pressure might come from current US policy stances, it seems that a lack of alternatives, especially at the peak of the financial crisis, has reinforced the role of the dollar as a reserve currency.

Challenges to the dollar

Most discussions of the reserve currency role of the dollar have centred on the possibility that the euro might provide a credible competitor. But there are two alternative challenges. The first could come from current policy decisions that might affect the structure of the international monetary system. Indeed, the Chinese authorities have proposed reviving the role of the SDR and possibly revising its composition by including the renminbi in the new basket.

There is also some indication that the Chinese would soon want to see the renminbi used as a means of payment in bilateral trade. China sold its first batch of sovereign bonds in renminbi in October 2009, further signalling its intention to make the renminbi an international currency.

These steps are consistent with China's rapid growth, which resembles the patterns of the United States and Japan during their transformation into economic powers in the interwar and post-war periods. If anything, the size of the Chinese economy relative to global GDP is bigger now than in those comparable situations. While the economy is still smaller than that of the United States or the euro area, it is expected to grow faster than the developed economies, increasing its global economic weight.

Nevertheless, at this stage the renminbi lacks many of the features that would make it desirable as a reserve currency: there are still controls on inflows and outflows of capital; domestic financial markets are still underdeveloped; and the Chinese bond market is not very liquid.

The second challenge to the dollar might come from post-crisis adjustments to the system. At the heart of such adjustments lie the role of global imbalances and their eventual correction. The two likely scenarios associated with the maintenance of the status quo or eventual corrections of the global

The rise of the renminbi and diversification away from the dollar might imply a future system with several reserve currencies

imbalances are crucial for understanding the challenges for the dollar.

In the first scenario, US consumers reduce their consumption and save to counterbalance public sector borrowing. In this case, a weakened dollar might provide the source of growth for the US economy. An orderly depreciation of the dollar would occur as long as the Chinese authorities are willing to accept losses in the valuation of their current holdings of dollar reserves.

In the second scenario, US consumers resume their pre-crisis spending pattern. As long as the Chinese are willing to finance this by buying US Treasury bonds, the system could sustain such an arrangement at possibly higher interest rates. But if the Chinese authorities do not maintain the pace of such a spending pattern by accumulating dollar assets, the result could be a weakening of the dollar (not necessarily orderly) coupled with a US debt problem.

In both scenarios, a weakening of the dollar is the likely outcome, while the speed of the transition towards a regime in which it is not the only reserve currency could be accelerated, depending on the interaction between the behaviour of US consumers and the Chinese authorities.

So the crisis may have advanced the date when the dollar is no longer the leading reserve currency. From a policy perspective, a welcome step would be to facilitate this development by improving the convertibility of the renminbi. At this stage, its limited convertibility is mainly related to the link between currency convertibility and the development of financial markets. Indeed, in general, a well-developed financial market increases the capacity of the domestic economy to cope with factors that affect external demand for the domestic currency.

It is not unreasonable to think that the renminbi has the potential to play a role in international trade and investment transactions, given the pace at which the Chinese economy is expanding. This could create the necessary market discipline to limit global imbalances by allowing for an alternative reserve currency option.

To sum up, while the dollar has maintained and reinforced its reserve currency status during the crisis, there are elements that suggest the fragility of this status quo. In the medium term, the dollar's destiny might lie more in Chinese than in US hands. A diversification away from the dollar and the rise of a new international currency might imply, in the near or medium term, a global system with several reserve currencies, rather than just the dollar.

This is an edited version of 'Challenges for the Dollar as a Reserve Currency' by Gianluca Benigno, a chapter in *Beyond the Dollar: Rethinking the International Monetary System*, a Chatham House report edited by Paola Subacchi and John Driffill (http://www.chathamhouse.org.uk/publications/papers/view/-/id/844).

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