WILL THE USD REMAIN THE WORLD'S RESERVE CURRENCY?

For a long time now a discussion has been going on among economists, as well as investors in the field of international capital and financial markets concerning the excessive increase in the USD-denominated reserves of Asian central banks as a consequence of their export-oriented economies. Economists fear that the excessive foreign currency reserves in the form of American government bonds holdings could in the future lead these central institutions towards limiting, or diversifying their reserves away from the USD, whereby the resources for the external financing of America's deficit would become limited.

Institutional investors from Asia place their financial resources gained through exporting goods (primarily to the USA) particularly in assets denominated in USD. In principle these represent intervention purchases of USD by central banks from domestic (Asian) exporters, which gained USD through exporting their production. Operations of this type (the continual sale of local currencies against the USD) maintain the high competitiveness of their exporters in the environment of global international trade. Such a recycling of assets has led over the past years to unprecedented growth in foreign currency reserves on the accounts of Asian central banks and subsequently to the growing purchase of American government bonds. This one-directional financial flow has at the same time led to a rise in the cost of American bonds in the form of the historically lowest yields (interest rates). According to the last data from the end of 2003 foreign investors own, in the form of portfolio investments, one-third of bonds issued by the US Government, while eight years ago the figure was only one fifth. Of this share the Asian region owns 39% and European investors 43%. For illustration, as at the end of June last year Japan owned American government securities totalling USD 442 billion, Great Britain held USD 123 billion and China owned American government bonds in the value of USD 122 billion.

With the introduction of the euro a new widely-used and highly-liquid currency appeared. From this aspect it seems that it is an attractive offer for managing the foreign currency reserves of central banks. Not long ago the opinion was asserted that in future years the restructuring of central bank portfolios should take place leading to foreign currency reserves ending up in euros to the detriment of USD. From this aspect the largest holders of foreign currency reserves – Asian central banks – are considered as a potential source of massive demand for the euro currency. This argument was often cited as one of the strongest structural factors supporting demand for the euro currency.

Ten largest owners of foreign currency reserves

Ranking	Country	USD billion	
1.	Japan	623.8	(776.8)
2.	China	420.3	(425.4)
3.	Taiwan	202.8	
4.	European Union	192.9	(246)
5.	South Korea	149.5	(157)
6.	Hong Kong	114.0	
7.	Singapore	92.8	(95.7)
8.	India	92.0	(99)
9.	Russia	64.4	(80)
10.	Mexico	56.0	(63)

data in brackets = latest available data (1st quarter of 2004)

A team of analysts at Morgan Stanley point to the behaviour of Asian banks as the largest holders of foreign currency reserves with a total volume of foreign currency assets exceeding the value of USD 1.8 trillion. For the direction of exchange rate development it is important what objectives these institutions follow. In analysing the reasons that could lead Asian banks towards a shift in the structure of foreign currency reserves, consideration is given in connection with the three functions of money: as a unit of account, a medium of exchange and a store of value.

A unit of account

Since the end of the Second World War, following the replacement of a short period of hegemony of the British pound, the USD has remained for Asian investors, including central banks, the most advantageous currency for clearing. This means that almost the whole volume of the foreign trade in goods and services within the Asian region, as well as most foreign trade transactions outside Asian countries, are executed exclusively in USD. If we work from the fact that the composition of foreign currency reserves should cover at least the level of demand for foreign currency for the purposes of clearing international trade in goods and services and for discharging foreign debt, then from the aspect of the need for holding foreign currency as a unit of account the USD it is a priority of choice. If we take into consideration the fact that the American dollar is the most widely spread currency in the region, this hegemony will persist, unless some possible harm to the American dollar as such occurs. The American currency has achieved its dominant status primarily through powerful geopolitical standing, and although this argument is difficult to quantify, it is one of the decisive reasons why the USD is the strongly preferred currency in contrast to the European currency. In times of geopolitical uncertainty it is American assets that provide investors in developing markets a safe haven.

The United States has the largest, most structured and most liquid financial markets, from which result low transaction costs. Besides this, the majority of the largest commodity exchanges operate in the USA, which means that most commodities traded on world exchanges are officially traded and priced in USD. Probably not one of these factors will change in the foreseeable future so as to cast doubt over the hegemony of the American dollar and force Asian central institutes to reduce the balance of their reserves denominated in USD in favour of assets denominated in EUR.

A medium of exchange

The American dollar will long remain for the Asian banks the most efficient medium of exchange, meaning that it is the best (and most available) source for the needs of intervention. Regardless of the preceding reasoning, the fact that several Asian banks hold such an excessive volume of foreign currency reserves indicates that the main reason for holding such a volume is primarily for intervention purposes, not only covering imports or repayment of foreign debt as such. For illustration, the amount of foreign currency reserves held by Japan is able to cover 22 times the volume of imports, which significantly exceeds the so-called "adequate level" of foreign currency reserves for covering imports (a three-month volume of imports). The level of foreign trade volume forms a high share of the gross domestic product of most Asian countries, and thereby limits the willingness of politicians to change the regime of fixed exchange rates in favour of floating rates.

In an effort to achieve a high degree of export competitiveness these institutions have piled up foreign currency reserves in the form of selling domestic currencies (competitive devaluation) against the USD. If the majority of Asian countries intervene on the dollar axis, then it makes sense for Asian central institutions to hold a volume of reserves to a greater degree than the level in relation to the volume of foreign trade denominated in USD. The tendency to amass foreign currency reserves in USD was strengthened also by the recent Asian currency crisis, increasing the role of reserves for rebuffing speculative financial flows.

In developing economies fears from unstable local currencies often lead to mass outflows back to the original foreign currency against which the local currency is priced. In the Asian region this currency is undoubtedly the American dollar. In the end result, the USD is for Asian central banks the most advantageous medium of exchange for whatever type of intervention: neutralising capital flows during financial crisis, maintaining export competitiveness or in fulfilling a stabilisation role during geopolitical tension. From this aspect the European currency is no where near as significant for these institutions as is the USD.

A store of value

Doubts over its function as a store of capital could be the only reason for reducing USD-denominated reserves and increasing holdings of EUR. If we look at the structure of foreign currency reserves from the portfolio management perspective in an effort to maximize return at an accepted degree of risk, then it makes sense for Asian central banks to consider a certain change in the share of foreign currency reserves in favour of the euro and to the detriment of the American dollar from the medium-term aspect. It is also necessary to mention that the risk profile of the foreign currency assets of central banks is very low, which results from the context of their nature. Although liquidity is a primary goal in the management of foreign currency assets, from the long-term aspect, for the function of storing a central bank's capital, it makes sense to diversify these reserves regardless of the volatility of profits achieved. This thinking supports the reasons for the change in the composition of foreign currency reserves away from the dominance of the USD and towards a more balanced structure of foreign currency reserves including the EUR.

The growing importance of the Chinese yuan (RMB)

The rapid development of China is currently the most important structural process occurring in the Asian region. This process will probably influence also the standing of the Chinese currency, the RMB, as a reserve currency, since with time it is expected that the Chinese central bank will give up the managed floating exchange rate of the RMB. Since the volume of regional trade within the Asian region is gaining in importance and the RMB behaves increasingly independently of the USD, for Asian banks it will become ever-more essential to hold a large part of their foreign currency reserves in the Chinese currency. This is why the American USD is currently the most advantageous medium of exchange for Asian central institutions and will for banks represent the most efficient way of modifying foreign currency reserves in favour of assets denominated in the RMB in the case that this exchange will be necessary.

In contrast to the past year when US representatives were placing increasing political pressure on China to begin freeing its exchange rate against the USD, it is now China itself that recognises the need to adopt measures for gradually reforming its own financial system. American politicians have long reproached China for maintaining the fixed exchange rate of the Chinese yuan against the USD in order to maintain competitiveness in the global trading environment. China however is at the same time now one of the largest buyer of American government bonds, whereby it contributes to financing the increasingly large US budget deficit.

According to statements by the vice-governor of the Chinese central bank, China is currently studying the possibility of diversifying the portfolio investments of its foreign currency reserves with regard to their excessive growth. At the same time however he confirms that the share of USD in the structure of foreign currency reserves will continue to greatly outweigh the share of other currencies, to a certain extent it will be replaced by the euro and also the Japanese yen, the British pound, the Canadian and Australian dollar. This diversification has been motivated by developments on the international capital markets, as well as the movement of individual currencies' exchange rates.

At present, according to IMF statistics, the share of the euro in the total volume of worldwide foreign currency reserves is around 13%, while the share of USD-denominated reserves is 68%.

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