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Dollar will be the reserve currency

With the US' military and geo-political clout, the greenback as an established reserve currency cannot be easily displaced

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PRIOR to World War I, Britain was the world's leading trading nation, and around 60 per cent of world trade was invoiced and settled in pound sterling. London was also the undisputed financial capital of the world, and, as a result, sterling was the logical invoicing currency for debt securities and other financial instruments. Conscious efforts were also made to encourage the use of sterling throughout the British Empire as a medium of exchange so as to simplify transactions.

In addition to sterling's roles as a vehicle and invoicing currency of choice, given that it was fully convertible, central banks used sterling most often to intervene in foreign exchange markets. All of this led to sterling becoming the pre-eminent reserve currency of the world.

Sterling's share in foreign exchange holdings of official institutions stood at 64 per cent in 1899, more than twice the total of its nearest competitors, the French franc and the deutschemark, and much greater than the US dollar.

Interestingly, sterling remained the global reserve currency despite Britain having forsaken its position as the world's largest economy in the late 19th to early 20th century. In fact, it was only after the shock of the two World Wars and the resulting devastation of the other European economies, as well as the gross mismanagement of the British economy, that the US dollar took over the role of the world's reserve currency, thus breaking the de facto 'sterling standard'.

In addition to the strength of the US economy, economic historians have argued that the creation of a Federal Reserve System in December 1913 and subsequent development of New York as the world's financial centre provided another strong impetus for the rise of the US dollar's role as a major international currency.

The Bretton Woods system of pegged exchange rate centring on the US dollar, which was put in place in the mid-1940s, consolidated the position of the dollar as the world's reserve currency in the postwar period. The US dollar's share of world's reserves peaked at almost 85 per cent in the early 1970s.

In contrast, sterling's share continued to drop dramatically following the successive devaluations in the 1950s and 1960s. Despite the collapse of the Bretton Woods system in 1971, the US dollar remained the dominant international currency, though its share in

global reserves began to decline, reaching a trough of 50 per cent in 1990, only to bounce back to about 60 per cent since the late 1990s.

What is behind the persistent pre-eminence of the US dollar in the international monetary system and can it be expected to last? Studies have estimated that every one per cent increase in a country's share of world product (measured in purchasing power parity terms) is associated with a rise of between 0.9 to 1.3 percentage points in that currency's share of central bank reserves.

So economic size is clearly important in determining the choice of a reserve currency. The United States is still the single largest economy in the world even though its relative share of world's GDP (in Purchasing Power Parity terms) has declined somewhat over the past two decades. The US is followed by China, Japan and India.

However, if considered in aggregate, the Eurozone with its 12 member economies becomes the world's second largest economy. If we add Denmark, Sweden and Britain, the Eurozone-15 surpasses the US in economic size. In view of this, it is generally believed that the euro in particular, but also the yen, pose the most likely near-term challenges to the dominance of the US dollar. The Chinese renminbi and possibly the Indian rupee are viewed as much longer-term contenders to rival the greenback.

This said, while the euro and yen have remained the second and third most important reserve currencies, together they still constitute only about a quarter of the world's reserves and have hitherto failed to come anywhere close to challenging the dollar.

In the heyday of the Japanese economy in the 1970s and 1980s, the yen's share of global reserves peaked at almost 9 per cent of global reserves in 1991, and there was a concomitant decline of the US dollar's share from 55 per cent in 1987 to 50 per cent in 1991 (although this was due also to the intensification of the European monetary integration).

However, the main factors hindering the yen's global use at that time were a conscious policy on non-internationalisation of the yen and Japan's underdeveloped financial markets. While the Japanese have been keen on promoting the international use of the Yen since the mid 1990s, the economy stagnated and its financial sector became burdened by inefficiencies and non-performing loans (following the bursting of the asset bubble).

In addition, Japan's bank based financial system has precluded the country from developing as deep and liquid financial and capital markets as are available in the US or Western Europe. Thus, despite Japan's size or rapid rate of growth before the 1990s, the yen has failed to become a significant competitor to the US dollar. The yen's share has in fact declined since the 1990s, falling to less than 5 per cent in 2003.

In contrast to Japan, Europe's financial markets have depth and liquidity (which has been further enhanced with the advent of the Euro in 1999), and many European policymakers

have been keen on promoting the euro as an alternative to the US dollar since its inception. A number of observers have long argued that the euro provides the first genuine rival to the US dollar's international pre-eminence.

While specific data are not available, there are indications that Russia and some other central banks in Asia and the Middle East may be gradually diversifying some of their reserve flows (although not stocks) into euros.

Nonetheless, a number of significant factors have been holding back the rise of the euro as a dominant reserve currency. First is the lack of economic dynamism in the Eurozone compared to the US and the urgent need for significant structural adjustments in many of the major Western European countries.

Second is the need for greater institutionalisation of European macroeconomic policies and for European Central Bank (ECB) to develop a credible track record in monetary policy like the US Fed. In addition to these ongoing concerns, more recently, the clear dissatisfaction by many European citizens with the Eurozone (as evidenced by the rejection of the EU constitution by France and the Netherlands) has been a further setback to the euro challenging the US dollar.

So, in the short and medium terms, while the euro is closer to challenging the US dollar as the world's dominant reserve currency than is the yen, it is unlikely that Asian and other central banks will be willing to shift a significant share of their US dollar-denominated reserve portfolios into these currencies.

There has been speculation that the one country that could possibly challenge the US dollar is the Chinese renminbi, given that China is likely to become the world's largest economy and trader within the next half century.

While this is an interesting point of view, the acute weaknesses of the Chinese financial system and shallowness of its financial markets, the non-convertibility of its currency, and the persistent restraints on the capital account, makes the possibility of the Chinese renminbi as a challenger to the US dollar extremely remote anytime in the near future.

Similar concerns rule out the currency of the other Asian giant, India, for the time being. While India's financial system is far stronger than that of China and arguably has better respect for property rights, India lags considerably China in terms of trade and investment linkages with the rest of the world.

Ever since 1990, once the US became a net external debtor (its debt is estimated currently at about 30 per cent of GDP), persistent concerns have been expressed about the external store of value of the US dollar - that is, the possibility of capital losses due to sharp or prolonged dollar depreciation.

Cyclical rebound

This concern is a structural one and will re-emerge once the recent cyclical rebound of the US dollar (since early January 2005) dissipates. Other things being equal, the greater the unease about the prospects for the long-term sustainability of the US dollar, the more rapid will be the transition away from the dollar.

However, one can never write off the US dollar, as an established reserve currency cannot be easily displaced. The 'US dollar standard' has proven to be very resilient since the second half of the 20th century.

The military and geo-political clout of the US (particularly critical in this age of global terrorism) and the deeply entrenched advantages enjoyed by the incumbent will work in tandem to ensure that the US dollar will remain the dominant reserve currency for a long time to come. The US economy would have to significantly underperform the rest of the world on a sustained basis for it to lose its global dollar hegemony.

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