The Internationalization of National Currencies

Additional Information

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I must confess that when Governor Tuma suggested I speak on this panel, I was a little hesitant because of the exchange-rate issues that could arise. In the United States, our Treasury Department takes the lead on exchange-rate policy. The Federal Reserve is responsible for achieving price stability and promoting maximum sustainable economic growth. So my remarks today will not be a commentary on exchange-rate policies. Instead, I will focus on international reserve currencies. Specifically, I will discuss the characteristics of international reserve currencies and the benefits that a country - or a region such as the Eurozone - can enjoy if its currency fulfills that role. I will conclude with comments on why global currency competition provides an incentive for central banks to pursue and preserve price stability.

My remarks today are my own and do not necessarily reflect the views of any of my colleagues in the Federal Reserve System.

Recent Changes in Official Reserve Currencies

I would like to begin by sharing a few statistics that will help convey a sense of recent changes in official reserve currencies. Although my comments pertain to official reserves - that is, assets held by central banks, such as foreign government securities - many of my points can be applied more broadly to private uses.

Since the early 1990s, the world has witnessed a pronounced increase in the accumulation of foreign-exchange holdings. Almost all of this increase has been concentrated among developing countries. Foreign-exchange reserves have more than doubled as a share of developing countries' international trade in the past 15 years and, moreover, the composition of these reserves has changed[1]

We have only limited information on the currency composition of those reserves, but the data and anecdotal evidence indicate that developing countries are adding euros to their portfolios faster than they are adding dollars. At the end of 2001, developing countries held 70 percent of their foreign-exchange reserves in dollar-denominated assets, but by 2006, this share had fallen to 60 percent. Valuation adjustments stemming from the dollar's depreciation since 2001 account for some of the decline in the dollar share, but not all of it.

The evidence suggests that the share of euros held in countries' reserve portfolios has increased. This appears to be consistent with the widening of the European Union and the prospective growth of the euro area. The euro now accounts for slightly less than 30 percent of developing countries' portfolios, and it is the second-most widely used international reserve currency. The British pound and Japanese yen remain well behind.

The Characteristics of International Reserve Currencies

With this background in mind, let me turn to the general characteristics that define international reserve currencies.

For any currency to serve as an international reserve currency, three features seem especially important: First, the currency must be widely used in international transactions. Second, it has to be linked to deep and open financial markets. Finally, people need to have confidence that the purchasing power of that currency will remain fairly stable[2]

It is easy to understand why countries with a large share of global trade, or with large and active financial markets, would be more likely to have their currency adopted as a global reserve asset. The larger a particular nation's role is in international trade, the more cost-effective it will be for other countries to settle their international payments in that nation's currency.

These benefits are reinforced when funds expressed in the currency can be moved efficiently from savers to businesses and entrepreneurs. This will happen when financial markets are safe, trading volumes are high, and capital controls are kept to a minimum.

A country will find its markets attractive destinations for global financial activity when its rules promote transparency and adequate risk management. Those rules should seek to achieve the goals of safety and soundness in the most efficient way. Thus, a well-functioning regulatory and supervisory environment is especially important in promoting the use of a nation's currency in international transactions.

Once a currency is widely used for official and private transactions around the globe, and once it is widely held as a reserve currency, its use is likely to continue. However, that situation can change. If a monetary authority fails to sustain confidence in the future value of its currency, participants in the global market will eventually find substitutes for the currency. One of the consequences of globalization is that substitutes do exist for any currency if policymakers allow its purchasing power to deteriorate.

The Benefits of Providing a Reserve Currency

Let me briefly describe some of the benefits of providing an international reserve currency.

The United States benefits from the fact that the largest share of world currency reserves are held in dollar-denominated assets. Among these benefits is our ability to borrow from the rest of the world at a low interest rate. Between 1980 and 2005, for example, the income paid to foreigners who owned U.S. assets was 4.9 percent on average. However, the income paid to Americans who owned foreign assets was 6.3 percent. In other words, the United States effectively borrowed at a discount of 1½ percent.

Some people have argued that this spread partly reflects the fact that the United States tends to borrow from the rest of the world in the form of safe, relatively short-term government debt, and much of U.S. lending to the rest of the world is in the form of foreign direct investment or riskier, long-term debt. While there is truth to this claim, I think that most people would agree that at least part of the difference in returns on investment reflects a willingness by foreigners to pay a liquidity premium to hold assets denominated in U.S. dollars.

Another benefit of providing a reserve currency is more subtle. The convenience of having others adopt your currency almost certainly benefits your own citizens. When the world uses your currency, there are no intermediate steps between you and your trading partners when you trade on global markets. This makes life easier for domestic businesses and consumers. It also may make it desirable for others to utilize the financial markets and institutions of the reserve-currency country. As a result, those markets gain added breadth and depth.

These benefits make it desirable for the world to choose your currency as an international reserve asset. Nations, then, will find it desirable to pursue policies that make that outcome more likely.

Currency Competition

The willingness of individuals and governments to hold a particular international currency depends on how they view the stability of that currency's long-run purchasing power. A potential loss of purchasing power can erode the economic benefits associated with using any particular currency for international trade. When viable alternatives exist, individuals and governments will gravitate toward the currency with the most stable purchasing power.

In a Federal Reserve Bank of Cleveland report, we took note of the fact that, in the current global environment, the market share of any international currency is "contestable," or subject to challenge[3]. As a result, substitutes are readily available for any currency that is losing its value too rapidly.

In a similar manner, Federal Reserve Governor Randall Kroszner recently argued that "globalization, deregulation, and financial innovation.have fostered currency competition that has led to improved central bank performance and, hence, the recent conquest of worldwide inflation.[4]" I agree with him. Monetary authorities have a role to play in maintaining market share in a competitive environment by keeping inflation low and stable.

An important point in this regard was made a few years back by former Federal Reserve Governor Laurence Meyer[5]. Governor Meyer noted that competition among currencies is not a zero-sum game. If better monetary and fiscal policies are developed by defending challenges to any particular currency's role in the international economy, then everyone stands to gain. Currency competition is therefore useful; it creates a win-win situation, and is to be welcomed.

I truly believe that a nation or region benefits when its currency becomes an international reserve currency. To sustain that status, the monetary authority must show that it will remain committed to protecting the purchasing power of its currency. Global competition for international reserve currencies gives central banks an added incentive to pursue that goal.

End Notes

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[1] Unless otherwise indicated, the reserve data come from the International Monetary Fund (IMF). Few countries publicize the currency composition of their reserves, but many allow the IMF to aggregate their data. The IMF knows and reports the currency composition for only about two-thirds of the total. The percentages in the text refer to the portion of known reserves, not total reserves. In reporting the data, we assume that the currency composition of the unknown portion parallels that of the known portion.

[2] These points are also made by Menzie Chinn and Jeffrey Frankel, "Will the Euro Eventually Surpass the Dollar as Leading International Currency?" NBER Working Paper 11510, August 2005, Cambridge, MA.

[3]"Governments and Money," Annual Report, Federal Reserve Bank of Cleveland, 1995.

[4] Randall S. Kroszner. "The Conquest of Worldwide Inflation: Currency Competition and Its Implications for Interest Rates and the Yield Curve." Remarks prepared for the Cato Institute Monetary Policy Conference, November 16, 2006.

[5] Laurence H. Meyer. Remarks prepared for the European Institute's Conference "Challenges to the European Millennium," April 26, 1999.