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ABSTRACT

At the close of nearly a decade of managed floating exchange rates, the U.S. dollar remains the world's primary international reserve asset and vehicle currency. Some underlying macroeconomic characteristics of the United States as the major reserve currency country have undergone a marginal dimunition relative to other emerging reserve centers, and noticeable currency diversification of private and official international liquidity has taken place. The underlying microfoundations of dollar financial markets remain dominant, however, and continue to underpin the U.S. currency in its reserve role.

In spite of efforts to introduce officially sponsored multiple currency units such as the International Monetary Fund's Special Drawing Right into a larger role, these currency composites have met with only limited success to date. One must look primarily to private markets for the future evolution of the international financial system, and on this basis it is likely that the dollar will remain most important.

The decade of the 1970's also witnessed a trend toward privatization of international financial markets in general, at the expense of the role formerly played by official lending agencies. This environment also will likely reinforce the role of market forces in determining the future course of the world monetary system.

The term "dollar overhang" is one that frequently has appeared in the literature of international finance in recent years. Although it is sometimes not defined precisely, this usually refers to those private and official dollar balances held by foreigners for international liquidity purposes. There is some connotation in the phrase, however, that suggests these dollars are held with some reluctance, and that the overhang is a threat to international monetary stability. This is of course not the case in a world in which there is a demand for as well as a supply of international liquidity.

The U.S. dollar has occupied center stage as an international reserve, investment, and transactions currency throughout the post World War II era. The period in which it rose to this status was one characterized by fixed exchange rates and an absence of viable competitor currencies. Other countries were lacking in the basic attributes of a reserve center country, and in an environment in which more stable underlying economic conditions enabled the existence of fixed exchange rates, there was little incentive for currency diversification to reduce exchange rate risk. With the dollar fixed to gold and other currencies fixed to the dollar, the position of the dollar was unique.

In the decade of the 1970's, however, several economic developments challenged the role of the dollar as an international currency. The overvaluation of the dollar, which developed in an arrangement under which non-reserve center countries were obligated to acquire unwanted dollar reserves by official intervention to fix their currencies to the dollar, is sometimes argued to have been a cause for the breakdown of the Bretton Woods adjustably fixed exchange rate system. But a more telling reason for the marginal decline in the role of the dollar is

the erosion of the reserve center country characteristics of the United States which took place during the 1970's. Intermittent periods of greater perceived currency risk in the managed floating regime then provided incentives for more currency diversification by both private and official entities.

The following discussion identifies both the microfoundations of a reserve currency and the supporting macroeconomic characteristics of the reserve center country. The prospects for reserve asset choice in the future are assessed, with particular focus on the outlook for international use of the dollar.1/

Microeconomic Foundations for a Reserve Currency

Private transactors and investors, as well as central banks, choose the currencies they will trade in and hold according to the extent to which each currency possesses certain attributes. In turn, the likelihood that a given country's currency will have these "reserve currency characteristics" is a product of certain macroeconomic aspects of the country itself, to be addressed in the following section.

Four critical attributes of a vehicle or reserve currency are: 1) convertability and stability, 2) a large pool of primary transactions, 3) efficiency of the financial system, and 4) deep domestic and/or external financial markets. The dollar dominated all other currencies historically in providing these conditions and so established itself as the chief international currency. Throughout most of the post World War II period, only the British pound, other than the U.S. currency, had any substantial reserve role at all.

Convertibility, or the assurance that free markets will continue to exist in the currency, is the prime concern of international transactors

deciding upon the currency denomination of their activities. This simply reflects the exposure faced by an economic agent who lives, consumes and trades in countries other than the one whose currency he holds. Even currency instability causes less problems than does a loss of convertibility, because instability can be insured against through forward markets at a reasonable price. Long periods of volatility can also dampen the desirability of a currency for transactions purposes, however, because of the increasing cost of insurance. Regarding official holdings, central banks are less likely to cover their currency holdings in the forward market since doing so may conflict with their official exchange intervention policies, and it may be difficult to obtain forward cover on such a large volume of holdings. Over the long run, a currency's stability depends importantly on the country's avoidance of high rates of inflation relative to its trading partners.

A high level of commercial and financial transactions in a given currency serves as a catalyst in the process of that currency's becoming a vehicle. When there are many transactions that involve the assets of a particular country, it is natural that the currency of that country be used to denominate settlements, unless other critical factors discourage its use. The more transactions that can be conducted in a single currency the less costly it is to use because conversion and covering costs are reduced. Additionally, there is less risk in holding a widely used currency because so many goods as well as other financial assets can be exchanged for it. This relates to the reserve currency country's world trade role and its overall size as discussed below.

A large transactions volume also prompts the development of an efficient financial system. Such a system is characterized by full and

immediate transmittal of information as well as sophisticated payments mechanisms. This is an attribute of currencies that is particularly important as transactors begin to demand immediate settlement of accounts, conversion from time to transactions accounts, and exchange across currencies. Elaborate payments systems are likely to accompany a high volume of transactions since these encourage their development.

Deep financial markets, finally, are an important attribute for a vehicle currency because they insure liquidity and low margins. Transactors holding assets or liabilities in a given currency need assurance that there are well developed secondary markets for the assets and that there is sufficient volume in the liabilities' markets to keep spreads reasonable and non-interest costs low. Standardization of terms and maturities, which adds to liquidity and reduces spreads, is also most complete in deep markets. Once again, the country's GNP and domestic financial market size are related to these characteristics.

Macroeconomic Aspects of Reserve Currency Country Status

The macroeconomic characteristics of a country that are most likely to produce a reserve role for its currency are 1) a commitment to price stability and economic growth, 2) a large share of total world trade, 3) a small trade/GNP ratio, 4) a large GNP, and 5) a sustainable outflow of funds on the long-term capital account.

At the rudimentary level, a long-run policy commitment to both economic growth and price stability by the potential reserve center country can be crucial. It is not likely that other countries or private investors will wish to accrue substantial reserve balances in a currency associated with a secularly stagnant economy. But the commitment to a low inflation rate can be even more important since domestic inflation leads to currency depreciation and undermines the currency as a store of value.

There are some aspects of a typical reserve center that make independence from external considerations important. An economy which is relatively less vulnerable to fluctuations in foreign economic activity can postpone adjustment and borrow to finance external payments deficits more easily than can other countries. For this reason a low trade/GNP ratio is desirable. On the other hand, the more important a country's trade is to the rest of the world, the greater the likelihood that its currency will be demanded as a medium of exchange for direct transactions with the country. This demand easily spills over into transactions between third countries because of global acceptability of the currency. A large trade volume is, thus, a factor contributing to reserve country status.

The greater the relative overall economic size of the country as measured by GNP, the greater its potential for conducting an active foreign policy and maintaining a strong defense establishment. These aspects, and a record of non-expropriation of foreign-owned funds, can play an important role in determining the security of balances held in a given country. The important characteristics of convertibility and stability, as discussed above, relate to size as well as long run macropolicy.

The extent to which a country provides liquidity to the rest of the world must be balanced by outflows elsewhere in the balance of payments, and it is in this sense that a monolithic reserve center is perforce a deficit country. Typically, the reserve center's financial intermediary function is accomplished by borrowing short term and lending long term in the external capital accounts. It is not likely that any overall payments deficit will derive for a very extended period and in substantial degree from a current account deficit. A persistent current account deficit will likely reduce the desirability of a country's currency

as a reserve asset. The heyday of the U.S. dollar as a reserve currency was characterized by a current account surplus, offset by larger net outflow in the longer-term capital accounts. (The current account surplus may of course derive from such things as investment income rather than trade in goods. During the pre-1914 gold standard years when the pound sterling was the major reserve currency, England often ran a merchandise trade deficit accompanied by an overall current account surplus.)

The economies of scale that are important in national financial market development are the same as those that make a financial center important internationally. One national quality that facilitates development and maintenance of a capital market is a relatively high level of domestic savings relative to consumption. A substantial market in government debt can also be important in establishing a reserve center role. If abused secularly a government deficit can have detrimental inflationary consequences, but the debt issue that finances the deficit can provide volume for domestic capital market development. Moreover, public debt issues, particularly short-term instruments with little price risk, have characteristics of security and liquidity that can appeal to both private and official foreign entities, especially the latter.

Sophisticated capital markets can develop in economies that are neither large absolutely nor relatively closed to the rest of the world. A significant constraint on such economies, however, is the magnitude of foreign capital flows relative to domestic liquidity. If the foreign component of a country's monetary base is large relative to the domestic component, for example, the domestic monetary authority may have more difficulty sterilizing the impact of foreign flows into or out of its

domestic markets, therefore surrendering some degree of monetary independence.

The Dollar as a Reserve Currency

Because the dollar embodied these essential properties to a greater extent than did any other currency in post-war years, it was drawn into the role of the world's vehicle currency. Under the Bretton Woods system, all major currencies were pegged to the dollar, which backed its value with an assurance of gold convertibility at a guaranteed price (then $35 per ounce). For several years, only the dollar was convertible against any other currency, so that the dollar became the vehicle currency of international payments. At the same time, the massive reconstruction of Europe and development of the rest of the world created a demand for U.S. physical plant, other manufactured exports, and a supply of U.S. dollars as a source of liquidity and reserves.

The belief in the strength of the U.S. economy and the stability of the U.S. political system fostered confidence in the value of the dollar, which reinforced its status as the key international currency. The sheer size, extent of development, and diversity of the U.S. financial markets, together with the virtual assurance of free capital flows, then sustained a major international role for the dollar. Despite the decline in the value of the dollar and in the trade share of U.S. goods over the last 20 years, the dollar has maintained its position as the key international currency. But the extent of its domination clearly eroded somewhat during the 1970's. The relative importance of the dollar in financing international trade and global activity can be gauged roughly by the dollar share of the international business of major European banks. The dollar share of the "Eurocurrency" market covered in Bank for

International Settlements statistics, foreign currency denominated liabilities of banks in eight European countries vis-a-vis nonresidents, constituted about 69 percent of the market in 1980, down from 78 percent in 1970.

This erosion corresponded to a shift in reserve currency country characteristics of the United States relative to the other potential reserve centers. U.S. real GNP relative to the combined total of real GNPs for the United States, West Germany, Japan, Switzerland, the United Kingdom, and France (those countries whose currencies have been held in greater or lesser amounts as reserves historically) declined to 49 percent in 1980 from 61 percent in 1960. The period during which currency diversification received the most attention, the late 1970's, also saw an increase in the U.S. inflation rate corresponding to decreases in the inflation rates of Germany, Japan, and Switzerland, whose currencies were demanded increasingly by those diversifying out of dollars.

It is useful to focus upon official foreign exchange holdings, since these are identifiable and because central monetary institutions' portfolio incentives may reflect established private market trends. Official International Monetary Fund statistics show some marginally diminished role for dollar, a reduced role for the British pound which partially shared the dollar's reserve role in the postwar period, and noticeable accretions for the German mark, Swiss franc, and Japanese yen. From the first quarter of 1973, immediately prior to the final break with fixed exchange rates, to the final quarter of 1979, the share of the U.S. dollar in the Special Drawing Right denominated value of total official foreign exchange declined from 84.6 to 77.8 percent. Over the same period the pound's sterling's share fell from 7.0 to 2.1 percent. The German

mark's share rose from 5.8 to 11.7 percent, the Swiss franc's from 1.2 to 3.1 percent, and the Japanese yen's from a negligible amount to 3.6 percent. Much diversification of official foreign exchange reserves over this interval can be attributed to oil producer and other outer countries' portfolio management strategies. Those countries whose currencies were a subject of diversification were able to diversify less themselves because their monetary agencies were often forced to acquire the less demanded dollars to stem the rise in their currencies.

The Potential for Artificial Currency Units

A frequently discussed alternative to dollar and non-dollar reserve assets in recent years of managed floating has been man-made composite units such as the International Monetary Fund's Special Drawing Right (SDR) and the European Community's European Currency Unit (ECU). These units have been proposed primarily as replacements for officially held currency reserves, but progress in instituting them officially would be enhanced by increased private use also. Through the early 1980's there was only limited introduction of such units in denominating private international financial instruments, although there is optimism in some quarters that more progress will be made now in this area. The limited use of official composite instruments follows the short-lived experience with various privately concocted "currency cocktails" earlier in the managed floating era. The SDR denominated subsitution account, intended to consolidate outstanding official reserve balances under the auspices of the IMF, failed to gain approval in 1980. Afterwards, attitudes shifted toward looking primarily to private markets for progress in instituting the SDR as "international money."

Aside from technical and mechanical problems of instituting a larger official role for such artificial units, several conceptual ones exist. Individual central banks or private institutions could conceivably assemble another superior currency portfolio for their own needs in terms of yield, risk, and overall attractiveness. Moreover, adding a unit such as the SDR to the already existing menu of potentialreserve assets might not stem diversification among all of them, if SDR holdings were strictly voluntary. Even the IMF has succumbed to changing the SDR's definition periodically since its inception. The future for units such as the SDR in private and official use may, however, be more optimistic in the denomination of longer-term investments than in short-term liquidity. These longer-term instruments may be converted before use for official intervention or other commitments; meanwhile the diversified basket does provide some risk reduction.

Privatization of International Financial Markets

Some central banks are now managing their reserve portfolios more like private funds managers might. In addition, the private market is asserting greater influence on the international flows of capital, exchange markets and money markets. It is important, therefore, to recognize that the development of a reserve currency is a product largely of market forces, not only of government design. Continuing privatization will strengthen the role of the micro and macro factors mentioned above as critical determinants of reserve currency status. As such, privatization will increase, not hamper, the predictability of shifts in the reserve status of various currencies. In addition, the market will exert a strong discipline on governments of actual or potential reserve currency countries, not because the private system works against government policy

but because it reflects changes in monetary, fiscal and exchange policies. It is likely that the dollar will maintain its central role if the privatization of international markets proceeds, depending upon the conduct of overall economic policy in the United States and elsewhere. Two major events during the 1970's drove the wedges which cracked open the barriers to the privatization of the international financial markets. These events were the demise of the Bretton Woods system of fixed exchange rates and the move to floating exchange rates in 1973, and the OPEC shock of 1973-74. The advent of floating exchange rates signaled a decline in the role of central banks in establishing exchange rates, and to an extent interest rates, opening the door for market forces to prevail as capital controls were reduced and cross country banking restrictions were eased.

The large payments imbalances created by the OPEC oil price hike then provided additional impetus to the private markets. The deposits were largely in dollars because the dollar markets were the only ones deep enough to absorb such large deposits without severe disruption, and liquid enough to support so much inward and outward investment. Deficit countries also turned increasingly to the private market and away from the public lenders. From 1975 to 1980, the total of new international Euro-bond issues almost tripled. The largest percentage increases in borrowing came from private entities rather than state enterprises, governments, or multinational organizations. The multinational agencies, such as the IMF and World Bank, while able to make loans at lower explicit interest rates, imposed high implicit costs on borrowers by requiring restructuring of countries' domestic economic plans as prerequisites to most loans. Meanwhile, the private market began to accommodate very large loans and to reduce any single bank's risk by the syndication of loans and bond issues.

These and other innovations furthered the move from public to private financing. Table 3 depicts these growth trends through the mid to late 1970's. A trend of general deregulation of financial markets can enhance a move towards privatization. The U.S. took the lead, through laws such as the International Banking Act of 1978 and the Depository Institutions Deregulation and Monetary Control Act of 1980, in moving domestive banking markets more towards this orientation.

Conclusion

In spite of some trend toward diversification out of the dollar in recent years, little in the above analysis suggests that the U.S. currency will not still be the primary store of international liquidity in foreign exchange reserves and private asset holdings. Although the dollar will likely not be unchallenged, it will still play a key role in any evolving multiple currency reserve asset system. Initially reluctant to assume major reserve center responsibilities because of constraints placed on their more open economies, the authorities in potential new reserve centers during the late 1970's acquiesced to the point of acknowledging some increased role for their currencies. For its part, the United States stressed repeatedly its intention not to artificially perpetuate the dollar's role, while at the same time noting inherent characteristics of the dollar that would continue to make it important. Ultimately the private market will determine the evolution of the international monetary system.

Professional economic opinion remains divided at this juncture on the potential stability of a multiple reserve system. It is not clear, however, that a marginal dimunition of the dollar's role and an encroachment by other currencies will lead to instability. A system

characterized by competition among several reserve centers can conceivably be just as stable as one with a monopoly center. Especially when the change is more of degree than kind, from a system with quite small non-dollar holdings to one with greater official and private portfolio balance, it is also not clear that any transition will be that traumatic. Addition of more assets than those considered as candidates now might even make the system more stable. This remains an important topic for future international monetary research.

FOOTNOTE

1. For a relatively recent more extended treatment of reserve asset choice, see C. Fred Bergsten, The Dilemmas of the Dollar: The Economics and Politics of United States International Monetary Policy (New York: Council on Foreign Relations Press, 1975), and references cited therein. Analysis of the reserve role of the U.S. dollar relative to other currencies and to other composite officially created reserve assets may be found in H. Robert Heller and Malcolm Knight, Reserve Currency Preferences of Central Banks, Princeton Essays in International Finance, No. 131 (Princeton, N.J.: International Finance Section, Princeton University, 1978) and Thomas D. Willett, International Liquidity Issues (Washington, D.C.: American Enterprise Institute for Public Policy Research, 1980).