Gertrude Tumpel-Gugerell: The future of reserve currencies

Speech by Ms Gertrude Tumpel-Gugerell, Member of the Executive Board of the European Central Bank, at the Saint Petersburg International Economic Forum, Saint Petersburg, 6 June 2009.

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Ladies and Gentlemen:

It is my pleasure to participate in this panel of distinguished experts. In particular, I am pleased by the fact that the organisers have gathered around this table both officials from international organisations, central banks and sovereign wealth funds as well as representatives from the academia and the private sector. We are here to discuss a topic which to some may appear as a technical issue for reserve managers but which is indeed broader as it may have repercussions on the global economy and the international monetary system. Let me focus in my remarks on the future of reserve currencies on three aspects of the issue. First, I will describe how we assess at the ECB the use of the euro in foreign reserve portfolios. Secondly, I will briefly recall the available evidence on the use of the euro in foreign exchange reserves with a focus on recent developments during the global financial crisis. Finally, I would like to share with you some general reflections on the key characteristics of international reserve currencies.

In general, the international use of currencies is a market-driven process which is determined by independent decisions of private agents and public entities. The ECB takes a neutral position on such matters, i.e. it neither promotes nor hinders the international use of the euro or other international currencies.

In the context of reserve currencies, history has shown that the currency composition of global foreign exchange reserves has often evolved very gradually and might be subject to considerable inertia stemming for example from anchor currency and liquidity considerations by central banks reserve managers. Can we underpin such considerations also with data for the ten years following the introduction of the euro? The only reliable source on the currency composition of foreign exchange reserves at the global level is IMF data which cover only around two thirds of total reserves and do not include assets managed by sovereign wealth funds. Let me therefore use this opportunity to encourage more central banks and sovereign wealth funds to disclose such information – on a confidential basis – to the IMF. The central bank of our host country, the Bank of Russia, even publishes the currency composition of its reserves in its Annual report and I would like to thank the colleagues for this important Russian contribution to greater transparency in the area of international reserves.

Keeping the incomplete coverage of the IMF data in mind, we can observe that the share of the euro has risen from 18% in 1999 to around 25% in 2003. Since then, if one adjusts the IMF figures – which are published in current exchange rates – for valuation effects, the share of the euro in global foreign exchange reserves has remained relatively stable hovering around 24-25%. Interestingly, this relatively stability of currency shares in global foreign exchange reserves persisted during the onset and intensification of the global financial crisis. In the fourth quarter of 2008, the share of the euro rose by around one percentage point – again, after adjusting for valuation effects (CHART 1). It is conceivable that these latest developments have been mainly driven by emerging market central banks which have intervened to defend their currencies during the second half of 2008 and have mainly done so by selling US dollar-denominated assets. Whether one should attribute this latest moderate increase in the share of the euro to a genuine change of currency preferences is therefore not obvious.

Ladies and gentleman, please also allow me to reflect a bit more generally about the nature of international reserve currencies. What are the requirements for a currency to achieve such a status? Price stability and the depth and liquidity of the respective capital market are important elements, and the euro appears to qualify in this regard. For example, in terms of liquidity, the euro appears to have become in the perception of reserve managers the second most attractive currency in the world (CHART 2). But what are the other factors that finally create a major international currency or even a “currency of exorbitant privilege” such as the US dollar? Recent research has shown that we can also use standard portfolio theory in order to get some useful insight into this question. For example, it appears that over the past 30 years it made sense for a global bond investor – like a central bank – to be long dollar since the dollar has been a good hedge for such a portfolio.[1]

One can also use standard portfolio theory in order to explain more specifically the currency choice in central bank portfolios over the past ten years. In fact, ECB research has shown that for many emerging markets with pegged or managed exchange rates it made a lot of sense to hold a sizable fraction of official reserves in their “anchor currency” which is often the dollar.[2] The underlying reason is not that these central banks necessarily have to intervene in their anchor currency. It is again portfolio theory applied to international bond portfolios that suggests that a country with a pegged or tightly managed exchange rate would overweight assets denominated in the anchor currency because they have a low variance in local currency terms and thus carry little risk. In addition, a high dollar share countries might be motivated by the fact that the dollar appears to be a good hedge against sudden stops in capital inflows – in particular at the global level. This empirical finding has been documented again during the intensification of the global financial crisis during which capital flows to emerging markets dried up while the US dollar appreciated.

Do these considerations mean that no changes to the current international monetary system are ever possible? As we know, history tells us that changes to the reserve currency status of currencies did occur. And we have at the country level recent examples of countries which hold today more diversified reserve portfolios than in the past. In Russia, the share of the euro has grown in 2008 for the first time above that of the US dollar and currently stands at 47.5%. What is important to note here is that the gradual diversification of Russia’s foreign exchange reserves had been preceded by a rising share of the euro in the Bank of Russia operational currency basket which is used as a point of reference in its exchange rate policy. This process has been gradual and started already in 2005. More generally, since decisions on a country’s anchor currency are typically determined by structural factors which change only slowly over time – for example the direction of trade flows or invoicing practices – changes to the currency composition of reserves are also more likely to occur in a gradual way. In fact, the recent financial and economic turbulences which were also accompanied by some exchange rate volatility have resulted in only in very limited changes to the currency composition of global foreign exchange reserves.

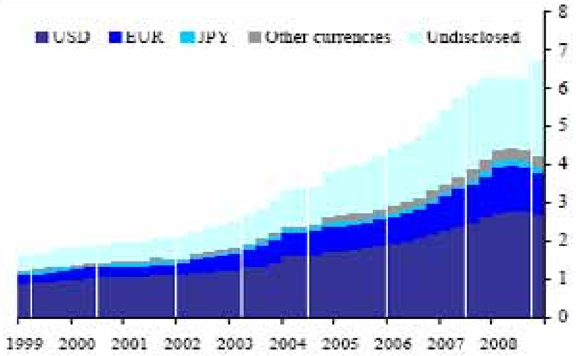
Thank you very much for your attention.

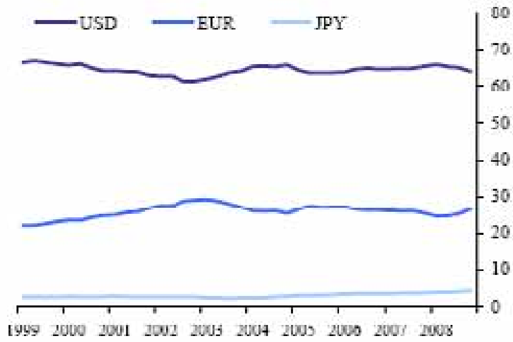
[1] See Campbell, J. Y., Serfaty-de Medeiros, K., and Viceira, L. M., 2007. “Global Currency Hedging”, NBER Working paper, 13088 May 2007.

[2] See Beck, R. and Rahbari, E. (2008). “Optimal reserve composition in the presence of sudden stops: The euro and the dollar as safe haven currencies”, European Central Bank, Working Paper No. 916.

Global foreign exchange reserves (with known currency composition)

Amounts (in USD trillion, at current exchange rates)	Shares (in percent, at constant end-2008 exchange rates)





Latest data: 2008Q4.
Sources: IMF and ECB calculations.

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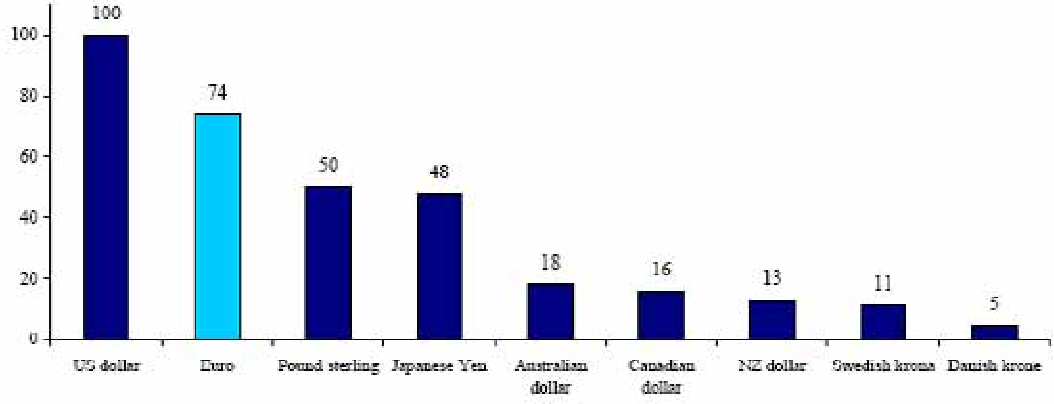
Liquidity of euro-denominated assets

Perceived liquidity of government bonds denominated in alternative reserve currencies
(percentage of central bank reserve managers ranking government bonds as "highly liquid")



Source: RBS Reserve Management Trends 2008.

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