Philip R Lane: "Multiple Reserve Currencies and the International Monetary System"

Panel remarks by Mr Philip R Lane, Governor of the Central Bank of Ireland, at the Seventh High-Level SNB-IMF Conference on the International Monetary System, Zurich, 10 May 2016.

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The world is in an important transition phase: the share of emerging economies in global GDP is far higher now than a decade ago. Over time, these countries are adopting a more liberal approach to international financial integration, building a larger set of domestic-currency financial markets that facilitate participation from overseas investors and permitting greater outward flows from the domestic private sector. In turn, the asymmetric configuration of the global financial system that characterised the decade following the Asian crisis (large external surpluses, accumulation of foreign currency reserves, the acquisition of foreign debt assets but the issuance of foreign equity liabilities on the part of emerging economies) is due for replacement but the exact properties of the new configuration is not yet clear (Lane and Milesi-Ferretti 2008).

In terms of the overall level of reserves, we know that traditional factors such as the level of trade openness and the exchange rate regime have been joined by financial factors, such as the size of the domestic financial system, the extent of capital account openness and the scale of foreign currency liabilities in determining the appropriate level of reserves. For instance, Obstfeld, Shambaugh and Taylor (2010) were prescient in emphasising the size of domestic financial liabilities that could potentially be converted into foreign currency as a driver of reserves, in view of recent developments in various emerging markets and the emphasis in the April 2016 IMF World Economic Outlook on gross capital outflows as an increasingly important driver of the financial account for these economies.

In related fashion, the empirical work on the composition of reserves identifies both trade and financial linkages as significant in explaining currency shares: all else equal, a country that trades a lot with the euro and issues a lot of euro-denominated debt will hold more euro reserves, compared to a country that is more closely linked to the US and issues a lot of dollar liabilities. Related work includes Eichengreen and Mathieson (2000), Lane and Shambaugh (2010) and Benetrix et al (2015).

The rise of China as a share of global GDP and the internationalisation of the RMB means that the share of the RMB in reserves will surely rise over time, especially for Asian economies. Still, the quantitative scale of this shift will depend on the success of the Chinese government in establishing the RMB as a major international currency. At the core, RMB sovereign debt must be classified as a safe asset by global investors if the RMB is to play a substantial role as a reserve currency.

While an outsized role for the US dollar in the international financial system is sure to persist due to an array of incumbency advantages, it is still useful to speculate about the properties of an international financial system with multiple reserve currencies. Given the importance of scale effects in building deep and liquid financial markets, it is likely that the number of major reserve currencies is likely to remain quite small, with the dollar, the euro and the RMB playing the most significant roles. An additional factor in limiting the number of reserve currencies is that a reserve-issuing bloc must be large enough and sufficiently anchored by domestic fundamentals to tolerate substantial exchange rate volatility.

At one level, an expanded stock of global reserve assets promises significant benefits. For those living in reserve-issuing blocs, the enhanced ability to issue domestic-currency liabilities to foreign investors helps to underpin financial stability. At a global level, to the extent that a world of multiple reserve currencies is also a world of multiple funding

currencies, the current tension between trade-weighted and financially-weighted exchange rates is mitigated. In similar fashion, we might expect to observe an increase in the popularity of basket pegs and basket reference benchmarks for managed float regimes.

An expanded supply of reserve assets also reduces the risk of over-valuation of these assets, which can distort resource allocation by suppressing term premia in reserve currency markets. The impact of a high level of foreign purchases on long-term rates is well documented for the dollar but is also evident in the market for euro-denominated debt (Carvalho and Fidora 2015).

A wider set of reserve currencies may also enhance risk management. While the appreciation of the dollar during the 2008 global financial crisis turned out to be an important stabilising factor for those holding dollar reserve assets, it is possible to imagine scenarios in which the dollar depreciates against the euro or the RMB during a period of international turmoil, such that a diversified portfolio of reserve currencies may provide enhanced protection against a wider array of risk factors.

At the same time, a system of multiple funding currencies may pose headaches for central banks. If there is a mismatch between the foreign currency liabilities of a country and its foreign currency assets, a central bank may need access to swap lines among the major reserve currencies. If such swap lines are not available, then a country in distress may turn to the IMF to resolve a currency-specific liquidity crunch. To avoid such scenarios, there needs to be sufficient cooperation among the issuers of the major reserve currencies together with the IMF in recognising the importance of reliable currency swap arrangements. The availability of timely and comprehensive data on the foreign-currency positions of the private sector is also essential for efficient reserve management in a multiple-currency world.

A world of multiple reserve currencies is also a world in which membership of a monetary union carries significant benefits. First, the ability to borrow and lend in a common currency and access to the liquidity facilities of a common central bank limits the need to accumulate foreign currency reserves. The provision of eurosystem liquidity provided an important buffer mechanism in coping with the sudden stops of private capital flows during 2008–2012. Second, the depth of currency swap markets for the euro against other major currencies (and the ECB swap lines with other major central banks) meant that non-euro foreign currency liabilities could also be managed effectively during the crisis.

Finally, the role of the euro as a reserve currency would be enhanced by a widening in the pool of euro-denominated safe assets. To this end, the proposal for European Safe Bonds (or ESBies) that would consist of the senior tranche of a diversified portfolio of the sovereign debt of the member countries would be an important advance in constructing an area-wide safe asset.

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