Talking Point

21st century reserve currencies - (how long) will the dollar-euro dominance prevail?

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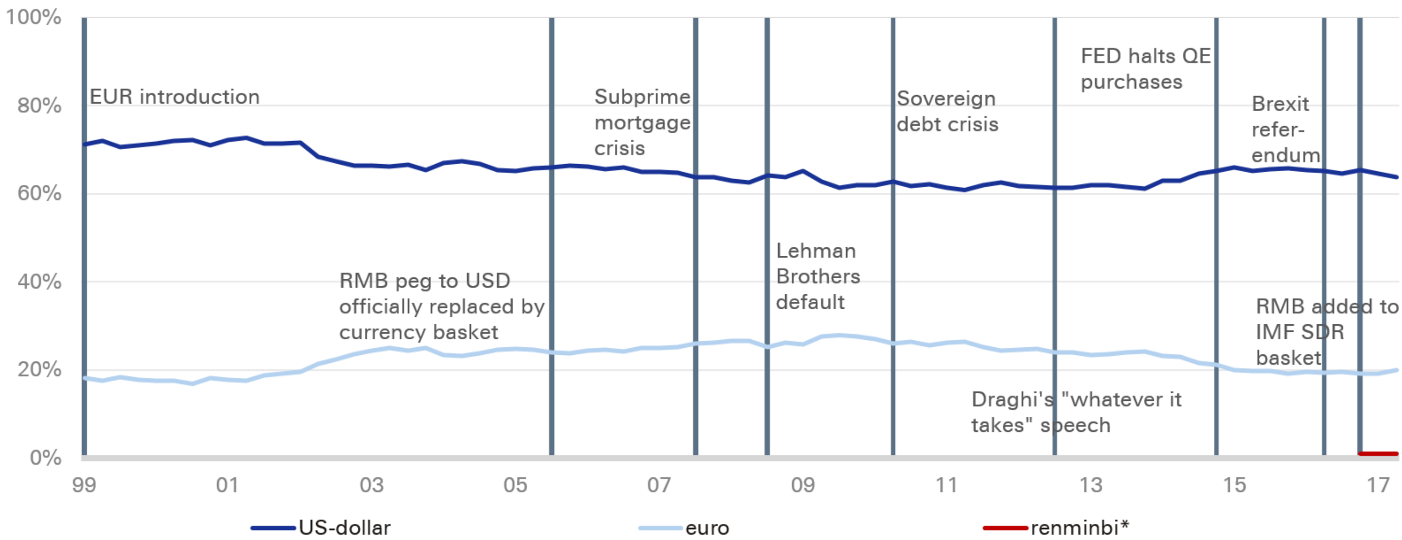
Share of global currency reserves



**Chinese RMB only seperately identified in IMF COFER from October 2016, previously included in "other currencies".*

Sources: IMF COFER, Deutsche Bank Research

The euro's second place among the world's most important reserve currencies has remained so far undisputed. The single currency's share of allocated foreign exchange reserves stabilised at 19.9% in Q2, according to IMF data[1]. This is slightly above the 19.4% share reported a year earlier, demonstrating its robustness despite heightened political uncertainty that followed last year's Brexit referendum and the rise of European populism. Also reserves in pounds sterling remained relatively unchanged at 4.4% (-0.14 pp yoy), despite the pound's sharp depreciation after the UK vote to leave the EU. The US dollar easily defended its position as the dominant currency in the international monetary system, even though its share of FX reserves dropped by 1.4 pp within a year to 63.8%. Last year, the Chinese renminbi was added as the fifth[2] currency to the IMF's basket of reserve currencies but since then its share has stagnated and remained marginal at only 1.1% of the USD 9.3 trillion in allocated reserves.

Post-crisis US dollar revaluation pushed euro's reserve share down

Before settling at close to 20% over the last two years, the euro's share of global currency reserves dropped substantially from the 28% high reached in 2009 when the financial crisis unfolded. However, a large part of this medium-term decline in the euro's relative weight can be attributed to valuation effects stemming from the re-strengthening of the USD. The absolute level of euro reserves increased by 56% since Q2 2009 in current exchange rates. It is up by a much higher 93% in constant Q2 2009 exchange rates though, i.e. adjusting for the 24% appreciation of the USD against the euro over the same period.[3] This observation gives credit to the resilience of euro reserves during times of elevated distress such as the euro area sovereign debt crisis when fears of a euro breakup were widespread. But it cannot hide that both the euro and the dollar gradually gave some way to other (non-traditional) reserve currencies over the last ten years or so. Regardless of whether this observation reflects structural developments or rather (temporary) shifts in reserve allocation due to increased diversification efforts among reserve holders in the aftermath of the financial crisis - it certainly fuels the discussion about the 21st century's leading reserve currency (or currencies). This is particularly true as China recently has become more proactive in promoting the international use of its own renminbi.

The "exorbitant privilege" of being the world's primary reserve currency

Whether it indeed is an "exorbitant privilege" to issue the world's leading currency as argued by former French President Valéry Giscard d'Estaing or rather comes at the cost of heightened international responsibility (and also some unwanted drawbacks such as more expensive exports and distributional effects) will continue to be disputed. But as in case of the US, it certainly grants preferential access to global financial markets and allows to sustain large current account and fiscal deficits without major repercussions. There might also be rather "soft" or symbolic advantages, including the diplomatic prestige gained from a leading reserve currency as manifestation of one's underlying economic and political strength. If the reserve currency status really is a good indicator of economic and political weight is another question.

Reserve currency status not necessarily reflects economic weight

Despite China's economic rise over the last decades, the importance of the renminbi as global reserve currency still remains low. The People's Republic of China is now the world's third largest economy (the largest in terms of PPP-adjusted GDP) after the US and the European Union, but the renminbi only accounts for a fraction of currency reserves.

While this phenomenon might appear puzzling at first, it is historically not considered an anomaly. Reserve currency status does not necessarily reflect a country's relative economic weight but is attributed to several economic, financial and political factors including network externalities, third countries' FX policies (e.g. currency pegs and baskets) and depth of its financial market. The United States has been the dominant (Western) political and economic power in the post-war period, with around one-fourth of global currencies pegged to the dollar, almost half of global payments settled in US dollar (including most of the oil trade) as well as a deep and liquid (Treasury) market. For China, despite its enormous importance for the world economy and world trade, its (still) restrictive exchange rate policy including capital controls as well as growing economic uncertainty might still contribute to reserve holders' reluctance towards stronger shifts to the RMB. But there also seems to be some element of inertia in reserve allocation, often illustrated by the dominance of the British pound in the first half of the 20th century, when the US had already long taken over as the strongest economic power.

This view, however, has been questioned by scholars, including Berkeley professor and former IMF senior policy advisor Barry Eichengreen. He sees the Chinese renminbi on the rise, following China's growing geopolitical weight, and possibly at some point challenging the leading role of the Greenback as global reserve currency. Different from the "traditional view", however, this might not necessarily lead to the establishment of a new predominant currency for the 21st century but rather to a multipolar scenario, where "several national currencies can play consequential international roles".[4] What role will be assigned to the euro in such a setting will probably depend on many factors, including the euro area's ability to reform and overcome its inner discrepancies as well as to remain competitive in a rapidly changing global economic environment.

[1] IMF Currency Composition of Foreign Exchange Reserves (COFER) database; allocated reserves in Q2 2017 cover around 83% of USD 11.1 trillion total global reserves, 17% are not publicly disclosed regarding the currency breakdown.
[2] The others being USD, EUR, GBP and JPY.
[3] Also see ECB (2017): "The international role of the euro".
[4] Eichengreen et al. (2017): "How Global Currencies Work: Past, Present, and Future"; Princeton University Press.