On Reserve Currencies

For most of the past decade discussions about capital flows have centered on the demand for USD as the world's central bank and sovereign wealth funds have tried to diversify their mix of foreign exchange reserves and liquid assets to lower exposure to the weakening of the world's dominant currency. China's PBOC, whose massive purchases of US Treasuries were the means for containing the appreciation of the renminbi, is a prime example. At its peak of dominance, USD represented about 71% of international reserves held by central banks in 2003 and since then has slipped steadily to about 62%. The nebulous euro gained much of the share lost by the American currency. Perhaps in part as a response to the euro's own fragility, the discussion has shifted to the potential supply of other available assets including gold and now the so-called 'commodity' currencies – CAD and AUS. This shift in focus belies a a hard reality of the current bipolar world economy – namely, as long as the Fed, ECB and BOJ are ensconced in quantitative easing mode, which may be a long time indeed, the rest of the world has a desperate need for alternative reserve assets. There are few viable alternatives and somewhat incredulously the non-convertible Chinese renminbi is a leading candidate to fill the void.

Prerequisites for being a reserve currency are at least fourfold:

1. The currency should be sufficiently liquid, which is tantamount to saying the issuing country's economy needs to be large enough to support a substantial money supply.
2. The currency already should be used in a wide range of international transactions and as the basis for debt issuance.
3. The issuing country should have favorable growth prospects and good credit fundamentals so that currency holders can earn a decent return.
4. The issuing country should have strong institutions and fiscal discipline.

Although CAD and AUS fare well on the last two conditions, they do not meet the first two prerequisites and probably never will. The size of their economies is limited by both climate and population. Moreover, it is not clear that either CAD or AUS adds much diversification to a portfolio of international reserves that is overloaded with USD. Specifically, both CAD and AUS (vis-à-vis the USD) are highly correlated with gold prices as one might expect for 'commodity' currencies. The implication is that central banks might as well just hold gold if it's likely appreciation is felt to be comparable to the carry on CAD or AUS. Moreover, gold has the advantage of being a safe haven in times of financial crises whereas both CAD and AUS have contrarian 'risk-on' attributes in times of stress. Thus, CAD and AUS might add some diversification to the international reserves, especially for a commodity-short country, but less so as a diversification against USD risk per se.

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By the same metrics, let's consider the RMB as a potential reserve currency. Like CAD and AUS, the RMB currently would not qualify based on prerequisites #1 and #2 above and is directly tied to USD, albeit with little volatility. The RMB does have the advantage of a long track record of slow but steady appreciation against the USD for those central banks with a long horizons and floating exchange rates that do not need to be defended in times of financial stress. As the world's largest creditor nation with the largest hoard of international reserves, China fares well on conditions #3 and #4, with the caveat that the PBOC has kept local interest rates too low to be attractive to foreign holders of its currency. Unlike CAD and AUS, there is a clear path to reserve status for the RMB that passes through reforms to address these deficiencies. Liquidity (#1) requires convertibility and more competitive returns, as in higher local deposit and short-term central bank rates. Higher deposit rates will serve the dual purpose of keeping flight capital at home as restrictions on convertibility are relaxed. Other key milestones will be the development of local currency bond markets and issuance of longer term maturities.

None of these reforms are likely to move quickly but the direction of financial reforms seems inexorably toward convertibility and an opening of the capital account. At a time when chronic current account deficits and quantitative easing are weakening the USD against the currencies of emerging countries, the world is looking for a viable alternative and conditions are ripe for the RMB's ascendancy. This opportunity is not lost on Chinese officials who understand the necessity of financial reforms not only to enhance its international stature but also to facilitate a transformation to domestic-led growth. A liquid currency necessitates a more open capital account. If China wants the privilege of financing its imports, especially energy and other commodities in RMB, then it must learn to live with a stronger currency with greater variability and must offer domestic investors positive real returns on the RMB deposits. As those changes evolve, the RMB is likely to become the next major international reserve currency.

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