

SOME PROSPECTS OF USING SDR AND EURO AS GLOBAL RESERVE CURRENCY

R.O. Dyshkant, 4th year

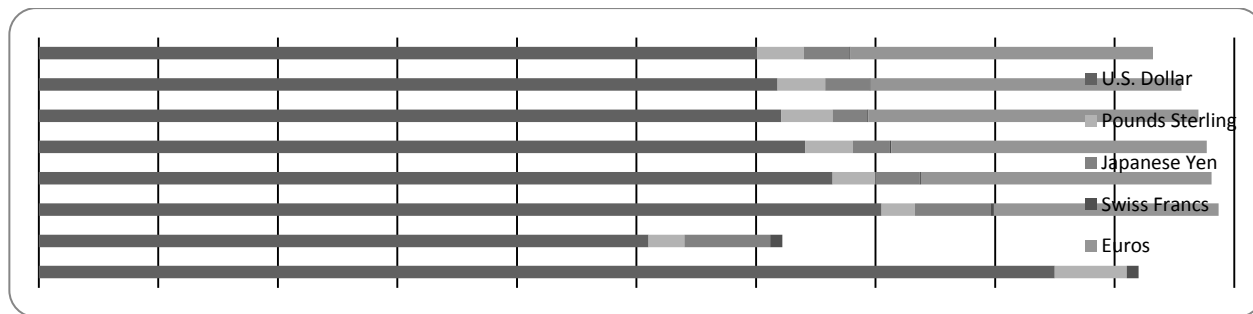
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The characteristic feature of the current economy is its instability, a striking example of which has become the financial crisis of 2008–09. The turbulence of economic processes stipulates for necessity of searching the ways of global economic structure transformation. The opinion, that stagnation of the world economy is prearranged to a great extent by the global monetary processes and disfunctions of the international currency system finds ever more support. The aim of the research is the analysis of possible alternatives to the US Dollar as the key global reserve currency.

The actuality of the research is stipulates for following factors:

1. The current international monetary system centered on the United States dollar appears to be at a crossroad . Notably, the supremacy of the dollar as a global reserve currency has been questioned following the August 2011 downgrade of the government debt held by the United States (US) from a top investment grade rating of ‘ AAA ’ to ‘ AA+ ’ by Standard and Poor ’s , and a warning of a possible further cut to ‘ AA ’ within two years .
2. International Monetary Fund showed the percentage of dollars held by central banks in their reserves is still declining year on year (Figure 1).

Figure 1 – Share of Major Currencies in Identified Foreign Exchange Reserves of Central Banks: 1973 – 2011 (%)



Source: IMF Currency Composition of Official Foreign Exchange Reserves Database [1]

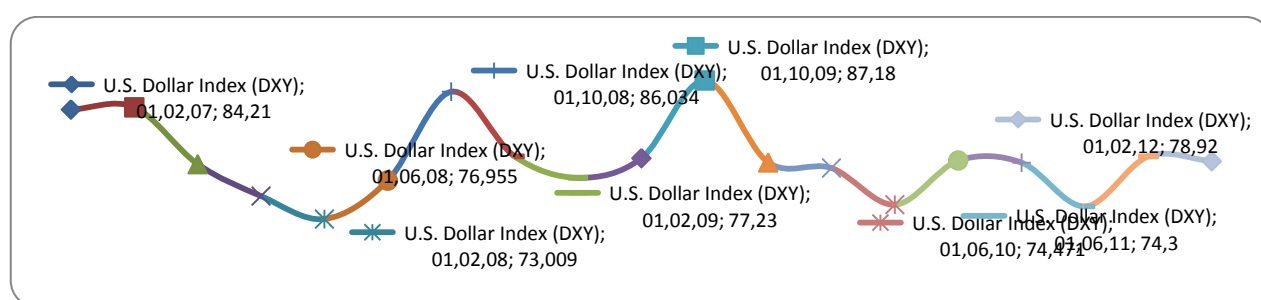
The proportion of dollars held by central banks around the world had fallen to 60.1% by the end of the year 2011. That compares with 61.8% at the same point last year. Measured over a decade, the trend is clear enough. Go back to 2001, and the proportion of central bank reserves held in dollars was 71%. It only goes down a bit every year. But over time, that starts to add up.

Many observers contend that this declining share signals the beginning of the end of the dollar supremacy. The structural weakness of the US economy and the long –term decline of the dollar over the last decade have only fuelled the anxiety of central banks holding large dollar assets, particularly those of China and the rest of emerging Asia which constitute about three – fifths of the total foreign holdings of US Treasury securities (around US\$ 2.5 trillion). Once the dollar drops below 50% of central bank holdings, we can officially declare that its days as the reserve currency are done.

3. UBS survey of investment institutions with \$8 trillion under management showed a majority no longer think the dollar will be the reserve currency in 25 years time.

4. Since 2007 permanent fluctuation of the US Dollar Index has been throwing doubts on its ‘safe haven’ status (Figure 2)

Figure 2 – The dynamic of US Dollar Index



Source: Bloomberg [2]

Therefore the recommendations of a great number of scientists and government officials to search alternatives to US Dollar supremacy as a centerpiece of the international monetary system are absolutely logical. The most presumptive challengers are SDR, euro, renminbi, gold, a currency unit based on a basket of commodities.

United Nations Department of Economic and Social Affairs recommended at its report to implement exactly SDR as the main reserve currency: “new reserve system must not be based on a single currency or even multiple national currencies but instead, should permit the emission of international liquidity – such as SDRs – to create a more stable global financial system [3].” A basket of the world’s biggest currencies would seem to offer a more solid store of value than just one. It diversifies the risk and recognizes that the U.S. is just one major economy among several.

But there are a lot of problems to realize this idea. First, the SDR currently constitutes less than 5 per cent of global reserves. Second, the SDR is not a conventional currency in that it can be used only in transactions between central banks and the IMF, and not between the government and the private sector. Third, without changes in its composition, the SDR will always be limited in attractiveness because 80 per cent of the basket of currencies that constitute the SDR is represented by the combined share of the US dollar and euro. That’s why some scientists recommend to take into consideration the national currencies of BRIC by SDR–calculation.

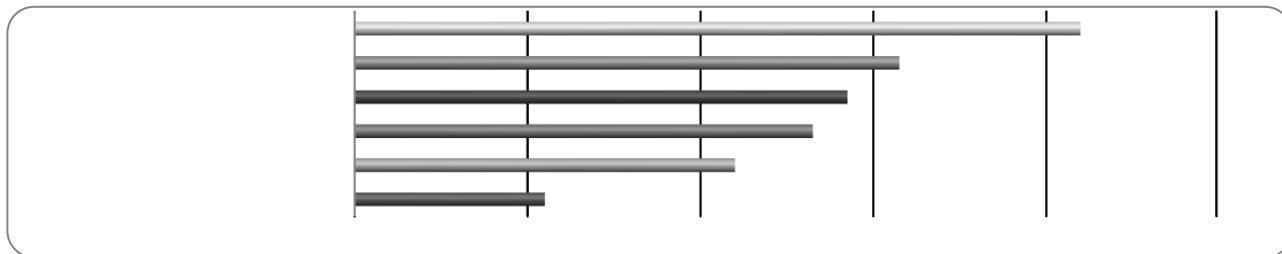
With about a quarter of allocated central bank reserves parked in euros (Figure 1), it seemed a logical competitor to the dollar up until the complex sovereign debt crisis that has engulfed the region raised concerns about the viability of the Eurozone.

The euro has seen a dramatic expansion only in debt issuance, while the dollar dominates in cross–border foreign exchange or banking transactions. The internationalization of the euro has also been concentrated within the Eurozone region, which reflects the limited and regional nature of its influence. Even though Europe’s financial markets may have the required depth and liquidity, a number of ‘structural’ factors have held back the rise of the euro as a dominant reserve currency.

For instance, even prior to the Eurozone crisis, the euro’s attractiveness was limited by the comparatively higher transaction costs, which stem primarily from the inability of the European Monetary Union to supply an instrument on par with the US Treasury bill that ensures both liquidity and convenience. Second, the euro has functioned as a ‘currency without a state’, founded as a result of an inter–state treaty.

The uncertainty associated with this governance arrangement has handicapped the euro, and thrown the Eurozone into a debate on the weak governance framework.

Figure 3 – Global Importance of the US Dollar in Percentage Terms (as of November 2010)



Source: The Economist [4]

Thus, absent significant structural and institutional changes within the Eurozone, it is rather unlikely that the euro will be a credible competitor to the dollar and will at most remain a regional currency, albeit a significant one.

Conversation about the end of the US Dollar supremacy is premature and exaggerated. While the downgrade was unprecedented, the predictions of the dollar's demise are neither new nor credible. The choice of a reserve currency also tends to be highly influenced by the peg that a particular central bank chooses to maintain. Here too, the dollar remains hugely important as it still acts an exchange-rate anchor for more than 60 countries, accounting for nearly 14 per cent of the world economy. A day after the S&P downgrade, the 10-year yield on treasuries surprised the markets by dropping 25 basis points to an all-time low. Thus the role of the dollar as the most preferred currency in international trade may only be strengthened in the near-term.

Nevertheless, despite the conserving of the supremacy status of the US Dollar as the global reserve currency, it has lost its position compared with the Bretton Woods system period. In this context a special attention has to be paid to increasing fragmentation of the global economic area, which is turning into an intricate system of local areas with more intensive relations against the background of the global transformation.

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