

# Reserve Currency

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A Briefing by: Neil Wilson



# What is a reserve currency

A reserve currency is a foreign currency that is held in significant quantities by central banks or other monetary authorities as part of their foreign exchange reserves. The reserve currency can be used in international transactions, international investments and all aspects of the global economy

# Why was it invented

Before the invention banks, debts owed and collected for international products or services had to travel to the world with gold and silver to make good on their promise of payment. However, the sheer weight and size of gold or silver created significant problems for safety and transportation. Thus banks were invented to handle international payments using gold or silver as depositories.

Because the world became a prominent place, banks invented reserve currency allowing businesses and travelers the ability to pay bills around the globe utilizing a stable monetary value system using a simple debit and credit ledger system.

Reserve Currency established a safeguarded utility for the world to trust, supporting global investments and transactions.

Today Our vast global trade system is approaching \$20 trillion in value, so enormous sums of currencies are needed in reserve. In fact, an estimated \$5 trillion in currency swaps trade hands every single day.

# Why are currencies held?

Exchange rate stability for the domestic currency

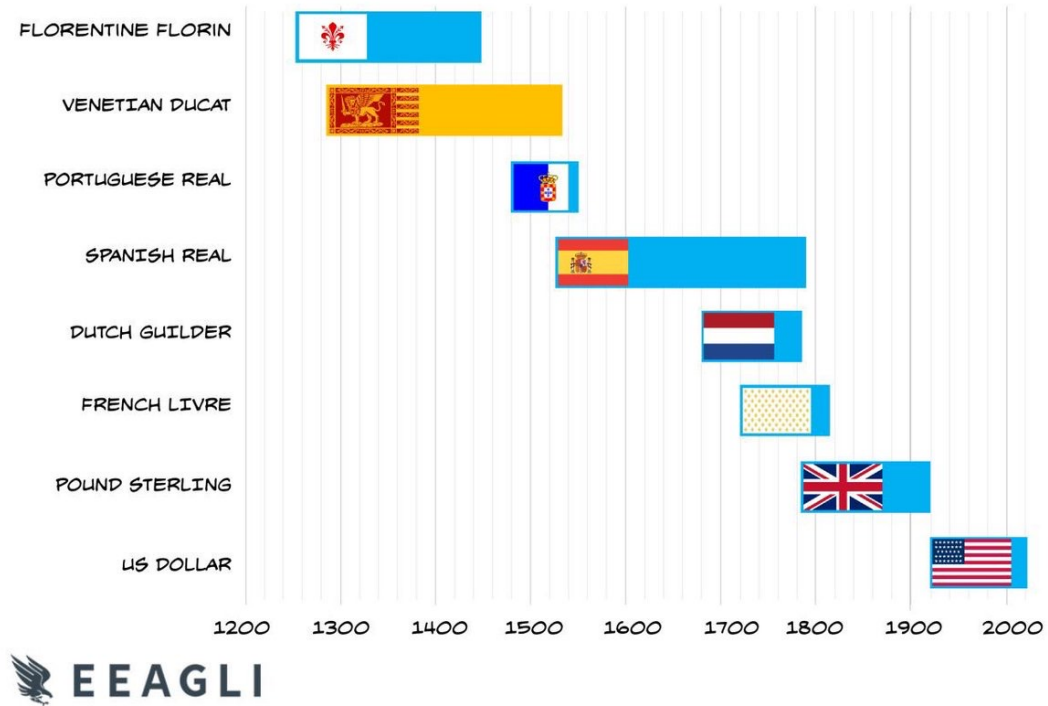
To ensure liquidity in times of crisis

To diversify central bank portfolios, which can reduce risk and improve credit ratings

All things equal, countries benefit economically from greater demand for their respective currencies

# Historical Currency Dominance

## Major reserve currencies since 1250



# Rise and fall of reserve currencies

- Some economists argue that the demand for currencies in the long run revolves around the economic relevance of a country. In general, the larger and more powerful a nation's economy is, the greater the network effect, and the more interlinked they are to the global economy. Thus, the greater demand there is to hold their currency in reserve.
- The last 120 years of currency reserve data shows some support for this claim. For example, Japan's economy hit a peak in terms of its relative share of global GDP in the early 1990s, just before the effects of the Lost Decade were felt. Subsequently, their peak as a reserve currency was around the same horizon, at 9.4% in 1990.

# Americas era of dominance

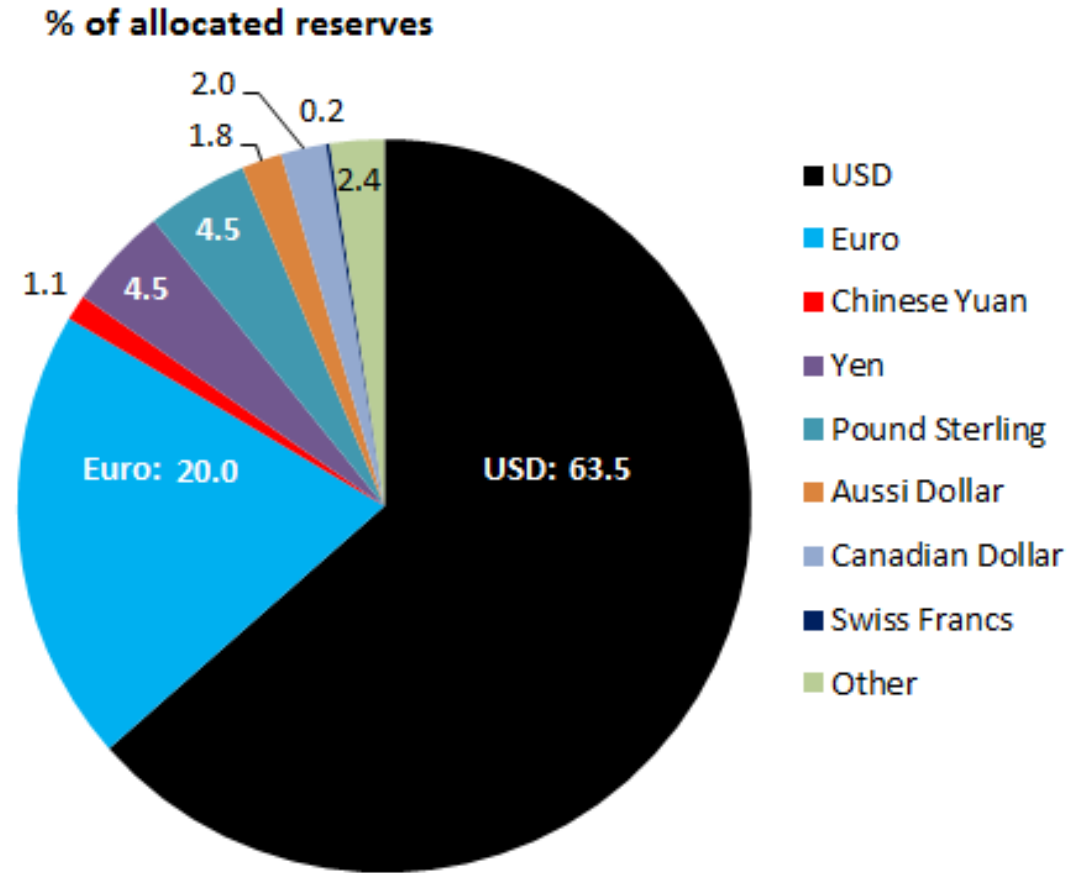
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- Due to the economic strength of the United States in the post-WWII era, the dollar is what economists call a vehicle currency.
- This means many non-dollar economies still choose to engage in international transactions using the dollar. These smaller and less accepted currencies are often converted to U.S. dollars before proceeding with any business or trade dealings. This is why, although Asian economies tend to have neighboring states as their top trade partners, they still engage in a massive portion of these transactions with the U.S. greenback as the currency of choice.
- Here are some facts that further exemplify the strength and power of the U.S. dollar:
  - More than 65 countries peg their currencies to the U.S. dollar
  - Five U.S. territories and a number of sovereign countries, such as Ecuador and Panama, use it as an official currency of exchange
  - Around 90% of all Forex trading involves the U.S. dollar
- Additionally, the dollar is often seen as a haven in times of extreme uncertainty and tumult. Given its status as the world's reserve currency, it can be perceived as less risky and can withstand economic shock to a greater degree relative to other currencies.

Current  
Reserve  
Currencies  
Held around  
the world.

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**Currency Composition of Official  
Foreign Exchange Reserves**



Source: IMF

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# New Challenges to the dollar

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- In the not-too-distant past, the U.S. displaced the UK economically and as the world's reserve currency. Today, the U.S. economy is showing signs of slowing down, based on GDP growth.
- China is on the rise, having already displaced the U.S. as the EU's top trade partner. With projections for China to overtake the U.S. as the world's largest economy before 2030 in nominal terms, could a new global reserve currency emerge?

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# What needs to happen for China to be used as the worlds largest reserve currency?

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- China would have to prove to central banks they can be trusted, and that Beijing would maintain its commitment to the free flow of foreign capital if it were faced with a major financial crisis?
- China current capital outflow control is a serious concern for foreign investors—including central banks—since controls have implications for liquidity. Currently outflow controls restrict investors' ability to sell renminbi-denominated assets and exchange the proceeds for foreign currencies. When used, they can effectively lock investors' capital in China.
- The increasing concentration of power in the hands of Xi Jinping has only increased the liquidity risk associated with China's currency. As Xi has consolidated his control of the economy over the last decade, China has become less transparent and more unpredictable.

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# Continued

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- Extreme policy moves have eroded trust in China's political system, further animating investor skittishness in holding renminbi. In China, it seems as if the rule of law has been replaced by the personalistic, anti-market "Rule of Xi." Foreign investors must consider the possibility that Chinese financial assets may become at once illiquid and non-convertible if Xi determines that China's economic stability is threatened by capital outflows.



## In conclusion

Despite some appealing attributes, the renminbi is unlikely to seriously challenge the US dollar's reserve currency status so long as politically induced liquidity risk concerns endure.

If Beijing is truly keen on promoting the yuan's global prospects, it must address the concerns of foreign investors, including central banks. To do this, it should finally move forward with lasting financial liberalization alongside meaningful political reforms. The former would entail the elimination and renunciation of capital outflow controls as a tool of exchange rate management. The latter would require the Chinese Communist Party to unwind the last decade of power concentration in the hands of Xi Jinping.

Presently, the chances of these steps taking place remain even smaller than the yuan's current global standing.