

## **Appendix 1: An Historical Perspective on the Reserve Currency Status of the U.S. Dollar**

The United States dollar has been the world's primary reserve currency for over 60 years. Under the Bretton Woods system, the dollar was pegged to gold and most other currencies were pegged to the dollar. As a result of this arrangement, dollars were used as the main intervention currency and, hence, reserve currency. Limits on convertibility of some currencies, particularly in the early years of the Bretton Woods system, also supported the use of the dollar as a reserve currency. With the collapse of the Bretton Woods system, fluctuations in the dollar's exchange rate and the rise of other global economic powers, there have been various predictions of the demise of the dollar as the primary reserve currency. Yet, data on currency composition of reserves indicate that the dollar's share of reserves today is roughly the same as 30 years ago, as is the euro's.<sup>1</sup> There have been variations in the dollar's share, but it has never fallen below 50 percent.

The rise of Germany and Japan as major economic powers led to the view that the deutschemark and the yen would rival the dollar, dividing the world into three currency blocs. The yen's share of global foreign currency reserves did rise in the 1980s, but peaked at close to 9 percent in 1991 and since has declined to less than 3 percent. The deutschemark was the main reserve currency among the euro legacy currencies and accounted for the largest share of reserves after the dollar. The share of reserves held in deutschemarks ranged from 10 to 18 percent between 1979 and 1998.

The decision to establish the European monetary union led to further predictions of the dollar's demise. The euro is currently the only other major reserve currency, accounting for one-fourth of foreign currency reserves. Throughout the 1980s, the combined share of the euro legacy currencies plus the European Currency Unit (ecu) hovered at around 30 percent.<sup>2</sup>

The dollar's role as the primary reserve currency (and, more generally, as the primary international currency) was not established by decree but, rather, because of the emergence of the U.S. as the world's major economy. Economists point to several key factors that determine the use of a currency for reserves. These are:

- the size of the domestic economy,
- the importance of the economy in international trade,
- the size, depth, and openness of financial markets,
- the convertibility of the currency,
- the use of the currency as a currency peg, and
- domestic macroeconomic policies.

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<sup>1</sup> Reserve composition data is reported on a voluntary basis and compiled by the IMF. Data prior to 1995 is only available in IMF annual reports. More recent data is available from the IMF's Currency Composition of Official Foreign Exchange Reserves (COFER) database. Currently there are 140 entities that report to COFER, including IMF member countries, non-members, and other foreign exchange reserves holding entities. Reporting is confidential, but the IMF has indicated that all advanced economies (as classified by the IMF) report to COFER. The results of the analysis in this appendix would not change unless non-reporters hold sharply different currency compositions of reserves and have changed those compositions over time.

<sup>2</sup> The ecu was the unit of account for the European Monetary System (EMS) the precursor to European monetary union. It was computed as a weighted average of the currency participating in the EMS.

Most of these factors suggest that the dollar and the euro would account for equal shares of global reserves. The size of the euro area economy is only slightly smaller than the U.S. economy. The economy of the euro area is only slightly smaller than the U.S. economy. Both the euro area and the United States account for a large share of global trade. Both the euro and the dollar are freely convertible, and both economies have a history of sound macroeconomic policies. In addition, the dollar and the euro are the only currencies to which other currencies are regularly pegged.

The key factor that may explain the smaller share of the euro as a reserve currency is the size and depth of government bond markets. Although total sovereign debt outstanding in the euro area rivals that of the United States, there is no common euro area sovereign debt market. This reduces the ease with which holders of euro-denominated securities can buy and sell them, compared with U.S. Treasury securities.

These factors also explain why no emerging market currency accounts for a visible share of global foreign currency reserves. A few emerging markets have become large economies and global trading powers. Likewise, several of the emerging markets have established a history of sound macroeconomic policies resulting in low inflation and sustainable public debt levels. Emerging economies typically, however, do not have well developed and open domestic financial markets and, in some cases, limit convertibility. Over time, financial markets in many emerging markets are almost certain to become more developed and integrated with global capital markets. Financial market development combined with sound macroeconomic policies and open markets should lead to an increased international role for emerging market currencies and a greater diversification of foreign currency reserves. Nevertheless, as long as the United States maintains sound macroeconomic policies and deep, liquid, and open financial markets, the dollar will continue to be the major reserve currency.

