

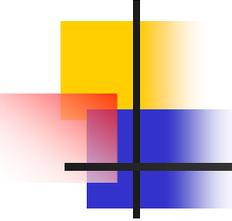
Implications of the crisis for international currencies

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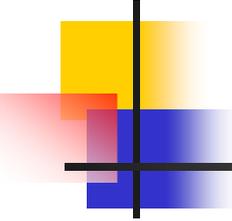
*Central Bank of the Republic of Turkey
Conference on 'Globalisation, Inflation and
Monetary Policy'*

Istanbul, 21 November 2008



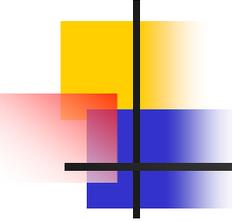
Road map I: the fundamentals

- Determinants of international currency status
 - Network externalities
 - Key role of *financial markets*: interplay between vehicle currency and asset currency functions
- Dollar and euro pre-crisis
 - reserve holding
 - anchor currency role
 - invoicing/quotation
 - investment currency
 - vehicle currency
 - world banker role
- Global imbalances at root of crisis and still threaten dollar dominance



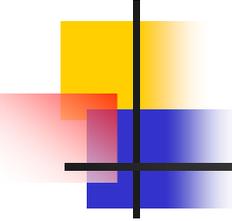
Road map II: crisis and change

- New features: financial markets, capital flows, exchange rates
- Will crisis be a 'tipping point'?
- 'Small' currencies squeezed out?
- Can euro now challenge dollar?



Markets choose international currencies, *network externalities* important

- But models with network externalities have multiple equilibria (Portes and Rey 1998)
- Might shift if expectations and transactions costs change and if there are high elasticities of substitution between assets denominated in alternative major currencies



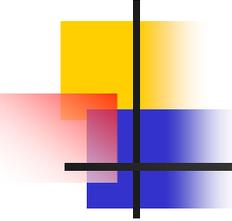
Financial globalisation and international currencies

- Cross-border financial flows up much faster than trade
- Asset trade (including with emerging markets) dominated by major international currencies
- Resulting customer-dealer transactions in FX markets → large volumes of intra-dealer transactions
- FX markets have expanded dramatically, also international use of derivatives etc.
- Hence ***international role of a currency today much more related to financial than trade flows*** (relative to 1990, say)



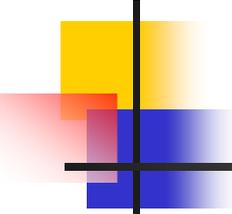
International currency *roles are linked*

- Choice of reserve currency depends on currency stability (store of value, unit of account), size of economy, role in world trade
- Financial market determinants of vehicle currency
- Vehicle currency influences composition of reserves for countries that manage exchange rate
- Size, depth and liquidity of financial markets also key in choice of investment currency



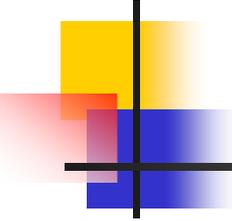
Dollar dominance in reserve holding

- Confirmed by Bretton Woods
- Maintained/explained by 'network externalities'
- But does that make sense for central banks?
- And diversification motive works the other way – especially if there are alternative assets tradeable in large, liquid and deep financial markets
- And increasing use of euro as pegging or 'anchor' currency may change incentives for reserve holders



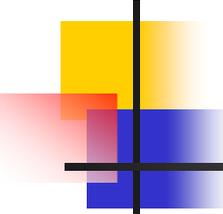
Central bank diversification

- Across assets – including activities of SWFs
- Across currencies
- Factors relevant to the currencies: inflation, ER volatility
- Regionalism – distance matters
- Inertia (persistence) – and fear of capital loss



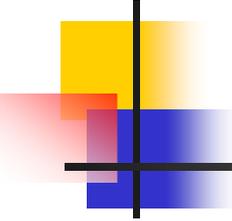
Anchor currency role

- Switch from \$ to basket pegs (Russia, Libya, China, maybe GCC)
- De facto anchoring – some switch towards €, comparing 2005-6 with 1994-8



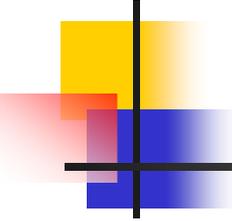
Private use: invoicing

- Data scant, but € gradually rising, especially when one party is an EU country
- Attractiveness of currency for invoicing affected by ER risk, volatility of inflation, capital market development, absence of capital controls – so € now attractive alternative
- Network externalities surely relevant here
- \$ used for reference-priced and exchange-traded goods – won't change without a major shock



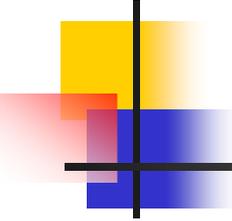
Investment currency

- Transaction costs now lower for €-denominated than for \$-denominated corporate bonds, close for government bonds (Biais *et al.*, Dunne *et al.*)
- Bid-ask spreads in FX markets now similar (very close to zero)
- €-area financial development now comparable to US and UK, superior to Japan
- Bund is world's most important hedging instrument
- But euro-area government bond market still has separate issuers, and corporate bond and equity markets much smaller than US



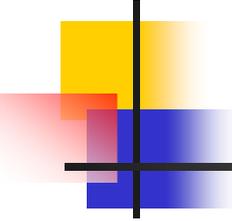
Issuing (quotation) currency

- € issuance exceeds \$ in international markets since 2001, and € ahead of \$ in outstanding stocks since 2004
- € has brought significant increase in liquidity of international debt markets (Bobba *et al.* 2007)



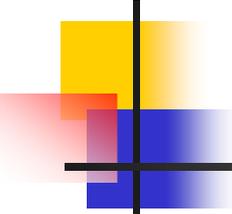
Other private-sector use

- Optimal *hedging* strategies (Campbell *et al.* 2007): bondholders should be in \$ (which appreciates when global bond prices fall), equity holders in € as well as \$ (both negatively correlated with global equity returns)
- Physical currency use: \$ still dominant, usage outside US 3 times greater than € outside EMU
- But €-denominated deposits held by non-€-area residents growing rapidly



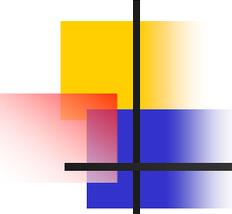
Vehicle currency in FX markets

- BIS (2007) shows \$ still dominant (appears in 86.3% of transactions, down from 88.7% in 2004)
- € at 37.0% (37.2% in 2004)
- \$ also dominates OTC FX derivatives
- But € exceeds \$ in market for OTC interest rate derivatives



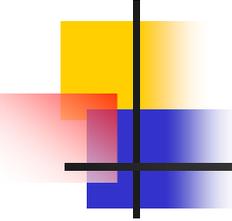
US is still 'world banker' with 'exorbitant privilege'

- US borrows short, lends long, and earns excess returns on all asset classes (Gourinchas-Rey)
- Since 1999, euro zone investors have not earned consistent excess returns
- Like the US, the euro zone obtains a positive valuation effect when euro depreciates and suffers a valuation loss when it appreciates (assets in foreign currencies, most liabilities in euro)
- Euro area assets and liabilities are a higher percentage of GDP than for US – more highly leveraged
- But US does more maturity transformation



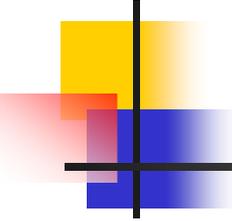
Global imbalances at root of crisis – and threaten dollar's dominance

- Unprecedented that main international currency is issued by country in substantial, continuing CA deficit, with NIIP $\ll 0$
- UK pre-1914 also borrowed short and lent long, but it ran a large CA surplus and was big net creditor
- In recent period, US deficits created international liquidity on unprecedented scale, led to low interest rates, search for yield, ...



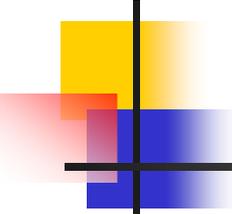
Crisis and change

- Fall in perceived advantages of US financial markets and instruments (but Gruber and Kamin (2008) say no previous evidence for 'superior US assets' story)
- Exchange rate showed no significant 'safe haven' effect in August 2007 – a 3% appreciation of \$ wrt € over 10 days, then € rise resumed
- But € down from \$1.60 to \$1.25 since 15 July
- Still, this is more likely due to deleveraging and unwinding of carry trades than safe haven response (€ *rose* 6% during 11-24 Sept)



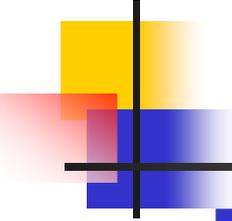
Will crisis be a 'tipping point'?

- Some evidence from a century ago that network externalities didn't fully dominate even in vehicle currency role, inertia not as great as previously believed (Eichengreen-Flandreau 2008a)
- And in interwar period, network effects didn't apply in reserve currency role (E-F 2008b)
- Indeed, during that last period of financial crisis, there was *switching*: \$ overtook £ in mid-1920s, then with \$ devaluation of 1933, £ regained dominance! – then came war, the greatest shock
- So no big obstacle to 'tipping' after all?



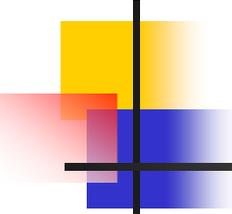
Will 'small' currencies be squeezed out?

- As in interwar period, we have two highly liquid financial markets without capital controls – reserve holders split between them
- Smaller currencies offer less stability, can't compete (even if, as for £, financial markets are highly developed)
- Examples: French franc interwar, yen in 1990s, Swiss franc and sterling now, yuan now and in future
- Indeed, serious threats to international currencies that are small compared to the size of their international financial sectors (sterling, Swiss franc)
- But if both \$ and € unattractive, reserve holders can switch into real assets (*e.g.*, SWFs)



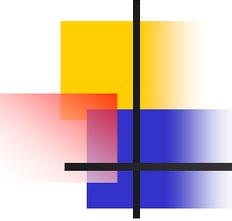
Can € now challenge \$? – structural factors

- Financial stability and regulation – fragmentation of regulatory authority
- Unclear LLR authority
- But crisis may force more clarity, closer coordination, more common policies
- And ECB has handled market liquidity problems at least as well as Fed
- € area (with UK) led on bank recapitalisation and market reliquification
- Meanwhile, global and European influence of US banks has fallen



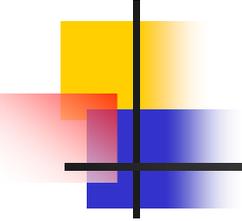
But might crisis threaten euro area itself?

- Expansion of euro area in question – won't greater vulnerability of East European economies and others keep them out?
- But evidence to the contrary from DK, IS, H, P – even in UK, EMU back on the table
- Will some existing members (have to) exit? – Italy, Spain, Ireland, Greece all seem in danger, sovereign spreads over bunds are up, CDS spreads up too
- But exiting would be worse than staying in – the 'mother of all financial crises' – even better to default in rather than out, if it came to that



Summing up

- Network externalities are important but not decisive – no big obstacle to ‘tipping point’
- Euro clearly gaining ground, except in vehicle currency role
- US is still the ‘world banker’, but on an increasingly precarious base
- Global imbalances at root of crisis, still threaten dollar dominance
- Fall in perceived advantages of US financial markets and instruments

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- No evidence of safe haven effects in crisis
 - Small currencies are threatened
 - The supposed 'structural weaknesses' of the euro area are overstated as impediments to international currency role
 - The euro area won't disintegrate
 - Overall, the crisis may have strengthened the euro's challenge to the dollar's dominant international status