



The International Role of the Dollar and the Euro:

Discussion of “The Euro as a Reserve Currency,” by Gabriele Galati and Philip Wooldridge

“The Euro and the Dollar in a Globalized Economy,” St. Louis, May 25, 2006

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Outline of my comments

- The focus will be on the currency composition of international reserves, as in the paper by Galati and Wooldridge
 - Why do we care?
 - Foreign exchange intervention
 - More comprehensively, why do countries hold reserves?
 - What currency should they hold?
 - Possible reasons for diminished role for the dollar.
- Some comments about the euro/dollar exchange rate.



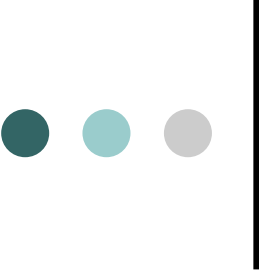
Why do we care?

- Financial gains for a country if its currency is a reserve currency
 - Pure seignorage
 - “exorbitant privilege” – below market rate on our debt
- Economic diversification
 - In bad times if currency depreciates, value of our debt falls.
 - An escape hatch
- Other reasons
 - Prestige
 - Increases interconnectedness of countries.



Reserves and foreign exchange intervention

- Several reasons for holding reserves
- But big events of last several years all have to do with the role of stabilizing exchange rates:
 - The accumulation by emerging markets of a “war chest” to defend against future currency attacks.
 - The massive intervention by Bank of Japan to stabilize the dollar/yen exchange rate
 - The huge accumulation of US securities by China as it maintains its exchange rate.



Does sterilized foreign exchange intervention work?

- Countries with capital controls in place – Malaysia and notably China – appear to be able to control exchange rates with sterilized intervention.
- But the academic literature has repeatedly shown that sterilized intervention has only a limited effect on exchange rates.
 - For example, Kearns and Rigobon (JIE, 2004), find interventions by RBA are successful against US dollar – but almost all the effect is within one day.
 - Was the BoJ intervention successful?



“Signaling” role of intervention

- It has long been suggested that intervention is a “signal” of future monetary policy, but there is little evidence to support this.
- Alternatively, intervention might “signal” the central bank’s belief about the right value for the currency. It is a way to deliver private information to the market. The central bank “puts its money where its mouth is”.
 - Perhaps, for example, the BoJ prevented a yen bubble.
 - Perhaps reserves in emerging market countries deter speculative attacks.



Taxonomy of reasons for holding reserves

Reason for holding reserves	Optimal reserve currency holding
Transactions balances	Dollar in most of the world Euro in Europe



Taxonomy of reasons for holding reserves

Reason for holding reserves	Optimal reserve currency holding
Insurance against speculative attack	Perhaps the dollar – to maximize signaling effect



Taxonomy of reasons for holding reserves

Reason for holding reserves	Optimal reserve currency holding
Currency stabilization – misalignments	Basket of currencies



Taxonomy of reasons for holding reserves

Reason for holding reserves	Optimal reserve currency holding
Currency stabilization – credibility	Major currency



Additional concern

- Currency exposure of central bank argues for diversification



Optimal reserve mix

Reason for holding reserves	Optimal reserve currency holding
<ul style="list-style-type: none">○ Transactions balances○ Insurance against speculative attack○ Currency stabilization – misalignments○ Currency stabilization – credibility	<ul style="list-style-type: none">○ Dollar in most of the world, euro in Europe○ Perhaps the dollar – to maximize signaling effect○ Basket of currencies○ Major currency
<ul style="list-style-type: none">○ Reserve diversification	<ul style="list-style-type: none">○ Basket of currencies



Recent trends

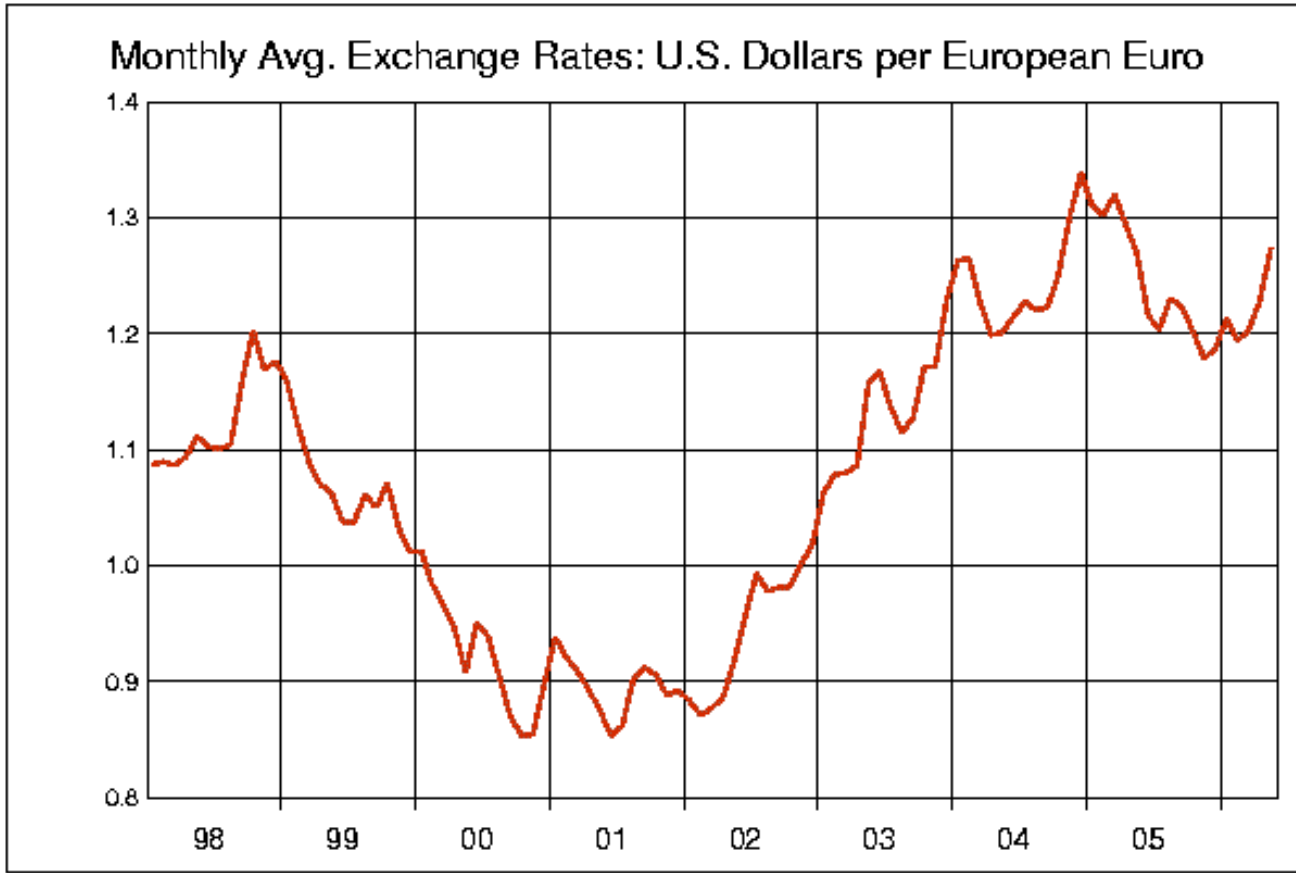
Reason for holding reserves	Optimal reserve currency holding	Reserve composition changes
<ul style="list-style-type: none"> ○ Transactions ○ Speculative attack insurance ○ Currency misalignments ○ Credibility 	<ul style="list-style-type: none"> ○ Euro in Europe ○ Dollar? ○ Basket ○ Major currency 	<ul style="list-style-type: none"> ○ Europe (euro) ○ China, emerging markets (dollar) ○ Japan (dollar) ○ China (dollar)
<ul style="list-style-type: none"> ○ Diversification 	<ul style="list-style-type: none"> ○ Basket 	

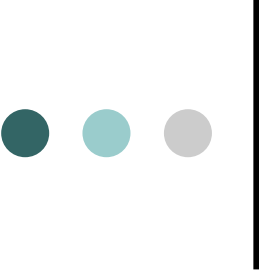


Will the use of dollars decline?

- Transactions reasons?
- International diversification – China?
- Credibility if the dollar becomes more unstable
- The forecasts that the use of the dollar will decline – especially use by China – seem to assume:
 - A lot of inertia by central banks
 - Or that commentators have better foresight than central banks.

The euro/dollar exchange rate





The traditional case for floating rates (Friedman 1954)

- Exchange rates can achieve optimal relative price adjustment when nominal prices adjust sluggishly
- Having one's own currency allows for independent monetary policy



The reality (2006)

- Exchange rates do not merely adjust to clear goods markets. They are an asset price.
 - They respond to news about the future.
 - Exchange rate swings may not deliver optimal short-run prices at all.
 - What underlying changes in current tastes or productivity could possibly account for these wide swings in the dollar/euro rate?



Optimal monetary policy

- These days, “rule based” monetary policy is the norm.
 - Central banks have eschewed “independent monetary policy”.
 - The question is, what should they target?
 - In some cases, there seems like a strong case for targeting exchange rates along with inflation and the output gap.
- Formally, this is laid out in “Expectations and Exchange Rate Policy,” Devereux and Engel, NBER Working paper 12213, May 2006.