

# Common Currencies and Reserve Currencies: *A Different View*

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# Summary

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## On common currencies:

Economic integration is *not* about the unit of account,

it's about *economic integration*:

common markets in labor, goods, services, property rights,  
corporate control and credit.

## On reserve currencies:

Reserve currency status is *not* about the unit of account,

it's about *the asset*:

a widely-accepted means of exchange and store of value used  
as the base asset in money creation (high-powered money).

# Basics: one market for capital

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## One pool of capital in the world

- Deployed in different places and to different ends

## But common benchmark for us all

- All investments are compared to the highest return / lowest risk
- Differences in anticipated, risk-adjusted returns will be reflected somewhere

## Exchange rates are one means of reflecting these differences

- If these differences are not to be found in exchange rates they will be reflected in other market prices and economic outcomes

# Rates of exchange and economic integration

Eliminating currencies does not eliminate the differences in returns

- Only eliminates one means of *expressing* those differences

To eliminate the *differences* in risk-adjusted returns

- Must create genuinely common markets
- Labor, goods, services, property rights, corporate control and credit

A common currency is neither sufficient nor a necessary condition

- A common currency and common central bank *may* facilitate the development of common market in credit
- But it is not a guarantee of integrated markets - no assurance of converging risk-adjusted returns to either labor or capital

# An example: U.S. economic integration

## 1861-65: Civil War fought over principle of labor market mobility

- Created a strong Federal government
- Committed to the free movement of free labor across continent

## 1865-1940: Judicial development of a common market

- States not permitted to restrict inter-state commerce
- Goods, services, ownership of property and corporate control

## 1931-1945: Continent-wide fiscal stabilizers

- “New Deal” response to Great Depression
- Counter-cyclical policies; social and corporate welfare
- War economy

# U.S. financial integration

## 1800s: Common currency (unit of account): the dollar

- 1830s to 1914: no central bank
- Monetary conditions reflected capital strength of local banks
- “Rates of exchange” between state bank notes and gold  
(Called “credit spreads” today)

## 1914: Created Federal Reserve System

- Intended *regional* monetary policies by 12 reserve banks
- Created national overnight funds market *by accident*
- Created national monetary policy in law only in 1930s
- Prohibited “inter-state” banking until 1980s

*Only in 1980s & '90s did U.S. create real common market in credit*

# A common currency is only an opportunity to integrate

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A common unit of account will not create economic integration.

If the goal is to reduce disparities in economic growth and in risk-adjusted returns, eliminating exchange rates is not a short-cut.

Eliminating the exchange rate will also eliminate an adjustment mechanism, putting more pressure elsewhere.

- Differences will be reflected in other economic outcomes.
- Making it more (not less) important to have truly common markets in labor, goods, services, property rights, corporate control and credit.

*Be careful what you wish for!*

# Reserve currency status: it's about the asset

Reserve currency status is not about the unit of account.

Size or importance of an economy is an imperfect proxy.

Reserve currency status: availability of a "reserve" asset:

- Widely-accepted means of exchange and store of value
- Held on balance sheet by credit intermediaries
- Leverage point in money creation - "high-powered money"
- Available in sufficient volume to correspond to growth in demand for credit and aggregate demand

# An example: 19<sup>th</sup> century United Kingdom

Sterling was the reserve currency (unit of account)

But the reserve asset was GOLD (not gilts)

- British banks had origin in London-based gold market
- Banks liquefied gold; sterling the unit of account of banks

Sterling lost reserve currency status after the First World War

- Economic decline but also the end of the gold standard
- Gold lost status not because of decline in value but because supply did not expand with credit needs
- British banks & sterling lost special connection to reserve asset

# Evolving source of U.S. dollar's status

## Early years of U.S. dollar as reserve currency:

- 1930s-'40s: default from Sterling; Depression; WWII
- 1950s-'60s: matter of "law" – Bretton Woods system
- 1970s: collapse of Bretton Woods
  - The end of the U.S. dollar's reserve currency status?
  - The Swiss franc as a reserve currency?

## Rising U.S. budget and current account deficits (1980s to present):

- Reserve currency status *in spite* of twin deficits?
- Or, perhaps, is the U.S. dollar's reserve currency status *because* of current account deficit and federal borrowing?

# Dollar's role expanding even as its end predicted

## U.S. Treasury securities as high-powered money:

- Not central-bank liabilities but central-government liabilities
- Store of value (payment of interest)
- Most liquid market (ever)
- Good enough for asset side of the Fed's balance sheet
- Did rapid growth in supply meet growth global credit demand?
  - 1970s to 1995: inflation threatened; volatile markets
  - 1995 to date: low and stable inflation and accelerating use of U.S. Treasuries as reserve asset of choice

## U.S. Treasuries and close substitutes provide base asset:

- Banks liquefy those assets
- Dollar = unit of account for U.S. capital markets

# Regime change or changes at the margin?

Dollar's "bold bid" for market share in reserve currency game:

- Accumulated current account deficit in trillions

Under what conditions will this regime continue or be lost?

- Dollar/Treasuries' retain status (deficits continue):
  - Liquid store of value: U.S. avoids accelerating inflation
  - Supply grows with aggregate demand and need for credit
- Loss of status: loss of liquidity, loss of store of value (inflation)
  - If supply does not grow fast enough
  - If an alternative develops that better serves needs

Big markets, changes at the margin are still seem quite large

# Conclusion

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Economic integration is not about the unit of account,  
it's about economic integration.

Reserve currency status is not about the unit of account,  
it's about the asset.