

On the composition of Asian central bank reserves: Will the euro replace the dollar?

Reid W. Click*

*George Washington University, School of Business, 2201 G Street NW, Suite 401,
Washington, DC 20052, United States*

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Abstract

Recent discussion in the financial markets has considered the possibility that Asian central banks might be shifting some of their international reserve holdings out of the dollar and into the euro. Prompted by this recent interest, we empirically examine the composition of central bank reserves in Japan, China, and Korea. The currency composition of reserves is a well-guarded secret for these central banks, so we offer statistical estimates of the quantity of euro reserves held based on the time series properties of total reserves and the value of the euro. We find that, over the period 1999–2004, euro reserves may average 1/3 of the total reserves of these countries. In contrast, in the pre-euro period 1993–1998, reserves in currencies that were replaced by the euro were generally insignificant. Because there has been a large build-up of foreign currency reserves in Asian central banks, the rise in the holdings of euros was likely accomplished without selling dollars and buying euros. However, euro acquisition must have amounted to nearly half of the large build-up in reserves. The main conclusion is that the euro is likely to be increasingly important in Asian central bank reserve portfolios, and may surpass dollar holdings if Asian central banks see the benefits of currency diversification or if Asian currencies reduce their traditional stability vis-à-vis the dollar in favor of a link to a currency basket.

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1. The issue

There is some current interest in the possibility that the U.S. dollar will lose its pre-eminence as an international reserve currency now that the euro is firmly established as a potential

* Tel.: +1 202 994 0656; fax: +1 202 994 7422.

E-mail address: rclick@gwu.edu.

competitor. For example, Chinn and Frankel (2007) consider the question and estimate the demand for international reserves by currency for the world at large. They conclude that there are two important scenarios under which the euro may surpass the dollar as the leading international reserve currency: if the remaining EU members join EMU by 2020 or if the recent trend of dollar depreciation persists into the future. Eichengreen (2005) considers the issue from an historical perspective, particularly looking at the demise of the British pound as an international currency, and concludes that the dollar and the euro will likely share the honors as reserve currencies.¹ In addition to academic interest, there is frequent interest in the financial press and practitioner publications; e.g., Flood (2005) and Valderrama (2005).

The discussion of dollars versus euros in foreign exchange reserves is particularly acute with respect to Asian central banks. These central banks have been building up reserves substantially and now hold large stocks of foreign currencies. The Bank of Korea shook financial markets in February 2005 when officials discussed diversification of their currency reserves and admitted that they had already begun to reduce dollar assets and increase nondollar assets.² Japanese Prime Minister Junichiro Koizumi made remarks on the desirability of diversifying currency reserves before the Japanese Parliament in March 2005.³ Subsequently, the reserve policies of the People's Bank of China have been the subject of considerable discussion in the context of their exchange rate regime and possible alterations. The State Administration of Foreign Exchange (SAFE) made an announcement in January 2006 essentially confirming discussion in the international financial markets, mentioning that it wanted “to improve the currency structure and asset structure of our foreign exchange reserves” (as reported in Balls & Dyer, 2006).

The purpose of this paper is to examine the composition of Asian central bank reserves in order to identify the importance of the euro vis-à-vis the dollar. In addition, we hope to stimulate some discussion on the possibility that the euro will replace the dollar as the pre-eminent currency in Asian central bank portfolios.

2. Empirical analysis

2.1. Main features of central bank reserves

To consider the roles of the dollar and the euro in international reserves, we focus on the three Asian countries with the largest foreign currency reserves: Japan, China, and Korea. Data on international reserves are available from the International Monetary Fund in *International Financial Statistics* (line 1d.d by country for foreign exchange reserves) and *IMF Annual Report* (2005) (as world aggregates). Table 1 puts the reserve position of Japan, China, and Korea into perspective. Together, at the end of 2004, these three countries held 44% of the total world reserves, with Japan accounting for half of this. In fact, Japan holds 18% of its GDP in the form of foreign currency reserves. China and Korea each hold even larger portions of GDP as currency reserves, at 37 and 29%, respectively. Clearly, these three countries are very important in the context of worldwide foreign exchange reserve holdings.

A continuous monthly time series of foreign exchange reserves for China is available beginning in mid-1992, so we examine the 12-year period 1993–2004 for all three countries.

¹ In response to other public discussion, Eichengreen (2005) also concludes that the Chinese yuan is not likely to become a major reserve currency during the next few decades.

² This followed similar announcements regarding reserve currency diversification in Thailand, Taiwan, and Indonesia.

³ In addition, the Reserve Bank of India began to talk about reserve diversification in May 2005.

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