

Stability or Upheaval?

The currency composition of international reserves in the long run

AUTHORS Barry Eichengreen, University of California, Berkeley | Livia Chitu, European Central Bank and Paris School of Economics | Arnaud Mehl, European Central Bank

DID THE BREAKDOWN OF BRETTON WOODS CHANGE HOW THE US DOLLAR DOMINATES INTERNATIONAL FINANCIAL TRANSACTIONS?

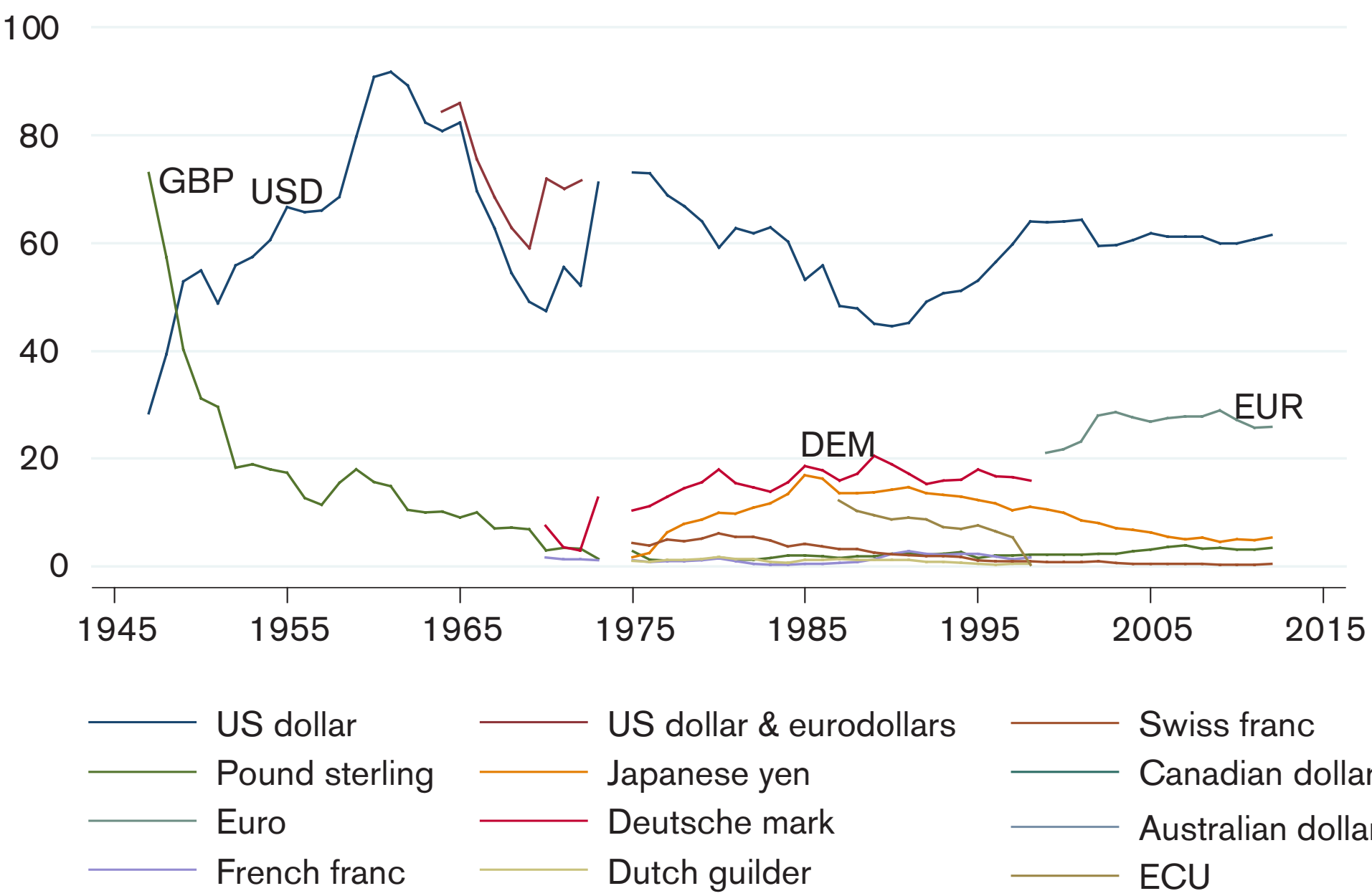
To answer this question, previous studies have used data on foreign reserves—the stock of foreign liquid assets held by other countries. This data helps investigate which features and policies of countries promote their currencies.

Using multiple sources, researchers Barry Eichengreen, Livia Chitu, and Arnaud Mehl extended upon data used by previous studies covering approximately 1973–1998 to cover 1947–2013. As shown in the figure below, using data from this longer period has several advantages:

- It covers the replacement of Sterling with USD as the dominant international currency.
- It covers before and after the 1973 breakdown of Bretton-Woods—an international agreement for countries to maintain fixed exchange rates.
- It covers the creation of the Euro.

With this data, the researchers sought to understand how the breakdown of the Bretton Woods system altered the behavior of reserve balances.

Currency composition of globally disclosed foreign exchange reserves at constant exchange rates (1947–2012, %)



METHODOLOGY

The research team tested three features of reserve balances, both before and after the Bretton Woods breakdown, to see if there are variations.

Inertia: How long it takes for reserve balances to adjust to changes [A 1% rise in reserve share at $t-1$ leads to an $x\%$ rise in reserve share at t .]

Network effects: Whether large connected countries are more likely to have currencies held by others [A 1% rise in the size of a country's GDP relative to the world leads to an $x\%$ rise in the country's reserve share.]

Currency stability: Whether a country's currency value is falling [how a 1% increase in the trend depreciation rate of the country's exchange rate affects a country's reserve share]

Do reserve balances behave the same way before and after the 1973 breakdown of the Bretton Woods system?

	Full sample	Pre-1973	Post-1973
Inertia (standard errors)	0.927 (0.021)	0.758 (0.037)	0.954 (0.009)
Network effects (standard errors)	0.216 (0.066)	0.815 (0.113)	0.115 (0.024)
Currency stability (standard errors)	0.051 (0.022)	-0.599 (0.033)	0.043 (0.024)

RESULTS

The researchers found that since the breakdown of Bretton Woods, inertia in reserve holding has increased to a half-life of 7 years, and network effects have become less important.

While inertia acts in favor of the leading currency, the weakening of network effects suggests the dollar's continued dominance should not be taken for granted.

