



THEIR VIEW

A reserve currency differs from one that payments are settled in

Its special characteristics of convertibility, usability and availability assure the US dollar a sustained role in global trade and commerce



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There has been a lot of discussions recently on the international usage of the US dollar (USD) as a currency for trade and investment payments that stems from its role as a reserve currency. The war in Ukraine has given rise to concerns about the USD's role as a currency that can be used freely for international payments, or for keeping reserves to make international payments when needed. In the context of geo-political tensions, there is speculation on whether the Chinese currency can be a better reserve currency or whether there will be a flight to gold, triggered by reports of central banks buying the metal.

Traits of a reserve currency: What is a reserve currency? What are its characteristics? It is one that is held by countries as foreign exchange reserves. These are required to meet the gap between a country's international payments and receipts and serve as a buffer to meet any contingency. Such reserves can be held in form of gold or any foreign currency that can be freely used—or what is called a fully convertible currency.

First, it is obvious that a reserve currency should not be subject to any controls by the country that issues it. In other words, the Chinese currency can be a reserve currency only if the Chinese government does not and/or is not likely to impose any controls on its use. The holding of the USD as a reserve currency is based on its credibility and the confidence its usage will not be subject to any controls. This critical characteristic of a reserve currency has been called to question with sanctions imposed on Russia by the US following the Ukraine war. The second requirement for a reserve currency is that there should be sufficient availability of that currency to be held as reserves. This may mean that the country is prepared to expand its currency in amounts sufficient to be held by other countries as a reserve asset, which means running current account deficits on a sustained basis. This is known as the Triffin's paradox. Third, a reserve currency should be available for investment in liquid form. Ensuring liquidity in a currency requires well developed debt and equity markets in that currency.

Historical experience: Historically, gold has been used as reserve currency, as final settlement of trade was usually done in gold. It was universally acceptable, there was no sovereign power that controlled its manufacture or use, and it always enjoyed a standard value in economic transactions. Over time, the supply of gold was not enough to meet the growing needs of trade and investment. This saw the emergence of reserve currencies. Currencies of dominant imperialist countries like the UK were accepted for international payments. As long as countries whose currencies was being held as reserves were committed to convert these



holdings into gold, these currencies held their reserve status. Initially, the UK's pound sterling (GBP) was the currency of choice, as it could always be converted to gold by the Bank of England. It lost its reserve currency status as it abandoned the gold standard during the Great Depression and became bankrupt following World War II. As the US began to dominate the global economy and stood ready to convert unlimited quantities of the USD into gold, it became the preferred reserve currency. Countries began holding their reserves in the USD rather than the GBP. The trend of holding dollar reserves continued even after the Bretton Woods system ended in 1971 and the US abandoned the gold exchange standard. The exchange rate system that emerged after that was a freely floating one with very limited and exceptional intervention by the major convertible currencies. Countries declared the exchange rate system of their choice ('pegged' or 'floating') and also their currency of intervention, for which most countries picked the USD. The system has broadly stayed the same since then. Special Drawing Rights (SDRs) are issued by the International Monetary Fund (IMF) to supplement member countries' official reserves, but their share of total reserves is only 7% and has not taken off for a variety of reasons. One major change was the emergence of the euro as a single currency for countries in the Eurozone. Many countries, especially in Africa, peg their currencies to the euro and hold euros as their principal reserve currency. The currency composition of allocated reserves in 2022 as compiled by IMF shows that 58% of reserves are held in USD and 19% in euro.

Payments settlement currency: Do recent global events following US sanctions threaten the use of the USD as a reserve currency? To a certain extent, countries today are toying with alternate currency and even payment arrangements for their global transactions.

As the Chinese economy started dominating

world exports, there was demand by countries for the Chinese currency. China allowed limited convertibility by letting non-residents hold renminbi accounts for trade payments. In 2015, it introduced the Cross-Border Interbank Payment System (CIPS), backed by the People's Bank of China, that offers clearing and settlement services for its participants in cross-border renminbi (RMB) payments and trade. On an average, CIPS handles renminbi 400 to 500 billion worth of transactions on a daily basis. This is still only a negligible share of transactions done through global clearing houses such as CHIPS. But it offers an alternative to the USD for making international payments in onshore Chinese currency. But having a payment arrangement that eschews USD use does not mean that the Chinese currency can become a reserve currency, unless it becomes fully convertible.

In 2022, the Reserve Bank of India (RBI) put in place an additional arrangement for invoicing, payment and settlement of exports/imports in Indian rupees (INR) through Special Rupee Vostro Accounts (SRVAs). As of 23 March, 18 countries had been permitted by RBI to open SRVAs for settling payments in INR. While such arrangements apparently allow increased invoicing of trade in INR without multilateral settlement, they are not very different from India's bilateral trade and payment arrangements with the former Soviet Union and later Russia, with all its attendant problems.

Geo-political considerations and the covid-19 experience of supply chain disruptions also forced countries to enter trading blocs and in some cases set up their own payment arrangements.

The role played by a reserve asset, however, cannot be replaced or minimized by these payment arrangements. A national currency serving as a reserve currency with key characteristics of convertibility, usability and availability will continue to be needed, and in this context, the role of the USD will continue to be important.