

**Reserve accumulation
=
risk accumulation?
The euro perspective**

Session 4:
Reform of Global Monetary System and the Euro

Cinzia Alcidi, CEPS

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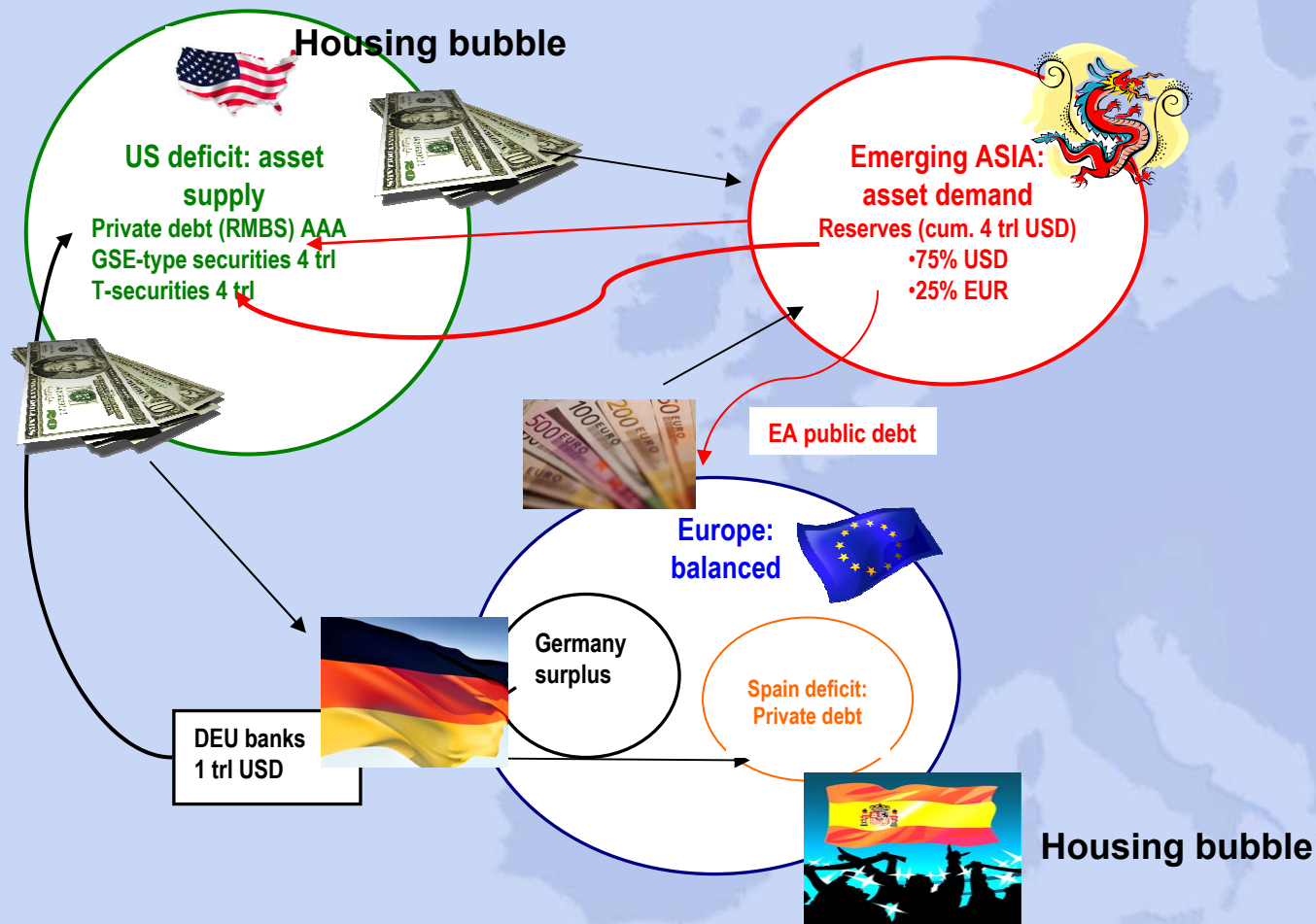
Outline

- ***De facto* reserve system before 2007-08**
 - EMEs reserves accumulation and US import of savings: stocks vs. flows
 - Risk accumulation & risk allocation
- **Perspective for the next decade**
 - Future path of reserve accumulation
 - Euro and the global re-balancing?
 - Reserve accumulation = risk accumulation?

The global monetary system before the crisis

- **Dollar dominance: store of value & unit of account-means of payment**
 - In global financial markets EUR plays second fiddle to USD
- **Global imbalances and asset mismatch:**
 - Extraordinary savings of Asian EMEs and US CA deficits
 - EMEs Central banks invest in safe, liquid and short term assets.
 - US households offered risky, illiquid and long-term assets (mortgages).

Global imbalances: accumulation & allocation of risk



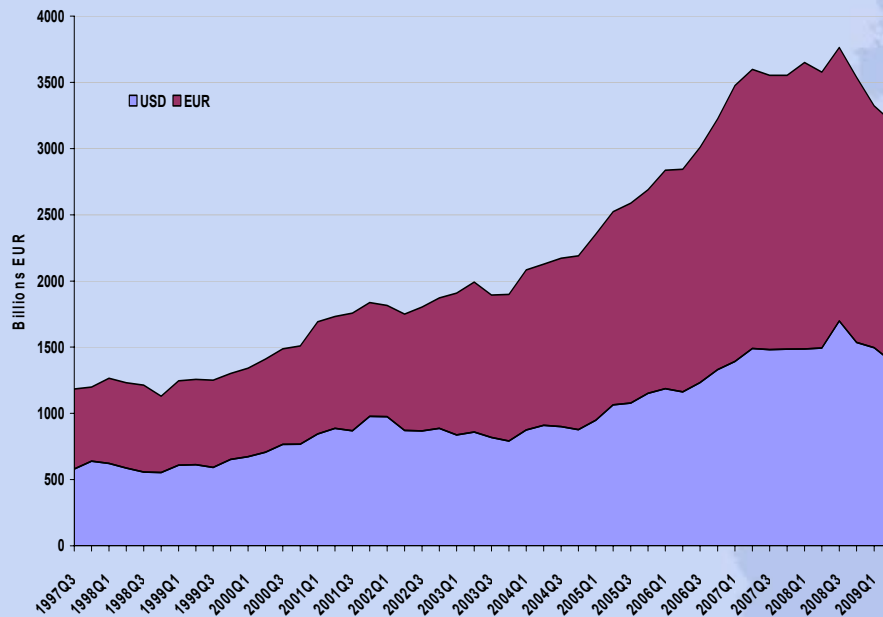
The displacement of private investors

Value of long-term U.S. securities held by foreign official institutions as percentage of the total foreign holdings

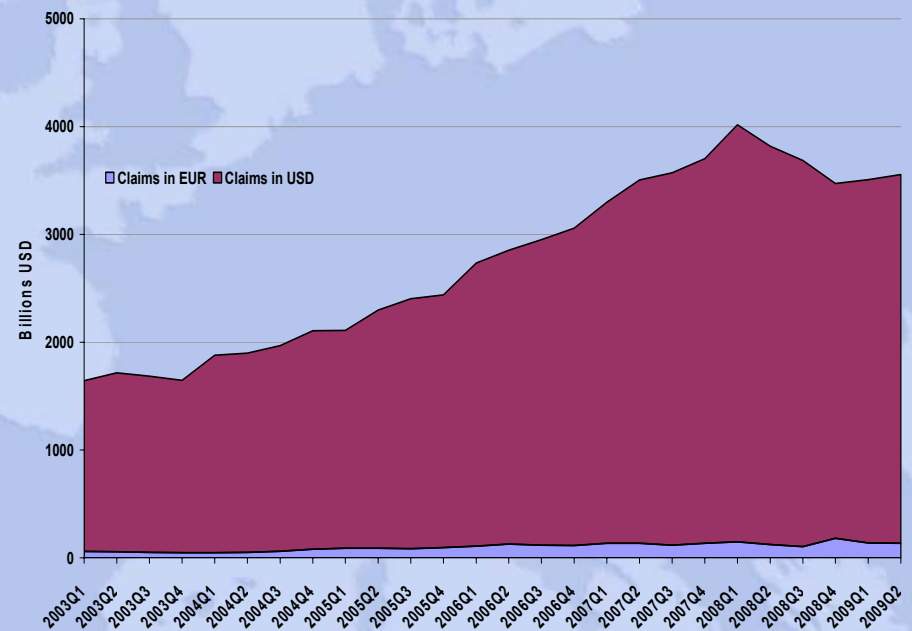
	Mar. 2000	June 2002	June 2007	June 2008
Type of Security				
Total long-term securities	18.3	20.3	28.1	33.0
U.S. Equity (1)	5.1	6.0	8.5	12.2
U.S. Treasury debt	52.6	61.7	73.9	76.2
U.S. Agency debt	33.7	27.2	57.5	66.0
U.S. Corporate debt	1.7	1.6	3.6	3.7

Liquidity risk: Lop-sidedness between the USD & the euro in the banking systems

Euro Area MFIs (Selected) Claims on foreigners: currency breakdown



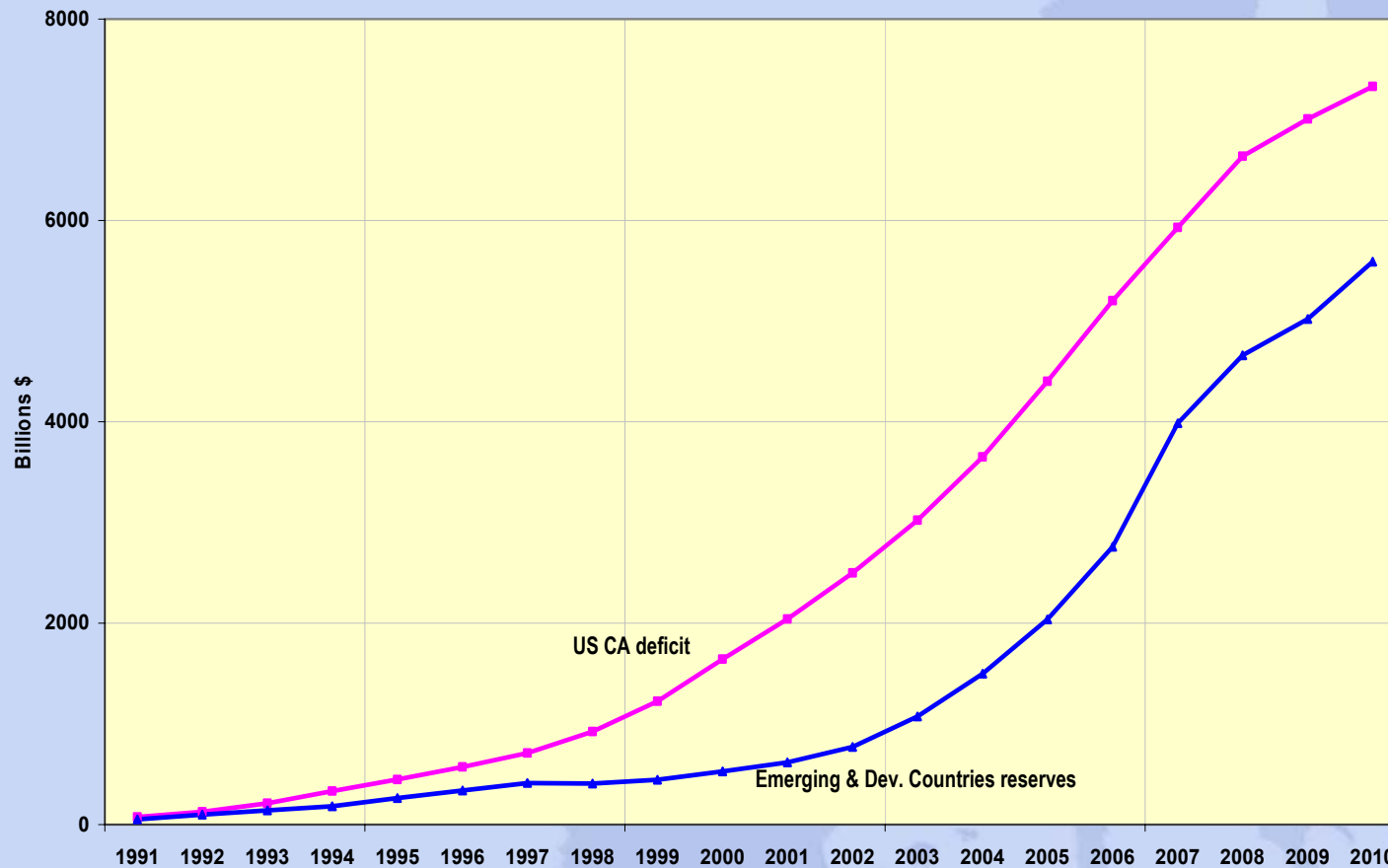
US banks: claims on foreigners



The Risk Transfer

- **US Financial sector transformed risky US mortgages into safe, liquid assets via securitization**
 - Thus taking on enormous risks
 - partially in the US shadow banking system,
 - partially transferred to savings surplus countries with investors hungry for yield, such as Germany
 - Crisis explodes when risk materialises with the bust of US housing mkt.

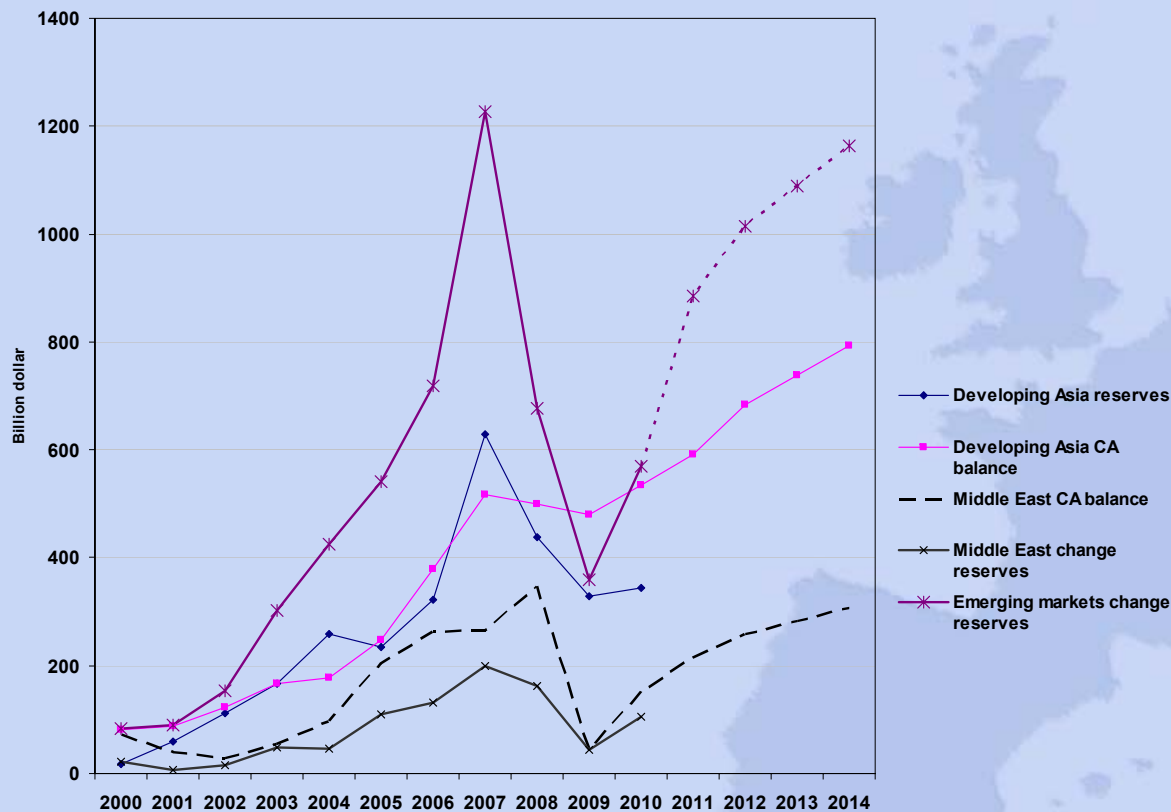
The bust: Asset demand-supply mismatch (stocks)



Source: WEO October 2009

The next phase: Will the old 'model' continue?

Projections suggest that reserve accumulation will continue

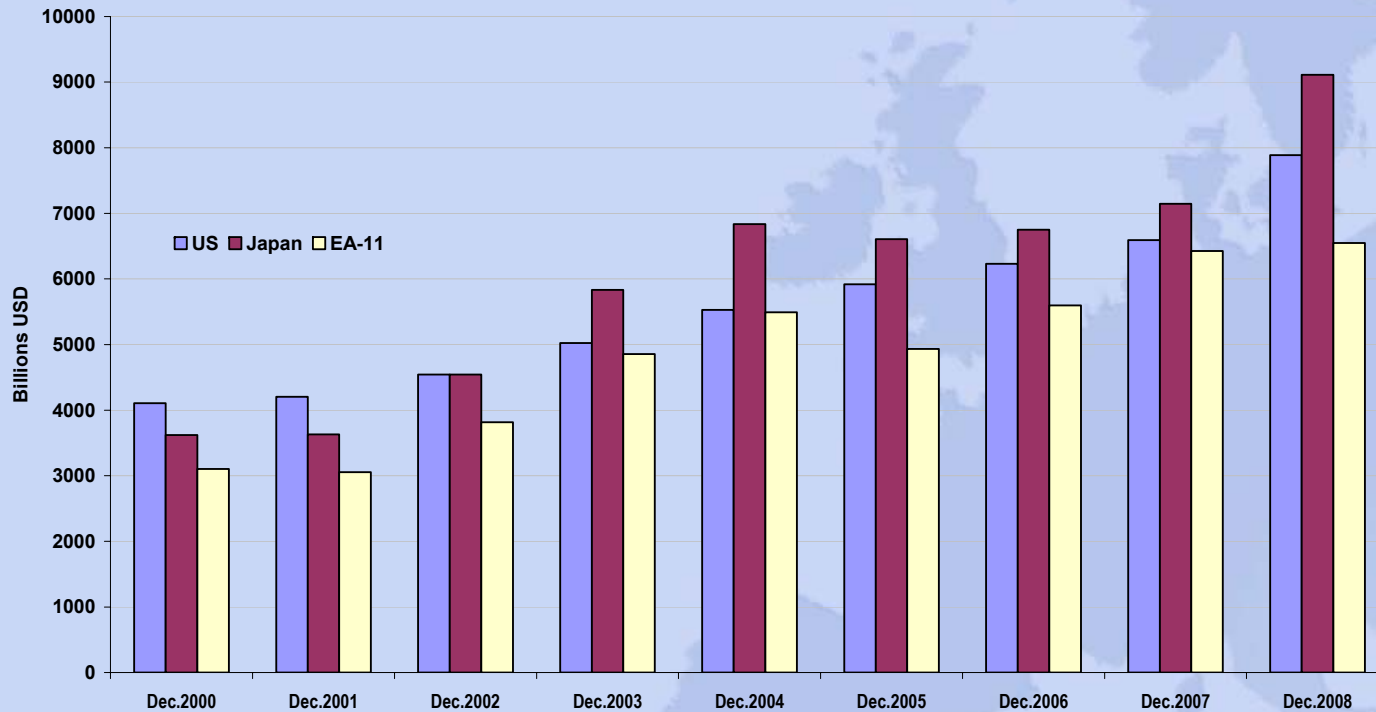


Source: October, 2009 and IMF estimates

- For the time being US offers more than enough safe (?) liquid assets
- Any change in sight for the euro as reserve currency?

Potentially the euro could rival the USD: sheer size of euro area security markets are as large as US.

Domestic debt securities: Governments



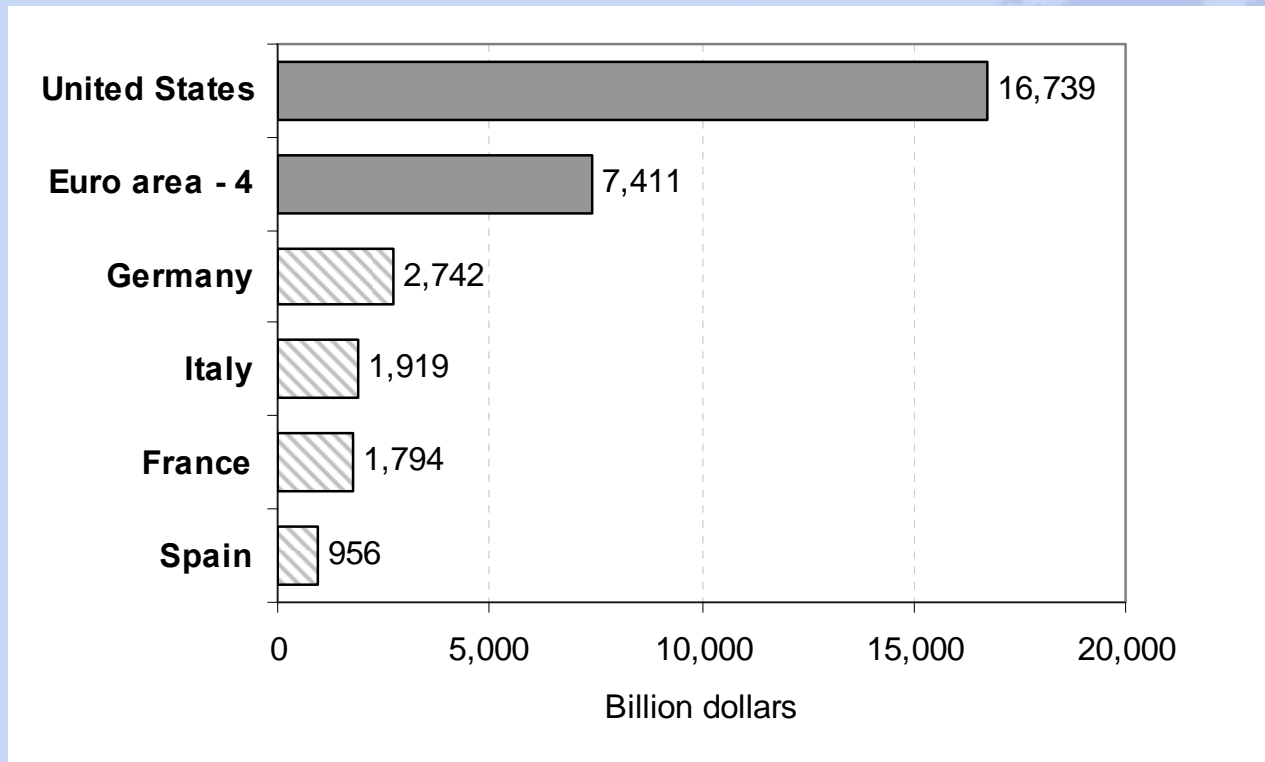
BUT....

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- **Policy issues (not addressed here):**
 - Lack of EA common voice particularly acute problem (e.g. IMF quotas)
 - Cons of being an reserve currency?
- **Market issues:**
 - Euro quasi-risk free security market is smaller than the US one and not integrated

Euro no competitor for reserve assets

Quasi-risk-free securities (GSE type and covered bonds) , 2008



Various national sources

Largest EU national market (Germany) is only one sixth size of US.

A thought experiment

- **EMEs central banks shift, say 50%, of their holdings into euro.**
- **1st Problem:**
 - Not sufficient suitable assets denominated in euro are available unless private sector gives up euro securities in exchange of US debt.
- **2nd problem:**
 - Exchange rate risk.

Concluding remarks I

Difficult to imagine equilibrium in a global monetary system:

- 1. Reserve accumulation continues on a massive scale, maybe even accelerates.**
- 2. US government still the most efficient supplier**
- 3. At the same time US external (and fiscal) deficits are being reduced**
- 4. Who is going to supply reserves? In which currency? New risks in sight?**

Concluding remarks II

- **Forex agreements shown to be unsuccessful**
- **Global imbalances \neq risk accumulation, the problem is their financing**
- **Mitigation approach:**
 - Transparency to prevent risk overload
 - Reduction of liquidity risk
 - Direct resources toward productive investment



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Thank you