Originally published in **The Financial Times**

December 10, 2009

Dollar weakness reflects a new role for reserves

By MARTIN FELDSTEIN

I am often asked whether the ongoing decline of the dollar implies that it can no longer serve as a reserve currency. My short answer is that most countries no longer hold dollars and other currencies as traditional reserves. The role of foreign exchange balances has changed from being short-term funds used to bridge export-import gaps to being long-term investment funds. In this new world, the dollar has shifted from being almost the sole "reserve currency" of many countries to being the primary "investment currency", a role that it will continue to play far into the future.

A bit of history is helpful for understanding this evolution. For several decades after the second world war virtually all countries pegged their exchange rates to the dollar. From time to time, international differences in inflation rates or changes in trade preferences meant a country had to adjust the level of its dollar peg.

Under this pegged-but-adjustable regime, countries managed aggregate demand to keep imports about equal to export earnings. But for periods when imports temporarily exceeded exports, the country needed a stock of dollars or some other acceptable "hard" currency "in reserve" to pay for excess imports. The dollar was the most liquid of these hard currencies and so the reserve currency of choice.

This system eventually proved unworkable. Countries shifted to a floating rate system in which international currency markets were, in principle, allowed to determine exchange rates. In a simplified textbook world of floating exchange rates, countries do not need reserves since fluctuations in the exchange rate would balance imports and exports.

In practice, however, lags in this adjustment meant that reserves were needed to finance temporary trade gaps. In addition, investment-related flows also added to a country's supply of foreign exchange or to its need for additional foreign funds. Most governments used foreign exchange for exchange market intervention to prevent large swings in the value of their currency. It was still meaningful to think of the foreign exchange funds owned by a government or central bank as "reserves" to be used to smooth the exchange rate and bridge the flows of imports and exports.

The experience of the late 1990s caused a fundamental change in the role of foreign exchange holdings. In 1997 the Thai government tried to maintain the Thai bhat at an overvalued level. When it exhausted its reserves doing that, it was forced to devalue, generating substantial profits for those who had borrowed bhat and sold it for dollars.

Speculators then attacked other Asian currencies. Even a currency not fundamentally overvalued could be profitably attacked if speculative borrowing and short-selling could force the government to exhaust its reserves and have to devalue.

These experiences taught governments two lessons. First, it is dangerous to try to maintain an overvalued currency. Second, even if its exchange rate is not overvalued, a country could face a successful attack by forex speculators if it does not have a very large amount of foreign exchange.

Countries responded by deliberately keeping their currencies undervalued to run trade surpluses and using these surpluses to accumulate foreign exchange. We now see Korea with foreign exchange assets of $200bn (€136bn, £123bn), Taiwan $300bn, Thailand $100bn and China more than $2,000bn.

These funds are no longer held to manage temporary swings in imports and exports or investment flows. They are best seen as investment funds that also deter attacks by forex speculators. Similarly, the oil-producing countries are converting oil reserves into financial wealth that will provide income for future generations. Asian countries andoil producers recognise the investment nature of their foreign exchange accumulation. Instead of just holding these balances in short-term US Treasury bills, they have created sovereign wealth funds with sophisticated investment strategies.

It is prudent for any country with large foreign exchange balances to diversify those funds. It is not surprising then that countries such as China and Korea are diversifying away from dollars, primarily into euros.

That diversification cuts demand for the dollar, putting pressure on its value. Market participants should see this as a natural consequence of the shift of foreign exchange balances from liquid dollar emergency reserves to longer-term multi-currency investment portfolios. But even as countries diversify away from exclusive reliance on dollars, the dollar will continue to be the main form of liquid investment for countries around the world.

As this portfolio rebalancing comes to an end,demand for dollars will stop falling. At the same time, the dollar's reduced value will shrink the US trade deficit, reducing the annual supply of dollars. This stronger demand for dollars and reduced supply can end the dollar's decline. What looks like a crisis of confidence in the dollar as a reserve currency is just part of the evolutionary process that will eventually halt the dollar's decline.

The writer is professor of economics at Harvard University