Multilateral Development Banks

EMU should have little immediate impact on the World Bank and the regional development banks because their functions are less related to monetary policy.

4.2. Reserve Currency Status of the Euro

This paper concludes that use of the euro as a reserve currency[8] by official reserve holders will not have major implications for global financial markets or for Canada. The euro will become a reserve currency as national holders of official reserves find it useful as an intervention vehicle in exchange markets and as a store of value.

The undertone of some discussion about the dominance of the US dollar in international trade and payments is that it puts Europe at a disadvantage, and that reserve currency status for the euro will correct this imbalance and somehow enhance European trade and finance. This way of presenting the issue is reversed - the euro will most likely become a reserve currency when European financial markets have become more integrated, liquid, secure, and competitive.

Reserve currency status is not an unmitigated blessing. Official capital account inflows associated with foreign purchases of reserve assets require the exchange rate to appreciate enough to reduce the competitiveness of the reserve currency county's traded goods and services sector to generate the current account deficit which must be the counterpart of the surplus on official transactions. For example, in 1995, US dollar reserve accumulation by foreign governments and central banks financed more than half of the US current account deficit. In times of international economic and political crises, the financial markets of a reserve currency country can suffer from "flights to quality" characterized by short-term capital inflows, exchange rate volatility and interest rate fluctuations which complicate the implementation of monetary policy. These phenomena are the "burden" of a reserve currency, and are why Japan and Germany have not been enthusiastic promoters of reserve currency status for the yen and the deutschemark.

The use of euros as a reserve currency will depend on the development of the euro-denominated money market. Official reserves are held in low risk liquid money market interest earning assets, and present there is no market that compares to the US dollar money market for this purpose. While the deutschemark may be an attractive and secure hard currency, the German authorities have until recently discouraged the development of a short-term market for funds. However, if banks find strong demand for euro denominated deposits by (official) investors, they will accept and intermediate such deposits. Presently, much of the

[8] A reserve currency is the (foreign) currency in which official international reserves tend to be held by national treasuries or central banks. These agents hold low risk liquid money market assets, often US treasury bills, as an asset in a reserve account. Some countries hold US dollar, D-mark, Yen, or ECU securities or deposits in the BIS and major banks as well.