Answer on Question#56475 - Economics - Microeconomics

Question

What role do countries play in the position of their currency in the world market?

Answer

Suppose that Country currency is suspected of being in poor financial shape. International speculators might sell their own holdings of Country's currency, or sell short or sell in forward trades. This will tend to depress the value of the currency. Other speculators may see the attack and join in, further weakening the currency. The Country could let its exchange rate fall, but most of them do not like this option. A falling exchange rate makes imports more expensive to its citizens and may also disrupt financing that Country's companies receive from foreign banks.

If Country has **sufficient foreign reserves**, it could **start buying its own currency**, **selling its foreign currencies to pay for its purchases**. With **deep reserves**, the Country could thwart the speculators. In fact, deep reserves would probably prevent the speculation in the first place. The financial speculators know that it is futile to bet against **a currency backed by substantial reserves**.

The Asian Financial Crisis of 1997-98 taught many countries the value of **having large reserves for foreign currencies**. Most countries are now pretty **heavily invested in their foreign exchange reserves**.

The U.S. dollar is the most common currency for international reserves, for good reason. First, because of the size of the USA economy, there are plenty of dollar-denominated securities available. The market for United States Treasury securities is liquid and deep. "Liquid" means that the securities can be sold quickly. "Deep" means that a substantial amount can be bought or sold without affecting the price too much. These are desirable features of a foreign reserve currency. If Country were to hold an obscure currency, such as Tajikistani Somoni, it might not find willing buyers on short notice. Even if it did, there is no way that Country could quickly sell billions of Somoni without pushing the foreign exchange rate disastrously low. Thus Country **needs to own currencies of large countries**, which are traded in large amounts on a daily basis.

The dollar fits the need pretty well. The Euro plays second fiddle, with Japanese Yen and British pounds sterling just barely in the band. A number of other currencies are used in small amounts.

An additional requirement for a good reserve currency is that **assets denominated in that currency are unlikely to lose value to a great extent**. Here's the tricky point. If defaults or credit downgrades were widely expected to reduce the price of U.S. Treasury securities, then other countries would prefer to hold their reserves in some other asset.