Network Effects in Currency Internationalisation: Insights from BIS Triennial Surveys and Implications for the Renminbi

Dong He
Hong Kong Monetary Authority
Hong Kong Institute for Monetary Research

and

Xiangrong Yu
Hong Kong Institute for Monetary Research

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Summary

The dominance of the US dollar in foreign exchange (FX) markets appears to reflect very strong network effects in the use of international currencies. What we observe today is the result of a slow-moving process that has witnessed a switch from the dominance of the pound sterling to the US dollar, perhaps during the interwar period in the early part of the 20th century. This paper presents a discrete choice model of FX trading that explicitly allows for this type of critical transitions in order to understand the dynamics of currency turnover in FX markets. We estimate the model using the Bank for International Settlements’ data from triennial surveys of FX markets and also examine the factors that could potentially shift the dynamic path and lead to an earlier critical transition. We then discuss the implications for the renminbi, a budding international currency. If the renminbi were to become a dominant international currency, it would require China to attain a much higher level of financial development and openness. It is important to note that our model does not address the possibility of a gradual weakening of the network effects in FX markets due to, for example, the advancement of trading technologies, which would allow the co-existence of a few equally dominant major currencies.