

US DOLLAR DOMINANCE – THE BEGINNING OF THE END?

Op Ed by Dr Rory Knight



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Trumpian international politics coupled with the pandemic may well herald the demise of the greenback as the world's reserve currency. The dollar has lost 9% against the euro since March, pushing it down to levels last seen at the start of the millennium. This may signal a return to its downward slide before the Great Financial Crisis of 2008 (GFC). Until the GFC the dollar had experienced massive weakening of around 30% against the euro. This trend reversed in the following years thanks to the quantitative easing and the other loose monetary policies of the US Federal Reserve. The dollar enjoyed a strong resurgence as it basked in the considerable benefits of being a reserve currency. The current slide in the dollar may not be the end but may well be the beginning of the end. Should we be concerned? No, in the long run it will benefit the whole global economy and, despite short-term costs, the US too. However it is unclear how exactly the dollar will be replaced and over what period. A number of alternatives are emerging.

The dollar: a reserve currency only at the pleasure of China

The dollar's status as the world's reserve currency is by no means guaranteed. It will only last as long as China and other creditor countries are prepared to hold their foreign reserves in

US dollar securities. These reserves have ballooned in the last twenty years from around \$2 trillion at the start of the millennium to close to \$12 trillion today - a six-fold increase! Much of this rise has been due to the expanding reserves of emerging economies, with China at the head of the field. China now has foreign reserves of over \$3 trillion, with the People's Bank of China holding over \$1.2 trillion in US government securities, making it the US's largest creditor. Meanwhile the US dollar's share of global reserves is slipping, dropping from around 70% in 2000 to a little over 60% today. China recently announced its intention to reduce its US dollar holdings by 20% possibly in favour of the euro. It is not therefore, surprising that the euro is strengthening against the dollar.

But do we need a single reserve currency?

The Central banks hold foreign reserves for several sensible reasons including the funding of trade, providing safe havens through diversification, managing domestic inflation and, most importantly, propping up their own currencies. These so-called precautionary balances are managed directly by central banks and indirectly by private individuals and firms. There are three major roles for international currencies:

- Currency units, for trade invoicing (private) and currency anchoring (central banks)
- Means of exchange, for trade transactions (private) and intervention (central banks)
- Store of value, for the denomination of debts and foreign reserves.

“The dollar's dominance will last only as long as China and other creditors are willing to hold their foreign reserves in US securities”

Central banks seek to establish a portfolio of currencies for their foreign reserves in order to minimise risk for their economies in all of these three uses. Since the dollar has been by far

the major unit for invoicing in international trade it is not surprising that most currencies exhibit a lower volatility with respect to the US dollar than any other currency, thus driving a demand for dollar reserves. However this demand is likely to diminish as the US share of world GDP falls in the face of the rise of China and other third country trade. As an exchange reserve, currencies need to be highly liquid and, as a store of value, to sit on top of deep and liquid securities markets. Historically the US dollar has been without rival respecting the last two criteria. However it is instructive to consider the fortunes of the previous reserve currency, sterling. Sterling was the world's reserve currency from 1860. Its demise began rather gradually in 1945 but by the mid-fifties the US share of foreign reserves overtook sterling's, and by 1971 its demise was complete along with the collapse of the 1944 Bretton Woods Agreement. Change this time could be much faster as politics and technology hand-in-hand with economics are playing a part in hastening the dollar's demise. Or maybe the process will not be so rapid after all. Sterling's replacement took at least two decades and for the whole of that period there were effectively two reserve currencies. Evidently there is no need for one currency to dominate, and it is possible that the retirement of the dollar will follow in the gradual footsteps of sterling meanwhile co-existing with other rivals.

Should the US be bothered?

The US derives considerable economic and political benefits from the dollar's status as the world's reserve currency. It has experienced a balance of payment deficit consistently since the early 1980s, with US citizens' consumption being paid for by foreigners. The willingness of creditor countries to hold US securities has also resulted in the US benefiting from extremely cheap money - reflected in today's almost zero interest rates. But all that could, and probably will, change. Although the US continues to have depth and liquidity in its capital markets and a sizeable, if shrinking, share of world trade, this will not be enough to sus-

tain its hegemony as a reserve currency. The critical planks underpinning a reserve currency are:

- Commitment to the rule of law and the enforcement of property rights
- Open and free markets and minimal politicisation of these markets
- Fiscal responsibility
- Absence of trade frictions & tariffs
- Leadership in support of international institutions

In short, creditor nations need to have confidence in the currency in which they hold their reserves. In recent years the US appears to have paid little attention to this and is as a result losing foreign investor trust. The factors undermining confidence in the US are legion: protectionism, indiscipline in public finances reflected in growing deficits and debt, the politicisation of finance seen in the banning of Huawei, TikTok and WePay and threats to delist many Chinese companies from US markets. Trump's handling of the pandemic has further exposed these concerns, triggering social and political unrest which in turn accelerates the process. Not surprisingly, other safe havens are being sought. This will inevitably result in the end of the dominance of the dollar as an international reserve currency.

Central bankers are calling for change

The US dollar is now perceived to be destabilising the world economy. Deep concerns were expressed at the recent Jackson Hole Economic Policy Symposium hosted by the US Federal Reserve. Given that emerging markets have an increasing share of world trade (now around 60%) and most invoicing is in US dollar, many economies are now exposed to adverse swings in the US economy. The concern is that there may be a liquidity trap involving ultra-low interest rates combined with slow growth. In other words, the global economy is

now disproportionately at risk to a US recession. Central banks around the world are unable to implement effective monetary policies tighter than those adopted by the US Federal Reserve without their currency becoming too strong. The world has effectively outsourced its monetary policy to the US Federal Reserve. So what could go wrong? In one word, inflation. It is very likely that in the wake of a pandemic-induced recession the world monetary system will change. There are a number of alternatives. Central banks such as the Bank of Korea must surely be rethinking their reserve policy. As Alexis de Tocqueville remarked of revolutions, once an idea has crossed peoples' minds it is all over. The idea of replacing the dollar is now very much crossing the minds of central bankers.

Alternatives

There are several pretenders to replace the dollar as a reserve currency but as yet no single frontrunner:

- The *euro* is a strong candidate with 20% of global foreign exchange reserves. The Eurozone constitutes a significant market for global trade, and recent developments have resulted in a €750 billion debt market. The EU is also the single largest holder of gold reserves with more than 10,000 tonnes compared with the US's 8,000 tonnes. On the debit side, the Eurozone is not a homogenous political entity and has an incomplete architecture in that it is not fiscally integrated. Finally, fortress Europe saddles its international trade with a plethora of tariffs and barriers, as highlighted in the current Brexit negotiations.

- China's *yuan* is another contender, at the head of what will soon be the world's largest economy. However it lacks the depth of financial markets and the liquidity to be the world's reserve currency. Given also its lack of easy convertibility, it is unlikely to provide the safe haven status necessary for the role.

- Japan's *yen*, although an unlikely candidate due to Japan's decades-

long weak growth, seems to be strengthening and is worthy of mention.

- *Sterling*, ironically given its history, is another outside contender. Whereas the UK's joining the EU in the early seventies put a symbolic end to sterling's reign as reserve currency, could its exit from the EU herald its return to the role? It has the historic experience after all. London is the global financial capital, and the Bank of England is the repository of many nations' gold reserves. However, sterling's value has been in decline for the last two decades and, with the UK economy reeling under the dual blow of lockdown fallout and Brexit, the currency is likely to be volatile for the foreseeable future.

- The *Swiss franc*, though lacking scale, would offer an excellent and politically neutral foundation for a new world reserve currency. The Swiss have for centuries been the world's bankers and per capita hold the largest gold reserves. The Swiss franc continues to offer an attractive safe haven.

However rather than any of these individually it is far more likely that central banks will opt to diversify their foreign reserves deploying all five currencies. Thus, a basket of currencies may well emerge as the world's new reserve currency. Please note, Bank of Korea: Korea might well benefit from further reallocation away from the dollar in switching to its future rather than its historic trading relationships.

Will gold make a comeback?

The increase in international political tensions exacerbated by the pandemic has seen gold surge to an all-time high. The BRICS countries now hold nearly 5,000 tonnes of gold, a holding which has more than doubled in the last decade. Russia and China have increased their gold reserves by 226% and 76% respectively over the last decade. It is likely that Korea will continue to increase its gold reserves, which have increased from 14 tonnes to 104 tonnes in the last ten years. In stark contrast, the US has not increased its holdings at all, and the Bank of England in 2002 sold off

more than half of its 705 tonnes of gold reserves at \$275 per ounce - a transaction which given gold's current price of \$1,940 per ounce, has imposed opportunity costs to Britain of around \$25 billion! Does the flight to gold herald a return to something resembling the gold standard as a reserve currency? I doubt it. Other high tech alternatives are poking their heads above the horizon.

Digitalisation will transform the concept of a reserve currency

There are a number of initiatives which signal that the digital revolution is already gathering pace. Korea being at the forefront of technological innovation has much to offer in this field. The Chinese are seeking to develop their own digitally based currency, and central bankers are speaking about a collaborative global project to develop a so-called "Synthetic Hegemonic Currency". These initiatives seek to capture the benefits of a decentralised digital currency but packaged as a fiat currency. But this notion is hopelessly doomed from the word go: central banks and centralised governments running a decentralised currency system is of course an impossible oxymoron. A non-fiat decentralised digital currency uncoupled from the dollar but possibly anchored to other areas of stability - that is how things might finally look. Gold denominated in bitcoins and stored in the Swiss Alps: now there's an idea for you!

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