


Could the US dollar lose its reserve-currency status?

by Karl Happe | 15/06/2018 



Summary

The US dollar has long been the currency of choice for banking and trade, and for valuing all other currencies. This has brought the US enormous economic benefits and significant structural downsides. Yet a shift away from the dollar may have begun, which could help the global economy in the long run.

Key takeaways

- In years past, the denarii, ducat, guilder and pound each took a turn as the world's reserve currency. Today, it's the US dollar. Will the euro, renminbi or yen be next?
- Central banks hold fewer US dollars than they did in 2004, and fewer international payments are being settled in dollars
- If the dollar were to eventually lose its reserve status, its exchange rate could fall, US interest rates could suffer, and US equities and fixed income could potentially underperform

What would happen if the world stopped depending on the US dollar? There is growing evidence that after years of dominance, the dollar could be losing its status as the world's reserve currency. Yet while a passing of the mantle could be painful for the United States, a more balanced reserve system – one that relies more on the euro, renminbi or yen – would likely help the global economy in the end.

Why do reserve currencies exist?

Throughout history, international traders and bankers have typically used one country's currency as a default base of exchange. Over time, the Roman denarii, Venetian ducat and Dutch guilder each took its turn as the commonly accepted medium for trade, and as the basis for valuing all other currencies.

The British pound sterling was the currency of choice for international trade and value preservation from the mid-19th century until the mid-20th, when two World Wars and a Great Depression took their toll. Then sterling's success story became a cautionary tale. Its share of currency reserves among international central banks fell from around 60% in the early 1950s to less than 5% by the mid-1970s, and its value fell from more than USD 4 per pound at the end of WWII to near-parity with the US dollar in the mid-1980s.

With the US dominating international politics during the post-War period, the dollar soon took the place of the pound and became the world's reserve currency. This brought the US both enormous economic benefits and significant structural downsides:

- For decades, the US dollar has stayed relatively strong versus other currencies as investors have pushed up its value.

- Doing cross-border business has been easy for the US, given that effectively all major commodities are traded and settled in dollars.
- On the downside, the US has been forced to maintain a permanent current-account deficit – in this case, a massive trade deficit funded by selling its government bonds abroad – to maintain its reserve-currency status.
- Although this trade deficit has enabled US citizens to consume more than they produce, it has also placed downward pressure on US wages – particularly for people manufacturing tradable goods.

The dollar's decline may have already begun

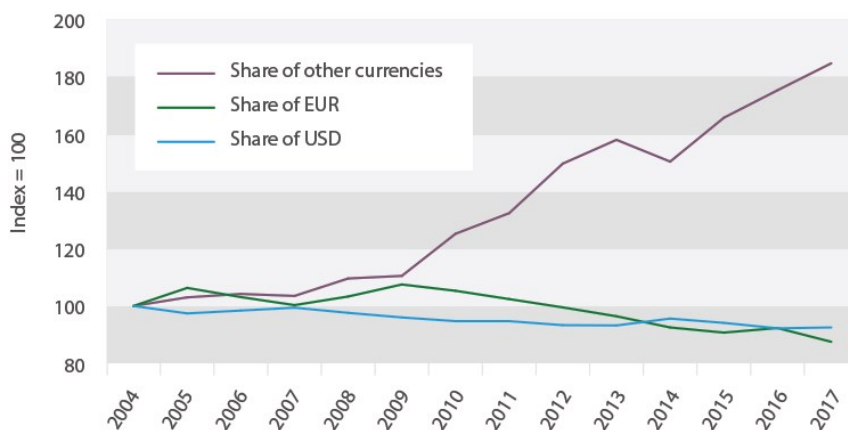
For a brief time around the turn of the millennium, there was some speculation about whether the euro would supplant the US dollar as the world's dominant reserve currency. Yet since then, there has been little movement on this front as the global financial crisis and European debt crisis seemed to curb the world's appetite for anything but the dollar's relative safety.

In recent years, however, certain political events – such as the Brexit vote and the election of US President Donald Trump – have brought the dollar's dominance back into focus. Many non-Americans have begun to notice how exposed they are to the protectionist US political activity that has been roiling global markets.

But this trend away from the US dollar predates the election of President Trump. As the accompanying charts show, central-bank reserves now hold fewer dollars than they did in 2004. Moreover, fewer SWIFT payments – the primary exchange for interbank fund transfers – are being done in dollars today than in 2015. (The euro is by far the next biggest currency for SWIFT payments in terms of overall volume, but there has been a shift to other currencies as well.)

Other currencies are gaining on the US dollar

World currency composition of official foreign-exchange reserves since 2004



Source: IMF. Data as at 31 December 2017. Chart shows world currency composition adjusted at average exchange rates, indexed to 100. "Other" currencies include RMB, JPY, GBP, AUD, CAD, etc.

Would the world be better off without "King Dollar"?

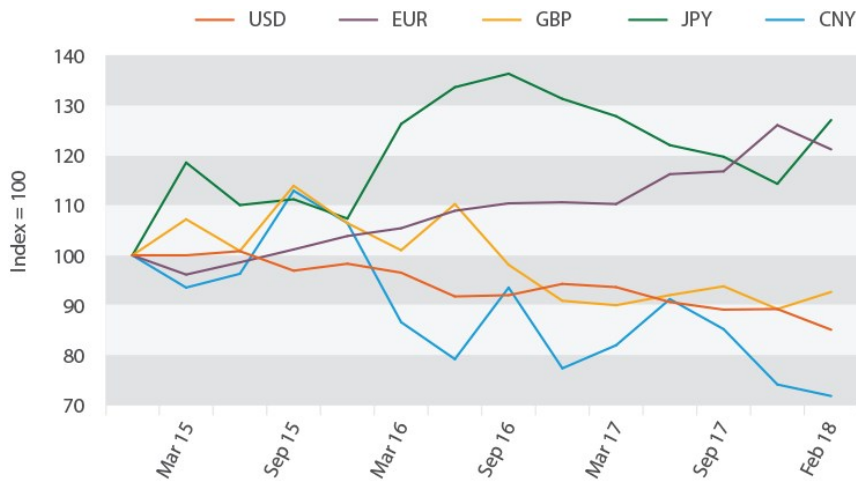
Many market-watchers believe it would be better for the global economy to have a more balanced international reserve system that relies less on any single currency. But the process of getting to this point would be a bumpy one, and it would have significant implications for both exchange rates and the cost of capital in different economies.

For the US, giving up reserve-currency status may help the country balance its trade relationships, but it would likely hurt the value of the dollar and create inflationary pressure on the prices of consumer goods. Ultimately, the United States' loss of reserve-currency status may only limit any further decline in wages, and there is a good chance it would also make US consumers a lot poorer.

For other countries or regions – perhaps the euro zone, China or Japan – increased usage of their currencies would likely make their currencies stronger. This would improve their purchasing power for commodities and tradable goods, and it would lower the cost of capital for their domestic industries. However, these economies might also suffer further income disparity, since stronger currencies make unskilled labour pools less competitive.

Fewer payment are being made in dollars

Currency shares of SWIFT payments since December 2014



Source: SWIFT watch. Data as at 28 Feb 2018. SWIFT = Society for Worldwide InterBank Financial Telecommunications.

Investment implications of a shift away from the dollar

In the end, a country that boasts the world's reserve currency will generally feel the positives more than the negatives. As a result, if the US dollar were to lose its reserve status, investors should anticipate a drop in the dollar's exchange rate, a negative effect on US interest rates, and potential underperformance for US equities and fixed income.

On the flip side, any currency that replaces the US dollar would likely pass along the benefits of lower capital costs and higher purchasing power to its issuing nation. Just as a shift to the euro as reserve currency might give the euro zone a relative growth boost, a move toward the renminbi or yen would likely also help China or Japan.

As a result, we will be closely watching the statistics on reserves and international settlement to see if the initial trends away from the US dollar continue. Perhaps it's only a matter of time until the dollar goes the way of the denarii, ducat, guilder and pound – and one or more upstarts rise to take its place.

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About the author



Karl Happe
CIO Insurance-related Strategies

Karl Happe is Chief Investment Officer (CIO) Insurance Related Strategies with Allianz Global Investors, which he joined in 2013. He leads a team that manages equity and fixed-income portfolios for insurers. Karl was previously the head of the global fixed-income strategy team, responsible for managing global fixed-income portfolios for Allianz. Before joining Allianz in 2004, he worked at McKinsey & Co. in Munich; at BankBoston as the head of non-USD fixed income derivatives trading; and at Morgan Stanley in private equity and fixed income derivatives structuring and trading in New York, Frankfurt and London. Karl has a B.S.E in civil engineering and operations research, summa cum laude, from Princeton University and studied at the University of Stuttgart on a Fulbright scholarship. He also has an M.B.A. with distinction from INSEAD.

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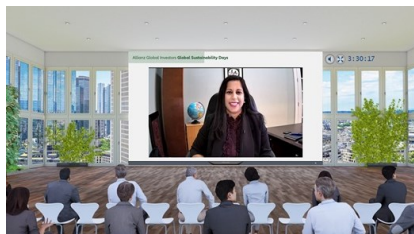


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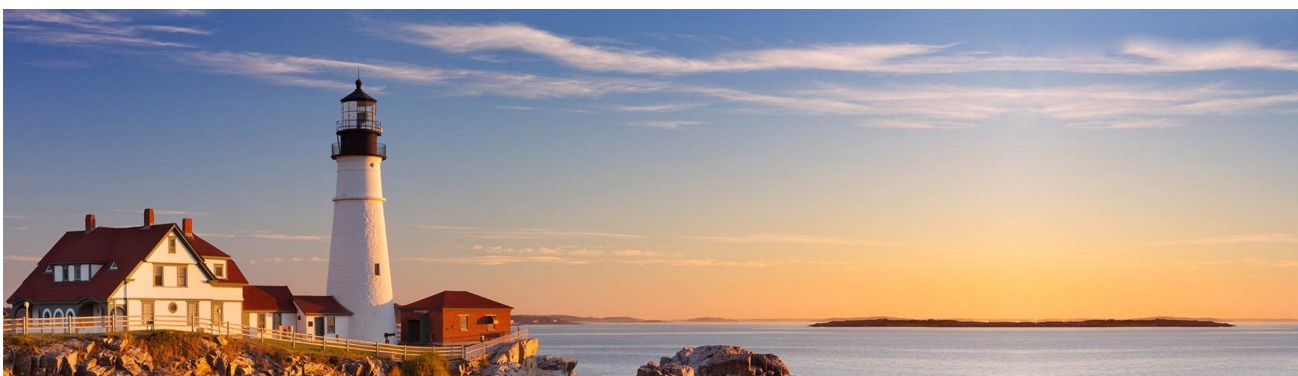
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Summary

While the global economy may be stuttering, there's still room for confidence. The second half of 2018 could get a steadying boost from the US economy – and US consumers.

Key takeaways

- Political turmoil and increased trade tensions have exacerbated the global economic slowdown, particularly in Europe and Latin America
- Unlike much of the global economy, the US has demonstrated stellar earnings and economic growth over the first half of 2018
- We expect the US to continue to be a source of stability for the second half of the year, but we will monitor key risks globally: political shifts/geopolitical tensions, rising inflation and tighter monetary policy from central banks

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