The Big Read US Dollar

The demise of the dollar? Reserve currencies in the era of 'going big'

The extraordinary stimulus measures in the US could undermine confidence in the greenback if inflation takes off

John Plender in London 5 HOURS AGO

Billionaire US fund manager Stanley Druckenmiller delivered an apocalyptic warning earlier this month that the dollar could cease to be the predominant global reserve currency within 15 years.

"I can't find any period in history where monetary and fiscal policy were this out of step with the economic circumstances," the chief executive of Duquesne Family Office declared.

He is not alone in expressing concerns about excess US demand, a more inflationary environment and accompanying dollar weakness. Such worries have been a contributory factor in the jittery equity markets of the past two weeks.

The dollar has survived at least four decades-worth of predictions of its demise. Yet Druckenmiller's views on currencies should not be cavalierly dismissed. This is the man, after all, who with George Soros "broke" the Bank of England when he made a hugely profitable bet back in 1992 on sterling leaving the European exchange rate mechanism.

Druckenmiller's warning comes against the background of a longstanding retreat from the dollar as the world has moved gradually towards a multiple reserve currency system. Even before the coronavirus pandemic and the extraordinary economic conditions it has generated, there were signs that the dollar's dominance was slipping.

Billionaire Stanley Druckenmiller is predicting the dollar's possible end as a reserve currency. His bets on sterling leaving the ERM, along with George Soros, 'broke' the Bank of England in 1992 © Christopher Goodney/Bloomberg

The IMF's latest survey of official foreign exchange reserves shows that the share of US dollar reserves held by central banks fell to 59 per cent during the fourth quarter of 2020 — its lowest level in 25 years. This compares with a share of 71 per cent when the euro was launched in 1999.

That protracted trend is logical. As Barry Eichengreen of University of California, Berkeley has long argued, the US accounted for the majority of the industrial production of the non-Soviet world after the second world war. It thus made sense that the dollar was the principal unit in which exporters and importers invoiced and settled their trade, in which international loans were extended and in which central banks held their reserves.

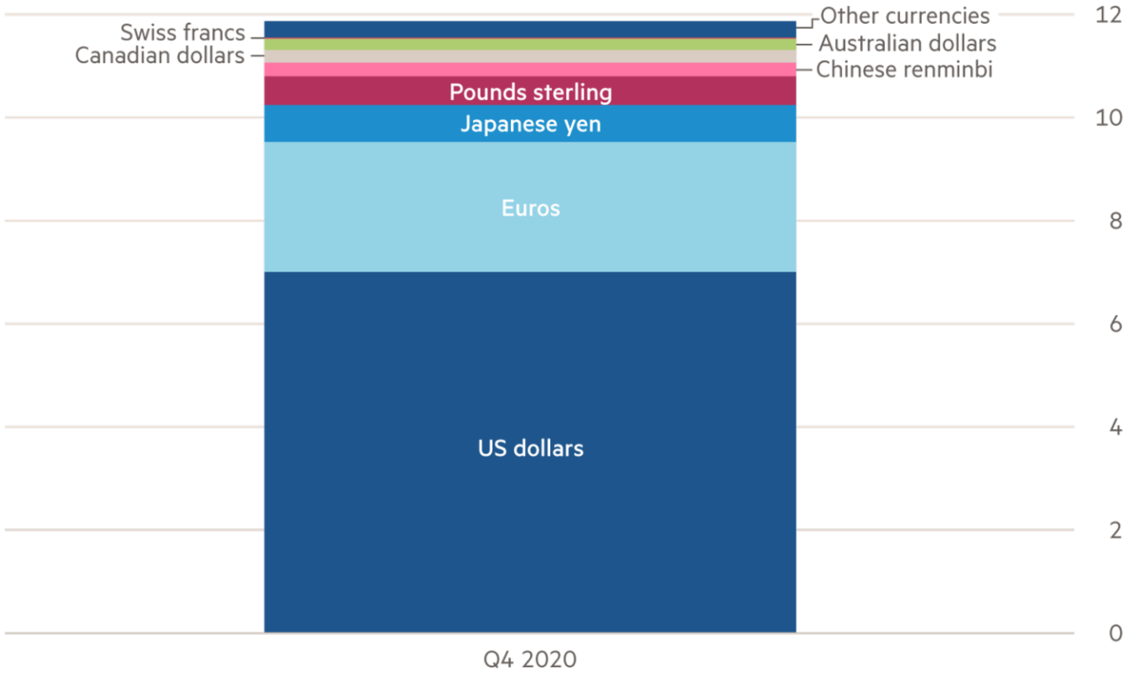
Today, with the US accounting for less than a quarter of global gross domestic product it makes less sense and leads to the accusation, levelled by the then French finance minister Giscard d'Estaing in the 1960s, of the "exorbitant privilege" whereby the US government can borrow more cheaply because of the greater demand for its IOUs arising from the reserve currency role. Another aspect of the exorbitant privilege is that the Federal Reserve, with a mandate geared to purely domestic conditions, sets a monetary policy for the whole world which for many countries is less than optimal.

The latest IMF numbers confirm that the privilege is eroding as countries that trade with and borrow from the euro area increasingly seek to hold euro reserves. That process is now happening with China and the renminbi. Yet the erosion has been very gradual.

The question then is are there circumstances in which what still amounts to dollar dominance suddenly could turn into a dollar rout?

The dollar's domination of central bank foreign exchange reserves

Official foreign exchange allocated reserves by currency (claims, US$tn)



Source: IMF
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Anti-inflationary credibility at stake

When it comes to reserve currency status there are huge advantages deriving from incumbency, partly from inertia but also from network effects. The more people use the dollar, the more useful it is for everyone else. And as Dario Perkins, head of global macroeconomics of TSLombard, points out, the leadership of the global economy does not change hands often. Most previous regimes changes, he says, whether in 15th century Venice, Amsterdam in the late 1700s or the UK in the 1940s, happened because of political turmoil usually involving devastating military conflicts.

That said, there is general agreement that the biggest single peacetime threat to reserve currency status is economic and financial mismanagement. And with the Federal Reserve having abandoned its longstanding commitment to tightening policy in anticipation of inflation and President Joe Biden "going big" with fiscal policy, the fear that inflation could undermine the currency is mounting — at least in some circles.

Janet Yellen, US Treasury secretary. She and President Joe Biden have been criticised for 'the least responsible fiscal macroeconomic policy we've have had for the last 40 years' by former Treasury secretary Larry Summers © Tasos Katopodis/Bloomberg

Those concerns have been most forcefully expressed by former Treasury secretary and fellow Democrat Larry Summers, who has said the Biden administration is pursuing "the least responsible fiscal macroeconomic policy we've have had for the last 40 years". In an interview with the FT last month he declared that "when it's explained that the Fed has an entirely new paradigm . . . it's a bit hard to understand why expectations should remain anchored." He added: "We're seeing an episode that I think differs both quantitatively and qualitatively from anything since Paul Volcker's days at the Fed, and it stands to reason that would lead to significant changes in expectations."

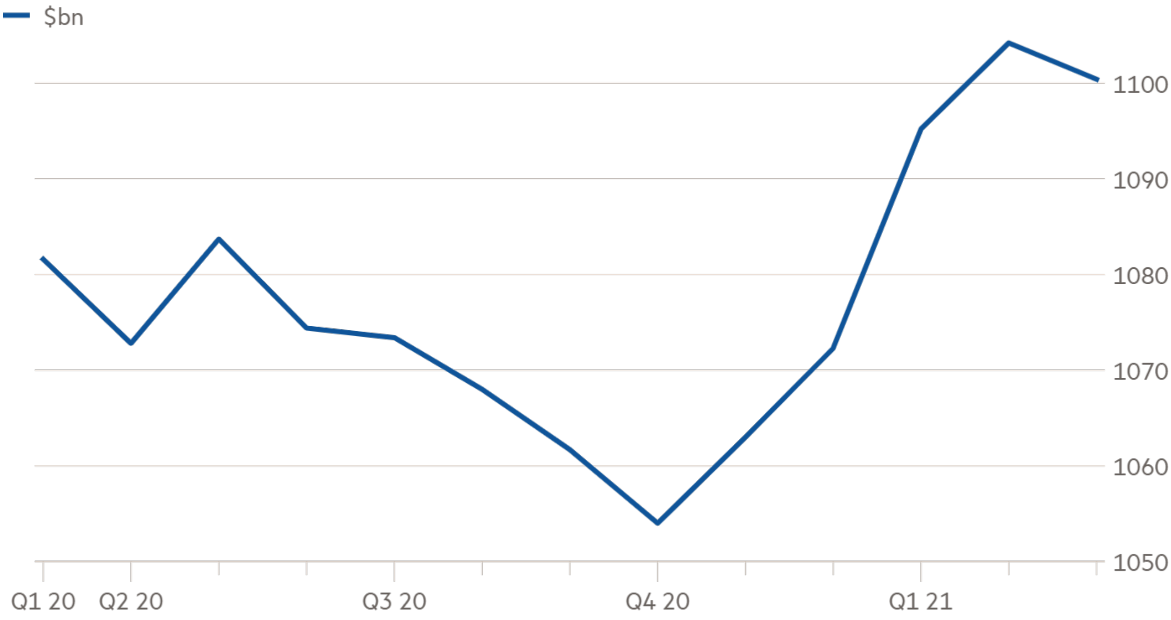
In other words the anti-inflationary credibility won at such high cost by the Fed over the past 40 years may now be in question, causing foreign investors to worry that the US will inflate away the value of their Treasury holdings.

One of the most fundamental requirements of a reserve currency is that it is backed by a state that can provide safe assets to global investors. The US has done that for more than 100 years, with the US Treasury market offering the safest haven in the world in times of crisis and the most liquid securities — that is, the easiest to trade.

Yet if the state pursues irresponsible policies those assets become less safe. The greatest potential threat to safety, as Summers implies, is inflation, which shrinks the real capital value of fixed interest investments.

China's holdings of US Treasuries increase after Biden's victory

Monthly data from Mar 2020 to Mar 2021



Source: US Treasury
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Erosion of safety

The fears about potential inflation are not the only reason some investors are raising new questions about the role of the dollar in the international financial system. The pandemic-induced turbulence in the Treasury market in March 2020 has raised important questions about the market's liquidity.

In early March, the Covid-19 scare sparked a typical, orderly flight to safety in US Treasuries. But from March 9 there was a disorderly flight from Treasury paper into cash. Analysis by the Basel-based Bank for International Settlements has shown that the dash for cash resulted substantially from forced selling by hedge funds that had borrowed heavily to profit from small differences in yield between cash Treasuries and the corresponding Treasury futures.

With the downward lunge in the market, the solvency of these highly leveraged funds was threatened and their lenders called in their loans, forcing the hedge funds to sell. In effect a feedback loop developed in which the inability of dealers to absorb sales led to further price declines, prompting more sales and leading to further price declines. Dealers responded by widening the bid-ask spreads they offered their clients on average by a factor of 13 in the first weeks of March. That should not have happened in what is usually termed the world’s deepest, most liquid government bond market.

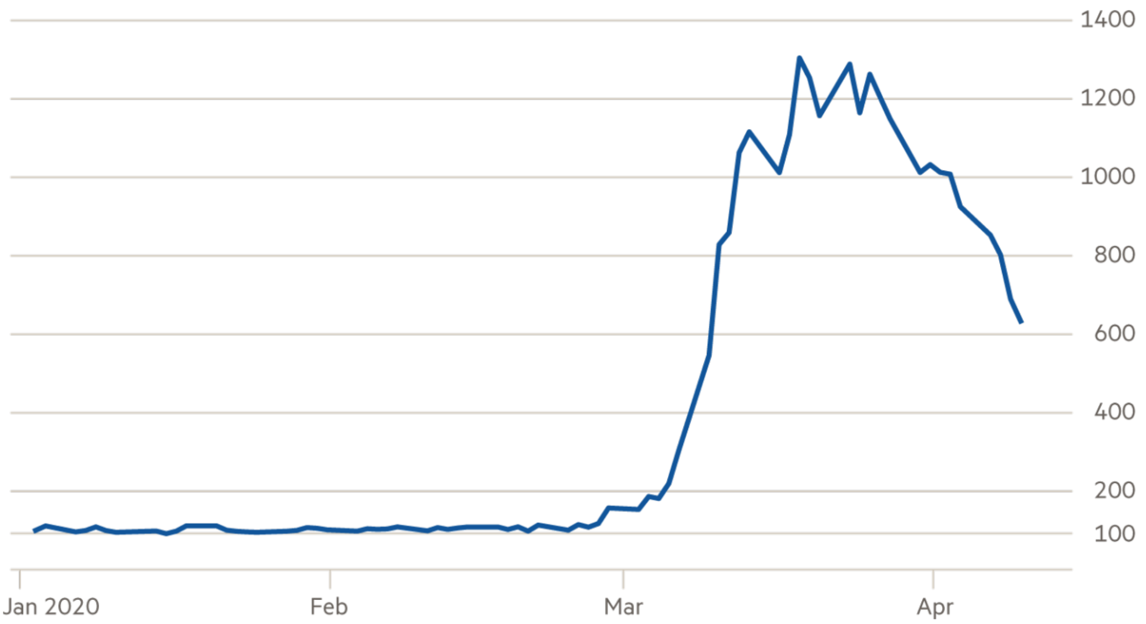
Traders on Wall Street watch Donald Trump giving a speech at the start of the pandemic. Trump’s dysfunctional presidency and the protectionist policies he pursued — and which Biden has so far kept — were not good omens for a reserve currency © Spencer Platt/Getty

US Treasury data show that much of this turbulence was internationally driven. Global investors' gross purchases of US Treasury bonds and notes reflected a classic flight to quality, jumping from $1.79tn in February 2020 to $2.67tn in March. Yet this was more than offset by foreign sales, which jumped from $1.79tn to $2.98tn, nearly a trillion higher than the previous peak over the decade.

This erosion of safety was a reflection of structural changes in the Treasury market. Darrell Duffie, a professor of finance at Stanford University Graduate School of Business, has pointed out that while growing federal deficits since the financial crisis of 2008 have caused the stock of marketable Treasuries to grow significantly, the balance sheets of the large banks that own the big primary dealers have not kept pace, partly because of tougher capital requirements introduced after the financial crisis. The gap has been filled by shadow banks such as hedge funds whose ability and readiness to provide liquidity in a crisis is limited.

Dealers widened Treasury spreads in March 2020's markets scare

Average Treasury bid-ask spreads (100=Jan 2 2020)



Source: Bloomberg Finance
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In the event, the Fed rescued the Treasury market from extreme dysfunctionality by flooding it with liquidity and relaxing bank capital rules. Yet there remains a risk that the Fed's morally hazardous interventions will ensure that bouts of illiquidity arrive with greater frequency and magnitude, given the historically high and growing ratio of federal debt to GDP and the ballooning stock of outstanding Treasury securities relative to the capacity of dealer balance sheets.

The other threat to the dollar's reserve currency role is dysfunctional politics. Donald Trump exposed hitherto unsuspected weaknesses in the checks and balances of the US system. With many in the Republican party questioning the outcome of the presidential election and Donald Trump having incited the attempted insurrection at the US Capitol on January 6, the quality of American democracy is in question. And while Biden has moved to restore relations with traditional allies and return to the principle of international co-operation, he is not rowing back strongly from Trump-era protectionism.

These are not good omens for a reserve currency. Yet there is a case to be made for the extraordinary stimulus under way. In seeking to pursue a more aggressive fiscal policy than the US adopted after the financial crisis, the Biden administration hopes to facilitate higher growth, which could make for less poisonous domestic politics and provide a more stable underpinning for the dollar.

Meantime, international capital appears to be giving Biden the benefit of the doubt. Given their security dependence on the US, big holders of dollar reserves such as Japan and South Korea are unlikely to dump the dollar. As for China, US Treasury data show that from August 2017 to October 2020 China's holdings of US Treasury securities declined from $1.2tn to $1.05tn. After Biden's victory they rose in monthly progression to $1.1tn — this despite the new administration's continuation of much of Trump's hostile approach to China.

Video screens in Times Square, New York, show the debut of Coinbase, the cryptocurrency exchange, on the Nasdaq. In 2019, Mark Carney speculated that a new synthetic hegemonic currency could be provided through a network of digital currencies issued by central banks © Levine-Roberts/Sipa USA/Reuters

Alternative gains

If the dollar has retained its hegemonic role thus far it is because reserve currency status is about relative not absolute advantages. The question has always been, what are the alternatives? In terms of economic might the only realistic immediate challengers are the euro and the renminbi. Both are gaining, albeit slowly, in relative advantage.

The chief difficulty with the euro has always been the lack of a government bond market capable of providing safe assets on a scale comparable with the US. Yet the response to the pandemic has finally pushed the bloc into moves to create a European Union recovery fund financed by commonly issued EU debt. Those moves are as yet tentative, but they suggest that the euro, currently making up 20 per cent of global reserves, could play an increasing role.

In the case of the renminbi, Beijing is committed to challenging the dollar and has actively encouraged the use of the renminbi in bilateral trade transactions. The Belt and Road Initiative provides new financing opportunities for the digital renminbi currently under development. And Beijing has the advantage that China has recovered more strongly than the other big economies from the Covid-19 setback. Foreign capital has been flooding in too as China has progressively opened its financial markets.

Gita Gopinath, chief economist at the IMF, is sceptical that a digital currency could replace the dollar's reserve role © Melissa Lyttle/Bloomberg

David Marsh, chair of OMFIF, the central banking think-tank, says the People's Bank of China has recognised that renminbi appreciation will help control inflation as well as foster a shift of focus away from external to domestic demand. A stronger renminbi will thus help the currency's internationalisation because foreign investors will be rewarded. Investors nonetheless have to include Chinese authoritarianism and a tradition of active state interventionism in markets in their calculations.

The wild card in this debate relates to digital currencies. Bitcoin, which moves several percentage points on a single tweet from Tesla chief executive Elon Musk, lacks credibility as a potential reserve currency. But Mark Carney, while governor of the Bank of England, suggested in 2019 that technology has the potential to disrupt the network externalities — the benefits of using a currency that many others are using- that prevent the incumbent global reserve currency from being displaced.

He speculated that a new synthetic hegemonic currency could be provided through a network of digital currencies issued by central banks. This would enable spillovers from shocks in the US through exchange rates and trade to become less synchronised across countries, while the dollar's influence over global financial conditions might likewise decline.

Many are sceptical. Gita Gopinath, IMF chief economist, believes that technology has plenty to offer in providing cheaper and faster cross-border payments and improving financial inclusion. But her view of the development of the international reserve system focuses more on old-fashioned development of institutions to improve the eurozone's architecture and resilience, and stronger domestic institutions and further liberalisation of markets in China.

History tells us that it took just 10 years for the dollar to remove sterling from its reserve currency role. That reflected the devastation wrought on British economic and financial might by the first world war. In the light of the extraordinary fiscal and monetary response to the pandemic it seems unlikely that the coronavirus will prove as economically potent as that military conflagration. But the threats to the dollar to watch are US fiscal profligacy and monetary debasement.