SECOR | ASSET MANAGEMENT

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Is the Dollar's Preeminent Role in the Global Economy Finally in Jeopardy?

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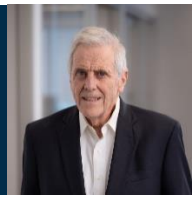

Over the last eighty years the U.S. dollar (USD) has served as the world's preeminent currency even though friends and foes have expressed resentment, particularly at the privileged access to credit that the US has enjoyed as a result of its dominant currency. Other currencies such as the euro, Japanese yen, and British pound sterling play important roles in the global economy, but the U.S. dollar (USD) continues to occupy the dominant position.

Now China's emergence as an economic and geopolitical rival of the US, new technologies, and the expanding role of the USD as a vehicle for economic sanctions are bringing new and perhaps even more compelling reasons to contend that at long last the dollar could be dethroned from its preeminent position.

In this opinion piece on the prospects for de-dollarization we discuss the following:

- **Economic, market, and institutional underpinnings of dollar's dominant role**
- **Is there an alternative to the USD: renminbi, gold, digital currency?**
- **Could geopolitics trump economic efficiency?**
- **Our opinion: Dollar's global role may evolve but its preeminence is likely to persist[1]**

Economic, Market and Institutional Underpinnings of Dollar's Dominant Role

The US economy accounts for only 12% of world trade and roughly 20% of world GDP, yet current financial data attest to the preeminent role of the US dollar in the global economy. The US dollar's leading role in foreign exchange, trade, and international finance is manifest across the following metrics: cross-border loans, international debt securities, FX transactions, official FX reserves, trade invoicing, and SWIFT payments. The USD was involved on one side or the other of nearly 90% of global FX transactions in 2022. Moreover, forty percent or more of cross-border loans, international debt securities, trade invoicing, and SWIFT payments were dominated in USD in 2022 (see Chart 1).

Chart 1: Share of US or USD in……
Source: BIS, IMF, various others

[1] The commentary and conclusions in this opinion piece are attributed to Edgar Sullivan, SECOR's Senior Economist. Mr. Sullivan acknowledges, however, that Eswar Prasad's acclaimed work: The Future of Money (referenced in footnote 4) helped him to crystallize his thoughts on this subject.

The global economy has achieved significant gains in efficiency by adopting the USD as a medium of exchange and store value. The dollar's role as the global reserve currency is supported by the following attributes: (i) the US' status as the world's largest economy, (ii) the depth and breadth of the US financial markets, and (iii) the institutional maturity and rule of law that underpin the US currency[2]. With the USD accounting for 58% of world's FX currency reserves in 2022 -- surpassing by wide margins the euro (21%), Japanese yen (6%), UK pound (5%) and Chinese renminbi (3%) -- the dollar's role as the world's preeminent reserve currency is well supported (see Chart 2).

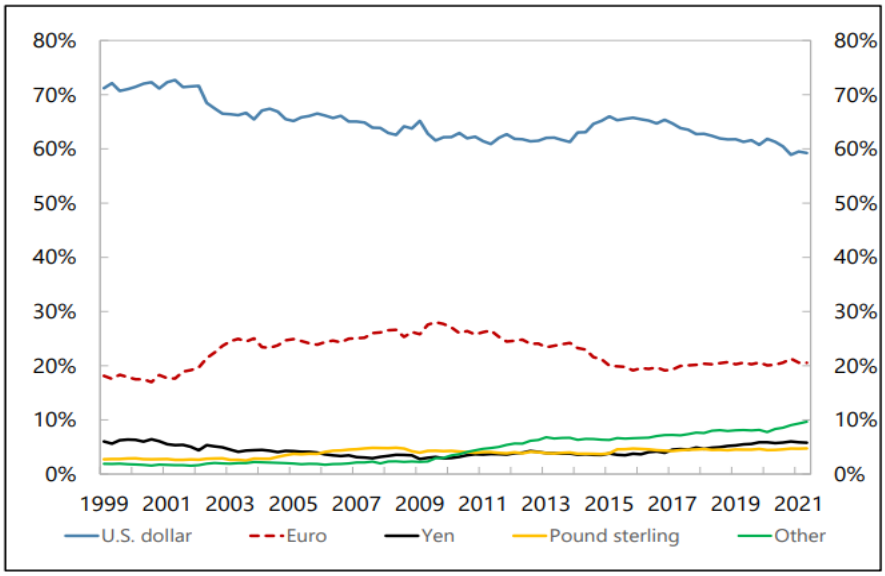

Chart 2: Global Currency FX Reserves
Source: IMF
Principal components of other: RMB (2.7%), CAD (2.4%), AUD (2.0%).

Is There an Alternative to the USD: Renminbi, Gold, Digital Currency?

Putting geopolitics aside for now, let's focus on three representative, possible alternatives: the renminbi, gold, and digital currencies. The **renminbi** is one of the so-called other or nontraditional currencies that have increased their share of global FX currency reserves at the expense of the dollar and other traditional reserve currencies in recent years. This increase, however, was attributed to typical investment behavior such as reaching for return in an environment when the Fed, ECB, BoE, and BoJ were pushing their policy rates down to zero or even negative[3]. Now that monetary policies in the US and Europe are normalizing and tightening the principal reason why that the nontraditional reserves were able to establish a "toe hold" (10% share) of the global FX reserves in recent years appears to have run its course. Thus, even though recent market conditions have facilitated China's ability to increase its share of global FX reserves to 3%, its capital constraints and currency management practices will impede further significant growth. In this regard, Eswar Prasad notes that even if China were to fully open its capital account and let its

[2] "Economies face stark choices on de-risking", Mohamed El-Erian, Financial Times, 5 May 2023
[3] "De-Dollarization – (Still) Contained and Constrained", GS Global Fx Trader, 21 April 2023

currency float, due to the country's one-party, authoritarian structure: "the renminbi will not be seen as a safe-haven currency that foreign and domestic investors turn to in times of global financial turmoil"[4].

Questions might also be raised concerning whether **gold** — a reserve asset that is currently experiencing a mini-renaissance – could regain its position as the world's preeminent reserve asset. Central banks significantly reduced the proportion of gold in their reserve assets as the double-digit inflation of the late-1970s/early 1980s was tamed and inflationary concerns subsided. But recently allocations to gold have started to edge up from their post-GFC troughs, presumably in response to renewed inflationary concerns and to provide a possible hedge against sanctions (see Chart 3).

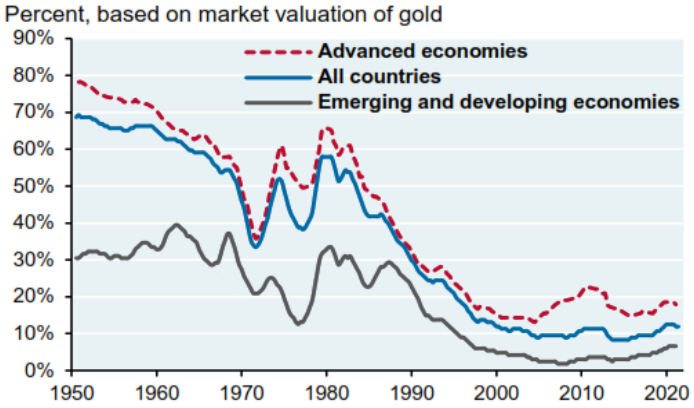

Chart 3: Gold in Official Reserve Assets
Source: IMF

Even though gold may have appeal as a diversifier and some countries including Russia, Turkey, and India have recently added it to their FX reverses (see Chart 4), supply constraints and the positive expected return derived from holding securities such as US Treasuries will, in our opinion, limit additional, significant allocations to gold. Due to the limited supply of gold, increasing purchases further could raise its price significantly[5]. Moreover, holding-highly rated government securities can provide current income, while gold does not pay interest and significant storage costs can be incurred by countries such as Russia that purchase physical gold.

Country	Gold (troy oz)	Change vs 2015 (oz)	Change vs 2015 (%)	Gold % of FX reserves
Russia	74.8	36.0	48%	25%
China	66.5	32.6	49%	4%
Turkey	24.5	7.9	32%	39%
India	25.4	7.5	29%	9%
Poland	7.4	4.0	55%	9%
Thailand	7.9	3.0	38%	7%
Japan	27.2	2.6	10%	4%
Singapore	6.6	2.5	38%	4%

Chart 4: Largest Increases in Central Bank Gold Holdings vs. 2015
Source: IMF, Bloomberg, JPM

Whether rapidly changing **financial technology --** which is likely to render cash obsolete in the next decade or two-- could dethrone the dollar from its current preeminent role in the global economy is another

[4] The Future of Money: How the Digital Revolution Is Transforming Currencies and Finance, Eswar Prasad, 2021

[5] Current above-ground supply of gold — 185,000 metric tons is valued at $12 trillion. Mining — which some environmentalists are calling for curtailing — only increase supply by 1.6% per year. Recent Cambridge University paper found that the carbon footprint of extracting gold was as much as all intra-European aviation. Principal source: "How long will the gold boom last?" Harry Dempsey & Leslie Hook, Financial Times, 25 May 2023

relevant question. My answer to this question is predicated on the discussion of Fintech (financial technology) and CBDC (central bank digital currencies) in Eswar Prasad's recent book on the future of money[6]. He notes that new financial technologies will increase the speed, improve transparency, and reduce the cost of cross-border transactions and thus, erode the dollar's role as the world's primary payment currency. In contrast, Prasad contends that even though the transition to a central bank digital currency is inevitable, it will not change the USD's preeminent role as a global reserve currency. "Digitalization, on its own, will make little difference to whether a currency is seen as reliable store of value or not. That will still be determined by the credibility of the central bank issuing the currency and the quality of a country's government and institutions."

Could Geopolitics Trump Economic Efficiency?

Economic efficiencies aside, geopolitical considerations might outweigh economic efficiencies and prompt US foes to pursue strategies that bypass the dollar. China's recent agreement to purchase oil from Saudi Arabia with its own currency is an example of a non-dollar, bilateral payment arrangement. Professor Nouriel Roubini acknowledges that many prior attempts to create a multipolar-reserve regime -- even an IMF Special Drawing Right basket that includes the renminbi -- have failed to replace the dollar. But in our increasingly divided geopolitical world this could change. Roubini envisions a transition to a bipolar currency environment in which the dollar and the renminbi replace the current unipolar dollar-based world in not-too-distant future[7]. Colin Weiss, a Federal Reserve economist, concurs with Roubini's prediction, but he notes that since around three-quarters of the foreign governments holding safe US assets are countries with a miliary tie to the US, reduced reliance on the dollar by a bloc of countries less geopolitically aligned is unlikely to end USD dominance[8].

Our Opinion: Dollar's Global Role May Evolve but Its Preeminence Will Persist

Looking ahead we acknowledge that new financial technologies are likely to erode the dollar's role as the world's principal payment currency and that increasing geopolitical dissonance may cause China and other US political foes to circumvent using the dollar when possible. Despite these likely changes, we believe the dollar will remain as the world's principal safe-haven currency for the foreseeable future. Our confidence is based largely on the key factors that we discussed: (i) The economic, market and institutional factors underpinning the dollar's dominance seemingly remain in place. They include the continuing strength of the US economy, the depth and liquidity of its financial markets, and the country's solid, albeit less than perfect, institutional foundation which is essential for maintaining investors' trust. (ii) There does not appear to be a viable alternative on the horizon -- the renminbi, gold nor the transition to a digital currency issued by the Fed are not likely to replace the dollar. (iii) Lastly, due to the breadth of the US' global alliances, a bloc of countries less aligned with the US is unlikely to end the dollar's dominance[8].

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[6] Prasad, ob. sit., p.356

[7] "A bipolar currency regime will replace the dollar's exorbitant privilege", Nouriel Roubini, Financial Times, 6 February 2023

[8] "Geopolitics and U.S. Dollar's Future as a Reserve Currency", Colin Weiss, Federal Reserve Discussion Paper, October 2022

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