MARCH 2021

THOUGHT LEADERSHIP: THE GREENBACK SLIDE – NOT ENOUGH FOR A RESERVE RESHUFFLE

WHITEHELM
ADVISERS

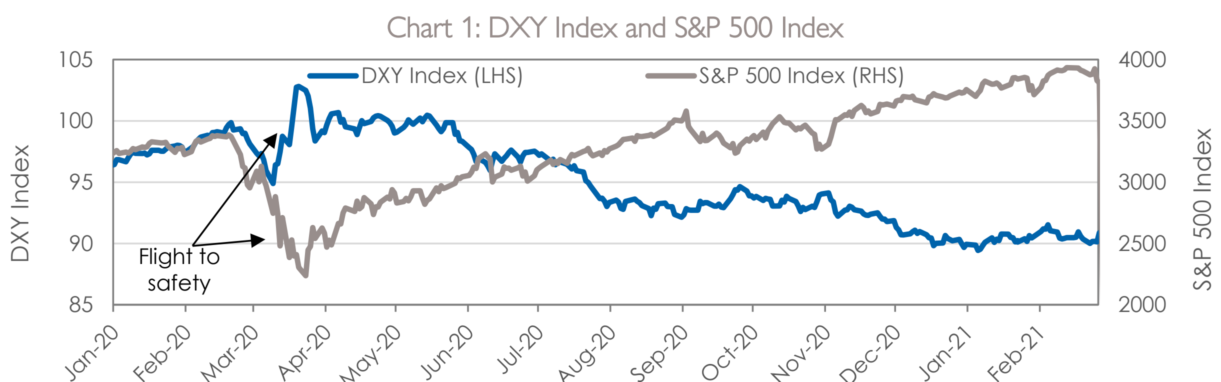
INTRODUCTION

The US dollar (USD) has long been considered a safe haven currency, and this was exemplified in the month from mid-February to mid-March 2020. A sudden spike in COVID-19 cases in countries other than China in mid-February illustrated the potential breadth and duration of the virus outbreak. In the month that followed, a dramatic 'flight to safety' in markets ensued. Investors exited their holdings of riskier asset classes, such as equity and credit, to invest in cash. Currencies such as the USD and the Japanese yen were particularly favoured for their perceived safety and the expectation they will increase in value during times of market turbulence. The USD's role as the global reserve currency means it typically acts as an insurance policy during such periods.

Since mid-March 2020, the USD has retraced all its first calendar quarter gains and more versus most developed market currencies. The unparalleled and coordinated monetary and fiscal support announced in mid-March supported a strong recovery in risk markets. Global equity markets posted double digit returns over the course of 2020 and the US Dollar Index (DXY Index) fell by 7% over the year, outcomes that would have seemed all but impossible in early March.

Caused by a combination of both history and America's dominant role in the global economy and financial markets, the USD is, broadly speaking, the preferred currency used globally by central banks and capital markets. It is the world's preferred unit of account, store of value and medium of exchange. However, the story of a weaker dollar looks sets to persist in the short to medium term which has restarted the recurring debate about the fragility of the USD's global reserve currency status.

In this month's article, we discuss the outlook for the USD in global financial markets, starting with the key drivers for the medium term and the associated investment implications. We discuss the role that the USD plays in global markets, and why its weak outlook has reignited claims it will lose its top currency spot. We finish by considering whether there are reasonable alternatives to the USD as the global reserve currency and if there is any imminent risk of a reserve currency rotation.



Source: Bloomberg

Note: The DXY Index indicates the international value of the USD by averaging the exchange rates between the USD and major developed market currencies.

MEDIUM-TERM OUTLOOK FOR THE US DOLLAR

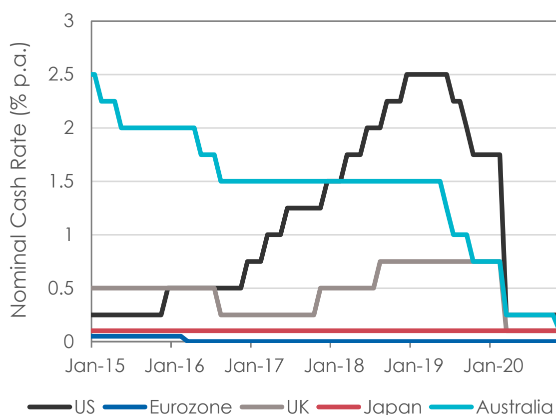
We consider there to be several structural factors and economic themes that mean the slide in the greenback will persist in the short to medium term.

Central Bank Response

From late 2015 to mid-2019, the US Federal Reserve (the Fed) embarked on a rate-hiking cycle, increasing the federal funds rate from the post-GFC target range of 0-0.25% to 2.25-2.50% per annum. As a result, the USD maintained a reasonable carry advantage over most other developed market currencies in the few years prior to the pandemic, as shown in Chart 2. However, the carry advantage was completely eroded by central bank actions in 2020, developed market cash rates have all been slashed to circa 2% or below. The USD's lack of carry advantage is expected to cause depreciation pressure on the dollar over the medium term given that it has reduced the incentive for yield-seeking investors to hold USD (and USD-denominated assets in general, for that matter) over other developed market currencies.

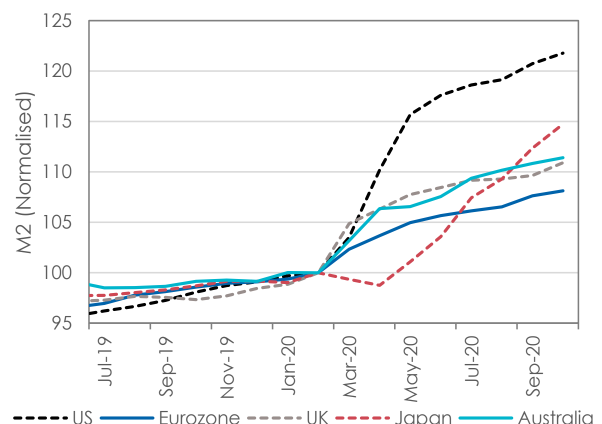
Additionally, the Fed dramatically increased the monetary base in 2020, most sharply during March. Many developed market countries embarked on their own versions of QE in response to COVID-19, but the Fed's approach was arguably the most aggressive, as shown by the rapid rise in US money supply in 2020, as per Chart 3. While the Fed's QE program has been critical in providing liquidity and supporting markets, there are mounting concerns that the dramatic expansion of the monetary base will lead to high inflation, especially relative to developed market peers.

Chart 2: Developed Market Cash Rates



Source: Bloomberg

Chart 3: M2 Monetary Base for Select Developed Market Nations



Source: US Federal Reserve, European Central Bank, Bank of England, Bank of Japan, Reserve Bank of Australia, Whitehelm Advisers

Note: M2s for all countries normalised to 29 February 2020

In late February 2021, bond yields increased sharply as markets grappled with the possibility of higher inflation. Our view, however, is that sustained inflation is unlikely to materialise until there is a significant reduction in the amount of spare capacity in the US economy. The unemployment rate is currently 6.3%, well above the pre-pandemic level of 3.5%. As such, we consider higher inflation to be a risk for the medium term, not the short term.

In any case, when inflation does materialise, the Fed is not expected to immediately curb it with a rate-hiking cycle, having reiterated its commitment to keeping the cash rate low until there is a significant reduction in the unemployment rate. Furthermore, its adoption of an average inflation target scheme (which no other central bank has adopted) means that it is expected to allow inflation to be above 2% per annum for a period of time, to make up for the sub-2% inflation that has persisted for a number of years.

The USD typically underperforms in environments when inflation is higher in the US than in other developed market countries. The pressure on the USD will be compounded by the Fed's reluctance to raise rates due to the average inflation target, given that it reduces the likelihood the USD will regain a carry advantage over other developed market currencies.

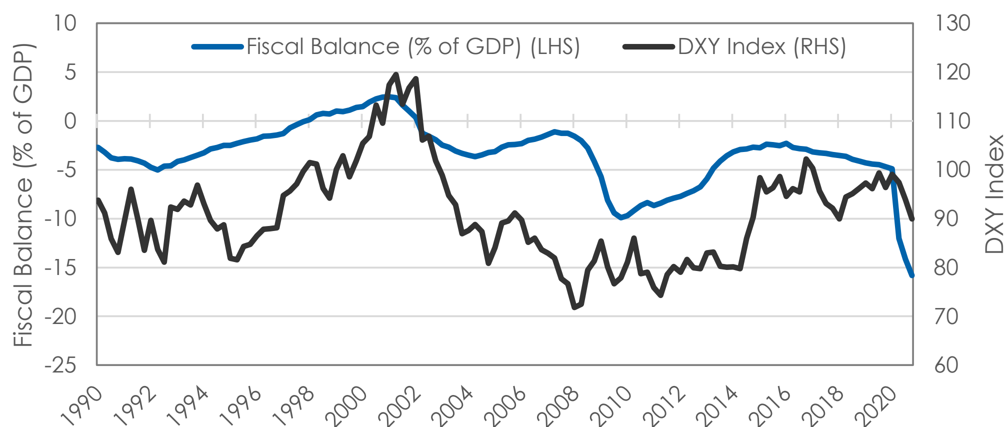
Twin Deficits

The US has long run twin current account (exports minus imports) and fiscal deficits. Fiscal deficits are not necessarily a bad thing – in times of slow economic growth or during a recession, it is an important way to support aggregate demand and economic growth. These deficits are funded by issuing debt to domestic and foreign investors.

While the US has run twin deficits for a long time, the government's fiscal response to COVID-19 caused a significant surge in the fiscal deficit in 2020, per Chart 4. President Biden's proposed COVID-19 recovery plans include a US$1.9 trillion fiscal spend (or 9% of GDP), which is currently working its way through the US Congress and Senate. This is not captured in Chart 4.

Widening fiscal deficits have historically been associated with weakness in the USD. The ratio of US federal government debt to GDP exceeded 100% in 2020, for the first time since the end of World War II.[1] Ratings agency Fitch downgraded its outlook for the US from stable to negative in July 2020, in light of the deteriorating public finances. Fitch flagged that while the US will be able to service its debt simply because it cannot run out of money, global investor perception of the safety of US government debt may deteriorate, yet another headwind for the USD.[2]

Chart 4: US Fiscal Balance and DXY Index



Source: Bloomberg

[1] Refer to https://www.cbo.gov/publication/56970
[2] Refer to https://www.fitchratings.com/research/sovereigns/fitch-revises-united-states-outlook-to-negative-affirms-at-aaa-31-07-2020

Global Outlook

While the pandemic is far from over, the global rollout of vaccines and continued fiscal and monetary support is expected to lead to a strong economic recovery in 2021, as per the International Monetary Fund's (IMF's) growth projections presented in Chart 5. An environment characterised by strong global growth, especially when the rest of the world is growing at a faster pace than the US, paired with extraordinarily accommodative monetary policy, is typically one in which the USD languishes. The strong global growth supports the demand for risk assets, including those outside the US, and reduces the appetite for safe havens, such as the USD and US Treasuries.

Valuation of USD

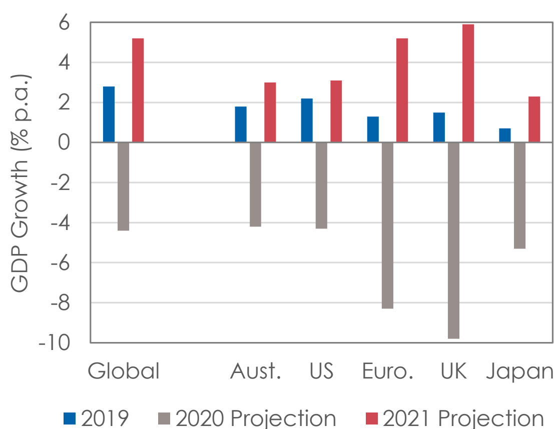
We consider the rate implied by Purchasing Power Parity (PPP) as a valuation metric for the major currencies. Despite the depreciation in the USD over the past year, it trades at large premiums compared to several developed market currencies, per Chart 6. Overall, the rates implied by a PPP valuation approach support the case for further USD depreciation over the long term, most notably versus the euro, and to a lesser extent the British pound and Japanese yen. It is worth noting that the differing rates of productivity growth across sectors within different economies can produce shifts in relative prices over time, which can result in divergence from the rates implied by PPP over the short to medium term.

What Does This Mean?

In isolation, each of the factors discussed in the previous section would be expected to be a headwind for the greenback. It is somewhat surprising that the USD has not fallen further given their totality. However, these more structural headwinds to the USD have been counteracted by short-term themes over the past 12 months, including the unpredictability of the pandemic, the Brexit saga and the tumultuous US political landscape. With these tensions easing somewhat at end-2020, the more medium- to long-term narratives discussed above are likely to prevail in pushing the USD lower against most major developed market currencies.

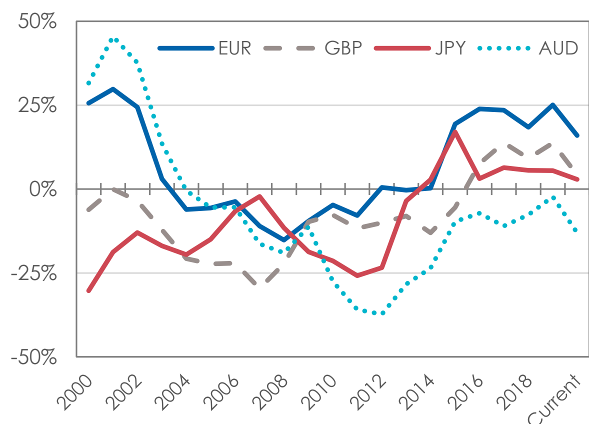
From an investment perspective, the outlook for a weaker USD has portfolio-wide implications. Investors not based in the US will typically have significant direct and indirect USD exposure based on the size of US financial markets (for example, the MSCI World Index is two-thirds US stocks) and the global influence of the USD in financial markets. In the boxes that follow, we touch on a few key investment areas (but clearly not an exhaustive list) that will be directly impacted by a weaker USD.

Chart 5: Actual and Projected Growth Rates

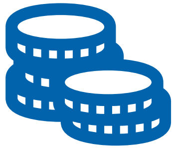


Source: IMF

Chart 6: USD vs. OECD PPP Implied Fair Value



Source: OECD, Bloomberg, Whitehelm Advisers



Foreign Currency Exposure

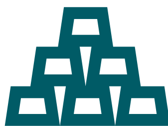
Investing in international assets involves being exposed to currency volatility, which can have a significant return impact. Australian investors benefitted from a positive interest rate differential in hedging developed market currency exposures for several decades, while European and British investors benefitted from a smaller, but still positive, differential for several years following the global financial crisis. By hedging USD-denominated assets, non-US investors could earn a yield pickup.

However, the Fed's 2015-2019 hiking cycle caused interest rate differentials to narrow significantly, and turn negative. As such, non-US investors were incentivised to increase their levels of foreign currency exposure (or lower the level of currency hedging), to benefit from the higher yield on offer by the USD. The interest rate differentials for Australian, British and European investors becoming effectively zero in 2020 and beyond, and the weak outlook for the USD, may require a re-think of hedging levels.

Emerging Markets Equity

Emerging markets equity (in local currency terms) typically underperforms during periods of sustained USD strength and outperforms during periods of sustained USD weakness. Many emerging market governments and companies have significant amounts of USD-denominated debt, so a weaker USD makes the debt easier to repay, which increases corporate and sovereign cash flows. Local inflation pressures are also lower as US imports are cheaper. Many emerging market countries are commodity exporters, and given that most commodities are priced in USD, cash flows in local currency terms rise.

In this environment, emerging market central banks are better able to maintain or cut interest rates. The lower domestic interest rates and higher cash flows to companies and households causes increased investment, and in turn, higher economic growth. The improved growth profile for emerging market economies attracts investment from overseas, especially from investors who are chasing yield not on offer from USD-denominated assets.



Commodities

Most commodities are priced in USD. During periods of USD weakness, foreign buyers have more purchasing power because it requires less of their currencies to purchase each dollar. This increases foreign demand for commodities, and thus ultimately their price (in USD), which is good for commodity-producing nations, as well as resources companies that are involved in commodity exploration and production.

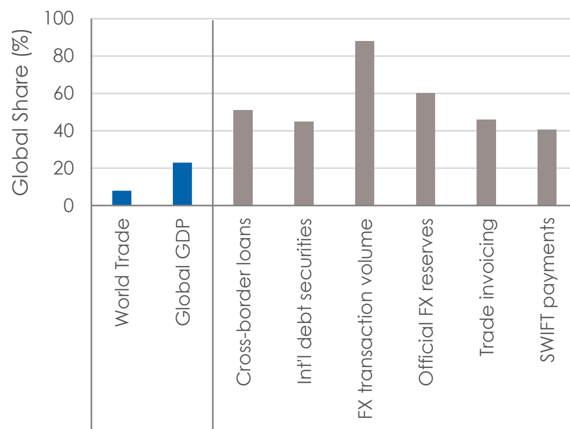
Gold is typically considered as a hedge against inflation. If inflation materialises and the USD is weaker, we could see a surge in gold prices.

CHALLENGERS TO THE US DOLLAR

The USD is the preferred currency of central banks and capital markets; it is the preferred unit of account, store of value and medium of exchange. The British pound was the global currency of choice throughout the 19th century and the first half of the 20th century. However, the USD gained top spot through the 1944 Bretton Woods agreement, which implemented a system of fixed exchange rates used by most developed nations whereby they pegged their exchange rates to the USD, which was in turn pegged to a parity price for gold. Even though the system was abandoned in the 1970s, it paved the way for the USD being the global reserve currency.

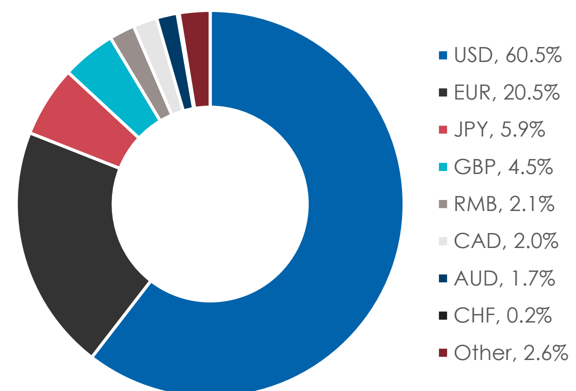
The unmatched size and openness of US capital markets and the prominence of the US in international trade and investment, America's role as the world's economic superpower, and its relatively strong political institutions have all backed the role the USD continues to play in global markets (per the collection of charts below).

Chart 7: International Role of the US and USD



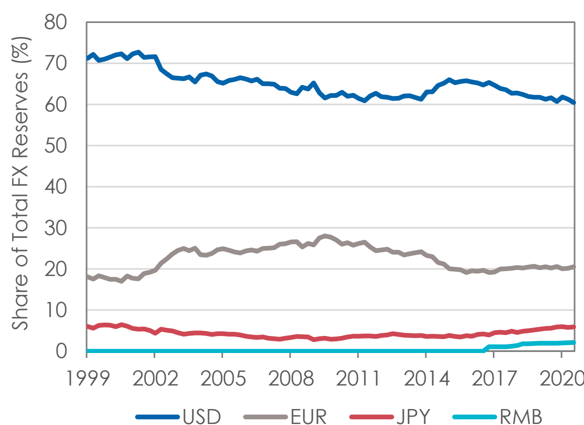
Source: Reserve Bank of Australia

Chart 8: Global Allocated Reserves by Currency



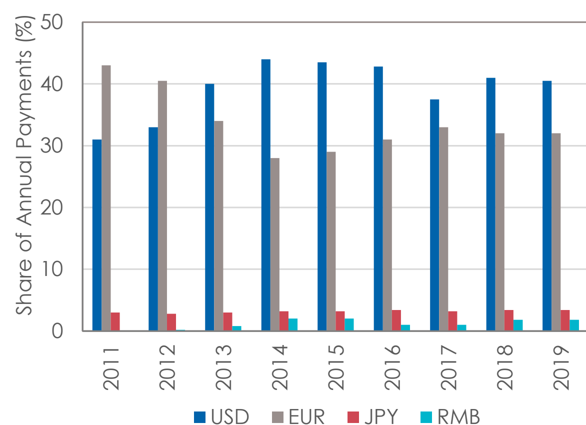
Source: IMF

Chart 9: Historical Share of Global FX Reserves



Source: IMF

Chart 10: Share of Global SWIFT Payments



Source: SWIFT

It has been an '*exorbitant privilege*'[3] to the US that its currency is the global reserve currency. The many benefits include:

- the demand for USD-denominated assets, particularly US Treasuries, means that the US Government can borrow from other countries at lower interest rates than would otherwise be the case;
- the US Government can run sustained fiscal deficits (because there is such high demand for US government debt) which gives the country freedom to implement its domestic policy agenda;
- given that the majority of commodities and agricultural products are priced in USD, American businesses and the US Government are significantly less exposed to exchange rate risk than their international counterparts; and
- the international reliance on the USD allows the US to have extraordinary influence over other countries' economic wellbeing. The US Government can implement economic sanctions by limiting a country's or a company's access to USD-based financial systems. In recent years, the US has implemented such sanctions on Russia, Iran, Iraq, among others.

There has been a recurring debate about the USD's role as the global reserve currency over the past few decades, a debate which typically gains steam during periods of sustained USD weakness. Previous predictions entailed the USD losing its prized status as early as 2022.[4] The current medium-term outlook for the greenback has again reignited the debate. Given that so many global central banks hold the USD in reserve as a means to repay debt and support their economies (including through pegging their currencies to the USD), the concern is that the USD may not be able to fulfill those roles if it lost a lot of its value.

A weakening outlook for the USD is likely not enough to bring the USD's reign to an end. However, the USD has lost its shine in other ways too. America is no longer the only economic superpower – various projections have China on track to become the world's largest economy by 2030. America's share of global trade has also fallen, with China eclipsing the US to be the world's largest exporter. Confidence in America's political and economic institutions has wavered, exacerbated by four years of President Trump's trade protectionism and nationalistic policies. Finally, Trump's penchant for engaging in financial warfare against America's foes, through the use of USD-based economic sanctions, brought renewed focus to America's outsized, and at times, dangerous, global influence.

However, an essential requirement for the USD to be replaced as the preferred reserve currency is for there to be a viable alternative. Next, we highlight the two currencies vying for top spot, the euro and Chinese renminbi, and discuss the structural headwinds both currencies face in gaining more market share. We also briefly touch on central bank digital currencies, an emerging, albeit immature, challenger of the USD.

[3] The term was coined by former French Minister of Finance Valèry Giscard d'Estaing in the 1970s, describing the USD's role in the Bretton Woods system.

[4] Refer to *Why the Euro Will Rival the Dollar*, Menzie Chinn and Jeffrey Frankel, 2008.

Euro

The inception of the euro in 1999 was perceived to be a pivotal moment for the European Union. The use of a single currency was hoped to promote economic integration across Europe and boost the economic status of the region globally. Loftier expectations included that the currency could rival the USD in international finance and even replace the USD as the global reserve currency.

The advent of the euro did improve a variety of aspects of Europe's economic landscape, such as increasing trade and reducing the currency risk that had previously existed between trading nations.

However, the 'one size fits all' monetary and fiscal policy inherent in the single currency approach has shown to have significant drawbacks. A unified monetary policy across 19 countries means eurozone nations do not have the freedom to independently use interest rates and money supply (and thus, exchange rates) as a way to stabilize their economies. Countries that use the euro are meant to keep their annual budget deficits less than 3% of the GDP and their debt to GDP ratios must be less than 60% - a task that has proven very challenging for many eurozone nations, and has inhibited growth in many cases.

The EU's COVID-19 recovery package, the €750 billion Recovery and Resilience Facility, marked an important step towards more advanced fiscal integration. The facility allows European nations to collectively borrow funds to support an economic recovery from the pandemic. However, it will take a long time to develop a low-risk bond market that is as liquid and mature as the US Treasury market.

Despite the original hopes of the euro rivalling the USD as the globe's dominant currency, the euro has so far fallen short. Since the euro's inception in 1999 compared to mid-2020, the euro's share of global currency reserves is unchanged as previously shown in Chart 9 (it reached as high as 28% at end-2009, but fell in the aftermath of the European debt crisis of the early 2010s). While the euro was the favored currency for global payments according to SWIFT data in 2011, its global share has fallen in the past decade, with the USD overtaking the euro in 2013, as shown in Chart 10.

The euro has not yet lived up to expectations. The eurozone's lack of fiscal integration and its various structural challenges have impeded the euro's ability to become a more dominant currency. While some promising steps have been taken in recent years in terms of improving its integration, the eurozone and the euro are expected to be plagued with continued uncertainty, a seemingly insurmountable headwind to it replacing the USD as the global reserve currency.

Chinese Renminbi

Over the past several years, the Chinese renminbi has experienced a period of internationalisation, in part a deliberate move on behalf of the Chinese Government, as well as due to the increasingly important role of the Chinese economy globally.

The Chinese Government has long been concerned about the economic influence the US wields due to the USD's reserve currency status. After the onset of the global financial crisis in 2008, the then-Governor of the People's Bank of China called for reform to the international monetary system, including the establishment of an international reserve currency, '*disconnected from economic conditions and sovereign interests of any single currency.*'[5] Since then, China has made a concerted effort in internationalising the renminbi.

[5] Refer to https://www.bis.org/review/r090402c.pdf

The process of internationalisation involved a variety of avenues, including establishing offshore renminbi clearing centres, which dramatically increased cross-border trade settlement in renminbi. China has also promoted the use of the renminbi in international trade, particularly through the establishment of bilateral currency swap agreements with a variety of other countries to reduce exchange rate risk.

In a notable step in its journey towards internationalisation, the renminbi was included in the IMF's Special Drawing Rights (SDR) basket of currencies in 2016, in recognition of the progress China had made in opening itself to the global economy. The SDR is an international reserve asset maintained by the IMF to supplement IMF members' international reserves. To be included in the SDR basket, the issuing country must be a large exporter (a criterion China clearly meets) and the currency must be 'freely usable', which is a more subjective criterion based on international usage. The renminbi's inclusion means it joins the USD, euro, Japanese yen and British pound in the SDR.

While these have all marked very positive developments in the renminbi being considered a serious contender as a global reserve currency, the renminbi has also faced a series of setbacks, many of them the government's creation. The country's managed exchange rate regime and capital controls mars its reputation internationally. In 2015, the Chinese Government introduced a more market-based approach to setting the value of the renminbi, which included a 3% devaluation in the currency. However, this move coincided with the dramatic Chinese share market sell-off that characterised late 2015 and early 2016. The Chinese Government reverted back to a more managed exchange rate approach in January 2016.

China's inclusion in global market indices, such as the inclusion of Chinese local bonds in Bloomberg's global bond indices in 2019 and Chinese A-shares in the MSCI Emerging Markets Index in 2018, marked a positive evolution in the development of China's capital markets. However, broadly speaking, they remain underdeveloped and are still reasonably inaccessible to many international investors. China continues to bear considerable political and economic risk, and the renminbi is unlikely to be taken seriously as a legitimate contender to the USD until investors are able to effectively manage those risks.

Finally, while the Chinese Government has taken conscious steps at opening its economy and financial markets, it has also shown signs of regressing on this front. With the rise of President Xi Jinping in the past decade, in many ways the Chinese Government has amplified the state control of the economy, with economic reform put on the back burner. It is nearly impossible to envisage a scenario where the Chinese renminbi has a legitimate chance at being the global reserve currency unless the Chinese Government dramatically relinquishes state control of its financial markets, and its currency.

Digital Currencies

While the debate around the future of the USD has historically focussed on the potential replacements being other national currencies, there is an emerging contender in the form of digital currencies. The Bank of International Settlements (BIS), with input from a variety of global central banks, published a report in 2020 considering the feasibility of central bank digital currencies. The BIS indicated that most central banks are conducting research into digital currencies, including how they would go about creating their own.

How digital currencies could contend with the USD is, as yet, very uncertain. Perhaps it could be a single independent digital currency (i.e. akin to Bitcoin), a single digital currency designed by a central bank or a collection of digital currencies issued by several central banks (this is the route the former Governor of the Bank of England, Mark Carney, has been a vocal advocate of). A discussion around central bank digital currencies is beyond the scope of this article, however it is an area to watch.

CONCLUSION

In the years leading up to the global financial crisis, there was a great deal of speculation about the fragility of the USD as the global reserve currency. The USD was in a period of sustained depreciation, and the euro was gaining steam in its international use. Predictions entailed the USD losing its prized status as early as 2022. However, the onset of the global financial crisis, despite being centered on US financial markets, unleashed demand for USD-denominated safe haven assets. The USD's safe haven status and global importance were exemplified, putting an end to that round of speculation of the greenback's future.

Toppling the USD as the global reserve currency seems incredibly unlikely at this point. But we know that it is not impossible – the British pound held top spot less than a century ago. Some conditions are ripe for a rotation. The medium-term outlook for the USD is significantly weaker than it was pre-pandemic. This is compounded by the deterioration of America's international standing in the past few years – in part due to President Trump's isolationist policies, but also because of the rapid rise in China as an economic superpower.

However, the most notable condition required for a rotation is for there to be a legitimate replacement for the USD. On paper, the euro and the Chinese renminbi are the two currencies with the most legitimate chance at rivalling the USD given the growing size of their economies. However, their respective financial markets are, as yet, no match to America's, in terms of depth, liquidity, maturity and openness. Furthermore, the respective economies and political institutions face sustained structural headwinds and have had difficulty embracing reform. While digital currencies are starting to garner more attention, full endorsement and adoption by central banks is expected to be several years away (at least).

We consider the risk of a global reserve currency shake-up to be extremely low in the short to medium term. However, it can never be ruled out as a long-term risk. That said, a more pressing medium-term scenario is expected to be for a weaker USD over the next few years. A concoction of factors, each of which in isolation would be expected to lead to USD depreciation, are pointing to an environment characterised by a much weaker USD than has been the case in several years. As the dominant financial market, and the dominant foreign currency in most investors' portfolios, a weaker USD could have important investment implications to be mindful of.

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