SALT INSIGHT

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Bevan Graham
Salt Economist

Wither the USD? Not so fast....

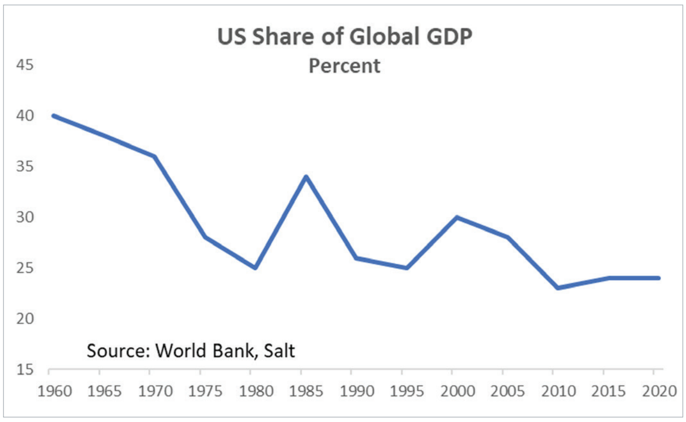
Being one of the more seasoned members of the Salt team (pun intended), it's interesting to see the issues that continue to pop up from time-to-time. One of those is the debate about the status of the United States dollar as the world's reserve currency, which seems to be doing yet another round of speculation and commentary.

This debate has been alive since President Nixon ended the USD's convertibility with gold in 1971. The last serious discussion was in the immediate aftermath of the Global Financial Crisis (GFC). How could the currency of the economy that was at the heart of the GFC retain its pre-eminent status?

Well, it did, and it has.

The reason its status persists is mostly due to two factors. Firstly, the US is still the world's biggest economy and largest democracy. Secondly, there is the problem of a lack of a viable alternative. During that last post-GFC debate the Euro was postulated as the next most likely reserve currency, though that was before the frailties of its construct were laid bare by the Eurozone debt crisis in the years 2009-13.

That said, the greenback's sheen has come off. America's rising debt, the loss of its AAA credit rating by Standard and Poor's in April 2011 and Fitch just last week, the occasional flirtation with populist politics, alongside the rise of the emerging economic powerhouses such as China with India following in its footsteps. In 1960 the US accounted for 40% of the global nominal economy. That ratio has now fallen to 24%. These factors have and will continue to contribute to ongoing debate about the continued dominance of the USD.



The history

The history of the US dollar as the world's reserve currency goes back to the post-World War II era. After the devastation of the war, the Bretton Woods Agreement was signed in 1944, establishing a new international monetary system. Under this agreement, the US dollar was pegged to gold, and other major currencies were fixed to the dollar.

The stability of the US economy and its position as the world's largest industrial power at the time led to global confidence in the so-called "Big dollar." Moreover, the US held a significant portion of the world's gold reserves, adding to the currency's perceived strength and stability.

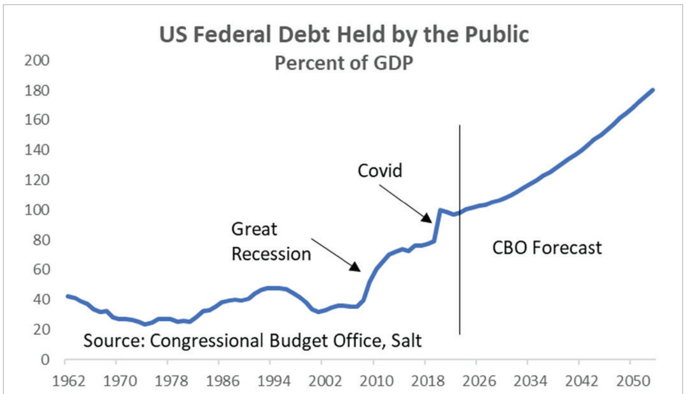
However, this system faced challenges in the 1960s when the US started running trade deficits and its gold reserves dwindled. By 1971, President Richard Nixon ended the dollar's direct convertibility to gold, effectively severing the link to an external criterion of value. At that point it became what is known as a "fiat currency" – one that is not backed by a physical commodity but is created and sustained by fiat (the Latin phrase usually spoken by God which means in essence, "let there be….something.")

Surprisingly, instead of losing its status, the US dollar's role as the primary reserve currency strengthened due to its liquidity, widespread use in international trade, and stability compared to other currencies.

The challenges

The debate surrounding the future of the USD as the world's reserve currency has intensified in recent years. On the one hand, supporters argue that the USD's historical stability, liquidity, and widespread use in global trade and financial systems will continue to support its dominance. They point to the size and strength of the US economy, the stability of its institutions, and the perceived safety of US government bonds as reasons for continued confidence in the dollar.

On the other hand, sceptics raise concerns about the mounting challenges, such as rising structural deficits and government debt, increasing geopolitical tensions, and the emergence of alternative currencies and financial technologies. They believe that these factors could erode trust in the dollar over time and lead to a gradual shift towards a more diversified global monetary system.



Central banks of various countries have also been exploring alternatives to the dollar in their reserve holdings and at the very least have been diversifying their reserves, signalling a growing desire to reduce reliance on the USD. Nevertheless, as the table shows, the trillions of dollars in reserve currency holdings have mainly been built up by the largest global trading nations. New Zealand is 70th on this list.

Rank [a]	Country or region	Foreign exchange reserves (millions US$)	Figures as of
1 —	China	3,384,853	30 June 2023
2 —	Japan	1,247,179	30 June 2023
3 —	Switzerland	898,588	June 2023
4 —	India	603,870	28 July 2023
5 —	Russia	594,000	28 July 2023
6 —	Taiwan	564,830	June 2023
7 ▲	Saudi Arabia	443,261	June 2023
8 ▲	South Korea	421,454	June 2023
9 —	Hong Kong	417,283	30 June 2023
10 —	Brazil	343,620	June 2023
11 —	Singapore	331,188	June 2023
12 —	Germany	305,140	June 2023
13 —	United States	242,731	3 March 2023
14 —	France	238,277	October 2022
15 ▲	Italy	234,034	June 2023

Source: IMF data.

As the global financial landscape evolves, the future of the USD as the world's reserve currency will remain a topic of debate, making its longevity a subject of ongoing interest and speculation.

The contenders

Several alternatives to the US dollar as the world's reserve currency have been proposed over the years.

One prominent contender is the Chinese yuan, given China's economic growth and increasing influence in global trade. Other major currencies like the euro and the Japanese yen are also considered potential alternatives due to the economic strength of their respective regions, however these mature developed economies are facing into much the same challenges as those leading to the potential demise of the USD.

I have always thought that a basket of currencies would be the most likely contenders. The International Monetary Fund's Special Drawing Rights (SDRs) - a basket of major currencies – has often been suggested as a supplementary reserve asset.

Moreover, the rise of cryptocurrencies like Bitcoin has sparked debates about their potential role in reshaping the international monetary system, although regulatory and volatility concerns persist. Ultimately, the future of the world's reserve currency system may involve a more diversified and multipolar approach.

Problems with the yuan

The Chinese yuan faces several barriers to becoming a global reserve currency. One major obstacle is China's strict capital controls, which limit the currency's convertibility and liquidity in international markets.

Additionally, concerns persist about the transparency and independence of China's financial system, which can affect investor confidence. The yuan's relatively limited use in international trade and financial transactions compared to the US dollar and other major currencies is another significant challenge.

Moreover, geopolitical tensions and trade disputes have raised questions about the yuan's stability and potential politicisation. Addressing these barriers would require China to undertake significant reforms and increase the yuan's global acceptance.

Problems with crypto currencies

Cryptocurrencies face substantial barriers to becoming the world's reserve currency. The primary challenges lie in their extreme price volatility, lack of intrinsic value, and regulatory uncertainties.

Central banks and governments are generally hesitant to adopt cryptocurrencies due to concerns about financial stability and potential for illicit activities. Additionally, the scalability and efficiency issues of existing blockchain technologies hinder widespread adoption. The absence of a central authority and the decentralized nature of cryptocurrencies may also present governance and policy challenges. A degree of association of cryptos with money laundering and concealing the true sources of funds is, needless to say, not desirable in an internationally-critical medium of common exchange value.

To become a reserve currency, cryptocurrencies would need to address these barriers, gain widespread acceptance, and demonstrate a level of stability and security comparable to traditional fiat currencies.

Special Drawing Rights

The IMF's Special Drawing Rights (SDRs) have the potential to serve as a stable and diversified reserve currency for the world. With SDRs, the inherent dependence on a single currency, like the US dollar, would be reduced, lowering vulnerability to economic shocks and geopolitical pressures.

As a basket of major currencies, SDRs offer enhanced liquidity and intrinsic value, instilling confidence among nations. Additionally, their allocation is based on the IMF member's contribution to the global economy, promoting a more equitable representation. However, challenges remain, such as ensuring adequate supply and efficient exchange mechanisms. Properly implemented, SDRs could contribute to a more balanced and robust global monetary system.

It's all relative and challenges abound for investors

Ultimately, it's all relative. If the USD is to lose its influence as a reserve currency, something must rise in influence to take its place and we are a long way from that being the case. Furthermore, such a change will be driven by structural forces that will take many decades to unfold. We are not going to wake up to headlines one day that the era of US dollar dominance is over.

That's not to dismiss the challenges, however. As active investors, we need to be alert to these structural forces. As the USD's dominance weakens, it may lead to increased currency volatility, making it harder for investors to manage exchange rate risks in international portfolios. Diversification away from the USD could result in greater exposure to other currencies, subjecting investors to the economic and political uncertainties of multiple regions.

Furthermore, if countries shift their reserve holdings away from the USD, that may impact the demand for US government bonds, potentially leading to higher interest rates in the US and affecting borrowing costs for both the government and private sector. This can have significant implications for global financial markets.

We will need to closely monitor evolving global economic trends and currency dynamics. Proper risk management and hedging strategies will become crucial in navigating the changing landscape of reserve currencies to safeguard investment returns and mitigate potential vulnerabilities.