On The Mark

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Demise of the US Dollar: Greatly Exaggerated or Destiny?

Key Takeaways

- US dollar has gotten a lot of press recently.
- Some “de-dollarization” is likely to occur over time.
- The long-term impact is both positive and negative.

Dollar fears

After a decade of relative strength, the US dollar has declined sharply over the last six months. This has coincided with media reports that the world may reduce dollar usage. We examine the US dollar from two perspectives – as a medium of global trade and as a reserve currency. Short-term, we see a mixed environment for the greenback; longer-term, the effects of de-dollarization are likely to be both positive and negative.

What is the Petrodollar system?

The Petrodollar system was created in the 1970s by the United States and Saudi Arabia. The system is an agreement between the US and OPEC[1], which among other things[2], requires OPEC member countries to use the US dollar when they sell oil. The Petrodollar has been dented over the last several years, as some non-OPEC oil-producing countries have been transacting in currencies other than the US dollar[3].

Earlier this year, Saudi Arabia made headlines when it announced it was open to selling oil in non-US dollar currencies. More recently, several non-OPEC countries[4] announced they have been discussing an alternative currency to the Petrodollar. Clearly, if the Petrodollar falls, that would mean a sea change in global politics and economics. However, settling on an alternative currency for oil transactions would be very challenging.

Any alternative currency would need to be relatively stable and easily exchangeable for other currencies or assets. Surprisingly, the number of currencies that meet these criteria is relatively small. Not coincidentally, these are some of the same characteristics of reserve currencies.

What is a reserve currency?

A reserve currency is a currency that is widely held by central banks and other institutions. These entities hold reserves to help manage exchange rates and facilitate global trade. The four largest reserve currencies are the US dollar (58% of global reserves), the euro (20%), the Japanese yen (6%), and the British pound (5%)[5].

While there are no official criteria for reserve currency status, reserve currencies tend to have the following:

- *Stable economies and political systems*: reserve currencies should be effective stores of value (i.e., have relatively stable exchange rates).
- *Free capital flows:* reserve currencies should be easily exchanged for another currency or asset and easily moved from one country to another.
- *Robust financial system:* reserve currencies should have liquid, transparent, and well-governed capital markets in which to invest, including a deep sovereign bond market.

While the Petrodollar system creates a natural demand for US dollars, the US also scores highly on the three criteria above. In our view, the most significant risks to the US dollar's reserve status are not external factors but internal factors relating to reserve currency criteria. Specifically, the stability of our political system has been called into question with issues around the peaceful transfer of power and the ability of our government to effectively legislate. Similarly, concerns about high government debt levels (and a potential government shutdown this year) have raised concerns about the stability of our economy.

De-dollarization?

Given the developments with the Petrodollar and the concerns mentioned above, the world is likely to diversify some of its exposure away from the US dollar. However, we believe the move is likely to be slow for three reasons.

First, the dollar remains the dominant currency for international trade. Outside of Europe, over 70% of exports are conducted in dollars. This "network effect" is very slow to change. Secondly, the dollar is also the dominant currency in global banking, with about 60% of foreign bank deposits and loans denominated in US dollars[6].

Lastly, countries' supply and demand change slowly. Developed nations like the US tend to have higher domestic demand than developing countries, meaning we import more goods than we export[7]. The US, for example, imports about $1.2 trillion more than we export. This $1.2 trillion gap needs to be invested in US dollar-denominated assets. Currently, no other sovereign bond market is deep enough to handle this level of investment[8].

Outlook for the US dollar?

Near term, the US dollar may weaken for the normal reasons currencies fluctuate in value (differences in interest rates, economic growth, and inflation rates across countries)[9], but we don't see a clear-cut bear case. Further, the US dollar remains one of the most reliable safe-haven currencies in the world. Longer term, it seems likely that global diversification away from the greenback will reduce demand for US dollars.

It is not clear to us if the US economy benefits from a consistently strong dollar. Too much demand for dollars results in lower US interest rates. Persistently low-interest rates tend to facilitate debt accumulation and asset bubbles, while also punishing US savers. A structurally lower dollar might require a painful adjustment, but several issues impacting the US economy (e.g., the income gap, position of US manufacturers) would likely improve.

Key takeaway

Global diversification away from the US dollar seems likely over time. Shorter-term, we see a mixed environment for the dollar. Longer-term, de-dollarization is likely to be a negative for the dollar; the impact on the US economy, however, will likely be both positive and negative.

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[1] Organization of Petroleum Exporting Countries

[2] Saudi Arabia agreed to sell its oil in US dollars and invest those dollars in US Treasuries, in exchange for US military support and weapons.

[3] Venezuela for example, began accepting euros, Chinese yuan, and other convertible currencies for its oil exports in 2018, before entering OPEC.

[4] Brazil, Russia, India, China, and South Africa

[5] While the US dollar share of foreign exchange reserves has declined, the decline has not been dramatic. 10 years ago, the USD share was 61%. Source: Bank of International Settlements.

[6] Source: US Federal Reserve.

[7] Conversely, developing economies like China and India tend to produce more than they can consume, so they export those goods to developed with higher domestic demand, like the US.

[8] US Treasury market is about $10 trillion. The Japanese Government Bond market is about $7 trillion (but they own most of it). All other countries have sovereign bond markets of less than $2 trillion. Source: Bloomberg.

[9] Among G-10 currencies, the US dollar ranks 2nd best, 5th best, and 6th best, on relative interest rate, growth, and inflation rates, but it ranks very low on trade and budget balances.

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