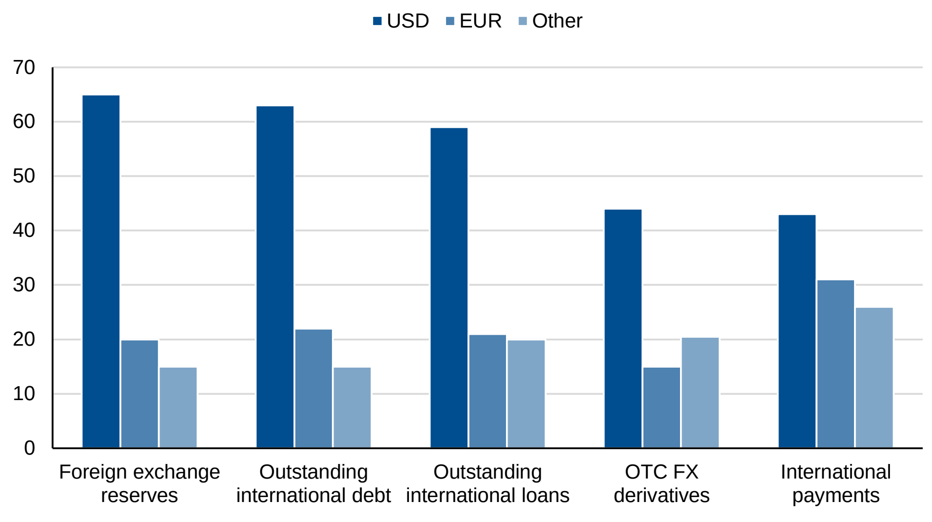
The Unparalleled Status of the US Dollar in an Evolving Global Environment

On 29 September 2017, Scope affirmed its AA rating on the United States with a Stable Outlook. Among the factors supporting the rating level, Scope identified the US dollar's unparalleled global reserve currency status, which enables the US to run fiscal and current-account deficits with limited sustainability concerns. In Scope's view, there is currently no reason for the dollar's status to come into meaningful question over the coming years, not least given the lack of credible alternatives. This special comment explores this credit strength in greater detail.

The US dollar has been the global reserve currency since the end of the Second World War, resulting in de facto guaranteed international demand for US Treasuries, allowing the US government to run fiscal deficits with limited debt sustainability concerns. In Scope's assessment, there is currently no reason to suppose that the dollar's pre-eminent reserve currency status will be questioned by investors over the coming years, not least given the lack of credible alternatives at this stage, like the euro or the yuan.

In Scope's view, given the world-wide dependence on the US dollar, the shift towards another global reserve currency – or a weighted basket thereof – is likely to take place either abruptly, via a major geopolitical shock akin to the one that led to the substitution of the British pound by the US dollar, or very gradually over a long period of time, owing to US policy and/or market-driven structural changes.

Figure 1: International finance, use of global currencies, % of total



Source: BIS, ECB, IMF

The US dollar's reserve currency status has been supported by emerging market economies buying dollars in order to i) keep their real effective exchange rates undervalued and ii) build up precautionary reserves. Based on these two demand drivers, the reserve currency status of the US dollar is unlikely to shift significantly as long as i) the US government does not take steps to prevent foreign countries from accumulating US assets for reserves; and ii) other global powers pursue economic growth strategies that include running large current-account surpluses and/or restrictions on the capital account. However, a third demand driver for US dollars, notably, commodity exporters recycling current-account surpluses into safe dollar-denominated assets, could, over time, be reduced by commodity-importers like China promoting trading systems denominated in their national currency.

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The unparalleled role of the US dollar

The US dollar has been the world's reserve currency since the Second World War

The US dollar has been the global reserve currency over the past decades, resulting in de facto guaranteed international demand for US Treasuries, allowing the US government to run fiscal deficits with limited debt sustainability concerns. Currently, Scope sees no reason for investors to question the US dollar's reserve currency status over the coming years, which represents a major credit strength. This status is also due to the fact that credible alternatives to the US dollar still need to emerge. While the euro remains unchallenged as the second most important reserve currency[1], its role is constrained by the scarcity of safe euro-denominated bonds. On the other hand, the availability of China's yuan is inhibited by tight controls on foreign participation in China's financial markets. In fact, according to the IMF's COFER database, about 64% of the world's total foreign exchange reserves are allocated in US dollars, followed by the euro (20%), yen (5%) and pound sterling (4%), while currently only 1% of allocated reserves are denominated in yuan.

No credible alternative

Similarly, the share of the US dollar remains the highest among multiple other indicators, including outstanding international debt securities (63%, followed by the euro with 22%), outstanding international loans (59%, followed by the euro with 21%), over-the-counter foreign-currency derivative contracts (44%, followed by the euro with 14%) and international payments (42%, followed by the euro with 31%)[2]. In addition, while the share of countries using the dollar as an exchange rate anchor has been steadily decreasing from 33% in 2008 to 20% in 2016[3], the US dollar maintains its position as the dominant exchange rate anchor, with eight countries having adopted the dollar as legal tender and another 31 using the dollar as their respective officially announced monetary anchor[4].

Scope's AA rating for the United States acknowledges the centrality of the US dollar in the international monetary system as a key credit strength. Scope takes this into account first in the quantitative scorecard, and, second, via three qualitative adjustments to account for the sovereign's 'excellent market access and funding sources', 'excellent external debt sustainability' and 'excellent resilience to short-term shocks' due to the dollar's status.

A changing geopolitical landscape

Shifting geopolitical environment and faltering US strength

Despite this worldwide reliance on the US dollar, Scope is mindful that the current geopolitical state of affairs coupled with the falling relative dominance of the US economy has induced power shifts away from the United States. However, the question is towards whom the power is shifting, both in relation to economic and political hegemony and the resulting dominance of the global monetary architecture.

Scope shares the view that reduced US dominance in security, trade, international relations and ideas is resulting in a break from decades of belief in the indispensability of US global leadership and leading to elements of a 'G-Zero world' – a term coined at the Eurasia Group to describe a world with no single global leader. Specifically, the United States has less interest in and capacity to assume worldwide responsibilities, while Europe remains mostly attentive to regional affairs. Russia's ambitions centre on its perceived regional sphere of influence while China is seeking to assert itself as an alternative to the US, but primarily on the regional economic front, though, increasingly, also globally[5].

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[1] https://www.ecb.europa.eu/pub/pdf/other/ecb.euro-international-role-201707.pdf?b4347db86b0303160e518b60e7ddb5fe
[2] Ibid.
[3] https://www.imf.org/~/media/Files/Publications/AREAER/AREAER_2016_Overview.ashx
[4] IMF, 2017 Annual Report on Exchange Arrangements and Exchange Restrictions
[5] https://www.eurasiagroup.net/files/upload/top_risks_2017_report.pdf

Changes in role of the dollar to happen either abruptly, via a major shock, or over decades due to structural change

In Scope's view, given the world-wide dependence on the US dollar, the shift towards another global reserve currency – or a weighted basket thereof similar to the IMF's special drawing rights – would take place either abruptly, via a major geopolitical shock akin to the one that led to the substitution of the British pound by the US dollar, or very gradually over a long period of time, owing to US policy and/or market-driven structural changes.

Triffin-dilemma-like tensions in the US

Triffin paradox then and now

From the US perspective, Scope notes that the Triffin dilemma between short-term domestic economic policy objectives and the pre-eminence of the dollar in the international monetary system still has applications today. In the 1960s, Robert Triffin identified the dilemma whereby if the United States refused to provide other countries with US dollars, trade would stagnate and the world economy would eventually be trapped in a deflationary bias. However, if the United States provided an unlimited supply of dollars, confidence that the dollar is convertible at a set USD 35 per ounce of gold would erode. Faced with this paradox, the United States ultimately, in 1971, gave up its commitment to keeping the dollar's fix to gold.

Today, the US dollar no longer needs to be substitutable into gold given that exchange rate adjustments have become an important element for rebalancing economies. In addition, the euro is the second most-used reserve currency, however with little impact on the dollar's centrality in the international monetary system. Most fundamentally, however, the US and the euro area are not obliged to run high current-account deficits to meet the demand for dollars or euros (per the Triffin thesis). Indeed, the euro area as a whole has been running a current-account surplus since 2009. This is because global liquidity now constitutes not only official liquidity but also that provided by deeply integrated global financial markets[6].

Short-term domestic policy objectives may supersede longer-term systemic concerns

Despite this difference from the past, as in the 1960s and 70s, short-term domestic policy objectives may supersede longer-term systemic stability concerns, reflecting the underlying tension in Triffin's thesis. The unabated demand for safe dollar assets has contributed to a weakening of US policy discipline as the country has relied on easy credit in normal times alongside expansionary macroeconomic policies in times of crisis, resulting in rising US indebtedness (see 'US Government Obligations & Contingent Liabilities: A High and Rising Fiscal Risk' published on 18 October 2017). As noted in a 2011 ECB speech, 'Short-sighted policies that support unsustainable growth models not only tend to fuel the booms that precede financial crises, but may also, over the longer run, undermine the confidence that is the basis for the reserve asset status of one or more national currencies.'[7]

In this context, Scope notes that, in addition to a systemic shock undermining confidence in the US financial system, important domestic policy decisions by the US administration could, under extreme circumstances which do not constitute Scope's baseline, affect the market's perception of the US dollar's safe-haven status. Specifically, a highly politicised selection process of the five upcoming appointments by the Trump administration for the seven-person Federal Reserve Board, including Chair Janet Yellen, could induce a shift in market confidence on the US monetary policy framework. This currently unlikely shift in market sentiment could arise if, for example, political interference were to weaken the market's view on the Federal Reserve's independence and ability to pursue its dual mandate of price stability and full employment, as well as effective regulation.

[6] https://www.ecb.europa.eu/press/key/date/2011/html/sp111003.en.html
[7] Ibid.

Largest economies benefit from dollar system

This US-specific tail-risk notwithstanding, from a global perspective, Scope notes that the world's biggest economies have much to lose from an abrupt end to the dollar-based monetary system as this would reduce politically convenient and economically stimulating trade surpluses, while at the same time trimming the value of their dollar-denominated assets. Thus, as long as the United States remains willing and able to run current-account deficits, and further, the global trading and financial system retains the centrality of the dollar, the US dollar will remain the only important global reserve currency.

Triffin-dilemma-like tensions in the rest of the world

In this light, Scope believes that alternatives to the US dollar, including supranational currencies[8], seem unlikely to supplant dollar primacy in the foreseeable future so long as other economies, including Germany and China, pursue economic growth strategies that include running current-account surpluses and/or maintaining restrictions on the foreign exchange and capital account.[9]

China's dilemma between economic stability and currency internationalisation

In this context, Scope points to China's own Triffin-like dilemma between short-term economic and financial stability and the internationalisation of its currency, the renminbi. While China continues to promote greater offshore use of the renminbi, efforts that would support the currency's global usage have slowed. This is due to the financial and economic turmoil in recent years, resulting in major yuan depreciations and subsequent policy measures to reduce capital outflows and reserve declines. In the context of a slowing Chinese economy, these developments have solidified a more sceptical state view on rapid exchange rate or capital account liberalisation.

Scope notes that in order to reduce future pressures on the yuan exchange rate, Chinese authorities have blocked certain outbound mergers and acquisitions to keep domestic companies from exporting capital[10] while simultaneously making capital repatriation more difficult for foreign companies. In addition, monetary authorities temporarily required financial institutions to restrict cross-border renminbi outflows to ensure these do not exceed inflows[11]. As a result of increased capital controls, the renminbi's share in global payments fell to 1.6%, its use in global bond markets is down 45% from a 2015 peak, and the share of China's cross-border trade settled in renminbi has fallen to around 12% presently from 35% in 2015[12]. Owing to a more nuanced pace of China's financial liberalisation, the convertibility of the renminbi and, as such, its use internationally will also necessarily be impeded.

As a result, Scope's opinion is that the US dollar's status as the global reserve currency is unlikely to materially shift in the foreseeable horizon as long as: i) the US government does not take steps to prevent foreign countries from accumulating US assets for their reserves; and ii) other global powers continue to pursue economic growth strategies that include maintaining current-account surpluses and/or restrictions on capital accounts.

Emerging US-dollar alternatives for commodity trading nations?

Commodity-trading countries could induce a long-term structural shift in the demand for the US dollar

Scope notes that an additional main driver of dollar reserve accumulation comes from commodity exporters recycling their current-account surpluses into safe dollar-denominated assets. Commodity-trading nations may over time be inclined to move away from the purely US-dollar-based system. In fact, China is expected to launch a crude oil

[8] This refers to the policy proposals to create a reserve currency 'that is disconnected from individual nations and is able to remain stable in the long run, thus removing the inherent deficiencies caused by using credit-based national currencies'. http://www.pbc.gov.cn/english/130724/2842945/index.html
[9] http://carnegieendowment.org/2016/07/22/how-china-s-currency-manipulation-enhances-global-role-of-u.s.-dollar-pub-64163
[10] https://www.nytimes.com/2017/08/18/business/dealbook/china-companies-deals-debt.html
[11] https://www.ft.com/content/519b02cc-24e6-11e7-8691-d5f7e0cd0a16
[12] Benn Steil and Smith, Emma. 'Bye Bye, Renminbi', The International Economy, Summer 2017.

futures contract open to foreign companies, priced in yuan and convertible into gold[13]. As China is the world's biggest oil importer, this contract could become an important crude oil benchmark. In addition, the exchange could be of interest to oil-exporting nations like Russia and Iran, which could circumvent US sanctions by trading in yuan.

The convertibility of yuan contracts into gold could also provide assurance to oil-exporting countries that they would not have to hold more yuan assets than needed, like the insurance valve originally implemented in Bretton Woods for the dollar. Over time, such an exchange could therefore induce a shift away from effectively swapping oil for US Treasuries to swapping oil for renminbi assets backed by gold. However, Scope cautions that a gold-backed exchange would ultimately face convertibility problems given the finite nature of the asset.

Nonetheless, China's growing international relevance, coupled with its ambition to transform the yuan into a commodity-trading currency in Asia and other developing regions, represents an important structural change that could eventually reduce the importance of the US dollar in the international monetary system. While this eventuality seems unlikely in the foreseeable future – continuing to bolster Scope's assessment of the US's credit rating – Scope is mindful of Rudi Dornbusch's observation that a fundamental change takes a much longer time to arrive than one thinks, but when it happens, it happens much faster than one would have thought.

[13] https://asia.nikkei.com/magazine/20170914/Business/China-aims-for-dollar-free-oil-trade

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