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Insight INVESTMENT

GLOBAL MACRO RESEARCH

THE US DOLLAR'S GLOBAL RESERVE STATUS: BENDING, NOT BREAKING

OCTOBER 2022

GLOBAL MACRO RESEARCH

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EXECUTIVE SUMMARY

- The US dollar has been the world's reserve currency since 1944, but recent events (including the imposition of sanctions on the Russian central bank, the inclusion of Chinese government bonds in global bond indices and genuine European Union (EU)-wide bond issuance) have refuelled the ongoing debate of whether the USD will at some stage lose its reserve status. // 03

- We analyse the attributes that constitute a good reserve currency and conclude the US dollar still comfortably remains the best choice for a global reserve currency:
  - Economic relevance and power: the US remains the dominant economic power // 04
  - Liquidity: the US dollar is the dominant currency used for trade in goods and services and US financial markets have the deepest liquidity, making it easy to undertake large transactions // 05
  - Store of value: during periods of financial stress investors frequently shift to the US dollar and the Federal Reserve is the key source of emergency liquidity via its provision of swap lines // 06

- Although the risks for the US dollar in the short term are limited and its value is likely to be driven by cyclical considerations, the long-term risks to the USD's hegemony are real and the pressure is building. More specifically, we think two trends could disrupt the US dollar's dominance as the world's reserve currency:
  - Historically, there have been few alternatives to the US dollar, but this is evolving. Joint bond issuance within the Eurozone and steps to internationalise in China are both important changes, with central bank digital currencies a potentially disruptive innovation. // 08
  - More recent moves to weaponize US financial infrastructure – either through the use of sanctions or by limiting access to systems like SWIFT – is likely to be diminishing the appeal of the US dollar as a reserve currency at it is forcing some countries to build competing payment systems and alternative sources of liquidity. This is leading to a fragmentation of global financial infrastructure. // 08

- While we don't think we are at a tipping point for the US dollar, our sense is that the share of US dollars held in global FX reserves will continue declining for the foreseeable future. A pronounced tipping point is likely to occur only when the major holders of FX reserves decide that intervening in their currency markets is no longer a desirable policy. As this is unlikely to happen in the short term, we expect FX reserve diversification to be only a very mild negative for the USD. // 09

THE CHANGING PROFILE OF GLOBAL CURRENCY RESERVES

THE ESTABLISHMENT OF THE USD AS NATURAL CHOICE AS RESERVE CURRENCY

The US dollar (USD) has been the world's reserve currency since 1944 when the Bretton Woods agreement on the post-WW2 global monetary system established both a system of fixed exchange rates versus the USD and convertibility from USD into gold at a fixed rate. The relative economic and military strength of the US compared to other countries in 1944 allowed the US to dictate much of the Bretton Woods agreement and made the USD the natural choice as reserve currency.

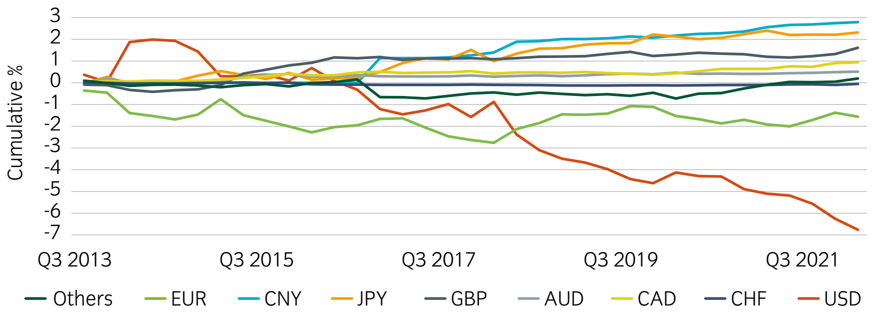
Despite the abolition of the gold standard in 1971, which fixed the rate of conversion between gold and the USD, the USD remains the global reserve currency.

RECENT EVENTS HAVE THE POTENTIAL TO UNDERMINE THE USD'S DOMINANCE

Predictions of the USD's demise as a reserve currency are certainly not new. However, recent events, including the sanctions imposed on Russia's central bank, the inclusion of Chinese government bonds in global benchmarks and genuine EU-wide bond issuance, have reignited debates about another currency supplanting the USD's reserve currency status. Indeed, the USD's share in global FX reserves has been on a declining trend for the last couple of decades.

Interestingly, unlike the narrative common at its genesis the EUR did not displace the USD as a reserve currency. Instead, over the last decade, the Chinese yuan (CNH) benefited most from the USD's loss of market share in global FX reserves due to China's increased economic power and its entry into the International Monetary Fund (IMF) Special Drawing Right (SDR) basket, displayed in Figure 1. While allocations to other currencies like the Japanese yen (JPY) and British pound (GBP) also increased over the same period, it is unclear whether this implies a genuine shift in allocation. More likely, the inclusion of China's FX reserve allocation in the 'allocated' part of the IMF's Composition of Foreign Exchange Reserves (COEFR) database in 2015 caused some shifts in the non-CNH portion of the FX reserves.

Figure 1: Change in Global FX reserves[1]



[1] Source: Morgan Stanley: Update: Bitcoin, Crypto and Digital Currencies, June 2021. Shows change in share of reserves at fixed Q3 2013 exchange rates.

THREE CHARACTERISTICS DEMONSTRATE THAT THE USD REMAINS THE DOMINANT RESERVE CURRENCY

The decision to diversify out of an asset is as much about the appeal of the asset itself as it is about the availability of viable alternatives. Therefore, a framework to judge what constitutes a 'good' reserve currency and if any viable contender to replace the USD exists is necessary to assess whether the USD's declining share of global FX reserves continues. This is a somewhat subjective process but there are a few measurable factors that can be useful.

NECESSARY RESERVE CURRENCY ATTRIBUTES

1 Economic relevance/power

To be adopted as the global reserve currency, it is usually necessary for the economy underlying that currency to be the dominant player in global growth and trade, reflecting the fact that most transactions are likely to be denominated in the the economy's currency. As shown in Figure 2, the US remains the world's largest economy, though the Chinese economy is expected to surpass the US at some point around 2030. This clearly shows how China is increasingly challenging the US's role as the dominant economic power. In fact, as Figure 3 shows, China has already surpassed the US in GDP growth.

Figure 2: Share of Global GDP[2]

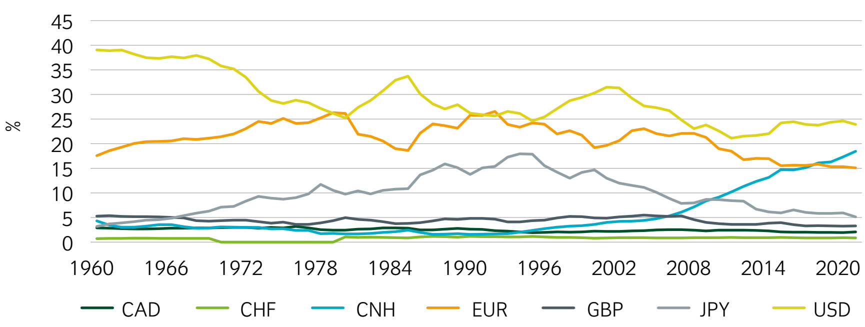
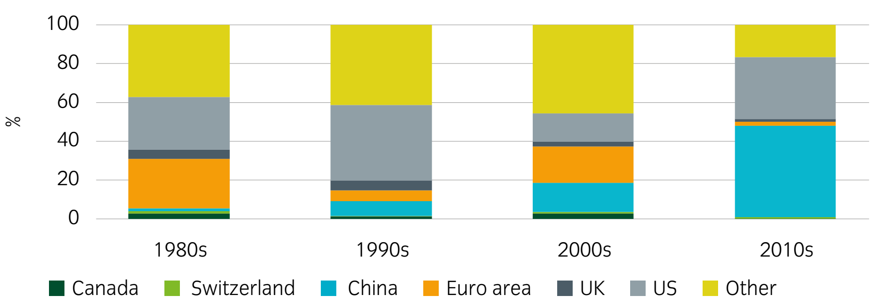


Figure 3: Share of global growth by decade (%)[3]

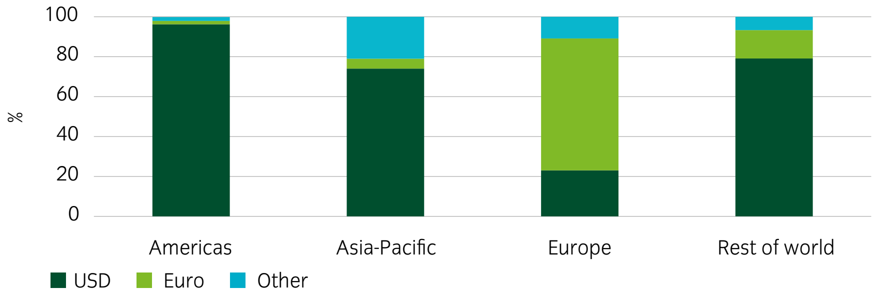


[2] Source: Macrobond. Data between 1960 and 2020.
[3] Source: World Bank.

2 Liquidity

In addition to economic relevance, a reserve currency also needs financial might. This can be proxied by looking at the range of real-economy goods and services priced in the currency, as well as the depth and liquidity of its financial asset markets within which holdings of the currency can be saved. The goods/services component can be proxied by the share of transactions that are denominated in each currency. As can be seen in Figure 4, except for the Euro (EUR), the USD remains the dominant currency for trade in goods and services. This is also underscored by the fact that the USD transactions account for 41% of all SWIFT payments, followed by EUR transactions at 36%. The share of CNY transactions is only 2%.

Figure 4: Share of global export invoicing (2009-2019)[4]



On the asset side there are more ways of measuring liquidity. For example, size of asset markets capitalization[5], turnover in FX markets, frequency of countries/companies choosing to issue debt in a currency other than their own. Figures 5 and 6 highlight the evolution of the role of the USD and other currencies. As evidenced, by these measures, the USD remains some way ahead of its rivals, with the EUR far behind. The CNY is only marginally preferable to GBP – despite having sizeable asset markets, there is very little CNY issuance from foreign entities, low turnover of CNH in FX markets and comparatively low foreign ownership of Chinese government bonds (around 4.5%). The only area where China has made sizable advance is in the size of its government bond market, the market capitalisation of which has almost reached that of the euro area.

Figure 5: Total debt issued by country of issuer[6]

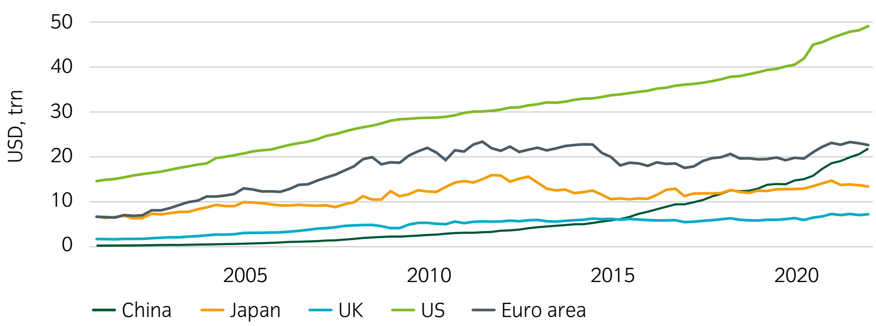
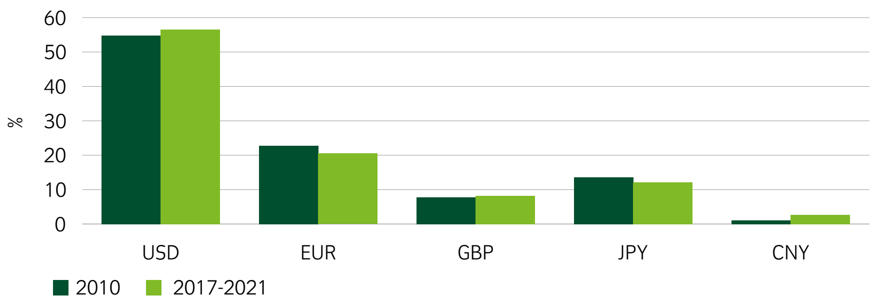


Figure 6: Daily FX market turnover (%)[7]

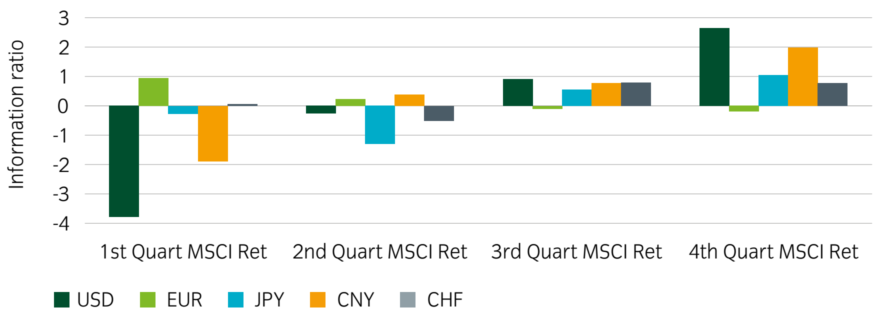


[4] Source: IMF Direction of Trade Statistics. Data between 2009 and 2019.
[5,6] Source BIS. Data as at 11 August 2022.
[7] Source: BIS. Data between 2010 and 2021.

3 Store of value

The ability to maintain value, particularly in challenging market conditions, is another key attribute for a reserve currency. To assess the USD and other currencies through this lens, we look at the performance of core currencies in different volatility regimes. Figure 7 shows the information ratio (IR) (a measure of return to volatility of the returns analysed) of being long the different currencies when the MSCI World Index (global equity) monthly returns are broken down in four quartiles. The 1st quartile represents the highest 25% of monthly returns on the MCSI world index between Jan 2000 and June 2022, while the fourth quartile represents the lowest 25% of monthly returns.

Figure 7: Information Ratio in different quartiles of monthly returns of MSCI World[8]



Secondly, we can see that when equity markets are under pressure, the demand for the USD outstrips all other currencies, reflecting the key role it plays in financial markets. Although the USD is not the only currency favoured by traders in times of stress, depicted in Figure 6 by the fourth quartile of MSCI returns, demand for liquidity in the real economy during such episodes is heavily skewed to USD. The provision of USD swap lines by the Fed proved critical to the provision of emergency liquidity during both the GFC and COVID crisis periods. Although demand existed for ECB swap lines during the GFC, during COVID it was negligible. The overwhelming take up was of USD liquidity from the Fed.

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Through this lens, the USD's dominance is clear

[8] Source Bloomberg and Insight Investment. Data between Jan 2000 – Jun 2022.

THE BEST CHOICE… FOR NOW

All of this suggests that, as things stand, the USD remains comfortably the best choice of global reserve currency by these rough measures. In Figure 8, we have ranked key currencies against all the mentioned above metrics, and it can be clearly seen that the USD ranked either first or second in all categories. The EUR is a credible alternative on most measures, though perhaps lacks the risk beta characteristics needed and the depth of financial markets. The CNY's role in global financial markets has clearly increased rapidly in the past couple of decades, but for it to become a viable alternative to the USD, much deeper internationalisation of China's financial markets is needed. Despite China possessing a dominant position in global trade, in the financial sphere, the USD still rules[9].

Figure 8: Average ranking across selected measures

Ranking		USD	EUR	GBP	JPY	CNY
Econ relevance	% of global GDP	1	3	5	4	2
Liquidity	% of invoicing	1	2	5	3	4
	Equity market cap	1	4	5	3	2
	Bond market cap	1	2	5	4	3
	Foreign ccy issuance	1	2	3	4	5
	SDR weight	1	2	5	4	3
	FX turnover	1	2	4	3	5
	Overseas bondholders	2	1	3	4	5
Risk properties	Equity data	2	4	5	1	3
	Vix correalation	2	4	5	1	3
Average		1.3	2.6	4.5	3.1	3.5

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…history indicates a loss of hegemony can be a slow-moving but steady trend.

[9] Source: Goldman Sachs. Top of Mind: (De)Globalization ahead. Issue 108, 28 April 2022.

DIMINISHING DOMINANCE

Although the USD's dominance has withstood the introduction of the euro and China's economic and political rise, its long-term resilience is not ensured. Indeed, if we look back at the first half of the twentieth century, despite US GDP meaningfully surpassing UK GDP in the late 1800s, the USD did not supersede GBP as a reserve currency until the mid-1900s[10]. Therefore, history indicates a loss of hegemony can be a slow-moving but steady trend. There are several reasons to think the USD's decline will follow such a path.

1 Increasingly viable substitutes

First, although the USD's resilience is, at least in part, due to a lack of available alternatives given the US's economic, financial, and geopolitical importance, this dynamic is slowly evolving. For example, steps taken by the EU to jointly issue debt in the aftermath of COVID-19 could be significant if the market for EU bonds grows. Historically, German government bonds have served as the eurozone's risk free asset, with other eurozone bond markets exhibiting a higher degree of risk. Genuine joint issuance from EU countries, if done on a large enough scale, could provide a credible alternative to US Treasuries.

Likewise, China's steps to internationalise the CNY are particularly important and are starting to bear fruit. In fact, China has experienced $121bn in bond and equity inflows in 2021 to 2022 following its recent inclusion in the FTSE World Government Bond Index (WGBI), Bloomberg Global Aggregate Index and JP Morgan GBI-EM indices. Additionally, the international allocation to CNY in FX reserves has doubled in the last five years. Technological advances could accelerate this trend in the coming years as the US lags in the race to develop Central Bank Digital Currencies (CBDC)[11]. Although Chinese authorities are likely to be very cautious at first and roll out the e-CNY only to nationals, this is likely to change as China's capital account liberalises. Greater accessibility of the e-CNY could support its use in global transactions and increase the demand for CNY as a reserve asset.

2 Overusing sanctions

Secondly, the United States' increasing weaponization of its dominant financial position for geopolitical goals is likely to further erode the USD reserve status. The efficiency of the US's aggressive use of financial sanctions is predicated on both the USD's pre-eminence in global transactions – 41% of all SWIFT payments are in USD – as well as the need for USD transactions to eventually flow through the US financial system. As former US Treasury Secretary Jack Lew said in 2016, the US "must be conscious of the risk that overuse of sanctions could undermine our leadership position in the global economy, and the effectiveness of our sanctions themselves"[12].

More fundamentally, a fragmentation of global financial infrastructure would reduce the demand for USD as a currency reserve. We can observe this fragmentation in action when assessing how different countries are building their own financial infrastructure, rather than relying on the global alternatives that already exist. The development of these alternative financial systems erodes the financial clout of the US, reduces the demand for USD as a reserve currency, limits the effectiveness of US sanctions and could lead to greater system fragmentation creating higher friction and inefficiencies.

[10] Source: https://goldalliance.com/blog/market-insights/if-the-dollar-loses-its-status-as-the-worlds-reserve-currency/.
[11] Source: https://www.insightinvestment.com/globalassets/documents/recent-thinking/q2-2022-global-macro-research/global-macro-central-bank-digital-currencies.pdf
[12] Source: Goldman Sachs. Top of Mind, Issue 108, 28 April 2022.

3 The potential decline of active currency management

There is one key development that could mark a more aggressive tipping point: a decline in the desire for central banks to manage the value of their currencies. It is not a coincidence that most the world's currency reserves are held by emerging markets, many of whom actively manage their currencies versus the USD.

If more emerging market countries embraced genuinely free-floating exchange rates, the need to hold reserve assets will decline, allowing a switch in focus to more strategic goals. The difference is an important one: while reserve assets must be held in the currency of the anchor and need to be very liquid and hold value in times of financial stress, reserves to be used for more strategic goals are able to encompass a broader array of assets such as commodities and foreign direct investment. Therefore, rising demand for strategic assets rises would reduce the USD's dominance and bolster the emergence of a more viable alternative.

CONCLUSION

Historically, the global reserve currency status has been given to the currency of the country with dominant financial and economic power. Over the last century, this country has been the United States. While both aspects of this dominance were unchallenged for a number of years, China's entry into the World Trade Organization (WTO) in 2001 and the meteoric economic growth and growing financial clout – albeit from a very low base – are starting to exert pressure on the existing dynamic as evidenced most clearly by the moderate, but steady, decline in the share of USD in global FX reserves.

While this trend is not new, rising geopolitical tensions between the west and both Russia and China are increasingly fragmentating the global financial infrastructure and precipitating a potential move away from the traditional US-dominated networks. Again, the shift away from US-dominated network is already an established trend, but it has accelerated since Russia's invasion of Ukraine in February 2022. Meanwhile, technological change in the form of central bank digital currencies (CBDCs) in which the US is lagging, represents an additional headwind for the USD.

In short, while we don't think we are at a tipping point for the US dollar given the US's unsurpassed financial clout, our sense is that the share of US dollars held in global FX reserves will continue declining for the foreseeable future. A pronounced tipping point is likely to occur only when the major holders of FX reserves, mainly emerging countries especially in Asia, decide that intervening in their currency markets is no longer a desirable policy. If this were to happen, the need for holding large FX reserves would decline precipitously – as it did in for most developed markets. As this is unlikely to happen in the short term, we expect FX reserve diversification to be only a very mild negative for the USD.

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15660-09-22