CONFERENCE ROUNDUP: THE END OF THE DOLLAR, OR NOT

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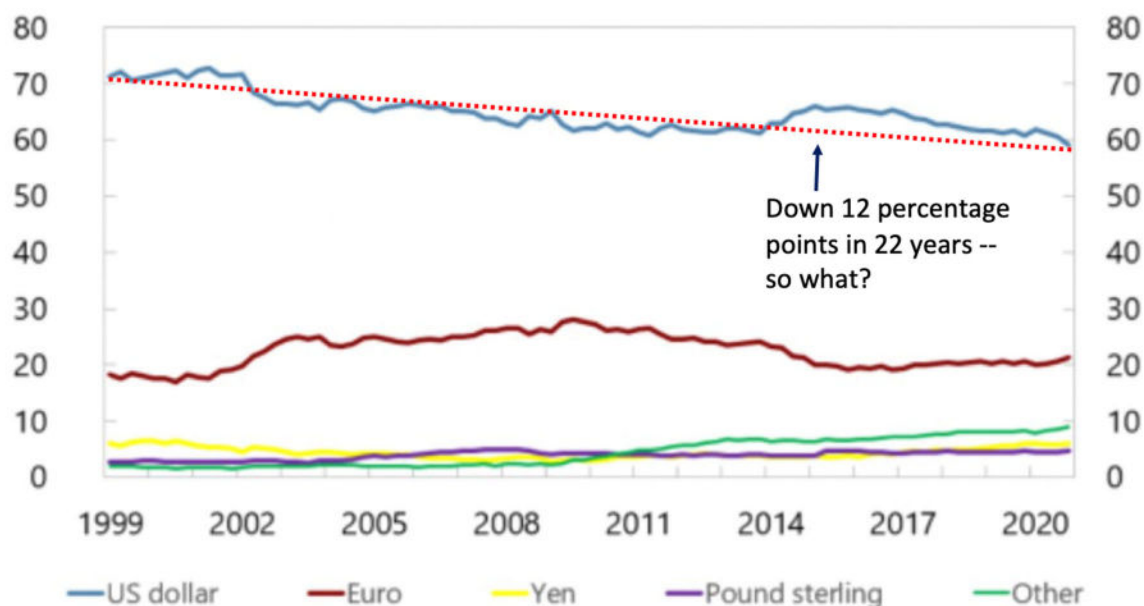
It's hard to read the news without being reminded that the 80-year-plus reign of the U.S. dollar as the world's reserve currency is over…or threatened…or just wobbly. Exhibit 1 shows the gradual downtrend in the dollar reserves held by the world's central banks.

EXHIBIT 1
PRINCIPAL CURRENCIES' SHARE OF GLOBAL FOREIGN EXCHANGE RESERVES 1999-2021



Source: Ron Liesching, Mountain Pacific Group, using IMF data.

This decline, along with concerns about the dollar's future, has prompted some alarming recent headlines and lead sentences:

- Bloomberg.com: "Goldman warns the dollar's grip on global markets might be over"
- Council on Foreign Relations: "Despite its continued dominance, domestic and international challenges to the U.S. dollar are mounting."[1]
- Barry Eichengreen for Project Syndicate: "Is the dollar poised to lose its dominance of global economic and financial transactions? Many commentators apparently think so."

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[1] https://www.cfr.org/blog/future-dollar-hegemony

These are all respectable sources. Gold bugs, perma-bears, and crypto hustlers say even worse things about the dollar. Let's ignore them. Instead, we'll hear from Ron Liesching, a currency manager with more than 40 years of experience, who spoke at a Foundation Financial Officers Group conference that I attended in Seattle in October. Ron is a founder and principal of Mountain Pacific Group, a currency overlay manager that also invests in emerging market equities, global ex-U.S. equities, and equity beta hedging strategies on behalf of its clients.

Ron will make the case that the dollar's dominance isn't going anywhere. But first — why should we *care* whether the dollar continues to be the world's reserve currency?

Upamanyu Lahiri, writing for the Council on Foreign Relations, explains:

> The U.S. government, economy, and citizenry reap huge benefits from the dollar's "exorbitant privilege," as [the] former French finance minister [and later president of France, Valéry Giscard d'Estaing] called it, in global financial markets. Because of the strong global demand for U.S. dollars and dollar-backed securities such as U.S. Treasury bonds, the United States can borrow at far lower interest rates than other countries. The U.S. government and firms are also able to borrow from foreign creditors in dollars rather than foreign currencies, so the value of the debt does not change with fluctuations in exchange rates... The global hegemony of the U.S. dollar also gives the United States government the power to impose far-reaching and effective sanctions on its adversaries, a powerful foreign policy tool.[2]

Ronald Layard-Liesching
Source

These are advantages that U.S.-based investors should not want to give up easily. The ability of the U.S. to borrow at low cost has helped propel the U.S. economy to a recovery from the Global Financial Crisis that looks very much like a restoration of global economic dominance (well, almost but not quite). Fareed Zakaria, writing in *Foreign Affairs*, points out:

> Despite all the talk of American dysfunction and decay, the reality is quite different... In 1990, the United States' per capita income (measured in terms of purchasing power) was 17 percent higher than Japan's and 24 percent higher than Western Europe's. Today, it is 54 percent and 32 percent higher, respectively... With which advanced economy would the United States want to have swapped places over the last 30 years?[3]

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[2] *Ibid.*

[3] Zakaria, Fareed. "The Self-Doubting Superpower: America Shouldn't Give Up on the World It Made." *Foreign Affairs,* January/February 2024.

Of course, being able to borrow at low rates has a downside. Low rates have helped the U.S. to accumulate a mountain of government debt that, predictably, has become expensive to service now that interest rates have risen. The debt is expected to continue to grow. At some hypothetical level of interest rates and some future level of accumulated debt, interest expense crowds out literally every other government expenditure — which would be very bad. But I'll save that topic for another day.[4]

Will the dollar continue to be the world's reserve currency?

Everything I've said so far is a long introduction to Ron Liesching's excellent conference presentation on currencies, so let's cut to the chase. Why does he believe the dollar will endure?

Other currencies are in short supply

The most important reason that the dollar cannot be replaced in the foreseeable future is that *global participants do not have enough of any other currency*. This situation has arisen — perhaps counterintuitively — because the U.S. runs persistent trade deficits.

To buy foreign goods, U.S. consumers first have to acquire foreign currencies with which to pay for the goods. They give dollars to foreign entities (governments, banks, etc.) and receive the desired non-dollar currency. Dollars thus accumulate in foreign hands. Exhibit 2 shows how U.S. trade deficits added $13.6 trillion to foreign reserves of dollars between 2000 and 2023. These are gross numbers, not the more familiar net numbers (net of funds that flow out of dollars) usually referred to as the current account. Because of these two-way flows, total foreign reserves of dollars as of late 2023 summed to a smaller amount, about $6.5 trillion — still much more than foreign reserves of any other currency.

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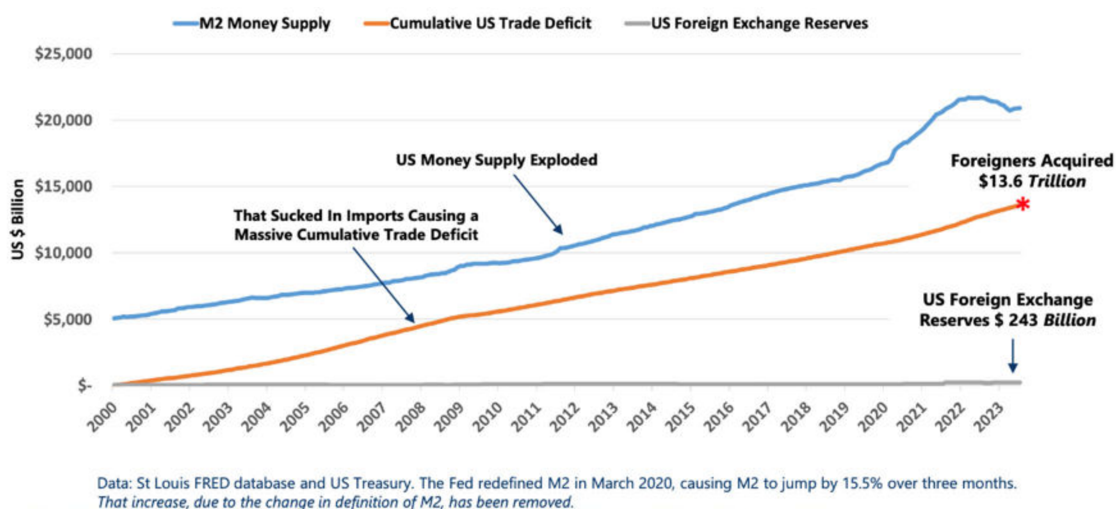
[4] In 2015, Stephen Sexauer and I wrote an article titled "Can We Recover from the Public Debt Crisis? Of Course We Can." Things are worse now, although far from hopeless. The public debt crisis can still be mitigated (that is, both the debt-to-GDP ratio and net interest cost as a percentage of revenue can be substantially reduced), but with substantially greater difficulty than in 2015. Because taxes can only increase, and expenditures fall, so much without causing a major economic disruption, the solution relies on high rates of economic growth over a long future period. If the economy grows faster than government spending, deficits and eventually the debt *will* fall.

Exhibit 2
The U.S. trade deficit, M2 money supply, and U.S. reserves of foreign currencies, 2000-2023



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The Triffin dilemma. In 1960 the economist Robert Triffin noted that there's a conflict between a country's desire to run trade surpluses and the goal of having its currency be the global reserve currency. This is a problem *if* trade deficits are a problem. I'm not convinced of it.[5] Any kind of "deficit" sounds bad, and government budget deficits really are bad, just like personal budget deficits — you're spending money you don't (yet) have.

But trade deficits are only one half of the trade equation; any given trade deficit is exactly balanced by a capital account *surplus*. Nobody is getting a raw deal (or they wouldn't trade). The economist Douglas Irwin succinctly explains: "If a country is buying more goods and services from the rest of the world than it is selling, the country must also be selling more assets to the rest of the world than it is buying."[6]

As an American, I'd keep the exorbitant privilege of having the world's reserve currency and suffer the consequences of trade deficits — if there are any. The idea of sending little pieces of

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[5] In case you think this is voodoo economics, or that I'm just confused, the idea that trade deficits can be good is shared by many (not all) prominent economists. No economist is more mainstream than Greg Mankiw, the former chair (2003-2005) of the Council of Economic Advisers, who said, "Rather than reflecting the failure of American economic policy, the trade deficit may be better viewed as a sign of success." https://www.nytimes.com/2016/12/02/upshot/want-to-rev-up-the-economy-dont-worry-about-the-trade-deficit.html

[6] Quoted in https://www.cato.org/testimony/americas-misunderstood-trade-deficit

paper to other countries and having them send us Volkswagens, avocados, and solar panels is rather enticing. It's good work if you can get it.[7]

Network effects

A second reason is the network externality effect. "There is a vast global network," Liesching writes, "of money transfer, settlement, custody, accounting, auditing, reporting, the Anglo-Saxon legal system, and so forth, all wired to run on U.S. dollars." The cost of switching this hydra-headed monster — a very useful and profitable monster — over to some other currency would be astronomical. Moreover, the other currency might not remain the global reserve currency for long, and yet another switch would be required. Most market participants agree that it's best to leave this system alone.

Derivatives and other financial markets

The final reason for continued dollar dominance comes from the financial markets. Most of the world's derivatives, supposedly with $1 quadrillion in notional value, are dollar-denominated and they are the principal instruments used to hedge every imaginable kind of risk. Actually, the whole financial system is dollar-denominated. Commodities, including the all-important energy complex, are quoted in dollars. These markets have high elasticity: they can take size. In that all-important characteristic, no other currency's financial markets come close.

Luck of the English?

Liesching compares the global supremacy of the dollar to the global dominance of English. English is spoken natively by only 400 million people (5% of world population) but is by far the world's most popular second language with 1.5 billion additional speakers or learners. Moreover, the English-speaking peoples punch above their weight in many domains. English is the language of science, business, academia, and diplomacy. Some 300 million Chinese speak or are learning English — about 400,000 Americans are learning Chinese. With an "installed base" like that, English does not have to worry about extinction or even irrelevance. The dollar isn't threatened by extinction or irrelevance either, for the same reason.

Some forecasts of the dollar's direction

While the dollar will not stop being the world's reserve currency for a long time, if ever, it has gotten expensive, having risen 60% against a basket of non-dollar currencies between 2011 and the high point in late 2022 before falling back more recently. Exhibit 3 shows this price action. Many analysts, including hedge fund billionaire Stanley Druckenmiller and former Morgan Stanley chief economist Stephen Roach, expect the dollar to decline substantially.[8]

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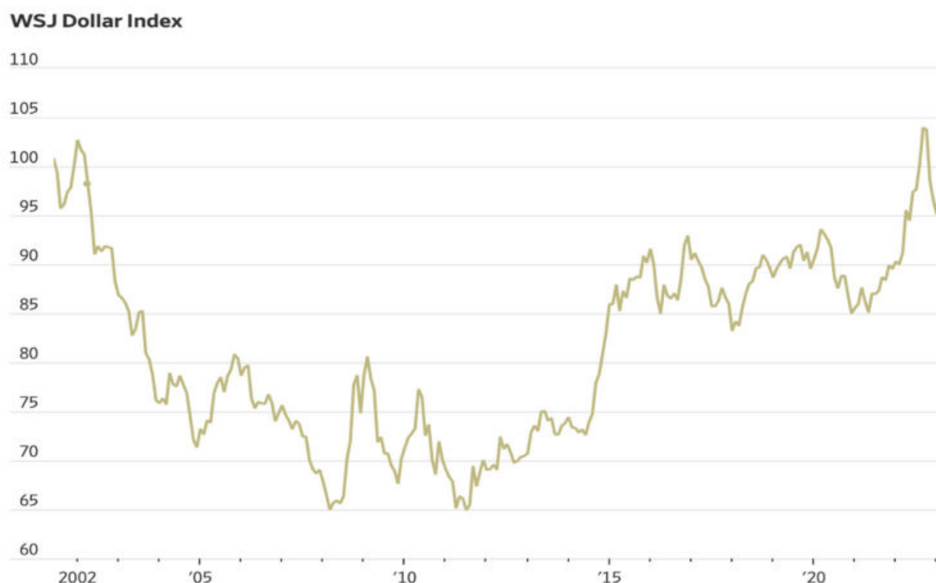
[7] The little pieces of paper, of course, represent real or monetary assets — shares of companies, claims to tax revenue, and so forth. They are not worthless and foreigners wouldn't send us real goods and services in exchange for them if they were. The exchange of pieces of paper for physical goods is just a teaching example showing that there is more than one way to obtain what you want and need.

[8] https://www.bnnbloomberg.ca/video/the-u-s-dollar-is-the-most-overvalued-major-currency-in-the-world-stephen-roach~2053036; https://www.ft.com/content/b74b0563-ee34-4cc6-b31e-c95f1598eecc.

Exhibit 3
The dollar has been on a roll



Source: https://www.wsj.com/articles/the-air-has-come-out-of-the-dollar-36c4c03f

Liesching agrees in the long run, noting that "the average non-U.S. investor has over 70% of their offshore capital invested in dollar-denominated assets. That is way too high." He regards it as a misallocation as large as when the market cap of Japanese equities was more than 70% of overall world ex-U.S. equities. Like Druckenmiller and Roach, Liesching expects "a long-run downtrend in the global value of the dollar."

In the short run, however, Liesching forecasts the opposite: "There is the real risk of an offshore shortage of dollars for borrowers with no dollar revenues." These borrowers currently service their dollar-denominated debts through more borrowing, mostly in the currency forward swap market — but when they cannot continue to do that, "they will be forced to buy U.S. dollars." This will drive *up* the U.S. dollar — before the expected long-term downtrend takes over.

Implications for U.S. investors in stocks and bonds

If these forecasts turn out to be correct, what do they mean for U.S.-based investors in stocks and bonds?

Stocks

First, the seemingly endless underperformance of non-U.S. equities could come to an end. While some of this underperformance reflects relative weakness in the real economies of countries outside the U.S., some is just the mathematical consequence of a rising dollar. (The two reasons are related and not easily separable.)

Second, a falling dollar has generally meant a rising stock market, and vice versa. The historical correlation between changes in the value of the dollar (versus a basket of other currencies) and returns on the S&P 500 has been substantially negative, -0.26 over the 15 years ending in late 2021.[9]. The primary reason is that a falling dollar makes U.S. companies more competitive on global markets. Foreign consumers (including intermediate consumers such as businesses) get more dollars in exchange for their domestic currencies, and can thus buy more U.S.-made goods.

This forecast is subject to a caveat. Second-order effects, based on fund flows, could flip this correlation positive; this has happened before. If foreign investors diversify (reduce) their holdings of U.S. equities, putting selling pressure on the prices, they will also have to *sell the dollars* received from these sales. So, the dollar could become positively correlated with the U.S. stock market, with both falling at once. If this occurs, it should be temporary and self-limiting because foreign investors won't want to divest themselves of all U.S. assets, or even a large portion. But U.S. stocks are potentially vulnerable to this second-order or fund-flow-related phenomenon.

Bonds

Finally, bonds could fall (yields could rise) further. U.S. dollar-denominated bonds have historically been positively correlated to the value of the dollar. Over the 10 years ending in October 2023, the correlation of returns between the dollar (versus a basket) and 10-year Treasury bonds was 0.50, a typical result. The reason is mechanical: high yields attract non-U.S. money, meaning that non-U.S. investors have to buy dollars with which to buy the bonds. Low yields repel money, and the dollar goes down.

Thus, if the dollar does trend downward from its current lofty level, that's bullish (but not incontrovertibly so) for stocks and bearish for bonds. The last thing we need right now is even higher interest rates, so we'd hope for a stable dollar on those grounds.

Conclusion

Mark Kritzman, another respected currency manager and investment theorist, has said that "nothing about currencies is simple." We tend to take currency for granted and look at the movements and prospects of our various investment securities from a single-currency lens (dollars if we're Americans). Money, or currency, is sometimes described as a veil obscuring the underlying transactions and making them harder to understand. Ron Liesching has helped us lift the veil and see what is going on behind it. We are well advised to pay attention to those phenomena.

[9] https://datatrekresearch.com/dollar-stock-correlations-sp-margins

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