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THE DOLLAR AND ITS RIVALS

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Here's a look at what some of our fund managers think about whether the US dollar's hegemony could be challenged anytime soon.

The freezing of about $280 billion of Russian assets after its invasion of Ukraine has once again triggered speculation about the future of the dollar as a store of value and medium of exchange. Such speculation is not new for the greenback and predicting the demise of the US dollar has been the favourite pastime for the media for many years. However, the scale and scope of the sanctions against Russia has called into question the long-held perception about the safety and accessibility of central bank reserves. Other countries such as Iran and North Korea too face the wrath of western governments.

> ***"The era of unipolar dominance for the US dollar and by proxy the US Government is truly over. The recent move to freeze Russian US Treasury holdings only served to accelerate this process"***
>
> NED NAYLOR-LEYLAND
> Investment Manager, Gold & Silver

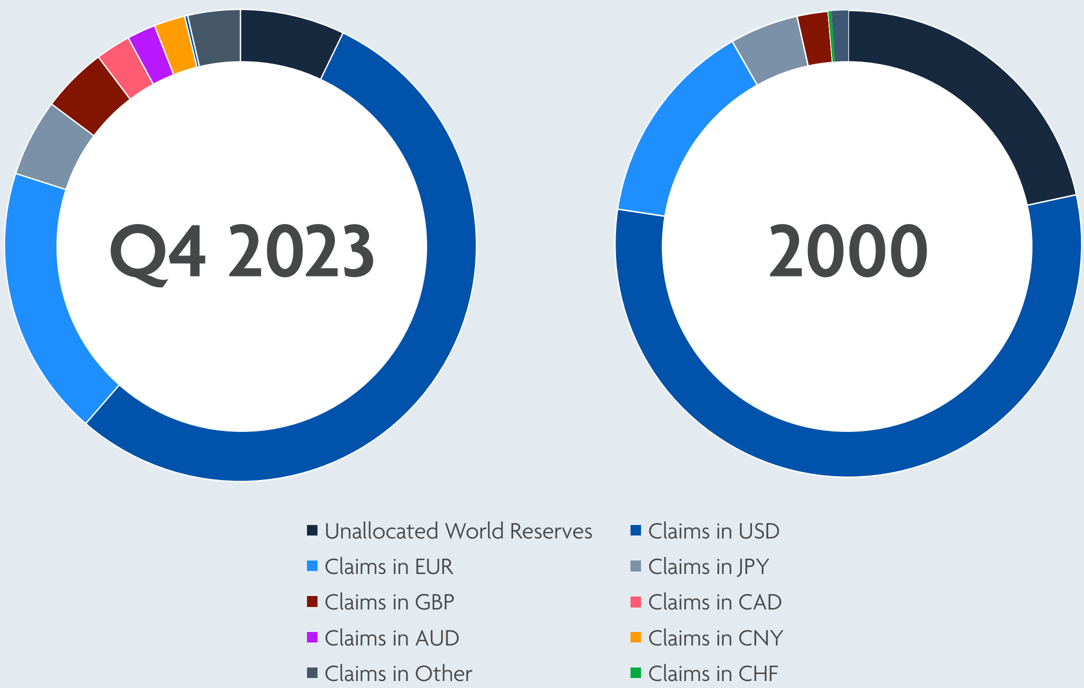
Extensive sanctions by the US and its western allies have constrained trade and investments, and restricted free flow of capital. The increased "weaponisation" of the dollar has made many countries feel vulnerable, keeping alive discussions about potential alternatives. About 60% of international reserves are held in dollar-denominated assets. It's also the most widely traded currency and plays an important role in global trade as well as the debt markets.

THE DEEPLY ENTRENCHED INCUMBENT

Many factors continue to back the pre-eminence of the dollar. The US economy, the world's largest, is bigger than China and Japan put together, the second and third ranked countries by economic output. It has a stable financial system marked by the independence of its institutions such as its central bank and a relatively open economy.

There are other positive attributes too. Reserves are accumulated by buying a country's sovereign debt. The US Treasury debt market is the most liquid in the world and provides a significant amount of top-rated debt. About 30% of the world's outstanding sovereign debt is issued by the U.S. government. The fact that the U.S. government has never defaulted on its debt commitments is a huge positive factor that drives investments into Treasuries.

Global FX Reserves



Source: IMF, 24.06.2024.

The dollar continues to punch way above its weight, thanks to a host of factors including its role as a global military power. While the military's role is not always explicitly evident, the agreement between the US and Saudi Arabia in the 1970s ensured that the oil producer invested its petrodollars in US Treasuries as part of its foreign exchange reserves in return for military aid. Many countries, including Hong Kong, the United Arab Emirates and Saudi Arabia, peg their currencies to the US dollar, underscoring the importance of the currency and the credibility of the Federal Reserve.

Even so, the share of the US in the global economy has been shrinking over the years as Asian countries, including China and India, continue to expand. There has been a geopolitical shift characterised by increased rivalry between the US and China, which has put the brakes on unfettered globalisation. The Covid pandemic starkly highlighted how a supply chain that's hugely dependent on China could hamper the rest of the world.

THE CONTENDERS

The dollar's rise didn't happen overnight. The US currency began to eclipse the Pound Sterling in the early part of the 20th century, with the disintegration of the British Empire accelerating the process. But the rise of Asia, particularly China, over the past 30 years has been increasingly tilting the balance of power.

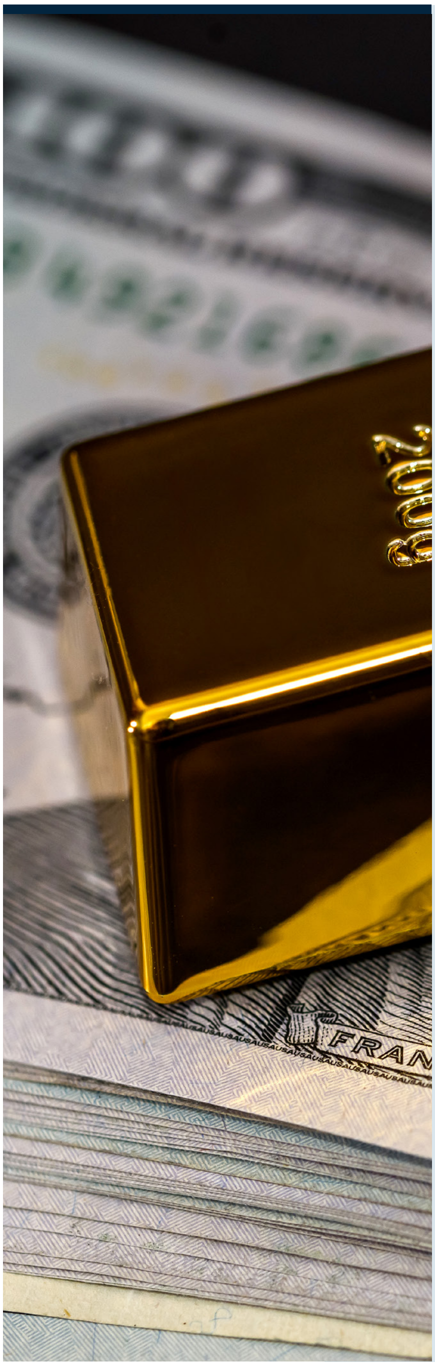
> ***"In a multipolar world, it doesn't make sense to have a dominant single reserve currency, there is a search for alternatives."***
>
> VIKRAM AGGARWAL
> Investment Manager, Fixed Income

Gold, the euro, the Renminbi and crypto currencies are talked of as assets competing with the dollar for attention. Although central banks have steadily sold down their holdings of gold following the end of the Bretton Woods system half a century ago, they have begun to emerge as net buyers over the past decade.

The yellow metal has advantages including acting as a store of value as well as acting as a hedge against inflation.

Gold has garnered more attention as central banks seek a buffer against financial stability risks stemming from heightened geopolitical tensions as well as events such as the global financial crisis and the Covid pandemic. About a fifth of the above ground gold stocks are held by central banks.

> ***"We are re-entering a multipolar world with Gold used as the neutral clearing currency, a return to that which was agreed post WW2, at Bretton Woods in 1944."***
>
> NED NAYLOR-LEYLAND
> Investment Manager, Gold & Silver



GOLD STANDARD: A BAD IDEA?

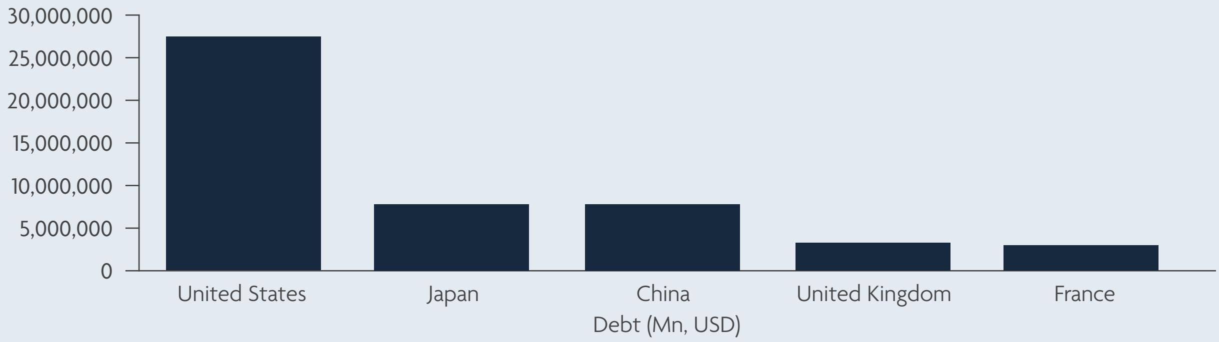
The Bretton Woods pact of 1944 was the answer to competitive devaluations and trade curbs that marked the interwar years, with the focus shifting to reconstruction and economic growth after the second World War. The signatories agreed to keep their currencies fixed but adjustable (within a 1 percent band) to the dollar, and the dollar was fixed to gold at $35 an ounce. This system was in place until 1971, when President Richard Nixon ended the dollar's convertibility to gold, prompted by US balance-of-payments deficits. The fixed exchange rate based on gold was completely abandoned in 1973 and an international monetary system based on floating exchange rates was established. The free-floating fiat currency of today is a far cry from the classic gold standard that was prevalent for twenty years until 1933, when the Roosevelt administration abandoned the policy. Under that policy, the Federal Reserve was required to hold gold equal to 40 percent of the value of the currency it issued and to convert those dollars into gold at a fixed price of $20.67 per ounce of pure gold. The move away from a metal standard to fiat currencies meant that the exchange rates was determined by supply and demand as well as the confidence in the country's economy.

"The question is whether the gold standard was necessarily a bad thing," asked Aggarwal, and wondered whether a gold or commodity backed currency could be the answer to the dollar. Such an arrangement could mean finite supply of currencies, unlike the dollar-dominated world that allows the US the liberty to print currencies unchecked and run a procyclical fiscal policy, which could be inflationary.

THE PRIME CHALLENGER

Introduced in 1999 as part of a move to gain strategic autonomy from the dollar, the euro offered potential diversification away from the dollar. Since the common currency was launched, the share of US dollar assets in central bank reserves has dropped by 12 percentage points to 59%, while the euro's share has hovered around 20%. The region has many attributes similar to that of the US, including deep financial markets and an open economy. But the common currency faced a jolt during the European debt crisis more than a decade ago and gained stability only after the then ECB President Mario Draghi's famous "whatever it takes" speech in which he vowed to defend the currency.

Top 5 Sovereign Debt Issuers



Source: BIS, 24.06.2024.

The European Union began selling debt denominated in euros only in recent years and therefore the size of outstanding debt in the currency pales in comparison to the US. The homogeneity of the US debt market also contrasts with bonds issued in euros, which are fragmented by country of issuance. Therefore, reserve managers must take recourse to investing in top-rated core bonds issued by countries such as Germany, Belgium and the Netherlands.

However, the changing geopolitical dynamics and the confiscation of Russian assets mean the confidence in the euro as a neutral reserve asset has been eroded to some extent. The lack of fiscal integration in the region could still come to haunt the region although it is monetarily integrated.

THE AMBITIOUS ASPIRANT

Chinese authorities have been increasingly promoting the usage of renminbi in bilateral trade.

> ***"The yuan is increasingly being used for buying oil and other commodities. Some other emerging market countries too are looking to diversify away from the dollar, particularly for their non-oil imports."***
>
> XUCHEN ZHANG
> Investment Manager, EMD-Fixed Income

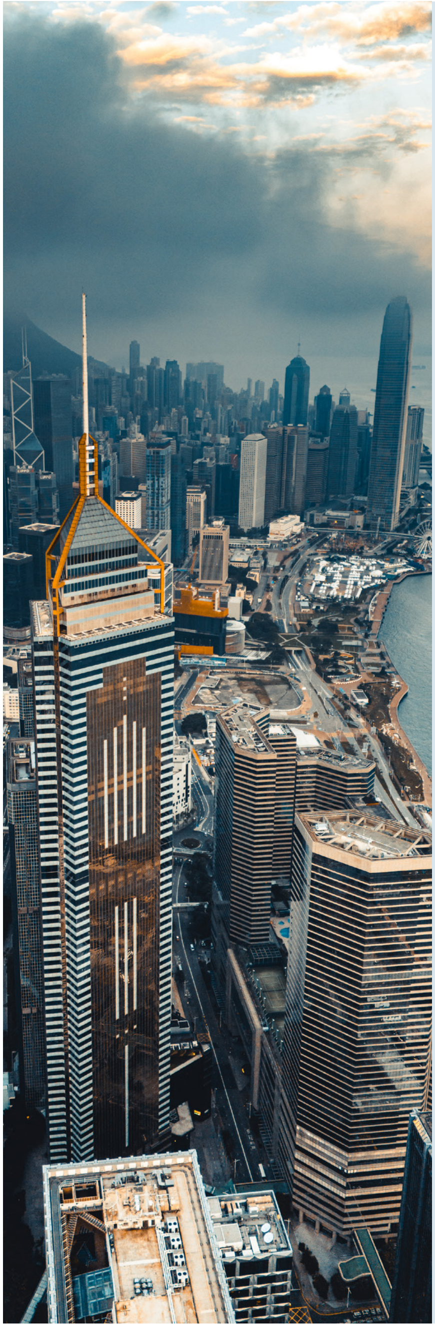
But the currency still needs to overcome many challenges to gain wider acceptance. For one, the currency isn't fully convertible through the capital account, which makes investors wary as their capital could be stuck if there is any policy change to prevent outflows. As a share of global reserves, Renminbi still lags way behind the dollar. In terms of global payment transactions, it ranks below the dollar, euro and pound sterling and its importance may continue to rise in the coming years as the country's economy and trade expands further.

There's no doubt China's government debt market is deep and offers attractive opportunities. To allow access to the onshore fixed income markets, the country launched "Bond Connect" in 2017 but various rules and conditions still make the process cumbersome for overseas investors.

THE NEW AGE UPSTARTS

In recent years, there's been a rapid growth in cryptocurrencies such as Bitcoin and Ethereum, giving rise to speculation that the international status of the dollar could be eroded by technology.

Whereas all the currencies discussed so far (with the exception of gold) are backed by a central bank, and ultimately by a nation (or union of nations), cryptocurrencies are not. And this, argue their supporters, is precisely their appeal: with no central authority, they provide a liberty that fiat currencies cannot. Instead of a central authority, cryptocurrencies verify transactions through cryptography.However, the volatility of cryptocurrencies has made them unpredictable investments. El Salvador, which became the first country to adopt Bitcoin as legal tender, learnt the pitfalls of the crypto currency the hard way. Cryptocurrencies seem to be held more for their speculative value than as a medium of exchange. Their unregulated nature is also a risk, as the recent case of Sam Bankman-Fried has shown.



HONG KONG'S CURRENCY PEG: HARBINGER OF RAPID DEDOLLARISATION?

Even as the rivalry between US and China grows, a part of China's territory continues to peg its currency to the dollar. The peg, which has been in place since 1983, was introduced following the pressure faced by the currency due to negotiations with the UK to transfer the financial centre to mainland China.

The Hong Kong dollar is pegged in a narrow range around $7.80 to the dollar and the band is maintained through a series of arbitrage and automatic intervention mechanisms. The US was the territory's largest trading partner when the peg was introduced. That's no longer the case and has been eclipsed by China. There is no doubt the Hong Kong Monetary Authority has the firepower to withstand any speculative frenzy. But the maintenance of the band means the HKMA doesn't have much say on the level of the territory's monetary base. The need to keep the monetary policy in tune with the US also raises questions about the suitability of the policy, disregarding growth or inflation signals of the territory.

The trouble is if Hong Kong interest rates are at variance with the US, that could provide arbitrage opportunities. It is worth remembering that overnight rates rose to almost 300% in 1997 amid the Asian crisis. *"One should closely watch whether the peg is removed for signals that dedollarisation is picking up pace,"* said Vikram Aggarwal.

NEWS OF DOLLAR'S DEATH IS EXAGGERATED

What's the future of the dollar given the geopolitical fragmentation underway now? Naylor-Leyland said the financial system is yet to recognise the seismic change brought about by the freezing of Russian assets as it continues to use US Treasuries as "risk free" collateral but believes the world will increasingly turn towards gold.

> ***"The US hegemon will no doubt continue to fight against this inevitable change but it will be in the best interests of everyone to once again use Gold as the risk-free rate, rather than feeding the exorbitant privilege of the US on a perpetual basis."***
>
> NED NAYLOR-LEYLAND
> Investment Manager, Gold & Silver

The world has changed a lot over the past 50 years. The dollar faced some hiccups within a few years after it switched to a floating rate mechanism, with high inflation in the late 1970s eroding its value. Since then, the US Federal Reserve has managed to keep inflation more or less stable.

While the speculation about the role of the dollar in global finance will continue to persist in the coming years, there doesn't seem to be a safe and reliable alternative as of now. The faith and confidence reposed on the greenback is demonstrated by the fact that investors rushed to buy the dollar even during periods of heightened stress such as the global financial crisis and the Covid-crisis.

> ***"It's pretty clear that the world will be moving towards de-dollarisation over the medium-term.But an alternative that ticks all the boxes is difficult to find at the moment."***
>
> VIKRAM AGGARWAL
> Investment Manager, Fixed Income

As a specialist, high-conviction, active asset manager, Jupiter has no house view to dictate positions, and the article reflects the views of the individual fund managers.

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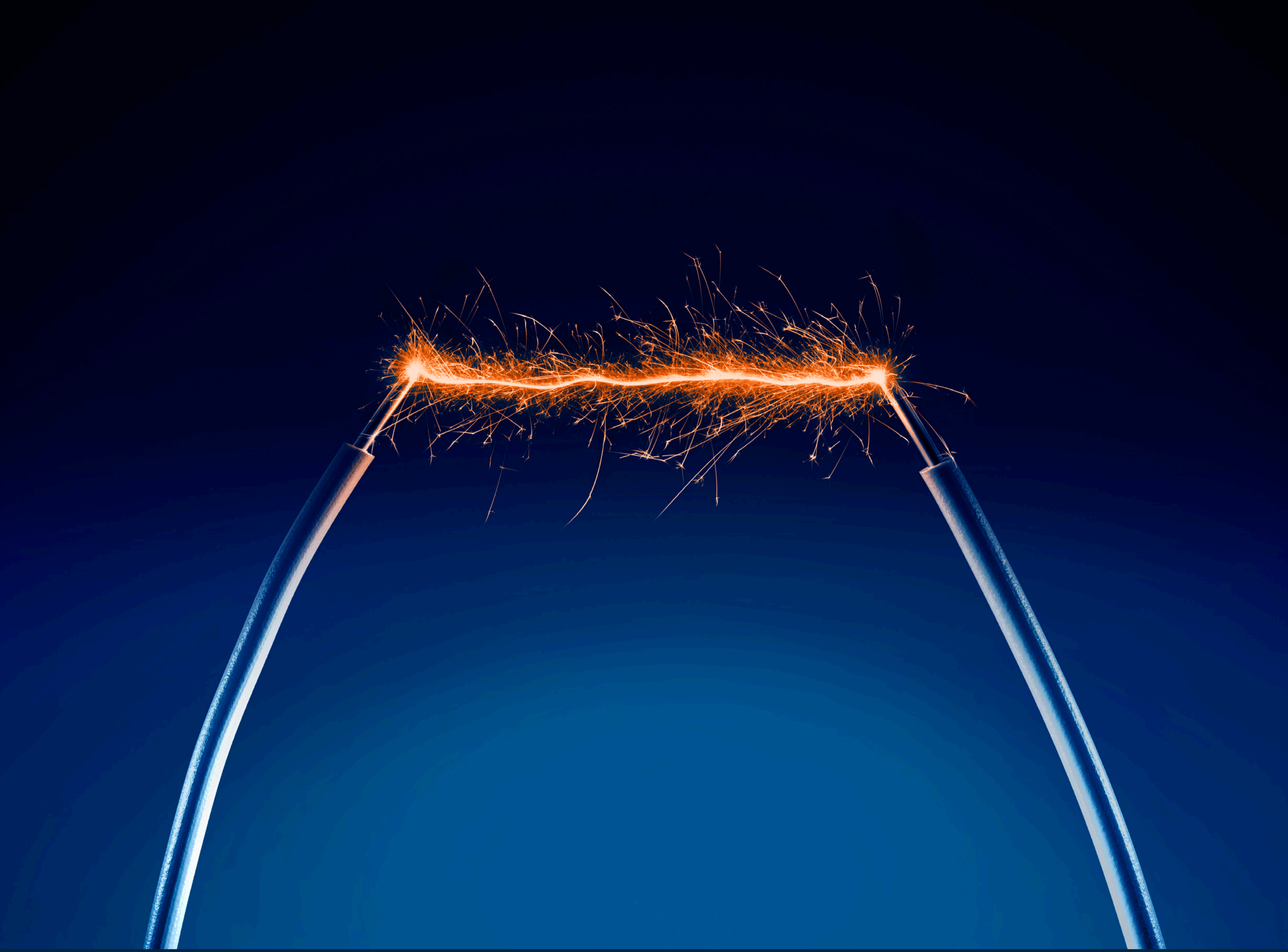

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