

Perspectives for Global Fixed Income: Losing Faith in the U.S. Dollar?

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Executive Summary

Speculation about the end of the U.S. dollar's role as the world's main reserve currency has been gathering strength for many years. That has partly been a function of a rebalancing world economy in which new economic powers are emerging. But it is also linked to growing concerns about the significant fiscal problems facing the world's largest economy and their effects on interest rates and currencies around the world. Standish Global Macro Strategist Tom Higgins says he believes the dollar's influence will diminish over the long term, but that in the short term, there is still no viable alternative to the dollar for the world's reserve currency. In the following discussion he looks at the risks posed by a dollar-based reserve system and the implications of a gradual transition to a diversified model of a basket of several international reserve currencies.

The U.S. dollar has enjoyed what former French Finance Minister Valery Giscard d'Estaing termed its "exorbitant privilege" as the world's leading reserve currency since it displaced the British pound from the top spot in the aftermath of World War II. Today, the dollar accounts for 60% of global currency reserves and is involved in more than 42% of all foreign exchange transactions (see Exhibit 1).¹ At present, there are few challengers to the dollar's supremacy.

Each of the most commonly suggested alternatives: the euro, the Japanese yen, the Chinese renminbi, or gold, all have limitations of their own. The euro is plagued by the sovereign debt crisis in the peripheral economies; the Japanese yen never circulated broadly because Japan is a relatively small country with a shrinking population and a stagnant economy; the Chinese renminbi is still not fully convertible; and the gold market is too thin and illiquid to be the basis of the international monetary system. Proposals for a new currency based on Special Drawing Rights (SDR) at the International Monetary Fund are also a non-starter in our view, since the dollar and euro comprise

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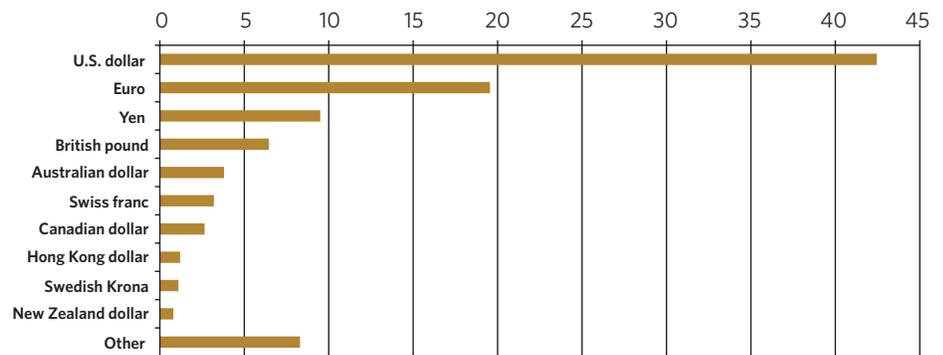


¹ "Triennial Central Bank Survey: Report on Global Foreign Exchange Market Activity in 2010," Bank for International Settlements, December 2010, p. 12.

nearly 80% of the SDR-basket. Consequently, the SDR would offer little protection if the dollar and euro lost value over time.² Thus, almost by default, the dollar's international role seems secure in the short term.

Exhibit 1 - The U.S. Dollar Is the Most Widely Used Currency

Currency share of global foreign exchange transactions



Source: Bank of International Settlements, as of September 30, 2011.

The dollar's use as a store of value, a key characteristic of a reserve currency, has already been called into question as growing fiscal deficits and a reliance on foreign borrowing have conspired to drive down its trade-weighted value by one-third since 2002.³

However, in the long term, we expect the dollar's dominance to gradually erode. The dollar's use as a store of value, a key characteristic of a reserve currency, has already been called into question as growing fiscal deficits and a reliance on foreign borrowing have conspired to drive down its trade-weighted value by one-third since 2002.³ The recent downgrade of the U.S. sovereign rating from AAA to AA+ by Standard & Poor's has added to the negative sentiment. Therefore, it would not surprise us to see some decline in the dollar's international role over time. It is our view that a transition from a single- to a multi-polar reserve system is in the best interest of the global economy. Yet, a global portfolio rebalancing on this scale would not be without its costs. There would be implications for not only the value of the U.S. dollar, but also for the global economy and fixed income markets.

Risks Posed by a Dollar-Based Reserve System

The four most commonly cited reasons why central bank policymakers accumulate reserves are: 1) they need to cover purchases of goods and services if there is a temporary shortfall in export earnings; 2) they need to service external debt coming due if there is a sudden reversal of capital inflows; 3) they seek to resist an appreciation of their exchange rate in order to sustain export growth; and finally 4) they may have a view about the optimal allocation of the government's financial investments with a bias toward liquidity.⁴

² Barry Eichengreen, *Exorbitant Privilege: The Rise and Fall of the Dollar and the Future of the International Monetary System* (Oxford: Oxford University Press), 2011.

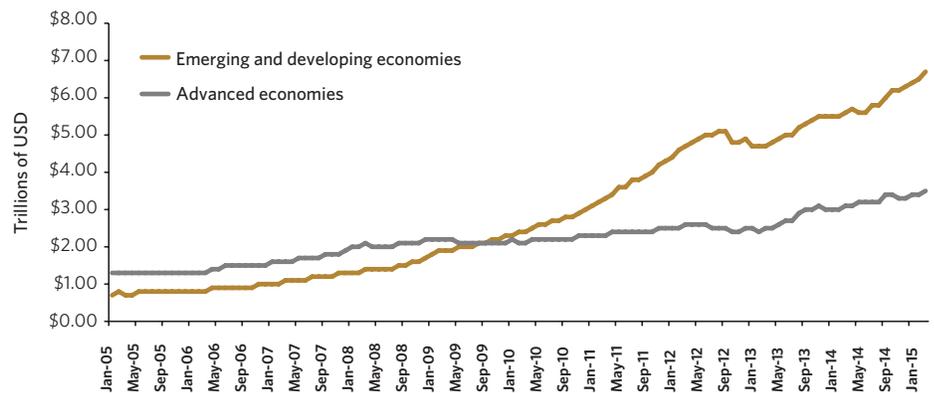
³ Federal Reserve H.10 Release: Summary Measures of the Foreign Exchange of the Dollar, October 2011.

⁴ Edmund Truman and Anna Wong, "The Case for an International Reserve Diversification Standard," *The Institute for International Economics*, May 2006.

In the aftermath of the Asian financial crisis of 1997, the region built a war chest of reserves to protect their economies against a repeat of the capital flight that resulted in disruptive currency devaluations during that period.

Roughly two-thirds of the \$10 trillion in official foreign exchange reserves held globally are concentrated in emerging markets, especially in Asia (see Exhibit 2). In the aftermath of the Asian financial crisis of 1997, the region built a war chest of reserves to protect their economies against a repeat of the capital flight that resulted in disruptive currency devaluations during that period. Official reserves in Asia grew from \$225 billion in 1997 to \$3.5 trillion in 2010.⁵ This level of reserves is far more than can be justified for the balance of payments purposes outlined above, as it amounts to two years of import coverage and is more than three times the amount of external debt outstanding in Asia.⁶ Instead, Asian reserve accumulation appears to be mostly a byproduct of the desire to stem an appreciation of their currencies.

Exhibit 2 - Global Foreign Exchange Reserves



Source: The International Monetary Fund Global Financial Stability Report, as of September 30, 2011.

To the extent that Asian currencies are managed, most track the dollar or a basket that is heavily weighted toward the dollar. As a result, the majority of these reserves are held in U.S. dollar-denominated assets, particularly Treasuries. Insofar as Asian reserve accumulation suppresses U.S. interest rates and supports U.S. demand, while simultaneously encouraging Asian investment and exports through an artificially low exchange rate, it aggravates global imbalances. The longer this pattern continues, the greater the risk of economic or financial market instability.

⁵ "World Development Indicators," The World Bank, April 2011.

⁶ *Ibid.*

In our view, the transition from a single to a multi-polar currency regime could enhance global financial market stability.

Setting this issue aside, the decision to allocate a large portion of one's portfolio toward Treasuries at a time when U.S. interest rates are already at rock bottom and the United States is running extremely loose fiscal and monetary policies could prove costly in the long term. The Federal Reserve has expanded its balance sheet through quantitative easing from \$900 billion in August 2008 to \$2.8 trillion in October 2011.⁷ At the same time, U.S. gross debt to GDP is poised to top 115% by 2015.⁸ These policies increase the risk of inflation and suggest that Treasuries may be overpriced at current valuations.

Even if the United States manages to get its fiscal house in order and the Fed removes policy accommodation in a timely manner, large allocations to U.S. Treasuries do not appear to be warranted, in light of more attractive risk-adjusted opportunities elsewhere. For instance, China is currently losing money on its \$1.1 trillion investment in U.S. Treasuries, given the negative carry between China's three-month government bill rate, which stands at 3.05%, versus the 0.02% yield on a U.S. three-month Treasury bill as of October 2011.⁹ And this does not include losses associated with a modest appreciation of the renminbi vis-à-vis the dollar over the past year. Hence, the decision to invest in U.S. Treasuries makes little sense from a return perspective.

Therefore, we believe global central banks may have an incentive to gradually reduce their dollar reserve holdings. The U.S. currency will continue to play an important international role, but it may share the stage with other currencies. In our view, the transition from a single to a multi-polar currency regime could enhance global financial market stability. Although the dollar's prominent status has allowed the U.S. to borrow cheaply in international markets, it has also lessened the effectiveness of domestic monetary policy by keeping market rates low even at times when the Federal Reserve was attempting to tighten policy. Additionally, a more diversified portfolio of reserves would lessen the exposure of any individual central bank to adverse changes in the U.S. economy, financial markets or government policy.

Few Alternatives to the U.S. Dollar in the Short Term

Even if we acknowledge the risks posed by a dollar-based reserve system, today's reality is that there are few alternatives to the U.S. dollar. A currency must have certain attributes before it is accepted as a reserve currency. The three most basic are that it must serve as a 1) medium of exchange, 2) store of value, and 3) unit of account for comparing the prices of goods and services.¹⁰ However, these necessary conditions by themselves are by no means sufficient for the international banking community to regard a currency as a reserve currency.

⁷ Federal Reserve H.4.1 Release: Factors Effecting Reserve Balances.

⁸ "World Economic Outlook: Slowing Growth, Rising Risks," The International Monetary Fund, September 2011.

⁹ Bloomberg.

¹⁰ Edwin Truman, "The Evolution of the International Financial System," remarks delivered at the Institute for International Monetary Affairs Eighth Symposium, Tokyo, Japan, 1999.

Advocates of a return to the gold standard claim it is a good store of value, but the market is too small and illiquid to be the basis of the international monetary system.

Bankers also require that the issuing country exhibit a stable political system, strong institutions in the form of a central bank and treasury/finance ministry, sound macroeconomic policies, and respect for property rights. Moreover, the issuer of a reserve currency tends to be a larger economy with a significant amount of global trade such that its currency circulates broadly. Finally, the issuer of a reserve currency must have deep and liquid capital markets that offer holders of its currency the option to hold an asset that provides some return (see Exhibit 3).

As mentioned, the euro, the Japanese yen, the Chinese renminbi and gold are four of the most commonly cited candidates for replacing the dollar. Advocates of a return to the gold standard claim it is a good store of value, but the market is too small and illiquid to be the basis of the international monetary system. Indeed, at a dollar price of \$1,750 a troy ounce, the total value of all the gold ever mined is roughly \$9 trillion, which is less than the \$9.5 trillion in U.S. money supply or the Euro Zone money supply of \$11.8 trillion.¹¹ Thus, if we were to return to the gold standard either the global money supply would have to contract sharply or the price of gold would have to increase dramatically.

Even if this problem is overcome, it is worth noting that the global economy was much more cyclical under the gold standard, because monetary policy was essentially determined by the rate of gold production.¹² In the period between 1870 and 1933 when the gold standard was in effect, U.S. recessions or depressions were 30% more common and their average duration was twice as long as such downturns have been in the period since then.¹³ The Chinese renminbi might be a better option than gold were it not for the fact that China maintains capital controls on the conversion of its currency. China would also need to make further progress on increasing the depth and breadth of its domestic bond market if central banks were to hold the renminbi as a reserve currency.

The Japanese yen's international role is challenged by the fact that Japan is a small country with a population of only 126 million, which is half that of the U.S. or eurozone, and the population is shrinking. This suggests that the base for launching the yen as an international currency is slowly disappearing. In addition, the Japanese economy has stagnated for much of the last two decades due to the bursting of its twin asset bubbles in the late 1980s. As a result, the yen's primary role over the past decade has been as a cheap funding currency to finance investments outside of Japan.

¹¹ Federal Reserve and Eurostat, October 2011.

¹² Brad DeLong, "Why Not the Gold Standard?" University of California at Berkeley, August 10, 1996.

¹³ Business Cycle Dating Committee, National Bureau of Economic Research.

... a country's share of world GDP or exports can provide a proxy for transactions done in the country's currency. Based on these measures, one would predict that the U.S. dollar's share of global reserves would be much smaller.

The closest viable alternative to the dollar in the short term is probably the euro. Not surprisingly, it is already the second most important reserve currency after the U.S. dollar. However, we will remain skeptical about the euro's suitability as the world's main reserve currency until the sovereign debt crisis in peripheral Europe is fully resolved, especially since Europe's economic fundamentals are not much better than those of the United States. The debt dynamics for some of the peripheral economies, particularly Greece, appear unsustainable in the long term. This threatens the European banking system given large cross holdings of peripheral sovereign debt. Until European leaders find a comprehensive solution to these problems, we do not believe that the euro will be seriously considered as a replacement for the dollar.

Exhibit 3 - Criteria for Global Reserve Currency

	Medium of Exchange	Store of Value	Unit of Account	Stable Political System	Sound Macro Economic Policies	Respect for Property Rights	Deep/Liquid Capital Markets	Broadly Circulating Currency
U.S. Dollar	X	X	X	X	X	X	X	X
Euro	X	X	X	X	X	X	X	X
Japanese Yen	X	X	X	X	X	X	X	
Chinese Renminbi	X	X	X	X	X			
Gold		X	X					
IMF Special Drawing Rights			X					

Source: Standish, as of September 30, 2011.

Determining an Optimal Reserve Allocation for the Long Term

Though there appear to be few alternatives to the dollar today, this may not always be the case. European leaders are addressing the problems that plague the eurozone, and the Chinese are gradually liberalizing their capital account by encouraging the development of an offshore renminbi market in Hong Kong, which features so-called dim sum bonds that are denominated in renminbi. Although the offshore renminbi market is still small with roughly RMB 550 billion (\$90 billion U.S.) in deposits, it has been growing rapidly.¹⁴

Determining how prominently the euro, the renminbi, or other currencies might be featured in a future reserve allocation is challenging. However, there are several economic and financial market indicators we can use to try to estimate the mixture. For example, a country's share of world GDP or exports can provide a proxy for transactions done in the country's currency. Based on these measures, one would predict that the U.S. dollar's share of global reserves would be much smaller. According to the International Monetary Fund (IMF), the U.S. economy accounts for only 20%

¹⁴ Ju Wang, Kumar Rachapudi and Jian Chang, "CNH Market Primer," Barclays Capital Emerging Market Research, August 2011.

... there is little reason why the dollar could not share the spotlight with two or three currencies in a diversified reserve basket.

of world GDP and 10% of world exports as of 2010, but the dollar still accounts for 60% of global reserves. By contrast, the IMF estimates that emerging market economies represent half of world GDP and more than one-third of world exports, but all of their currencies combined account for less than 5% of global reserves (see Exhibit 4). Even if we add a premium for the depth and breadth of U.S. financial markets, the dollar's international role appears disproportionately large.

Some economists attribute this phenomenon to a so-called network externalities effect, which describes a strong incentive to conform to the choice that dominates the marketplace, similar to computer operating systems or language. They argue that this incentive implies there will always be a single dominant reserve currency. However, this conclusion is not supported by historical experience. Indeed, the British pound shared the international stage with the French franc prior to World War I and with the U.S. dollar afterward. Furthermore, financial innovation and advances in technology have combined to reduce transaction costs in currency markets.¹⁵ Hence, there is little reason why the dollar could not share the spotlight with two or three currencies in a diversified reserve basket.

Exhibit 4 - Global Economic & Financial Market Indicators

	Share of Global Reserves in Q1 2011	Share of Global GDP	Share of Global Exports	Share of Global Equity Markets	Share of Global Debt Markets
U.S. Dollar	61%	20%	10%	31%	27%
Euro	27%	15%	26%	11%	21%
Japanese Yen	4%	6%	5%	7%	28%
UK Pound	4%	3%	4%	7%	3%
Emerging Markets	<5%	48%	36%	23%	13%
Other	>5%	9%	20%	21%	7%

Source: The International Monetary Fund World Economic Outlook and Global Financial Stability Reports, as of September 30, 2011.

Indeed, we see signs that the process of reserve diversification has already begun, as foreign central banks, particularly those in emerging markets, start diversifying their reserves away from the U.S. currency. The dollar's share of global currency reserves has declined from more than 70% a decade ago to around 60% today.¹⁶ Valuation adjustments account for some of this decline, but by no means all of it.

¹⁵ Barry Eichengreen, "Sterling's Past, Dollar's Future: Historical Perspectives on Reserve Currency Competition," University of California at Berkeley, April 2005, p. 21.

¹⁶ International Monetary Fund. Currency Composition of Official Foreign Exchange Reserves.

So while we don't expect the dollar to lose its reserve status any time soon, we believe that the increasing liquidity and better macroeconomic policies of many emerging market economies will prompt global central banks to increase their holdings of these currencies as they seek to achieve an optimal reserve allocation.

There are also structural factors at work in emerging markets, including less reliance on external debt and an ongoing transition from fixed to floating exchange rate regimes. According to the IMF, around three-quarters of developing country currencies were pegged in 1975 compared to less than half today. The euro has been one of the beneficiaries of this reserve diversification, but the largest percentage gains have been posted by the category the IMF labels as *other*, which include emerging markets. This category has increased from less than 2% of official FX reserves in 2008 to nearly 5% as of the second quarter of 2011.¹⁷

Implications for Fixed Income Markets

So what does this gradual transition mean for global bond markets? Gauging the impact of changes in U.S. dollar reserves on U.S. fixed income markets with any precision is difficult. According to the Standish bond model, each \$100 billion in foreign capital inflows into the U.S. Treasury market shaves roughly 10 basis points from U.S. 10-year Treasury yields. If we assume the share of U.S. dollars in global reserves gradually declines back toward the U.S. economy's share of world GDP over the coming decades, holding all other variables constant, by 2030 U.S. 10-year yields might be as much as 50 basis points higher than would be the case if we held the share of reserves constant. Thus, we see little value in U.S. Treasuries at current yield levels.

By contrast, we believe emerging markets may offer more compelling value over the long term. As the international role of emerging market currencies grows, those currencies should appreciate, and demand for bonds denominated in those currencies will expand. The amount of emerging market local currency bonds now outstanding exceeds \$6 trillion compared with only \$1 trillion in the mid-1990s.¹⁸ Although these markets are still dominated by local institutions, foreign participation has been increasing rapidly. We expect this trend to continue, supported by sound economic fundamentals in emerging markets. For example, debt to GDP ratios for emerging markets average 30% compared to 100% in the advanced economies, and real GDP growth rates are nearly three times faster at 6% versus 2% per annum.¹⁹

So while we don't expect the dollar to lose its reserve status any time soon, we believe that the increasing liquidity and better macroeconomic policies of many emerging market economies will prompt global central banks to increase their holdings of these currencies as they seek to achieve an optimal reserve allocation. We believe this will be part of a larger transition to a multi-polar global reserve regime that will ultimately reduce the potential risks associated with exposure to a single fiat currency.

¹⁷ *Ibid.*

¹⁸ Shanaka J. Peiris, "Foreign Participation in Emerging Markets' Local Currency Bond Markets," IMF Working Paper, April 2010.

¹⁹ "World Economic Outlook: Slowing Growth, Rising Risks," The International Monetary Fund, September 2011.

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