Meketa Investment Group Global Macroeconomic Research Series

The World's Reserve Currency
A Gift and a Curse

January 2014

Issue Twelve

Global Macroeconomic Working Group

Stephen McCourt, Coordinator

Alan Spatrick

Frank Benham

Shane Enete

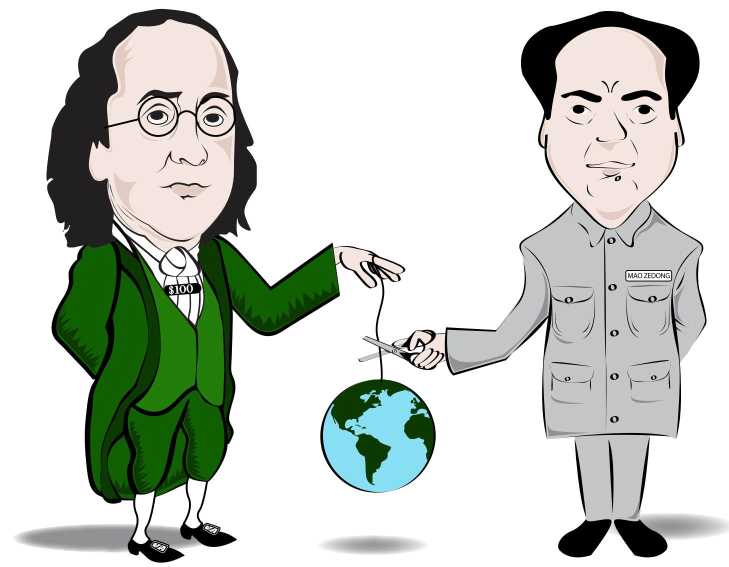
Ed Omata

Richard O'Neill

Edmund Walsh

Since World War II, the U.S. dollar has served as the world's reserve currency. This arrangement has played no small part in the dominance of the U.S. economy since that time. Though often viewed as an "exorbitant privilege," maintaining the world's reserve currency has some important disadvantages as well. Understanding this cost/benefit trade-off is a critical piece of understanding the unique role that the United States plays in the world economy. In this paper we discuss the definition of a reserve currency, its costs and benefits, and whether the U.S. dollar may lose this status any time soon.

The Future of the U.S. Dollar as a World Reserve Currency



A Brief History

In July 1944, still in the midst of World War II, 730 delegates from all 44 Allied nations gathered in Bretton Woods, New Hampshire, for what later became known as the Bretton Woods Conference. The common goal was to avoid a repeat of the Great Depression through a greater level of cooperation amongst countries within the global financial system[1]. Prior to 1944, each country's currency was individually convertible into gold at a specific exchange rate. The Bretton Woods system, as it came to be called, established that all foreign currencies would be tied instead to the U.S. dollar, which would then be the only currency that was directly convertible into gold (at $35/ounce). As a result, the U.S. dollar effectively became the anchor for the entire global financial system.

The Bretton Woods system endured until August 15, 1971, when President Richard Nixon terminated the convertibility of the U.S. dollar into gold. This made the U.S. dollar (and all other currencies by extension) "fiat money," unbacked by anything other than the credibility of the issuing government. It also allowed foreign currencies to float freely, as opposed to being tied to the dollar at a specific exchange rate. Today, even though many countries maintain their own free floating currencies, the dollar remains the dominant global currency.

[1] As discussed in our "Currency Wars" newsletter, the "beggar thy neighbor" policies of competitive currency devaluation and protectionism by many countries during the 1930s exacerbated the effects of the Great Depression.

Global Macroeconomic Working Group

Stephen McCourt, Coordinator

Alan Spatrick

Frank Benham

Shane Enete

Ed Omata

Richard O'Neill

Edmund Walsh

Definition of a Reserve Currency

A reserve currency is generally defined as a currency that is both held in significant quantities by foreign governments and institutions as part of their foreign exchange reserves, and used most frequently in international financial transactions. While there are a handful of other currencies that fit that definition today (e.g., euro, Japanese yen, British pound), it is clear that the U.S. dollar remains *the* dominant reserve currency for the rest of the world. Roughly 61.4% of the world's foreign currency reserves are held in dollars[1], and the dollar is used in 86% of global currency transactions[2].

While its reserve currency status was initially cemented by the Bretton Woods system, the dollar has maintained its global reserve currency status over the past 70 years for a number of other reasons. The most obvious is the depth and liquidity of U.S. financial markets. Any global reserve currency needs to be able to support the ever-increasing transaction volume of the entire world, and no other country comes close to the U.S. in this regard.

The second pillar of the dollar's reserve currency status is less quantifiable, but no less important, and that is confidence. Over the past 70 years, the U.S. dollar has proven to be a "safe haven" asset in times of global stress. Investors all over the world have come to believe that the U.S. dollar will provide them with safety and liquidity no matter the economic/financial circumstances, and this confidence tends to be self-reinforcing.

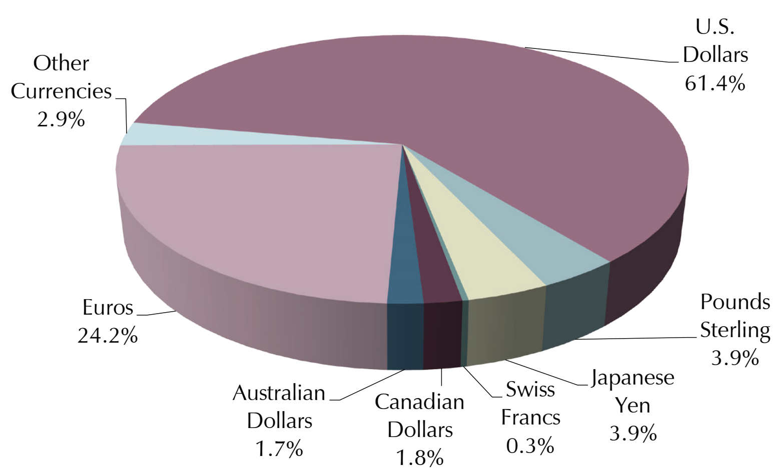
> "Maintaining the world's reserve currency comes with a number of clear benefits."

The Benefits

Maintaining the world's reserve currency comes with a number of clear benefits. In the 1960s, the French Minister of Finance coined the phrase "exorbitant privilege" when describing the benefit the United States receives from being the world's reserve currency. He saw the Bretton Woods system as not merely a convenient way to balance international payments by tying all world currencies to the same anchor (the U.S. dollar), but as something that gave the United States a significant advantage over the rest of the world. For the most part, he was right.

The first critical point to understand is just how much the rest of the world relies on U.S. dollars to facilitate trade with each other (let alone with the United States). More often than not, when foreign countries engage each other in trade, rather

Allocated Global Currency Reserves



Source: IMF, Currency Composition of Official Foreign Exchange Reserves (COFER)

[1] Source: IMF, Currency Composition of Official Foreign Exchange Reserves (COFER)

[2] Source: Bank of International Settlements, Triennial Central Bank Survey

Global Macroeconomic Working Group

Stephen McCourt, Coordinator

Alan Spatrick

Frank Benham

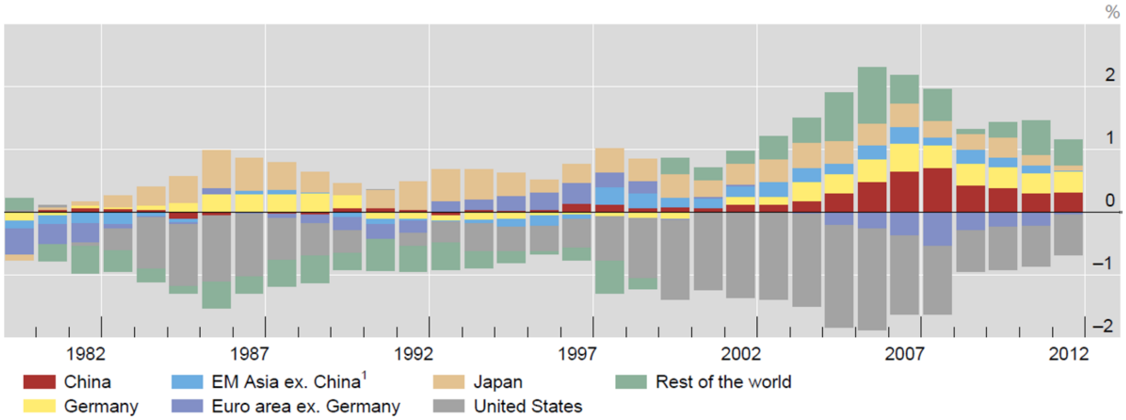
Shane Enete

Ed Omata

Richard O'Neill

Edmund Walsh

The U.S. Has Been *THE* Liquidity Provider to the World for Decades
(Current Account Balances by Country, % of Global GDP)



Source: Guonan Ma & Robert McCauley, "Global and Euro Imbalances: China & Germany." BIS Working Paper #424. September 2013

than simply purchasing goods using their home currencies, they must first swap their own currencies for U.S. dollars in order to complete the transaction. This is because the selling country often has no use or desire for a foreign currency other than the U.S. dollar, and thus demands payment in dollars.

As a result, there is a constant foreign demand for U.S. dollars to facilitate trade. This foreign demand forces up the value of the dollar vs. other currencies. A stronger dollar benefits U.S. consumers as imports become less and less expensive. Thus, the "exorbitant privilege" of reserve currency status allows U.S. citizens to purchase goods and services at prices somewhat lower than the rest of the world must pay.

Foreign demand for dollars also has a profound impact on how the U.S. economy is structured. Essentially, it allows the United States to continually consume more than we produce because the dollar effectively serves as an exported good. Said differently, we are able to import more than we export because the difference (the outflow of dollars) is in constant demand from the rest of the world. It's as if we are able to write checks that never get cashed. No other country has this luxury. In theory, what a country purchases/sells needs to balance over time, and countries that "live beyond their means" for an extended period of time eventually run into trouble. But with our currency effectively serving as an export, that theory simply does not apply to the United States.

The dollar's reserve currency status also creates significant advantages from a policy perspective. Typically, countries that pursue overly stimulative monetary and/or fiscal policy run the risk of foreign investors rejecting their currency due to fears over inflation (monetary policy) or excessive debt (fiscal policy). Given that the rest of the world, in aggregate, has a relatively inelastic demand for dollars, this market feedback loop is much more muted for the U.S. than other countries. Thus, all else equal, the United States can pursue more aggressive policy measures than other countries that must worry about a resulting collapse in their currency.

Our advantage is further accentuated by what foreign countries do with all of these dollars once they acquire them. Eventually, all of these dollars used by foreign countries for trade wind up at their local central bank.

Global Macroeconomic Working Group

Stephen McCourt, Coordinator

Alan Spatrick

Frank Benham

Shane Enete

Ed Omata

Richard O'Neill

Edmund Walsh

The foreign central bank then has a choice – hold those dollars in cash and earn nothing, or invest them in dollar-based assets (usually U.S. Treasuries) and earn a return. Predictably, most choose the latter. Further, many governments actively "recycle" currency reserves into U.S. Treasuries to reduce the value of their local currency, thereby elevating the competitiveness of their home country export sector. This added demand for U.S. Treasuries pushes their prices up and their interest rates down, thereby lowering the cost of borrowing for the U.S. government. How big of an impact does this have? With a roughly $17 trillion debt, every basis point lower on U.S. Treasuries equates to a savings of $1.7 billion per year for the government.

Foreign demand for U.S. Treasuries not only lowers the borrowing costs for the U.S. government, but also lowers the benchmark rate for every other form of borrowing in this country (mortgage loans, auto loans, credit cards, etc.). That allows U.S. consumers to borrow and spend more than they otherwise would. In some ways this is a form of vendor financing where foreign countries lend their acquired dollars back to the U.S., so that we can continue to buy their products and keep the cycle going.

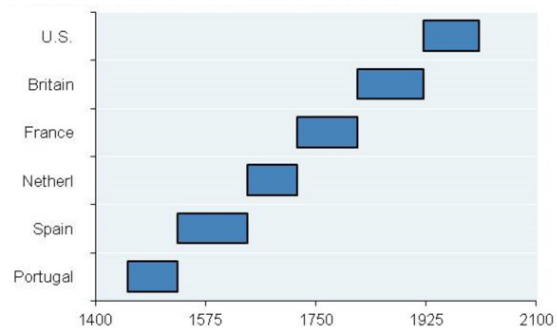
"The U.S. dollar is not the world's first reserve currency"

Taken for Granted?

While many Americans probably can't imagine a world without the U.S. dollar (and by extension, the United States) at the center of it, history tells us that reserve currencies come and go.

The U.S. dollar is not the world's first reserve currency, and most likely it will not be the last. What might cause the dollar to lose its current status? Political standoffs threatening default on U.S. debt certainly don't help. It's reasonable to think that each similar episode erodes a bit of the world's confidence in the dollar, even if default never actually happens. But even if the rest of the world does lose some confidence in the dollar, are there any realistic alternatives? The euro was supposed to be the latest challenger to dollar supremacy, but not long ago its very existence was being called into question. The Japanese yen is another possibility, but new Prime Minister Shinzo Abe has implemented drastic policies intended to, in part, drive down the value of the yen. Other currencies such as the British pound or the Canadian dollar have some inherent appeal, but do not have nearly the depth and liquidity in their financial markets to accommodate such a position.

Dominant World Reserve Currency by Year



Source: Hong Kong Monetary Authority

Perhaps the most intriguing challenge to the dollar will ultimately come from the Chinese yuan (or renminbi). China's rise over the past 20 years has been nothing short of spectacular, and they have done little to hide their ambition of playing an ever greater role on the world stage (financial and otherwise). Furthermore, as the largest single foreign holder of U.S. Treasuries (which represent a significant portion of their roughly $3.6 trillion in foreign currency reserves), they have often expressed dissatisfaction with U.S. monetary policy and its impact on their

Global Macroeconomic Working Group

Stephen McCourt, Coordinator

Alan Spatrick

Frank Benham

Shane Enete

Ed Omata

Richard O'Neill

Edmund Walsh

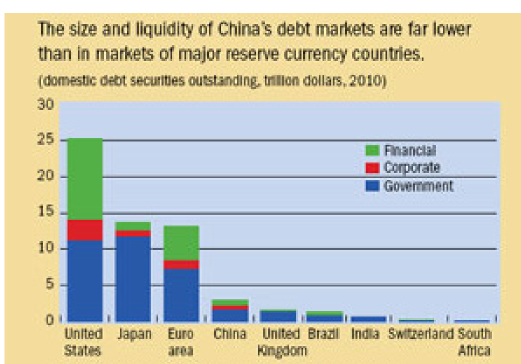
Easing Off on Dollars

Sources: People's Bank of China; U.S. Treasury; WSJ calculations
Note: Figures as of June each year

dollar-based holdings. So much so, that they have begun to diversify away from the dollar in recent years.

While it appears likely that China prefers an alternative to the current dollar-centric system, it is much less clear that they want the yuan to simply replace the dollar as the world's reserve currency. Largely, this is because the yuan is unable to fulfill the requirements of a reserve currency. The Chinese bond market is not nearly large enough to provide the liquidity needed for central banks to allocate reserves and to affect global trade. While the euro bloc and Japan arguably have bond markets of sufficient size to compete with the U.S.,

Behind the Biggest



Sources: Bank for International Settlements: and authors' calculations
Note: The chart above shows the amount of domestic debt outstanding by evidence and sector of issuer. Euro area data do not include Estonia

they presently have much more significant economic problems that prevent them from being viable alternatives.

Recent public comments from Chinese officials have been more geared towards establishing an alternative system that combines the world's largest currencies in some set proportion (i.e., diversifying away from a single currency dominated system). This, however, would require a level of international collaboration not seen since Bretton Woods.

There are a number of legitimate reasons that the rest of the world is unhappy with the current arrangement. As already discussed, the current system does provide the United States with some significant advantages. Furthermore, many countries would argue that the U.S. has not been the best steward of the world's reserve currency, particularly recently (debt ceiling debates, zero interest rate policy, quantitative easing, etc.) But the lack of a viable alternative is probably the biggest reason that there is little near-term risk to the dollar's reserve currency status.

The Burden

Understandably, most of the narrative surrounding the world's reserve currency focuses on its advantages. But there are some clear drawbacks as well. As described earlier, a constant demand for dollars from the rest of the world allows the U.S. to run a chronic current account deficit. Looked at differently, however, this same dynamic in some ways forces the U.S. to run a current account deficit. Because foreign countries need dollars to transact amongst themselves, a constant outflow of dollars from the United States (i.e., a current account deficit) is needed to facilitate global trade. Thus, while there are some negative consequences associated with continually running a current account deficit, the dollar's reserve currency status doesn't give us much of a choice.

Global Macroeconomic Working Group

Stephen McCourt, Coordinator

Alan Spatrick

Frank Benham

Shane Enete

Ed Omata

Richard O'Neill

Edmund Walsh

Foreign demand for dollars also has the effect of driving up the value of the dollar higher than it would otherwise be. Many countries (particularly emerging markets countries) accumulate huge sums of U.S. dollars as foreign currency reserves to promote stability within their financial systems. Some even have explicit policies of buying dollars and selling their own currencies as a means of keeping their currency values low. This reduces the cost of their exports to other countries, thereby increasing their competitiveness and promoting economic growth.

> "Ever-increasing debt can have severely negative consequences."

Of course, this has the opposite effect on dollar-based exports which become less competitive as their relative price rises. All else equal, declining competitiveness of U.S. exports would lead to declining corporate profitability, declining economic growth, and rising unemployment. One way to offset these negatives effects is to promote increased consumption. Ideally, rising consumption can be supported by rising incomes. If the required growth in consumption exceeds the growth in incomes, however, the gap is often filled by debt. This is the dilemma that the U.S. has faced in recent years as the provider of the world's reserve currency. In the context of a less competitive export sector, all else equal, rising U.S. consumption levels can only be maintained by taking on increasing amounts of debt from the rest of the world.

As many countries have learned the hard way, ever-increasing debt can have severely negative consequences. But a reserve currency country is effectively forced to choose between slow growth and rising unemployment (due to uncompetitive exports), or rising debt levels (in order to fuel consumption). Most countries when faced with this dilemma have chosen to increase debt and hope to push off their problems for another day. But rising debt can ultimately erode the world's confidence in a reserve currency (as doubts begin to grow that their debts will ever be repaid), and is one of the main reasons why reserve currencies don't last forever.

Conclusion

As of today, only the U.S. economy is large enough, open enough, and flexible enough to accommodate reserve currency status. That is unlikely to change any time soon. The world's reserve currency provides significant advantages, and has allowed the U.S. to avoid many of the balance of payments issues that have plagued a number of other countries. It has also allowed the U.S. to pursue aggressive policy measures to stimulate our economy without the fear of a collapsing dollar. But along with these benefits comes the burden of rising debt levels and overconsumption. Understanding this cost/benefit trade off of being the world's reserve currency helps one understand the United States' unique position within the world economy.