Perspectives

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The US dollar and its future as the global reference currency.

IHAG PRIVATBANK

One currency rules the roost.

Dear investor

When circumstances change, so too do the tools required to deal with them. Throughout history of mankind, means of payment have taken different forms, depending on the situation. A striking example is that of cigarettes in day-to-day prison life. But in other extraordinary situations too, such as military conflicts, smokable substances have served as currency.

For example, from various films about the war in Vietnam we know that cigarettes of the Marlboro brand – albeit not those with the logo shown on camera, which was only developed later – were used as means of payment between soldiers. However, it was actually cigarettes of the Lucky Strike brand that really established themselves as a form of currency for much of the conflict. The brand name was apparently a reference to the fact that some of the cigarettes actually contained marijuana, meaning that the fortunate recipient had truly stumbled on a "lucky strike". No doubt a welcome diversion for the soldier in question.

But while this marijuana story should be classified as an "urban myth", in the circumstances it nonetheless helped the brand to establish itself as an accepted means of payment between servicemen. Credibility and hope lent this brand acceptance and an additional level of value as an established means of payment – characteristics that can also be observed in the US dollar.

But just as the dominance of the "greenback" was only logical after two world wars and the rise of the United States as the world's leading economic power, so too is it only reasonable to question the future of this currency. Not only does the US government have record high levels of debt, to the point where it lost the prestigious AAA-rating for its bonds some years ago, its dominance as an economic power is increasingly being whittled away, with the rise of China in particular as the world's potentially largest economy threatening the pre-eminence of USD.

How did the US dollar become the world's dominant currency in the first place? How can it retain that position despite the obvious adversities it faces, and what will the future bring? These are the questions we intend to explore in this publication.

And by the way, the brand name Lucky Strike really does derive from a stroke of fortune. But in fact it refers to the era of the gold-digger, when a stumble across a major deposit was known as – a lucky strike. In its advertising the brand enjoys playing on the ambiguity of its name. In order to target women in particular, in the 1920s and 1930s the brand actively encouraged women to believe that consuming Lucky Strikes would help them to lose weight. Quite clearly, this marketing ploy hardly works as an explanation for the acceptance of the brand by the US military.

We wish you an enjoyable read.

Christoph Boner
Chief Investment Officer

Persistent pre-eminence despite erosion of value

Following the economic turmoil of the inter-war period, as the Second World War came to its end the hunt was on for a new currency order that would above all secure economic stability. In particular, economic policymakers were keen to prevent exchange rate fluctuations and spikes in inflation where possible going forward – not least to avoid the kind of social upheaval and dire political consequences that the world had experienced following the global economic crisis. To this end, a new currency system was established with the signing of the Bretton Woods agreement in 1944.

This defined the US dollar as the lead currency, offering inherent stability and protection against inflation by being linked to the price of gold. The other participating currencies were pegged to the dollar at fixed exchange rates and with defined fluctuation bandwidths.

The great drawback of fixed exchange rates is the absence of balancing mechanisms between different economic areas. If exchange rates cannot float freely, adjustments for different growth rates, different rates of inflation, and different rates of interest have to occur through other mechanisms. In the absence of such adjustment, tensions build up in such a system that can also be exploited by speculators.

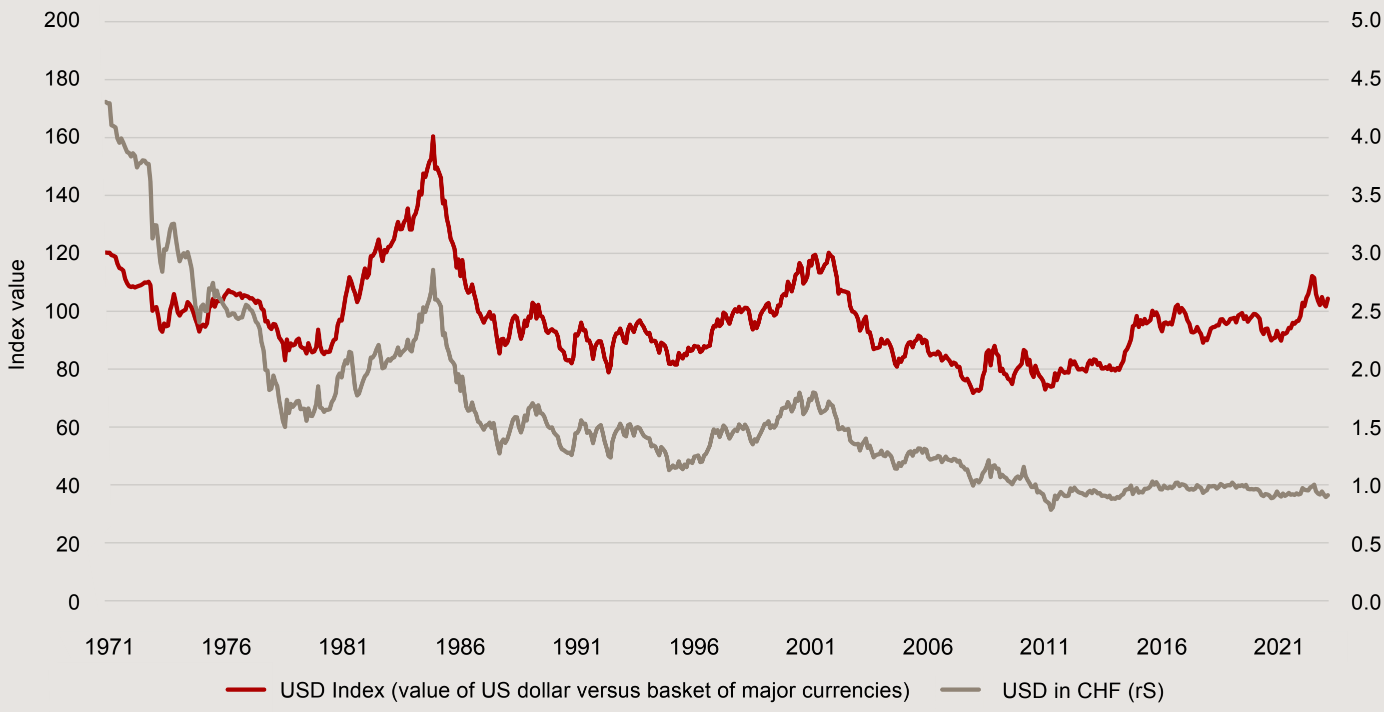
However, the real death knell to the post-war currency system was dealt during the Nixon era in 1971, when the coupling of gold to the US dollar at a specific level was suddenly abolished. This step came as a surprise, and sent shockwaves through the currency system, ultimately causing it to collapse. The reason for the sudden removal of the link to gold was the fact that global dollar reserves had already far exceeded existing US gold reserves in the 1960s, and unshackling the greenback from the price of gold was considered necessary to protect the US economy. As a consequence, the dollar lost more than 80% of its value. Despite these dislocations in the exchange rate system and the decoupling from the price of gold, the US currency retained its pre-eminence.

As the dollar had been the anchor currency of the Bretton Woods system by definition, and the various central banks derived a direct benefit from holding their currency reserves in USD, the proportion of global currency reserves accounted for by the dollar remained high in subsequent years too. While over 75% of global central bank reserves took the form of USD back in 1970, this share still stands at more than 50% even today. The next most important currencies by this metric are EUR (just over 20%) and JPY (slightly more than 5%).

Similarly, more than 50% of global financial transactions are executed in US dollars. The euro is the second most important currency in this respect with a share of 25%, while what was once the world's key currency – the British pound – still accounts for some 10% of transactions.

The Swiss franc also formed part of the Bretton Woods exchange rate system. Just before its collapse, this currency was fixed at an exchange rate of 4.375 to the US dollar. But with the end of pegged exchange rates, the Swiss franc appreciated steadily against the dollar, achieving parity for the first time in March 2008, when one franc was worth one dollar. The world's second most important currency of the modern era was born in 1999 with the creation of the euro. Despite the flawed way in which the European single currency was constructed, which saw it come under significant pressure at certain times, USD has also lost ground to EUR overall since the latter's inception.

Development of the US dollar



In addition to the historical dimension and its function as a global reserve currency, the dominance of the US dollar is also partly explained by the economic might of the world's largest currency-integrated economic region. In terms of value creation, the USA remains the world's largest economic area with a global share of over 24%, followed by China with around 18%. In terms of global stock market capitalisation, the US is even further ahead of the field, with a share of more than 50%. Furthermore, key commodities such as oil are exclusively traded in dollars, which strengthens the pre-eminence of this currency – as does its widespread use in the world of illegal trading.

373%

The percentage by which the Swiss franc has appreciated against the US dollar since the end of the fixed exchange rate system in 1971.

6,471 bn USD

The total volume of central bank reserves held in USD as at the end of 2022. This equates to 54% of all global currency reserves.

The only reference currency – for a lack of alternatives

The possibility of the US dollar losing its pre-eminence in the foreseeable future has been raised time and again, and not just by commentators who are critical of the US. There are actually a number of factors that could call the dominance of the greenback into question:

Development of economic regions

Whereas the US economy contributed almost 40% to global value creation back in 1960, that share has now fallen to below 25%. In particular, the rise of China and the foreseeable end to the economic supremacy of the US could raise further questions over the logic of having USD as the global reference currency.

US government finances

By downgrading the credit rating of the US government in 2011, ratings agency Standard and Poor's sent out a clear signal. Unlike countries such as Germany, Canada and Switzerland, the USA no longer boasts a perfect credit rating, which is above all attributable to the development of public finances stateside. The extent to which the currency issued by this sovereign borrower should remain a global anchor is therefore a reasonable question to ask.

Multipolarisation of the global order

With the rise of other global regions and the relative loss of significance of the USA, the position of USD too is increasingly under scrutiny. These doubts are compounded by the fact that the USA repeatedly uses its currency as a trade weapon for sanctions and to apply other forms of pressure outside of its own territory.

Bretton Woods (USA): 44 countries signed the agreement here in 1944.

But even if the above points are undisputed, and could give the impression that the US dollar is on the verge of losing its pre-eminence, there is one key counterargument – there are no obvious alternatives.

The next-largest economy's currency, the Chinese renminbi, is used for just 3% of global transactions. Although its use as a reserve currency has risen, it is still languishing at less than 3%.

Even the euro, which was partly deemed to have the potential to end the pre-eminence of the US dollar, has lost some of its significance in recent years, although its current share of global currency reserves is still around 20%.

The Chinese renminbi is the only realistic alternative to the US dollar as a global reference currency. But in terms of importance, it still lags well behind USD, and the fact that China's capital markets remain largely closed is hardly conducive to its rise as a replacement, quite aside from political and ideological differences and other fundamental reservations. For the foreseeable future, the greenback will remain top dog.

Ultimately, only the Chinese renminbi can be considered a viable alternative to the dollar as the global reference currency.

But given the ideological and political differences, and the way the world's capital markets are organised, it is unlikely to replace USD as the world's most important currency in the foreseeable future.

Confidence in a currency is the key factor.

Christoph Boner
Chief Investment Officer

What makes a currency a currency in the first place?
A currency is a means of payment. And a means of payment is simply a transferable, standardised repository of value that can be used to pay for goods and services. Currencies are typically issued by a state-regulated issuer. Due to the fact that its acceptance is similarly enshrined in law, a currency's value as a means of payment is guaranteed, even if it does not have to have any intrinsic value (other than the material it is made of). In the past, currencies were often coupled to the price of gold in order to ensure their value-retaining ability and strengthen trust in the monetary system. However, modern monetary systems for the most part function without any such link to a precious metal.

Why is the US dollar considered a reference currency in the international context?
There are various reasons for the dollar's relevance at a global level. For one thing, the USA is the world's largest economic area with a homogeneous currency. Both the liquidity and the stability of the greenback are further reasons why many central banks hold currency reserves that (may) arise from managing their own currency in USD.

In addition, the sheer size of the US economy makes the dollar the most important currency in international trading. In particular, many commodities – such as oil, for example – are predominantly traded in USD.

How did the dollar become the world's dominant currency?
The historic relevance of the US dollar dates back to the creation of the Bretton Woods system. This system, which was based on fixed exchange rates, was set up in 1944 with the aim of creating a stable international economic order. This saw the currencies of all participating nations pegged to the dollar, which in turn was coupled to the price of gold. Even after the collapse of the system in the 1970s and the uncoupling of USD from the price of gold, the dollar remained the pre-eminent currency in the international currency system.

Why is the pre-eminence of the US dollar under threat?
Once the link to the price of gold is severed, the confidence of economic protagonists in a currency becomes a key factor. In this respect, the organisation of the currency system – e.g. the organisation of central banks and the general political stability of a country – become crucially important. Other relevant factors include the economic strength of the corresponding currency area, the perceived power of a currency, and the public debt situation of the state in question.

The relative importance of currencies has changed over time. At the beginning of the 20th century, for example, the British pound was the key global currency. Although another relevant currency emerged with the creation of the single European currency (the euro), the renminbi could likewise grow in significance due to China's powerful economic growth.

What determines the value of a currency?

In the absence of any link to a real asset such as gold, the value of a currency is driven by supply and demand. The supply side is determined by the dedicated (state) issuing body in question, while demand is above all determined by economic activity in a currency. If the relationship of supply and demand gets out of kilter, this gives rise to inflation (the currency depreciates) or deflation (the currency appreciates). The key interest rate, which is determined by central banks as the issuers of money, plays an important role in determining the supply of (and demand for) money, and is thus used as a means of managing the money supply. Taking into account the velocity of money, i.e. the speed at which money changes hands, the money supply needs to be in constant proportion to the goods and services produced by a country if it is to retain its value stability.

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