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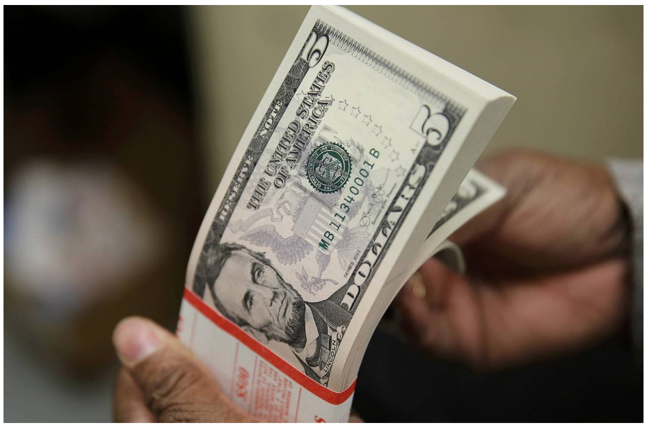
MARKETS | STREETWISE

Imagining a Dystopia of the Dying Dollar

But alternatives to the greenback are hard to identify



A packet of former U.S. President Abraham Lincoln five-dollar bill currency being inspected at the Bureau of Engraving and Printing in Washington in March, 2015. *PHOTO: REUTERS*

By

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In a dystopian vision of the future published earlier this year, novelist Lionel Shriver portrayed a U.S. plunged deep into depression after an incompetent U.S. president triggered a trade war and the world stopped using the dollar.

"The Mandibles: A Family, 2029-2047" is set 13 years hence; could the real-life new president bring forward the day the dollar loses its reserve-currency status?

The markets aren't worried. The dollar has soared since Donald Trump was elected, with the ICE U.S. Dollar Index showing the greenback up 4% against a basket of developed-market currencies, and far bigger gains against emerging markets.

Yet, Mr. Trump's policies and past comments could, if followed through, make the U.S. a less attractive place to park money. If foreigners start to doubt that they will be repaid in full, they may pare back their reliance on U.S. Treasurys in foreign-exchange reserves, forcing the government to pay more to borrow and weakening the currency. A shift to a more populist style of leadership could also threaten the rule of law, which is craved by international investors.

At the very least debt seems certain to rise as taxes are cut and infrastructure spending goes up, adding to what is already a gross debt the International Monetary Fund says hit 105% of gross domestic product last year.

Mr. Trump hinted at extreme options during the election campaign, saying he could "make a deal" to lower debt costs, and later saying the U.S. had "a lot of power" over China because it owed the country so much. In both cases he denied default was an option, but without the threat of default there is no reason for creditors to accept less than full repayment.

Stephen King, senior economic adviser at HSBC, points out that the dollar's reserve status suffered after President Richard Nixon reneged on the promise to redeem dollars for gold at $35 an ounce.

"All those foreigners who had bought the dollar thinking it was as good as gold discovered that it wasn't," he said.

However, a few years later the dollar had recovered and cemented its position as the foremost reserve currency. Today is far ahead of the euro, yen, sterling and the nascent yuan in foreign-exchange reserve holdings and as the currency of trade.

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> —Ed Parker, head of Europe, Middle East and Africa sovereigns at Fitch Ratings

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The result is that the dollar has what Valéry Giscard d'Estaing, former French finance minister and later president, called the "exorbitant privilege" of printing money the rest of the world buys. Dollars held abroad for foreign-exchange reserves and to support dollar-based trade generate $10 billion a year for the U.S., the McKinsey Global Institute estimated in 2009. Lower bond yields due to the extra demand for Treasurys from foreigners is worth another $90 billion a year—although against this, reserve currencies go up in a crisis, hurting exports.

The threat to the dollar is explicit. Ed Parker, head of Europe, Middle East and Africa sovereigns at Fitch Ratings, says any loss of reserve status would threaten the U.S.'s top credit rating, which it holds despite its heavy debt load. "We believe the U.S. has exceptional debt tolerance because of the dollar's role in the world financial system," he said, as well as the depth of its markets. "It's difficult to see it losing that role but over time it can be diminished."

There is a good reason why the market can ignore the threats to the dollar, though: the lack of anything better, at least for now. Eswar Prasad, professor of trade policy at Cornell University and former chief of the IMF's financial studies division, says the U.S. is the only market able to absorb foreign-exchange reserves on the scale needed.

"The harsh reality is that there really isn't anywhere else to turn," he said. "A few billions, you can go into the euro, yen, gold. But when you start talking about hundreds of billions of dollars there really isn't anywhere else to go."

China is often highlighted as the coming alternative to the dollar, but for the moment at least it isn't an option for large amounts of reserves, thanks to chaotic markets, patchy rule of law and the risk of instability within its one-party state.

The biggest long-term danger to the dollar might come from the U.S. pulling back from its role as world policeman. Sterling's decline as the global currency of choice set in after the catastrophic losses Britain suffered in the World War I, sealed by the loss of empire after the World War II.

"If Trump is symptomatic of a broader sense of decline for the U.S. then that ultimately should be reflected in a gradual loss of reserve status for the dollar," Mr. King said. "But that's a decade story, not a Trump [term of office] story."

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In The Mandibles the dollar loses out when the rest of the world gangs up on America and creates its own reserve currency run by a reconstituted IMF. Jim Rickards, former general counsel for collapsed hedge fund Long-Term Capital Management and now an author, thinks the IMF's existing special drawing rights will be the dollar's replacement. SDRs are valued against a basket of major currencies, including the yuan since October, and issued by the IMF to its members as a reserve asset.

“The forces that would damage or destroy the dollar’s reserve currency status have nothing to do with Trump,” he said. In The Road To Ruin, published this month, he argues that in the next crash it will be SDRs, not dollars, that are relied on to rescue the financial system.

For the moment such apocalyptic scenarios remain the stuff of fiction. If anything, the world is suffering from a shortage of dollars, with one measure of Japan’s demand for dollars, the cross-currency basis swap, this week reaching the most extreme ever.

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