

GLOBAL Insight



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Special report

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It's been a privilege

The dollar's role in the global economy is evolving, and its "exorbitant privilege" looks to be as well. We examine the greenback's role as the reserve currency and the implications of the world's changing currency appetites.

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Special report



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It's been a privilege

The U.S. dollar has been the preeminent reserve currency for over 75 years, facilitating international trade and financial transactions while also providing stability during economic crises. Today, the dollar's role in the global economy is evolving, and its "exorbitant privilege" looks to be as well. We examine the greenback's role as the reserve currency and the implications of the world's changing currency appetites.

- **The dollar's reserve status may not be as important to the U.S. economy as is often assumed.**
- **Issuers of reserve currencies face fiscal and trade headwinds that are problematic for the U.S.**
- **We think reserve holders are likely to slowly diversify into other currencies, helping reduce the risks of the transition.**

"An exorbitant privilege" is how former French President Valéry Giscard d'Estaing once referred to the U.S. government's ability to issue the global reserve currency.

And there's no question—in our minds—that the dollar's role as the world's savings vehicle contributed to U.S. economic success in the last 75 years. But currency leadership has less helpful consequences as well, including fiscal and trade imbalances. With the dollar's role in the global economy evolving—and in our view likely declining—we think this is an opportune moment for investors to consider what comes next and how changing currency appetites are likely to impact the global economy.

Contrary to popular wisdom, we believe there's a strong case to be made that the exorbitant privilege of reserve status is now a net liability for the U.S. and that a shift to a more balanced global currency reserve basket is likely a more stable framework for global economic activity. At the same time, a potential declining role for the dollar represents the weakening of another global unifying force, with likely negative implications for U.S. leadership and possibly global political stability.

The good

Currency reserves are simply an economist's way of describing how a nation chooses to store its savings. Countries save for many reasons, but their primary goal is to secure access to food, fuel, and other critical inputs in the event of a domestic economic crisis. Countries could choose to save these materials directly—like the U.S. does with its strategic petroleum reserve—but that requires significant storage and defense costs. Most countries instead hold a basket of foreign currencies, relying on their ability to trade those holdings for needed goods and services. Since World War II, the majority of world savings has been held in U.S. dollars; the greenback's current share of global saving is roughly 60 percent.

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This reliance on the U.S. currency for savings has two main implications.

First, countries that hold dollars want to make sure that trade continues to be denominated in dollars. They've bought into the ecosystem, and if trade starts shifting over to rubles or euros or yuan, then their dollar savings may not be helpful in a crisis. A country could try to switch to a different currency, but that's an expensive—and risky—move: make the wrong choice or move too soon and your country could be locked out of vital markets. It's much easier to perpetuate the current system and support the dollar as the trade vehicle.

For the U.S., having the dominant currency involved in global trade matters. The theoretical benefit is that it eliminates the risk that the U.S. cannot buy needed inputs. That's nice, but given the size of the U.S. economy, not a lot of folks were losing sleep over that risk. The real benefit of the dollar's role in trade, in our view, is that small and midsize U.S. companies have a much easier time expanding into export markets. Hedging currency risk is complicated and often involves a tradeoff between protecting margin and satisfying customers. A U.S.-based exporter selling in dollars avoids those costs and headaches, making it easier for firms to begin exporting earlier in their corporate development.

The other main benefit to having the reserve currency is that it helps keep government borrowing costs down. Once foreigners have acquired dollars, they need a low-risk, easily accessible way to hold them, and that tends to mean owning U.S. Treasury bonds. This demand for government securities has helped reduce long-term borrowing costs, giving a financial boost to the U.S.

Not all sunshine

But not all the consequences of being the source of the world's reserve currency are positive.

To begin with, there's the basic issue of how foreigners can acquire dollars. There are only three ways:

- They can be given them, through financial aid;
- They can borrow them, typically by having central banks exchange blocks of their respective currency in a so-called “currency swap” arrangement;
- Or they can earn dollars through a trade surplus.

Since countries tend to grow their reserves over time, the U.S. effectively needs to run a persistent trade deficit if it wants the dollar to retain its share of reserves. The only alternative means of providing dollars to foreign savers is through large amounts of financial aid, potentially to strategic rivals, or by having the U.S. Federal Reserve run an extremely complicated and potentially risky book of multicurrency swap lines globally. Both alternatives are political and economic nonstarters, in our view, so the U.S. can choose between a trade deficit or a diminishing percentage of global reserves in the long run. It's not a coincidence that the U.S. has run trade deficits for decades.

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Once foreigners have acquired dollars, they need a place to store them, and that usually means Treasury bonds. The flipside of being the reserve currency and borrowing cheaply is that a country must issue enough debt to keep up with reserve holder demand. A key reason why countries have shied away from euro reserves, in our view, is the lack of truly eurozone-wide debt and the insufficiency of German and other perceived low-risk sovereign bonds. The recent push by Germany to expand issuance to fund defense spending could help increase the attractiveness of the euro as a reserve currency, in our view.

Certainly, U.S. fiscal deficits go well beyond what is required for foreign reserve growth, but even if the U.S. federal government shifted toward a more balanced budget, a persistent budget surplus is problematic for a reserve currency issuer.

Too expensive?

When the U.S. began running persistent fiscal deficits in the 1980s, the stock of federal debt outstanding was around 30 percent of GDP. Today, existing debt is closer to 120 percent of GDP. The numbers for trade are directionally similar, although to a lesser degree.

Separating out the impact of currency reserve status on debt accumulation and trade levels is beyond art versus science. There are simply too many variables moving simultaneously to reach robust conclusions.

We think it's fair to say, however, that a reasonable person could conclude that the marginal cost of additional debt accumulation is higher at 120 percent of GDP than 30 percent of GDP, and that expanding U.S. trade deficits from their current levels will likely exacerbate domestic economic and political concerns. In short, the longer the U.S. runs these imbalances, the greater the costs become.

The benefits of reserve currency status, arguably, have not kept pace.

What comes next?

So far, we've been discussing the dollar's reserve currency role and its implications for the U.S., but the issue is, of course, global in nature. For nations accumulating reserves, we see a real possibility that tariffs and their impact on international trade prove to be the driver for rethinking reserve strategy.

As we've discussed elsewhere, we think the Trump administration's tariff policies are designed to exploit foreign nations' reliance on American consumption. It's an incredibly powerful lever, in our view, for the U.S., and by extension it's a key strategic liability for both allies and rivals. While the Trump tariffs are the most immediate and explicit reminder of other countries' economic dependence on the U.S., there's a long history of Washington using unilateral economic sanctions and freezing dollar assets. This has generated significant international pushback and resentment, primarily from organizations like the BRICS, a multilateral group founded by Brazil, Russia, India, China, and South Africa.

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Given the U.S.'s increasing willingness to flex its economic might, we would be surprised if countries did not seek to better balance their own internal supply and demand, reducing reliance on the U.S. consumer. The shift away from international trade is likely to lead to slower global growth as the efficiencies from trade are lost. This is a dynamic that has been going on for years, as we've previously discussed in our ["Worlds apart" series](#), but we believe tariff threats are likely to accelerate the shift.

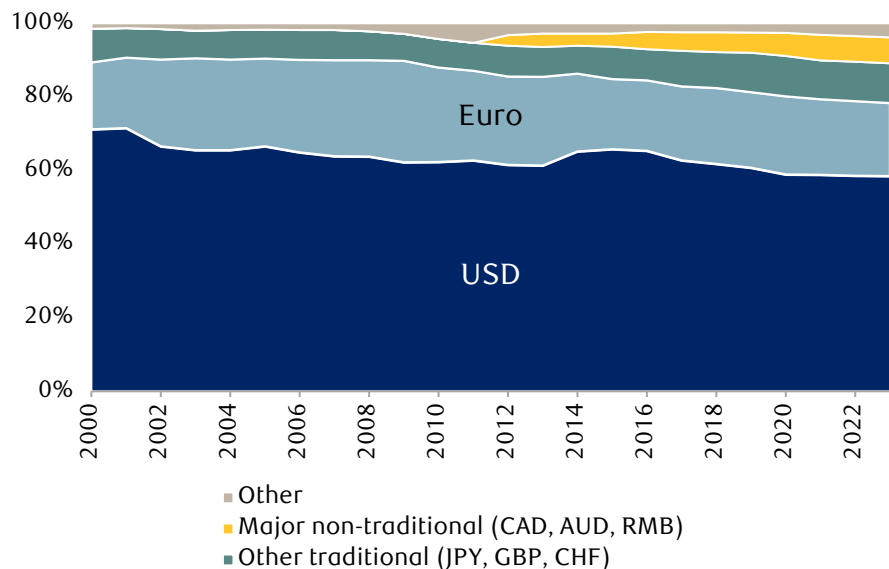
Countries tend to base their reserve balances on the value of their imports, so if countries shift away from trade and toward more of a balanced domestic economy, they will likely find themselves with excess reserves.

Our expectation is that most countries would maintain current reserve levels. This would essentially allow them to "grow into" their current stock of savings versus aggressively drawing down reserve totals to match a reduced import bill. The reason for our view is simple—drawing down reserves is a risky move, and central bankers by their nature tend to be risk averse.

Once nations re-enter a phase of reserve accumulation, we would expect them to add to their savings with a focus on non-dollar currencies. This is exactly the behavior we've seen since the turn of the century.

Emerging currencies fill the space created by the U.S. dollar's declining role in global reserves

Share of global currency reserves



Source - RBC Wealth Management, International Monetary Fund

The risk that a country would move to immediately shift its currency composition—essentially sell Treasuries and dollars and buy euros or yen—is mainly theoretical. No other currency offers sufficient high quality, stable value, liquid investment alternatives to act as a dollar replacement. Unless or until that changes, the practical choice, in our view, is dollar savings or lower savings.

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If this interpretation proves correct, the short-term outcome is nearly ideal for the U.S. Investing nations would continue to roll over their Treasury holdings and dollar-based international trade would remain the norm. Some degree of regional trade would likely migrate to a different currency, but if most countries continue to hold Treasuries, the incentive to trade in U.S. dollars remains.

Longer term, the U.S. would no longer enjoy its exorbitant privileges, but it would also not face the inherent need to provide both dollars and debt to the world. Less helpfully, a world that is less dependent on the U.S. consumer is also less invested in the health of the U.S. economy. Historically, foreign nations have not had much reason to push hard during economic negotiations with the U.S.; after all, for most of the world a healthy U.S. economy was key for their domestic economies' production and profits. From our vantage point, if and when countries shift toward regional trade partners and their own domestic buyers, all sorts of bilateral discussions look less cooperative and more like a zero-sum game.

Bretton Woods, Bancor, and beyond

The idea that the existence of a single reserve currency can create global imbalances is nothing new. John Maynard Keynes is perhaps best known for his statement that “in the long run, we're all dead,” but he also was one of the first to identify the inherent instability of a single currency acting as the global reserve. He made a push at the Bretton Woods Conference in the 1940s to base international trade on a global unit of account called the Bancor, rather than the U.S. dollar.

The idea was to have all trade settled in Bancors and run through an international clearing union. Countries that ran either a Bancor surplus or a deficit would be charged a penalty rate on the imbalance. This would provide incentives for trade to remain largely balanced. The idea has been refloated on occasion, most notably following the global financial crisis, but it has failed to be adopted largely because, in our view, countries have been unwilling to cede that degree of control to an international body. While we think the idea of a global unit of account has significant merit, we see the geopolitical barriers as nearly insurmountable.

Instead of a radical transformation, we believe currency reserves are likely to go through an evolutionary process. Falling trade will lead to slower global growth and declining reserve needs, but the reduction will likely be done passively. Some countries may choose to rebalance part of their holdings away from the dollar, but the lack of “safe” investment options for non-dollar currencies will act as a constraint, in our opinion.

While any shift away from dollar reserves is likely to be presented as a negative for the U.S. economy, we are not convinced the facts support that interpretation. Instead, we think we've reached the point Keynes foresaw, where the fiscal and trade implications of issuing the reserve currency outweigh the rather limited benefits of reserve status.

In other words, we believe that in the long run Keynes may be dead, but he's still got a point.

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			Count	Percent
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