Confluence INVESTMENT MANAGEMENT

Weekly Geopolitical Report
By Bill O'Grady

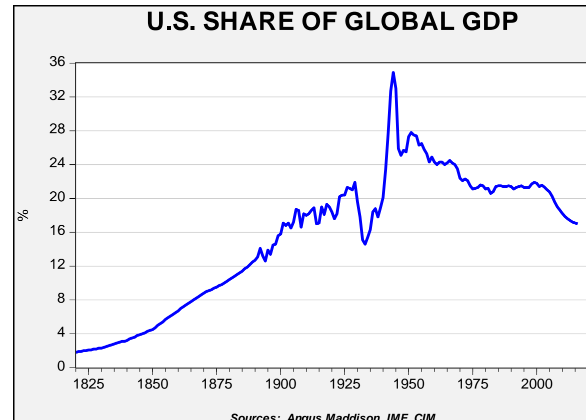
October 31, 2016

The Geopolitics of the Reserve Currency: Part 2

In Part 1 of this report, we discussed how the reserve currency facilitates trade, provided a short history of the dollar's evolution as the reserve currency and examined the theoretical backdrop of the reserve currency and its role as a global public good.

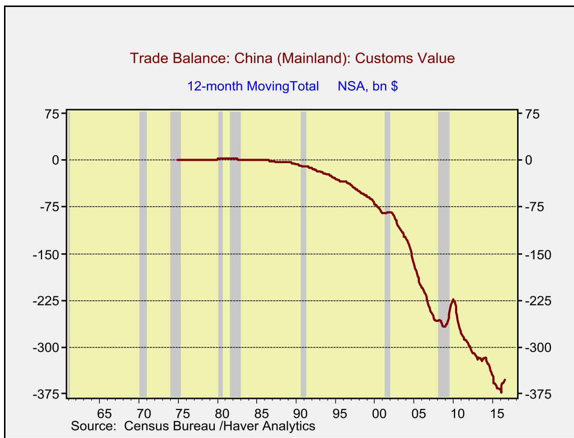
In this week's report, we will conclude with the economics and geopolitics of the reserve currency and discuss potential market ramifications.

The Economics of the Reserve Currency
When the U.S. accepted the reserve currency role in 1944, the U.S. economy dwarfed the rest of the world. However, the relative size of the American economy has declined, in part due to the success of U.S. policy in rebuilding the free world after WWII. This situation accelerated with the development of China. On a purchasing power parity basis, the U.S. is currently the second largest economy in the world, with China being the largest.



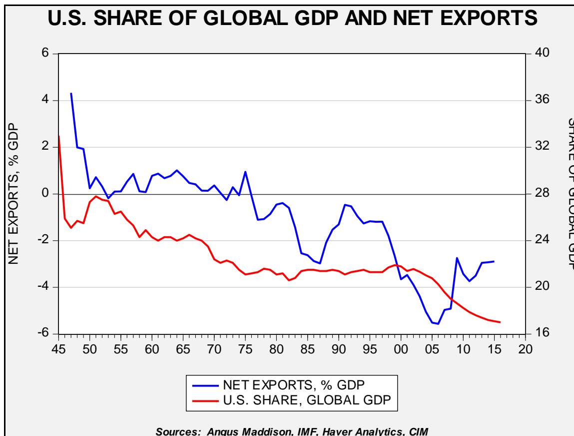
This chart shows the share of U.S. GDP from 1820 to 2015. Note how the American share has declined since 2000, coinciding with the rise of China.

Like virtually all nations since WWII that have moved from developing to developed nation status, China has done so through export promotion. This program of development has been the most successful model in the postwar era, but a critical requirement for success is an importer of last resort. Unless some nation is willing to absorb the expanding economy's exports, the export promotion model will fail to work. This chart shows the U.S. trade deficit with China on a rolling 12-month basis. Since 1990, the deficit has increased at a steady pace. It did recover during the 2008 financial crisis but has since resumed its downtrend.



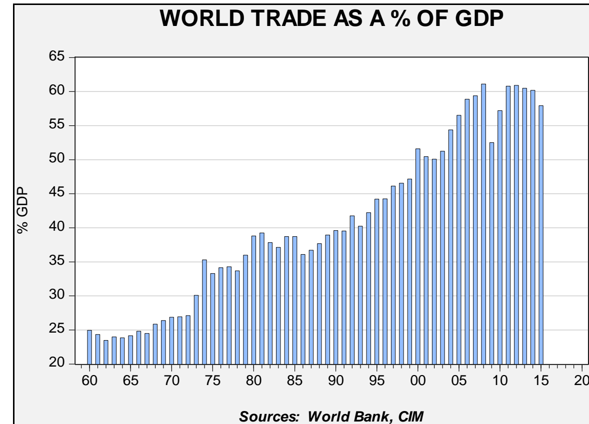
China's rapid economic development since 1978 would have been impossible without U.S. openness to purchasing Chinese exports.

Until the early 1980s, the U.S. economy was large enough to absorb the world's imports without significant current account deficits. However, the rise of the dollar during the Volcker Fed era led to growing trade deficits. This became exacerbated as the relative size of the U.S. economy fell.



This chart shows the U.S. share of global GDP along with net exports as a percentage of GDP, a national accounts measure of trade. Note that the trade account worsened as the U.S. share of GDP declined into the turn of the century. Even the advent of shale oil, which reduced the level of American oil dependence, has not led to trade surplus.

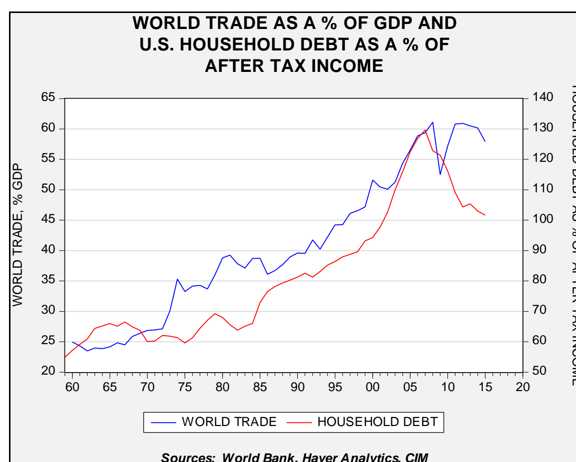
Another way of displaying the issue of the reserve currency is through the growth of world trade.



This chart shows total imports and exports as a percentage of GDP. Not only did the decline in the relative size of the U.S. economy play a role, but more nations appeared to be using export promotion as a development model. As global trade expanded, the need for the reserve currency to transact this trade rose as well. The U.S. was required to run persistent trade deficits to support global trade.

The issue of providing the reserve currency faced an additional complication due to U.S. economic conditions. Steadily rising inflation, from 1965 to 1980, was partly due to a set of policies designed to promote equality at the cost of efficiency. The U.S. economy was heavily regulated during this period and the inefficiencies caused by this regulation supported rising price levels. President Carter began the process of deregulating the economy and President Reagan expanded it. Deregulation and globalization did make the economy more efficient but at the cost of greater inequality, which led to less income being available to the majority of Americans.

Although this policy was clearly successful in lowering inflation, the resulting inequality undermined another U.S. policy goal—providing the reserve currency. The U.S. still had to act as importer of last resort and meeting the demand of the reserve currency became difficult with the global share of trade rising and the U.S. economy declining in relative scale. The response from policymakers and the economy was to lift household debt.



This chart overlays world trade as a percentage of GDP with U.S. household debt as a percentage of after-tax income. Note the two series have risen in tandem. Also note that household debt began to rise at an increasing pace in the 1980s, in part due to the deregulation of financial services and in part due to rising income inequality. Less affluent households began to take on more debt to maintain their spending which could no longer be sustained from income alone. Although domestic pressures called for weaker consumption, the reserve currency requirement led to rising consumption. ***Simply put, the high level of consumer debt wasn't due to Americans' spendthrift habits; it was due to the reserve currency status of the dollar.*** It is worth noting that global trade growth has stalled as U.S. households have deleveraged.

The Geopolitical Issues

In perusing the seven characteristics of a reserve currency nation, it is possible some of those roles could be adopted by a group of countries. Policy coordination could be done within the G-20. It might be possible to employ the IMF to act as a lender of last resort and provide counter-cyclical, long-term lending. It might even be possible for the IMF or the G-20 to support a stable system of exchange rates.

However, it isn't obvious how a group of nations could act as consumer of last resort. The reserve currency nation gets to enjoy the benefits of consuming imports without having to pay for them with its own imports. However, the downside is that the reserve currency nation must remain open to trade and be willing to sacrifice domestic industries to provide the reserve currency. Over the years, the U.S. has given up the shoe, textile, furniture, a significant part of the automobile industry and the low-cost consumer electronics industries. There is little evidence to suggest any nation other than the United States will play that role. And, as the recent political season in the U.S. has shown, there is a profound backlash against this cost. It may not be directly expressed in this manner, but the growing opposition to globalization in America is, in effect, a rejection of the dollar's reserve currency status.

If the dollar is going to lose its reserve currency status, what will be the outcomes? There are five possibilities.

- First, we could see an attempt to replace the public goods offered by the reserve currency nation with those from an international body, such as the G-20 or the IMF. However, as stated previously, this will only work with some of these global public goods and even providing a few public goods will require a high

degree of coordination. This level of cooperation is unlikely.

- Second, another nation could take over the reserve currency role, similar to how the U.S. took over that function from Britain. Sadly, this looks unlikely as well. Although the euro could be a replacement, three major problems exist which will prevent that outcome. First, the Eurozone does not issue its own debt; instead, individual nations issue debt denominated in the European currency. This means that there really isn't a Eurozone-wide, risk-free instrument that is issued by the Eurozone itself. The only safe sovereigns that exist are from individual nations. This factor limits the availability of financial assets and their safety is more of an individual nation issue, rather than a Eurozone one. Second, there is little evidence the Eurozone is willing to sacrifice industries for reserve currency status. Third, Germany, the most significant economy in the Eurozone, is an export-promoting economy and won't even take steps to boost imports within the Eurozone to boost the periphery nations within the single currency. Accepting persistent trade deficits would be a historic change in German economic policy. Meanwhile, China's currency is not fully integrated into the global financial markets and the Chinese financial system is too immature to provide enough financial products to serve in this role. Other emerging nations, while growing fast, do not have the advanced financial systems required to take over the role of a reserve currency.

- Third, the IMF could take on the role of a global central bank. John Maynard Keynes argued for the creation of a global currency at Bretton Woods (the 'bancor') that would avoid the problems inherent in having a nation provide the reserve currency. However, having a global central bank would require all nations to give up one of the key elements of sovereignty, the control of one's money. It is hard to see how governments would be willing to give up monetary control to an international body.

- Fourth, the world could opt for a return to the gold standard or a similar type of crypto-currency (e.g., bitcoin). However, historical evidence suggests that support for the gold standard is strongest when suffrage is restricted to creditors.[1] When the vote is expanded, the ability of governments to remain in a restricted currency system is lessened. Thus, this option is probably unlikely.

- Fourth, the nations of the world can simply abandon globalization and opt for regional constructs. This might mean an Asian currency group dominated by Japan or China, a Eurozone-dominated group, a South American group dominated by Brazil, and a North American group run by the United States. There would be trade within these blocs but little trade outside of them. Global trade would be settled in gold or other commodities between blocs. This outcome would likely lead to the steady erosion of globalization.

- Fifth, the U.S. could remain the reserve currency but curtail the role it plays. In other words, it could selectively apply trade barriers against nations it feels are taking advantage of America's openness

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[1] Simmons, B. (1994). *Who Adjusts? Domestic Sources of Foreign Economic Policy during the Interwar Years*. Princeton, NJ: Princeton University Press (Chapter 2).

to trade and make export promotion a less attractive model of development. This outcome would be quite detrimental to emerging economies. In addition, this shift would steadily undermine globalization and eventually devolve into option #4.

Overall, we would not expect the world to abandon the dollar as the reserve currency anytime soon. However, the political pressure to back away from globalization, especially in the U.S., is increasing and one of the key factors behind globalization is the existence of a reserve currency. If the dollar begins to lose its status as a reserve currency, there is no immediate viable alternative.

Ramifications

A world without a reliable reserve currency is one that will see deglobalization. Thus, assets that perform better in a globalized environment will tend to suffer. These include foreign equities, especially emerging markets, which would suffer from the loss of unfettered access to the U.S. consumer. Large cap stocks, which are more globally integrated, would likely underperform small and mid-cap stocks. Although the scarcity value would likely drive the dollar higher, commodities would probably still perform well as concerns over the security of supply would overwhelm the rising dollar's impact on demand.

We want to reiterate that the dollar will likely remain the global reserve currency for the foreseeable future. Thus, portfolio adjustments for this issue are not required in the near term. However, we believe the reserve currency is one of those mostly misunderstood and underappreciated elements of globalization and the risks are growing for a political movement to undermine the dollar's reserve currency role. The reserve currency is one of the pillars of American hegemony. If it is lost, it will be more difficult for the U.S. to project power and maintain global peace.

At the same time, it should be recognized that the policies that support the reserve currency carry burdens that have been disproportionately shared. U.S. political leadership needs to address these concerns; whether they can meet these issues and maintain the dollar's reserve role remains to be seen. Thus, we will continue to monitor these trends going forward.

Bill O'Grady
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