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AEP: Dollar hegemony endures as share of global transactions keeps rising

The world has never before been so dependent on the dollar and the US Federal Reserve

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The US dollar is tightening its grip on the global financial system at the expense of the euro, entrenching American hegemony and rendering the US Federal Reserve more powerful than at any time in history.

Newly-released data from the Bank for International Settlements (BIS) show that the dollar's share of the $5.1 trillion in foreign exchange trades each day has continued rising to 87.6pc of all transactions.

It is the latest evidence confirming the extraordinary resilience of the dollar-based international order, confounding expectations of US financial decline a decade ago.

Roughly 60pc of the global economy is either in the dollar zone or closely tied to it through currency pegs or 'dirty floats', and the level of debt issued in dollars outside US jurisdiction has soared to $9 trillion.

This has profound implications for monetary policy. The Fed has become the world's central bank whether it likes it or not, setting borrowing costs for much of the global system.

The BIS data shows that the volume of transactions in which the euro was on one side of the trade has slipped to 31.3pc from 37pc in 2007. The dollar share has ratcheted up to 87.6pc over the same period.

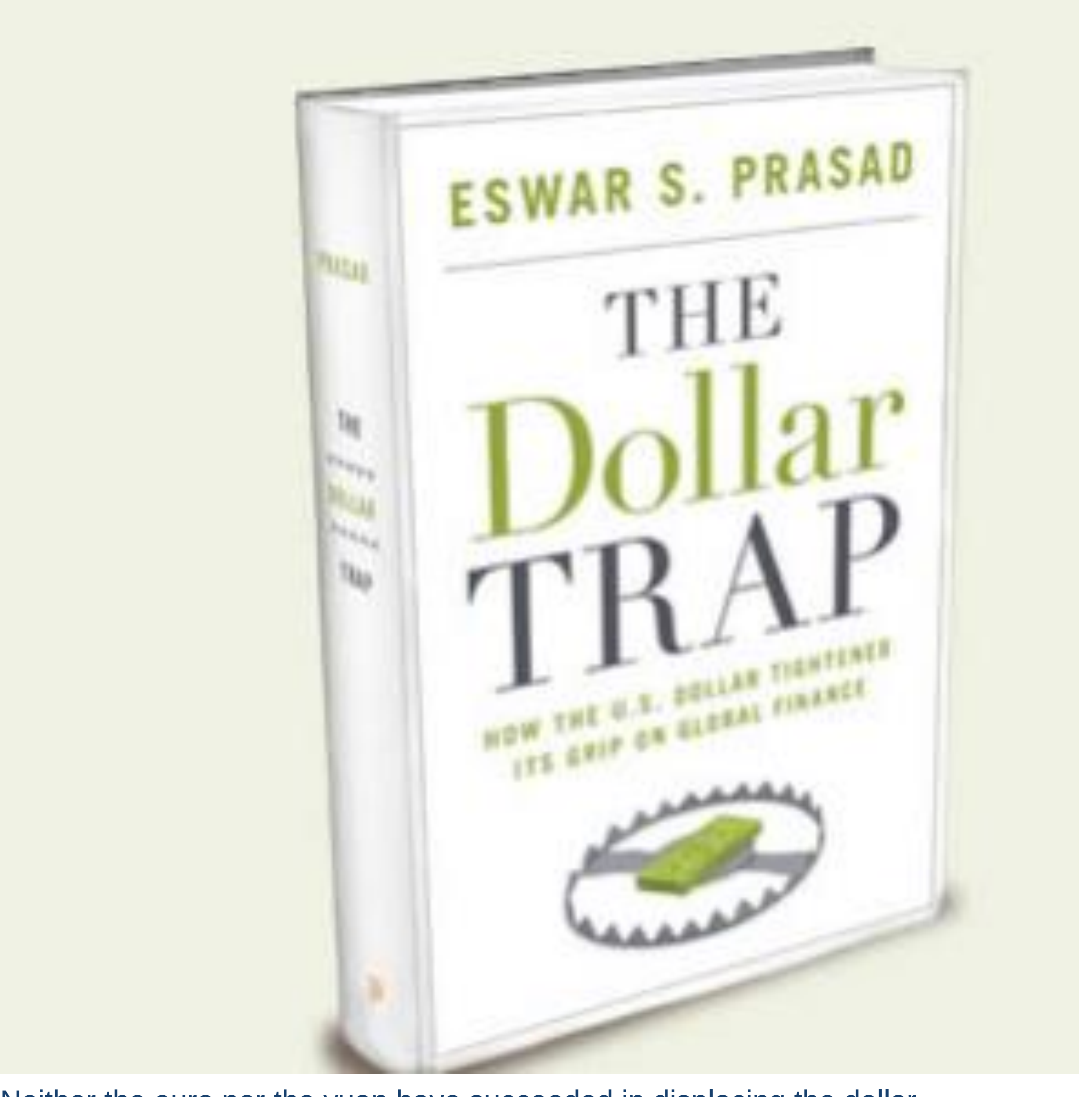
It is much the same picture for the foreign exchange reserves of central banks, a good barometer of global trust. The dollar share has recovered to 63.6pc, roughly where it was a decade ago.

The euro share has tumbled over the last eight years from 28pc to 20.4pc, and is barely above Deutsche Mark share in the early 1990s.

"There are no foreseeable rivals to the dollar as a viable reserve currency," said Eswar Prasad from Cornell University, author of "The Dollar Trap: How the US Dollar Tightened Its Grip on Global Finance".

"The US is hard to beat. The US has deep financial markets, a powerful central bank and legal framework the rest of the world has a great deal of trust in," he said.

The eurozone is crippled by the lack of a unified EU treasury, joint bond issuance, and a genuine banking union to back up the currency. It would require a change in the German constitution to open the way for fiscal union, an unthinkable prospect in the current political climate.



Neither the euro nor the yuan have succeeded in displacing the dollar

“There are existential questions about the euro. The tensions pulling monetary union apart have not been resolved. It not going to challenge the dollar even if it does get its economic act together, and that doesn’t look likely,” he said.

Prof Prasad, former head of the International Monetary Fund’s China desk, said the Chinese yuan is gaining global currency share steadily - at the cost of the euro – but it would be decades before it comes of age. First China has to tame its $27 trillion credit bubble and break out of the middle-income trap, weaning its economy from investment-led catch-up growth on steroids.

He said the Communist system had become even more rigid under president Xi Jinping, raising the risk that social and political order “might unravel suddenly and dramatically,” in the event of an economic shock.

CREDIT: AP

With hindsight it is clear that the US was never as weak as it looked in the aftermath of the Lehman crisis in 2008, when China seemed to be walking tall and much of the emerging world was in a secular commodity boom.

The pendulum has since swung back. Zero rates and quantitative easing by the Fed flooded emerging markets with dollar liquidity, leading to credit booms that have mostly ended painfully over the last for years.

The shale revolution in the US and the revival of its energy intensive industries have eliminated much of America’s current account deficit. The US Treasury’s draconian policies forced a quick clean-up of the US banking industry, in stark contrast to years of debilitating drift in Europe.

The 20pc surge in the dollar index since mid-2014 has silenced any serious talk of a dollar crisis, and revealed just how painful this can be for emerging markets. “The world is more reliant on the dollar than ever before. I don’t think people appreciate this enough,” said Stephen Jen from Eurizon SLJ Capital.

Mr Jen said trade globalisation is creating a multi-polar economy with many rising stars but financial globalisation is pulling in the opposite direction. “It is a very unstable system. The Fed is way too powerful, and it is scared of its own power,” he said.

The US Federal Reserve CREDIT: AFP

The Fed discovered to its horror with the first ‘taper tantrum’ in 2013 that mere hints of a rate rise could cause the global markets to seize up, in an experience repeated episodically ever since, with a fresh rout earlier this year after the first actual rate rise in December.

The Fed has backed off each time, afraid of its international shadow. “They won’t dare hit the brakes. They are trapped,” he said.

The BIS data showed that London’s share of global foreign exchange turnover has held steady at 37.1pc, down slightly from the last survey but higher than it was a decade ago. The eurozone share has fallen to 8pc.

Whether this will survive Brexit is a hotly-disputed question. Mr Jen, a Chinese-speaker from Taiwan, said Britain would flourish once it has broken free of a region caught in a failed currency experiment.

“London’s position is very secure. The talent is here and so is the scale. There is a very clear and strict rule of law. In five or ten years I think the pound will become a super-charged Swiss franc,” he said. Let us at least dream.