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U.S. Dollar – Alive and Well

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Executive Summary

- What allows the U.S. dollar (USD) to function effectively as the global reserve currency is its large, deep, and liquid capital markets. By offering the ability to invest reliably and profitably across a massive and best-performing opportunity set, the U.S. dollar holds an advantage that is still unrivaled.
- Many countries peg their currencies to the U.S. dollar or allow them to fluctuate only within a tight range relative to the greenback.
- While the U.S. only accounts for 10% of global trade, more than 30% of international bank loans and 40% of international debt securities where both borrower and creditor are non-U.S. residents is denominated in USD. This creates a structural shortage of dollar liquidity that supports global demand for the greenback.
- We remain focused on the trajectory of the U.S. debt and view it as the primary threat to the USD fair value and status. Reducing the gap between fiscal spending and revenue, and between investments and private savings, could negatively impact domestic consumption in the short-term and lead to some dollar depreciation, but would also keep the U.S. debt on a more sustainable path in the long term.
- While the dollar share of total FX reserves has fallen by around 7%, the dollar value has increased from $4.4 trillion at the end of 2014 to $6.8 trillion in Q1 ’24. De-dollarizing requires a viable alternative, which still doesn’t exist. The ~7% reduction in the dollar share of total FX reserves has been sparsely allocated across several other currencies, and no real replacement has emerged.

What made the dollar the global reserve currency?

The U.S. dollar’s status as the global reserve currency[1] can be traced back to the 1944 Bretton Woods Conference, during which the International Monetary Fund (IMF) and the World Bank were founded by forty-four member countries. As part of the accords reached at the Conference, each country agreed to peg the value of its currency to the U.S. dollar (USD), which in turn would be convertible to gold at the rate of $35/ounce. As a result, the dollar became a source of stability intended to prevent currency wars by which frequent devaluations were executed to gain a competitive trade advantage.

The U.S. dollar’s convertibility to gold was suspended in 1971 by President Richard Nixon as gold reserves held by the U.S. were not enough to cover the stock of dollars in circulation outside of the U.S. A system of floating exchange rates replaced the Bretton Woods system, which was instrumental to cementing the global dominance of the U.S. dollar. Many countries still peg their currencies to the dollar or allow them to fluctuate only within a tight range relative to the greenback. Major commodity markets are priced in USD, around half of global payment transactions executed on the SWIFT[2] network are denominated in dollars, around 70% of foreign currency debt is issued in dollars, and global monetary authorities have allocated around $6.7 trillion in foreign exchange (FX) reserves to dollar claims.

Ultimately, what allows the dollar to function effectively as the global reserve currency is its large, deep, and liquid capital markets. As of Q2 ’23, foreign investors held around 23% ($7.5 trillion) of the $23 trillion total marketable[3] Treasury debt, 27% ($4 trillion) of the $15 trillion U.S. corporate debt, and 17% ($14 trillion) of the $80 trillion U.S. equity market. By offering the ability to invest reliably and profitably across a massive and best-performing opportunity set, the U.S. dollar holds

[1] A reserve currency is a globally accepted store of value that is held in large quantities by international governments and institutions and is at the core of global investment, payment, and trading systems.

[2] Society for Worldwide Interbank Financial Telecommunications (SWIFT) is a member-owned cooperative that provides safe and secure financial transactions for its members.

[3] Debt held by the public.

an advantage that is still unrivaled. The primary benefit of the dominant role of the dollar on the international stage is that it creates structural demand for dollar-denominated assets. This allows the U.S. government to fund its growing external debt liabilities at relatively low and stable interest rates, although, as we discuss below and here, there could be limits to this privilege.

There is no evidence of broad de-dollarization

The IMF releases data on the currency composition of official foreign exchange reserves, also known as COFER, on a quarterly basis. This report shows that the USD share of global FX reserves has declined from 66% in 2015 to 59% in Q1 '24, fueling concerns that a broader departure from the dollar as the global reserve currency is underway. However, COFER is only a partial representation of the aggregate usage of the greenback, and there are a few reasons to take this report with a grain of salt:

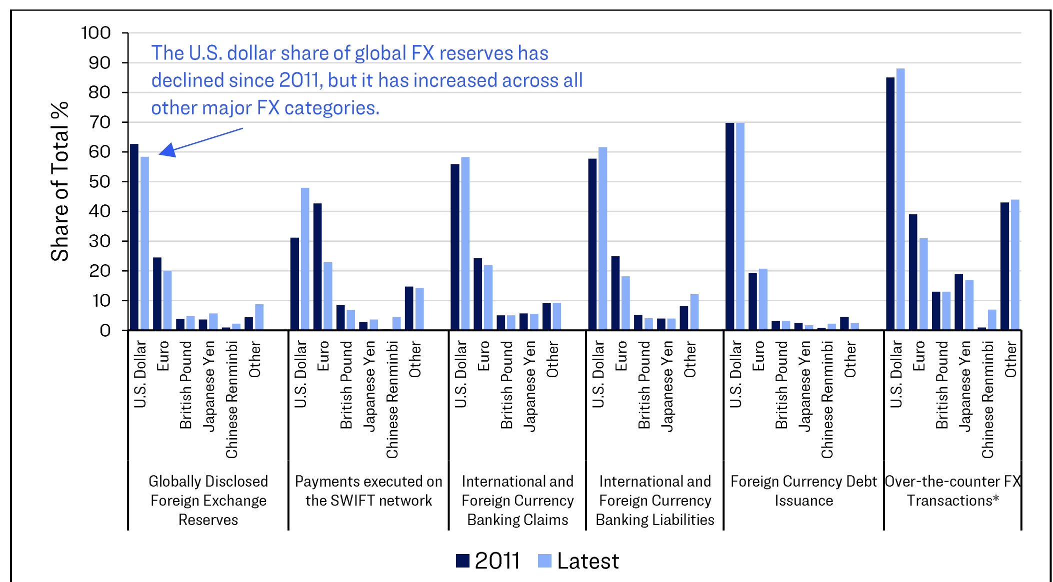
- The lower allocation to the USD is driven by countries that have strategic and economic reasons to decouple from the U.S., like China and Russia. In particular, China's USD reserves have declined by $450 billion since 2014, in line with the $480 billion decline in Chinese holdings of U.S. Treasury securities.

- While the dollar share of total FX reserves has fallen by around 7%, the dollar value has increased from $4.4 trillion at the end of 2014 to $6.8 trillion in Q1 '24.

- De-dollarizing requires a viable alternative, which still doesn't exist. The ~7% reduction in the dollar share of total FX reserves has been sparsely allocated across several other currencies, and no real replacement has emerged.

A more complete view suggests that the dollar is at least as widely used as it was in 2011, from payment transactions to banking claims and foreign currency debt issuance (Figure 1).

Figure 1
Currency composition of different foreign exchange categories.



Source: Bank for International Settlement, SWIFT, International Monetary Fund, Federal Reserve, TIAA Wealth Chief Investment Office

We expect the dollar to preserve its global role going forward, as most of the key pillars that have supported its dominance are still firmly in place:

- The U.S. economy has strongly outpaced other advanced economies over the past 20 years, with nominal GDP up 123%, compared to 76% in the Eurozone, 100% in the UK and 13% in Japan.

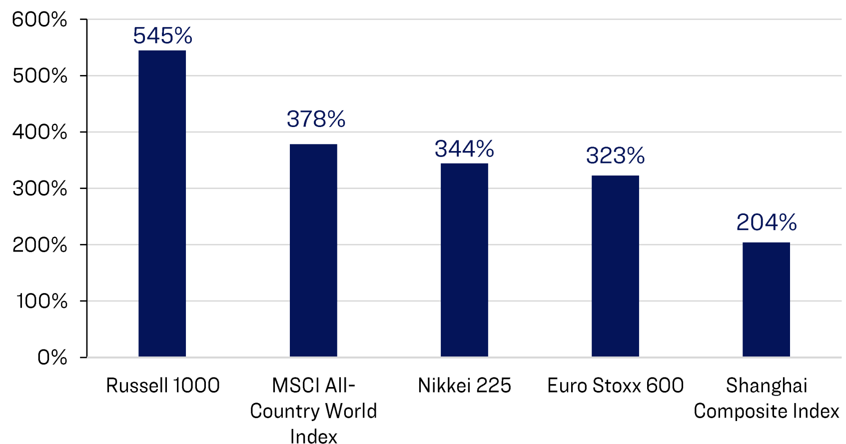
- Strong innovation and a more dynamic labor market have contributed to best-in-class productivity growth, which in turn raises the growth potential of the U.S. economy. Since Q1 '04, labor productivity is up 37% in the U.S., compared to 17% in the European Union. Given the potential of artificial intelligence (AI) to boost productivity, and the broader exposure of the U.S. corporate sector to AI trends, the growth potential of the U.S. economy looks poised to remain elevated relative to other advanced economies going forward.

- Alongside productivity, the other key ingredient of long-term growth is demographics, and specifically labor force growth. The Congressional Budget Office projects the working-age population (aged 15-64) to increase by around 5% over the next 10 years, almost entirely driven by immigration flows. This would be in stark contrast to some other major economies like the Eurozone and China, where the working-age population is expected to decline by 5% and 1% over the next 10 years, respectively. A significant change in migration flows that could be brought about following the 2024 U.S. Presidential election could alter these projections, as we highlighted in our May CIO Focus*Point*; however, demographics should remain more favorable for the U.S. compared to some other major economies even under stricter immigration policies.

- Stronger economic growth, higher quality innovation, faster productivity growth, and a more dynamic labor market have all contributed to solid capital market returns and steady investment inflows. The consistency of market outperformance over the past few decades has solidified the U.S. as the most desirable destination of foreign capital (Figure 2).

Figure 2

Total return performance from January 2003 to December 2023.



Source: Bloomberg, TIAA Wealth Chief Investment Office

- Strong and independent political and policymaking institutions, robust property right protections, and a long history of honoring debt payments also contribute to shoring up confidence in the U.S. economy.

- Finally, while the U.S. only accounts for 10% of global trade, more than 30% of international bank loans and 40% of international debt securities where both borrower and creditor are non-U.S. residents is denominated in USD. This creates a structural shortage of dollar liquidity that supports global demand for the greenback. Moving away from this regime would require a complete overhaul of the global financial system, which could only happen over several decades and lacks clear catalysts at this point.

What could undermine the dollar status?

While the U.S. dollar dominance is underpinned by the fundamentals described above, we are cognizant of a few dynamics that could threaten both its medium-term fair value and its long-term status:

- A sharp and broad increase in trade tariffs could cause an acceleration of recent efforts to reduce the reliance on the dollar. Some of these efforts are evident in the ongoing decline in the dollar share of official FX reserves; in the decision by major oil producers including Saudi Arabia to start accepting payments in other currencies; and in the development of payment networks alternative to SWIFT, such as SPFS[4] by Russia and CIPS[5] by China.

- Over the past 20 years, the cumulative primary budget deficit (budget deficit excluding interest payments) in the U.S. has totaled more than $15 trillion, while gross domestic investments have outpaced gross domestic savings by almost $13 trillion. This has resulted in a large negative net international investment position (the difference between foreign assets owned by U.S. investors and U.S. assets held by foreign investors) equal to around 70% of GDP as of Q1 '24. Therefore, the reliance on global investors to fund domestic consumption means that concerns over the sustainability of government debt could have an outsized impact on the dollar's fair value and attractiveness.

- Another risk is linked to the preservation of the Federal Reserve's (Fed) independence, which is viewed as key to its credibility in ensuring stable prices. Any attempt to weaken this well-established tenet would most likely lead to higher inflation expectations, higher yields, and reduce the attractiveness of dollar holdings.

- Finally, the accelerating growth of the national debt, coupled with worsening political brinkmanship, means that the debt ceiling is likely to become a recurring issue that investors will have to contend with periodically. While the probability of a full-blown U.S. default is extremely low, especially given the entirely self-imposed nature of the ceiling, political disfunction associated with the legislative process risks eroding international confidence as well.

What are the Presidential candidates' views on the dollar?

Throughout the past 40 years, both Democrat- and Republican-led administrations supported a "strong dollar policy" as a reflection of America's economic dominance. In 1984, Treasury Secretary Donald Regan argued that a strong dollar was a vote of confidence in the U.S. economy. In 1994, Treasury Secretary Robert Rubin stated that a strong dollar was "in our national interest." However, this view has been less widely shared over the past decade. Presidential candidate Donald Trump has often complained about the negative impact that a strong dollar has on the competitiveness of U.S. exports, and both he and his running mate J.D. Vance have publicly endorsed devaluing the dollar as a solution. How would this work in practice?

- Direct market intervention represents the most straightforward tool at the government's disposal to influence the value of the USD. The Treasury would direct the trading desk at the Fed to intervene in the open market to sell dollars and buy foreign currencies. However, the effectiveness of any intervention would likely be short-lived since the Treasury has

[4] The System for Transfer of Financial Messages is a Russian equivalent of the SWIFT financial transfer system which has been under development since 2014, when the United States government threatened to disconnect the Russian Federation from the SWIFT system.

[5] The Cross-border Interbank Payment System is a Chinese payment system that offers clearing and settlement services for its participants in cross-border renminbi (RMB) payments and trade. CIPS is backed by the People's Bank of China and was launched in 2015 as part of a policy effort to internationalize the use of China's currency.

limited dollar assets that can be liquidated (~$180 billion as of May 2024). The government could always try to convince the Fed to use its ~$7 trillion balance sheet assets to sell dollar securities and buy international ones, but we see this as unappealing for the central bank as it would likely cause material volatility in U.S. and global fixed income markets and cause the Fed to own lower-rated and much more illiquid securities.

- During his first administration, President Trump frequently complained about what he perceived to be unfair trade practices from trade partners. Under his tenure, the Treasury Department also designated China, Switzerland, and Vietnam as currency manipulators. The ramifications of such designation are more symbolic than substantive, especially without the support of the IMF (which disagreed about China being added to the short list in 2019). But verbal intervention can reduce upside speculation on the USD, at least in the short term.
- What is most likely to work against Trump's preference for a weaker dollar are his flagship agenda items: fiscal stimulus, and higher tariffs. Both would likely have the effect of raising the short-term fair-value of the U.S. dollar. However, the medium-to-long-term impact is less clearcut. As we discuss above, the perception that the debt trajectory is unsustainable could impinge on the dollar's fair value and its attractiveness.
- The most durable way to achieve a weaker dollar would be to convince other economies to save less and spend more. This could be achieved through a protectionist trade policy that forces other countries to shift their focus from exports to domestic consumption, which would at the same time boost the growth potential of their economies, taper the inflow of savings into the U.S. market, and hence reduce demand for the dollar. However, this fundamental shift could come with unintended consequences, including weaker consumption and higher inflation in the U.S.

Ultimately, while it is probable that President Trump, if re-elected, would occasionally lean against a strong dollar via verbal intervention and accusations of currency manipulation, effective and immediate measures at his disposal to artificially devalue the dollar look limited, and the greenback would likely trade in line with its fundamental drivers. To this extent, it seems unlikely that any administration would actively pursue a softer economy simply to weaken the currency. In the case of a Trump presidency, we would rather focus on how trade and fiscal policies are executed, as well as on his relationship with the Fed, as factors that could contribute to undermining the dollar status as the global reserve currency. And in this regard, it is helpful to note that "keeping the dollar as the world's reserve currency" is one of the key agenda items on the Republican party platform.

How about the democratic presidential ticket? While both Vice President Harris and her running mate Governor Tim Walz so far have not targeted the dollar as a primary policy tool, there are good reasons to expect a Democratic administration to adhere to the long-held view that currency rates are determined by market forces. Treasury Secretary Janet Yellen has often stated that, under her leadership, the Treasury department would refrain from seeking a weaker U.S. dollar to gain a competitive trade advantage.

Conclusions

The U.S. dollar benefits from a strong economy, favorable productivity and demographic trends, reliable political and monetary institutional frameworks, and large and deep capital markets. Its role as global reserve currency is unlikely to be threatened as long as these conditions remain in place, also because of a lack of viable alternatives. We see some risks, some of which could become more realistic following the U.S. election in November, depending on the outcome.

We are particularly focused on the trajectory of the U.S. debt and view it as the primary threat to the USD fair value and status. Reducing the gap between fiscal spending and revenue, and between

investments and private savings, could negatively impact domestic consumption in the short-term and lead to some dollar depreciation, but would also keep the U.S. debt on a more sustainable path in the long term. More organic growth could be made possible by AI-related productivity gains and favorable demographics.

While we are mindful of the risks described above, we believe opportunities will continue to outweigh risks in the U.S., and the U.S. dollar will preserve its attractiveness as a store of value.

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