De-dollarisation – fact or fiction?

Issue 102: May 2023

Might we see the demise of the United States Dollar (USD), or merely the end of another cycle in USD-strength? Since World War 2 (WW2) history has been littered with headline grabbing announcements calling the end of the mighty USD. Such calls are often accompanied by predictions of a total collapse of the stock markets and perhaps a return to a gold standard. Gold bullion sellers salivate at this topic. They promise that so long as their customers buy gold (or silver) bullion from them, all these uncertainties will evaporate. We provide context and revisit some key milestones, crises and how they played out for the USD.

Bretton Woods

The strongest anti-USD views were probably aired during the early 1970's when the Bretton Woods system of fixed exchange rates collapsed. It was a very significant moment – likely the one when the risk for the USD was greater than at any other time since WW2. The global monetary regime after WW2 started as the USD being fully backed by gold. International trade was not settled by transferring physical gold between governments anymore, but by paying USD in the full faith that the Federal Reserve (the central bank of the United States of America) holds the gold at $35 per ounce on behalf of the owners of the USD. Exchange rates of other nations were fixed to the USD (it could fluctuate within a 1% band). Due to large trade deficits and the cost of its foreign wars, the US could not maintain the gold/USD peg. The disparity with central bank pricing became so large that the US had no choice but to abandon the system in 1971.

1987 stock market crash

On 19 October 1987 the US stock market fell 22% within one day. Panic was everywhere. The end of the world seemed nigh. The USD (and stock markets) survived.

Supply disruptions in the oil market

Oil supply disruptions in 1973 (Yom Kippur war), 1979 (Iranian revolution), 1991 (Gulf War), 2003 (Iraq), 2020 (lockdowns and oversupply) have not had any lasting long-term effect on the USD.

The Dot-com crash of 2000

The NASDAQ index lost 80% of its value and took more than a decade to recover. The S&P 500 index fared far better. The USD, after initially selling off, recovered as US interest rates rose above European interest rates.

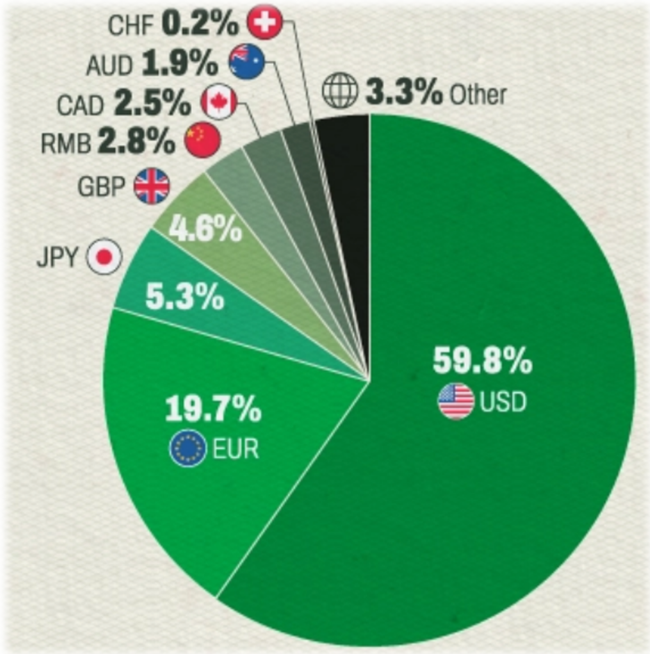
Great Financial Crisis (GFC) of 2008

Most of the financial crises since the 1970s did not originate in the US. The heart of the 2008 GFC was a US subprime mortgage crisis. Poor quality property loans were repackaged and sold to other investors for a higher yield during a low interest rate environment. The bankruptcy of Lehman Brothers in September 2008 set this crisis in motion. It was a spectacular credit crunch with fear and distrust reigning financial markets. The Federal Reserve stepped in and started printing large quantities of USD during March 2009. By the end of the so-called quantitative easing process, base money had expanded by a factor of 4. The USD doomsayers were once again on the front page. Yet 15 years later the USD is 30% stronger (measured by the USD Index).

Most recent US monetary expansion and gold

It is estimated that the lockdowns of 2020 put more than 20 million people out of jobs (roughly 13% of the workforce). The US government decided to shower people with money. Consequently, the US central bank printed a few more trillion USD. By the end of the process base money expanded by another 2 times.
In contrast with the GFC, the expansion was much faster and accompanied by significant supply chain disruption (e.g. goods could not get from China to where it needed to be). The scarcity resulted in very high inflation. The doomsayers are out again, but are unable to explain why the USD remains so strong.

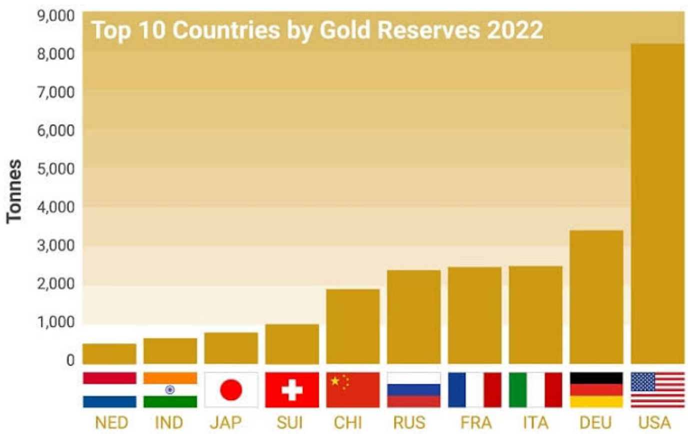
For international trade, the USD remains dominant. According to the Bank for International Settlements the USD was the second leg of 88% of currency transactions during 2022.



Above is data from the IMF (International Monetary Fund) showing the continued dominance of the USD in reserves held by central banks across the globe.

What if things do go wrong for the system?

The USD may not remain this strong. When interest rates are cut again, the USD will most likely fall back. If there ever needs to be a reset, gold is the most likely fixed reference point for newly issued medium of exchange.



Source: TradingEconomics

He who has the gold, makes the rules. Below is a table of central bank of each country and their Gold holdings. It is obvious that the US remains (along with its Western allies), by far, the largest holder of Gold bullion.

Should investors fear a weaker USD?

We think not. An orderly weakening of the USD would be part of the normal business cycle and likely helpful for US companies because:

- US Exports are more attractive to international markets (the goods and services won't be as expensive anymore)
- The S&P 500 broad market index (listed companies) earns much of its revenue outside of the United States. When the USD currency weakens, its earnings are worth more in USD terms
- USD funding is generally cheaper for international markets, typically leading to higher economic growth potential for economies and stock markets outside the US.

Conclusion

None of the previous USD doomsday predictions have come true. Maybe someday it will, but on a balance of probabilities it appears the United States will remain the dominant nation for a few more decades. As such, its reserve currency status for international trading purposes will likely remain for the foreseeable future.

At this point, the size of the US economy, the strength of its military and the depth of its commercial reach internationally cannot be matched by any other nation. In addition, the USD is backed by a very strong and diversified domestic economy far away from geopolitical conflict. Despite best efforts by its rivals, we are unlikely to see the end of the dollar's reserve currency status anytime soon; especially since the United States still holds the majority of Gold reserves (with reference to the table above).

We therefore remain confident to invest client's funds in global financial stock markets. We are essentially buying fractions of companies producing goods and services that people consume across the globe).