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OPINION | COMMENTARY

The Dollar May Be Knocked off Its Pedestal

America's competitors, friend and foe, have opportunities to challenge the U.S. currency.

By Sahil Mahtani

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U.S. dollar notes, Nov. 7, 2016. **PHOTO**: DADO RUVIC/REUTERS

Will the U.S. dollar soon lose its status as the world's pre-eminent currency? The consensus is no—it's said that any move away from the dollar would take decades. This view is too complacent.

Developments in foreign-exchange markets during the past 18 months point toward dedollarization. Consider that Chinese "petroyuan" crude-oil futures, launched last year in Shanghai, now sit right behind Brent and West Texas Intermediate in trade volume. The world's central banks bought more gold last year than at any time since President Nixon took the U.S. off the gold standard in 1971. Markets recently learned that China added gold to its reserves for the fifth month in a row. Earlier this year, the U.K., France and Germany created a new payment-processing system to permit payments to Iran. It will begin quietly with humanitarian aid, then move to other goods and services, potentially competing with the American-influenced Swift system.

The increasing use of economic sanctions under Presidents Obama and Trump is the immediate cause of dedollarization. In European finance, few have forgotten the $8.9 billion fine meted out to French bank BNP Paribas in 2014 for violating U.S. economic sanctions against Iran. It's not that surprising, or even that significant, when Russia shifts $100 billion of dollar-denominated reserves into Chinese yuan, euros and Japanese yen, as it did last year. But the change in posture among the trans-Atlantic democracies is noteworthy. At his final European State of the Union address, European Commission President Jean-Claude Juncker said: “It is absurd that European companies buy European planes in dollars instead of euros.”

Surging U.S. oil production also has implications for the currency. By 2025 the U.S. is expected to overtake Saudi Arabia as the world’s biggest oil exporter. This has already scythed domestic oil imports by 25% since 2010, and that number will keep falling. This is in many ways positive for the U.S. economy, but if America buys less international crude oil while the Chinese ramp up purchases, the likelihood increases that oil exporters will accept currencies other than the U.S. dollar. Oil companies in Russia, Iran and Venezuela have already begun accepting yuan. Were Saudi Arabia to join them, the effects could be substantial.

Structural changes in Chinese demographics play a role as well. China’s working-age population peaked in 2016 and will likely continue to decline. This will reduce household savings, putting consistent pressure on China’s current account. Deficits will become more common, and to avoid incurring foreign-currency debt in perpetuity, China will need foreigners to become more comfortable buying Chinese assets in yuan. That’s why China has been so keen to get global-bond and equity indexes to include Chinese assets. Yuan-denominated bonds were included in the Bloomberg Barclays Global Aggregate Index in April.

Meanwhile, political polarization in the U.S. implies budget deficits as far as the eye can see, driven by tax cuts and higher entitlement spending. Congressional Budget Office forecasts show U.S. federal debt hitting 152% of gross domestic product by 2048, up from 78% today. The U.S. twin deficits—fiscal and current account—are a good leading indicator, with a two-year lag, of dollar weakness. They currently imply double-digit percentage declines in the dollar’s value over the next few years.

Significant currency shifts are rarely long and slow affairs. Britain’s pound sterling was in a gentle postcolonial stupor until the early 1970s, when it still accounted for just under a third of global sovereign reserves. By the end of that turbulent decade, it was less than 1/20th. In the 1930s countries off the gold standard, such as the U.K. and Italy, saw currency declines of 20% to 40% in three to five years. Even the dollar lost nearly half its value against the deutsche mark from 1971-78. Foreign currency became so expensive that U.S. soldiers stationed in Germany at the end of the decade received care packages from sympathetic West Germans.

Some will say that we've heard this all before. Persistent talk of a shift away from the dollar began in the 1970s, and recalls historian A.J.P. Taylor's assessment of the revolutions of 1848: "a turning point that did not turn." Habitual dollar use remains high—everywhere. Nevertheless, the emergence of a genuinely multipolar world means the coming market cycle is likely to be different. The U.S. dollar may finally be knocked off its pedestal.

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