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Shifts in the global monetary order

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"A future world economy might be made up of a patchwork of antagonistic coalitions divided by more or less visible data curtains." Adam Tooze, Financial Times

There is increasing evidence that after decades of globalisation, the trend has started to reverse, and we are seeing clear signs of “slowbalisation” or deglobalisation (see Figure 1 below). The Trump administration seemed to mark the major turn. Many events since 2016 have contributed to this shift, such as Brexit, COVID-19, the Russia-Ukraine war, and the China-US tensions have been widely credited as underpinning this reversal.

Mounting geopolitical tension has led to the polarisation of some of the world's largest economies. The trade tension growing between the East and West is escalating and will continue to result in significant inefficiencies as past trade and technological gains wane. Governments have begun pivoting to a more protectionist policy, as seen with the US Inflation Reduction Act, which aims to catalyse investments in domestic manufacturing capacity and technology and encourage procurement of critical supplies locally.

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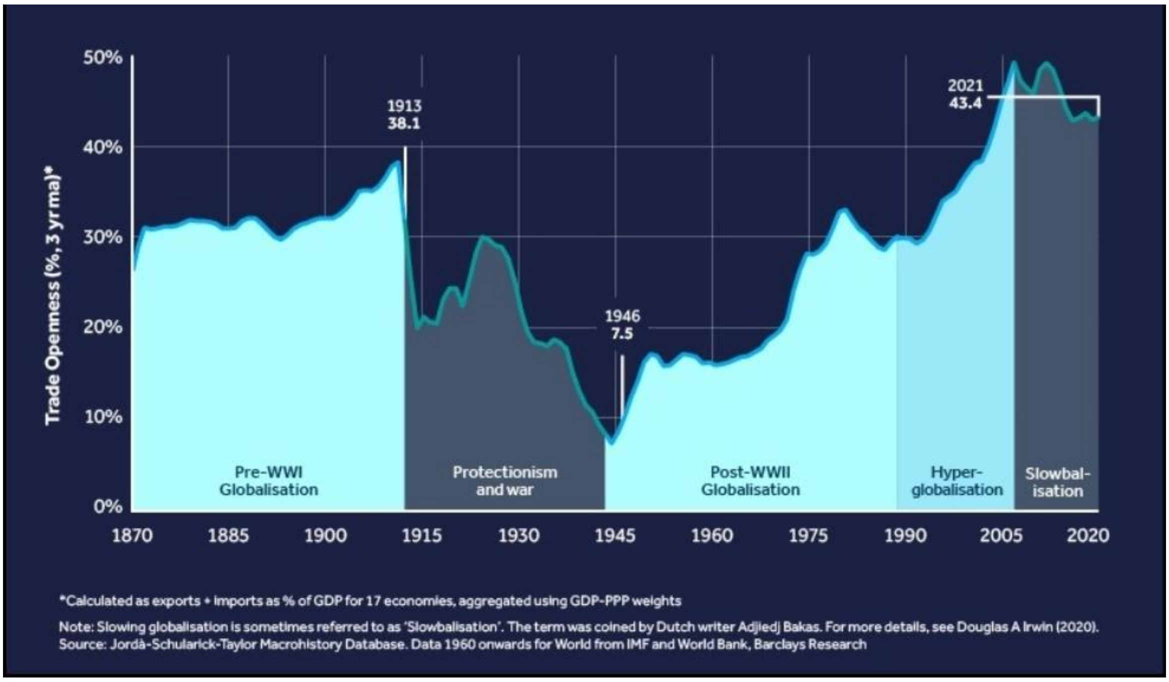
Figure 1: Globalisation rises and falls



Source: Jorda-Schularick-Taylor Macrohistory Database, Barclays Research, IMF, World Bank

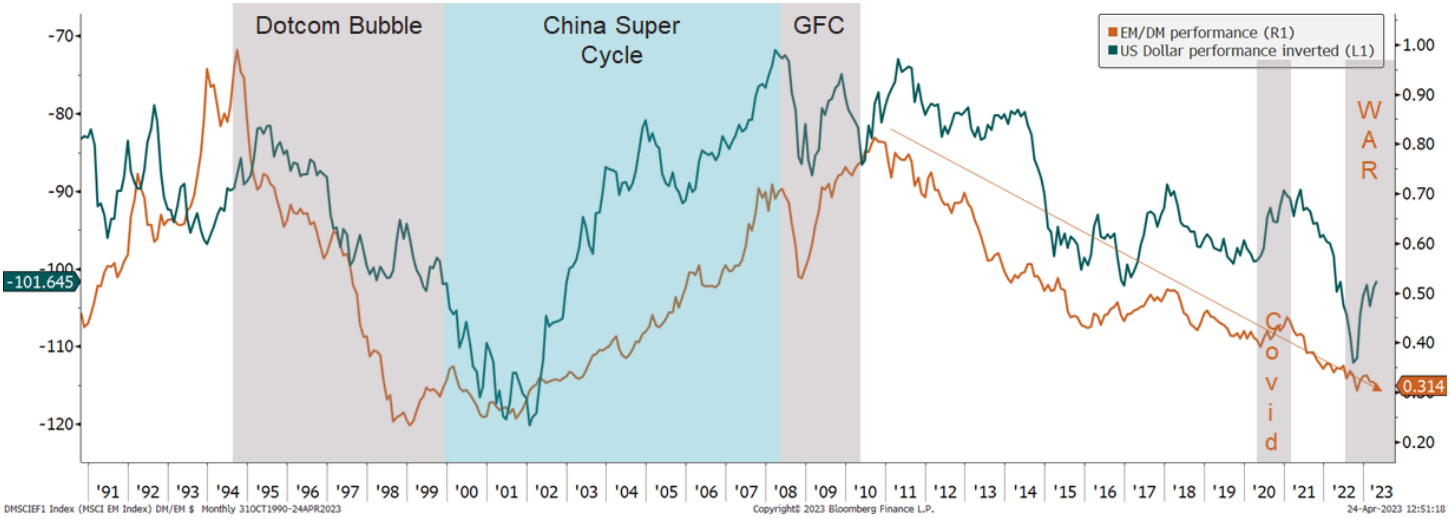
When America sneezes, the world catches a cold.

The prominence of the US dollar has made the world highly susceptible to the boom-and-bust cycles of its economy. The dollar is a counter-cyclical currency, and the US economy is less open relative to its trading peers and benefits when the rest of the world is slowing. The impact of a stronger dollar is the most pronounced across emerging markets that fall at the mercy of the greenback. This correlation is clearly seen in Figure 2 below – during periods of dollar strength, emerging markets tend to underperform their developed market peers.

A stronger dollar may have several significant negative implications on certain economies, for example:

- Imports (in domestic currency terms) become expensive, placing upward pressure on inflation. This, in turn, forces central banks to respond to currency weakness and inflation by increasing interest rates, ultimately increasing the cost of borrowing.
- Countries with substantial dollar-denominated debt face increasing debt repayments in their domestic currency – this poses a risk for countries with high levels of external debt relative to foreign exchange reserves and may lead to capital outflows and sovereign rating downgrades.

Figure 2: Dollar correlation with emerging market performance.



Source: Bloomberg, Fairtree Asset Management. (Note: the dollar line above has been inverted.)

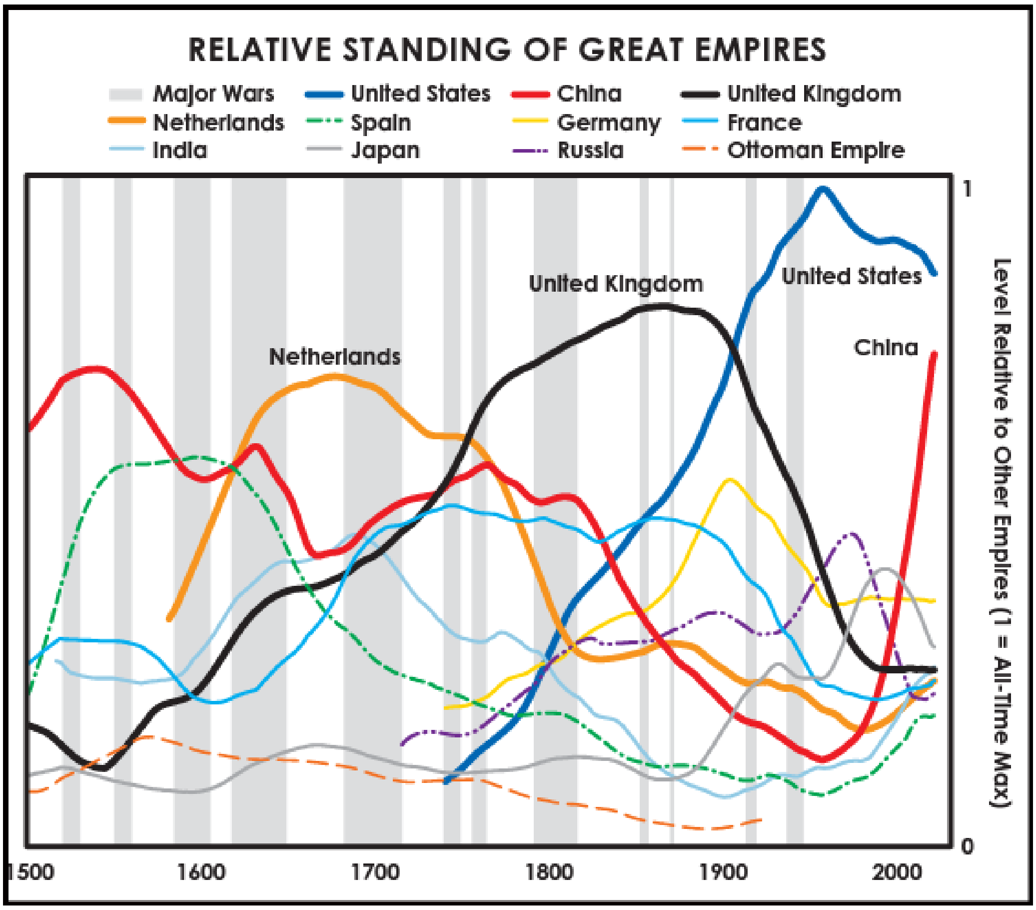
Key nations, including China, have enforced several protectionist policies whilst making a concerted effort to curb their overreliance on the US dollar as a reserve currency. Through the Belt and Road Programme, China sought to internationalise the Renminbi. Iran proposed a Euro-like Shanghai Cooperation Organisation (SCO) currency for trade among the Eurasian bloc to the Shanghai Cooperation Organization, and in January, India concluded agreements for currency exchanges with the UAE, Japan, and several Asian countries. Most notably, the BRICS nations (including the Middle East) have been reported to be improving relations and developing a new form of currency. This is meaningful given the world's reliance on these geographies for commodities, most notably energy.

The evolution of reserve currency status

Reserve currencies are the foundation of monetary policy, a conduit to facilitate international transactions and stabilise exchange rates. The US dollar rose to prominence and cemented its status in the aftermath of the Second World War with the establishment of the Bretton Woods Agreement and System, fixing the currency to gold and pegging other currencies to the greenback, ultimately dethroning the British pound (see Figure 3 below).

The rise of the greenback's global hegemony was underpinned by the US becoming an international economic superpower and reinforced through the increasing relevance of the US in international trade, the increasing depth and liquidity of US financial markets, the ease of USD currency conversion as well as political stability.

Figure 3: The rise and fall of global empires



Source: The Changing World Order: Why Nations Fail by Ray Dalio

Throughout history, we have witnessed several shifts where empires have risen and fallen. This process of the reassignment of power occurs through a substantial change in global networks (including the monetary system). The presence of a contending rising power, de-legitimation of the incumbent power as well as a crisis period - be it wars or severe economic disruption - set the stage for the rise of a new global hegemony. The US has long occupied the throne since the turn of the 20th century, and with China's meteoric rise, it does beg the question of whether the sun is setting on the US global superpower. But dethroning a behemoth, although not impossible, is not a simple task and can take much patience and tactical craftsmanship….it takes time.

The case for further dollar weakness

The case for a cyclically and structurally weaker dollar going forward is not a difficult one to argue. Some of the near-term drivers of dollar weakness are:

1. **Rate differentials**

Policy rates in the US may peak earlier than initially expected, particularly relative to European policy rates that may still have further to increase. This is a whole discussion in itself, and the market remains as unsure as the Fed where the actual peak lies.

2. **Growth differentials**

Europe & China's growth expectations are higher relative to the US due to the resolution of the energy crisis and the post-pandemic reopening. Given the dollar's countercyclical characteristics, if the rest of the world is looking better from a growth perspective, it could weigh on the dollar.

3. **Flows**

The US has benefited from flows into its equity and bond markets due to the relative attractiveness of the markets and the most recent flight to safety. Given that other regions (most notably emerging markets) are starting to look more attractive from a valuation perspective and have better growth expectations, some of these flows into the US may reverse.

These are short-term in nature and predominantly cyclical headwinds for the dollar, and we have seen them play out many times in the past, and we have seen the dollar recover as the aforementioned pressures had subsided. More important are the longer-term structural headwinds that are facing the US dollar, namely:

a. A growing current account deficit - there is an expectation that there will be less support from cheap fossil fuel production (due to underinvestment) that historically helped lessen the current account deficit.

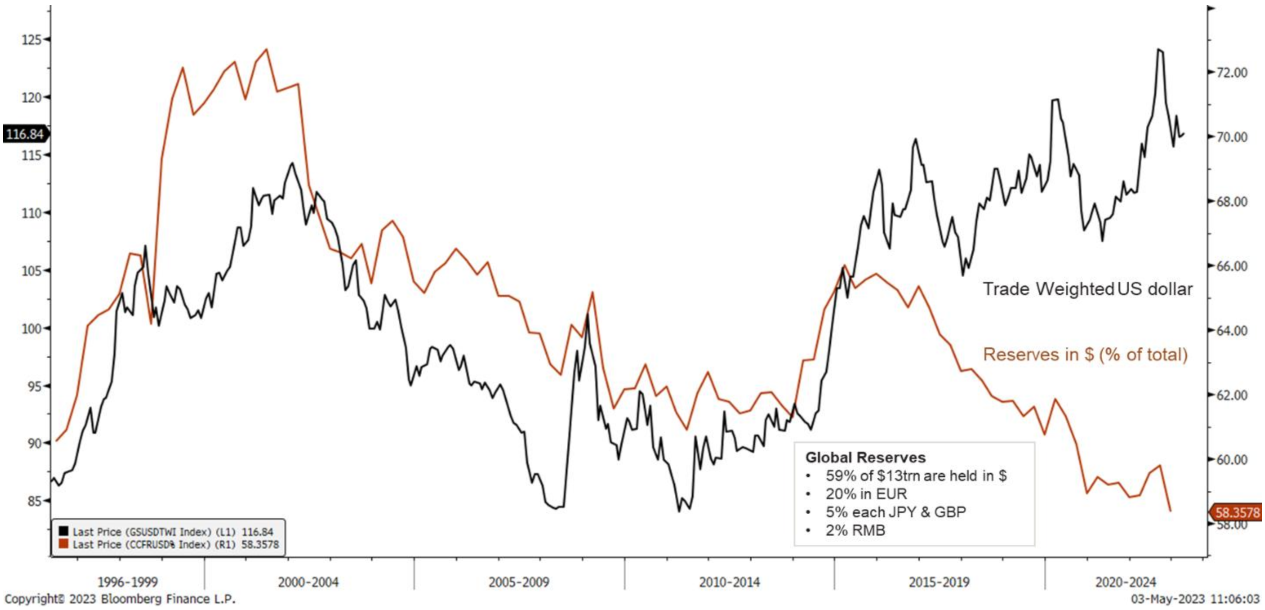
b. Slowing dollar demand going forward - many nations are seeking to reduce their dependence on the dollar, as previously mentioned, and we have seen this most expressed across the BRICS nations.

c. The last structural headwind may play out over a long period and is not imminent but worth highlighting. It centres around the growing change in the perception of the stability of the US economy, thus impairing the greenback of its safe-haven status. The US debt-to-GDP ratio is at unprecedented levels. This, coupled with an ever-growing large fiscal deficit, is likely to impact future risk perceptions of the dollar [over time].

Dethroning a behemoth is no small feat.

It is evident that conditions for a global hegemonic revolution are ripe, coupled with the expectation that the dollar will not only cyclically weaken from the current levels, but structural headwinds are at play. However, displacing the dollar will not be a small feat. Evidence would suggest that we are not quite on the precipice of a new epoch. Around 60% of global reserves are held in dollars compared to the Renminbi at only 2% (see Figure 4 below). Foreign exchange turnover is still heavily skewed towards the USD, representing around 90% of all FX transactions.

Figure 4: USD currency share of global FX reserves



Source: Bloomberg, Fairtree

But it would be naïve to ignore the trends that have been set in motion - global empires are all powerful at points in time, and it's impossible to predict the exact moment they lose importance and are dethroned. We have entered a new era of world power, and it is difficult to see how the encumbered hegemon can stop this erosion of importance. Perhaps the way to dethrone the beast is on a completely different playing field, such as virtual currencies? Either way, it will take time.

Glacier Research thanks Chantelle Baptiste and Siya Mbatha for their contribution to this week's *Funds on Friday*

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