ECONOMY & MARKETS

DOLLAR: THE RESERVE CURENCY IS HERE TO STAY

Dollar – The Reserve Currency Is Here to Stay

By Harry Dent, Founder, Senior Editor, *Economy & Markets*

FIRST it was the U.S. government, then the Fed, and later the Chinese. Over the last decade, a steady flow of villains were supposed to murder the greenback.

Through poor economic policy, overuse of the printing press, and sheer economic muscle, these financial bad boys were clearly going to knock the U.S. dollar off of its pedestal, right? That would obviously lead to devaluation, followed by rising U.S. interest rates and bone-crushing, unstoppable inflation.

There were only two questions: What asset should you buy before this happens (the normal answer being gold), and when will it occur?

Those waiting for the dollar apocalypse will have to keep waiting.

Yes, the U.S. government made some dumb financial moves, and yes, the Fed perpetrated the greatest theft in all of history. However, the Chinese don't have near the monetary might that people assume.

But none of this is the point. Valuing currency doesn't happen in a vacuum. If one goes, another must rise, and that's where the U.S. dollar shines.

To think that investors, nations and large corporations will suddenly abandon the U.S. dollar implies that they will immediately embrace some other currency. This line of thinking misses the colossal change in the way currencies work since Nixon took the U.S. dollar off the gold standard in 1971.

We now operate in financial ether, where no currency is backed by a precious metal. Instead, currencies are valued against each other, and production and trade determines this value. Because of this, the greenback is far and away the most widely-used currency on the planet, and it shows no signs of losing its place.

So anyone holding out for the Fed to be punished for its larcenous, money-printing actions will be sorely disappointed. And those expecting the Chinese to elbow out the greenback simply because their currency was added to the IMF's Special Drawing Rights (SDRs) will also be left scratching their heads.

More importantly, anyone basing their financial future on a falling dollar will be not just disappointed, but left behind financially.

It's All About Trade

The important thing to remember is that traditional definitions are no longer valid. In today's world, where no currency is pegged to a precious metal, a reserve currency is not a storehouse of value. Instead, it's all about trade.

It is easy to say that most companies and countries conduct trade in U.S. dollars, but the reasons for this, as well as just how deeply the greenback is embedded in international trade, can't be overstated.

The dollar's ascendancy in terms of international trade began when other countries started breaking their ties to the greenback. That left the dollar as the only currency that was still tied to a hard value. This made it the preferred choice for international trade, and put the U.S. in a dominant position where it could demand trade on its terms.

In today's world, the international obligations referred to earlier typically take the form of exchanging currency with domestic traders who buy and sell in other countries. To conduct international trade, companies have to agree on the method of payment. This involves settling not only on the terms, but also on the currency to be used.

For example, when exporting to the U.S., a company will typically price its goods in U.S. dollars. This allows the price to remain the same to the U.S. consumer, even though the selling company is taking a risk on currency volatility.

It works the same in other countries. When selling in large quantities, it makes sense to price goods in the currency of the final buyers, because it allows them the luxury of stable pricing over time. This means the countries with the largest imports will drive international trade in their home currency.

Starting in 1971, the U.S. began importing more than it exported, leading to a negative balance of payments almost every year since. This left excess dollars outside the U.S. that could be used to meet obligations among foreign parties or invest back in the U.S.

In addition to money outstanding, the U.S. also maintains a sizeable debt. While having debt isn't seen as a good thing, it actually facilitates a reserve currency, because it provides foreign holders of the currency with a place to store their funds.

Instead of simply holding cash balances, international investors can purchase U.S. debt in order to invest the funds they hold in something considered safe and liquid.

All of this implies a free flow of capital across international lines. Holders of U.S. dollars or even U.S. debt are free to exchange or sell their holdings as they see fit. This free flow of capital is one of the main tenets of any currency that is to be used for international trade settlement and global payments.

Another factor that has caused dollar supremacy is that, over time, goods that can be substituted for each other tend to be priced in the same currency. This allows for easy comparison among providers and is called "coalescing."

Given that the U.S. was and remains a very large buyer of goods, and that many markets around the world used greenbacks in order to eliminate local currency fluctuation, many raw goods came to be priced in U.S. dollars. The most obvious example of this is oil.

No matter how hard the Iranians and others try, most oil transactions are still priced in dollars. This makes sense when you consider what would happen otherwise. If any exchange priced oil in something other than dollars, then an arbitrage opportunity would potentially exist, allowing participants to pit sellers against each other. Every time the exchange rate of a currency pair changed, so would the price of oil in one currency or both.

If the value of the dollar falls against the euro by $.01, does oil become more expensive in dollars on an exchange based on euros? To avoid such confusion, sellers of such commodities tend to follow each other and simply use one currency to price their goods.

The Dollar is Here to Stay

Looking at reserve currency through the lens of trade brings a lot of clarity to our current situation.

It is obvious that the dollar enjoys a unique position in terms of international trade settlement, but this position is not due to any love affair that other countries have for our currency. It is simply a matter of efficiency and size.

Yes, the Chinese renminbi has come on fast, but there still exists a vast gulf between the dollar and everyone else. In 2013, the Society for Worldwide Interbank Financial Telecommunication (SWIFT) announced that the renminbi had surpassed the euro to become the second most widely used currency for settling international trade.

Three years later, the euro has recaptured second place from the renminbi, but the Chinese in the global picture, have gained ground somewhat.

The question is: “How much ground?”

The Bank of International Settlements (BIS) compiles a report on foreign exchange transactions (forex) every three years. In 2016, the dollar was party to 88% of all such transactions, which is up from 87% in 2013, and up from 84.9% in 2010. By comparison, the renminbi was party to just 4.0% of all transactions in 2016.

The stark difference, even in the face of rising use of the renminbi for trade finance, reflects the complexities of international finance and illustrates why the renminbi will not seriously challenge the U.S. dollar as the world’s reserve currency.

In terms of global payments — not trade finance — the world breaks out a little differently. SWIFT reports the top five currencies used for global payments as:

Currency	$ of Global Payments
U.S. Dollar	42%
Euro	31%
Great Britain Pound	7%
Japanese Yen	3%
Canadian Dollar	2%

These numbers are clearly concentrated in U.S. dollars and euros, with British pounds a distant third. Notice the absence of the renminbi. When it comes to global payments, the Chinese currency is ranked sixth with a 1.68% share, twice of what it was three years ago, but still with significant catching up to do. This is double its percentage from three years ago, when the renminbi’s share of global payments was 0.84%. But it’s still extremely small when compared with the world’s most popular currencies.

The difference between the amount of renminbi used for trade finance and the amount used for global payments points out a distinction that illustrates why the renminbi should grow dramatically in terms of international use without ever seriously challenging the U.S. dollar. It’s the difference between trade and capital.

What I mean by that is China is a big international trade partner. In fact, in 2013, it overtook the U.S. as the world’s largest trading nation. So it makes sense that parties trading with China would use more renminbi one-on-one with it, either financing their trading or making a payment to the Chinese.

However, for third-party transactions (i.e., ones that don’t involve China) no one is using renminbi. This is where the dollar still reigns supreme. That’s why I fully expect use of the renminbi to grow, but only as it relates to financing and paying for direct trade with China. I don’t expect it to become a currency used in third-party transactions.

As for the renminbi joining the SDRs last year, before it happened, we pointed out that it would be a non-event. SDRs are not units of currency used in trade. They simply represent deposits of currency that IMF member nations can access when their currency is in turmoil.

The renminbi now makes up about 11% of the SDR basket. However, that basket only holds $300 billion overall, so there's about $33 billion worth of renminbi sitting at the IMF. So what?! Over $5 trillion of currency trades every day. The modest amount at the IMF, and the even smaller amount attributable to the Chinese currency, is meaningless.

Even more importantly, the Chinese simply have no interest in making the renminbi into a reserve currency. They would have to give up control… not something they're keen on doing.

For the renminbi to gain significantly wider use as an international currency, there would have to be a huge supply of renminbi on the international markets.

People in countries around the world would have to have access to the currency through some- thing as simple as a forex counter at their local bank. This is something that is possible with the dollar, euro and even yen today.

In short, before payments can be made in renminbi, people have to have renminbi. Remember from above that one of the main ways that people get greenbacks is through our negative balance of payments.

The U.S. imports more than it exports, sending hundreds of billions of dollars abroad every year. These funds are available on the international market for trade. The Chinese do not run a negative balance of payments and have shown no interest in doing so anytime soon.

Then there is the matter of what a country or institution would do with their excess renminbi as they held it.

The Chinese government does not issue many bonds. There is no readily available market for investing renminbi that is considered both safe and liquid. The only thing a country or company can do easily is buy more stuff from China, which puts people right back in the game of direct trade with the country that issued the currency in the first place.

This would suit the Chinese just fine, but would not help countries that might want to use their reserves for something other than more trinkets from the Middle Kingdom.

A more esoteric point is the question of hedging. For companies and countries to build and use large currency positions for international trade, they must be able to hedge their holdings whenever they see risk.

This would imply a well-developed, functioning capital market that includes futures trading. This does not exist for the renminbi today, although it would be the least difficult piece of the puzzle to address.

A final thought on the U.S. losing its status as the reserve currency is to ask: "Why would anyone else want that burden?" In the world today, every country is busy trying to export its way out of a financial mess. The U.S. wants to send more stuff abroad, the Europeans are counting on the steady flow of BMWs and Audis off the continent, and China continues selling all it can to other nations. Everyone wants to be a net exporter.

But when a currency gains favor — and everyone rushes to buy it — the currency goes up in value. This means that country's exports become more expensive. Why would China — or the euro bloc or Japan for that matter — want to encourage international players to buy more of their currencies simply to use them as reserves? They'd completely undermine their efforts to boost exports and alleviate their economic weaknesses.

Putting this all together, it is clear that the U.S. does not enjoy its position as the reserve currency due to any goodwill, or because the U.S. has been so financially responsible.

It is simply a matter of currently accepted practices (coalescing), the availability of dollars, the well-developed status of capital markets, the size of U.S. trade, and the fact that becoming the reserve currency would not be to anyone's benefit.

Unless something dramatic occurs, the Chinese renminbi will grow in use to match a substantial portion of the trade of the country but likely no more than that. Meanwhile, the euro bloc and Japan continue their efforts to devalue their own currencies, not make them more expensive.

For those of us in the U.S., it means that Fed-printing will not lead automatically to a decline in the use of the dollar abroad and, therefore, will not cause a drop in the value of the greenback. Anyone pinning their hopes on a cheaper dollar — by purchasing inflation-protected assets like TIPS or gold — will be disappointed. In fact, the opposite is likely to occur. When the U.S. and the world hit the next rough spot, the U.S. dollar is likely to spike in value, not fall.

The Dollar is the Ultimate Safe Haven

As the biggest, strongest, richest kid on the block, the U.S. dollar has a great many detractors. But despite the copious gripes of those critics, the dollar remains the ultimate safe haven in a financial crisis.

As the next round of deflation takes hold, a strong dollar will mean that anyone who has a claim on streams of income can purchase more assets, more services and a higher quality of life down the road.

As for future growth, our economy appears to be in a "muddle-through" mode, while consumers continue to shed debt (excluding student loans and car loans) despite ongoing income stagnation. All of this puts us on the path of deflation, which is quite normal after such an incredible boom in debt as we had in the 1990s and 2000s.

Debt deleveraging, deflation and a strong currency all work to drive interest rates down, or simply hold them at low levels, and to boost the value of cash, not inflation-protected assets. This means that people who are busy buying assets could be in for a rough ride, while those who are amassing streams of income are buying protection.

The U.S. dollar has proven itself as the undisputed champion in the currency arena. It's the reserve currency to the world's $70 trillion economy. It's the most ubiquitous method of payment. And it's the best currency investment in times of global financial turmoil.

Trumping the Buck

The biggest "X" factor facing the U.S. dollar isn't the Fed or the Chinese, it's our own president. The newly-elected Commander-in-Chief has put forth several proposals, some of which would strengthen the dollar, and others that could cause it to weaken.

Will we have trade skirmishes that slow the flow of dollars overseas, starving the world of greenbacks and pushing up their value? Will we have expansive new infrastructure spending with no offsetting reductions or tax increases, leading to larger deficits and potentially inflation? Will we have both?

At the moment, there's no way to know. Even as these plans come into sharper focus, it will be months or even a year before the outcomes are known.

But remember that these are adjustments at the margin. The bigger questions regarding the dollar, like its status as the reserve currency of the world and its place among rivals, is settled for years to come.

As policies unfold and we learn more about how they could affect the value of the dollar and any other commodities, timing will become increasingly important. During some periods, investments in particular stocks could be very profitable, while others could be costly. This is why you should follow our weekly email alerts and monthly issues of Boom & Bust closely. This is where we'll tell you what's coming next, what to do about it and how to adjust your financial plans and portfolio for maximum benefits, and minimum pain. In short, we'll guide you step by step. *Gain access to Boom & Bust here!*

About *Economy & Markets*

In 1989, Harry S. Dent wrote the book *Our Power to Predict*. In it, he revealed how an investor could use demographic trends to accurately predict the direction of the markets, sometimes decades in advance.

Since then, Harry and his business partner Rodney Johnson have been using this New Science of Finance to accurately identify booms and busts well ahead of the mainstream.

They gained national attention for their work in warning investors of the 2008 credit crisis and subsequent stock market collapse, many months before it happened.

But this was not the first time they were "on the money" with their big picture forecasts.

For example, in 1989 Harry accurately forecast the Japanese economic collapse and the multi-decade depression in Japan that would follow.

He also called a Dow of 10,000 by the early 2000s at a time when most economists, politicians, businessmen, analysts and investors were expecting the exact opposite. The Dow broke the 10,000 barrier for the first time on April 5, 1999.

In other words, they accurately predicted most of the major economic and stock market events that could have made you substantially richer over the past 20 years.

How do they do it? Well, while most economists focus on short-term trends… policy changes… technical indicators… elections — things that are volatile, unstable and can change from day-to-day — Harry and Rodney focus on long-term trends. Demographics. Business cycles. Human behavior patterns. Things that have demonstrated themselves over hundreds (even thousands) of years to be consistent, predictable and measurable.

They study the past to predict the future… an approach that enables them to forecast years into the future with an incredible degree of accuracy. Then they make minor tweaks and adjustments in response to short-term events that occur along the way.

And that's what they bring to you in *Economy & Markets*, so you'll know what's coming next… where the immediate opportunities are… and where to park your money for the longer term.

As a *Economy & Markets* subscriber, you will know, for example, when it's time to start profiting from the rise of specific emerging market economies. And exactly what industries and investments will hand you the fastest profits, first.

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You'll be ahead of the markets on every boom and bust… access the tools you can use to prepare yourself to survive and prosper.

Meet the Experts

Harry S. Dent Jr.
Founder & Senior Editor

Harry studied economics in college in the '70s, but found it vague and inconclusive. He became so disillusioned by the state of his chosen profession that he turned his back on it. Instead, he threw himself into the burgeoning New Science of Finance where identifying and studying demographic, technological, consumer and many, many other trends empowered him to forecast economic changes.

Since then, he's spoken to executives, financial advisors and investors around the world. He's appeared on "Good Morning America," PBS, CNBC and CNN/FN. He's been featured in *Barron's, Investor's Business Daily, Entrepreneur, Fortune, Success, U.S. News and World Report, Business Week, The Wall Street Journal, American Demographics* and *Omni*. He is a regular guest on Fox Business's "America's Nightly Scorecard."

Harry has written numerous books over the years. In his book *The Great Boom Ahead*, published in 1992, he stood virtually alone in accurately forecasting the unanticipated boom of the 1990s. That same year he authored two consecutive best sellers: *The Roaring 2000s* and *The Roaring 2000s Investor* (Simon and Schuster). In T*he Next Great Bubble Boom*, he offered a comprehensive forecast for the following two decades.

In *The Great Depression Ahead*, he outlined how the next great downturn is likely to unfold in three stages, with an interim boom stage between 2012 and 2017 before the long-term slowdown finally turns into the next global boom in the early 2020s.

In *The Great Crash Ahead*, he outlines how this next great crash is likely to unfold in the coming months. He explains why there is nothing the government can do to protect us as deflation takes hold of the economy.

In *The Demographic Cliff, How to Survive and Prosper During the Great Deflation Ahead*, shows why we're facing a "great deflation" after five years of stumilus — and what to do about it now.

Harry's latest best-selling book, *The Sale of a Lifetime*, details how we are about to go through a very difficult few years, but shows how you can build a personal fortune despite the broader shakeout.

Today, he uses the research he developed from years of hands-on business experience to offer readers a positive, easy-to-understand view of the economic future.

Harry got his MBA from Harvard Business School, where he was a Baker Scholar and was elected to the Century Club for leadership excellence.

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