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# Macro Matters: Emerging Tensions

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**Amid all the talk of deglobalisation, certain tenets of the world remain fixed in our minds. Key among these assumptions is the status of the dollar as the global reserve currency.**

Today, almost all global trade is conducted in dollars and foreign countries are among the largest holders of US Treasuries. This has cemented US hegemony – a tactic presciently summarised by the American journalist Ludwell Denny in his 1930 book America Conquers Britain: "We shall not make Britain's mistake. Too wise to govern the world, we shall merely own it."

For the US, there are clear benefits to this dominance. Beyond global geopolitical clout, it also allowed policymakers the latitude to implement unprecedented monetary stimulus and vast deficits, as markets acquiesced to the preservation of the existing economic order.

The evidence would argue that this has worked. After a decade of quantitative easing, a steady flow of positive economic news for the US has led to talk of normalisation. Unemployment is down, growth is up and interest rates are finally rising.

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The sense is that a punishing war of monetary attrition is finally being won. Talk has turned from recovery to tightening.

Markets have grown to accept the inevitable and have even shrugged off earlier worries. The taper tantrum of 2013 proved to be a short-lived histrionic fit.

But before we break out the champagne, there is a glaring omission. One only has to look across to Turkey as the latest example to understand.

The Federal Reserve is not just the central bank of the US. It is also the most influential central bank in the world and the real power behind the throne for countless economies such as Brazil and Turkey, whose own notional central banks bend pliant like reeds in the face of US monetary power.

Unfortunately, the impact of tightening on these economies and managing the fallout is outside the Fed's focus. As US interest rates rise, while the rest of the world lags, the dollar becomes a strengthening noose around the necks of many of these countries.

Incremental shifts in the dollar yield curve soon transmute into large changes in capital flows, real exchange rates and inflation elsewhere thanks to the dollar's reserve status. This is especially true for emerging markets, which have significant dollar borrowings, thanks to the credit boom fueled by a decade of monetary experimentation.

The Bank for International Settlements estimates that dollar credit to emerging markets rose to $3.7trn (€3.2bn) at the end of March 2018, with international debt securities growing by 16% in the last year alone. Those borrowings also accentuate their fragility and sensitivity to any dollar strengthening.

It is not a coincidence that emerging markets have had a period of sustained weakness in 2018, as the dollar has rallied. The trade-weighted broad dollar index has risen by 4.5% in 2018 through to the beginning of August, and by 7.6% from its 2018 lows at the end of January. For emerging markets, this strengthening is monetary tightening through the back door, with little regard for their particular conditions.

Students of history will know that assumptions hold until they do not.

Hegemonies also evolve. The US inherited its dominance from the UK, the previous incumbent, as it became increasingly focused on domestic priorities and rebuilding its balance sheet after the world wars. The new US hegemony was based on an expansionary capitalism, significant and growing economic clout and economic largesse, most notably the Marshall Plan.

But before the British, there were others: Spain, the city state of Florence, the Byzantine Empire and so on – all dominant economic powers of their era.

There is a cycle and today we are seeing another turning point.

Where countries in the past have accepted fluctuations in the dollar, there is today growing concern about the US as a reliable partner. Recent US presidents – not just Donald Trump – have increasingly focused on domestic priorities, turning inwards and abdicating the responsibilities of hegemony, namely leadership.

More recently, the protectionism and shocking diplomacy espoused by Trump – even if premeditated bluster – has created global trade tensions, eroding trust and incubating further uncertainty about the global role of the US.

As Turkey and others come under financial strain and worry about growth, not to mention their own social strains, this all weakens the status of the dollar, particularly as new pretenders come to the fore.

China has superpower aspirations and is fast learning many of the lessons from the US's past dominance. Its growth and economic clout are well-known but less has been said about the other strands of pitching for reserve status.

These days, it is the Chinese President Xi Jinping who has emerged as the defender of multilateralism. He has praised free trade, called for more dialogue and co-operation, and talked of inclusive growth. China has gained significant credibility and much like the former US, it is embarking on an expansionary capitalism aided by state largesse.

The ambitious Belt and Road initiative seeks to increase connectivity across Eurasia and Africa, ultimately creating an economic sphere of Chinese influence to drive future growth. Infrastructure investment is key to this ambition, and China has been quick to lend vast sums of money into Africa and Asia to fund ports, railways and the like.

This new 'debtbook diplomacy' is rapidly extending Chinese influence and making the renminbi a key currency for these countries. It is also incubating hegemony as countries become unable to repay the debt. China now owns 72% of Kenya's public debt. In Sri Lanka, the government sold China a 99-year lease in 2017 on a strategic new port in place of debt repayment.

The generous use of US sanctions is another driver of change. As countries begin to view their dollar ties as a geostrategic weakness, they are seeking out other currencies in which to trade. Russia has greatly increased its economic ties with China since sanctions were first imposed, while Iran has also cultivated closer links.

As demand for the renminbi grows, central banks are beginning to view it as a reserve currency. In October 2016, the International Monetary Fund added the renminbi to the basket of currencies that make up the Special Drawing Rights that supplement central bank reserves. Several African and Asian central banks have looked to introduce bilateral currency swap agreements with the People's Bank of China, while 14 African central banks met in Harare earlier this year to discuss holding part of their reserves in renminbi.

This is all growing evidence that US hegemony is eroding, most likely to a plurality of powers in the near future. China and the renminbi are clearly gaining traction. But the euro is still an important currency that has its own sphere of influence. As the US focuses further inwards and other countries jostle for influence, we are seeing the beginnings of a new multi-polar system with competing currencies – the dollar and renminbi as primary, and the euro co-existing as the awkward cousin on the fence.

The hegemony of the US and the status of the dollar as the global reserve currency can no longer be taken for granted. If this transition occurs, then it will accompanied by increased splintering, further trade tensions and yet more currency volatility for those countries caught in the middle.

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