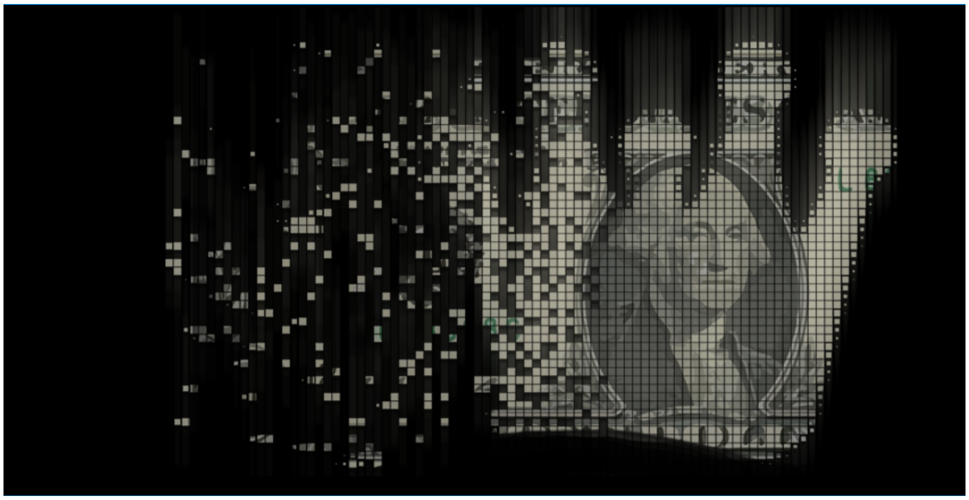
King Dollar Risks Being Dethroned as Blockchain Breaks Down Barriers to Entry

Bill Campbell | November 2021



For three quarters of a century, the U.S. dollar has reigned supreme as the world's reserve currency. Even amid America's declining share of the global economy and, since the Global Financial Crisis (GFC), massive monetization of the U.S. national debt, countries outside the U.S. had few alternatives to transacting cross-border in dollars and maintaining large foreign-exchange (FX) reserves in dollars. I believe the end of this era of dollar supremacy is underway. New financial regimes are busy rewiring the world's monetary and payment systems. New cross-border payment systems and regional trade agreements are laying the infrastructure for a post-dollar financial order. Blockchain technology has already begun to provide a new system in cross-border payments aided by stablecoins and central bank digital currencies.

Timing of a large-scale disintermediation of the dollar from global trade and payment settlement remains an open question. Dollar predominance could fade within this decade, although third-party projections of digital currency growth suggest a slower, more protracted demise for the buck as reserve currency. However, one aspect of the timing is coming into focus: The deposing of the dollar is coming precisely at a time when the U.S. is stepping back from its prior role as the leading actor on the global stage. So, the regime change will represent as much an abdication by the U.S. as a usurpation by forces independent of Washington. In any event, this monetary realignment will prove momentous for dollar-denominated investments. International central banks hold a large stock of dollar reserves relative to the size of the U.S. economy's share of the global GDP. This sets the runway for a big unwind of the currency that would only further accelerate the adoption of nondollar settlements.

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Stablecoin: The Crypto Catalyst of the Next Global Payments Order

Not waiting for government and bank policymakers, the private sector is making significant advances on a rewiring of the global financial system. One important piece of this development has been the blockchain networks popularly known as the technology underlying cryptocurrencies. Blockchain exemplifies the very definition of "decentralized finance" (defi): through peer-to-peer technologies, participants settle payments outside the global ecosystem of sovereign fiat currencies tendered by the world's central banks. The defi revolution solves a variety of problems that arise in traditional finance, including those related to the speed, cost and security of transaction settlement, especially in cross-border payments.

A stablecoin is a digital asset whose value is pegged to another asset. The most popular stablecoins are pegged to the dollar, but other stablecoins are linked to other currencies and assets such as gold. In an Aug. 3, 2021, speech, Gary Gensler, chairman of the U.S. Securities and Exchange Commission, said about 75% of all transactions that occur in digital currencies have a stablecoin on one side of them.[1] In fact, stablecoins are already facilitating cross-border payments and trade settlement as a de facto digital dollar.[2] In a report published Nov. 1 of this year by the U.S. President's Working Group on Financial Markets, the Federal Deposit Insurance Corp. (FDIC) and Office of the Comptroller of the Currency (OCC) call for stablecoins to be regulated as banks, which only further legitimizes stablecoins as a financial asset going forward.[3]

Stablecoins had a market value of $136 billion as of November 11, 2021[4] and, as noted by Chairman Gensler, account for over two-thirds of the volume on at least one side of all cryptocurrency transactions.[5] The two biggest players in this space are Circle USDC and Tether USDT, according to data provided by the cryptocurrency-tracking newsletter The Block. The rapid growth in stablecoins shows the viability of this new private marketplace. The digital networks/blockchains allow for international settlement of stablecoins for many different types of transactions, not just for digital assets such as tokens or currencies. These developments are leading to a private alternative to international payment settlement that is faster and cheaper than many existing options. According to a recent article published by McKinsey & Co., global payment revenues, which totaled $1.9 trillion in 2020, are set to climb to about $2.5 trillion by 2025.[6] As blockchain technologies continue to develop and enter wider usage, stablecoins will grow as a competitor in the global payment space.

Central Bank Digital Currencies vs. Private Money

There are concerns about the collateral backing stablecoins. In a stressed market environment, some worry, stablecoins could essentially "break the buck" akin to 2008 when money market funds failed to maintain net asset valuations at $1 per share. This vulnerability creates an opening in this developing market for central bank digital currencies (CBDCs). As with the fiat currencies such as the dollar, euro and yen, CBDCs are backed by the full faith and credit of a sovereign state or, in the case of the European Central Bank, a superstate. That promissory guarantee could make CBDCs more preferred stablecoins versus private stablecoins.

Central banks, however, have a choice in how they structure their CBDCs, including whether they will be able to see all holders and transactions, as was the case in China. If central banks follow the lead of Beijing and do not offer privacy in their new digital money, market participants still might prefer private money. In the United States and Europe, the rapid progress in the private stablecoin space could overtake CBDC research and development at the Federal Reserve and the European Central Bank.[7]

The Trade-and-Settlement Side of the Digital Coin

Outside the U.S. and Europe, bank and trade authorities have been forging ahead with the development of digital settlement infrastructure. Project Dunbar, a case in point, brings together the Reserve Bank of Australia, Bank Negara Malaysia, Monetary Authority of Singapore and South African Reserve Bank with the Bank for International Settlements Innovation Hub to test the use of CBDCs for international settlements.[8] Results will inform development of global and regional platforms and support a G-20 roadmap for improving cross-border payments. The private infrastructure is already building in this direction.

The Society for Worldwide Interbank Financial Telecommunication (SWIFT) is the largest payment settlement network in the world. The dollar accounts for 85% of one side of all cross-border transactions settled by SWIFT.[9] However, in recent years, the United States has stepped back from its traditional role as the underwriter of globalization in order to focus on its domestic job market and re-onshore its supply chains. Nature, so goes the axiom, abhors a vacuum. Around the globe, countries outside the U.S. are taking the initiative to build on and build regional trade agreements without the U.S. as a signatory. Growing country-to-country and regional trade agreements virtually necessitates cross-currency settlement infrastructures. For much of this trade, bilateral settlement might make more sense than settlement mediated through the dollar. In fact, to my eye, bilateral settlement seems an almost inevitable choice as regional economies become more interlinked through imports and exports of goods and services. The central banks of countries significantly engaged in regional trade will need to hold more of the currencies of their trading partners and commensurately less in dollar reserves.

The Organisation for Economic Co-operation and Development (OECD) notes that regional trade agreements (RTAs) covered more than half of world trade in 2019.[10] *(Figure 1)* In an example of this movement, China recently became a signatory to the Asian Regional Comprehensive Economic Partnership and aims to become a member of the Comprehensive and Progressive Agreement for Trans-Pacific Partnership.

Evolution of Regional Trade Agreements Over Time

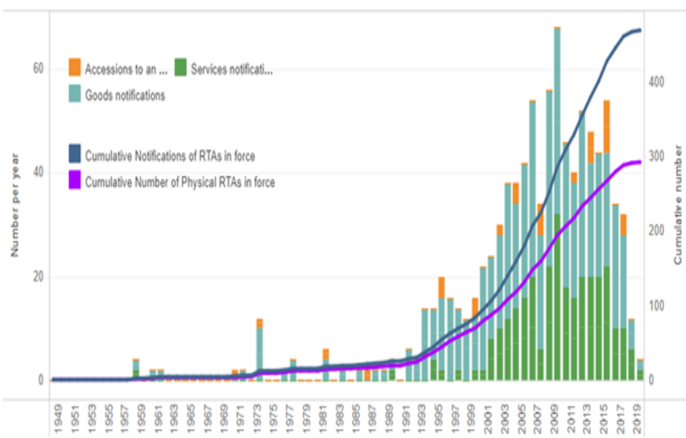


Figure 1
Source: World Trade Organization, as of January 28, 2019

A Dollar Float Over Its Skis

The U.S. dollar remains at the heart of international trade, accounting for 59.23% of world allocated reserves in the second quarter of 2021, according to the International Monetary Fund (IMF). *(Figure 2)* In contrast, the U.S. economy accounted for only 15.86% of global GDP in October 2021, according to the IMF. That gap leaves a lot of room for global central bank divestiture of dollars as regional trade and cross-border payments pick up.

World - Allocated Reserves by Currency for 2Q2021

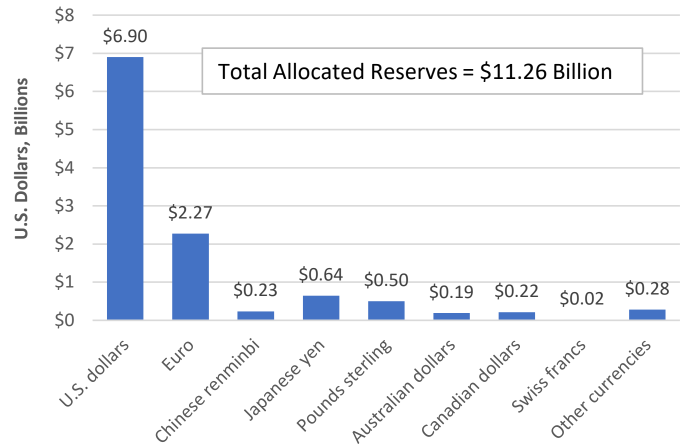


Figure 2
Source: International Monetary Fund as of June 30, 2021

As with any nascent market trend, timing is tricky. But the conditions are in place for reserve-currency regime change, and once the trend gets started, it is likely to run faster and farther than many market participants expect. Since the advent of the GFC in 2008, U.S. markets have attracted a large percentage of international savings. The U.S. Net International Investment Position as measured by the IMF has moved from a deficit of $4 trillion in 2008 to a deficit of $14 trillion as of the first quarter of 2021. *(Figure 3)* This means that $10 trillion more of foreign capital has moved into the U.S. than the U.S. has invested abroad. The tide of this large pool of international savings could reverse. A net outflow of capital from the U.S. of such a magnitude would pose a major and obvious threat to the dollar.

IMF United States Net International Investment Position with Fund Record

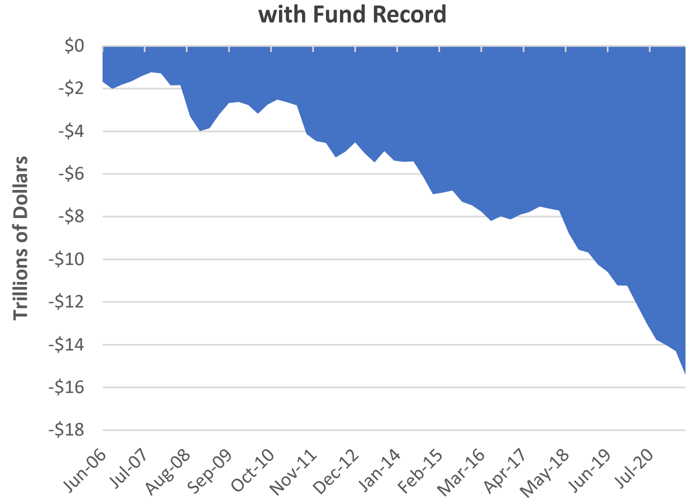
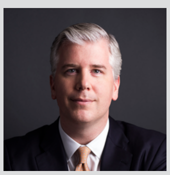


Figure 3
Source: International Monetary Fund, Bloomberg, as of June 30, 2021

The U.S. also is the world's largest consumer, with one of the largest nominal current account deficits on the planet. That means that the U.S. purchases more globally than it sells. These purchases give foreigners dollars that they can choose to hold and invest or spend on dollar-denominated assets or services, or they can sell those dollars. If the dollar starts to depreciate, the likelihood of foreigners holding dollars goes down. All this adds to a bad long-term picture for the dollar. The federal government is funding a large portion of U.S. growth via deficit spending – to an extent that would assume limitless forbearance on the part of America's creditors. Investor concerns about how these debts will be repaid only adds to the risk of a foreign buyer strike on the dollar.

For these reasons, I believe that the dollar will undergo a structural move lower in the coming years. History, however, will not repeat itself in the form of a new single currency taking the place of the dollar, as the dollar nearly a century ago succeeded the British pound as the primary linchpin of global trade and payment settlement. Instead, the digital advancements of blockchain will likely pave the way for sovereign states to select their own fiat currencies, digital assets or a mixture of both for international payments.[11] Each will choose modes of settlement and transaction most closely aligned with their own national interests and those of their trading partners. In the aftermath of King Dollar will arise a new order of fiat and digital principalities. ■



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Mr. Campbell joined DoubleLine in 2013. He is a Portfolio Manager for the DoubleLine Global Bond Strategy and is a permanent member of the Fixed Income Asset Allocation Committee. He covers Developed Markets, Central & Eastern Europe, Middle East and Africa (CEEMEA), and China. Prior to DoubleLine, Mr. Campbell worked for Peridiem Global Investors as a Global Fixed Income Research Analyst and Portfolio Manager. Previous to that, he spent over five years with Nuveen Investment Management Company, first as a Quantitative Analyst in their Risk Management and Portfolio Construction Group, then as a Vice President in their Taxable Fixed Income Group. Mr. Campbell also worked at John Hancock Financial as an Investment Analyst. He holds a BS in Business Economics and International Business, as well as a BA in English, from Pennsylvania State University. Mr. Campbell holds an MA in Mathematics, with a focus on Mathematical Finance, from Boston University.

Foreign Exchange (FX) – Foreign exchange (forex or FX) is the trading of one currency for another. For example, one can swap the U.S. dollar for the euro. Foreign exchange transactions can take place on the foreign exchange market, also known as the forex market. There is no centralized location, rather the forex market is an electronic network of banks, brokers, institutions and individual traders (mostly trading through brokers or banks).

G-20 (Group of 20) – The G-20 comprises the European Union leadership and 19 countries that look to cooperate on international financial matters. The member countries are: Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Mexico, Russia, Saudi Arabia, South Africa, South Korea, Turkey, the United Kingdom and the United States.

Net Asset Value (NAV) – Net value of an entity calculated as the total value of the entity's assets minus the total value of its liabilities. Most commonly used in the context of a mutual fund or an exchange-traded fund (ETF), the NAV represents the per share/unit price of the fund at a specific date or time.

Citations

1 "Remarks Before the Aspen Security Forum," Gary Gensler, Aug. 3, 2021. https://www.sec.gov/news/public-statement/gensler-aspen-security-forum-2021-08-03

2 The utility of stablecoins extends well beyond international trade and cross-border payment settlement, the topics of this paper. Stablecoins are often backed by collateral similar to the collateral underlying a U.S. bank. The linking of digital assets 1-to-1 to the dollar has enabled defi to expand into such activities as securitization, lending and credit.

3 "Report on STABLECOINS," President's Working Group on Financial Markets, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency, Nov. 1, 2021. https://home.treasury.gov/system/files/136/StableCoinReport_Nov1_508.pdf

4 For the market capitalization of stablecoins, see this running tabulation by The Block newsletter: https://www.theblockcrypto.com/data/decentralized-finance/stablecoins

5 For the stablecoin share of transactions (on one side), see this running tabulation by The Block newsletter: https://www.theblockcrypto.com/data/crypto-markets/spot

6 "Global payments 2021: Transformation amid turbulent undercurrents," Philip Bruno, Olivier Denecker and Marc Niederkorn, Oct. 7, 2021. https://www.mckinsey.com/industries/financial-services/our-insights/global-payments-2021-transformation-amid-turbulent-undercurrents

7 For more on the progress of some central banks and the private sector in developing digital currencies amid relative inaction by the U.S. Federal Reserve and the European Central Bank, please see Bill Campbell, "Are Central Banks Whistling Past the Crypto Graveyard?" June 15, 2021. https://doubleline.com/wp-content/uploads/Campbell-on-Crypto-Graveyard_June-2021.pdf

8 "Project Dunbar: international settlements using multi-CBDCs," Bank of International Settlements. https://www.bis.org/about/bisih/topics/cbdc/wcbdc.htm

9 "Global payments 2021"

10 "Regional trade agreements are evolving – why does it matter?," Organisation for Economic Co-operation and Development. https://www.oecd.org/trade/topics/regional-trade-agreements/

11 See also Bill Campbell's "Taking Aim at the U.S. Dollar as the World Builds a Multipolar Trade-and-Payments Order," Feb. 1, 2021. https://doubleline.com/wp-content/uploads/Taking-Aim-at-the-Dollar-in-a-Multipolar-Order-January-2021.pdf

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