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Chapter 6

The Global Financial Order in 2030: Moving – Glacially – Towards a Multi-Polar Financial World

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The aftershocks of the U.S.-led financial crisis of 2008 and the ensuing financial crisis in the eurozone have produced cracks in the global financial architecture and triggered multiple calls for a re-examination of the post-war, Western-led global financial system. Adding urgency to this narrative: the U.S. government shutdown and the bitter debt ceiling debate in 2013, which damaged the global brand of the United States and raised doubts in the minds of many foreign investors about the credit worthiness of the United States, the world's largest debtor nation.

Trust in the standard bearers of the postwar financial system – the United States and Europe, along with Western-backed multilateral financial institutions like the International Monetary Fund and World Bank – has been diminished. Meanwhile, China in particular and developing nations in general are flush with capital and agitating for a greater say on how the global financial system is run and governed. The massive capital accumulation of the developing nations gives this cohort more power when it comes to shaping the financial order of the future. On a grand scale, however, change will be more evolutionary than revolutionary, gradual rather than sudden.

More than five years after the collapse of Lehman Brothers, Wall Street and the United States remain at the center of the global financial universe, backed by one of the largest and most resilient economies in the world. The global appeal of the U.S. dollar remains relatively strong, while the eurozone crisis has diminished investor appetite for the euro. Meanwhile, developing nations – despite having over $10 trillion at their disposal in the form of international reserves – have failed to use their financial firepower effectively to stave off a cyclical economic

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slowdown, let alone marshal their massive savings to fundamentally remake the global financial order in their image. Fears of "tapering" by the U.S. Federal Reserve, or the removal of excess liquidity from the U.S. capital markets, sparked a firestorm in the emerging markets in 2013, prompting massive capital outflows in many developing nations and attendant macroeconomic problems for nations like South Africa, Brazil, Russia, Turkey and many others. These trends were a strong reminder that the developed nations still largely dictate and influence global capital flows and remain at the center of the global financial universe.

That said, the global financial architecture is being reconfigured. A more multi-polar financial world will evolve between now and 2030, with the United States and the U.S. dollar likely to remain first among equals. Below, we examine the various metrics supporting the status quo – or a dollar-anchored world – as well as the key underlying trends pointing towards the beginning of a more multi-currency world. Various crosscurrents are at work.

The present baseline: It's a U.S. dollar-based world (for now)

Any discussion of the global financial system has to start with the U.S. dollar, since the greenback has been the long-time anchor of the world financial order. Ever since representatives from the United States, the United Kingdom and 42 other nations met at Bretton Woods, New Hampshire, to hammer out a new international monetary agreement in 1944, the U.S. dollar has dominated global trade and finance—the currency of choice whether in world oil trade, global mergers and acquisitions, and daily transactions in the foreign exchange markets.

Reflecting the latter, according to the latest figures from the Bank of International Settlements, trading in the world's foreign exchange markets now averages a staggering $5.3 trillion a day, a rise of 331% from the levels of 2001 (see first exhibit).

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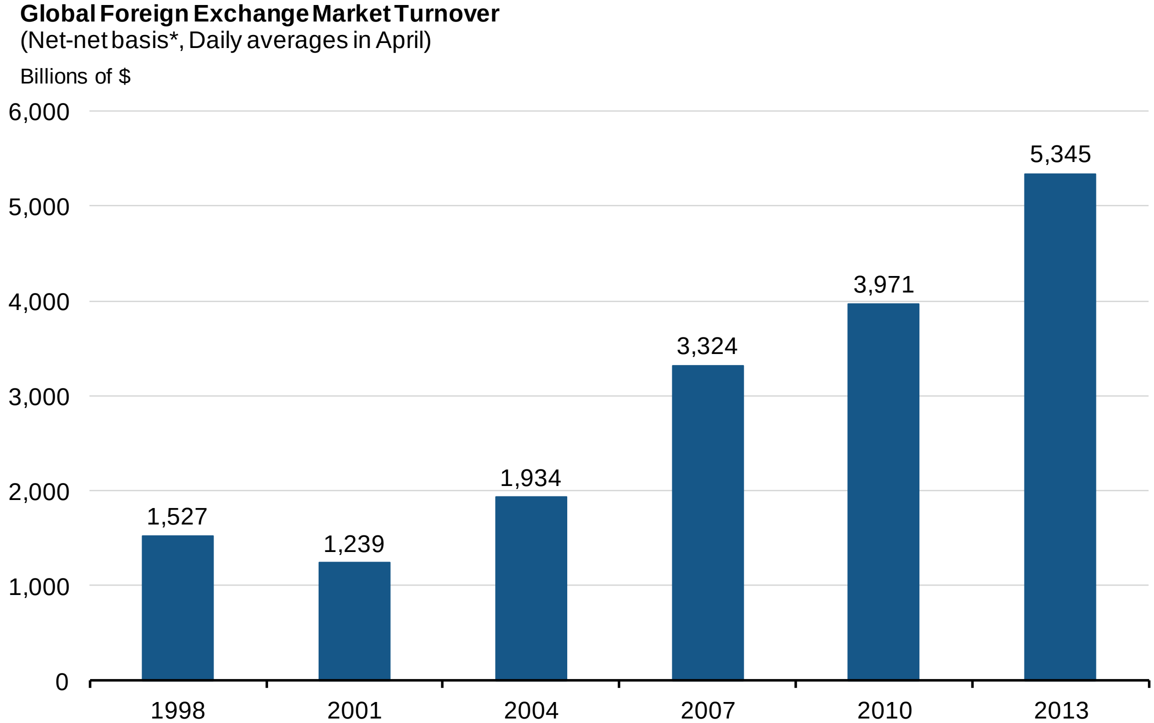
Figure 1.

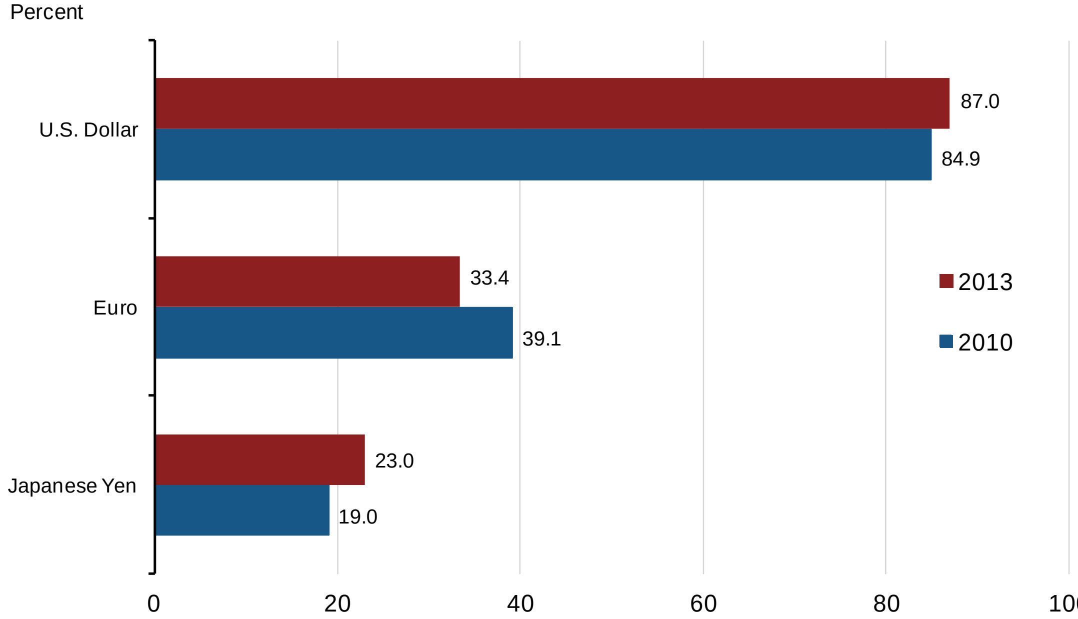


*Adjusted for local and cross-border inter-dealer double-counting.
Source: Bank for International Settlements.
Data as of September 2013.

The dollar was the leading currency behind all this activity, involved in 87% of all trades in April 2013, the last available data. That was up from 2010, when the dollar was used nearly 85% of the time. The euro was the second most traded currency, although its share fell to 33% in April 2013 from 39% in April 2010. The turnover of the yen rose from 19% in 2010 to 23% in 2013.

Figure 2.

Global Foreign Exchange Market Turnover
(Net-net basis*, Daily averages in April)



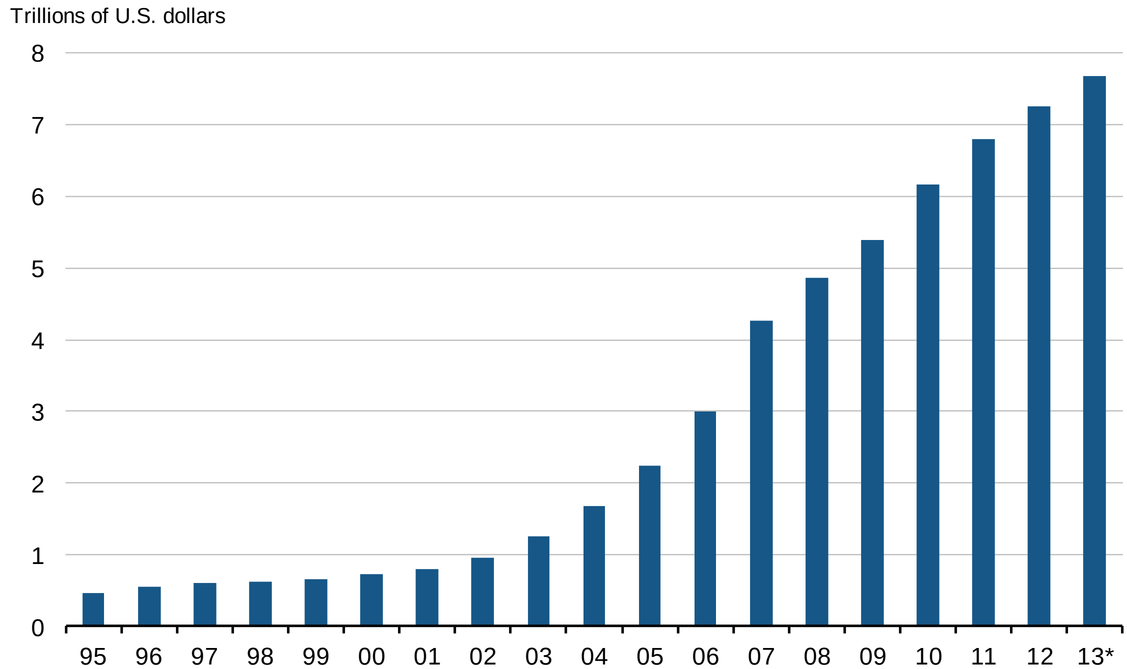
*Adjusted for local and cross-border inter-dealer double-counting.
Source: Bank for International Settlements.
Data as of September 2013.

After the U.S. dollar, euro and yen, the most popular currencies are the British pound, Australian dollar, Swiss franc, and Canadian dollar. While the shares of Australian and New Zealand dollars rose in the latest survey, the British pound, the Canadian dollar, the Swedish krona and Swiss franc all lost ground in global FX trading.

It is clear from all of the above that the currencies of the developed nations are at the forefront driving global foreign exchange trading, and at the top of this monetary hierarchy – unequivocally -- is the U.S. dollar. That is another way saying that is far too early to write the dollar's obituary – a favorite and common narrative of some. Granted, the world financial order is in flux. The West – namely the United States, developed Europe, and Japan is severely in debt and in the midst of a multiyear period of deleveraging and austerity. The developing nations, meanwhile, are flush with capital and in a very strong position to demand a new global monetary order. But the anchor of the global monetary order remains the U.S. dollar.

Figure 3.

Total Foreign Exchange Holdings of Developing Countries



Source: International Monetary Fund
*Data through 3Q 2013.
Data as of December 2013.

The staying power of the buck

A number of factors undergird the dollar's world reserve currency status. One such underpinning is America's capital markets, among the deepest, largest and most innovative in the world. This gives the dollar a built-in competitive advantage relative to other currencies—or, as some say, the power of incumbency. Notwithstanding the "Made in America" financial crisis and the staggering growth of the financial assets of the emerging markets, the U.S. remains at the core of the global capital markets. America is not only a global titan when it comes to total bank deposits, government debt securities, corporate debt, and equities but is also at the forefront of financial innovation and expanding financial services.

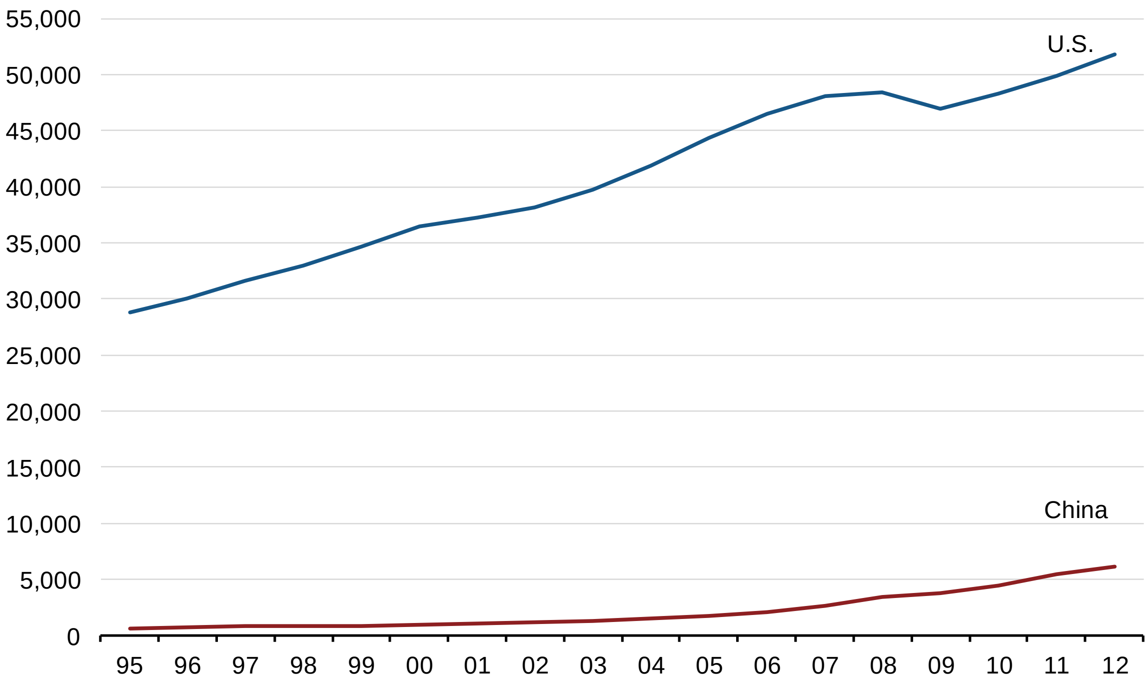
Underpinning support for the dollar is that global trade remains predominantly denominated in U.S. dollars, with more than 80% of world trade estimated to be invoiced in U.S. dollars. This is despite America's declining share of global trade over the past half-century. More than 80% of trade exports of South Korea and Thailand are priced in dollars, notwithstanding the fact that only 20% of their exports are destined for the United States. Similarly, more than 70% of Australia's exports are invoiced in U.S. dollars, although the U.S. accounts for just a fraction of Australia's total exports. In the aggregate, the U.S. dollar is used in 85% of all foreign exchange transactions.

The widespread global use of the dollar gives the greenback more staying power than most observers recognize. To this point, key commodities like petroleum continue to be invoiced in dollars despite grumblings from some Middle East states over the steady decline in the value of their petrodollars. There has been increasing talk of creating petroeuros. But the talk has been just that – talk. The status quo in the Middle East pivots around oil being priced in dollars and dollar-pegged currencies—this decades-old arrangement in the Middle East will continue in exchange for U.S. military services and protection. America's massive military commitment to the region suggests that the dollar-oil nexus will remain quite strong over the medium term.

In addition to the above, there are a host of other variables that continue to underwrite the global supremacy of the U.S. dollar. Notably, the dollar's dominance reflects the fact that the U.S. economy is the largest, most productive and resilient economy in the world. While much has been made of the rise of China in recent years, the usual ominous narrative about China's budding strengths rarely mentions the fact that in 2012, total U.S. economic output ($16.2 trillion) was roughly twice the size of China's $8.2 trillion economy. This makes the average American about 8.5 times more affluent than the average Chinese. Granted, based on purchasing power parity metrics, the gap is not that wide. But this still does not subtract from the fact that early in the 21st century, the U.S. economy remains one of the largest and most dynamic in the world.

Figure 4.

The Wealth Gap: China versus the U.S.
(GDP per capita, nominal $)

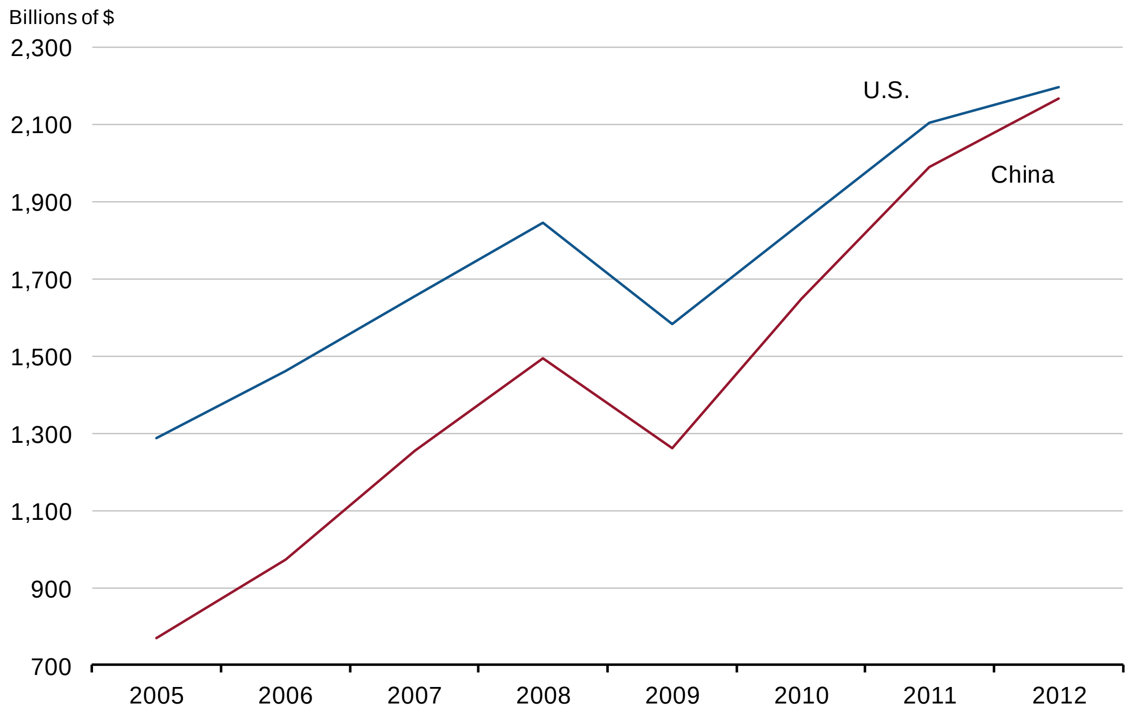


Source: World Bank.
Data as of December 2013.

The dollar's supremacy mirrors the strength of the U.S. economy and the unappreciated and little-acknowledged attributes that set the economy apart from others. For instance, despite the consensus that the United States has lost its manufacturing prowess, it remains among the top manufacturers of goods in the world, with a global share of over 17% in 2012. The United States is also the world's largest exporter of goods and services and reigns as the world's most favored destination for foreign direct investment and portfolio flows.

Figure 5.

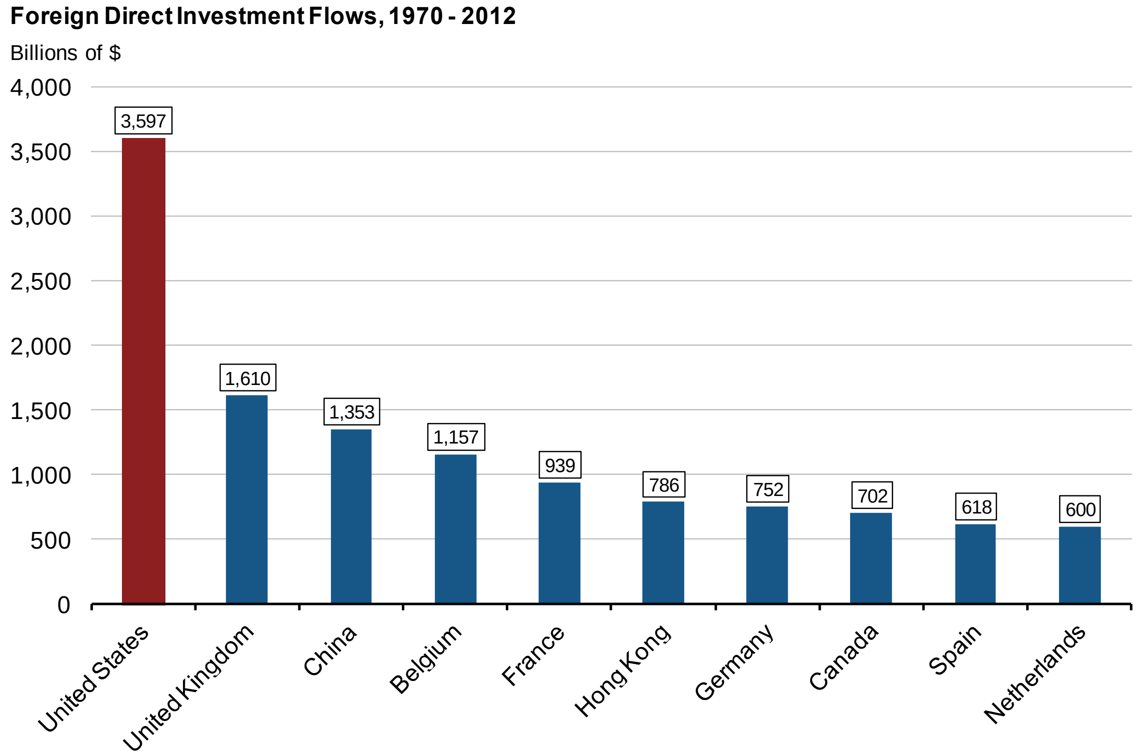
U.S. and China Exports of Goods and Services



Source: International Monetary Fund
Data as of July 2013

The U.S. is a magnet for foreign portfolio investment thanks to its large and transparent capital markets. Meanwhile, America's wealthy consumer base, skilled labor pool, world-class technology capabilities, and protection of intellectual property rights make the United States the prime destination of foreign direct investment. To wit, from 2000 to 2012, for every $1.00 China attracted in foreign direct investment, the United States attracted $2.23. The more global trade and foreign direct investment are conducted with the United States, the greater the demand for and stature of the U.S. dollar.

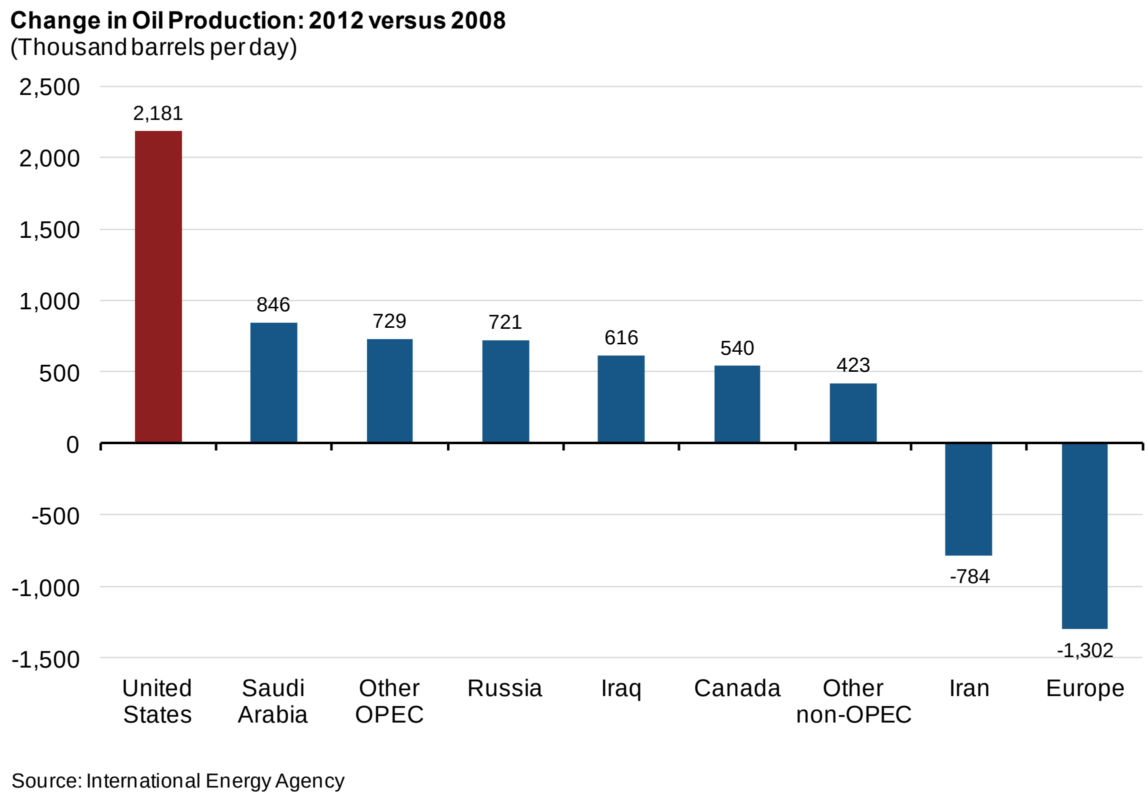
Figure 6.



Source: United Nations Conference on Trade and Development.
Data as of August 2013.

The dollar is also supported by the fact that when it comes to technological innovation, the United States ranks number one in the world, a competitive advantage supported by America's top-ranked university system. The United States is also home to nine out of the top ten consumer brands in the world (soft power) and the number-one military power in the world (hard power). America's energy revolution, with the United States poised to emerge as the world's largest oil and gas producer by the end of the decade, will only add to the economic and financial strength of the nation.

Figure 7.



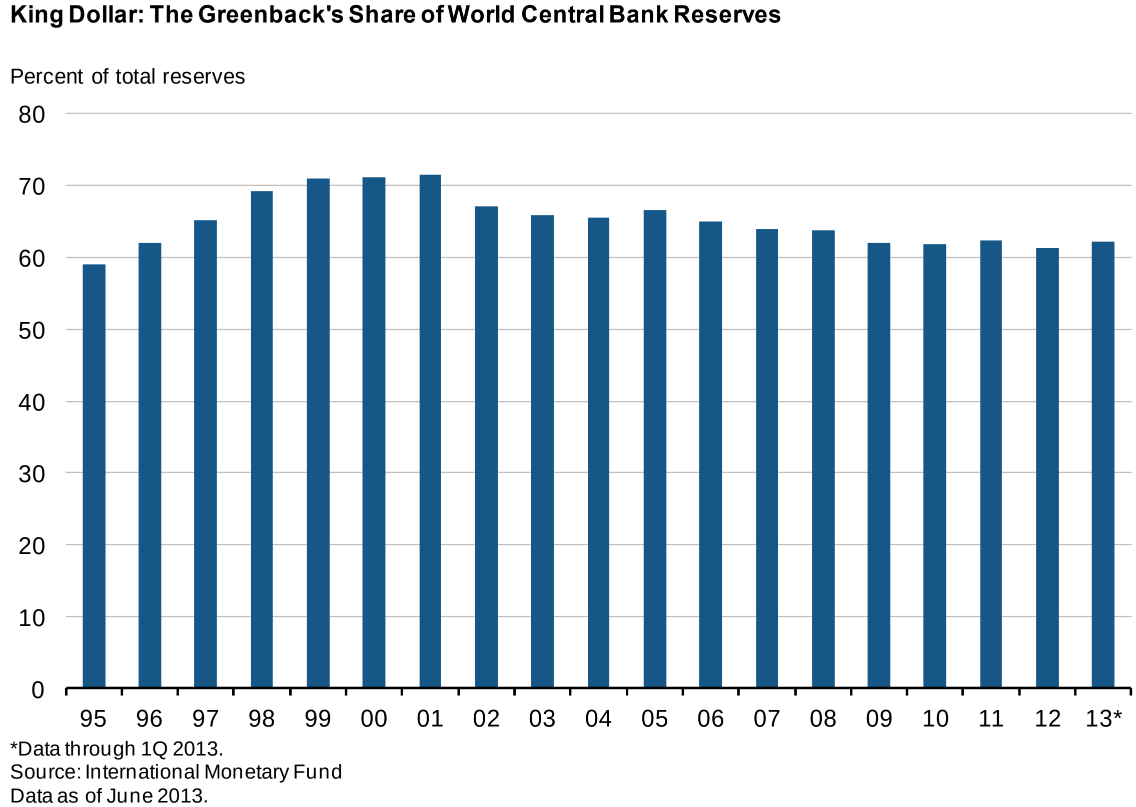
Considering all of the above, it is little wonder the U.S. dollar remains the world's primary reserve currency. Today, the greenback is the world's only true international currency, backed by strong economic fundamentals and robust institutions.

The U.S. dollar: Number One for how long?

However, the past is not likely to be prologue. Other economies are on the rise and other currencies are likely to gain importance in the years ahead. Global trade and investment flows are shifting towards the developing nations. The emerging markets, collectively, have begun to coordinate policies in attempt to refashion the global financial system. The dollar-centric global monetary order of the past half-century is being reconfigured, with the euro and renminbi poised to become alternative reserve currencies, while a host of other currencies increase in importance over the next decade and a half.

Emblematic of this trend, the dollar's share of central bank holdings has declined by roughly 11 percentage points since 2000, falling to a share of 61% in 2013 from a high of 72% at the start of the century. The decline in dollar holdings reflects many variables, with America's sliding share of world output, trade and foreign direct investment over the past few decades chief among them. Persistent budget deficits and large current account deficits, and the attendant decline in the relative value of the dollar against other major currencies have also eroded the reserve currency status of the U.S. dollar.

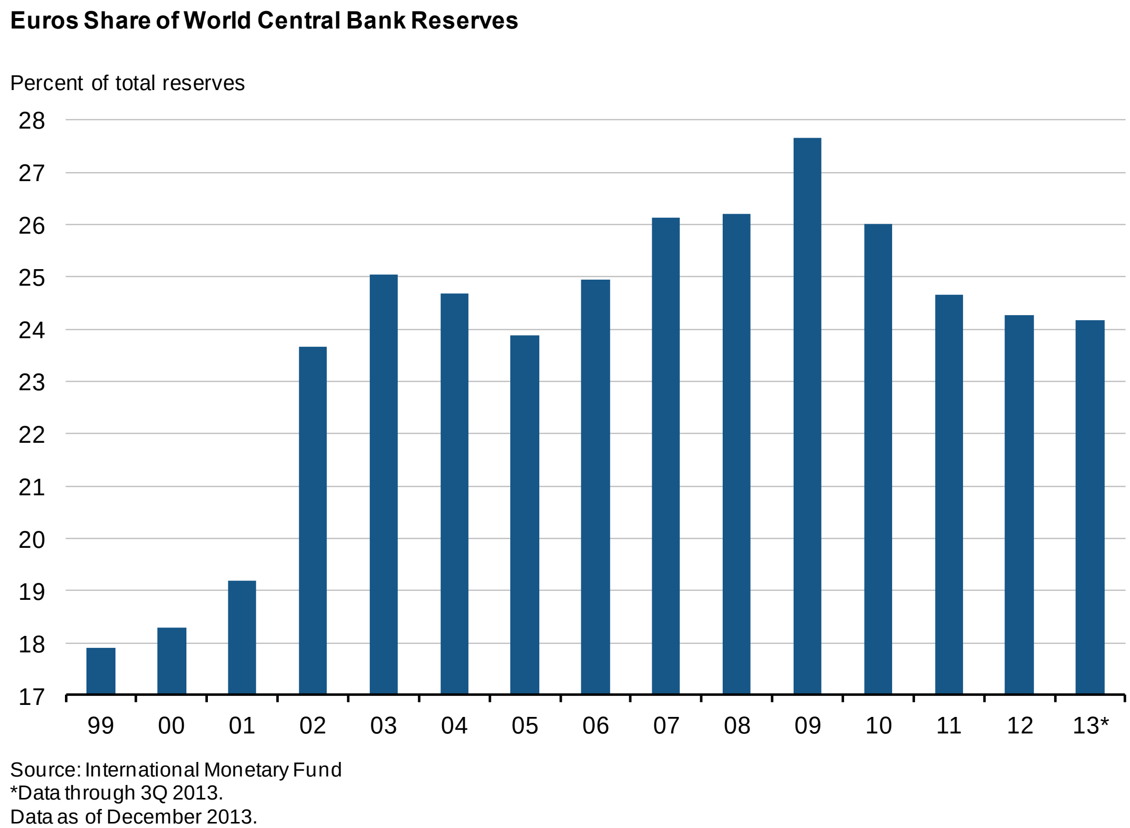
Figure 8.



So has emergence of Europe's single currency – the euro. While the euro has seen its share of central bank holdings decline over the past few years due to the euro zone crisis, the euro still accounted for roughly 24% of total reserve holdings of central banks in the first quarter of 2013. That is up from 17.5% at the start of 2000 or shortly after the euro was introduced. Meanwhile, according to the last data from the BLS, the euro remains the second most traded currency in the world, with the euro accounting for 33% of all global foreign exchange trading in April 2013.

The euro is also supported by a number of macroeconomic variables. The European Union, a proxy for the euro zone, is one of the largest and wealthiest economic entities in the world, a dynamic that will support the financial primacy of Europe for decades to come. Europe is not only rich and large, but also home to some of the most competitive economies and multinationals in the world, a fact that should underpin Europe's leading position in global trade and finance over the medium term.

Figure 9.



To underscore Europe's primacy in the global economy, it is worth noting the following: after the sovereign debt crisis in Europe in 2011 and the attendant euro zone recession, bilateral trade and investment flows between Europe and the developing nations contracted significantly, triggering a host of macroeconomic problems in the emerging markets, China included. Trade financing from Europe declined sharply, while import demand in Europe collapsed, leaving many export-dependent developing nations confronting weaker-than-expected real growth.

Assuming that Europe muddles through over the near-term, that the euro zone stays intact, and that Brussels makes some headway in creating some type of banking union over the next few years, the region will remain a key node in the global financial order.

China: Ready for prime time?

Beside the euro, the only serious contender to the dollar as the world's reserve currency comes from China and the renminbi (RMB). The growing global importance of the renminbi reflects many variables, including China's expanding role in global trade (the nation is now one of the largest trading nations in the world), China's growing influence in trade finance (the RMB recently replaced the euro as the second most heavily used currency in international trade finance) and the rising use of the RMB in FX trading (the RMB is now the world's ninth most traded currency). Add China's stellar economic performance since 1980, when an economic backwater was transformed into the second largest economy in the world, and the prospects of the RNB becoming a legitimate world reserve currency become more credible.

Beijing has taken a number of steps over the few years to internationalize the RMB. An offshore market, for instance, for RMB transactions has been established in Hong Kong and other global financial centers like London. China has also entered into a number of currency swaps with nations like South Korea, Indonesia, Malaysia and Hong Kong, and has agreed to price bilateral trade with Brazil and Argentina in local currency, moves that will further underpin the global use of the renminbi. In another sign of financial liberalization, U.S. companies like McDonalds and Caterpillar have sold debt priced in RMB, while China's renminbi-denominated debt market is already the largest among the emerging markets. In addition to the above, financial reform and the deepening of the capital markets are top priorities of China's new leadership.

In general, Beijing has charted a course that will ultimately elevate the global stature of the RMB. Less clear is the pace by which all of this will happen. It is going to be some time – another decade at the earliest – before the Middle Kingdom's currency challenges the greenback as the world's top reserve currency.

Much work remains to be done

In order for China's currency to remotely challenge the reign of the greenback, China has to first modernize and open its financial sector, allowing for the build-out of efficient money and capital markets. At the moment, China's banking sector is more closed than opened. The RMB is not convertible, or free to trade in the global capital markets. Not until the mainland fortifies and opens its capital account, strengthens its financial sector, and establishes full convertibility of the RMB will the Chinese currency even have the slightest chance of being a world reserve currency.

The international role of both the renminbi and euro will expand over the coming decade, but the process will be gradual and deliberate. To what extent the euro emerges as a world reserve currency will be determined by Europe's attempts to forge a banking union and create a pan-European capital markets that would pool and allocate capital more efficiently and effectively.

China's influence in the global financial order could be compromised or slowed by the nation's secular slowdown, with the Middle Kingdom, after 10% per annum growth for decades, now struggling to re-set its growth model away from exports and investment and towards consumption and service-led growth. China has hit upon a slow-growth patch; this will slow – not postpone/negate – China's rising influence in shaping the future global financial order.

Meanwhile, beyond the euro and RMB, the use of other currencies in global trade and investment, and as a store of value for central bank holdings, will continue to rise over the next decade, collectively chipping away at the preeminent status of the U.S. dollar. Among this list of secondary reserve currencies will be the British pound, Swiss franc, the Australian dollar, the Brazilian real and perhaps the India rupee.

The outlook over the medium-term

The shape and character of the global financial architecture over the medium term will be largely determined by three variables: the fiscal/financial health of the United States; Europe's ability to stabilize and fortify the euro zone and therefore the euro itself; and the pace by which China allows the internationalization of the reminibi.

Starting with Europe, policy makers are struggling to craft a coherent and cohesive banking union; the euro's global appeal will go lacking without the latter. In addition, relative to U.S. banks, European banks remain highly leveraged and undercapitalized, making the euro that much more suspect in the eyes of many foreign investors. Notwithstanding these near-term challenges, as long as the euro zone remains intact, the European Union continues to function and muddle through, the euro will remain a key component of the global financial system.

In China, the pace at which China allows its currency to become more global will in turn determine the pace at which the world moves toward a more multicurrency world. The process is expected to be gradual as China slowly shifts from export-led growth to more consumption-led growth. As the Communist Party shifts economic gears, moves on the currency front will be nominal at best over the near term.

That said, it is worth nothing that it is in China's own interests not to see the dollar dethroned in a sudden and unexpected fashion. As one of the largest holders of U.S. dollars, a sharp decline in the value of the dollar would cost the Chinese dearly. Rather, China is all in favor of a steady move toward a more multilateral currency regime since such a scenario would entail the gradual emergence of the renminbi as a top global currency while preserving the value of the U.S. dollar. In other words, it is not in China's interest to see a dollar crisis, contrary to some narratives in the United States.

Finally, no other party will influence the future of the global monetary order as much as the United States. The U.S. dollar and its role as the world's reserve currency hang in the balance. The cost of two wars (Afghanistan and Iraq) and the tab associated with one of the largest financial crises in U.S. history, juxtaposed against soaring entitlement programs, threaten to undermine the financial health of the United States. The financial health of the United States today versus a decade ago is stunning. Recall that the United States entered the new millennium in respectable financial shape. The country enjoyed a budget surplus in 2000, while the ratio of government debt (held by the public) was quite manageable. Reflecting the rather small role of the public sector in the economy, government outlays were below the historic average in 2000. Total revenues were at an all-time high. And Japan, America's ally in Asia, was the largest foreign holder of U.S. Treasuries according to the U.S. Department of the Treasury.

Thirteen years on, America's financial landscape looks radically different. Since the start of the century, the country's level of debt has roughly tripled, rising from $5.6 trillion in 2000 to over $16 trillion in 2013. The latter number includes debt held by the public and debt held in government accounts, and recently exceeded the debt ceiling imposed by Congress.

The massive accumulation of debt reflects near-constant federal budget deficits—since the 1970s, the U.S. has posted deficits in every year but four. Thanks to two tax increases over the 1990s, reduced military spending, and strong federal revenues, the U.S. posted a budget surplus for four straight years, starting in 1998. A decade later, in fiscal year 2009, the United States posted its first trillion-dollar deficit, running a $1.4 trillion federal deficit; that was equal to 9.9% of GDP, one of the highest in peacetime. In FY 2010, 2011, and 2012, trillion-dollar deficits were the norm, although in the fiscal year just ended, the deficit declined to roughly $640 billion.

Looking forward towards 2030, the more the financial health of America declines, the faster the world will shift away from the dollar-centric global economy of the past 60 years. This shift is inevitable, but is expected to play out over decades.

Barring an utter collapse in the finances of the U.S. government, the U.S. dollar will remain first among equals in the gradual movement towards a more multi-financial world. As highlighted above, despite the financial shenanigans of Washington, the U.S. economy, led by a dynamic and hyper-innovative private sector, remains among the most open and competitive in the world. This makes any move or trend to dramatically reconfigure the global monetary system harder to accomplish. Between now and 2030, the United States is expected to remain one of the largest and most competitive economies in the world, and a leading recipient and supplier of trade and investment capital for the world. In the end, in a world where economic growth is becoming more dispersed and less U.S.-centric, it is only natural that a multi-polar global financial order will emerge.

The question is at what speed this transition will take place – gradually and orderly (as expected) or abruptly due to an external shock. The latter would include the breakup of the euro zone, rupturing Europe's financial ties with the United States and developing nations. Another shock could take the form of a second financial crisis in the U.S., and a more debilitating and lasting impact on the U.S. and global economy. Slower-than-expected growth in China that would prompt Beijing to halt or slow the pace of RMB convertibility, could also prove destabilizing for the world financial order.

Another potential disruptive factor to the global monetary order includes a crisis-prone global economy that operates at sub-par levels, triggering more trade and investment protectionism around the world. Under this scenario, capital stays local, or closer to home, and the world financial system becomes more balkanized and looks similar to the interwar years, when capital controls were the norm. A worldwide explosion in income inequality and the attendant backlash against globalization, including the unfettered flow of capital, could have a similar devastating effect on the global monetary system. The rise of a virtual currency ranks as another disruptive element to the world financial order, although this prospect remains slim given investor unease with the concept.

In contrast to the disruptive forces mentioned above, an orderly passage to a multi-polar financial system would help sustain global growth, promote global rebalancing and further integrate the global economy. It would be positive for the United States, Europe and the developing nations. It took two world wars and a Great Depression to radically alter the global monetary system of the 20th century. It will take a similar shock to dramatically reconfigure the current order. Barring such an event, the global monetary order is likely to become gradually more multi-polar in the decades ahead, with the United States, Europe and China at the forefront of this monetary system.