February 21, 2025

Global FX Reserves & The U.S. Dollar

- The U.S. dollar's share of global currency reserves has been declining for the last quarter century.
- Rather than the currencies of the largest economies (i.e. the eurozone and China), reserve managers have been diversifying into smaller currencies, like the CAD and AUD.
- Given that these smaller currencies have relatively low liquidity, it may not be possible for reserve managers to increase their allocation significantly more.
- With still no major rival, the dollar should remain the dominant reserve currency for the foreseeable future.
- Rather than fretting about the dollar's reserve status, investors need to focus on more important issues that will set the direction for the greenback.
- Potential tariffs, U.S. fiscal policy, the Fed, and Chinese growth will be key for the dollar.

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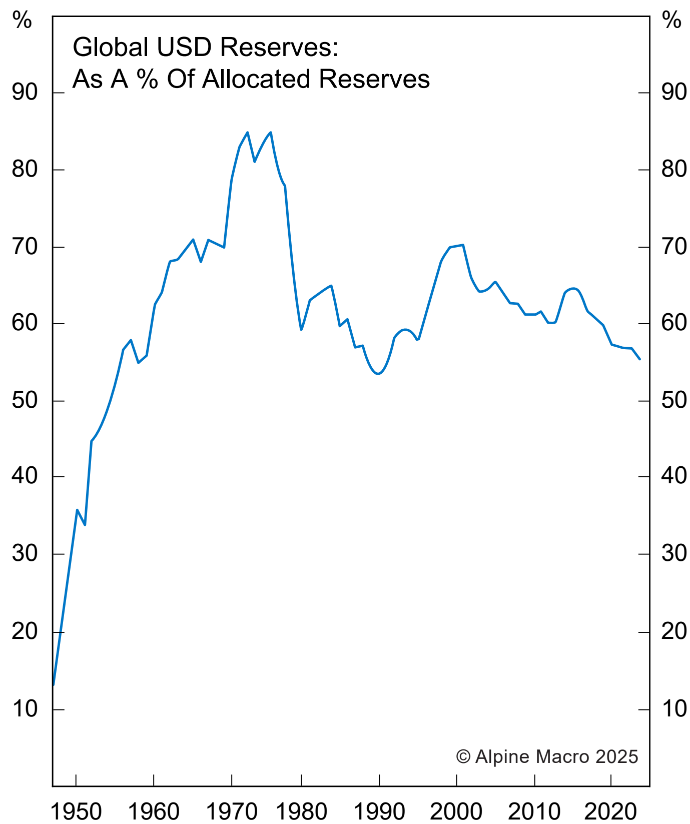
There is often hand-wringing over the U.S. dollar's dominance as a reserve currency. Concerns about the dollar's prominent role were first raised in the 1960s by Valéry Giscard d'Estaing, the French finance minister. He accused the U.S. of abusing the greenback's "exorbitant privilege". More recently, doubts over the dollar's supremacy increased with the freezing of Russia's FX reserves following its invasion of Ukraine in 2022.

Chart 1 The U.S. Dollar's Share Of Global FX Reserves



Source: IMF

Chart 1 provides a long-term perspective on the dollar's evolution as a reserve currency:

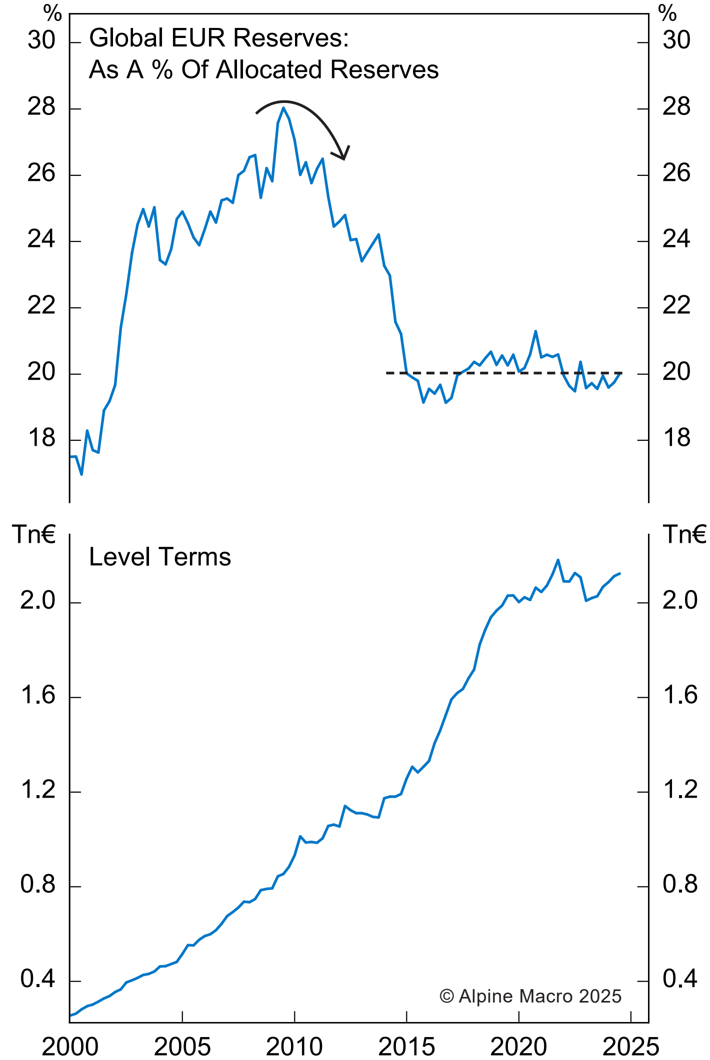
- The dollar's share of global FX reserves rose sharply after WWII and the establishment of the Bretton Woods system. Its share of global reserves reached a peak of 85% in the early 1970s.
- With President Nixon closing the gold window in 1971 and effectively ending the Bretton Woods system, the dollar's share of reserves fell for the next two decades, dropping to a low of near 50%.
- The 1990s then witnessed an upside reversal as the dollar's share of FX reserves, which rose to 72% by the start of the new millennium.
- Except for a temporary bounce following the European debt crisis, the dollar's share of global currency reserves has been declining for the last quarter century and currently stands at 57%.

Which currencies have benefited from the dollar's diminishing share of FX reserves since the new millennium?

For the first decade after its launch, the euro was the dollar's main rival. The eurozone's economy was comparable in size to the U.S. and it had well developed capital markets.

However, the European debt crisis in 2011 exposed the fundamental flaws in the monetary union. The euro's share of reserves peaked at 28% in 2010 and has stabilized at around 20% since 2015 (**Chart 2**, top panel). Nevertheless, total holdings of the euro have continued to rise and currently stand at a near-record high (**Chart 2**, bottom panel).

Chart 2 **The Debt Crisis Knocked Down The Euro's Share Of FX Reserves**



Source: IMF COFER

Without greater political and fiscal unity, it will be difficult for the euro to make further significant progress as a reserve currency. The recent widening in French-German bond spreads warn that underlying strains continue to linger more than a decade after the European debt crisis.

Additionally, the freezing of Russia's FX reserves has not given the euro a boost as a reserve currency. This is because ***all*** of Russia's G10 FX reserves have been frozen. Russia spent years shifting its reserves out of the U.S. dollar and into the euro. As a result, nearly 50% of Russia's frozen reserves are in the euro compared to about 25% in the dollar. The unified Western sanctions against Russia highlight that it was a futile endeavor to swap out of dollars for euros.

As the euro's star began to fade with the debt crisis, there was some optimism that the Chinese renminbi could gain more prominence as a reserve currency. China led the global economy out of the GFC and there was still lots of enthusiasm over China's long-term growth prospects in 2011.

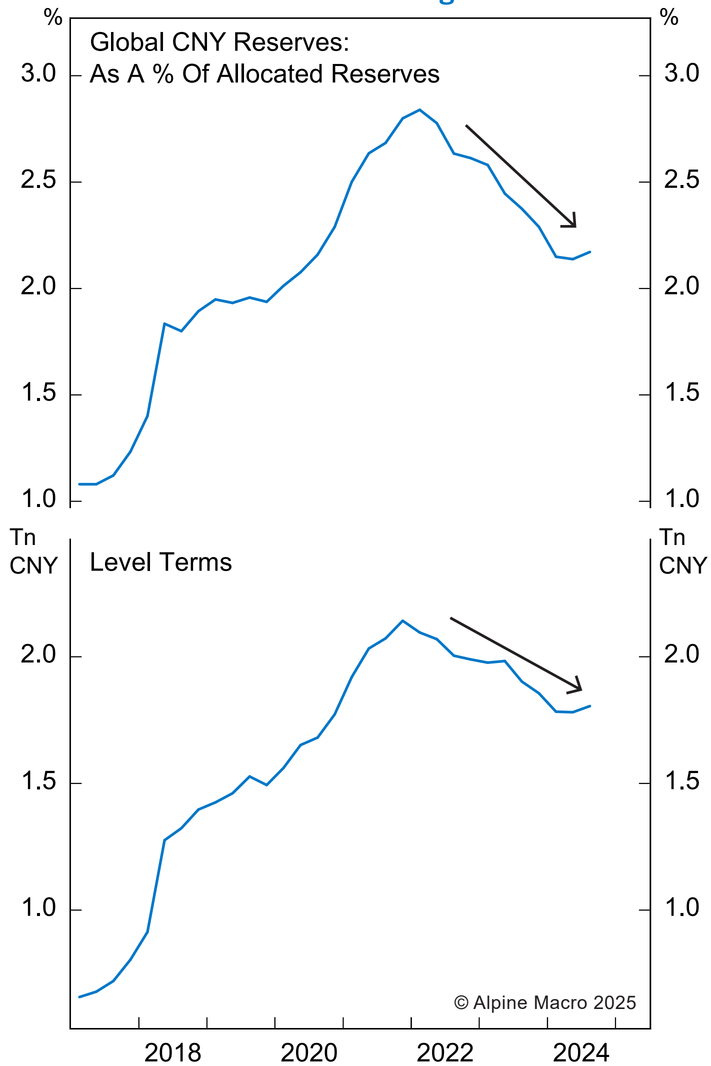
The IMF only began to report FX reserves held in the renminbi from 2017. There was a modest increase until 2021, but holdings of CNY reserves have been declining for the last three years (**Chart 3**).

The downtrend in CNY holdings coincided with Russia's invasion of Ukraine. This has made reserve managers more worried about the geopolitical rivalry between the U.S. and China. The potential for U.S. sanctions has raised concerns on whether China is "investable".

Aside from potential geopolitical risks, China's capital account is not completely open and its financial markets are still under-developed. It could be years and possibly decades before Chinese capital markets are freely accessible and fully developed to rival the U.S. Therefore, the renminbi is unlikely to dislodge the dollar anytime soon.

If not into the euro or the Chinese renminbi, how have reserve managers been diversifying away from the greenback in recent years? The answer is that they have been mainly moving into smaller currencies, such as the Canadian and Australian dollars.

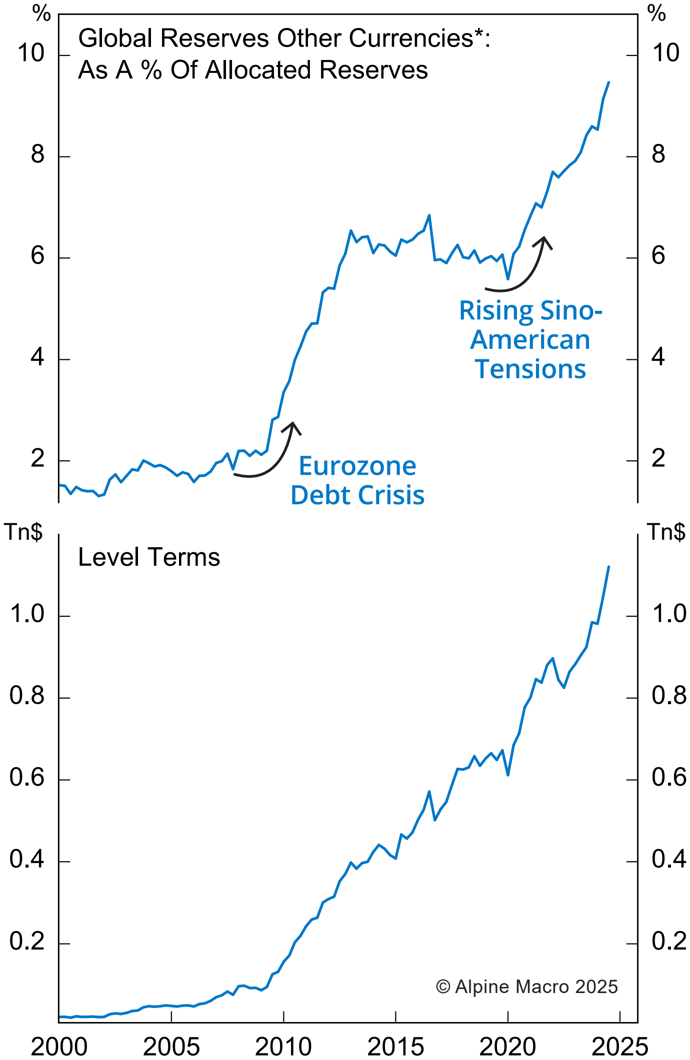
Chart 3 The Allocation To CNY Reserves Has Been Declining



Source: IMF COFER

Chart 4 shows the allocation of FX reserves to other non-U.S. dollar currencies. This excludes the euro, British pound, Japanese yen, Swiss franc, and Chinese renminbi. The allocation to these alternative currencies has increased from less than 2% in 2000 to nearly 10% currently. This rise occurred in two waves. The first up-leg started with the eurozone's

Chart 4 Reserve Managers Have Favored Small Non-Dollar Currencies

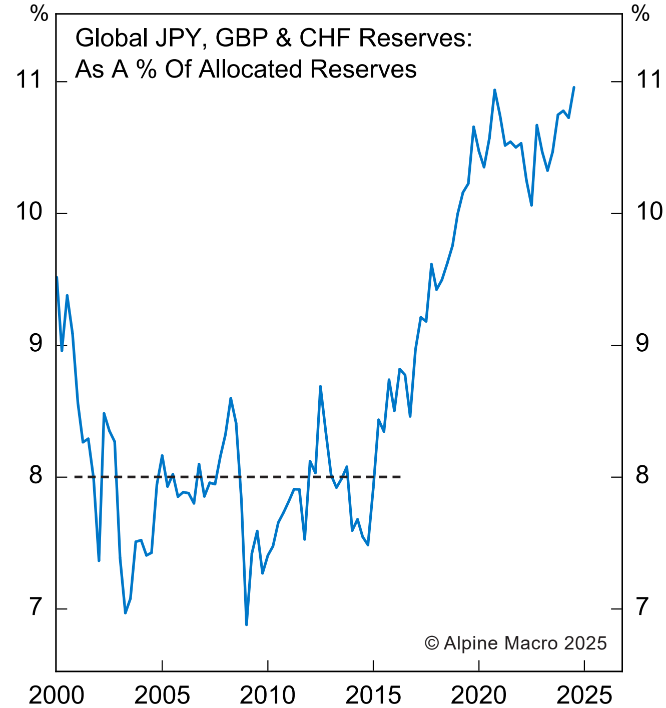


*Excludes USD, EUR, JPY, GBP, CHF & CNY
Source: IMF COFER

debt crisis. The second increase coincided with the growing geopolitical tensions between the U.S. and China.

These smaller other currencies account for the majority of the dollar's declining share of global FX reserves since the start of the millennium. But given that these currencies have relatively low liquidity, it may not be possible for reserve managers to increase their allocation significantly more.

Chart 5 A Modest Increase In Reserve Allocations To The JPY, GBP & CHF



Source: IMF COFER

Finally, Chart 5 shows the combined allocation to the other major G10 currencies: Japanese yen, British pound, and Swiss franc. From an average of about 8% during 2000-2015, the allotment to these currencies has increased only modestly to 11% currently.

Bottom Line: The U.S. dollar's share of global FX reserves has been declining since 2000. However, the main beneficiaries have not been the currencies of the largest economies, such as the euro or the renminbi. Instead, it has been the smaller currencies that have won out the most.

Reserve Status Vs Cyclical Drivers

Even though the U.S. dollar has lost some ground to smaller currencies, it should remain the dominant reserve currency for the foreseeable future. The dollar still has no major rival:

- In the post-war period, the euro posed the greatest threat to the dollar. But the European debt crisis revealed the fundamental defects with the monetary union and the euro. Coupled with years of anemic growth, the euro's bid to unseat the dollar has failed.

- The shine has also come off the Chinese renminbi. The authorities have mishandled the economy and they maintain tight controls over the capital account. Confidence in the Chinese economy and the currency has been shaken.

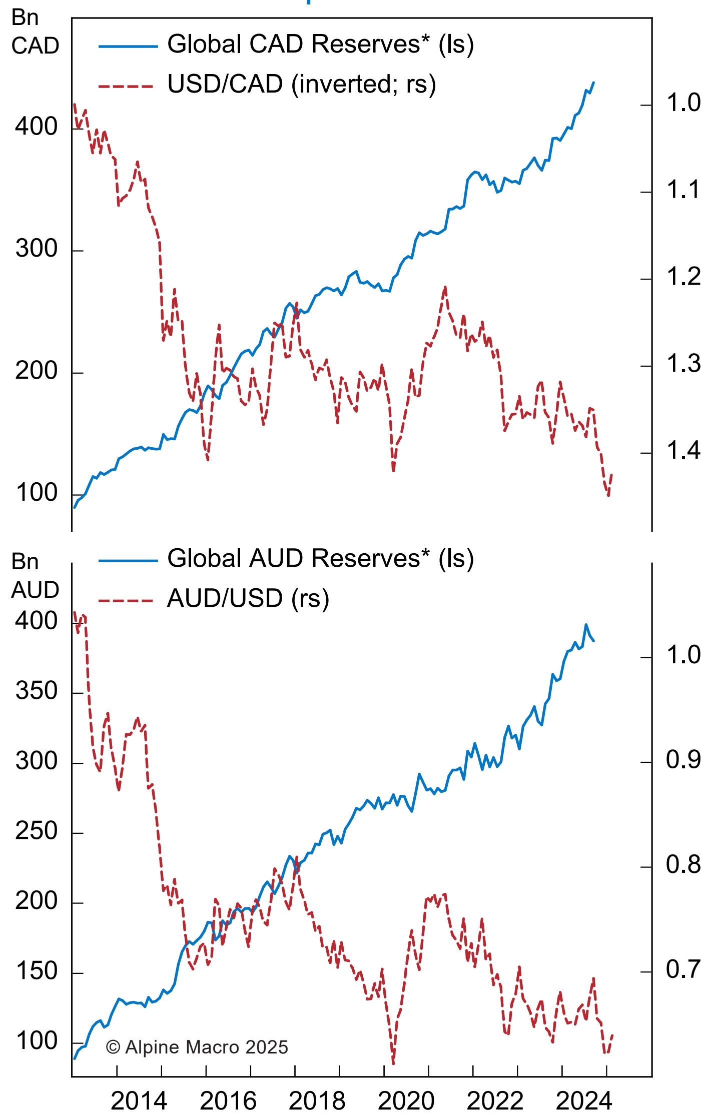
While its prominent reserve status is secure, this will not be the principal factor that drives the cyclical trends in the U.S. dollar. The dollar's share of global reserves has ebbed and flowed over the last 50 years, but there is no direct correlation with the dollar's performance. For example, the greenback strengthened over the last decade even as its share of global reserves fell.

This point is quite apparent in the performance of the Canadian and Australian dollars. Despite experiencing strong and steady demand from reserve managers, the Canadian and Australian dollars have fared poorly over the last decade (**Chart 6**). Fundamentals other than reserve flows have mattered much more.

Rather than fretting about the dollar's reserve status, currency managers need to focus on more important issues that will set the direction for the greenback. We believe investors should direct their attention to four critical issues: potential tariffs, U.S. fiscal policy, the Fed, and Chinese growth.

Rarely a day passes without President Trump threatening to raise tariffs on specific products or nations.

Chart 6 **Strong Demand For Reserves Has Not Helped The CAD & AUD**



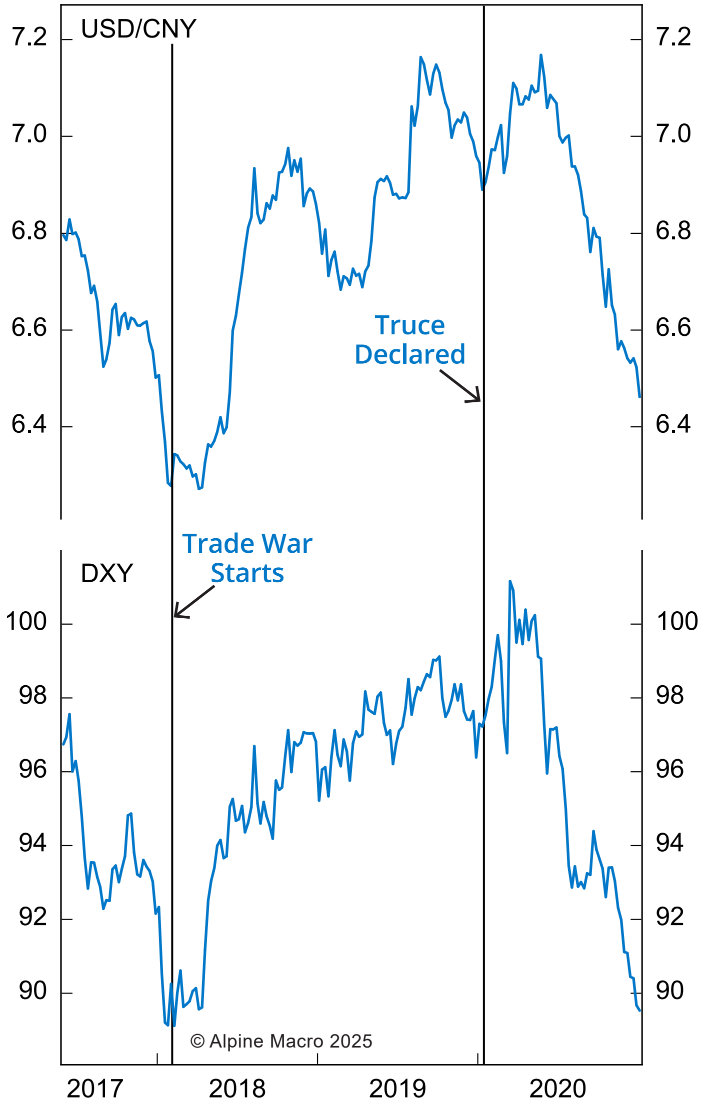
*Source: IMF COFER

As we discussed in a recent report, tariffs cannot narrow trade imbalances.[1] The U.S. trade deficit is mostly a reflection of the government's large fiscal deficit.

As new tariffs will not address the fundamental savings and investment imbalance in the U.S. economy, the dollar would need to strengthen as a

1 Alpine Macro *Global Fixed Income & FX Strategy* "Tariffs 101" (February 7, 2025).

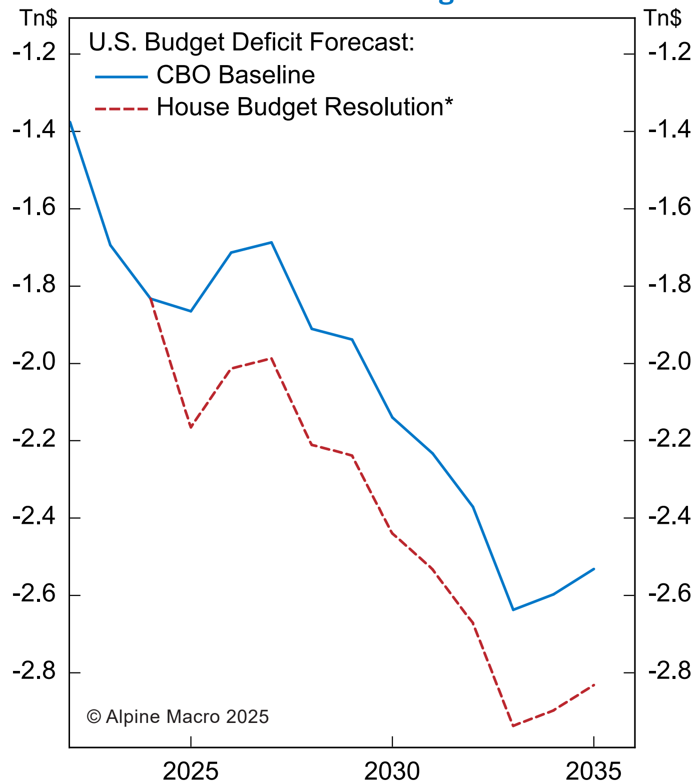
Chart 7 Trump's First Trade War Led To A Stronger Dollar



counterbalance. A stronger dollar will keep imports attractive and penalize exports. This will neutralize the effect of the tariffs on the trade balance. Bear in mind that Trump's first trade war in 2018/19 resulted in a stronger dollar (**Chart 7**).

Higher tariffs could also force the Fed to turn more cautious. The implementation of new tariffs can lead to a one-time increase in the price level. This effect will eventually wash out, but the Fed could

Chart 8 The House's Budget Proposal Would Lead To Larger Deficits



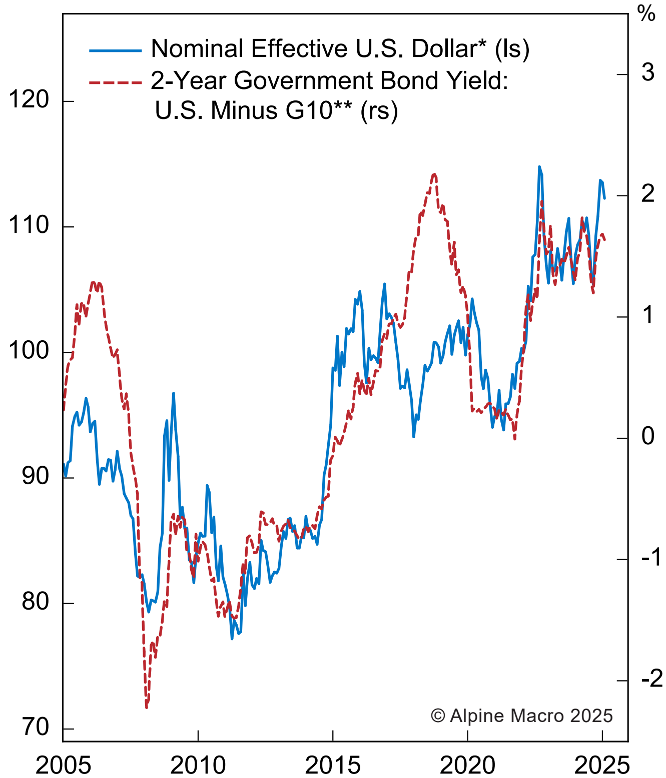
*Source: Manhattan Institute

keep the easing cycle on pause for longer to ensure inflation expectations remain well-anchored.

Easier U.S. fiscal policy would make the Fed even more nervous. The Republican-controlled House Budget Committee is proposing $4.5 trillion in tax cuts, which will be only partially offset by spending cuts. According to the Manhattan Institute, the GOP proposal would add $3.3 trillion to the deficits over the next decade (**Chart 8**).

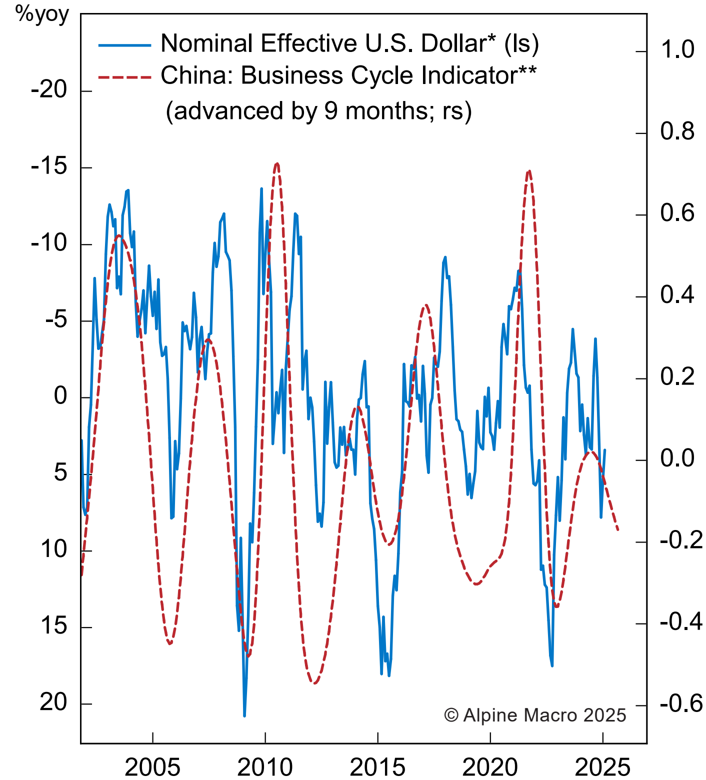
Fiscal stimulus could stall the downtrend in U.S. inflation and force the Fed to take a more hawkish stance. If the Fed keeps monetary policy restrictive, while most other major central banks continue with their easing cycles, yield differentials will widen further in favor of the dollar (**Chart 9**).

Chart 9 Yield Differentials & The Dollar



*Source: BIS
**Equally-weighted average of G10 excluding U.S.

Chart 10 China's Cycle & The Dollar



*Shown inverted; source: BIS
**Alpine Macro proprietary indicator

Finally, the performance of the Chinese economy will also be important for the dollar's direction. Chart 10 illustrates that the dollar is inversely correlated with China's cycle (the dollar is shown inverted in the chart). This is because China is the main driver of non-U.S. global growth. Capital flows more freely to riskier assets outside of the U.S. when global growth is strong. Conversely, weakness in China acts as a drag on growth outside of the U.S. and makes the dollar more attractive.

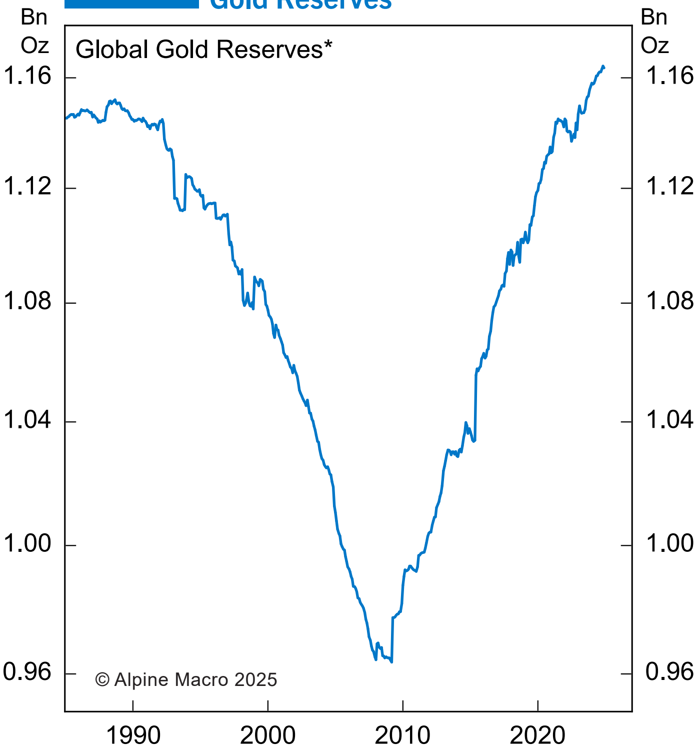
The weak performance of the Chinese economy over the last few years has been a boon for the dollar. Beijing has hinted at a 5% GDP growth target for 2025, which will require further policy easing, particularly in the face of additional U.S. tariffs. The upcoming National People's Congress in early March will be a key event to watch. A failure to deliver strong policy measures would support the dollar.

Bottom Line: Higher tariffs, easier fiscal policy, a relatively hawkish Fed, and weakness in China could send the dollar higher.

What About Gold?

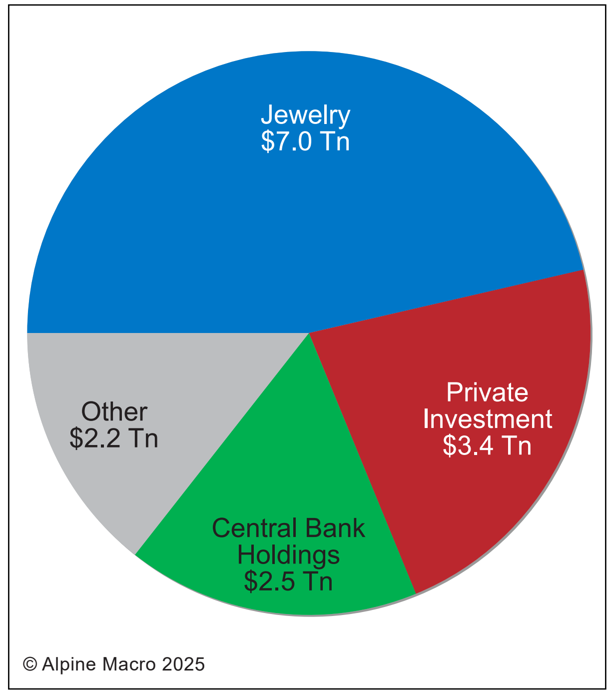
Aside from other non-dollar currencies, central banks have also been diversifying into gold. For two decades from 1990 to 2010, they were persistent sellers of bullion (Chart 11). Interest-bearing government securities were preferred for their reserves. But after the GFC, central banks have been rebuilding their gold reserves.

Chart 11 Central Banks Are Rebuilding Gold Reserves



*Including gold deposits & gold swapped; source: IMF

Chart 12 The World's Above-Ground Gold Stock



The gold market is relatively small and strong demand from central banks will keep pushing prices higher. The total global value of above-ground gold is about $15 trillion, of which nearly half is in the form of jewelry (**Chart 12**). $2.2 trillion is tied up in industrial use and $2.5 trillion is locked away in central banks' vaults and is not for sale. That leaves the readily tradeable gold stock at only $3.4 trillion. In comparison, total non-gold FX reserves are nearly $13 trillion.

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Currency Outlook

Vs THE DOLLAR

	1-3 Months	9-12 Months
EUR	FLAT	DOWN
JPY	UP	UP
GBP	FLAT	DOWN
CHF	FLAT	FLAT
CAD	FLAT	DOWN
AUD	FLAT	DOWN
NZD	FLAT	DOWN

Vs THE EURO

	1-3 Months	9-12 Months
JPY	UP	UP
GBP	UP	UP
CHF	UP	UP
SEK	FLAT	UP
NOK	FLAT	UP

Fixed-Income Outlook

OVERALL PORTFOLIO DURATION

AT BENCHMARK

COUNTRY ALLOCATION*

U.S.	3
Japan	1
Eurozone	4
Core	5
Periphery	2
U.K.	3
Switzerland	2
Norway	4
Sweden	3
Canada	2
Australia	4

* Numbers denote allocation where 1 = maximum underweight and 5 = maximum overweight

Currency Positions

Recommendations	Open Date	Open Level	Target	Stop	P&L		
					Spot	Carry	Total
Long AUD/NZD	2019-04-29	1.0574	1.2000	-	5.04%	-4.05%	0.99%
Long Gold	2022-03-04	1,928	-	-	52.40%	-	52.40%
Short EUR/JPY	2024-11-08	165.17	-	Rolling -3%	4.76%	-0.84%	3.92%
Short EUR/GBP	2024-11-08	0.8318	-	Rolling -3%	0.35%	0.50%	0.85%

Fixed Income Positions

Recommendations	Open Date	Open Level	Target	Stop	P&L
Long 2-Year/Short 10-Year U.S. Treasuries	2022-12-02	4.24%/3.51%	-	-	96.55 bps

A Unique Mind On The Markets