US dollar as a dominant currency: implications for multi-currency risk management

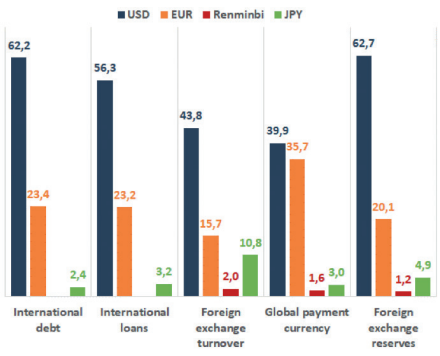
Thierry APOTEKER,
Chairman,
TAC ECONOMICS[1]

Sandrine LUNVEN,
Senior Economist,
TAC ECONOMICS

The dollar remains the world's dominant currency, as shown by its place and weight in financial operations or trade transactions. When translated into exchange rate movements across a large number of different currencies, this dominance is statistically confirmed with a driving role of USD movements for most if not all currencies. But this domination is heterogeneous, by country as well as by time-periods. For large companies managing a multi-currency exposure, the role of EUR/USD management is therefore both central and insufficient, particularly in a context of more frequent currency shocks[2].

Dominant role of the US dollar: evidence and statistical findings

The dominant role of the USD has been much analyzed and documented. The primary metrics for the various role of potentially "international" currencies include share in official foreign exchange reserves, in capital market operations, in transaction and in trade. On all front, the USD share is massively dominant, with an ambiguous exception for transactions: here the fact that intra-Euro Zone transactions are still registered as international transactions provides an artificial boost to the Euro's share.



Role of international currencies. Source: ECB

We conducted an econometric analysis on 103 currencies, with movements of each country's exchange rate against a "neutral" currency (here, the CHF) explained by changes in international currencies' exchange rate against the same neutral currency. The basket of international currencies includes USD, EUR, GBP, JPY and CNY, and the computation is made over two sub-periods, one from 2000 to 2008, the second from 2010 to 2018.

The results show a very clear reinforcement of the dominant role of the dollar since the European crisis of 2010, whereas the previous period had seen a rebalancing of the roles. Since 2010, 81% of exchange rates are significantly influenced by the USD, while only 42% are influenced by the EUR. All non-USD currencies have seen their role and influence decline over the past 8 years.

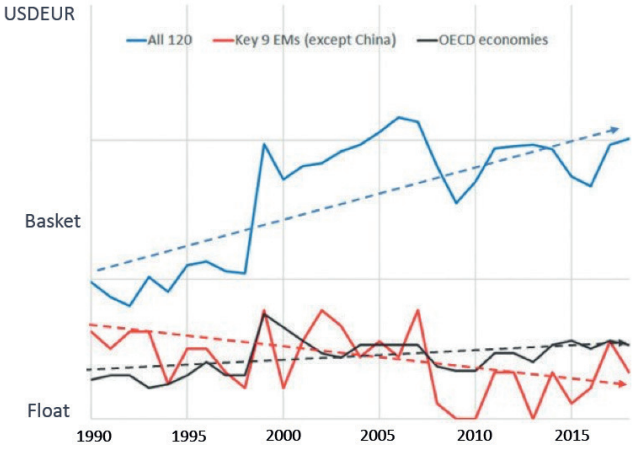
	2000-2008	2010-2018
USD	61%	82%
EUR	60%	42%
GBP	26%	17%
JPY	47%	12%
CNY	41%	24%

% of exchange rates (on a total of 103) with a statistically significant role of a « driving international currency ».
Source: TAC ECONOMICS

We complement this econometric analysis with a more complex observation and quantitative assessment of countries' exchange rate regime, i.e. what is the de facto policy in a large range from fully floating to fixed / pegged exchange rates.

1/ TAC ECONOMICS is an independent research group focusing on international economic and financial issues – more info at www.taceconomics.com
2/ This note is derived from a presentation made at the 10th Annual Meeting of Debt and Currency Professionals, Paris, February 19, 2019

The technique used identifies the driving forces among USD, EUR and CNY for all different regimes. The exercise is conducted on 120 different countries and exchange rates. Results confirm a trend of increasing influence of the USD in most semi- floating regimes, though not for the other international currencies where the "floating" regime has been more flexible and less driven by USD broader movements.



Trend in exchange rate regimes: reinforcement of the number of currencies aligned on the USD/EUR.
Source: TAC ECONOMICS

Changing correlations over time and by country / currency

Finally, we observed time- and country- specifics in the relation to the USD. We took a sample of 18 bilateral exchange rates (16 EM, plus EUR and JPY) against the USD and computed rolling correlations across all exchange rates on different sub-periods since 2000. We derive a couple of simple but robust conclusions from this computation.

- Splitting the whole period into two similar sub-periods centered around the global financial crisis, we observe a confirmation of the increasing role of the USD, with the matrix showing high positive correlations in 2009-2018, though the CNY (China), MXP (Mexico), ZAR (South Africa), KRW (South Korea) and JPY (Japan) showed lower or negative correlations during the pre-crisis period;

- Focusing more on the recent period and changes in correlations since 2014, we observe significant changes on 2-year windows: in particular, the more turbulent 2015-2016 time-window shows correlations across exchange rates that are high but both positive and negative, suggesting larger differences during more uncertain economic outlook and higher global risks. Conversely, the relatively "positive" mood and favorable macro-performances in 2016-2017 have induced a re-correlation movement and a greater role of the USD in overall exchange rate dynamics worldwide. Overall, the trend since 2014 is one of lower but same-direction correlation after periods of much higher but more diverse correlation factors. Indeed, the latest matrix (2017-18) shows more general positive but lower correlations across currencies.

- Some countries have remained more "independent" from the USD (or more dependent to other factors, e.g. China or commodity prices), notably Brazil, Russia, South Africa and Japan.

Implications for currency management

The dominant role of the dollar mechanically indicates that EUR / USD remains central for all FX exposure, including other mature currencies and emerging markets.

It is not enough, given the variations between countries and by period of the economic and financial cycle. A central issue is the ability to neutralize non-EUR / USD risks through a currency portfolio: it is possible, but very dependent on the portfolio.

The period is conducive to unanticipated shocks or sudden and possibly systemic breaks: geopolitical context, currency divergences, systemic and cyclical uncertainties, political issues in the «heart» of the international monetary and currency system, untested monetary policies are all factors able to create immediate currency turbulences, all the more so if preceded by currency misalignment.

- Changes in the «macroeconomic exchange rate regime» becomes more frequent on the EUR / USD rate, with rapid oscillations between financial regime versus economic regime.

- Increased risk of sudden depreciation in some emerging countries, with strong differentiations by country / geographical area and complex contagion effects. ■