



Market Commentary: De-dollarization, Debt Defaults and Other Difficulties

April 2023

A new world order was established with the conclusion of World War II (“WW II”), with America firmly set as a leader, at least for the “West”, as defined at the [Bretton Woods Conference](#) and other similar events. Globalization flourished and global wealth increased dramatically, as America policed global waterways and promoted international trade.

Many believe we are at the precipice of a new world order, where the US pulls back from its initial goals and self-established obligations post WWII as increasing international growth is no longer in its self-interest and as certain world actors take on an increasingly authoritarian and belligerent tone. In this new world order, de-dollarization may take on a political rather than rational goal of less friendly nations. De-dollarization would necessitate selling dollar-based assets, further stressing US debt levels given lower demands for our previously pristine and conservative debt.

¹Given this new world order, with limited cooperation between countries, let’s entertain the realities of moving away from the dollar for a fictitious island of which I have elected myself a leader of!

I am the finance minister of a beautiful island, Delos, whose main industry is tourism. In order to attract these tourists, I need energy – to move tourists from the airport to my beautiful beaches and ensure they have air conditioning, lights, food, and the like. I reach out to a bunch of oil producing countries and I receive back quotes in their respective currencies: the Saudi Riyal, the Russian Ruble, the Brazilian Real and so on. I get quotes to transport the oil to Delos in Canadian dollars, the Euro, and the British Pound. I work on negotiating multi-year deals to lock in availability and general costs with a few counterparts. None of our counterparts want our currency, the DelCoin, so I go about converting to the appropriate currencies, not an easy task, and seek to hedge future obligations. If no one visits our beautiful Island, there will be a lack of demand for our currency, resulting in a potential decline in our currency’s value relative to others. This can spell disaster through an increasingly relative expensive cost of imports. Given the state of the world, I do not want to enter into a derivative transaction with some international bank – who knows if they will be around? I can go about and simply convert to the necessary currencies now and hold it in our country’s reserves – this will allow us to readily pay in the necessary currency at the appropriate time, while also providing some levers to control our currency within the global market! But wait, I realize I do not want to hold the Brazilian Real given some political uncertainties and bad economic policies in that country. Wow – this is complicated.



¹ We recognize there is no way to compete with the [Dogecoin](#) but there is mythical background to our imagined island that blows away the Shiba Inu dog from Doge in our coin.... Created via the imaginative Dall*E



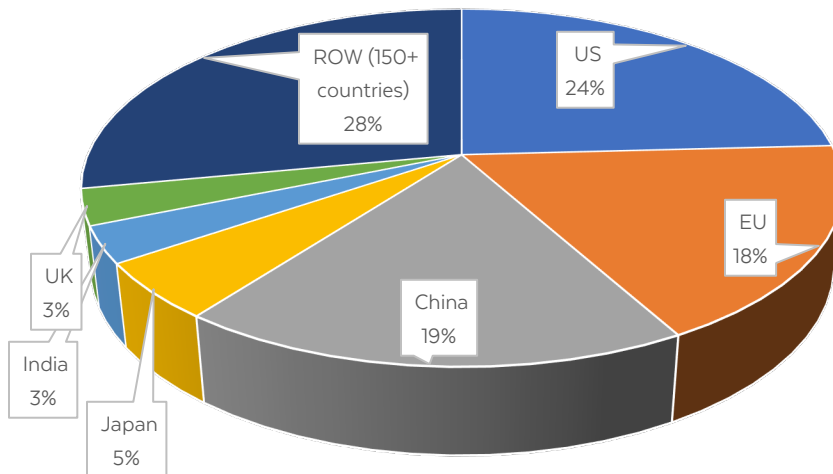


I call back all the countries and say, “Listen, I know you are not interested in my currency but what if I pay you in US dollars? There is a tremendous float, it is extremely liquid and easily convertible, and they do not artificially control their currency’s value too much.” Everyone says yes and now Delos simply holds 20% of its reserves in US dollars. So much easier.

The US Dollar is the world’s “reserve” currency, but it is not the only currency that the world transacts in. It is also not the only currency held in reserve accounts of other countries. However, the US has been so dominant that a gradual decline in dollar-based transactions and reserves should be expected and may in fact be healthy for the global economy (and not necessarily unhealthy for the US. To be clear, America is expected to be a leading global force for the foreseeable future for a variety of reasons (e.g., [Is Our Empire Crumbling?](#)). At the moment though, it is unreasonable to believe that the US dollar will simply disappear as a reserve currency for some of the reasons quoted by Delos’s esteemed finance minister: It [the US dollar] is very liquid, not volatile, trustworthy, and managed by the most powerful country on Earth.

As will be seen in the following charts, the US enjoys a materially larger role as a reserve currency relative to its economic might. The following chart shows the US continuing to maintain its global pole position economically as measured by annual Gross Domestic Product (GDP), but China and the EU are close behind.²

Countries by GDP %, 2021



Source: worldbank.org

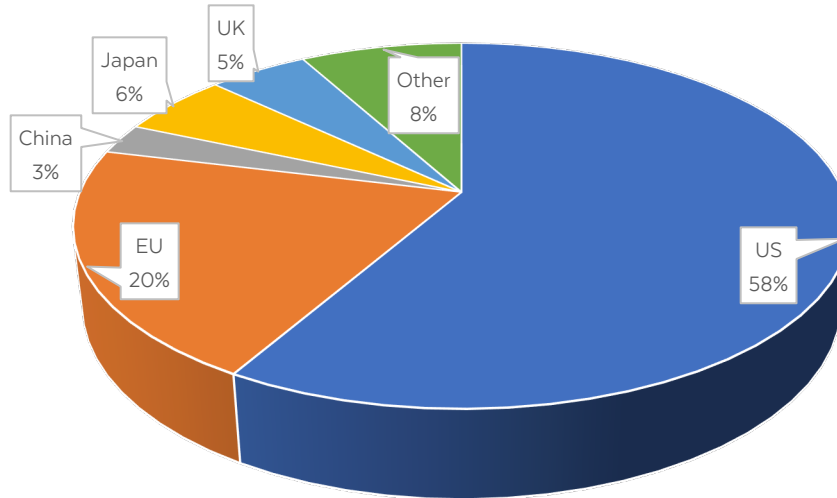
Yet, the Chinese Renminbi³ (a unit being “Yuan” which we will use going forward) only represents 3% of foreign exchange reserves as of the end of 2022, as seen in the pie chart below.

² The EU is still relatively new. It had made some headway in its share of global reserves until the financial crisis which uncovered some issues between EU countries (e.g., Germany vs the Southern countries of Greece, Italy and Spain).

³ Yuan is a unit of Renminbi

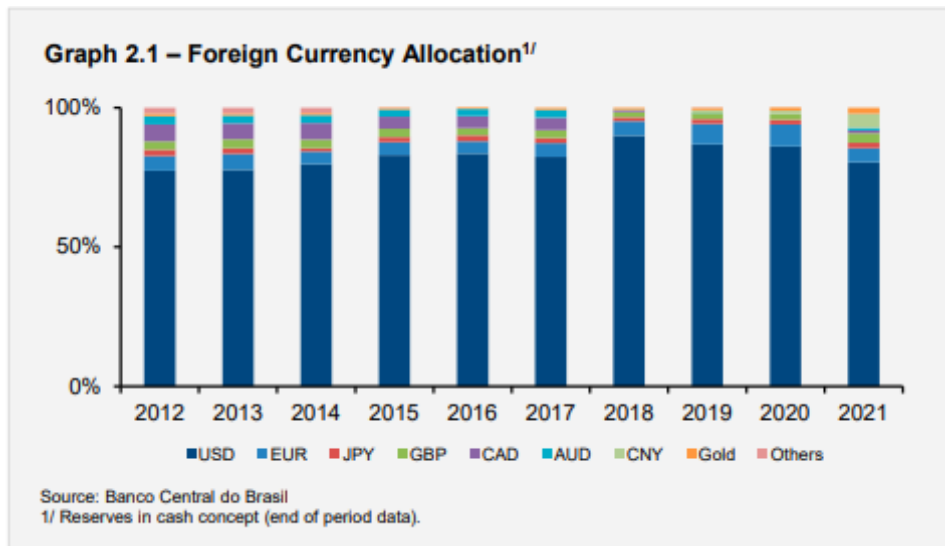


Foreign Exchange Reserves by Currency, Q4 2022



Source: IMF.org

Based on the increasingly obvious importance of China on the world stage, partially represented by their share of global GDP, one would expect China to represent closer to 20% of global foreign exchange reserves – not a measly 3%. In fact, some of the recent concerns around the dollar’s upcoming demise was due to a viral headline where China and Brazil were now going to trade directly in Yuan.⁴ Yuan represents around 5% of Brazilian reserves according to their most recent report as compared to 80% USD.⁵



In our opening example, every country Delos called was fine holding US Dollars as they knew they could rely on it given deep liquid markets allowing for low costs in converting and the faith and backing of the US government, which has **never defaulted**. China either has or can easily provide many of the same characteristics the US delivers within the US Dollar. The reason that countries are not quite as fine with the Yuan as evidently apparent from World reserve holdings is that there are concerns around the financial infrastructure

⁴ Gasp! [Yuan tops euro as Brazil's second currency in foreign reserves | Reuters](#)

⁵ [Relatorio_anual_reservas_internacionais_en_2022.pdf \(bcb.gov.br\)](#)





and controls of China, especially within China. For instance, China still uses outflow controls to restrict currency exchanges of its local population. With Premier Xi consolidating power, a major risk for the global market is a clamp down on the ability to exchange out of Renminbi-denominated assets and/or the currency regardless of nationality.⁶

Turning our attention now to the game of chicken being played by our political parties, one risk of the US defaulting on our debt would be a faster decline of the US as a reserve currency. It will become hard to hold US dollar-denominated debt if there is any concern over that debt being paid back. Our political system has allowed us to go to the brink a number of times, but we have not quite crossed the line yet. We expect and hope that our leaders in Washington understand these consequences as they attempt to get what they want in return for raising the debt ceiling. Expectations are for an agreement to occur prior to X Day which is seemingly being kept purposefully ambiguous and conservative, again, in the hopes of averting an actual default.

In summary, simply based on our oversized currency presence relative to our economic and general (military, etc.) might, we would expect our reserve status to slowly decline but, absent a true outlier event, like a prolonged default caused by our political system, we expect the US to maintain its pole position as a reserve currency and all the benefits that come with it.

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⁶ A good read on what China needs to do to become more competitive as a reserve currency: [The renminbi rises but will not rival the dollar \(brookings.edu\)](https://www.brookings.edu)

