Learning Insights

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In this issue:

Sanctions Expose US Dollar Vulnerability but Dominance Set to Continue

ESG Runs into Category Confusion

Sanctions Expose US Dollar Vulnerability but Dominance Set to Continue

For the past century the US dollar has enjoyed unrivalled supremacy in global trade and finance. But the war in Ukraine and subsequent imposition of sanctions on Russia – the so-called "weaponization of finance" – has drawn attention to this dominance. It has also given pause for thought to those who would look for an alternative to the present regime. But in spite of major incentives for some countries to diversify away from the greenback, there remains a lack of credible alternatives.

Following the invasion of Ukraine, the Western coalition froze nearly half of the Russian central bank's USD 630 billion in foreign exchange and gold reserves as well as the assets of certain individuals and banks. It also heavily restricted access to the SWIFT payments system. While Afghanistan, Iran, and Venezuela had previously been targeted by similar measures, the size and significance of this action against a military power such as Russia was unprecedented.

Why the US dollar dominates

The impact of financial sanctions reflects the central role of the US dollar in the global financial system. The four main reasons for its primacy were succinctly articulated by former US Federal Reserve Chairman, Ben Bernanke, in 2016.

Stability of value: Although we are currently experiencing a surge in inflation, since the mid-1980s, Bernanke contended, the Fed has "done a good job" keeping inflation low and stable.

Liquidity: US financial markets, especially the US Treasury market, are the deepest and most liquid in the world. Bernanke attributed this to network externalities (the fact that people like to trade in the Treasury market because other people trade in it). But there are also structural reasons: the Treasury market is large and homogeneous, while the market for government bonds traded in euros (a leading potential competitor to the dollar) is fragmented by country of issuance.

Safety: From time to time Congressional members have played politics with the debt limit, but there is a large supply of dollar assets considered to be very safe, including Treasury securities. The dollar is considered a "safe haven" currency, which tends to appreciate during periods of stress but which makes holding dollar assets attractive in normal times as well.

Lender of last resort: According to Bernanke, "The Fed served as a backstop provider of dollars during the financial crisis by instituting currency swaps with fourteen central banks, including four in emerging markets. Under the currency swaps, foreign central banks could obtain dollars which in turn they lent to banks in their jurisdictions which needed to transact in dollars."

Yet the effect of initiating financial sanctions threatens to undermine the very basis on which US dollar dominance rests. Once the power of the US dollar and related sanctions is used, those countries who fear they might ultimately one day be targeted are immediately put on notice as to their vulnerability – and naturally look to take steps to reduce their exposure.

Euro/US Dollar Spot Rate:

Source: Refinitiv

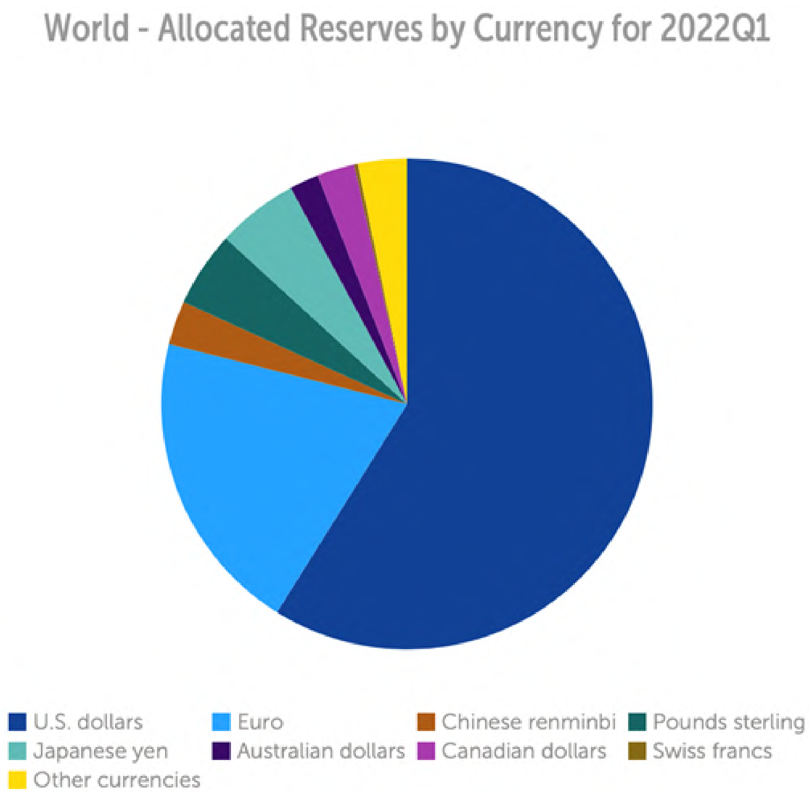
In fact, the US dollar's share of global official foreign reserves has been in decline since 1999, with its proportion falling from 70% in 1999 to 59% at end-2021, according to IMF figures. While 1999 marked the arrival of the euro, one-quarter of this decline is attributable to a rise in the Chinese renminbi and other non-traditional reserve currencies.

Why the US dollar reserves share is in decline

The fall in the US dollar share has been due to the increased liquidity of many rival currencies, coupled with falling transaction costs that are in turn attributable to migration to electronic trading platforms, automated market making, and automated liquidity management. These developments have allowed currency reserve managers to deal more easily in currencies outside the established "big four" of the US dollar, euro, Japanese yen, and British pound sterling.

Another contributing factor is the growing tendency of currency reserves managers toward active management, allocating reserves toward investment rather than as passive liquidity buffers. This allows more latitude on the part of reserves managers to allocate funds to riskier, non-US denominated assets.

This would seem to bear out the general view that, in spite of the mounting incentives for countries such as Russia and China to lessen their dependence on the US dollar, the greenback is unlikely to lose its preeminent status any time soon. Several reasons are advanced to support this.



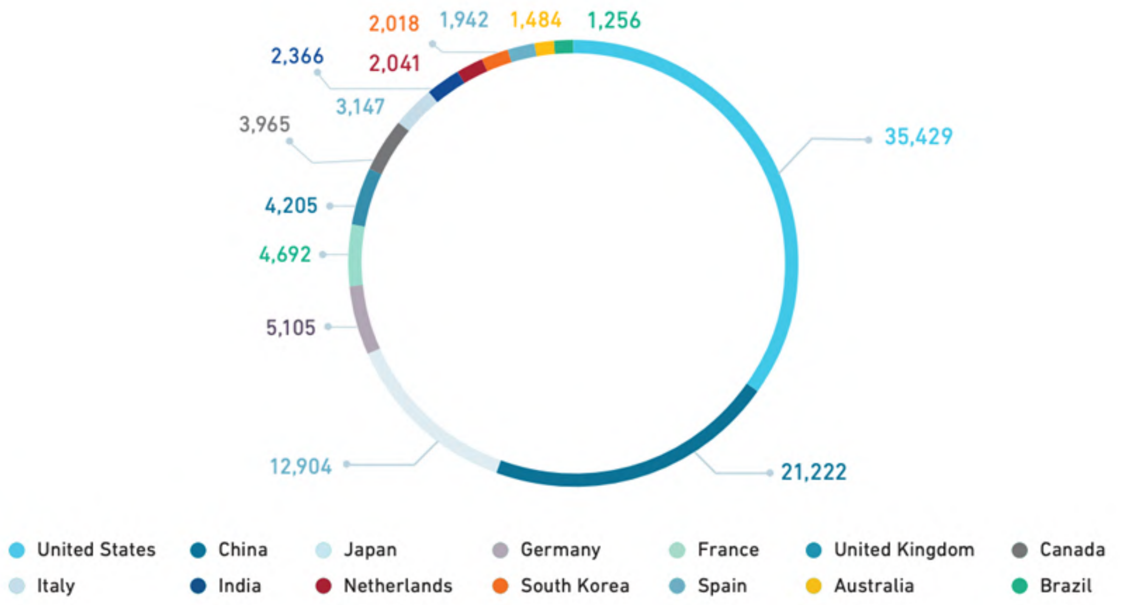
Source: IMF Currency Composition of Official Foreign Exchange Reserves (COFER)

US dollar set to retain primacy in financial markets

The main one is the previously cited unrivalled depth and liquidity of the US financial market and in particular the might of the Treasury bond. There is little in the way of alternatives. While the euro is most credible, the global financial crisis and the increased threat of the break-up of economic and monetary union meant the euro reserve share dropped from 27.7% in 2009 to 20.6% in 2021.

For China, with more than USD 3 trillion in foreign currency reserves, the US Treasury bond market is the foundation of its reserves management. Meanwhile the renminbi, still subject to some capital controls and less than fully convertible, cannot hope to emulate the qualities of the US dollar as an international reserve currency. Easy convertibility and minimum state intervention are directly correlated to attractiveness as a reserve currency.

Size of Top 14 Bond Markets US$B:



Source: Bloomberg, July 2021

Following the imposition of sanctions, Russian officials were quick to point to the subsequent recovery in the ruble exchange rate and announce the beginning of the end of US dollar dominance, as they equated the sanctions with theft. But the recovery of the ruble is largely attributable to strict capital controls and interest rate increases that are having the effect of crippling the Russian economy and boosting inflation.

The main obstacle to the replacement of dollar dominance is the sheer cost of upending the status quo and dismantling the US dollar financial ecosystem. For the foreseeable future, the effectiveness of financial weaponization facilitated by a dominant US dollar seems assured.

Intuition Know-How has a number of tutorials relevant to the content of this article:

- Foreign Exchange (FX) Market – An Introduction
- The Foreign Exchange Business
- FX Spot Market – An Introduction
- FX Spot Market – Trading
- Foreign Exchange – Factors Influencing Exchange Rates
- Financial Authorities (US) – Federal Reserve
- US Bond Market
- European Bond Market
- Financial Authorities (China)

ESG Runs into Category Confusion

One of the unforeseen consequences of the war in Ukraine has been a re-evaluation of industry categories hitherto understood to be contrary to economic, social, and governance (ESG) principles. This, in turn, has also exposed the limitations of ESG as a convenient catch-all term for ethical investing.

Specifically, the war in Ukraine has placed defense and energy – two sectors until now considered major offenders in ESG terms – center stage. A case can now be made for the role of defense as a counter to unprovoked aggression such as that witnessed in Ukraine: a critical factor in the preservation democracy and the safeguarding of freedom – the foundation of all social values.

Energy and defense sectors turn "green"

Traditional (and dirty) forms of energy likewise are being viewed in a new light in terms of providing energy security in wartime – something with inherent social value. Energy self-sufficiency is now acknowledged as crucial as we transition to a green energy future, so can be viewed as consistent rather than contrary to ESG principles – a view notably endorsed by the EU parliament recently.

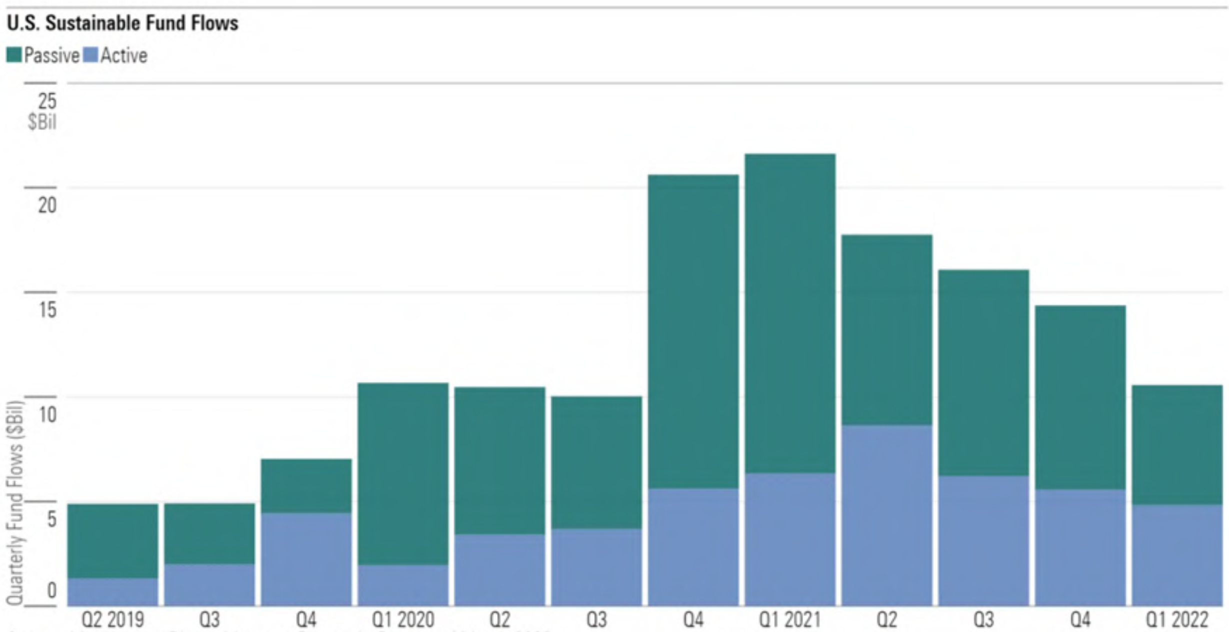
In parallel, the market has repriced both sectors – something perhaps not unconnected with this re-evaluation in ESG terms.

Brent Crude Oil Futures:

Source: Refinitiv

Slowdown in sustainable funds flows

Under the relatively new ESG-conscious regime that surrounds so much of the business of investment management, it has long been an article of faith that returns from sustainable business should outperform over the longer term. This assertion is fundamental to the ESG marketing message of virtually the entire asset management industry. But the evidence of the past few months indicates that, in fact, sticking to the accepted ESG-compliant business sectors can have negative implications for performance – at least over the short term. This has been reflected in a slowdown in sustainable funds flows.



Source: Morningstar Direct, Manager Research. Data as of March 2022.

As long as ESG-compliant investments outperform, so there will be widespread and aggressive deployment of the term in the context of industry marketing. But the performance reversals of late position ESG-led marketing in an entirely different light, understandably leading to calls for a reappraisal of the criteria by which certain sectors and activities are (or are not) considered sustainable.

In fairness, all of this has highlighted the undoubted nuance and complexity that surrounds ESG issues and how compliance with these principles is a moving target depending on market conditions. That has not deterred regulators from attempting to impose a degree of standardization, notably the EU Taxonomy Regulation (or "Green" Taxonomy). Under that regulation (and to the annoyance of many), natural gas and nuclear energy has now been, under certain circumstances, classified as "green." In justifying its decision, the European Commission drew attention to the role of natural gas and nuclear in facilitating the transition toward a predominantly renewables-based future.

These nuances – as evidenced by the revised attitude towards energy and defense – mean that blanket exclusions by sector on grounds of ESG transgressions are unwise. Such exclusions tie the hands of active managers who might otherwise be in a position to engage with issuers with a view to encouraging them to modify their ESG practices.

Social issues falling behind in ESG considerations

Another issue highlighted by the revised perspective on energy and defense has been a realization that much of the focus of ESG has been on environmental factors and much less on social which is concerned with general societal wellbeing and the maintenance of living standards.

The issues highlighted by the ambiguity over defense in relation to ESG and the controversy over the classification of energy in the EU taxonomy demonstrate the genuine challenges in arriving at a standardized approach to ESG that can credibly counteract accusations of ”greenwashing.” While the term ”ESG” is neat and compelling, and thus has major attractions in relation to marketing application, it is clear that this powerful acronym encompasses a range of often contradictory objectives. By its nature, ESG is inherently dynamic, a moving target where efforts to reconcile its constituent parts are destined to be perpetual.

Intuition Know-How has many tutorials relevant to the content of this article:

- ESG – Primer
- ESG – An Introduction
- ESG Factors
- Climate Risk – An Introduction
- Climate Risk – Banking & Decarbonization
- Sustainable & Responsible Investing – An Introduction
- Sustainable & Responsible Investing – Strategies
- Impact Investing
- Sustainable Finance – An Introduction
- Sustainable Finance – Principles & Frameworks
- ESG Data & Ratings – An Introduction
- ESG Data & Ratings – Reporting Frameworks
- ESG Reporting
- Sustainable Finance Disclosure Regulation (SFDR)
- Taxonomy Regulation (Europe)