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SINAI'S MARKET PERSPECTIVES

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The Weakening Dollar and "Next Great Global Currency"
by Allen Sinai*

Dollar as Reserve Currency Fading

De facto, but fairly gradually so far, the world is moving away from the dollar as the major global reserve currency.

The weakening dollar of recent years reflects changes in short-term cyclical and longer-run fundamental forces that suggest erosion and decline.

Current Decision Economics, Inc. (DE) projections indicate 1.60 Euro to the dollar by late in the second half, near 100 Yen, 2.05 to 2.10 for the Pound-Sterling, and a 15% to 20% appreciation of the Chinese Remnimbi for this year.

The dollar negatives are 1) a "recession" economy; 2) further sizeable declines in short-term interest rates compared with firm to even rising interest rates elsewhere; 3) domestic economic, political and geopolitical uncertainties; 4) declining attractiveness of the U.S. as a place in which to invest; and 5) shifts in currency flows against the dollar on changes in the global lineup of strengths and weaknesses in various country economies and wealth. The decline of a currency is one of the adjustment mechanisms for an economy in recession vis-à-vis other countries with expanding economies and brighter prospects.

In such a situation, policymakers will typically accept the declines because of its help on exports and the current account, and tolerate the inflation that can be a byproduct. Such is the case now in the U.S. for the U.S. Treasury and Federal Reserve. A strong dollar is the goal for the long-run, but not for the short-run given the deteriorating economic situation in the U.S..

Dollar Alternatives

An *informal* array of alternatives has arisen. These include the Euro, Pound-Sterling, Yen, slowly the Chinese Remnimbi, and some other currencies such as the Canadian and Australian dollars. The Federal Reserve Broad Dollar Index is down 25.8% since February 2002 and recently has accelerated in its decline, falling 10.1% over the last twelve months.

Increasingly, commodities, such as gold and crude oil, are being bought as a store of value and dollar alternative as the economic, financial, and political fundamentals surrounding the U.S. deteriorate compared with those of many non-U.S. countries and regions.

Ten Years from Now

Ten years from now? By then, formalization of the de facto exit of the U.S. dollar as the chief global reserve currency is likely.

What appears to be in-process is a secular trend reflecting a changing global economic and financial geography where previous "have-not" countries have become "haves," the new collective energy in global economic growth from the developing (emerging market) world has become very significant, and seismic shifts have occurred in the wealth of numerous countries, especially China, Asia and elsewhere where current account and foreign exchange surpluses loom large to permit them to act as "bankers" directly, and indirectly through a growing number of Sovereign Wealth Funds (SWFs), thus shifting economic and financial power away from the United States.

As yet, the forces of reversal in the dollar's erosion do not appear to be emerging, suggesting that the shift away from the U.S. dollar to "the next great global currency" will continue.

Concluding Perspectives

The best bet is that a more *formal* currency basket will emerge, containing a mix of currencies, although perhaps with some commodity, such as gold, that might be included, for those countries that have strong economies, strong domestic and international financial positions, stable politics, and surpluses on current account and in foreign exchange.

Markets will first identify those currencies and commodities that will be part of "the next great global currency," not a single currency such as the dollar has been, but a basket of currencies and commodities reflecting the new and emerging realities of global economic wealth and power. A defined currency bloc, or basket, would follow, neither a single region nor country bloc, but more likely a cross-section of a limited number of strong currencies from the limited number of powerful countries. Of course, the dollar would be included, but much less so than before.

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*Remarks prepared for a Currency Forum of *The International Economy* magazine.