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Investors dare to imagine a world beyond the dollar

The US could dismantle its own exorbitant privilege by pushing the big bond market beasts into the arms of others

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US President Donald Trump in the Oval Office. If the EU acts quickly, it could tap in to a deep well of willing buyers keen to trim their exposure to America © Andrew Harnik/Getty Images

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Investors are starting to imagine a financial system without the US at its centre, handing Europe an opportunity that it simply must not miss.

This exercise in thinking the unthinkable comes despite a cacophony of noise in markets. Mansoor Mohi-uddin, chief economist at Bank of Singapore, recently travelled to clients in Dubai and London. To his surprise, not one of them asked him about short-term issues like tech stocks or tweaks to interest rates. Instead, he says, "people were saying, 'What's going on?' The free trade, free markets, globalisation era is over, and nobody knows what's going to replace it."

They refer, of course, to the new US administration. Within a month of retaking his seat at the White House, Donald Trump & co had all but trashed the transatlantic alliance, and ridden roughshod over the key checks, balances and institutions on which true US exceptionalism is built.

"It's such a momentous change going on. If it continues like this, capital allocators will wonder: 'Do I want to stay allocated to the US?'" Mohi-uddin says.

This cuts across asset classes. In stocks, the preference for Europe is clear — markets are streaking ahead of the US in a highly unusual pattern. But flighty stock markets are just the surface. The bit that really matters is the international use of the dollar, and dollar bond markets, as the supposedly risk-free bedrock of global finance.

This is already starting to show. On Tuesday, for instance, despite the shock of new US trade tariffs on Canada and Mexico, the dollar is not climbing in its usual fashion. Deutsche Bank says this in part reflects "the potential loss of the dollar's safe-haven status".

"We do not write this lightly," wrote currencies analyst George Saravelos. "But the speed and scale of global shifts is so rapid that this needs to be acknowledged as a possibility." What was once outlandish is now becoming plausible.

Economists close to Trump have been clear that they view the dollar's status as the world's pre-eminent reserve currency as a blessing and a curse — "burdensome" as adviser Stephen Miran put it. It remains a possibility — again unthinkable just a few weeks ago — that the US could seek to pull the dollar lower in an effort to support domestic manufacturing. But the US could also dismantle its own exorbitant privilege through accident rather than design by pushing the big beasts of bond markets — foreign central banks and other official reserve managers — into the arms of other nations.

The dollar makes up more than 57 per cent of global official reserves, according to benchmark data from the IMF, far in excess of the US's slice of the global economy. The euro accounts for 20 per cent, and everyone else is picking up scraps.

Starry-eyed optimists have argued for years that the euro's slice of the pie should be bigger, but they have been fighting reality. Europe's bond markets are fragmented into constituent states, with Germany at the centre. The monetary cohesion is there but not the fiscal or strategic cohesion. No national market is simultaneously large, safe and liquid enough to suit a reserve manager's needs. Super-sized trades leave a mark and in an emergency, these big hitters find only the slick US government bond market will do.

The EU has struggled to offer an alternative. That is where this moment in history comes in. Its urgent need for defence spending simply overwhelms the capacity of its individual national bond markets. Joint borrowing — easily said but devilishly tricky to do — is the obvious answer. The result could well be that Europe is thrust further to the centre of the global financial system.

The Covid-19 pandemic offered a taste of how pooling resources might work at scale. Then, bonds issued by the EU itself, rather than individual states, were met with enormous demand. The urgency of the present situation offers little choice but to move fast. “Collective action could be an answer, even if consensus has not built yet,” said analysts at rating agency S&P Global in a note last month.

If the EU could seize this moment, it would tap in to a deep well of willing buyers keen to trim US exposure. “Plenty of reserve managers could shift very quickly,” says Mohi-uddin. “There would be huge take-up.”

US dominance of global debt markets does not have to end with a bang. Large, slow-moving investors would simply have to accumulate other assets rather than necessarily dumping their Treasuries. But over time, the result would be the same. Regime shifts of this kind do not happen often. But they do happen. Sterling was the global reserve currency once too.

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