Dollar’s woes could boost global and emerging market debt: BNY Mellon

By Editor Test *Wed, Nov 30, 2011*

The dollar's share of global currency reserves has declined over the last 10 years as emerging markets rely less on external debt and move from fixed to floating exchange rates, a new report says.

The diminishing role of the U.S. dollar as a reserve currency could create growing opportunities in global and emerging market debt, according to a white paper from Standish Mellon Asset Management Company LLC, the fixed income specialist for BNY Mellon Asset Management.

The U.S. dollar’s influence is likely to diminish over time as foreign central banks diversify their reserves away from the U.S. currency, leading to a multi-polar global reserve regime, according to the recently published report*, Perspectives for Global Fixed Income: Losing Faith in the U.S. Dollar?*

In the report, Standish expects the dollar will retain its role as the world’s main reserve currency in the short term, as it has no obvious challenger. The report notes all of the most commonly suggested alternatives have their own limitations at the present time.

These include the impact of the European sovereign debt crisis on the euro, the lack of full convertibility for the Chinese renminbi, and the lack of liquidity for gold, the report said. It also notes that the Japanese yen never circulated broadly because Japan is a relatively small country with a shrinking population.

But over time, the dollar’s dominance will continue to erode and a number of other currencies could combine to fill the vacuum, the report predicts. These could include the euro and renminbi, as they overcome their challenges, and a growing role by several emerging markets currencies, according to Standish.

“Fiscal deficits and a reliance on foreign borrowing have combined to drive down the U.S. dollar’s trade-weighted value by one third since 2002,” said Thomas D. Higgins, global macro strategist for Standish and the author of the report. “The recent downgrade of the U.S. sovereign rating has added to the negative sentiment.”

The process of reserve diversification already has begun as foreign central banks, particularly in emerging markets, have begun to lower their allocations to the U.S. currency, the report notes. The dollar’s share of global currency reserves has declined over the last 10 years as emerging markets are relying less on external debt and move from fixed to floating exchange rates, Standish said.

Foreign central banks have held U.S. Treasuries for a number of reasons, including boosting exports to the U.S. by holding down the values of their own currencies against the dollar, the report said. Standish proprietary research estimates that each $100 billion in foreign capital inflows into the U.S. Treasury market shaves roughly 10 basis points from U.S. 10-year Treasury yields. However, low yields of U.S.

Treasuries and the declining value of the dollar have resulted in losses by foreign central banks holding Treasuries, providing an impetus for foreign central banks to continue divesting Treasuries, the report said.

The share of U.S. dollars could gradually decline back to its share of world GDP over the coming decades, which could increase U.S. 10-year yields by as much as 50 basis points, according to the report. This would make Treasuries unattractive, while emerging market debt could offer more compelling value over the long term, it said.

“As the international role of emerging market currencies grows, these currencies should appreciate and demand for bonds denominated in those currencies should expand,” said Higgins. “The amount of emerging market local currency bonds has expanded significantly in the last 10 years, and it should continue to increase in emerging markets with solid economic fundamentals.”