The Debt Dollar: The New Face Of The US Dollar Hegemony

Analysis

The petrodollar system had established the USD as the *de facto* world's reserve currency

The 1947 Bretton Woods agreements established the US Dollar as the world's official reserve currency. Two decades later, blow-out deficits, due in part to the Vietnam war, forced the US to unilaterally suspend these these agreements, by ending the dollar's convertibility to gold. This was accompanied by a devaluation of the dollar vs. gold, a stock market crash, a global recession and the breakdown of the international dollar-pegged monetary system. The U.S. went from oil export to import after its own production peaked.

In the face of these dramatic events which threatened American military and monetary supremacy (the two pillars of the empire) the Nixon administration began high-level talks with Saudi Arabia to unilaterally price international oil sales in dollars only - despite US assurances to its European and Japanese allies that such a unique monetary/geopolitical arrangement would not transpire. Moreover, Saudi Arabia accepted to invest its dollar surpluses into US debt securities held at Western banks. In exchange, the US would protect Saudi Arabia military, and restrain from meddling in its internal affairs.

Until 1975 the other OPEC countries agreed to similar deals.

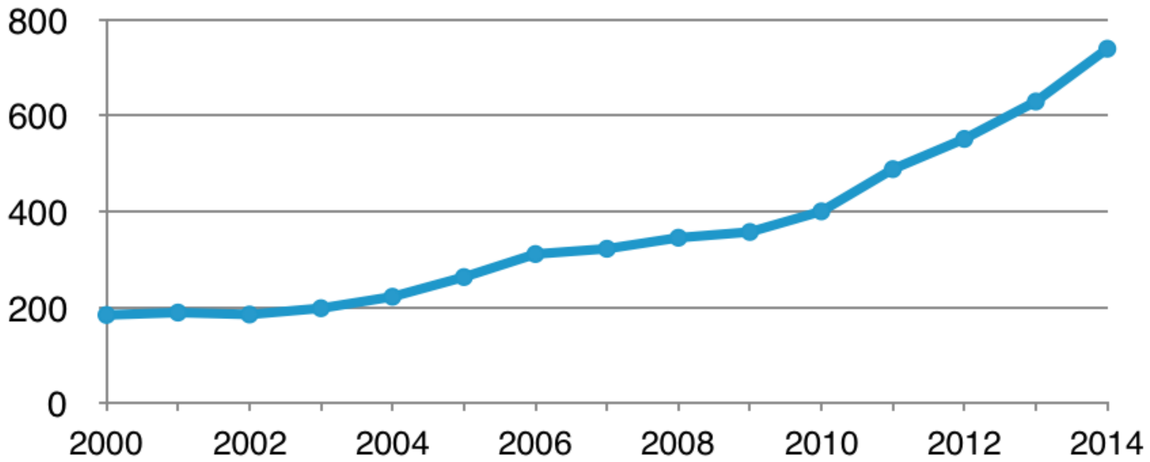
These agreements - the petrodollar system - resulted in a never-ending demand for US dollars, reestablishing the currency's reserve status not only on paper, but also in practicality. From then on, the United States were virtually free to run up twin deficits (fiscal and trade) without any adverse consequences for the value of its currency, or its long-term interest rates.

OPEC's propensity to spend had endangered the petrodollar system

The petrodollar system guarantees a permanent demand for US dollars as long as OPEC countries run substantial trade surpluses, and keep investing these surpluses in US Treasuries.

However, over time, Saudi Arabia and the rest of the OPEC have developed a taste for the good life, and increased their government spending along with the rise of oil prices **(Chart 1)**. From 2008 to 2015 alone, the Saudi budget more than doubled; after all, what good are oil riches if you can't spend them to buy social peace?

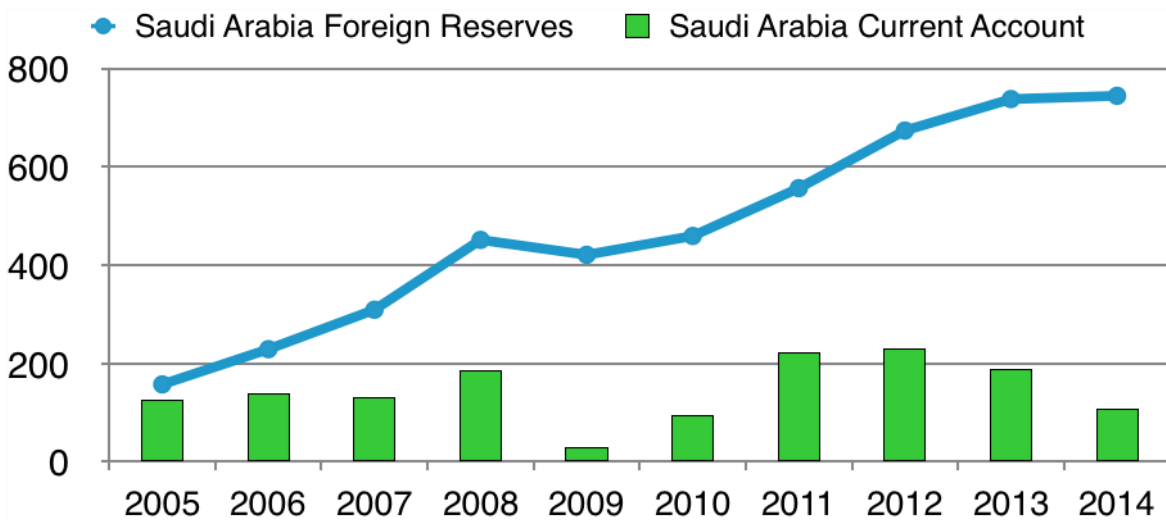
Saudi Arabia government spending, billions SAR (source: Saudi Arabian Monetary Agency)



This new propensity to spend showed the limits to the petrodollar arrangements. OPEC governments had increased handouts along with the rise in oil prices. Should oil prices fall, it would be very hard for these governments to claw back, and they would need to sell foreign reserves to maintain their budget levels.

A first warning shot came in 2008, when a first slump in commodity prices brought OPEC trade balances into the red **(Chart 2)**. Saudi Arabia et al. responded by dipping into their savings, and selling a little bit of their pile of US Treasuries. If they were stuck with a budget deficit for a prolonged time period, the dollar would find itself under pressure, and long-term dollar US Treasury yields would rise.

Saudi Arabia foreign reserves, billions USD (source: Saudi Arabian Monetary Agency, World Bank)



The second, real shot, came in 2014. We're currently living through the devastating effects of central bank / sovereign wealth fund deleveraging.

The increased volatility of the price of oil over the last decade has clearly shown the limits of the petrodollar arrangement to long-term US geopolitical strategy.

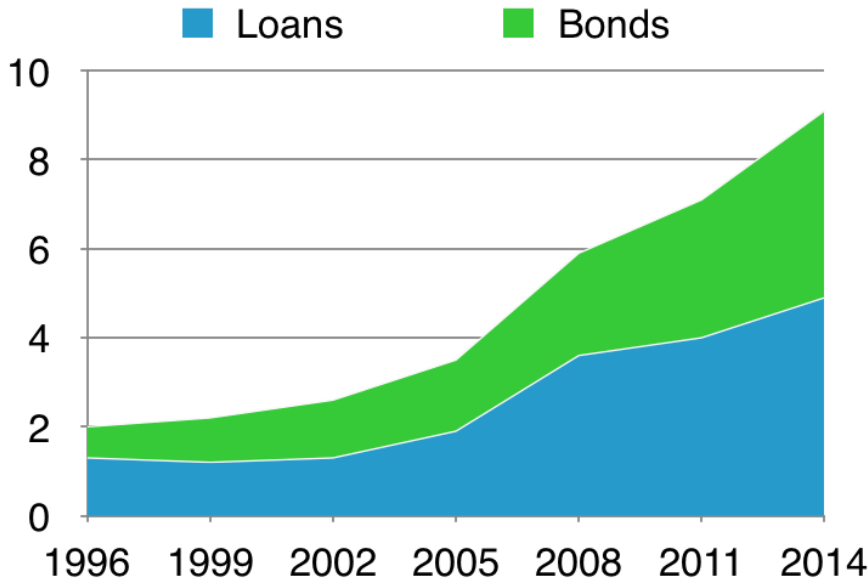
The Fed's ultra-accomodidative policy stance led to a buildup of foreign USD debt, creating a demand for dollars for coupon payments

The US has found another way to create a never-ending demand for US dollars, to safeguard its unique twin deficit privilege. We're witnessing the new system in action.

By keeping a super-accomodidative stance for too long, the Fed has enticed governments and corporations

to borrow in US dollars. This has led to a foreign buildup of USD debt **(Chart 3)**.

USD credit to borrowers outside of United States, trillions USD (source: BIS)



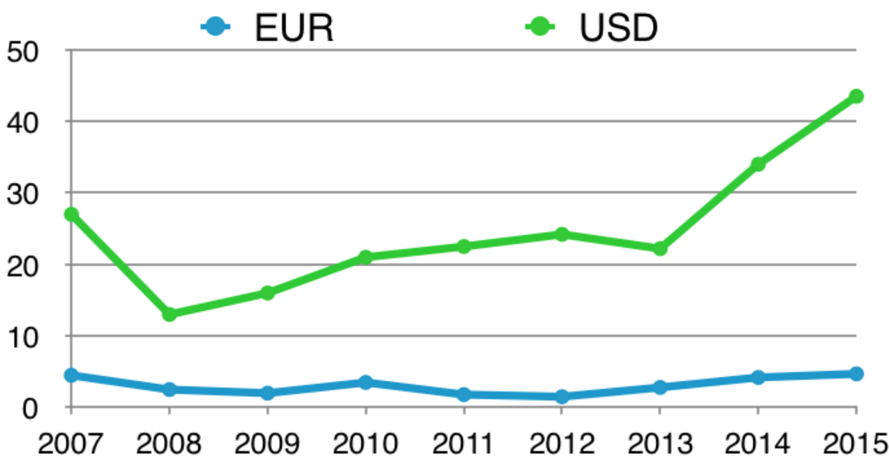
In 2005, non-financial USD debt in countries outside the US stood at 10,7% of their GDP (world GDP - US GDP). In 2010, the level grew to 13,7%, and again to 14,5% as we're writing this piece.

Emerging markets were the most avid borrowers, and contributed strongly to the overall increase. Their aggregate USD debt rose from $0.8 trillion in 1998, to $3.3 trillion in 2014.

The Bank of International Settlements noted in its January 2015 paper "Global dollar credit: links to US monetary policy and leverage", "when central banks […] raise their policy rates, borrowers shift from domestic to foreign currency loans". In other words, the Fed's dovish stance was indeed responsible for the buildup of USD debt on the balance sheets of foreign entities.

This borrowing spree has focused on the dollar, despite ultra-low Euro rates **(Chart 4)**. Moreover, foreign Euro borrowing, which stands at around 2,5 trillion, is mostly concentrated in Eurozone neighboring countries, whose economies are very much linked with the Euro anyway.

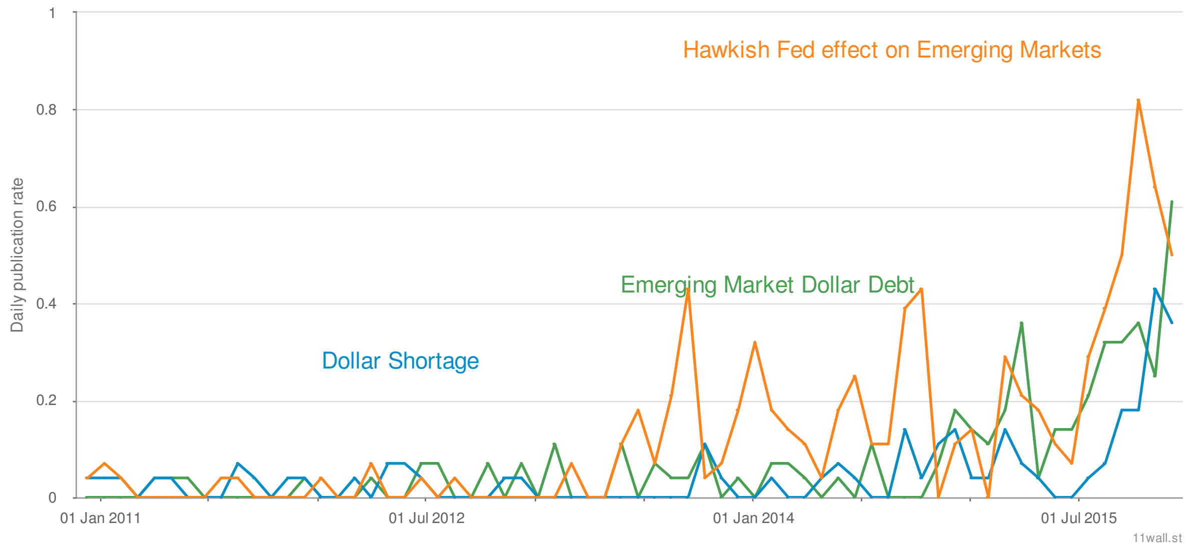
Non-Fin. Corporate Bond issuance in foreign currency, percentage (source: IIF, Thomson One)



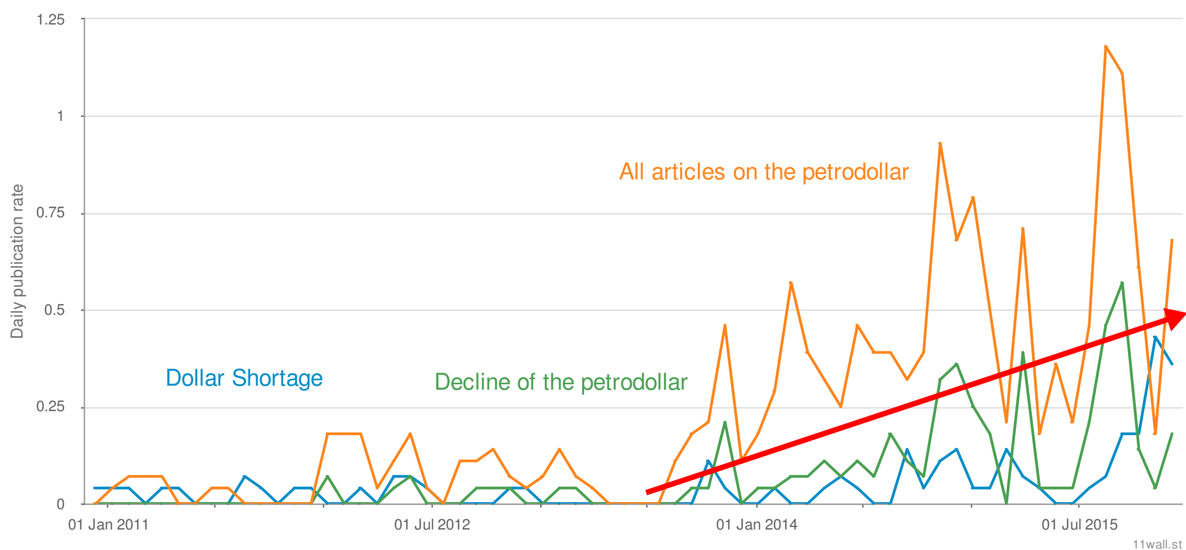
We've seen this phenomenon before, when Central European countries rushed to borrow in CHF in mid-2000. When the borrowing spree ended in 2007, a shortage of Swiss francs led to a sharp appreciation of the currency, pushing the SNB to its limits.

We're currently seeing a similar move in the dollar, which is putting increasing pressure on the borrowers, as the amount of debt due increases in local currency terms, along with credit spreads.

The awareness for the pile of USD debt in emerging markets has grown in lockstep with the Fed's shift towards a more hawkish policy stance. Crashing commodity prices have put further pressure on economies that rely on low-level exports for their forex inflows, resulting to nothing less than a dollar shortage **(Chart 5)**.



The dollar shortage theme emerged just as the decline of the petrodollar system was accelerating **(Chart 6)**.



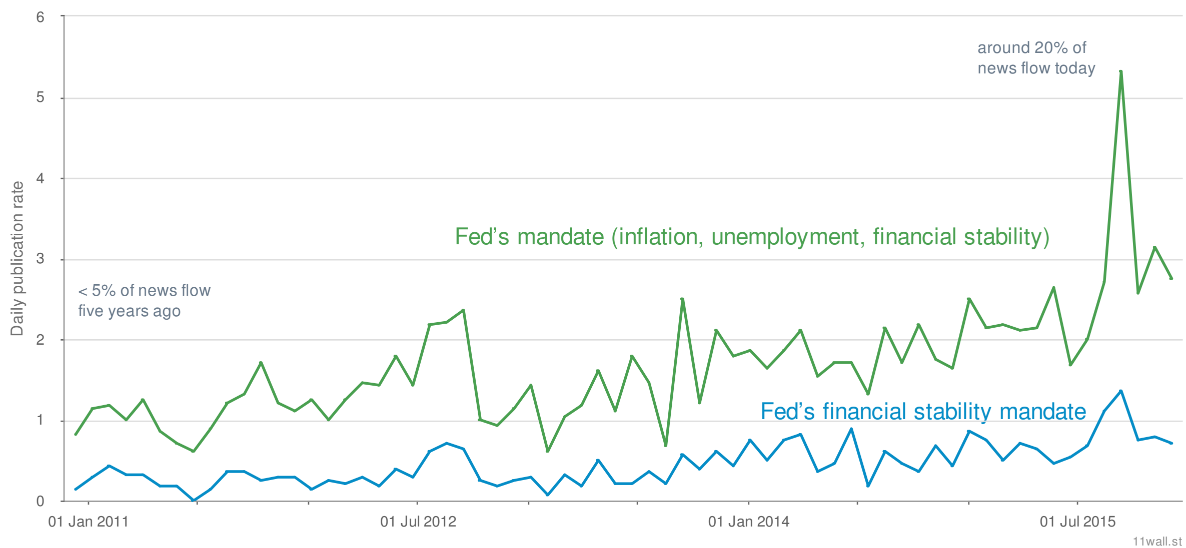
The Fed's inexplicably long period of zero-interest rates has led to a debt bubble. There's a potential stroke of genius in this setup. Putting a conservative 5% average interest rate on the 9 trillion external USD debt pile, leads to a recurrent demand of $450 billion a year for coupon payments, a figure that's very close to the current US trade deficit.

The Fed is in charge of keeping the new debt dollar system running

The US has much better control over this dollar flow, than they had over the petrodollar system, where they needed the cooperation of all OPEC members. Now, the Fed can very efficiently target US dollar demand

through interest rates, which set the coupons due on the debt pile.

No wonder the Fed's "financial stability" mandate is gaining ground, from under 5% of all news flow concerning its mandate five years ago, to around 20% today.



The US has established a new kind of dominance over the rest of the world, one of access to funding. The first casualty of this dominance was Russia, who simply chose not to play the US game, and cut itself off of international debt markets, albeit at a bloody price, as it had to devalue its currency by 60%. Other countries, where governments don't have such a strong rule over their citizens, will probably opt to go along with US demands.

Roadmap & Playbook

- The US needs to maintain this status of elevated indebtedness to keep the dollar demand alive. Thus, no large-scale defaults will be allowed, and emerging market credit spreads will remain wider than in the past, to keep interest payments high. In this scenario, EM bonds will never fully recover, but will never fall to distressed levels either. This is our call: "buy EM bonds at 70 cents to the dollar, sell at 95".
- Dollar strength will be, for years to come, an early signal for credit stress. The US Dollar's status as a safe heaven will be stronger than ever before.
- The Fed's policy will be much more influenced by the US geopolitical agenda, and its current account deficit.
- The US will probably take cue from the European Union and the way it dealt with Greece (and to a certain extent, Italy). On the first instance of a debtor country floating the idea of a default, its government will become the subject of immense international pressure and sheer ridicule, losing elections and being replaced by technocratic puppets from the IMF. The subsequent « cure » of austerity will convince every other government, and electorate, that the default option is much worse than to just accepting the debt serfdom.
- The US could make an example out of one of the smaller debtor countries - its own version of Greece. In this scenario, we would refrain from buying distressed bonds of small economies, irrespective of their fundamentals, out of the concern that it could become the scarecrow for the rest of the debtor pack.
- The US will distance itself from Saudi Arabia. They simply don't need this alliance any more. This is bad news for the current Saudi regime. Given the recent turn of events, we are doubtful as to whether Saudi Arabia will be able to fend off a default in the next three to four years.

Probability	Event	Early signs
70%	Emerging market economies are never in a position to reduce their USD debt burden, but never default. The Fed rescues them in times of crisis, but their budgets and current account balances remain constantly in the red. The US uses this leverage to enact its own geopolitical agenda.	• EM governments guarantee or assume the debt of failing corporates and banks. • Increasing influence and interference of IMF & BIS • Localized debt crises correlate with political spats with the US • Deterioration of US relations with Saudi Arabia • • The US makes an example out of one of the small EM countries, forcing a default and ridiculing the ruling political class, publicizing the country's economic and social hardship
20%	Emerging markets default on their bonds, and chose to be cut off of debt markets, rather than being puppets of the debt dollar hegemony.	• Radical changes in EM governments • The first country to default handles it pretty well
10%	Emerging markets manage to gradually reduce their debt burden back to sustainable levels.	• Self-imposed austerity programmes (à la Latvia or Lithuania in 2009-2010)

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