

Europe Watch

TWO HISTORY LESSONS FOR DOLLAR AND EURO

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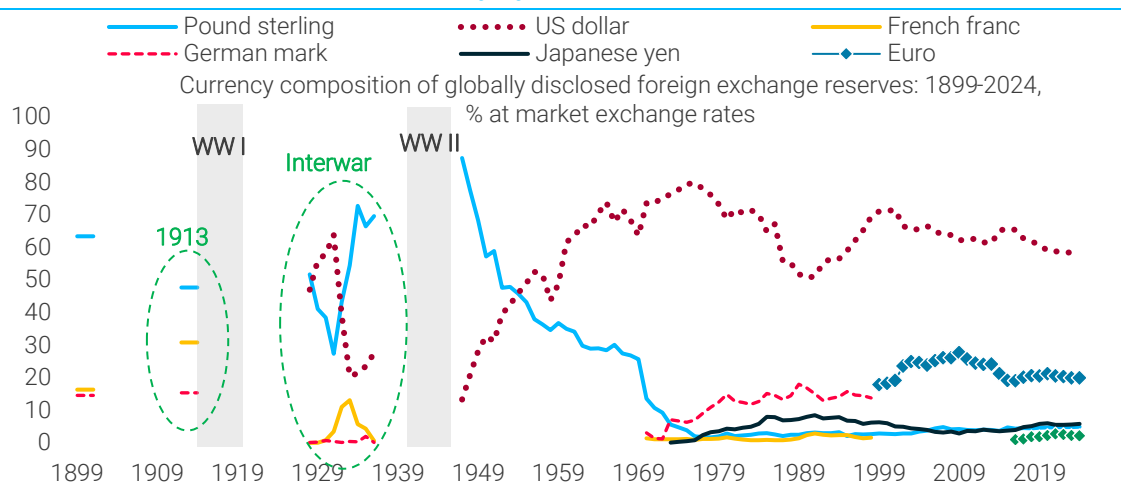
- Interwar history (1920-30s) shows a “multipolar” reserve currency system is possible
- Shifts in international currency usage can happen faster than consensus realises
- The USD has no international currency rival yet, but any diversification benefits Europe

Marks of capital flights are all over the simultaneous sell-off in US dollar, stocks and bonds of the past weeks. High-frequency data provide not only evidence of violent outflows from US equities into other DM assets, but also of true “flight to safety” dynamics, encapsulated by the sudden shift from US Treasuries into German Bunds and the related surge in the euro. With Donald Trump disrupting global trade and undermining relationships with US allies and the very foundations of the dollar-centric global financial system, investors now genuinely wonder if the dollar could be losing its role. **Our short answer is that, for now, the dollar is likely to remain the world’s top “key currency”, but that the Trump administration’s interference with capital flows and/or with Fed’s independence could precipitate a serious fracturing of the dollar system.**

Last week’s threats to “terminate” Jay Powell’s term at the Fed earlier are just the latest of a series of signals that risks to the institution and the dollar are material. Unsurprisingly, US dollar, stocks and bonds all sold off again yesterday. **As the unthinkable has now become possible, there are strong reasons for investors to continue “diversifying” away from US assets and the dollar, especially in favour of European assets and the euro. Extremely rich US valuations as a starting point provide even more room for adjustment.**

Two interwar monetary lessons. The return of high inflation in 2022 revived investors’ interest in the monetary and financial history of the 1970s. Talks about a “Mar-A-Lago Accord” did the same for Bretton Woods and for the Plaza and Louvre Accords of the 1980s. Now, amid growing

Chart 1: “Multipolar” reserve currency systems can exist



Sources: CEMGCD database / globalcurrenciesdatabase.com, GlobalData TS Lombard.

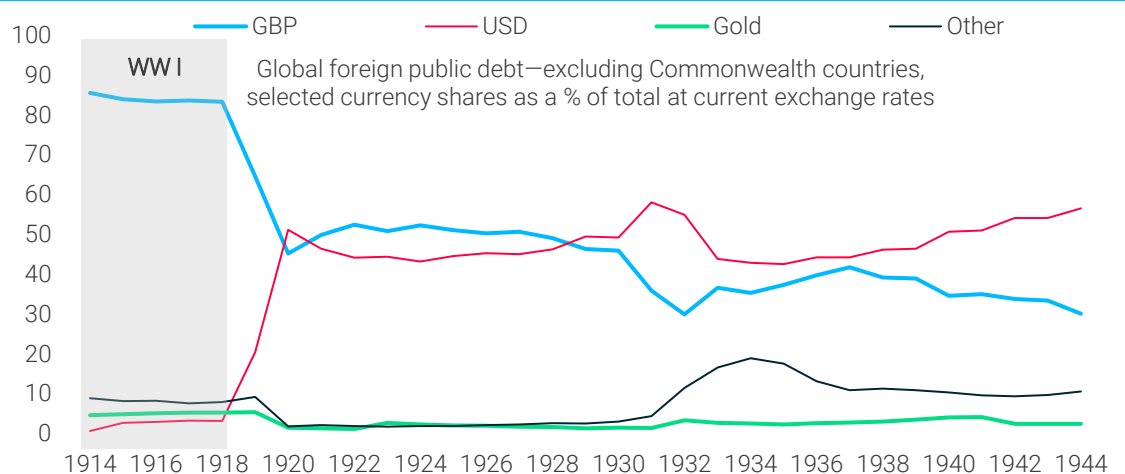
questions about the fragility of the dollar system, it is time for interwar (1920-30s) monetary history to stage a comeback with two crucial lessons. **First, a “multipolar” reserve currency system can exist. Second, shifts in the usage of international currencies can happen much faster than it is often assumed (i.e. in months and years rather than decades), although they require institutions in place that allow for substantial financial market deepening.**

The idea that at any point in history there can only be one global reserve currency – e.g. the pound sterling then, the dollar now – is mostly the result of two factors:

- **Recency bias.** A superficial look at events over the second half of the 20th century (with special emphasis placed on the dollar superpower since the 1980s) that disregards both previous monetary history and the fact that specific economic policy choices after World War II (WWII) also prevented competition with the dollar.
- **The false notion that “network externalities” (i.e. strong incentives to conform to a prevailing market standard) always dominate any other consideration in reserve currency selection.** In turn, this also masks a confusion between the two main functions of a so-called “key currency” – i.e. currency of denomination of reserves (“reserve currency”) and currency for trade invoicing and issuing foreign debt securities (“international currency”). These functions overlap largely, but not perfectly. If the “network externality” argument (essentially “market liquidity”) is crucial for an international currency, it’s not as important for a reserve currency. It’s easy to imagine cases in which it can be worth trading in some reserve liquidity for greater reserve diversification. It’s such trade-offs that create “multipolar” systems.

In the 1920-30s, the British pound shared its reserve currency status with the US dollar and the French franc. Data from the new Chitu-Eichengreen-Mehl Global Currencies Database (CEMGCD, available at globalcurrenciesdatabase.com) show that the pound share of globally disclosed foreign exchange reserves had fallen to 27% in 1931 from 52% in 1928; the dollar share, by contrast, had risen to 64% from 47% over the same period. But soon after, the French franc, which accounted for a mere 3.4% share in 1931, rose to a 13% share by 1933, as pound and dollar exchanged place once again in global reserve portfolios (see Chart 1 above). The dollar was not used at all in international transactions before World War I (WWI), but the establishment of the Fed in 1914 greatly expanded the liquidity of the New York market, which was then further boosted by the US decision not to follow the UK and other European countries into embargoing gold exports, but to keep free gold convertibility even after entering war in 1917. By the end of WWI, as the US commanded a much larger share of international trade and foreign lending and the UK stagnated, the dollar gained prominence at the expenses of the pound.

Chart 2: Shifts in international currency usage can be faster than one thinks



Sources: Chitu, Eichengreen, Mehl (2012), CEMGCD database / globalcurrenciesdatabase.com, GlobalData TS Lombard.

Further evidence of a “multipolar” monetary system during the interwar period comes from the international bond market, and data show that a shift in international currency usage can be much faster than consensus still assumes. Using data on currency denomination of public debt issued in foreign markets (“international bonds”), [Livia Chitu, Barry Eichengreen and Arnaud Mehl \(2012\)](#) show that the financial deepening of US markets engineered since the creation of the Fed allowed the dollar to match the pound sterling as key currency of choice for international bonds already in the 1920s – some 20 years earlier than traditional narratives assume. Post-WWI capital flows boosted financial development further. War reparation payments to the US were recycled into new US lending to Europe, where devastation and capital scarcity provided high returns for US capital flows. Dollar-denominated security issues for foreign borrowers made up a large part of those flows to Europe. As US banks helped foreign governments and corporations to place the newly issued debt, they soon began to originate foreign bonds themselves and to aggressively market them by upgrading the network of branches and travelling salesmen that they set up to distribute Liberty bonds. Chart 2 shows that, once issuance data are adjusted to exclude Commonwealth countries, whose reliance on the pound sterling was an artifact of dominion status rather than a market choice, the dollar share of international debt rose from virtually zero (3.4%) to 51% in just two years from 1918 to 1920 and averaged around 47% until the end of WWII, while the pound share steadily declined.

All that said, a “multipolar” monetary system was not confined to the interwar years. As Chart 1 above also shows, even before WWI the pound sterling only accounted for 48% of total foreign exchange reserve balances, closely followed by French franc at 31% and German marks at 15%, whose use prevailed on the European continent. Moreover, the rise of the dollar as single reserve as well as international currency after WWII was also favored by the fact that other potential key currency issuers such as Germany, Japan and France pursued policies that prevented this possibility, leaving the dollar without any competition. Under the Bretton Woods system, those countries implemented capital controls. A closed capital account is incompatible with an international currency just like gold convertibility is necessary under the gold standard. What is more, Germany thought that the international use of the mark would be inflationary as the money supply would need to be bigger than for a national currency. Japan and France saw managing an international currency as interfering with their system of directed credit. We cannot exclude that without such policies the Deutsche mark, Japanese yen, and French franc could have played a bigger role in international markets as well as in reserve portfolios.

To be sure, for now, there is no perfect alternative to the dollar as top key currency for the world, but the euro and European assets offer the best way to diversify. Neither the euro nor the renminbi satisfies all major conditions to take the dollar place: (i) a large economy with global trade footprint; (ii) rule of law, including property right enforcement, separation of powers and institutions enhancing financial market functioning and liquidity – especially an open capital account and an independent central bank that cares about financial and price stability; and (iii) a strong army. China and the renminbi satisfy condition (i) and (iii), but not (ii). The EU satisfies (i) and (ii), but not (iii). Regardless of Trump’s decisions, the general thrust of US policy implies that the renminbi’s international role will continue to expand, especially for trade invoicing. **However, the euro and European assets offer to global investors, especially in the West, the best way to diversify away from the dollar, as rule of law, democracy and an open capital account prevail over any attraction that China’s rising military power can exert on financial wealth, while large scale and limited currency volatility make the euro a better destination for large capital flows than any other DM.**

That said, as we saw from the development of the dollar-denominated international bond market in the interwar period, any durable shift in usage of international currencies requires substantial financial market deepening. This is a cautionary tale for euro enthusiasts, predicting the imminent demise of the dollar. The EU still needs to complete the infrastructure that could unlock the expansion in financial market liquidity, depth and breadth necessary to take over the dollar role on a sustained basis. **However, the various Trump's shocks have propelled the completion of the "Savings and Investment Union" (as the old "Capital Market Union" has been rebranded) on top of the European Commission and EU leaders' agenda, building on the strong momentum from the Letta and Draghi Reports.** It is then not surprising that Christine Lagarde last week put so much emphasis on the ECB's recommendation to speed up the implementation of capital market reforms and the roll-out of a digital euro. **As we said, the euro is unlikely to fully replace the dollar any time soon, but it has a historic opportunity to gain significant prominence on the global currency stage, while accommodating structural global portfolio rebalancing towards European assets.** (There is a lot to write about this topic. If interested, watch out for the next Europe Watch).

To conclude, monetary history shows that "multipolar" monetary systems are possible – albeit unstable – and that shifts in international currency usage can happen much faster than consensus assumes. This implies that "network externalities" and the benefit of incumbency are not as strong as generally thought, with profound implication for the dollar. If Trump's insistent tampering with Fed independence continued or steps were taken to curtail US capital flows (for example by imposing a "user fee" as Stephen Miran, Trump's chief economic adviser suggested recently), the dollar system could be fractured beyond repair.

It would be hard to express the current predicament of the global monetary system better than Charles P. Kindleberger did in 1967, even before the dollar displayed its full power: "The strength of the dollar as a world exchange standard lies in the international capital market operated in dollars. If the USA must cut itself off from the provision of capital to the world by reason of its worries about its balance of payments, the role of the dollar as a vehicle currency is seriously and perhaps fatally damaged." ("The Politics of International Money and World Language", 1967; in "International Money", 1981)

Meanwhile, the euro and European assets stand to benefit most from the rebalancing of global asset and reserve portfolios.

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