



Cambridge Centre for Risk Studies

Cambridge Risk Framework

De-Americanization of the Global Financial System

# DOLLAR DEPOSED STRESS TEST SCENARIO

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This report describes a hypothetical scenario developed as a stress test for risk management purposes. It does not constitute a prediction. The Cambridge Centre for Risk Studies develops hypothetical scenarios for use in improving business resilience to shocks. These are contingency scenarios used for 'what-if' studies and do not constitute forecasts of what is likely to happen.

## De-Americanization of the Financial System Stress Test Scenario

# Dollar Deposited

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# De-Americanization of the Financial System Stress Test Scenario

## Dollar Deposed

### 1 Executive Summary

The rise and fall of dominant currencies, associated with trade and linked to financial and political systems, is a recurrent theme in financial history.

We describe a de-Americanization of the global financial system as one of our four Financial Catastrophe scenarios. Scenarios can generally be used to cover the spectrum of extreme shocks, such as those proposed in the Cambridge Taxonomy of Threats, which encompasses five classes of business risk. A suite of scenarios is a basis for a global enterprise to self-stress test and improve its resilience.

#### De-Americanization as a Financial Crisis

The rise and reign of the US dollar, signposted by the end of the Second World War, is the most recent and most complete example of how monetary hegemony functions as a stabilising force in the global economy.<sup>1</sup>

#### *From “greenback” to “redback”*

This scenario imagines a global financial shift from the US dollar to the Chinese renminbi resulting from continued, rapid and massive development of China on a track towards becoming the world’s largest domestic economy.<sup>2</sup>

The overall impact of the changeover in monetary hegemony does not lead to a worldwide recession in any of the scenario variants.

The US, however, suffers a year long recession in the first year of the shock, and an ultimate loss of 5.2%, 7.3% and 8.4% of domestic GDP across all variants. In the S1 and S2 scenarios, the overall loss, expressed as lost global Gross Domestic Product during the scenario compared with the projected rate of growth (“GDP@Risk”), is between \$1.9 and \$1.6 trillion, respectively.

In the extreme variant, X1, however, the global GDP makes a return of \$1.6 trillion above the projected non-crisis growth.

#### What is the life expectancy of a global currency?

##### *Scenario selection*

“Global” currencies have existed as long as there has been cross-cultural trade, exemplified by the commercial empires of historical Rome, Byzantium, Italy, the Netherlands, and Spain. Hegemony stability theory postulates that a dominant reserve currency with a weakening economic base is suggestive of a trade currency or reserve currency shift.<sup>3</sup>

The Dollar Deposed Scenario is analogous to the post-World War II replacement of the British Pound Sterling by the US dollar as dominant currency in that it is underpinned by economic weakness, large debt and significant geopolitical shifts that are external to the reserve currency nation.

##### *Variants of the scenario*

In our ‘standard’ scenario, identified as S1, the size of the shock is gauged by the depreciation of the US dollar by 10% against the Chinese RMB, which supplants it as the new reserve currency. Scenario variant S2 increases the shock to a 25% depreciation of the dollar while the most severe variant, X1, considers 50% depreciation.

The scale of loss inflicted by the Dollar Deposed Scenario has been calibrated to correspond to an event that happens about once a century on average, a 1-in-100 year event. Two indicators that may give a sense of the likelihood of a catastrophe scenario occurring are its impact on equity returns and growth rates, which are expected to be negative in the throes of a catastrophe.

US (UK) equities over the last two hundred years have experienced return rates below -24% (-13%) about once in twenty years, with return rates below -36% (-20%) signifying 1-in-100 events.

In our scenario variants, those return rates are similar regarding the US, with return rates of -30% for S1 and -44% for S2, (and less dramatic for the UK where the scenario return rates are -9% for S1 and -13% for S2).

<sup>1</sup> D. Calleo (ed.), *Money and the Coming World Order*, Lehrman Institute, New York University Press, 1976

<sup>2</sup> KPMG, “China’s 12th Five-Year Plan: Overview”, 2011

<sup>3</sup> A. Walter, *World Power and World Money*, Prentice-Hall, 2003



That is, these suggest that an impact at the scale of the Dollar Deposited Scenario is roughly comparable with 1-in-100 year event. Near zero economic growth rates are found in our scenarios which differ from the historical record of US (UK) growth rates below -7% (-3%), which are 1-in-20 year events, or rates below -13% (-5%) which happens every century.

### *This is a stress test, not a prediction*

This report is one of a series of stress test scenarios, produced by the Centre for Risk Studies, to explore management processes for dealing with an extreme shock. It does not predict a catastrophe.

## **The unfurling scenario**

### *Dragon rising*

China continues to invest heavily in expanding its industrial base. For the first time, there is massive growth in infrastructure north and west of traditional economic zones exemplified by the coastal Pearl River Delta and central Chongqing province.

This is accelerated by growing China's domestic bond markets as well as developing regulation and financial market infrastructure within China and in the pursuit of international markets.

### *The dragon makes rain*

As China's internal economy lurches forward, resource and social stressors rise to the fore. The Chinese government responds with a frenzy of combined trade and foreign "partnership" campaigns aimed at locking in decades of foreign commodity supplies.

China's infrastructure and commodities spending spree, funded from its vast store of US treasuries, moves the value of the US dollar down and simultaneously forces the floatation of the Chinese RMB.

Shockingly quickly, the RMB supplants the US dollar as the global reserve currency.

### *Coming through the storm*

The USA is hit hard and there is a global loss in confidence in the USA as a stable long-term economy. Foreign Direct Investment in the USA falls. Investors engage in a flight to quality by moving out of the US and boosting China's inward Foreign Direct Investment.

Overall, the world economy suffers short term losses due to the hasty transition of global currencies but the longer term macroeconomic view is healthy due to the growth of the dynamic domestic Chinese market.

## **Global GDP impact**

We estimate the macroeconomic impact of this scenario by shocking the US Dollar, the Chinese RMB

and interest rates and foreign direct investment levels in both the USA and China within the Global Economic Model of Oxford Economics. This yields 'GDP@Risk' which estimates the loss to the global gross domestic product over 5 years, i.e., the cumulative effect of this scenario on the global economy. GDP@Risk, expressed in real terms in US dollars, ranges from \$1.9 trillion for S1, a loss, to a global gain in the X1 variant of \$1.6 trillion.

The US expectedly takes the largest plunge in GDP output losses, while the other major economies record gains or negligible impacts to their GDP, signalling that growth in the Chinese economy is ultimately beneficial globally. These impacts are considered insignificant when compared to the Great Financial Crisis whose GDP@Risk is around \$20 trillion in 2015 dollars.

## **Financial market impact**

We estimate the portfolio impacts of this scenario by modelling the outputs from Oxford Economics' Global Economic Model into portfolio returns, projecting market changes and cash flows while keep the allocation percentages fixed. We also default all corporate bonds given the 2008 default rates.

Although, the macroeconomic shocks are applied for 5 years, this is the only scenario where we see the portfolio begin generating positive returns after the first year. The maximum downturn experienced for the Conservative portfolio in the S1 variant is -18.94% in nominal terms which occurs in Yr1Q4. The worst performing equity are the US stocks (W5000) while the best performing equities are the UK (FTSE 100). The worst performing fixed income bond is the US while German bonds perform the best. The worst performing portfolio structure is Aggressive, with a -20.06% loss for the S1 variant.

For portfolio protection it is recommended that equity and fixed income allocation is shifted away from US towards UK and Germany.

## **Risk management strategies**

### *Scenarios as stress tests*

This scenario is an illustration of the risks posed by social unrest triggered by catastrophic event. The Dollar Deposited scenario is just one example of a wide range of scenarios that could occur.

This scenario aims to improve organizations' operational risk management plans around contingencies, and strategies for surviving financial and counterparty challenges. It presents a capital stress test for insurers to assess their ability to manage underwriting losses while also suffering market impacts on their investment portfolios.

Summary of Effects of Dollar Deposed Scenario and Variants						
Scenario Variant	S1		S2		X1	
Variant Description	Standard Scenario		Scenario Variant		Extreme Variant	
<b>Bond Market Stress (US)</b>	210%		280%		440%	
<b>Short-term Interest Rates (US)</b>	180%		250%		310%	
<b>Dollar devaluation</b>						
- Against Chinese RMB	-10%		-25%		-50%	
- Against RoW currencies	-2%		-5%		-10%	
<b>Macroeconomic losses</b>						
<b>Global recession severity</b> (Minimum qtrly growth rate global GDP)	0.7%		-0.3%		0.8%	
<b>Global recession duration</b>			No recession			
<b>GDP@Risk \$Tr</b> (5 year loss of global output)	\$1.9 Trillion		\$1.6 Trillion		-\$1.6 Trillion	
<b>GDP@Risk %</b> (as % of 5-year baseline GDP)	0.5%		0.4%		-0.4%	
<b>Portfolio Impact</b>						
<b>Performance at period of max downturn</b>						
<i>High Fixed Income</i>	-17%		-24%		-31%	
<i>Conservative</i>	-19%		-27%		-36%	
<i>Balanced</i>	-20%		-28%		-37%	
<i>Aggressive</i>	-20%		-29%		-37%	
<b>Asset class performance</b>						
	<b>Yr1Qr4</b>	<b>Yr3Qr4</b>	<b>Yr1Qr4</b>	<b>Yr3Qr4</b>	<b>Yr1Qr4</b>	<b>Yr3Qr4</b>
<b>US Equities (W5000), % Change</b>	-22%	9%	-36%	7%	-118%	3%
<b>UK Equities (FTSE100), % Change</b>	1%	26%	0%	29%	1%	30%
<b>US Treasuries 2yr Notes, % Change</b>	-15%	-4%	-23%	-5%	-31%	-10%
<b>US Treasuries 10yr Notes, % Change</b>	-55%	-26%	-81%	-60%	-108%	-121%

Table 1: Summary impacts of the Dollar Deposed scenario

## Trillion US\$ GDP@Risk across scenarios









		S1	S2	X1
	<b>Millennial Uprising</b> Social Unrest Risk	1.6	4.6	8.1
	<b>Dollar Deposited</b> De-Americanization of the Financial System Risk	1.9	1.6	-1.6
	<b>Sybil Logic Bomb</b> Cyber Catastrophe Risk	4.5	7.4	15
	<b>High Inflation World</b> Food and Oil Price Spiral Risk	4.9	8	10.9
	<b>Sao Paolo Influenza Virus</b> Pandemic Risk	7	10	23
	<b>Eurozone Meltdown</b> Sovereign Default Risk	11.2	16.3	23.2
	<b>Global Property Crash</b> Asset Bubble Collapse Risk	13.2	19.6	
	<b>China-Japan Conflict</b> Geopolitical War Risk	17	27	32
<b>2007-12 Great Financial Crisis</b>		18		
<b>Great Financial Crisis at 2014</b>		20		

Table 2: GDP@Risk impact of the High Inflation World scenario compared with previous Centre for Risk Studies stress test scenarios

## 2 Financial Catastrophe Stress Test Scenarios

This scenario is an illustration of the risks posed by a plausible but extreme financial market based catastrophe. It represents just one example of such a catastrophe and is not a prediction. It is a “what-if” exercise, designed to provide a stress test for risk management purposes by institutions and investors wishing to assess how their systems would fare under extreme circumstances.

This scenario is one of a series of stress test scenarios developed by the Centre for Risk Studies to explore the management processes for dealing with an extreme shock event. It is one of four financial market catastrophe scenarios being modelled under this work package and includes the following:

- Global Property Crash: Asset Bubble Collapse;
- High Inflation World: Food and Oil Price Spiral;
- Eurozone Meltdown: Sovereign Default Crisis.

The scenarios present a framework for understanding how global economic and financial collapse will impact regions, sectors and businesses throughout the networked structure of the economy. These financial stress tests aim to improve organisations’ operational risk management plans to form contingencies and strategies for surviving and minimising the impacts from market-based financial catastrophe. In particular, the stress tests allow institutions to manage and build resilience to different forms of risk during periods of financial stress.

These risks include:

- financial and investment risk stemming from a collapse in asset prices across different sectors and regions;
- supply chain risk and the ability of an institution to effectively manage its input requirements through its supply chain, to meet internal production and operational requirements;
- customer demand risk and knowledge for how demand might shift for goods and services during periods of low investment and consumer spending;
- market or segmentation risk and an understanding of how other firms within the same sector will react and perform during periods of financial stress and how this may impact on the business;
- reputational risk and the protection of brand image for reacting appropriately and confidently under crisis conditions.

Each individual scenario may reveal some aspects of potential vulnerability for an organisation, but they are intended to be explored as a suite in order to identify ways of improving overall resilience to unexpected shocks that are complex and have multi-faceted impacts.

### Market catastrophe risk and financial contagion

The Great Financial Crisis of 2007-8 not only revealed the extent to which the global financial system is interconnected but how interrelationships between commercial banks, investment banks, central banks, corporations, governments, and households can ultimately lead to systemic instability. As global financial systems become increasingly interconnected, a shock to one part of the system has the potential to send a cascade of defaults throughout the entire network.

In 2008, it was only through government intervention in the form of extensive bailout packages that a widespread collapse of the global financial system was avoided. New models of the global financial system are an essential tool for identifying and assessing potential risks and vulnerabilities that may lead to a systemic financial crisis.

The literature identifies three types of systemic risk: (i) build-up of wide-spread imbalances, (ii) exogenous aggregate shocks and (iii) contagion (Sarlin, 2013). Similarly we work with three analytical methods that help deal with decision support: (i) early-warning systems, (ii) macro stress-testing, and (iii) contagion models. All three methods are actively under research in the Centre for Risk Studies and utilised in the development of these stress test scenarios.

### Understanding financial catastrophe threats

This scenario explores the consequences of a financial market catastrophe by examining the notional 1-in-100 possibility for a Dollar Deposited Scenario and examining how the shock would work through the system.

For a process that truly assesses resilience to financial catastrophe, we need to consider how different market-based catastrophes occur and then propagate these shocks through global financial and economic systems. This exercise would ideally include a thorough analysis for each different type of market catastrophe in addition to the four financial catastrophes included in this suite of stress tests.



Such an analysis would also include a range of different severities and characteristics for these scenarios would occur as a result of these different financial and economic crises.

The Cambridge Risk Framework attempts to categorize all potential causes of future shocks into a “Universal Threat Taxonomy.” We have reviewed more than a thousand years of history in order to identify the different causes of disruptive events, collating other disaster catalogues and categorization structures, and researching scientific conjecture and counterfactual hypotheses, combined with a final review process. The resulting Cambridge taxonomy catalogues those macro-catastrophe threats with the potential to cause damage and disruption to a modern globalised world. The report *Cambridge System Shock Risk Framework: A taxonomy of threats for macro-catastrophe risk management* (CCRS, 2014) provides a full description of the methodology and taxonomy content.

Within this universal threat framework we have developed a specified taxonomy for financial catastrophes. This can be seen in Figure 1 and includes a list of seven unique financial, market and economic catastrophes. A large economic or financial catastrophe seldom affects just one part of the system.

The historical record shows that multiple market catastrophes tend to occur at the same time and impacts cascade from one crisis to the next. The recent Great Financial Crisis (GFC) is one example of this. The financial crisis started in the US as a sub-prime asset bubble but quickly spread to the banking sector where many major banks were left holding assets worth much less than had originally been estimated. The complicated nature of the various financial derivatives that were being sold made it difficult for traders to understand the true underlying value of the asset that was being purchased. This result was a systemic banking collapse that had worldwide implications that still remains to be solved across the globe.

Throughout history there have been many other examples where multiple forms of financial catastrophe have cascaded from one form of crisis to the next, examples include the 1720 South Sea Bubble; 1825 Latin American Banking Crisis; 1873 Long Depression; 1893 Bearing Bank Crisis; 1929 Wall Street Crash and Depression; 1997 Asian Crisis and the 2008 Global Financial Crisis.

### Scenario design

Each scenario is selected as a plausible, but not probable, extreme event that is driven by a number of factors and would cause significant disruption to normal lifestyles and business activities.

They are illustrative of the type of disruption that would occur within a particular category of “threat” or “peril” – that is, a cause of disruption.

In this scenario, we explore the consequences of a “Dollar Deposed” scenario when the weakening dollar loses its place as the chief global reserve currency to a strengthening Chinese renminbi.

The analysis estimates losses to the real economy using the OEM to calculate losses in expected GDP output. We have also estimated how the event would impact investment asset values, using standardized investment portfolios to show the effect on indicative aggregate returns.

Investment managers could apply these asset value changes to their own portfolio structures to see how the scenario would potentially affect their holdings. The impacts of the different variants of this scenario are applied to four financial portfolios: high fixed income, conservative, balanced and aggressive.

### Developing a coherent scenario



**Figure 1: Financial catastrophe “FinCat” taxonomy**

It is a challenge to develop a scenario that is useful for a wide range of risk management applications. Fully understanding the consequences of a scenario of this type is problematic because of the complexity of the interactions and systems that it will affect.

The economic, financial, and business systems that we are trying to understand in this process are likely to behave in non-intuitive ways, and exhibit surprising characteristics.

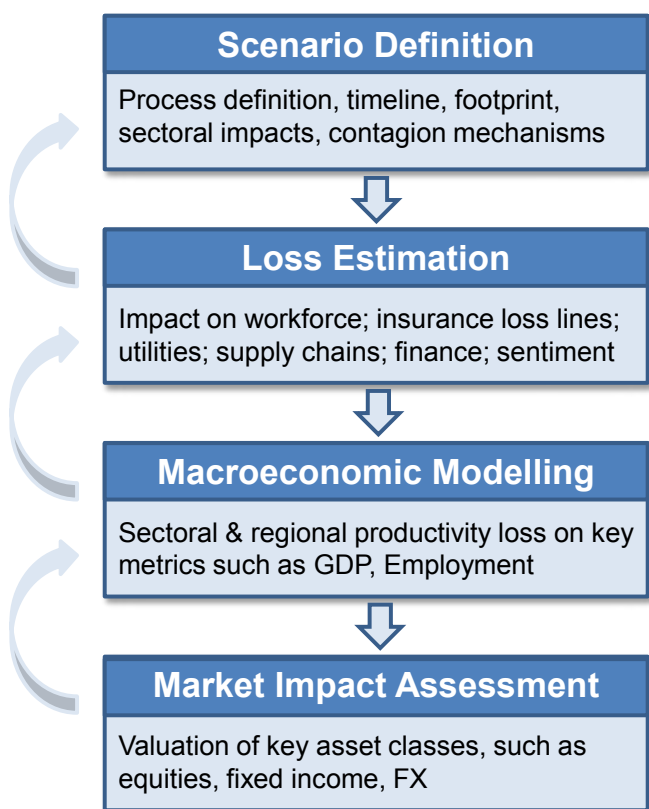
During this process we try to obtain insights into the interlinkages through using an extreme scenario.

To develop a coherent stress test we have devised a methodology for understanding the consequences of a scenario, as summarised in Figure 2.

This involves sequential processing of the scenario through several stages and sub-modelling exercises, with iteration processes to align and improve assumptions.

We believe it is important to create a robust and transparent estimation process, and have tried to achieve this through a detailed recording of the assumptions made, and by making use of sensitivity tests regarding the relative importance of one input into another.

In the macroeconomic stages of the modelling, we are conscious that we are attempting to push macroeconomic models, calibrated from normal economic behaviour, outside their comfort zone, and to use them in modelling extreme events. We have worked closely with economists to understand the useful limits of these models and to identify the boundaries of the models functionality.



**Figure 2: Structural modelling methodology to develop a coherent stress test scenario**

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**Use of the scenario by investment managers**

The scenario provides a timeline and an estimation of the change of fundamental value in assets in an investment portfolio. These are segmented into broad asset classes and geographical markets to provide indicative directional movements.

These provide insights for investment managers into likely market movements that would occur if an event of this type started to manifest. In real events, market movements can sometimes appear random.

This analysis suggests how the underlying fundamentals are likely to change over time, due to the macroeconomic influences. The spread of asset class and geographical distributions enable investors to consider how different portfolio structures would perform under these conditions and how to develop strategies for portfolio management that will minimize the losses that might occur.

Where there are obvious winners and losers by economic sector, these have been highlighted to provide inputs into optimal hedging strategies and portfolio diversification structures.

This report provides performance projections for a standardized high-quality, fixed income portfolio, under passive management.

This is to enable comparisons over time and between scenarios. We also estimate returns for individual asset classes to help investment managers consider how this scenario might impact their particular portfolio and to consider the intervention strategies over time that would mitigate the impact of this financial catastrophe.

### **Use of the scenario by policy makers**

International agencies like The World Bank, The International Monetary Fund (IMF), The Organisation for Economic Co-operation and Development (OECD) and G7-G8 Group Meetings recognise the serious global implications of market-based catastrophe. Scenario stress testing is a sensible and appropriate tool to improve the awareness and decision-making ability of policy advisors.

This scenario is proposed as an addition to the existing frameworks and procedures that are already being used to understand risk and contagion in the global financial and economic systems.

National governments, central banks and other regulatory authorities including the Prudential Regulation Authority (PRA) in the UK use stress tests to determine whether banks have sufficient capital to withstand the impact of adverse economic developments. Many banks also carry out stress tests as part of their own internal risk management processes. Such tests are designed as an early detection system to identify vulnerabilities in the banking sector so that corrective action can be taken by regulators. These stress tests focus on a few key risks such as credit risk, market risk and liquidity risk. In many cases, banks are subject to performance reviews against classified versions of these scenarios and they are a mandatory requirement for many national regulatory authorities.

This scenario is a contribution to the design of future versions of these policy-maker scenarios. It offers a view of the economic environment and broader financial disruption that will be caused. It provides inputs into the decision making and resource planning of these authorities, and is offered as context for policy-makers concerned with stemming the impacts of market catastrophe.

### **Complex risks and macroeconomic impacts**

Financial and economic systems are inextricably linked. Thus, financial market catastrophes are of interest because they represent complex risks – they impact the networks of activities that underpin the global economy, disrupting the interrelationships that drive business, and cause losses in unexpected

ways and places. They have multiple consequences, causing severe direct losses, as well as operational challenges to business continuity, cascading effects on the macroeconomy through trading relationships, and on the capital markets and investment portfolios that underpin the financial system.

The stress test is aimed at providing an illustration of the effects of an extreme event, to help a non-specialist audience understand the potential for events of this type to cause disruption and economic loss. It is aimed at informing risk management decisions for a number of different communities of practice.

### 3 De-Americanization of the Global Financial System as a Financial Catastrophe

Certain currencies are held in reserve quantities by central banks and governments in order to influence domestic exchange rates and facilitate the payment of international loans. The practice of accumulating reserve currencies is a by-product of an ever growing international trade economy.

An international system of monetary hegemony provides a basic “foundation of order” in the greater world economy. Historical precedents indicate that functional, international economic cooperation is difficult both to achieve and sustain when there is no dominant liberal power that establishes a hierarchy of currency values. Global currencies have existed as long as cross-cultural trade. After the collapse of Rome and loss of its centralised currency, the monetary systems of the medieval and early modern period were drawn from the largest centres of trade – Byzantium, Italy, the Netherlands, and Spain. The dominant reserve currencies amongst these cities survive with a lifespan of roughly a century for many historical global currencies. Hegemony stability theory suggests that the erosion of economic health is indicative of a dominant reserve currency which can no longer uphold the system.

The global economy as it exists today is a product of the long period of fiscal continuity shared between United Kingdom and the United States and stemming from the latter years of the 19th century. Economic globalisation is, arguably, a product of reserve currency use, permitting unrelated nations to trade in fluid and convertible terms.

#### **Pax Americana, 1945-present**

The rise and reign of the US dollar is both the most recent and most complete example of how monetary hegemony functions as a stabilising force in the global economy. American dominance in the financial system was vital to the re-establishment of international economic order following the Second World War.

Throughout the war, the United States was the industrial centre of the allied West and aggregate demand and output production remained strong during the conflict. Ultimately, the US was the only economy to benefit from the war. It emerged in 1945 with an unrivalled merchant fleet, having captured new markets and territories in the Pacific and South America and accumulated more than two-thirds of

the world’s gold reserves. Britain, in comparison, suffered a 25% reduction in its national wealth during the war and emerged with its shipping industry and foreign investments heavily damaged.

The central banks of recovering nations were glad to stock their vaults with US treasuries.

In his book *Money and the Coming World Order*, economist David P. Calleo states, “it is widely accepted that the United States has acted since World War Two as a kind of world central bank.”

The Bretton Woods system, begun in 1944, sought to establish a method of stabilising international exchange rates by basing monetary management scheme around a central, dominant US dollar.

The worldwide reliance on the gold-backed dollar led to the financial “disequilibrium” of the 1960s and 70s, revealing the currency’s weaknesses and the vulnerabilities inherent in an interdependent global economy. Despite this and Richard Nixon’s 1971 decision to close the gold window the US dollar remains the international global reserve currency.

#### **Weakness of the greenback**

The monetary dominance of the United States stems from the diversity of its markets, its role as a major exporting and importing nation, and the size of its economy. As newly industrialised and diversifying rival markets emerge onto the world stage, the dollar’s position is becoming contentious.

As of 2014, around 60% of the world’s central bank reserves are made up of dollars. The majority of foreign trade is conducted in dollars: “dollar diplomacy” props up both legal and illegal markets in Latin America and East Asia; since the 1970s, petrodollars have been the standard currency for oil markets across the world. China, in particular, is a central player in the dollar standard’s supremacy as it owns such a high proportion of US debt – in 2015, around 8% in all.

Some economic commentators feel that the global reliance upon the dollar actively puts undue burdens on the US financial system. At the risk of losing its international monetary supremacy, the US suppresses domestic demand in favour of maintaining cheap foreign trade incentives.<sup>4</sup>

<sup>4</sup> J. Bernstein, “Dethrone ‘King Dollar’”, *The New York Times*, Aug 27, 2014



Historical Case Study  
**Pax Britannica, 1821-1914**



During the peacetime which followed the Napoleonic Wars in Europe, the convertible gold standard reigned supreme as the premiere reserve currency for most of the developed world.

From 1821 onwards until the Great War, the gold standard system grew out from British imperial territories and directed the flow of international finance directly through London for nearly a century. The outbreak of war in 1914, however, limited the movement of gold supply and belligerent nations suspended the gold standard in order to fund the conflict. The First World War shook the political foundations of the international gold standard and it never fully recovered.

After the war, gold supplies remained low as nations drained their stockpiled reserves to pay reparations and the standard failed to support economies struggling to rebuild. Many countries pegged their local currencies to the dominant Pound sterling and US Dollar, deemed stronger economic units than the fixed price of gold.

However, as the Fed keeps US interest rates down in an effort to bolster inflationary growth, the incentive for foreign banks to purchase dollars with no practical promise of return diminishes. Further weakness in the dollar and US economy aggravates shocks to oil and energy systems in international markets and ennui in the system grows. BRICs economies must purchase dollars in order to meet exchange rate objectives but, in the light of US current zero-interest rate policy, the currency is becoming less of a viable investment.

### Continuation or change?

In the wake of the 2007 financial crisis, a 2009 statement from the People's Bank of China called for the replacement of the dollar with "an international reserve currency that is disconnected from individual nations and is able to remain stable in the long run."<sup>5</sup>

<sup>5</sup> Z. Xiaochuan, *Reform the International Monetary System*, statement by The People's Bank of China; 23 March 2009, 2

Ten years before, in 1999, the size, strength and stability of the European Union strongly suggested that the newly introduced Euro would ultimately overtake the US Dollar as the world's number one reserve currency. The 2010 Greek debt crisis, however, has cast doubt on the Euro's long-term prospects as a robust monetary system, leaving an open question as to the continuation of dollar supremacy or a changeover to an entirely different, more attractive currency.

Today, it is the emerging industrialised BRICs markets which pose the greatest threat to dollar hegemony. Despite its claims for a more selfless international currency scheme in 2009, it is China that is making the policy changes necessary to replace the dollar's role.

If money and power are intrinsically linked, then it seems clear that as China's economy usurps the US as the world's largest market, the RMB/yuan will gradually depose the dollar as the dominant global currency. It is not a matter of "if," but a question of "when."

Regardless, the dollar maintains its international position as a "safe haven," even in times of financial crisis. It has survived catastrophes in the 1970s, 1980s and 2000s and yet remains robust. As of 2014, the US Dollar Index was back at a four-year high after a period of poor performance following the Great Recession. Confidence is the basis of the dollar's reign and as confidence returns with the US economic recovery, the dollar retains its position as the first mover in global finance.

While monetary hegemonies come and go, the "King Dollar" is not likely to go anywhere fast. Despite the Fed's low interest rates, at this stage, only a "cataclysmic" event would depose the dollar as the world's first currency.<sup>6</sup>

<sup>6</sup> D. Calleo, *Money and the Coming World Order*, Lehrman Institute, 1976



## 4 Defining the scenario

The practice of using stress tests to check the health of banks and economic institutions in the wake of the Great Financial Crisis is currently a point of some contention in financial circles. While stress tests have restored confidence in some instances, they have also failed to accurately capture the risk limits of the institutions whose health they seek to diagnose. The rate of change in economic conditions has, of late, been such that stress tests have little longevity with results soon rendered obsolete. In this period of general economic recovery there are concerns that current stress tests are either too predictable or poorly applied, and require closer re-examination.

In the light of this issue, the University of Cambridge Centre for Risk Studies devised a new suite of coherent stress tests designed to reflect four potential, though improbable, global financial crises to address this identified stress test 'longevity gap'.

The following scenario examines the impacts of a hypothetical transfer of the global reserve currency from the US Dollar to the Chinese renminbi over an ultra-short period.

### Rise of the redback

China's 12th 5 year plan, running from 2011 to 2015, is critical to the development of China and promises to have a large impact on the global economy through trade and finance. The plan is summarised as internal economic development underpinned by industrial development and facilitated by marked progress in China's financial markets and their regulation.<sup>7</sup>

One goal of the 5 year plan is for China's economy to be driven by domestic consumption rather than by exports. The plan therefore includes specific industrial development priorities, one of which is further investment in China's underdeveloped western regions. Its broader industrial priorities follow the themes of sustainable growth, particularly with reference to green energy, biotech, new materials, IT innovation and high tech manufacturing.

The internal transition of China's domestic economy will rely on ongoing progress in financial mechanisms and markets. The stages of the RMB as an international currency are its growing strength across three dimensions: trade, investment, and reserve holdings.<sup>8</sup>

<sup>7</sup> KPMG, "China's 12th Five-Year Plan: Overview", KPMG Advisory (China) Ltd, March 2011

<sup>8</sup> HSBC, "RMB Internationalisation: RMB going global", August 2013

Only the last of these is currently minor, hence the road to the RMB becoming a global reserve currency invites continual speculation. Taking its domestic economic and international financial agendas together, two of China's longer term goals are to reduce its dependence on the US economy, hence on the dollar, and simultaneously increase its global political influence.

Given that the shift away from the US dollar to the Chinese RMB would represent a global cataclysm as suggested in the previous section, this eventuality could be regarded as a trend, i.e., the domination of the RMB will emerge gradually over the next decade or three.

In the scenario to follow we suggest that there nevertheless may be a shorter term shock, i.e., in the next decade, representing a loss of confidence in the US dollar by investors as their collective consciousness registers the long-term shift.

Global investors' views on dollar-denominated instruments could be dampened or accelerated in the negative direction by China's actions as it works on the nuts and bolts of its 5 year plan, specifically<sup>9</sup> its development of the stock market and more ambitious plans to develop markets for bonds, monetary instruments, foreign exchange, gold, insurance, and futures and financial derivatives.

It is noted that the latter developments, including access to significant volumes of Chinese bonds, are expected to play an important role as reserve instruments in foreign banks.

Thus, China could take a deliberate stance to spark or speed up a sentiment-driven shift away from the US dollar, and hence toward the RMB.

### What's the likelihood?

The scenario we describe is unlikely to occur. We stress that, for a counterfactual event that has never occurred, estimating how its severity corresponds to its return period is problematic. Historical changes in dominant reserve currency have happened naturally and as a by-product of changing international and economic fortunes. There has never been a planned or purposeful changeover in the order of monetary hegemony as is reflected in this scenario.

In the past five years, China has repeatedly confirmed that it views US Treasury bonds as a key component of its national reserves and a useful tool

<sup>9</sup> The 12th Five-year Plan for the Development and Reform of the Financial Industry, Peoples Bank of China

in the formulation of its financial policies.<sup>10</sup> With the increased globalisation of the international economy, the two countries have grown more interdependent in their plans for ongoing expansion.

### Scenario variants

We have introduced a set of variants to the scenario to provide sensitivity analysis and so as to gain a better understanding of the greater effects of the dollar deposed scenario.

**Standard scenario S1** represents a best estimate of what a dollar deposed scenario might mean to the United States and the global economy. The dollar depreciates two percent with respect to the rest of the world, and depreciates 10 percent against the Chinese RMB, which supplants it as the new reserve currency. **Scenario variant S2** increases the shock to the dollar depreciation to five and 25 percent respectively, while **extreme variant X1**, which is the most severe variant considered in this impact analysis, further depreciating the dollar by 10 and 50 percent respectively.

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<sup>10</sup> “China is seeking more exposure for the renminbi”, *The Economist*, Global Forecasting Service, May 18 2011

## 5 The Scenario

### Phase one: Trouble brewing for the US dollar

The general economic weakness in the US is exacerbated moderated by the upturn in the US domestic economy, namely the emergence of abundant and cheap natural gas via fracking.

This energy production boom effectively relaxes decouples the link between US manufacturing and the global oil economy, pushing the US balance of trade in a positive direction and reducing the global liquidity of the dollar.

Simultaneously China has continued to grow in international trade, inward and outward investment, and the governance and market prerequisites for floating the RMB.

Continuing the growth trend set in the last 5 years we now have:<sup>11</sup>

- 200+ countries doing RMB business in a typical month
- 100 countries with RMB capabilities
- 50 territories with swap / settlement agreements
- 6 offshore RMB centres

In order to fulfil its declared policy objectives for increased internal consumption, China begins a domestic industrial investment plan starting with developments in the northern and western parts of the country. These draw on China's unused economic potential by engaging its rural, traditionally farm-based, citizens in the development of infrastructure, funded partly by developing domestic bond markets; business development there is predicted to follow.

Politicians in China and elsewhere, supported by some economic historians, identify China as the "centre of the economic solar system", the "sun" around which other economies including the USA are orbiting "planets".

### Phase two: trigger for dumping the dollar

As China's internal economy grows, resource and social stressors come to the fore.

The Chinese government responds with a package of combined trade and foreign "partnership" campaigns aimed at locking in decades of future foreign commodity supplies.

China's infrastructure and commodities large scale expenditure commitments, funded from its significant store of US treasuries, drives the value

of the US dollar down and simultaneously forces the flotation of the Chinese RMB, causing a de facto "dump" of US bonds.

The RMB quickly gains credibility as a global reserve currency, greater pressure is put on the US dollar, fuelling perceptions of unsustainability of US long-term debt as a stable investment and leading to questions over the sovereign-risk rating of the US.

Private ratings agencies such as Egan-Jones Rating Co. have been questioning for some months whether a ratings "correction" for the USA is on the horizon. A significant market correct develops when Moody's reduces the country's rating from AA+ to AA- in what becomes known as its US Double Whammy following its 2011 downgrading of the USA from AAA (outstanding) to AA+. This is also a double downgrade in that it overshoots the AA rating that lies between AA+ and AA-.

This downgrading signals what some smaller ratings agencies fund managers and financial pundits have been forecasting: the dollar is taking a large downward correlation.

Panic ensues as private and institutional investors dump the \$US denominated assets, with the exchange rate of the dollar dropping markedly against most currencies as it comes under severe selling pressure.

### Phase three: the rise and rise of the RMB

The global economic effects of the downgrading of the USA develop predictably and increasingly quickly. Although the dollar is cheaper than ever and the RMB is correspondingly at a historical high, the smart money favour growth prospects in China. US interest rate rises as the world loses faith in the dollar and Foreign Direct Investment in the USA drops relative to China, in spite of US manufacturing continuing to improve in its competitiveness, due to the loss in confidence in the USA as a stable long-term economy and the evident growth prospects in China.

The US quickly falls into a recession which lasts four fiscal quarters as the dollar exchange rate falls significantly relative to the RMB. Investors engage in a flight to quality by moving out of the US and into China, boosting the inward Foreign Direct Investment and China's domestic interest rates fall as the RMB becomes more expensive globally.

Overall, the global economy suffers short term losses due to the rapid transition between reserve currencies. Long-term outlook, however, is positive, due to the dynamic growth of China's central markets.

<sup>11</sup> C. Ho, "Overview of RMB Internationalisation", HSBC, 8 May 2013, Slide 6

## 6 Macroeconomic Analysis

### Economic impacts of dollar deposited

The dollar deposited scenario occurs when the dollar value declines to the extent that its reputation collapses and no longer serves as the dominant reserve currency. When the dollar's standing collapses, the value falls at such a rate that bond holders panic and rush to sell at any cost.

There is no historical example of a changeover in monetary hegemony which mirrors the situation proposed in the dollar deposited scenario exactly but a study of the rise of the dollar over the pound sterling in the early 20th century bears some key similarities.

With reference to this historical precedent, we have identified several conditions that must be in place for a reserve currency to be replaced.<sup>12</sup>

First, there must be an underlying economic weakness in the host country of the reserve currency, such as the two World Wars which ravaged the British economy from 1914-1945. Next, there must be a viable and reliable alternative currency to substitute the weakening reserve stocks which, after a final trigger, begins to attract wider global attention.

During the first and second World Wars, when the British borrowed heavily in order to subsidise the war effort, the United States transitioned from a net debtor to net creditor of the United Kingdom. Further, the US economy had surpassed the British economy in size by the early 1900s (Chinn and Frankel, 2008). At the time, the dollar was the only currency which retained its convertibility into gold under the Bretton Woods System, which allowed it to become the accepted international currency for trade and finance.

During the 1900s "Pound Dethroned" scenario, the trigger was the outbreak of war. Though the pound retained its dominance in the years that followed the war, this was largely due to economic inertia arising from the Allied Powers victory.

The replacement of the dominant reserve currency has always been a substantial and gradual process, requiring the shared resolution of the global economy.

As seen with sterling, the fall from a position of dominance in the world financial system is not to fall into abeyance, and the pound's trajectory has mirrored the fortunes of the nation.

<sup>12</sup> Amadeo, Kimberley, "US Dollar Collapse: Causes, Impact, and When It Would Happen," 14 January 2014

The historical pattern suggests that new reserve currencies rise from strong economies, just as incumbent reserves decline with the loss of national economic and military dominance.

### Macroeconomic consequences of dollar deposited

In the dollar deposited scenario high interest rates and weak investment sentiments could dampen domestic economic growth and worsen unemployment rates in the US.

Although US exports will be relatively cheaper and this may provide a brief boost to its economy, import prices will be driven up and lower the purchasing power of the general public. On the global stage, any political or economic influence that the American policy-makers currently enjoy will diminish significantly. Moreover, the initial triggering shock might send the entire global economy into deep recession due to the high uncertainties regarding the future outlook.

Nonetheless, these economic shocks and impacts may be transitional; the market could stabilize or even outperform its original growth projection as soon as the new currency gains the trust and confidence of the global economy.

### Oxford Economics Global Economic Model

We use the Oxford Economics Global Economic Model (GEM), a quarterly-linked international econometric model, to examine how the global economy reacts to the various dollar deposited variants.

The model contains a detailed database with time series and cross-sectional data of many economic variables and equations that describe the systemic interactions among the most important 47 economies of the world. Forecasts are updated monthly for the 5-year, 10-year and 25-year projections.

These models are suitable to analyse the impacts of future policy changes, especially in our case of catastrophe modelling, shocks to the respective major economies from an exogenous source.

### Assumptions and uncertainty

The economic estimates presented in this analysis are subject to the assumptions imposed during the narrative development and how the scenario unfolds over time.

The modelling and analysis completed are also subject to several sources of uncertainty.

S/N	Macroeconomics input variables	Scenario Variants			Justification for shock	Scenario-specific key assumptions
		S1	S2	X1		
<b>1</b>	<b>Bond Market Stress</b>					
	United States	+5%	+8%	+12%	<ul style="list-style-type: none"> <li>Stressed bond market increases credit spreads</li> <li>Historical high adjusted spread was up to 20% in 2008<sup>12</sup></li> </ul>	<b>Collapse of the dollar:</b> <ul style="list-style-type: none"> <li>Widespread sell off of US assets by irrational investors at a loss weak</li> <li>Weak investment sentiments and high uncertainties regarding the future outlook of the US</li> </ul>
<b>2</b>	<b>Short-term Interest Rates</b>					
	United States	+4%	+6%	+8%	<b>USD became world's reserve currency by mid-20th Century:</b> <ul style="list-style-type: none"> <li>UK short-term interest rates increased from less than 1% to more than 5% (1951-1960)<sup>13</sup></li> </ul>	<b>Upward-adjustment of interest rates:</b> <ul style="list-style-type: none"> <li>Compensate for the currency devaluation</li> <li>Attract more foreign capital</li> <li>Increase local currency demand</li> </ul>
<b>3</b>	<b>Currency Exchange Rate</b>					
	China	+10%	+25%	+50%	<b>20th Century devaluation of the British Pound:</b> <ul style="list-style-type: none"> <li>USD gained appreciation (to the GBP) by more than 100% over the century<sup>13</sup></li> <li>Many other countries devalued simultaneously or soon after<sup>14</sup></li> </ul>	<b>China rising to global economic superpower:</b> <ul style="list-style-type: none"> <li>The Chinese economic output overtook the US in 2014<sup>15</sup> by measurement of purchasing-power parity</li> <li>Contracting US economy<sup>16</sup> and declining industrial production<sup>17</sup></li> </ul>
	Other countries <sup>#</sup>	+2%	+5%	+10%		

<sup>#</sup>Other countries include: The Eurozone, the United Kingdom, Japan, Australia, Indonesia, South Africa, Argentina, Brazil, Malaysia, Thailand, Philippines, Singapore, South Korea, Taiwan, Hong Kong, Canada, Chile, Russia, and India.

**Table 3: Catalogue of macroeconomic scenario assumptions made in the modelling process**

<sup>12</sup> B. Romanchuk, "Corporate Bond Market Stressed, But Not Yet in Crisis", *Seeking Alpha*, 23 November 2015

<sup>13</sup> L. H. Officer, "Dollar-Pound Exchange Rate From 1791," *MeasuringWorth*, 2015

<sup>14</sup> N. Lewis, "Currency Devaluations of the 1930s," *New World Economics*, 30 September 2012

<sup>15</sup> B. Arends, "It's official: America is now No. 2," *MarketWatch*, 4 December 2014

<sup>16</sup> D. Blanchflower, "The US Economy is Slowing: Blanchflower", *Bloomberg*, 15 October 2015

<sup>17</sup> B. McTeer, "Our Weakening Economy is Getting Harder to Ignore", *Forbes.com*, 16 May 2015



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