Global Fixed Income Thematic Viewpoint

HIROYUKI HIGUCHI
SENIOR PORTFOLIO MANAGER
HEAD OF FIXED INCOME AND CURRENCY

MAY 2025

Mitsubishi UFJ Asset Management (UK) Ltd.
A member of MUFG, a global financial group

The Future of the Dollar as Reserve Currency

Last month's markets tested the credibility of the dollar as a reserve currency and asset classes became strongly positively correlated. If we express general market movements as a 99% confidence interval, then last month's movements fell within the 1% range. The catalyst was the reciprocal tariffs announced in early April. This led to speculation that the Trump administration may attempt a coordinated weakening of the US Dollar, reminiscent of the Plaza Accord, or that it might pressure countries like Japan and Taiwan to strengthen their currencies. This temporarily triggered a flight from U.S. assets, resulting in declines in stocks, currencies and bonds.

In this article, I will examine the Trump administration's stance on the dollar and speculate on its future developments.

While Trump has publicly advocated for a strong dollar, his policies and statements suggest a preference for a weaker dollar. Meanwhile, the market generally perceives the Trump administration as seeking a weaker dollar, which may have contributed to the aforementioned speculation about dollar weakening.

Stephen Miran, Chairman of the U.S. President's Council of Economic Advisers, stated in his November 2024 report titled 'A User's Guide to Restructuring the Global Trading System' that the dollar, as the reserve currency, has become overvalued, leading to the decline and hollowing out of U.S. manufacturing and trade deficits. He proposed a new international currency coordination framework inspired by the 1985 Plaza Accord. This is referred to as the 'Mar-a-Lago Accord,' named after Trump's resort. The proposal also mentions using tariffs as a tool to negotiate currency devaluation, with tariffs of up to 60% imposed on countries that do not comply with the accord. As a result, when the idea of reciprocal tariffs emerged, the market began to expect that the Mar-a-Lago Accord or negotiations would lead to requests for individual countries to appreciate their currencies, effectively leading to a weaker dollar. A sharp dollar depreciation driven by currency policy would make it difficult to hold U.S. assets such as U.S. stocks and bonds. This could lead to a triple decline in U.S. assets. Miran's argument has been criticised by Nobel laureate Paul Krugman as illogical, and it has not been well received by investors, making its feasibility highly questionable.

The one who saved the situation from such chaos was Treasury Secretary Scott Bessent. It is believed that he proposed Trump postpone reciprocal tariffs amid the market turmoil, and the Trump administration, which had tolerated a stock market decline, demonstrated that it would not tolerate a decline in U.S. Treasury prices this is highly significant. He also stated that the Treasury Department would consider purchasing government bonds if necessary, which helped calm the market turmoil. My view on seeing U.S. Treasury bonds being sold alongside the dollar was that we may see increased risk that a hedge fund could collapse and trigger a financial crisis. My view was that the Fed would need to implement a twist operation (extending the maturity of Treasury bonds held by the Fed). However, Bessent's remarks dispelled these concerns. The market likely perceived Bessent as a 'put option' (a form of insurance against declines).

He reaffirmed his support for a strong dollar and did not pressure Japan to weaken the yen or normalise its monetary policy during tariff negotiations. Such a statement, which could be interpreted as encouraging dollar weakness, was likely deemed risky. It was a wise decision.

Bessent is the former head of George Soros's hedge fund's London office. He gained notoriety in 1992 by shorting Sterling against the Bank of England, making over 1 billion dollars in profits. He is undoubtedly one of the few people who truly understands the terrifying consequences of losing the status of the world's reserve currency or the credibility of U.S. Treasury bonds.

Bluntly put, the United States controls the world's trade routes through the U.S. Navy and has enshrined the dollar as the reserve currency for trade settlement, thereby creating demand for dollars. U.S. Treasury bonds are the repository for that capital. This model has allowed the United States to expand its fiscal budget, boost its economy, and prop up stock prices. And this business model benefits Americans who hold those stocks as pensions. In other words, the current U.S. business model is based on the dollar's status as the reserve currency. Attempting to reduce the trade

deficit by weakening the dollar, which would undermine the dollar's reserve currency status, would reduce the number of investors in U.S. Treasury bonds. The knock-on effect would likely be higher U.S. interest rates, falling stock prices, and accelerated capital flight from dollar-denominated assets.

Given this, it seems unlikely that the current Trump administration would explicitly pursue a policy of weakening the dollar. While it is reasonable to expect that countries will seek to normalise their exchange rates in response to other countries' deliberate currency manipulation, the likelihood of coordinated intervention to weaken the dollar is low. If such measures were taken, it would likely accelerate the flight of capital away from U.S. assets – seriously jeopardising the current US economic model.

Recently, Japan's Finance Minister Kato, as the world's largest holder of U.S. Treasury bonds, stated that this position could be used as a bargaining chip in tariff negotiations – this is risky talk. Essentially, it implies using the status of the reserve currency as a bargaining tool, which is a diplomatically unwise move. Although the statement was promptly retracted, it could still have adverse implications for future U.S.-Japan negotiations. In any case, we must not forget that U.S. assets are currently based on a rather fragile foundation.

As of 6 May, when this article was written, in yesterday's trading the Taiwanese and Hong Kong dollars experienced their sharpest appreciation against the dollar since the 1980s. This was caused by speculation that the U.S.-Taiwan trade negotiations would lead to a stronger Taiwanese dollar, increased hedging needs for U.S. assets held by Taiwanese insurance companies, and doubts about the sustainability of the Hong Kong dollar's peg to the dollar. In other words, the instability of the dollar as the reserve currency is the root cause, and the embers of this crisis are still smouldering. Although the market appears to have regained some stability, tariff negotiations are ongoing, and the uncertainty surrounding U.S. assets remains high – there remains a possibility that a second shock could occur in the near future.

Important Information

This document is issued by Mitsubishi UFJ Asset Management (UK) Ltd. ("MUFG AM (UK)") which is authorized and regulated in the UK by the Financial Conduct Authority ("FCA") No. 121816. Information within this document may contain material that may be interpreted by the relevant authorities in your country as a financial promotion or an offer to purchase securities. Accordingly this information is only intended for persons who fall outside the scope of any law that seeks to regulate financial promotions in the country of your residence. The information provided in this document is not intended for any United States person or any person in the United States, any state thereof, or any of its territories or possessions. This report is prepared for professional investors and is not intended for retail clients as defined in the FCA rules.

The information contained in this report has been taken from sources which we deem reliable but we do not represent that such information is accurate or complete in part or in whole. Any opinions expressed here reflect our judgment at this date and are subject to change. Although we have taken all reasonable care that the information contained within this document is accurate at the time of publication, we make no representation or warranty (including liability towards third parties) express or implied, as to its accuracy, reliability or completeness. If you rely on this document, you do so at your own risk. We expressly disclaim any duty of care which we might otherwise owe to any person relying on this material. Any opinions expressed here reflect our judgment at this date and are subject to change.

Any reference to past performance should not be taken as a guide to future performance. The value of investments may go down as well as up.

Companies in the Mitsubishi UFJ Financial Group and connected persons may have positions in, or may perform or seek to perform advisory or banking services to companies whose securities are mentioned herein. Mitsubishi UFJ Asset Management (UK) Ltd. or related companies may have used researched material before publication and may have positions in or may be materially interested in any of the securities mentioned.

This brochure does not constitute an offer or a solicitation of an offer to buy a security. Neither MUFG AM (UK) nor any of its related companies accept any liability whatsoever for any direct or indirect or consequential loss arising from any use of information or material contained herein.

MUFG Asset Management is a brand of Mitsubishi UFJ Trust and Banking Corporation, Mitsubishi UFJ Asset Management Co., Ltd., Mitsubishi UFJ Real Estate Asset Management Co., Ltd., Mitsubishi UFJ Asset Management (UK) Ltd. and Mitsubishi UFJ Alterative Investments Co., Ltd.