NORTHERN TRUST

MARCH 28, 2025

WEEKLY ECONOMIC COMMENTARY

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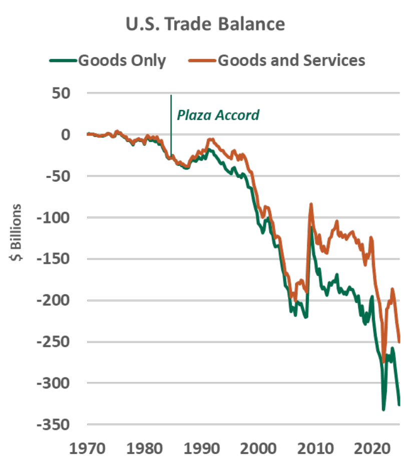
Over 50 years ago, U.S. Treasury Secretary John Connally summarized the dollar succinctly to his European counterparts: "The dollar is our currency but your problem." Today, the U.S. administration seems to think that the dollar is America's problem, and is considering steps to solve it.

The last time the dollar needed policy intervention was in 1985. The dollar was ascendant, and that put American exports at a disadvantage. The White House arranged an international response, with five nations agreeing on the "Plaza Accord" to realign global exchange rates. The effort succeeded in devaluing the dollar, but it did little to bring better balance to the U.S. trade position.

In recent years, the dollar has once again been persistently strong. Its standing stems (in part) from its role as the world's reserve currency. As we discuss in our interview with Northern Trust's chief foreign exchange dealer (linked below), we do not expect that to change. The dollar remains a highly liquid currency which is used most frequently to settle international transactions. The U.S. dollar also represents the majority of central banks' foreign reserves.



Sources: Federal Reserve, BEA, Haver Analytics

Having the reserve currency can create complications. Offshore demand for the dollar subjects the U.S. to the *Triffin Dilemma*: The reserve currency must keep its supply of money in check to maintain stability, while also meeting increased global demand. The nation that offers a global reserve currency will inevitably run a trade deficit, as exports of currency are offset with imports of goods.

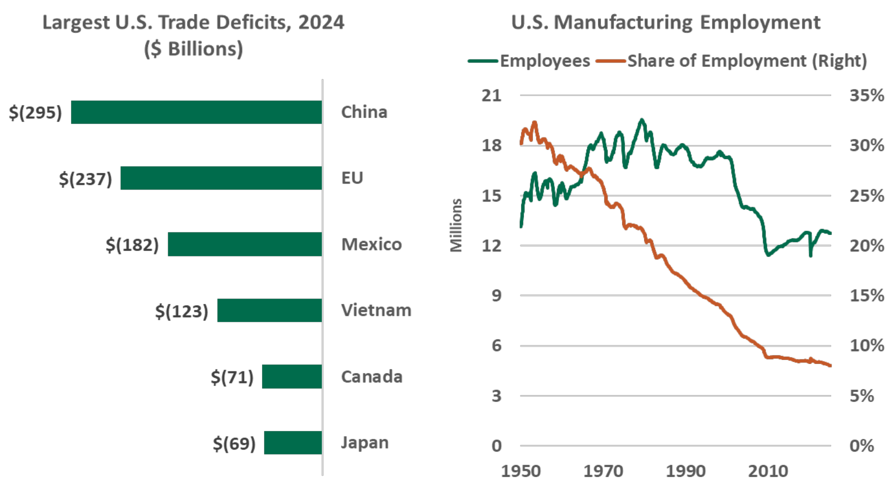
The U.S. has also borne the cost of its wide defense umbrella, helping to ensure a peaceful world order that supports global trade and growth. The nation's military budget of $842 billion is multiples higher than any other country. Its dominant military and currency have given the U.S. its position of "exorbitant privilege," running fiscal and trade deficits without adversely affecting its borrowing costs or currency stability.

Viewed across centuries of history, the United States' run as the leading global power has generally been a time of peace, prosperity and advancement for the world. Viewed transactionally, though, U.S. hegemony has been costly. The strong dollar eroded the competitiveness of U.S. manufactured goods. Americans without higher-skill training have been left behind. The nation's debt is rising and getting more expensive to service amid higher interest rates, forcing contentious discussions of government spending cuts.

Enter what has been called the "Mar-a-Lago Accord." To be clear, an Accord is not a stated policy goal of the Trump administration. However, it offers hints of how the Trump agenda could be achieved.

The outlines of the Accord—and the first appearance of its name—took shape in a position paper titled "A User's Guide to Restructuring the Global Trading System." The author, Stephen Miran, was an investment strategist when he published the paper in November 2024; he now chairs the president's Council of Economic Advisers. After describing the Triffin dilemma and its outcomes, Miran offers a strategy to balance the conflicting objectives of weakening the dollar while maintaining its reserve status.

Could the U.S. bring about global currency coordination today?



Sources: Census Bureau, Bureau of Labor Statistics, Oxford Economics, Haver Analytics

The Plaza Accord set a precedent for governments to devalue their currencies cooperatively; the dollar's appreciation was distorting global economies. The Mar-a-Lago Accord aspires to another adjustment. The U.S. dollar could be weakened through U.S. acquisition of foreign currencies. These interventions would likely lead to higher U.S. interest rates as Treasuries are sold off. To avoid higher yields, foreign nations would be encouraged to swap their current U.S. Treasuries into very long-dated, low-yield bonds. The U.S. would thus avoid the risk of higher debt service costs from higher rates.

This is not an attractive proposition for counterparties to the United States, who would not welcome lower interest receipts or stronger currencies. To overcome this resistance, Miran's paper proposed to use tariffs and security as leverage. Nations who cooperate will receive lower duties and the support of the world's largest military. Those who resist will struggle to sell into the U.S. market and may lose an important ally.

We are skeptical of the Mar-a-Lago Accord. The dollar is strong based on its fundamentals, and not overvalued in a meaningful way. China runs the largest surplus with the U.S. and is the nation's second largest foreign holder of Treasuries (behind Japan). China would be least amenable to a higher exchange rate as it pushes to maintain its export sector; it would also not be compelled by an offer of mutual defense. Moves by nations to enhance their militaries, notably in Germany, illustrate a rising suspicion of the durability of U.S. alliances.

Major changes bring major risks.

The strong dollar has been a modest impairment to the export prospects of U.S. manufactured goods, but weakening it would not immediately alter the global trade landscape. The U.S. will still have higher labor costs, more environmental restrictions and older infrastructure that will limit its competitiveness. And a lower-value currency will raise the costs of imports required for raw materials and many consumer goods, raising the risk of inflation.

The Plaza Accord did not arrest the decline of U.S. manufacturing jobs, and it is not clear that the current proposal would be much more successful. And if the Mar-a-Lago Accord's demands erode the dollar's position as global reserve currency, the U.S. could pay dearly over time.

The year to date has been marked by a high degree of policy uncertainty and volatility. To its authors, the Mar-a-Lago Accord places these actions into a more cohesive policy agenda. But obstacles to its implementation are legion, and it could easily create more harm than good for the United States. Today, the dollar's value is neither a problem nor a solution to global trade issues.

Here's The Deal

Editor's note: one of the suggestions we received during our annual reader's survey was to periodically feature market color. To respond, following is an interview with Brian Liebovich, Global Chief Dealer for Northern Trust's foreign exchange desk. Brian has been following currencies for more than thirty years, and manages a global team of 18 people.

What themes have you observed in foreign exchange markets during the first quarter?

The narrative has changed since President Trump's inauguration. The threat of a trade war has raised concerns that U.S. exceptionalism is coming to an end. The fear is driving capital flows out of the U.S. into other developed and emerging markets (EM). The more that markets expect the Federal Reserve to cut interest rates aggressively, the more EMs benefit from capital flows.

Europe's greater urgency in boosting its defense spending, along with Germany's large fiscal stimulus, have created optimism around the bloc's growth prospects, leading to repricing of the European Central Bank rate path. These forces have been the main catalyst for the reversal in the "Trump trade" and the weakening of the U.S. dollar.

Do you think the dollar is in any jeopardy of losing reserve currency status?

No, but I understand why you're asking. A global de-dollarization campaign has grown over the past decade as countries press forward with plans to reduce the dollar's role in the global economy. The BRICS 2024 summit comes to mind as the most recent push to reduce reliance on the greenback. But they haven't made much progress. According to the Bank for International Settlements, the U.S. dollar is involved in about 88% of all foreign exchange trades, followed by the euro at 31%, the yen 17%, sterling 13% and renminbi (RMB) at just 7%.

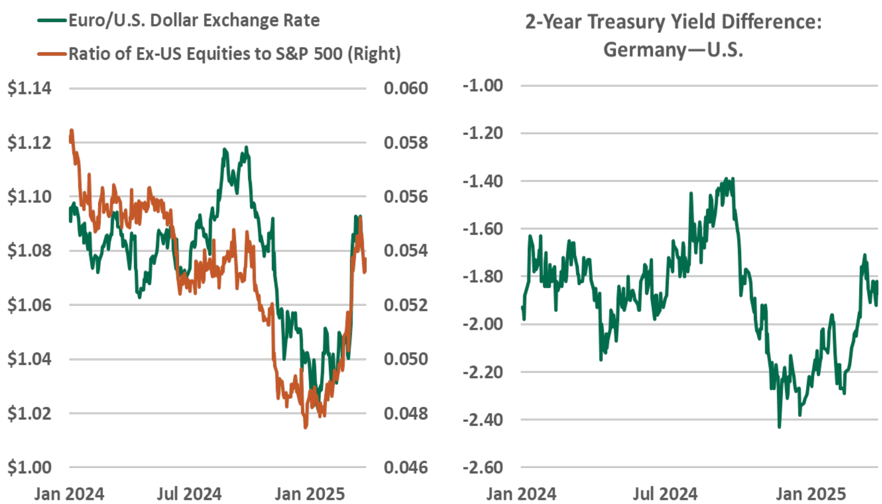
None of those currencies are positioned to overtake the dollar. Europe's fiscal and political shocks have worked against the euro. Japan's low growth, low inflation and unfavorable demographics makes the yen a much weaker candidate. China is trying to push for increased international acceptance of the RMB. However, without further liberalization of the economy and removal of stringent capital controls, this will remain a distant dream. At most, the world's central banks will likely push for further diversification of their reserves.

What drives the value of the dollar?

Trade flows certainly matter. Countries have to buy the currencies of countries they import from, so countries with a big trade deficit usually have weaker currencies.

Of course, the United States is the exception to the rule. That is because currency rates are affected by cross-border investment flows. When a country offers attractive returns on stocks and bonds, its currency benefits. You can see this in the linkages between exchange rates and the relative level of stock markets. As well, countries with higher interest rates often attract more inbound investment, raising their exchange rates.

Investment factors are important determinants of exchange rates.



Sources: WSJ, S&P, Federal Reserve, Deutsche Bundesbank, Haver Analytics

How does the Northern Trust FX desk help our clients?

Northern Trust Global Foreign Exchange provides client-focused solutions and dedicated service. Our products range from direct dealing and electronic FX, to tailored solutions such as currency management and outsourced securities-related FX (CompleteFX). Our experts are on hand across our hubs in Singapore, London and Chicago to discuss trading requirements and to provide informative insight on market conditions.

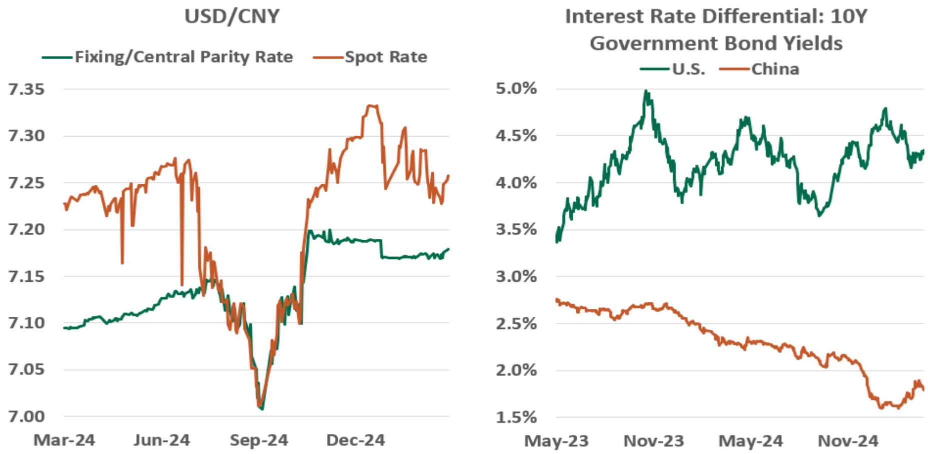
In A Fix

The Japanese style of management has given the world principles like just-in-time inventories and *kaizen* (continuous improvement). But not a lot is documented about Chinese management practices. China's industry-driven management approach is characterized by a top-down style with a strong emphasis on authority. The country takes a similar approach to managing its exchange rate system.

The Chinese yuan (CNY) is not free-floating like the U.S. dollar (USD) and other major currencies; it is actively managed by China's monetary authority. While most currencies have gained against the dollar this year amid high volatility, the CNY has remained stable. The U.S. effective tariff rate on Chinese goods surged to slightly above 30% in a matter of weeks, and interest rate differentials with the U.S. remain wide. Yet, the USD/CNY fixing has been lower than its level before President

Trump's inauguration.

This is a sign that Chinese policymakers are unlikely to weaken the CNY to counter the impact of U.S. tariffs. By allowing the currency to depreciate, Beijing would risk being relabeled a currency manipulator by the U.S., leading to further trade hostilities. China has allowed the CNY to depreciate by only about 15% against the U.S. dollar over the past two decades, an agonizingly slow pace.



Sources: Haver Analytics, CFETS

China is trying to avoid opening a new battle front with the U.S.

While some managed depreciation of the CNY may be in store, letting the currency weaken would do more harm than good to the economy. A sharp depreciation would partially offset the impact of tariffs, but would also dent sentiment and trigger capital outflows.

The People's Bank of China (PBoC) is keeping options in reserve as it awaits more clarity on trade ties with the United States. The central bank has pledged to balance easing moves with currency stability to prevent short positions from arising. But the focus on maintaining a stable exchange rate is an added constraint to monetary easing.

Japanese factory workers are empowered to intervene in production processes if they observe a problem. Chinese policymakers will almost certainly have to continue intervening in currency markets as trade problems with the United States escalate. Holding the line on the CNY will be no easy task.