WhiteHaven

De-dollarization: I can feel it, coming in the air tonight!

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The year is 2035. In a bustling New York City café, 24-year-old financial analyst Sarah watches as her father, a Wall Street veteran, pays for their coffees – using digital Chinese yuan. The café's speakers are blasting the classic Phil Collins tune, "In the Air Tonight." Sipping her latte, she wonders: What happened to the US dollar's golden days, when it was the kingpin of global finance? She's just about to broach the subject of de-dollarization with her father when…her iPhone's alarm abruptly wakes her.

It was just a dream!

While the concept of moving away from the US dollar isn't new, it has re-emerged as a heated topic, fueled by sanctions on Russia and discussions around a potential competing currency from the BRICS nations (Brazil, Russia, India, China, and South Africa). Before diving into the topic, it's essential to first review the historical context of reserve currencies and understand that technological, economic, and geopolitical shifts have always played an important role in determining which currency holds this heavyweight title.

A historical review of currencies

The Spanish currency era

In the 16th and 17th centuries, Spain was a global power, and its currency was a precursor to modern reserve currencies. Bolstered by precious metals from its American colonies, Spain amassed more silver than the rest of the world combined, making its coins a widely-used medium of exchange. Despite this, Spanish currency never achieved official reserve currency status, which is used by governments for international settlements. Over time, internal conflicts, economic struggles, military defeats, and the rise of other European powers like the UK weakened Spain's influence. Its profligate spending led to inflation and global economic imbalances, eventually diminishing its currency's global role.

The British pound era

The British pound sterling set itself apart from the Spanish currency by being anchored to gold instead of silver. The pound's rise to global prominence can be attributed to two key factors: Britain's industrial revolution and its formidable naval fleet. The country's technological advancements in manufacturing boosted its economy to the largest in the world, and its naval superiority allowed it to become the super power of its time. The pound became a highly stable and trusted currency worldwide.

However, this global strategy came with several drawbacks, notably Britain's detrimental impact on the regions it controlled: "colonization." Additionally, as technological innovation spread to other countries, the pound started facing competition, diminishing its unrivaled status as a global reserve currency.

The US dollar era

After World War II, the U.S. became the world's leading economic powerhouse. Its economy was so big, it was arguably as large as all other economies combined. But the U.S. did things differently than Great Britain had. Instead of trying to take over Europe, the U.S. offered to help them rebuild. It promised to protect the continent, allow European countries to trade with them, and use the U.S. Navy to keep international waters safe for global trade. All Europe had to do in return was let the U.S. write their security policies, mainly to stand up against the Soviet Union.

This deal, named the Bretton Woods system, was something most European countries were in favour of. They got the benefits of being part of the global market without the need for large military spending, at a time when their economies were in complete turmoil. This led to what we now call "globalization." This deal sealed the US dollar's status as the go-to trusted currency in the world. It's a position it still holds today, thanks to a stable government, a robust economy and a strong rule of law.

What qualifies a currency as a reserve currency?

Before diving into potential alternatives to the US dollar, we must first grasp the gravity of what it means for a currency to earn the status of a global reserve currency. There are two principal criteria that it must satisfy:

- Sufficient scale and volume
  Today, a global reserve currency cannot be just another run-of-the-mill currency; it needs to be MONUMENTAL in its reach. It demands an expansive circulation to underpin international dealings. This characteristic is not just a fancy addition; it's vital to ensure the currency is versatile enough to facilitate diverse global transactions, from trade agreements to complex financial operations. To shed some light on the enormity of the US dollar's dominance, let's consider these figures: it was part of a staggering 88% of all foreign exchange trades in a single month last year (2022), as noted by the Bank for International Settlements[1]. Furthermore, between 1999 and 2019, the US dollar was the keystone for 96% of trade invoicing in the Americas, 74% in the Asia-Pacific region, and 79% in other parts of the globe. It is the preferred choice for banks, being used in nearly 60% of all international deposits and loans.

- Exchange rate stability
  A reserve currency should NOT care what happens to its value on any given day!
  Nations will be reluctant, if not downright resistant, to adopt a currency that's susceptible to unpredictable swings or undue manipulation, particularly when considering it for reserve status. In this arena, a currency's **dependability** is its ticket to being recognized and valued as an acceptable global reserve currency.

Notable competitors for a reserve currency

Now we can delve into the hot topic of which of the world's currencies will replace the US dollar as a reserve currency? Quick answer: you guessed it…none! In the short term, there is no competition. In the long run, we'll have to wait and see how the world's conflicts and economic strife play out.

But first, let's look at some of its so-called competitors!

- *The case of the euro*
  The euro actually came close to challenging the dollar, but it ran out of steam during the European banking crisis in the 2000s. Actions such as confiscating insured bank deposits to finance bailouts tarnished its image, causing it to slip from being the number one trade finance currency to its current lower rank. Today, the euro is used mostly for international trade but not as a real reserve currency. In addition, it has become a subset of the US dollar and not a direct competitor.

- *The case of the Chinese yuan*
  While China aims to internationalize the yuan, its priority to maintain control over its financial system contradicts the openness needed for a currency to be used as a global reserve currency. China is often accused on manipulating its currency and therefore no one really wants its currency. Recent unofficial statistics have shown that Russia may hold close to 1/3 of Chinese yuan in circulation. Not much appetite for the world to hold Chinese Yuan! Despite all the buzz, the yuan's global usage is not even back to its pre-financial crisis levels.

- *The case of the British pound*
  The pound could always make a comeback, but the uncertainties surrounding Brexit have made it a non-candidate for the time being.

- *The case of the Japanese yen*
  Japan had ambitions to internationalize the yen in the 1980s, but that experiment fell apart due to the country's unwillingness to open up its financial sector, and resulted in close to 20 years of stagnant growth.

- *The case of the BRICS*

  The BRICS—Brazil, Russia, India, China, and South Africa—have garnered global attention for years. Recently, the group has focused on two key issues: adding more member countries and the potential introduction of a common currency. While both ambitions aim to strengthen the group's global influence, progress has been slow, revealing the complexity and challenges the BRICS face.

  Russia has actively pushed for both expanding the group and introducing a shared currency, largely influenced by the sanctions it faces from the West. China also sees value in the BRICS as a way to lessen its dependence on Western financial systems, particularly the US dollar. Brazil and India view the BRICS as a platform to increase their influence in global politics. South Africa's membership brings Africa into the group's focus as a strategically important continent.

  In 2015, the BRICS launched the Contingent Reserve Arrangement (CRA) and the New Development Bank as alternatives to established financial institutions like the IMF and the World Bank. China plays a leading role in these financial structures, contributing the most to the CRA and holding considerable voting power.

  Though there have been moves towards de-dollarization, especially from Russia and China, these are generally reactive to external factors such as sanctions, rather than a unified, proactive strategy within the BRICS. In other words, the decrease in the use of the US dollar seen last year has nothing to do with Russia and China rebuffing that currency. It stems from the U.S.'s message that, if they don't play by the rules, they won't have the luxury of using the US dollar. This, and not the propaganda of the fall of the US dollar, has left Russia and China scrambling to figure things out.

  The idea of a common currency for the BRICS faces substantial obstacles. Achieving economic cohesion is a challenge, given the varying economic systems and governance frameworks among the member nations. Furthermore, the geographical spread and absence of strong naval capabilities make creating an efficient shared market difficult.

  Starting in 2024, the BRICS will expand to include Argentina, Egypt, Ethiopia, Iran, Saudi Arabia, and the UAE, adding more complexity to the group dynamics. For instance, Iran aims to increase its diplomatic leverage, while Saudi Arabia and the UAE are primarily interested in security matters, especially given the U.S.'s decreasing involvement in the Middle East.

In essence, the likelihood of the BRICS adopting a common currency in the near term seems quite unlikely, given the group's differing goals. While the BRICS continue to attract global interest, their role as a significant counterforce to existing economic powers remains unconfirmed.

The lack of a viable alternatives today

While it is easy to suggest that the US dollar is losing its grip as the world's primary reserve currency, the data tell a more nuanced story. According to the International Monetary Fund (IMF)[2], the US dollar accounts for over 58% of global reserves. Its closest competitor, the euro, stands at around 20%, and other currencies like the Japanese yen and the British pound are significantly lower. The decrease in euro reserves has led to some diversification, benefiting the Japanese yen and the Canadian dollar, rather than diminishing the US dollar's role. It's important to also keep in mind that countries often don't publish their complete currency reserve data for national security reasons.

The US dollar's continued dominance isn't just about its intrinsic strength. It also reflects the lack of a compelling alternatives. Gold, often touted as a potential substitute, presents its own challenges, particularly volume issues. There isn't enough gold in circulation to replace the dollar. Digital currencies, like a possible Central Bank Digital Currency (CBDC), are still in their infancy and cannot yet provide a serious alternative.

Role of sanctions

The weaponization of the US dollar against Russia has made nations think about diversification of their currency reserves in a more serious manner these days. In reality, those nations scrambling to diversify are the ones not on the U.S.'s side. I would argue that sanctions are showing the U.S.'s currency is actually getting stronger within its trading partners.

After experiencing the force of financial sanctions, Russia made attempts to shift reserves into the Chinese yuan. However, this strategy was unsuccessful, mainly because the yuan isn't freely convertible and now Russia is stuck with Chinese yuan; this continues to highlight the strength of the US dollar. Furthermore, in the last 18 months, India has started buying Russian crude oil at a discount, but has yet to make any payments to Russia since the latter refuses to be paid in Rupees, viewing them as useless. To makes things worse, India cannot pay in U.S. currency because of the sanctions imposed. It’s a complete mess!

Why alternatives won’t work…right now!

The periodic discussions about de-dollarization might capture headlines, but they rarely change the underlying dynamics. While the notion of reducing dependence on the US dollar is rhetorically powerful, the practical challenges are immense. Given the requirements for a currency to become a global reserve highlighted earlier—criteria that the dollar uniquely fulfills—it's clear why alternatives have yet to pose a significant challenge.

In essence, while de-dollarization is a hot topic, it remains more myth than reality. The US dollar, with its combination of scale, stability, and rule of law, will continue to reign supreme as the world's primary reserve currency for the foreseeable future.

What about the US dollar?

So far, the discussion has been about the past and the alternatives, but what about the actual U.S. economy? What impact does a reserve currency have on the current U.S. economy? Well, the dollar's status as the world's reserve currency offers stability to the American financial system. This stability, however, comes at a cost: it makes it more difficult to regulate domestic financial markets. It is extremely complex to manage the world’s largest economy and oversea the world financial markets.

One of the advantages, however, is that when the U.S. moved off the gold standard in the Nixon era, the world had little option but to adapt. Even today, the U.S. maintains control over its money supply and can effectively neutralize any efforts from foreign countries trying to hurt its economy by threatening to dump the US dollar.

But the true power of the US dollar lies in its influence over global transactions. For example, sanctions against small countries like Iran have been effective partly because the dollar is so widely used in international trade. However, this does not mean that the dollar is invincible and will have this kind of power forever.

A possible, if unlikely, scenario

For those who still think the dollar is losing its swagger, let's assume for a second that this actually happens and some other reserve currency takes its place. The U.S. would still largely use the dollar as its domestic currency, relegating it to the status of a "normal currency," as the majority of the country's economy is actually domestic and therefore less exposed to global risks. People seem to also forget that the U.S. is a net exporter of energy and food, and is the country least engaged in international trade relative to its GDP. Most of its international trade is within Canada and Mexico, its main allies, limiting once again its exposure to global risks.

Therefore, under this scenario, the potential impact would mostly be felt in the country's fiscal policy, forcing the political leaders to be more judicious with spending since they couldn't easily offload debt onto other economies. That could be seen as a silver lining, forcing a more disciplined approach to economic governance.

Putting it all together

While the idea that global reserve currencies historically last about a century, it's also crucial to note that we are nowhere near a tipping point for the US dollar today. The United States has the healthiest demography among the G20 nations (excluding Argentina), the largest economy, the best managed financial system in the world, and isn't interested in what happens on a day-to-day basis to its currency. It's the least engaged economy in international trade as a percentage of its GDP and has a respected legal system, making it improbable for another currency to take its place in the foreseeable future.

For countries seeking more independence from American influence, de-dollarization may seem attractive. But it comes with its own challenges, including establishing a stable alternative that nations can trust to protect the greater global economy.

For the U.S., losing the ability to influence global economic exchanges would diminish its geopolitical power, which they are not prepared to do. And what's more, they have the most powerful military in the world, giving the U.S. and its allies options in a world where uncertainty is increasing. Having options is a good thing!

A future contender

History has shown us that nothing lasts forever and likely the U.S. currency will not stay the reserve currency forever. So, what triggering event could eventually challenge the US dollar? This will happen sometime in the future, when technology advances so much that:

- Energy can be produced locally (i.e., renewable energy)
- Food can be produced locally (i.e., vertical farming)
- Manufacturing becomes a local economy (i.e., 3D printing)
- Existing goods can be collected and re-used (i.e., recycling)
- We figure out what economic model makes sense for post-growth economies (i.e., export-oriented countries in demographic collapse).

This will all lead to less dependence on others and less international trade, which will bring less power to one nation and one currency. But, don't expect the US dollar to be dethroned anytime soon.

References:

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