The outlook for dollar dominance

Economics | 14 July 2023

Highlights

- The US dollar has served as the world's dominant reserve currency since the Second World War, but a de-dollarization narrative has seen a resurgence in recent months.
- Several pieces of economic data can provide an insight into whether there has been a change in the desire to hold or use US dollars, including its share in reserves held by central banks, its share in currency trading and the role played by the dollar in offshore funding markets.
- While there has been a shift in dollar reserve holdings since the early 2000s, the US dollar still accounts for almost 60% of reserves held by central banks. Beyond forex reserves, the US dollar is also dominant in currency trading, accounting for 88% of total turnover in 2022, relatively unchanged since 2004. The US dollar additionally plays an outsized role in offshore funding markets, with around half of international debt securities and cross-border loans being US dollar denominated.
- These three measures suggest that the dollar's prime position appears largely unchallenged, thus far. But there are developments that may yet drive a longer-term shift away from the US dollar, including the use of sanctions as a US foreign policy tool. There has also been a rise in bilateral agreements to settle trade in local currencies rather than the US dollar.
- Despite a potential longer-term desire amongst some economies to diversify away from the dollar, there are also some fundamental stumbling blocks that may slow or limit this process. In particular, recent work by the IMF suggests that there is significant inertia in reserve currency status, with a strong bias to using whichever reserve currency has been dominant in the most recent past.
- One possible reason for this inertia may be the US dollar's safe-haven status, evident in the perennial demand for US government bonds, even during times when there is heightened risk within the US economy itself.
- There is also a lack of feasible alternatives, with both the euro and the yuan facing their own issues as real challengers to the dollar.
- Apart from traditional currencies becoming more important, there has also been speculation that unconventional alternatives could be used as a global reserve currency, including crypto and central bank digital currencies (CBDC). But the characteristics of these alternatives mean that they are unlikely to re-order currency dominance in of themselves.
- In the near-term US dollar dominance is likely to continue, but over the longer-term it appears plausible that a more diversified set of reserve currencies may develop. Ultimately the pace of diversification in central bank reserves and the choice of currency for trade and cross-border debt settlement will be contingent on developments in these alternate currency regimes, such as increased liberalization of China's capital account. Trust in the institutions, policy predictability and robust regulatory frameworks in the issuing country will also be key to the emergence of dollar alternatives.

Edward Bell
Head of Market Economics
+971 (0) 4 609 3055

Jeanne Walters
Senior Economist
+971 (0) 4 609 3009

Is the dollar at risk of losing its reserve currency status?

The de-dollarization narrative has seen a resurgence in recent months, with several emerging economies highlighting their desire to move towards either creating their own regional currencies or allowing settlement of trade without the use of the dollar as an intermediary. Criticism of the dollar's role as an international reserve currency is not new, with the then French Finance minister, Valery Giscard d'Estaing, complaining about the "exorbitant privilege" of the US as far back as the 1960s, referring to the US's ability to run constant current account deficits, and issue debt relatively cheaply. In part this renewed interest in a move away from dollar dominance may stem from the US's ability to exert influence over financial markets for political reasons, through the use of sanctions. But how likely is de-dollarization, and what might the possible alternatives be?

Why is the US dollar the world's reserve currency?

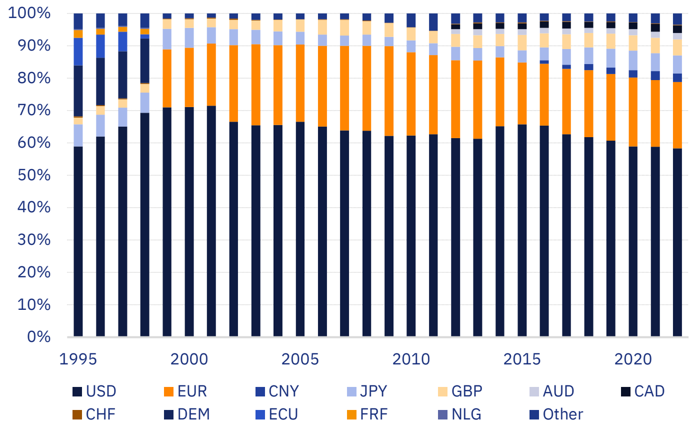
The US dollar has served as the world's dominant reserve currency since the Second World War, thanks to the Bretton Woods system. Under this system countries were effectively required to peg their currencies to that of the US, with the dollar then pegged to the value of gold. Although this system ultimately collapsed in the early 1970s with participant nations free to select any other exchange rate system, it laid the foundations for dollar dominance.

Outside of historical reasons, there are a set of attributes that are likely to play a significant role in determining reserve currency status. The first is the economic size of the reserve issuer, the larger the economy (and by extension its role in international financial transactions) the more likely it is to have reserve currency status. The size of the US economy therefore helps maintain the dollar's dominant role. The second is the credibility of the issuer, with credibility ensuring that the currency offers a store of value. Trust in US public institutions remains high, with the dollar generally being considered a safe-haven asset. The third is whether the currency is widely used in transactions, either for trade settlement or in finance-related payments, giving it value as a medium of exchange. Together with the dollar being highly liquid and freely convertible, there are also a plethora of dollar denominated assets for states, corporates, and individuals to buy and sell. These characteristics are central to a currency holding value for policy makers, financial markets, corporates and households. While some other currencies share some of these features to a degree, the US dollar currently comes closest to having the strongest claims on all of them.

Is there any evidence of a broad move away from the dollar?

Several pieces of economic data can provide an insight into whether there has been a change in the desire to hold or use US dollars. The first is the share of the USD in reserves held by central banks. As at the end of 2022 the US dollar accounted for just under 60% of global central bank foreign exchange reserves. The share of global forex reserves held in US dollars has fallen steadily from a peak of 71.5% in 2001, as the introduction of the euro in 1999 took up a large but now stable share of reserves (around 20% by end 2022).
In more recent periods however the decline in the dollar's share was not driven by a shift towards traditional reserve currencies, such as the euro, pound sterling or yen, but rather a shift towards several non-traditional reserve currencies. A 2022 IMF working paper by Arslanalp, Eichengreen and Simpson-Bell highlights that after 2008, the share of these non-traditional reserve currencies rose from near-negligible levels to around 10% in 2021. However, only around 25% of the shift away from the US dollar during this period was because of an increase in holdings of the Chinese yuan (CNY), which accounted for 2.7% of total forex reserves as of Q4 2022. Moreover, by the end of 2021 nearly a third of all yuan denominated reserves were held by Russia, a share which may have risen in the wake of the conflict in Ukraine.

Central bank foreign exchange reserves by currency



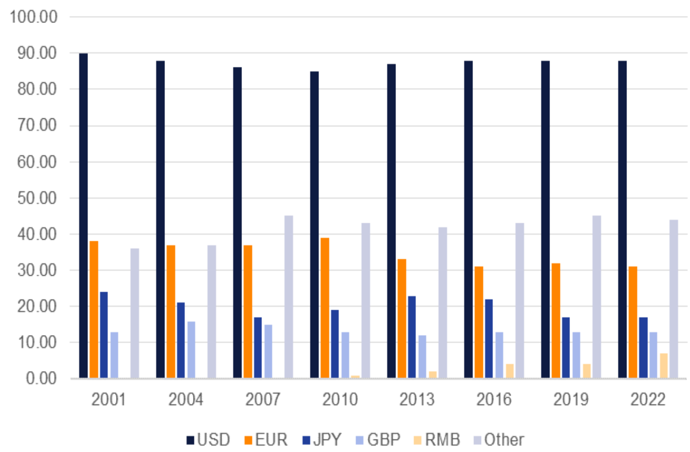
Source: IMF, Allocated reserves

In contrast over three-quarters of the shift away from the dollar, between 2008 and 2021, was because of a rise in the share of currencies from smaller economies, such as the Australian dollar, Canadian dollar, Singapore dollar, Swedish krona and the South Korean won. The authors of the IMF paper suggest that these currencies have increased their shares because they are issued by countries with relatively open capital accounts and have governments that have historically made "sound and stable policies".

So, while there has been some shift in dollar holdings by individual central banks (the Russian central bank sold a large share of its USD reserves after Russia's invasion of Crimea in 2014) the dollar's prime position in reserves thus far appears largely unchallenged.

Beyond forex reserves, the US dollar is also dominant in currency trading, accounting for 88% of total turnover in 2022 according to a BIS survey. The dollar's share of currency trades has been relatively stable, holding at near 90% in surveys since 2004. Apart from trade in US goods and services, there are two other key reasons why there is high demand for dollars in forex transactions. The first is that goods or services are often priced in dollars (crude oil for example), regardless of whether a US entity is involved or not. And secondly, total forex demand for dollars is often driven by a lack of liquidity amongst smaller currency pairs, resulting in it playing an intermediary role in forex transactions between third party countries: a trade between INR and CNY for instance could involve trading INR for USD then USD for CNY even if the underlying contract had no reference to US generated goods/services.

Share of currencies in forex transactions



Source: BIS. Total is 200% as two currencies are involved in each transaction

Lastly, the US dollar also plays an outsized role in offshore funding markets, with around half of international debt securities and cross-border loans being US dollar denominated. Furthermore, according to the BIS, as of Q2 2022, roughly 88% of international debt securities have neither a US-resident issuer/borrower or lender. These measures suggest that there has been little to no change in the role played by the dollar, but there are recent developments that may yet drive a longer-term shift.

What are the factors that might drive a change?

The use of sanctions as a US foreign policy tool has emerged as a key reason to move away from dependence on the US dollar in recent years, with a freeze of USD accounts held by some foreign countries eroding the medium of exchange argument for the primacy of the US dollar. We have already seen some movement on this front with Russia shrinking its holdings of USD assets, owning just USD 629m of US Treasuries, less than 0.01% of the total outstanding, as of December 2022. A central bank may thus choose to build up reserves in an alternative currency to avoid being targeted by US sanctions, but this doesn't preclude the authorities of the alternative currency also using sanctions to encourage political change etc.

Another way to reduce dependence on dollars is to move away from the dollar's role in trade. In particular, there has been news of a rise in bilateral agreements to settle trade in local currencies rather than the US dollar. In theory such agreements should have the additional benefit of reducing transaction costs. Officials at the Reserve Bank of India are reportedly in discussions with their counterparts in the UAE, Malaysia, and Nigeria, to set up local currency non-oil trade. Separately, Russia has already begun to settle oil exports in the local currency of key trade partners, including INR and CNY, following sanctions on Russian banks and a ban on transactions using SWIFT. Additionally, Arslanalp *et al* argue that new technologies such as electronic trading platforms, automatic market-making and automated liquidity management systems are likely to make it cheaper and easier to trade currencies of smaller economies.

Recent sanctions have also spurred discussion amongst the BRICS nations as well as some South American countries around developing their own common currencies which could be used to settle trade. Earlier this year, ASEAN members agreed to develop a Local Currency Transaction Framework to boost intraregional trade settlement in local currency. But these sorts of trading arrangements only shift forex activity from the dollar in so far as these nations actually trade with one another. It is also only helpful in situations where there are no major trade deficits or surpluses between these trading partners, otherwise the surplus countries will simply accumulate large deposits of the new currency, the use of which may be limited more broadly. For example, in 2022 Brazil ran a trade surplus of USD 44,3bn with China but a trade deficit with the USA worth USD 15.8bn. If Brazil's trade with China had been settled in yuan, Brazil would have accumulated significant yuan reserves, but would then need US dollars to settle their trade deficit with the USA.

The recent debt ceiling crisis in the US may add further impetus to the longer run move to diversify away from the dollar. Although the debt ceiling was ultimately raised in late May 2023, the brinkmanship in US politics generated significant uncertainty in financial markets. The debt ceiling is set to remain a perennial issue in US politics, with the current ceiling in place until January 2025. Any deterioration in the credit risk of the US wears down the US dollar's store of value argument.

What are the factors that might act as barriers to change?

Despite a potential longer-term desire amongst some economies to diversify away from the dollar, there are some fundamental stumbling blocks that may slow or limit this process.

In particular, the 2022 Arslanalp et al paper suggests that there is significant inertia in reserve currency status, with a strong bias to using whichever reserve currency has been dominant in the most recent past. The authors of this IMF study argue that this tendency has become even stronger since the 2008 global financial crisis.

One possible reason for this inertia may be the US dollar's safe-haven status. This is evident in the perennial demand for US government bonds, even during times when there is heightened risk within the US itself. Examples of this sustained demand include the period after the 2008 financial crisis, which had the US housing market at its center, as well in the initial stages of the Covid-19 pandemic and most recently during the negotiations around the US debt ceiling.

A second potential source of this reserve currency status inertia may also be the often-cited lack of feasible immediate alternatives. Both the euro and the yuan are arguably the most likely contenders, but both face their own issues as real challengers to the dollar. The euro has the advantages of being backed by strong institutions and financial markets but lacks a unified fiscal authority and bond markets, meaning there are likely to be more limited assets to invest in for holders of euros when compared to the dollar.

The yuan in contrast is hamstrung by an opacity of Chinese institutions, and capital controls which limit liquidity and convertibility. Both the US dollar and euro are highly liquid and freely convertible currencies, hence their share in total forex transactions is the highest in the world. Even so, data from the BIS suggests that the US dollar is traded nearly 3x more than the euro and almost 13x as much as the yuan. Any material opening of the Chinese capital account would probably spark a much bigger hit to the primacy of the US dollar.

That said, recent work by Arslanalp et al (2022) suggests that full liberalization of Chinese financial markets is not a prerequisite to increase the yuan's role in international markets. The authors argue that China's establishment of the Cross-Border Interbank Payment System (CIPS), in 2015, has laid the groundwork for increased use of the yuan. CIPS is a Chinese payment system that offers global clearing and payment services in yuan across 109 countries, as of 2022. The authors argue that these payment services together with the continued expansion of central bank swap lines (the PBOC currently has around 40 lines in place) and the development of further offshore markets for exchanging the yuan, could see the CNY rise in importance, although not displace the USD. A 2020 study by the IMF, into the drivers of reserve currency status, also suggests that the role of financial links in driving reserve currency status appears to be growing in importance, especially since the global financial crisis. In particular, the IMF study points to the currency denomination of external public debt and cross-border claims being key to building reserve currency status.

A final barrier may also be the continued use of currency pegs across the globe. IMF member country data suggests that roughly 60% of countries maintain either a hard or soft currency peg, the majority of which will be pegged directly or via a basket to traditional reserve currencies such as the US dollar or euro. Maintenance of these pegs in turn necessitate the accumulation of the corresponding currency anchor(s).

What about unconventional alternatives?

Apart from traditional currencies such as the euro and yuan becoming more important, there has also been speculation that other unconventional alternatives could be used as a global reserve currency, including crypto and central bank digital currencies (CBDC).

Bitcoin has been touted as a potential reserve currency in recent years, but there are several characteristics of bitcoin that would appear to reduce the likelihood of its widespread adoption. As highlighted earlier, key to any currency's status as a reserve currency is its use as a store of value. While bitcoin has undoubtedly gained in value since its inception, it has also been plagued by significant volatility. Recent regulatory crackdowns on crypto exchanges such as Binance and Coinbase, together with the 2022 collapse of the FTX cryptocurrency exchange will have undermined trust in crypto more broadly. In addition, a reserve currency also holds value as a medium of exchange, and while bitcoin is convertible and can act as a peer-to-peer payment, it is not widely accepted for payments and is not legal tender. Furthermore, transactions conducted in Bitcoin are slow, limited to small transaction volumes, and are relatively more expensive than fiat currency. And finally, the supply of bitcoin is designed to be finite. Although this is an attribute which arguably strengthens the argument for bitcoin as a store of value, as governments cannot simply print more of it, it also means that it is not useful as a policy tool during times of economic crisis.

Other crypto proponents have suggested that so-called stable coins (crypto currencies pegged to the value of another currency or financial asset) could emerge as the next reserve currency. Most stable coins are as of now pegged to the US dollar, suggesting that their adoption would ultimately do little to de-throne the dollar from its current position. Alternatively, a stable coin could be pegged to the value of another crypto currency, such as bitcoin, but without security about the underlying value of the anchor this also seems unlikely.

CBDCs have also risen in prominence of late, on the back of increasingly cash-less societies. CBDCs can be defined as the digital form of a country's fiat currency, issued by central banks. It is worth noting that although we already have digital money, CBDCs differ from the current system because they essentially side-step commercial banks. Under the current system central banks issue digital currency to commercial banks in the form of reserves, and commercial banks then in turn issue digital currency to consumers via deposit accounts. CBDCs in contrast would be issued directly by the central bank to the consumer, with the benefits of CBDCs often being cited as the same degree of anonymity as cash for retail customers and increased efficiency and reduced costs for commercial banks. Several central banks are currently looking into the possibility of issuing CBDCs, with the PBOC having already started a digital yuan trial in 2020.

While the IMF suggests that the early adoption of CBDCs by a smaller country, that has a credible policy framework in place, could encourage the use of that currency as a reserve, it remains unlikely that the introduction of CBCDs will re-order currency dominance. This is because currency dominance rests not just on the depth of the issuing country's financial market or the economy's size but on the economy having a robust institutional framework. It therefore appears more likely that the issue of a CBDC by a country whose currency is already being held in central bank reserves could increase demand for CBDCs denominated in that currency.

In fact, Eswar Prasad of Cornell University has highlighted the possibility of any widespread adoption of crypto and CBDCs strengthening dollar dominance. He argues that as crypto and CBDCs make cross-border flow of money easier, developing economies are likely to become more vulnerable to the actions of domestic and international investors, which may in turn encourage policy makers to further expand stocks of "safe-haven" hard currencies.

Conclusion

In the near-term US dollar dominance is likely to continue, but over the longer-term it appears plausible that a more diversified set of reserve currencies may develop.

It is also worth highlighting that a shift towards a more diversified set of global reserve currencies might on balance be beneficial for the world economy. In particular, the reserve currency status of the US dollar has been cited as playing a role in creating saving and investment imbalances which contributed to the 2008 financial crisis (rising dollar savings reduced interest rates which drove borrowing to purchase riskier assets). Additionally, a move to debt being denominated in currencies other than the US dollar may potentially weaken the link between periods of relative US dollar strength and increased debt burdens faced by emerging economies, which may be particularly challenging for those economies which are also exporters of dollar-denominated commodities.

A changing attitude towards the US dollar is perhaps a necessary but not sufficient condition to drive diversification of global reserve currencies. Ultimately the pace of diversification in central bank reserves and the choice of currency for trade and cross-border debt settlement will be contingent on developments in these alternate currency regimes, such as increased liberalization of the yuan or development of CBDCs. Trust in the institutions, policy predictability and robust regulatory frameworks in the issuing country will also be key to the emergence of dollar alternatives.

Disclaimer