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De-Dollarization Is Not Imminent, But the Debate Will Linger

Global Economics & Investment Analysis, May 17, 2023

Every few years, market doubts about the U.S.' macro excesses and foreign policy follies crop up and raises the specter of 'De-dollarization' –the notion that the dollar is about to play a much-diminished role in global finance. This is distinct from cyclical moves in the dollar which largely reflect the waxing and waning of relative macro and policy cycles, and the occasional 'flight to safety' in times of crisis. In view of heightened market speculation about de-dollarization, **we put forward our main points of view on this topic**:

1. **The dominant role of the USD is nowhere close to being undermined anytime soon.** A well-entrenched dollar-centric financial ecosystem and U.S.' historical geo-political alliance system, create powerful network effects and, allow the dollar to tick all the right boxes in terms of scale and acceptability for fulfilling the role of an international means of exchange, provider of liquidity and store of value.

2. **However, a growing number of emerging markets (EMs), especially China, will continue promoting the use of their own currencies for the settlement of their own trade.** Fracturing geo-politics and improvements in payments systems are increasingly relevant here. Just as many advanced economies (AEs) seek to boost supply chain resilience and mitigate concentration risk, so also several EMs may seek to insulate trade settlement capabilities and gradually diversify, a portion of, their reserve holdings.

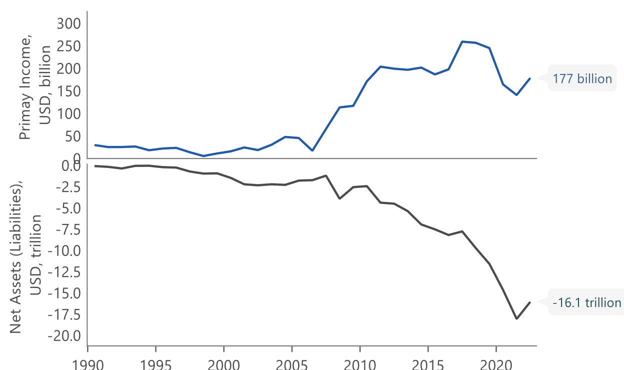
3. **Even with an incremental ease of its use over a longer horizon, however, the dollar is likely to remain the single-most important currency in international trade and finance.** The Chinese Yuan's use in trade-invoicing is also poised to rise. But it will ultimately need deep institutional or policy-regime changes to truly morph into a 'reserve' asset. These seem unlikely under the current political dispensation in Beijing. In the absence of far-reaching policy shifts, CNY's co-dependency with the dollar will persist.

4. **Conceivable risks which could tip the scales against the dollar are further, aggressive use of economic sanctions, a lurch toward greater isolation or self-inflicted harm**. These could include an unexpected exit by the U.S. from trade agreements and military alliances with key allies and economic partners or a failure to resolve the debt ceiling impasse. However, these are not our base case.

Chart 1: Exorbitant Privilege: The U.S. runs the largest net liability position in the world but generates investment gains from its net foreign assets (it earns more than it pays out to foreign creditors on its much larger liabilities).

United States: Net Primary Income Vs. Net Asset (Liability) Position

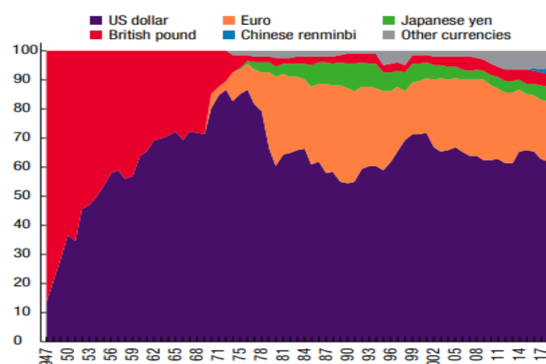
— Net Primary Income (on net assets), USD — Net Asset (Liability) Position, USD



Source: Macrobond, BNY Mellon Investment Management, International Monetary Fund (IMF)
Data as of 5/15/2023

Chart 2: The USD's dominance arose in the 1950-60s and its strong 'network effects' over time has underpinned the U.S.' exorbitant privilege, allowing it to routinely borrow at well below (implied) market cost.

Figure 2. Currency Composition of Allocated Reserves, 1947–2019
(Percent of total)



Source: Iancu (et all), Reserve Currencies in an Evolving International Monetary System, International Monetary Fund, 2020

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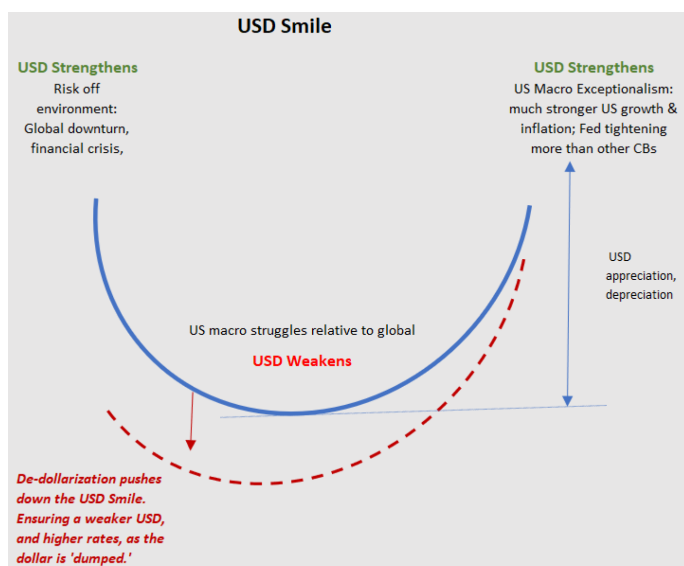
AT THE OUTSET IT IS IMPORTANT TO DISTINGUISH BETWEEN A 'WEAK DOLLAR' ARGUMENT FROM 'DE-DOLLARIZATION'.

The strength of the dollar, or lack thereof, simply reflects the waxing and waning of relative macro and policy cycles, and the occasional 'flight to safety' in times of crisis. A growing consensus among market participants, since earlier this year, has been for the dollar to weaken going forward. GEIA's own view is for a stable to weakening path ahead for the USD, as explained in our latest quarterly Vantage Point. Chart 3 below --the 'dollar smile'-- summarizes the stylized relationship between trade-weighted dollar appreciation (depreciation) and U.S. macro exceptionalism (or lack thereof).

Chart 3: The USD and its relationship with global risk conditions, U.S. macro & policy exceptionalism



Source: Author's depiction, May 15, 2023
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De-dollarization, on the other hand, is about the USD playing a much-diminished international role as a reserve currency or trade-invoicing currency. This notion --that the dollar's prominence in international finance is about to be eclipsed, or that the Chinese Yuan is on the brink of stepping into its shoes-- has grown in prominence (to almost a clamor) in recent weeks, in the financial press. For instance, CNBC ran a story about "Calls to move away from the U.S. dollar grow." Bloomberg News put out a piece, authored by hedge-fund manager Stephen Jen, "De-dollarization is happening at a stunning pace." China Daily weighed in with a piece called "Why De-dollarization is spreading globally." There has even been talk of a new BRICS currency, the R5 –named after the (Russian) Ruble, (Chinese) Renminbi, (Brazilian) Real, (Indian) Rupee and (South African) Rand.

If de-dollarization were indeed plausible or imminent it would cause a downward shift in the 'USD Smile' (red-dashed line, Chart 3). **It would imply a much weaker outlook for the dollar and a vulnerability to market runs**. It would most likely require higher market rates to draw sufficient global capital flows to fund the U.S.' twin deficits. In the rest of this note we clarify some of these misconceptions by presenting our four main arguments.

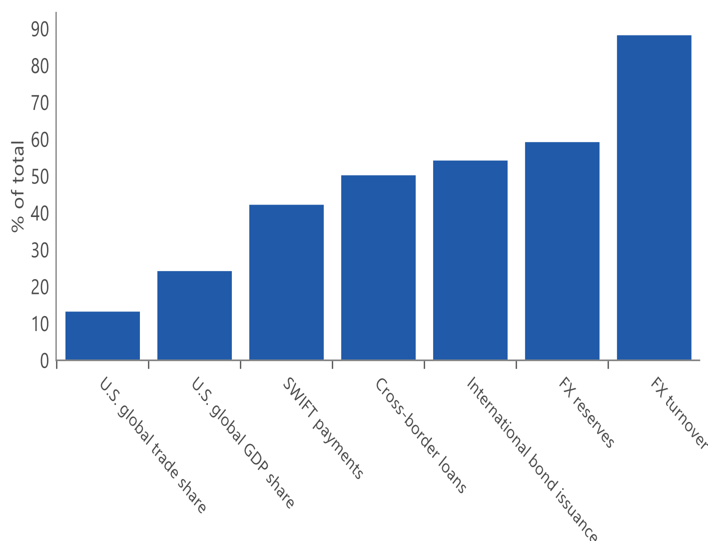
1. US DOLLAR DOMINANCE IS NOWHERE CLOSE TO BEING UNDERMINED ANYTIME SOON.

At its most rudimentary level, the **core attributes of money comprise its acceptability as a unit of account, means of exchange, and store of value**. Acceptability of any currency, along these dimensions, requires trust in the currency's intrinsic value, strong network effects, and lack of credible alternatives.

From an international finance prism, **this is akin to a currency's global use in trade invoicing, foreign-exchange (FX) settlement and the currency of choice in global central bank reserves**. Using this prism, our assessment looks at long-term trends in the dollar's share in the Society for Worldwide Interbank Financial Telecommunication's (SWIFT's) monthly data on trade payments (i.e., trade invoicing), Bank for International Settlements (BIS) triennial data on FX turnover (to gauge FX settlement), and the International Monetary Fund's (IMF) quarterly data on the composition of foreign exchange reserves (COFER) at global central banks. These are summarized in chart 4.

What we find is that **the dollar still ticks all the right boxes in terms of its scale and acceptability** for fulfilling the role of an international means of exchange (42% of total international trade invoicing), provider of global liquidity (on the other side of nearly 90% of all worldwide FX transactions) and store of value (58% of global central bank reserves). It plays these roles in a way which, currently, no other currency can. But the Euro comes close.

Chart 4: USD dominance remains overwhelming, and far above the U.S.' share in global GDP and trade.



Source: Macrobond, BNY Mellon Investment Management, BIS (The Bank for International Settlements), SWIFT, International Monetary Fund (IMF)
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The persistence of the out-sized role of the dollar, and to a lesser extent the euro, is striking considering the much lower the share of the U.S. in global trade (Chart 4). Specifically, the U.S. comprises around 12% of total global trade at the end of 2022, but the dollar accounts for around 42% of trade invoicing. By comparison, the Euro area's share in global trade is around 28%, and the euro's share in trade invoicing is around 33%.

In our view the dollar's key role is underpinned by two mutually reinforcing, path-dependent trends: **1) the "dominant currency paradigm[1]"**, and **2) the historic role of post-war geo-politics[2].**

Dominant currency paradigm postulates that contrary to neo-classical assumptions --of trade-invoicing in the currency of the exporting country or that of the destination country-- **most international trade is, in fact, invoiced in a handful of international currencies. The most prominent of which is the dollar.**

The rise of the dollar's international role can be traced back to the displacement of the British Pound in the 1950s (chart 2, 1st page), and its dominance has become entrenched by network effects formed around a series of inter-locking trade and capital market developments as explained below:

- Countries tended to initially invoice their trade receipts and payments heavily in the U.S. dollar, decades ago, when the U.S.' proportional share in global GDP and trade was much higher than it is today.
- That then resulted in the need to hold some working capital in dollars, and it also drove the issuance of offshore dollar liabilities (resulting in the rise of the Eurodollar, or offshore US dollar, market).
- In turn, this fueled the preference for safe dollar assets. That is, by holding a safe dollar deposit (in this case, central bank foreign reserves), emerging market importers could guarantee themselves a safe level of imported goods or anchor their own local currency risk-premia in times of market stress.
- The build-up of these dollar reserves (excess demand for dollar assets) then lowered dollar risk premiums allowing the U.S. to 'live beyond its means' --i.e., sustain larger twin-deficits, and run up larger net international liabilities, than most other countries would be able to.
- Finally, large-scale U.S. consumption and the supply of safe and near unlimited amounts of easily accessible U.S. Treasuries perpetuated further dollar invoicing, dollar debt issuance and the build-up of dollar foreign reserves, thereby, entrenching the U.S. dollar ecosystem (see the interlinked depiction of the entrenchment of the dollar's use, in Chart 5).

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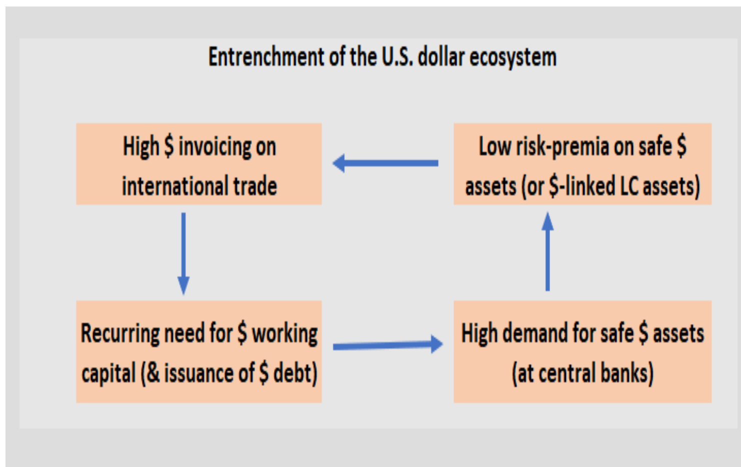
[1] Gopinath (et all), Dominant Currency Paradigm, National Bureau of Economic Research (NBER) Working Paper 22943
[2] Weiss, Colin (2022). "Geopolitics and the U.S. Dollar's Future as a Reserve Currency," International Finance Discussion Papers 1359. Washington: Board of Governors of the Federal Reserve System, https://doi.org/10.17016/IFDP.2022.1359.

Chart 5: Dollar Dominance & its interlocking network effects



Source: Author's depiction, May 15, 2023

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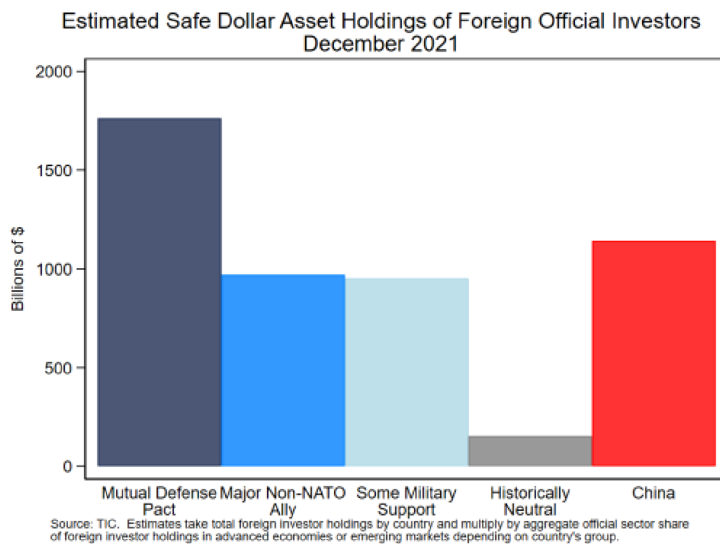
The geo-political argument, which also safeguards the dollar's pre-eminence, is closely related to the 'dominant currency paradigm' in that the bulk of dollar reserve holders have comprised U.S. allies and economic partners. This **reflects an underlying link between geopolitical ties with a reserve currency issuer and that currency's share of FX reserves** –with holdings of an ally's foreign assets signaling implicit support of the issuer's policies or as a basis for obtaining security guarantees from the reserve currency issuer.

Recent work by the Federal Reserve shows that **U.S. allies' central banks have historically, and consistently, comprised around 50% to 60% of total safe dollar assets (U.S. Treasury holdings) at global central banks**. These allies comprise countries which either have a mutual defense treaty with the U.S. or carry the designation of a major non-NATO ally. When 'friendly' countries, or those which enjoy 'some military support' from the U.S. are brought into this mix, the share of safe assets held at allies + friends rise to three-quarters of the total amount of safe dollar assets. The definition of friendly countries includes nations which are not formal allies per se, but have significant political or economic ties with the U.S. The most notable countries in this group include India, Indonesia, United Arab Emirates, Saudi Arabia and Hong Kong --the last three maintain hard currency pegs to the US dollar. A summary of these categories of countries is depicted in Chart 6.

Chart 6: U.S. allies, near and far, & its friends account for three-quarters of all official holdings of safe dollar assets



Source: Colin Weiss. Geopolitics and U.S. Dollar's Future as a Reserve Currency, Board of Governors of the Federal Reserve System, 2022.

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The combination of a well-entrenched dollar-centric financial ecosystem and the U.S.' geopolitical alliances, alongside the sheer scale of the U.S. economy and its capital markets, are formidable obstacles against any challenge to the dollar's dominance.

2. However, a growing number of emerging markets (EMs), starting with China, will continue promoting the use of their own currencies for the settlement of their own trade.

Fracturing global geo-politics is one important driver. A growing list of large EMs are trying to set up mechanisms to settle trade with one-another in mutually suitable bilateral currencies, rather than the dollar. Many such countries, in the global South, condemned Russia's invasion of Ukraine but did not participate in western-led sanctions against it. As an upstream producer of energy commodities, food, and military supplies, and as a permanent member of the United Nations Security Council, Russia is simply too big and influential, to be forsaken by EMs not directly impacted by the Russo-Ukraine conflict.

In particular, **the threat of widening sanctions** --to include entities found to be helping or working with Russia-- **and the precedent of a confiscation of the Central Bank of Russia's reserves may have fueled EM anxiety and efforts to insulate their trade settlement capabilities** and gradually diversify, at least a portion of, their central bank reserves. For instance, the central banks of the BRICS countries (Brazil, Russia, India, China and South Africa) have raised their purchases of gold even though their underlying trade remains more reliant on advanced country demand than EMs (or vis-à-vis each other, see charts 7, 8 on next page).

Advances in payments systems is another driver of payments diversification and trade re-invoicing (away from the USD). Most notably, efforts by regional central banks to build out local currency settlement systems are growing in scale.

- China's Cross-Border Interbank Payment System (CIPS) has already begun settling Sino-Russian trade amidst a sizable swing in Russian trade flows away from western countries, and the true scale of CNY settlement may be undercounted by the current SWIFT data.
- In recent months several member countries of the Association of South-East Asian Nations (or ASEAN) have intensified efforts to settle a proportion of their trade bilaterally in their local currencies.
- A few ASEAN member countries have also reached specific bilateral agreements to settle some trade in local currency directly with China as well as with India and its vaunted United Payments Interface (UPI).
- Outside Asia, Argentina and Brazil have recently announced early-stage plans on forming a common currency called 'Sur.'
- Saudi Arabia has announced it is open to re-denominating a portion of its oil exports in non-dollar currencies.

We view these efforts as self-insulation and as a counterpart to the trend of a growing number of advanced economies (AEs) working to secure their supply chains and reduce concentrated geo-political risks.

All told, own-currency trade-settlement is still at very early stages at most major EMs. In contrast to the network advantages of the dollar, there are payments costs and inefficiencies (larger bid-ask spreads) on bilateral FX quotes with no reference to the USD. Moreover, as bilateral payments imbalances pile up, it is far from clear that deficit EM countries can provide the liquid securities and store of value to their surplus EM counterparts. This became evident recently in the Indo-Russian payments disagreement about Rupee usage for settling bi-lateral trade. India runs persistent deficits vis-à-vis Russia on its ongoing purchases of defense equipment and growing amounts of cut-rate Russian oil. India offered Indian Government Bonds as an investment vehicle for Russia's Rupee surpluses. But, beyond certain limits, the Russians would prefer to be paid in more widely usable CNY for purchasing much needed manufactured products.

In comparison to most EMs, the role of the CNY is clearly poised to rise in importance in trade invoicing in view of China's rising heft in global GDP and international trade, and its dominance of global manufacturing which, at 30% of the world-wide total, now exceeds the combined value-added production of the next seven largest manufacturing nations**. China has also been providing bi-lateral FX swap lines to a growing number of EMs to facilitate trade settlement**. This is, in fact, a key plank of "Renminbi Internationalization."

But this should not be conflated with a displacement of the dollar. An ability to settle one's trade in one's own currency is not the same as providing an alternative to the dollar –whose global role, as we explained, remains anchored by the dominant currency paradigm and its alliance-based international economic linkages, and the network effects they mutually reinforce.

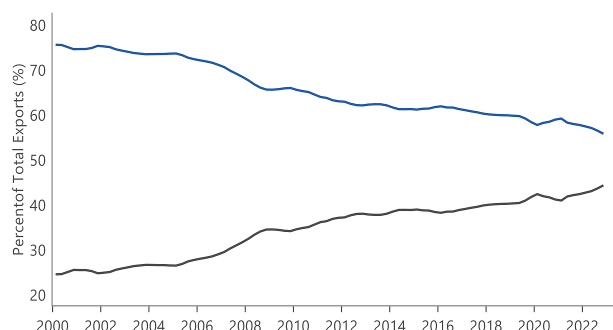
More specifically, **the increasing use of bilateral FX swap lines and the offshore Renminbi (CNH) market will internationalize the Renminbi no doubt, but it will also leave China co-dependent on the dollar**. Access to CNY through FX swap lines and the CNH market, by China's trading partners and reserve managers, create expectations that these CNY balances will be liquid (i.e., they can be borrowed, bought and sold) at reasonably stable prices. What this implies is that the PBOC will still need to hold dollars and other convertible currencies in its reserves to provide an undertaking of reasonable FX stability (and timely re-conversion). In other words, Renminbi internationalization may slowly chip away at dollar dominance in trade invoicing, but it will keep the CNY subservient to the dollar as a reserve asset.

Chart 7: Although the gap is narrowing, BRICS economies remain more reliant on developed economy demand than on EMs or on each other

BRICS Exports to Advanced Economies Vs. Emerging Markets, % of Total

BRICS group of countries comprise Brazil, Russia, India, China & South Africa

— BRICS exports to Emerging & Developing Economies
— BRICS exports to Advanced Economies



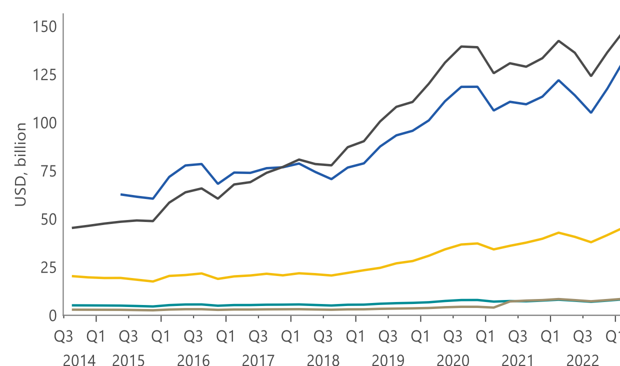
Source: Macrobond, BNY Mellon Investment Management, International Monetary Fund (IMF)
Data as of 5/15/2023

Chart 8: BRICS economies have recently scrambled to raise their holdings of gold, which have nearly doubled since just before the pandemic

Gold Holdings of BRICS countries, in Official Reserve Assets, USD bn

BRICS countries comprise Brazil, Russia, India, China & South Africa

— Brazil — South Africa — India — Russia — China



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3. EVEN WITH AN INCREMENTAL REDUCTION OF ITS USE OVER A LONG HORIZON, THE DOLLAR IS LIKELY TO REMAIN THE SINGLE-MOST IMPORTANT CURRENCY IN INTERNATIONAL TRADE AND FINANCE.

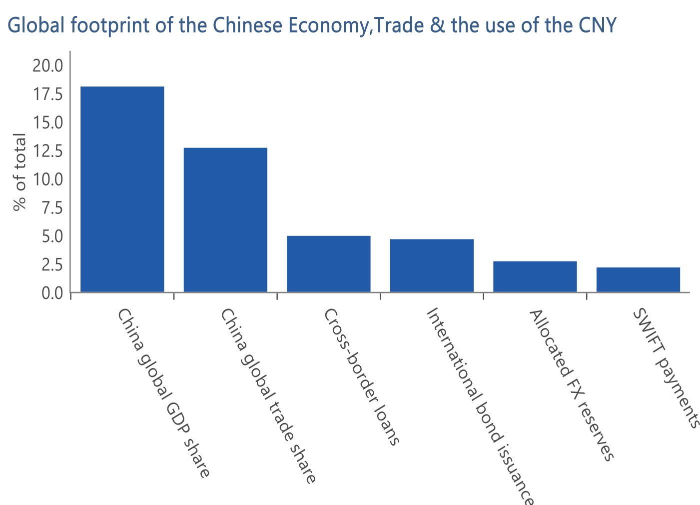
Lack of scale remains a key impediment to bilateral currency settlement for many EMs. Using one's own currency to settle trade goes back to the neo-classical assumption of settlement in the producer country's currency or that of the destination (importing) country. But this also requires a large and growing trade and capital market footprint, as well as mutual political agreement, to justify de-dollarizing and forsaking the efficiency (and low cost) of a well-established trade-settlement mechanism. Although it is growing rapidly, it is worth noting that intra-EM trade is still smaller than EM's trade with reserve-currency issuing advanced economies.

China has the scale but lacks the financial openness and remains mercantilist in its trade policies. The bilateral use of the CNY could very well pick-up, as we explain above --allowing China to wean itself away from a dollar-based trade-invoicing system. But for its increasing use, in trade settlement, by third countries and for the CNY to truly emerge as a store of value and be widely used as an asset in EM central bank reserves, the yuan will still need either much greater convertibility or China will need to run sizable current account deficits. Only such far reaching changes will provide more durable CNY liquidity and genuine price-discovery. But any opening-up of the capital account or a willingness to run sizable current account deficits

require deep institutional or policy-regime changes. These seem implausible to us under the current political dispensation in Beijing.

If it were a cinch to use the CNY as a reserve currency, Hong Kong's Monetary Authority, as a special administrative region (SAR) of China, would have done so already. We, therefore, remain skeptical that Saudi monetary authorities or other major central banks (reserve managers) will easily jump fence and undertake a widespread portfolio shift into CNY denominated assets. **We are not dismissive of China's (and other EM's) efforts to incrementally enhance own-currency trade-settlement**. We just think the preconditions for large scale or imminent diminution of the use of the dollar are simply not in place.

Chart 9: CNY's growing financial role has yet to catch-up relative to trade and economic share in global GDP



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Even if, for the sake of argument, we were to witness much bigger than expected shifts in trade-invoicing that would still most likely leave the dollar's relative dominance intact. Recent academic studies[3] show that a one percentage point fall in the dollar's invoicing share of a country's exports is estimated to result in a 0.2 to 0.5 percentage point reduction in the dollar's share of that country's FX reserves. If one were to apply the upper-limit of that estimate, or even stretch it to a full-1 percentage point fall in reserves, and associate that with a hypothetical wholesale shift, say, by Hong Kong ($427bn in FX reserves) and Saudi Arabia ($450bn), it would still leave the U.S. dollar with the largest allocation of global reserves at 48%, down from 58% at the end of 2022 --and the single-most important reserve currency.

4. CONCEIVABLE RISKS WHICH COULD TIP THE SCALES AGAINST THE DOLLAR ARE FURTHER, AGGRESSIVE USE OF ECONOMIC SANCTIONS, A LURCH TOWARD GREATER ISOLATION OR SELF-INFLICTED HARM.

Widespread sanctions on a G-20 country like Russia, a prolonged conflict in Ukraine and the risk of escalation or a widening of hostilities has made many EMs nervous. However, a rapid diminution of the dollar's role will likely require a body blow to U.S.' international standing and its anchor position in the international monetary system.

Key risks include the U.S.' exit from NATO or G-7, or a rupture in relations with several important trade partners or military allies. It could also include a prolonged domestic political impasse which results in a lack of resolution of the government's debt ceiling, and an inability to quickly cure any arrears. But none of these are currently our base case scenario.

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[3] Arsanalp, Serkan, Eichengreen, Simpson-Bell. (2022). "The Stealth Erosion of Dollar Dominance: Active Diversifiers and the Rise of Nontraditional Reserve Currencies." IMF Working Paper 22/58

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IS-382922-2023-05-12

GU- 423 - 12 May 2024