

CASE ANALYSIS:

Are we Approaching End of Dollar Hegemony

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Dollar - The Reserve Currency

Reserve currency is the currency that is held in large quantities by central banks and other monetary authorities worldwide to be used for international transactions and for various global activities.

The United Kingdom's pound sterling was the primary reserve currency in the 19th century. That status ended when UK was bankrupted fighting World War I and its place was taken by the United States dollar.

The dollar was first printed in 1914, a year after the establishment of the Federal Reserve as United States' central bank by passing of the Federal Reserve Act 1913. During World War I in 1914, United States became lender to many countries and also supported UK when it was on the verge of bankruptcy. Since then, it became one of the world's strongest currencies.

In 1944, during World War II, delegates from 44 countries met in Bretton Wood and decided that world's currency will be pegged to USD instead of gold since USD was already linked with gold as US owned the majority of the world's gold. The arrangement was known as Bretton Woods Agreement and since then, the dollar officially turned out to be the world's reserve currency. However, due to high demand for gold, in 1971, President Richard Nixon de-linked dollar from gold leading to floating exchange rate that exists today.

As per the Q4 2022 data of Currency Composition of Foreign Exchange Reserves (COFER) published by IMF, USD remains the dominant currency with 58.36% in foreign exchange reserve, followed by Euro with 20.47% share in world reserve. Pound sterling is at the fourth position with only 4.95% share.

Petrodollar and Petrodollar Recycling

Petrodollars are not a distinct currency. They are U.S. dollars accepted as payment by oil exporters. The term ‘petrodollar’ gained prominence in the mid-1970s when oil crisis led to rising oil prices and thus generated large trade and current account surpluses for oil exporting countries. The exporters then started accepting dollars because of U.S. status as the world's largest economy and goods importer and its openness to international trade and investment.

The origin of petrodollar happened during 1944 when Saudi Arabia signed an agreement with US to accept US dollars as the only payment currency in exchange of oil for military and business training.

Petrodollars are the primary source of revenue and wealth for many members of the Organization of Petroleum Exporting Countries (OPEC) as well as non-OPEC oil and gas exporters including Russia, Qatar, and Norway.

Petrodollar recycling refers to the investment of dollar revenue generated by exporters from the sale of oil. Examples of petrodollar recycling is setting the deal term between U.S. and Saudi Arabia to reinvest Saudi petrodollars into U.S. Treasuries in 1974 and pay for U.S. run development projects in Saudi Arabia in 1979.

Many oil exporters invest their petrodollars in stocks, bonds and other financial instruments through sovereign wealth funds.

De-dollarization refers to reducing the dollar's dominance in global markets. It is a process of substituting the US dollar as the currency used for trading oil and other commodities, buying US dollars for the forex reserves, bilateral trade agreements, dollar denominated assets. This process would help to reduce dependence of other countries' on US dollar and US economy, which could mitigate the impact of economic and political changes in the US on their own economies.

Advantages of de-dollarization	Challenges with using local currencies
<input type="checkbox"/> Reduction in dependence on US dollar	<input type="checkbox"/> Not fully convertible
<input type="checkbox"/> Improvement in economic stability	<input type="checkbox"/> Currency fluctuations
<input type="checkbox"/> Increase in trade and investment	<input type="checkbox"/> Limited use of national currencies in international trade
<input type="checkbox"/> Less US monetary policy influence	<input type="checkbox"/> Impact in monetary sovereignty

Signs of De-Dollarization

Major countries are initiating non-dollar currencies trade and are seeking to diversify their foreign exchange reserves. This can mark as the beginning of de-dollarization trend across the world.

China and Brazil have reached a deal to carry out trade and financial transactions in Chinese yuan or Brazilian reais, instead of US dollar. China has similar currency deals with Russia, Turkey, Pakistan, and several other countries. During the last week of March 2023, China carried out its first ever yuan settled energy deal i.e. 65,000 tons of liquified natural gas (LNG) with the French company Total Energies in United Arab Emirates (UAE).

On March 29, 2023 Indian Commerce Secretary Sunil Barthwal said that the rupee will be used to trade with countries that are facing shortages of dollars or currency failures. India is already trading in INR with Russia, Mauritius, Iran and Sri Lanka. Recently, RBI gave approval to 18 countries, including UK, Germany, Russia and UAE to trade in rupees. India have lately made payment of most Russian oil in UAE dirham and Russian ruble. The transactions in the last three months equal to USD 700m.

Some of the US allies have reduced their holdings of US debt to diversify their foreign exchange reserves. The dollar weight in foreign reserves has fallen below 60%, more than 10% lower over past two decades, according to the IMF's COFER Q4 2022 report.

BRICS is pondering to develop a new currency to settle trade among member states. In World Economic Forum Summit held in Davos in January 2023, Saudi Arabia's finance minister Mohammed Al-Jadaan said that his country is open to the idea of settling oil trade in currencies other than the US dollar. This can be a steep step towards de-dollarization as Saudi Arabia is one of the biggest oil producer and is the country from where petrodollar was born.

What led to the beginning of De-Dollarization?

The dollar is America's superpower. With its reserve currency status, it gives US government ability to weaponize the dollar against its political adversaries by imposing sanctions on any country in the world and inflicting massive economic costs on them.

The profound economic disruption experienced by Iran in 2012 when US and its closest ally Europe imposed sanctions on Iran oil exports unless it curtails its nuclear programme and the recent sanctions imposed on Russia for its invasion in Ukraine by seizing nearly half (USD 300bn) of Russia's foreign currency reserves and evicting Russian banks from SWIFT, an interbank messaging service that facilitates international payments have reminded the world of the reach and dependence on the dollar.

These sanctions have shaken the faith in the greenback, demonstrating that US can arbitrarily and unilaterally, based on its own policy considerations can cut off reserves of a foreign nation.

The central banks across the world have started keeping less of their reserves in dollars, and are settling most of the trades in local currencies. Countries around the world are also seeking to replace the SWIFT payment system by aiming to develop their own digital payment system to avoid US monetary coercion.

Can Dollar be Dethroned?

China is pushing its currency, the yuan, to be the primary competitor to the dollar in international trade. It has established trading partnerships with Russia, Brazil, Saudi Arabia and other countries to deal directly in yuan.

The yuan has surpassed the US dollar as the most traded currency in Russia in monthly trading volume in February 2023, increasing significantly in March, same year. Before Russia's war in Ukraine, the yuan had a negligible trading volume in the Russian market.

The yuan has passed euro and emerged as the second most important currency in Brazilian foreign reserves. Till 2018, yuan had no share in Brazil's foreign reserves and now accounts for 5.37% holdings at the end of 2022 surpassing 4.74% euro's share.

China's central bank has approved 31 yuan-clearing banks in 29 countries or regions. As per China's Ministry of Commerce, trade worth around 7.92tn yuan was settled in yuan in 2022, a surge of 37.3% from a year before.

Apart from China, India, Russia and BRICS have also begun to conduct trade in their local currencies.

Trade is generally preferred in currencies that are freely convertible and highly liquid. The yuan is neither, because of its domestic policy choices and economic restrictions. Russia and China lack transparency in their economic policy. Since the decision-making process in these countries is undemocratic, it will be difficult for traders to completely rely on these currencies as reliable alternatives.

Can Dollar be Dethroned? (cont....)

Today, nearly 60% of foreign exchange reserves maintained by the world's central banks are held in dollars. Though it is a decline from about 70% in 2000, there hasn't been emergence of any other dominant currency. Euro's share has gone up only marginally since its launch, from 18% to just under 20%. China's yuan, though has grown the fastest since 2016, accounts for only 2.7% of global reserves. While Russia's ruble, Brazil's reais, India's INR, UAE's dirham and others which are currently being accepted for trade forms negligible part of total reserves.

The dollar's dominance is unlikely to change in the near future, and it will remain the principal currency of international trade and transactions. No other currency is close to replace its dominance.

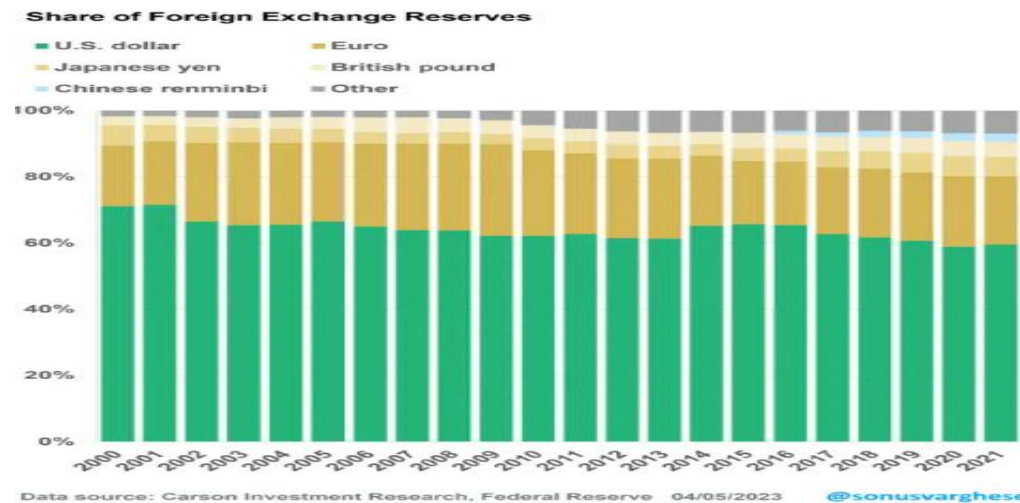
But its hold on the global financial system could weaken if more countries start trading in other currencies and reduce their exposure to the dollar. It is likely that world is moving towards a more "multipolar" world as evident by the falling share of the US dollar in forex reserves and yuan can become one of the major trading alternative.

Key Reasons behind continuation of Dollar Dominance

According to Carson Group, financial advisor, there are three big reasons behind USD to stay resilient despite ongoing threats worldwide.

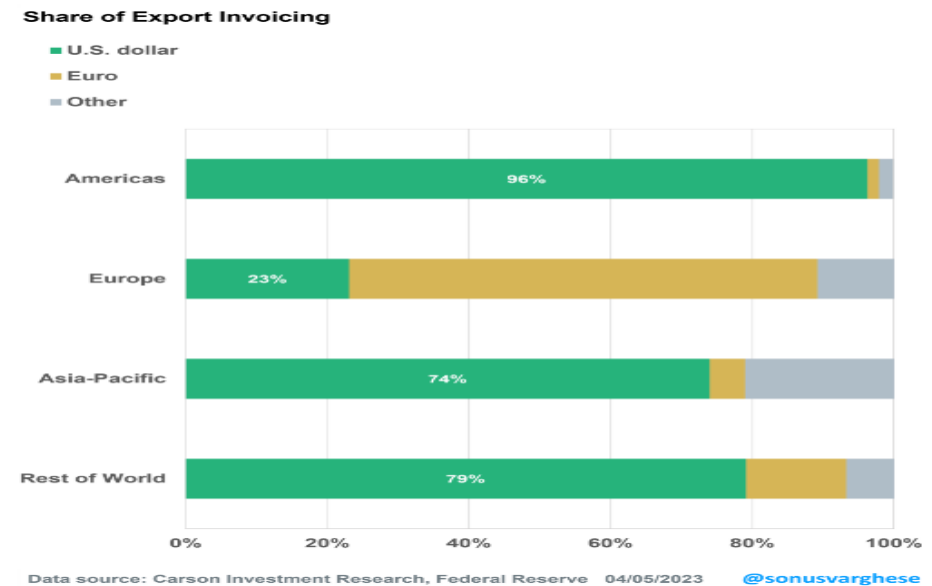
1. *The World has confidence in the US, and thereby the U.S. dollar*

US has the world's deepest and most liquid financial markets owing to the size and strength of the US economy, open trade and capital flows with fewer restrictions and strong rule of law and property rights. This is the reason why, despite the US making up just about 25% of the world economy, about 60% of global foreign currency reserves are denominated in USD.



2. *The US dollar is dominant in trade and international finance*

USD is the world's most popular medium of exchange in global trade. 60% of international foreign currency banking claims, i.e., bank deposits and loans in foreign currency are dollar denominated and this has been fairly stable since 2000 and has increased over the last few years.



Key Reasons behind continuation of Dollar Dominance (cont....)

3. *US is willing to maintain massive trade deficits*

America imported USD 3.3tn worth of goods in 2022 while exported only USD 2.1tn worth of goods in the same period leading to a huge trade deficit of USD 1.2tn and leaving foreigners with lot of US dollars.

In order make use of the dollars, foreigners either invest it into the most safest, US treasuries or hold it in cash. As of Q4 2022, rest of the world held about USD 7.4tn in US securities and USD 1tn in USD banknotes. These are liabilities of the US government that the US is willing to issue. No other country, including the Eurozone, looks capable or willing to do that anytime soon.

