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What Does the Weaponization of Global Finance Mean for US Dollar Dominance?

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After Bretton Woods II, the US Dollar (USD) grew to dominate trade invoicing, credit expansion, and as a reserve currency, making it central to the global monetary and financial system. However, the USD's hegemonic status is not without its own set of challenges.

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In a resounding 2019 speech, Mark Carney, then-governor of the Bank of England, highlighted his concern about the hegemonic role of the USD.[1] He claimed, "Given the widespread dominance of the dollar in cross-border claims, it is not surprising that developments in the US economy ... can have large spillover effects to the rest of the world..."

As a way of highlighting the severity of this point, he broadened the Nixon era dictum of 'the dollar is **our currency, but your problem**' to **'any of our problems is your problem.'**

Russia certainly experienced that "USD problem" in response to its invasion of Ukraine. The Western Alliance froze nearly half of the Russian Central Bank's estimated US$630 billion[2] in foreign exchange and gold reserves, approximately 35 percent of Russian GDP, froze assets of several individuals and Russian banks, and severely limited Russia's access to the SWIFT payment system – though there are carve outs to preserve trade in key commodities such as oil, gas, and wheat. In the past, we have seen similar measures selectively applied to countries such as Afghanistan, Iran and Venezuela. However, the sanctions package imposed against Russia is unprecedented — not only in its scope and magnitude, but also because it targets a major world power.

These actions represent a tectonic shift from the policy of neutrality signaling to the world that each country's access to their reserves could become contingent on their foreign policy. Some view it as a masterstroke as it effectively crippled Russia's ability to trade in international markets.[3] Russia sees it differently. The Russian foreign minister Sergey Lavrov labeled the move as "theft."[4] "This is the beginning of the end of dollar's monopoly in the world," declared Vyacheleslav Volodin, speaker of the Russian Duma lower house of parliament.[5]

Is Volodin correct? Do these historic sanctions signal the end of the USD's dominance? We believe that any imminent change is highly unlikely, but these sanctions have dramatically raised incentives for United States' adversaries to reduce their USD exposure.

That said, the world is deeply financialized with global debt topping US$300 trillion in 2021 and much of it is USD-denominated.[6] A change in this ecosystem with the USD reigning less than supreme would have far-reaching consequences in international finance. As noted by Ben Bernanke, the former chair of the US Federal Reserve, the centrality of the dollar has given global sovereign governments and corporations access to liquid, safe and stable markets with a lender of last resort in the US Government.[7] This access has been central to the growth of international trade in the last few decades and is at the risk of loss should that centrality be lost. We believe that any challenges to the hegemonic role of the USD would be part of a broader realignment of global trade and supply chains. The risk in this journey of realignment is a holistic fragmentation of both the real and financial global order that follows the fault lines of what US Secretary of the Treasury, Janet Yellen, calls "friend shoring".[8]

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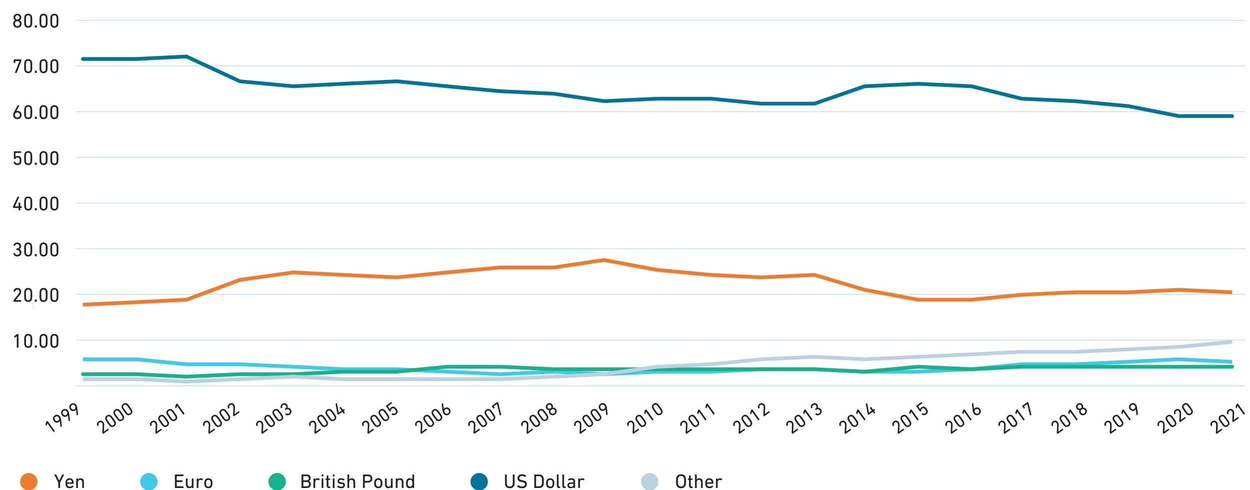
A Slow Decline in USD Dominance Since 2000

The role of USD has been declining for the past two decades, with the USD share of reserve currencies down from 70 percent to 60 percent over that period.[9] (Figure 1.) A detailed analysis of the International Monetary Fund (IMF) Currency Composition of Official Foreign Reserves (COFER) data shows that a quarter of the decline in the USD is a shift into the Chinese renminbi (RMB) and nontraditional reserve currencies. The shift into nontraditional reserves is broad-based and now stands at nearly 10 percent (US$1.2 trillion) of total identified reserves at the end of 2021.[10]

Figure 1: Currency Composition of Global Foreign Exchange Reserves 1999-2021 (as percent)



Sources: IMF Currency Composition of Official Foreign Exchanges Reserve (COFER).
Note: The "other" category contains the Australia dollar, the Canadian dollar, the Chinese renminbi, the Swiss franc and other currencies not separately identified in the COFER survey. China became a COFER reporter between 2015 and 2018.

Two key factors drive this erosion. First is the growing liquidity in many currencies outside the Big Four (US Dollar, Great Britain Pound, Japanese Yen and Euro), which historically did not have deep markets – markets with an abundant supply of investable assets with low transaction costs. However, falling transaction costs — following the advent of electronic trading platforms, automated market making (AMM) and automated liquidity management (ALM) — have deepened these markets, thereby enabling currency reserve managers to comfortably deal in currencies outside the Big Four.

The second factor driving the USD's erosion as a reserve currency is a growing push by reserve currency managers towards active reserve management due to the demarcation of "investment tranche" from "liquidity tranche", the latter being amounts held to meet the worst-case scenario requirement for reserves in a balance of payments crisis. The investment tranche is sizeable. For example, among 55 emerging market economies for which the IMF conducts its reserve adequacy analysis, 30 had excess reserves as of year-end 2017.[11] In these countries, total reserves exceeded the IMF's minimum adequate reserve levels by 58 percent on average, thereby providing a sizeable 'investment tranche'.[12] As this investment tranche is less constrained in both asset class choices and currency risk, non-USD assets can be accommodated in larger shares.

Other changes contributing to the USD's slow erosion as the world's dominant currency are also underway. For example, foreign cargo used to be priced predominantly in USD, but that is changing after the outbreak of war in Ukraine. Russia is now invoicing its commodity exports to "non-friendly" nations in rubles. Saudi Arabia is open to China paying for oil in renminbi. We are starting to see a move away from USD in the invoicing realm.

The decline of the USD's dominance appears already to be set in motion and we expect the forces contributing to this decline to continue. We examine the impact of the war in Ukraine on the speed and magnitude of this trend in the following section.

It is difficult to find true alternatives to USD-denominated reserves given the depth and liquidity of the US financial market and its reliably positive Treasury bond yields.

Do Post-Ukraine Financial Sanctions Represent a Regime Change?

The actions to freeze Russian reserves have raised alarms in global financial markets. Indeed, it has been reported that the Chinese finance ministry had been put on alert and called for risk scenarios.[13] Will the centrality of the USD change dramatically following the deployment of the USD as a weapon in the recent conflict in Ukraine? We think not.

There are three core reasons that the USD will largely retain its dominant position, much to the chagrin of US adversaries.

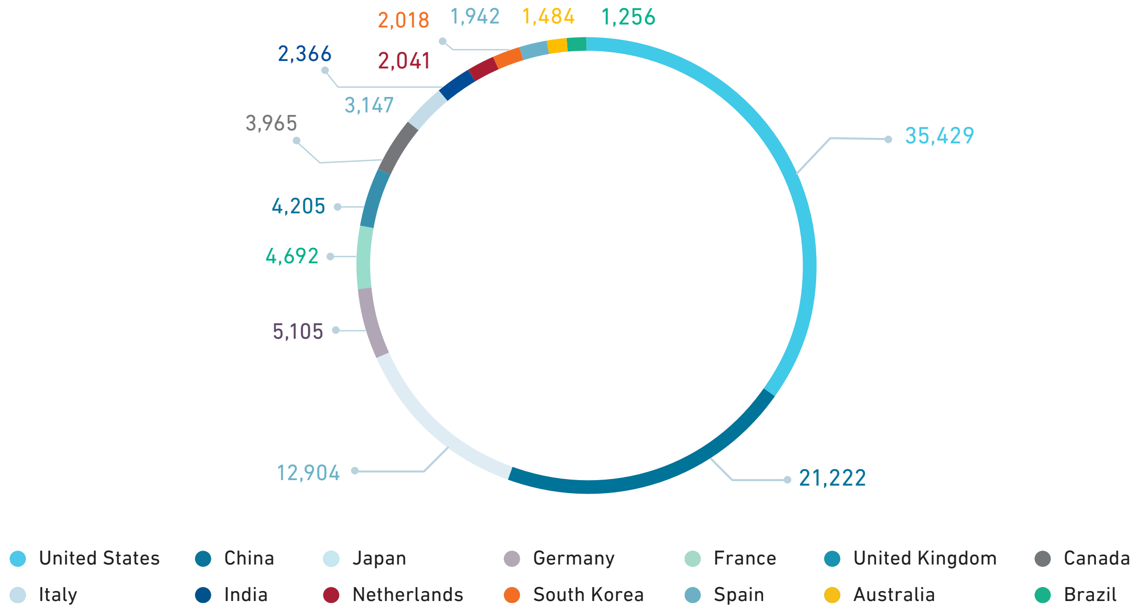
The first is liquidity. It is difficult to find true alternatives to USD-denominated reserves given the depth and liquidity of the US financial market and its reliably positive Treasury bond yields. As depicted in Figure 2, the overall size of bond markets outside of the US alliance system is minimal, making it difficult to realize meaningful diversification.

Second, desirable reserve currencies need to be dependably tradable or convertible into other currencies and backed by governments with robust financial institutions and legal restrictions against unfettered executive power. Markets believe that the USD amply possesses these traits, which makes transitioning to an alternative reserve currency extremely challenging.

Third, the complexity of recreating the whole ecosystem in a different currency renders a regime change unlikely. Indeed, the decline in USD reserves has advanced at a glacial pace, taking more than 22 years to decrease by only 10 percent. It is hard to see a dramatic acceleration in the pace of the USD's decline given the difficulty in disassembling the complex USD ecosystem of trade invoicing, credit, and reserve status.

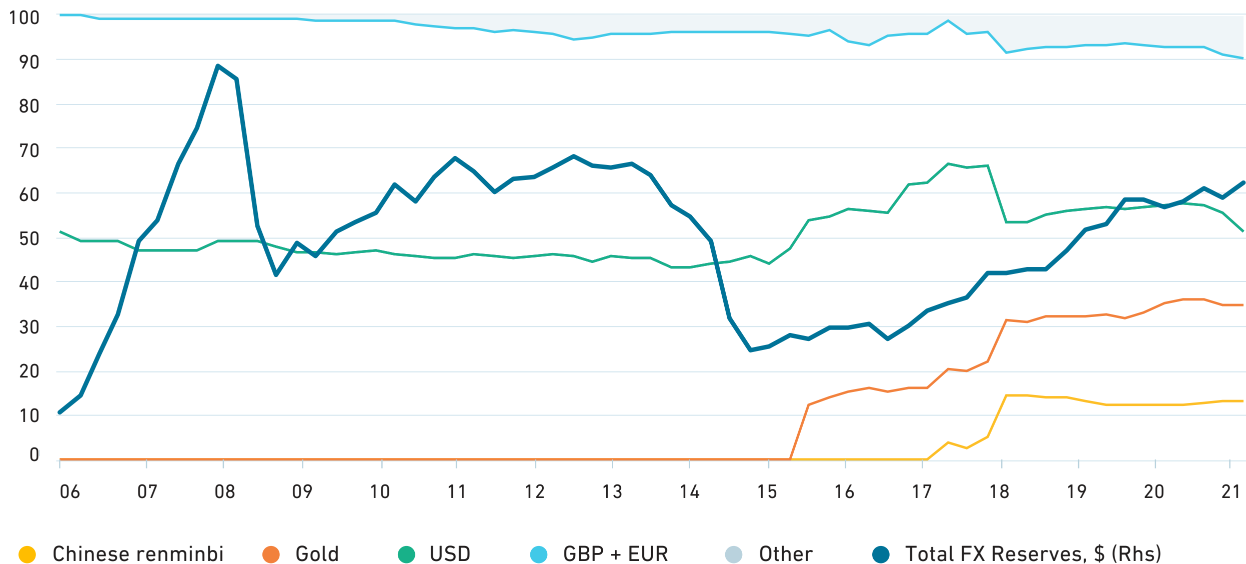
To further illustrate these points and the limits of the impact of the recent Russian sanctions on the USD's hegemony, it is useful to evaluate some possible alternatives to the USD as the world's dominant currency.

Figure 2: Size of Top 14 Bond Markets (US$B)

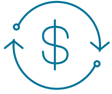


Source: Bloomberg, July 2021

Figure 3: Russian FX Reserve Composition 2006-2022



Source: Russian Central Bank



Are Other G7 Currencies a Viable Alternative to the USD?

As liquidity improves and markets deepen, we see a continuation of the slow 20-year trend diversification into other developed market currencies such as the Australian and Canadian dollars. However, we do not see potential for a meaningful acceleration of the trend away from USD and into other reserve currencies outside the Big Four. The more likely source of an accelerated diversification away from USD is for the euro to regain some of its share in reserve portfolios. The euro reserve share dropped from 27.70 percent in 2009 to just 20.6 percent in 2021. As part of the transition away from the USD, we believe that the euro is increasingly well-positioned to regain much of its lost share for several reasons: reduced fears of an Economic and Monetary Union (EMU) breakup decreases catastrophic euro tail risk; elevated bond issuance to fund fiscal deficits coupled with a reduction in the bond purchases by the European Central Bank increases bond supply available for public purchase; and, finally, improved prospects for euro interest rates to move reliably back into positive territory, will improve expected returns. Overall, the pace of diversification is likely to remain slow as these G7 currencies are unlikely to attract substantial new capital from political opponents of the Western Alliance, given the "reserve-currency-as-weapon" example set by the Russian sanctions.

Could the Chinese Renminbi or Gold Dethrone USD as the Currency of Choice for Reserves?

The Chinese renminbi and gold are definitely more politically acceptable to countries outside the Western Alliance. However, these contenders have their own limitations.

Russia's experience over the last 15 years provides meaningful insights in this regard. During this time period, Russia was determined to reduce exposure to USD and rotated heavily into gold and the Chinese renminbi (Fig. 3). However, neither choice provided the reserve functionality of USD-allied reserves. On one hand, gold reserves are simply not "user-friendly" in large quantities. Gold needs to be stored domestically and requires an international transaction to convert it into foreign currency for payment purposes. In brief, gold performs well on safety but falls short on liquidity.

On the other hand, the Chinese renminbi clearly offers a potential long-term alternative and will likely attract some additional reserves from its political allies in the wake of the Russian sanctions. But Chinese capital markets still do not provide the features required by reserve managers. China's willingness to shut down swaths of its economy, impose or remove capital controls or change the convertibility into non-Chinese assets makes USD-allied assets relatively more attractive. For that reason, even Russia's reserve allocation to Chinese renminbi quickly peaked at about 14.7 percent of reserves.[14] It is our view that the Chinese renminbi's attractiveness as a reserve currency will only grow at a sluggish pace for the foreseeable future.

Can Digital Assets Provide a Globally Attractive Alternative to USD and USD-Allied Reserves?

It is possible that digital assets will emerge that are beyond the reach of geopolitical influence and still mimic features of classical reserves in terms of safety and liquidity.[15] While none of the current blockchain-based crypto-assets or stablecoins yet sufficiently meet those standards, future innovations could deliver a more credible alternative. In fact, Carney's speech highlighted the possibility of a consortium of central bank-backed digital currencies as a potential alternative to the USD. We believe that the origin and design of most digital assets are likely to reinforce – not undermine – the USD's dominance in the medium term. The USD is the primary fiat currency underpinning most stablecoins as they are backed by US Treasury Bills and other low-risk USD-denominated money market instruments. In addition, most of the innovation in the digital finance space is embedded within the US economy, despite the concept of non-territoriality. Thus, it is very difficult to dethrone the USD as the reserve currency of choice.

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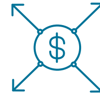

Reserve Reduction as an Option to Reducing USD Dominance

Given the limited options for reserve diversification, the one major potential change in the response to the weaponization of the global financial system could be an overall reduction in official reserves.

Could countries simply liquidate reserves to reduce the effects of the USD's hegemony? We see clear incentives for such a reduction given the limited structural options for diversification. On the surface, it appears that the action of selling off reserve assets to reduce overall reserve levels would likely be a threat to USD dominance. However, the expected impact of such an action on the USD is very difficult to predict, largely because it depends on how and where the former reserves are invested and where imports are sourced. To determine the impact of a general reduction in reserves, it is important to measure the resulting changes in the global web of trade and portfolio flows.[16] However, these changes are impossible to model. Therefore, the impact of a reduction in reserve levels as a way to counter the threat of USD weaponization is highly uncertain.

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Residual Risks to the Current Order

While we do not see a dramatic acceleration of the pace of decline in the USD's dominance, it is critical to consider even modest changes in the context of the current broader slide toward global economic fragmentation along competing political and economic blocs. US Treasury Secretary, Yellen's, "friend shoring" is not new. A 2021 White House Report[17] on "supply chain resilience" forecast resilience strategies for industries such as semiconductor, pharmaceuticals and others. Recent IMF research shows that technology fragmentation alone can lead to losses of nearly five percent of GDP for many countries.[18] Seen in this context, even a modest increase of the pace of fragmentation in the global financial order could amplify the negative impacts from fragmentation of the real economic activities from friend shoring or other forms of de-globalization across industries and technologies.

One clear conclusion from the extraordinary weaponization of the USD in the Ukraine war is that it serves to increase incentives toward financial fragmentation. Although the ability to move away from the current USD-centric system is structurally limited for now, that structure can change over time. The economic costs of such change, particularly when considered alongside the broader effects of global fragmentation, may be very high indeed.

Footnotes

1. A transcript of his speech "The Growing Challenges for Monetary Policy in the Current International Monetary and Financial System" is available at:

   https://www.bankofengland.co.uk/-/media/boe files/speech/2019/the-growing-challenges for-monetary-policy-speech-by-mark-carneypdf?la=en&hash=01A18270247C456901D4043F59D4B79F09B6BFBC

2. "Column: Russia central bank freeze may hasten 'peak' world FX reserves." https://www.reuters.com/markets/europe/russia-central-bank-freeze-may-hasten-peak-world-fx-reserves-mike-dolan-2022-03-02/

3. "Sanctioning Russia Is A Masterstroke That Can Cement The Greenback's Dominant Position In World Affairs." https://worldnewzinfo.com/business/sanctioning-russia-is-a-masterstroke-that-can-cement-the-greenbacks-dominant-position-in-world-affairs/

4. "Financial warfare: will there be a backlash against the dollar?" https://www.ft.com/content/220db8f2-2980-410f-aab8-f471369ac3cf

5. Ibid

6. "Global debt is fast approaching record $300 trillion - IIF." https://www.reuters.com/business/global-debt-is-fast-approaching-record-300-trillion-iif-2021-09-14/

7. "The dollar's international role: An "exorbitant privilege"?" https://www.brookings.edu/blog/ben-bernanke/2016/01/07/the-dollars-international-role-an-exorbitant-privilege-2/

8. "Transcript: US Treasury Secretary Janet Yellen on the next steps for Russia sanctions and `friend-shoring' supply chains." https://www.atlanticcouncil.org/news/transcripts/transcript-us-treasury-secretary-janet-yellen-on-the-next-steps-for-russia-sanctions-and-friend-shoring-supply-chains/

9. Source: IMF, COFER

10. "The Stealth Erosion of Dollar Dominance: Active Diversifiers and the Rise of Nontraditional Reserve Currencies." https://www.imf.org/en/Publications/WP/Issues/2022/03/24/The-Stealth-Erosion-of-Dollar-Dominance-Active-Diversifiers-and-the-Rise-of-Nontraditional-515150

11. "The Stealth Erosion of Dollar Dominance: Active Diversifiers and the Rise of Nontraditional Reserve Currencies." https://www.imf.org/en/Publications/WP/Issues/2022/03/24/The-Stealth-Erosion-of-Dollar-Dominance-Active-Diversifiers-and-the-Rise-of-Nontraditional-515150

12. Hentov, Elliot; Petrov, Alexander; Kyriakopoulou, Danae and Ortlieb, Pierre. "How to Central Banks Invest? Embracing Risk in Official Reserves." https://www.ssga.com/library-content/pdfs/ic/how-do-central-banks-invest.pdf, (2019)

13. "China meets banks to discuss protecting assets from US sanctions." https://www.ft.com/content/45d5fcac-3e6d-420a-ac78-4b439e24b5de

14. "China's Russia Decision." https://www.bloomberg.com/news/newsletters/2022-03-01/what-s-happening-in-the-world-economy-could-china-come-to-russia-s-aid

15. For a related discussion on the digitization of money and central bank digital currencies, see "The Digitization of Money." https://www.statestreet.com/ideas/articles/digitization-of-money-risk-and-opportunities.html

16. For example, China could choose to sell reserve assets and invest locally. The increased investment relative to savings would reduce the current account deficit, likely via increased imports. If all of the increase in imports came from the US, then the demand for USD to purchase imports would offset the sales of USD from liquidating reserves, and the USD would be unaffected. In what is potentially a worst case scenario for the USD, China could opt to sell down only USD reserves and increase imports from Europe and its Asian neighbors. China would sell USD and all of the resulting investment would flow into non-USD currencies via increased import revenue. However, even in this case the impact is unpredictable. The beneficiaries of the increased import revenue may well choose to invest those revenues into US assets, again offsetting USD depreciation from the sale of reserve assets. Of course, the reality is even more complex than this simple example.

17. "Building Resilient Supply Chains, Revitalizing American Manufacturing, And Fostering Broad-Based Growth." https://www.whitehouse.gov/wp-content/uploads/2021/06/100-day-supply-chain-review-report.pdf

18. Georgieva, Kristalina; Gopinath, Gita and Pazarbasioglu, Ceyla. "Why We Must Resist Geoeconomic Fragmentation--And How." https://blogs.imf.org/2022/05/22/why-we-must-resist-geoeconomic-fragmentation-and-how/?utm_medium=email&utm_source=govdelivery

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