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De-dollarisation: Temporary blip, prolonged dip, or inevitable demise?

Anupam Manur

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Summary: The dollar will remain the global reserve currency for a while, though there is increased competition at the margin, especially for trade payment and invoicing.

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Executive Summary

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While there is a gradual shift away from the dollar for trade related purposes and even more gradual shift for reserves, there are no contenders in the foreseeable future that can replace the dollar. The United States has made central banks and investors apprehensive with the weaponisation of the dollar as part of its sanctions strategy, but it remains the most trustworthy and safest asset in the world for investment.

De-dollarisation itself may be an inappropriate and inaccurate term. This paper would prefer terming this as de-monopolisation of the dollar.

With gradual increase in export competitiveness and greater participation in regional trade blocs, India can try in the medium to long-term to persuade countries to accept payment in rupees, as long as those countries find Indian goods attractive and competitive. In the meanwhile, India's approach should be to diversify its forex portfolio and at the same time get into regional trading arrangements that are promoting the use of other currencies and payment mechanisms for trade. However, it should refrain from promoting greater global use of Chinese Renminbi.

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1. Introduction

Signs of de-dollarisation have been emerging in the global economy since the pandemic, though the dollar remains the world's dominant currency. De-dollarisation refers to a process of moving away from the global reliance on one currency (the United States Dollar) as the chief reserve currency.

A reserve currency is a relatively strong and stable currency that is used in international trade and held in large quantities by central banks of either countries as part of its overall foreign exchange reserves.

Money has three important functions — a medium of exchange, a unit of account, and a store of value. Its function as a store of value has seen some movement away from the US dollar. The greenback's share of foreign exchange trading volumes remains close to the record highs of 88 percent and its use in trade invoicing has largely remained unperturbed, it is the share in forex held by central banks that has witnessed near record lows of 58 percent.

Geopolitical developments — Russia's invasion of Ukraine and the resultant sanctions — saw the weaponisation of the dollar and the reserve currency status that has accelerated the desire to move away from the US dollar both for trade and monetary reserves purposes. Discontent over the dollar's unquestioned supremacy is now spreading over Southeast Asia[1], the Middle East[2], and Latin America.[3] It has also become part of the geopolitical strategies of countries. [4]

De-dollarisation has been referred to as both "an economic inevitability" and "political fantasy" by analysts studying the situation.[5] As with most macroeconomic predictions, there seems to be little consensus on the future of the dollar as the reserve currency, the true implications of the current situation, the effect of this on the global financial system or on what form alternative arrangements can emerge.

The dollar's supremacy has been questioned at various points of time since its takeover as the global reserve currency from the British pound. The dollar has been prematurely pronounced as irrelevant a few times in the past.

In this paper, we will examine recent developments towards de-dollarisation, study its extent, understand the best possible explanations for the current situation, and explore the factors driving the process. We will further examine if the Chinese Renminbi (RMB) can play a bigger role as a reserve currency. Finally, the paper will look at the implications of this for India and the possible path forward.

The paper concludes that the term de-dollarisation itself might be inaccurate and prefers the term de-monopolisation of the dollar. While there is a gradual increase in the usage of other currencies for trade invoicing and payments, foreign exchange reserves held by central banks continue to be dominated by the dollar. The overall weight average usage of the dollar is still miles ahead of every other currency and no currency can provide a viable alternative to the dollar, which ensures the continued hegemony of the dollar for the foreseeable future, though there might be competition at the margins. Several factors need to be aligned for the RMB to replace the dollar, which cannot be taken for granted.

2. Is the global economy de-dollarising?

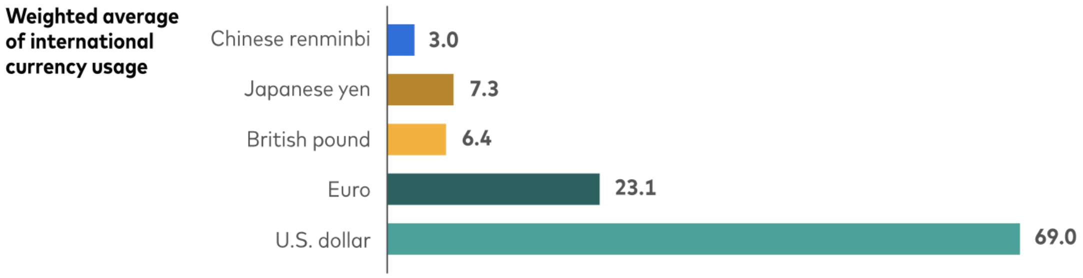
Like the domestic role of money, an international currency plays the role of being a medium of exchange (mode of payment for international trade), a unit of account (invoicing trade and debt denomination) and a store of value (forex reserves). The US dollar performs all these functions in the global economy and has thus gained the status of reserve currency.

A country attempting to de-dollarise will need to reduce its reliance on the US dollar and find alternative arrangements for these three functions.

One analysis (in 2022) of the dollar's dominance in the global economy took the weighted average of the different use cases of currencies, which includes the currencies' share of globally disclosed reserves, forex transactions volume, forex currency debt issuance, foreign currency and international banking claims, and foreign currency and international banking liabilities.[6] Based on this, the dollar's global usage stood at 69 percent, which is more than the sum of all other currencies combined.

The clearest area of dominance of the US dollar is for foreign exchange transactions volume. The forex market is the deepest and highest volume market in the world, with a daily trading volume of nearly $7.5 trillion, of which 88 percent is carried out in dollars.[7]

The U.S. dollar far outpaces rivals as a global currency



Notes: The chart shows how broadly each currency is used across borders, using weighted averages of five metrics: the currency's share of globally disclosed reserves (25% weight), foreign exchange transaction volume (25%), foreign currency debt issuance (25%), foreign currency and international banking claims (12.5%), and foreign currency and international banking liabilities (12.5%). The renminbi is the currency of China and the yuan is the main unit of the currency.

Sources: The U.S. Federal Reserve's calculations using data as of December 31, 2022, from the International Monetary Fund, the Bank of International Settlements, and Refinitiv.

Figure 1: USD is still far ahead (Source: The US Federal Reserve's Calculations)

a. Medium of exchange (Trade payment) and Unit of Account (Trade & debt invoicing)

Increasingly, there have been attempts by countries to get into bilateral and multilateral arrangements to settle trade in local currencies instead of US dollars. According to a Reuters report, "Since then (freezing of Russian forex reserve assets by the US) Saudi Arabia and China have begun talks to settle Chinese oil sales with the yuan, Brazil and China have announced the phase-in of a yuan clearing arrangement for some trade between the two countries while China and Russia are also now doing a significant portion of their trade in yuan".[8]

Though the use of RMB remains small globally, accounting for 2 percent of total cross-border transactions, there are some interesting developments. China is increasingly using its own currency for settling about half of its cross-border trade and investment transactions.[9] Other countries are increasingly using the RMB to pay for their trade with China. An IMF paper finds that for a sample of 125 economies, the median usage of RMB in cross-border payments with China increased from 0 percent in 2014 to 20 percent in 2021.[10]

There are also some isolated incidents of third-party payments through the RMB — Indian oil refineries using Yuan[11] to pay for Russian oil and Argentina paying off[12] some of its IMF debt using Yuan. Currently, third party transactions involving the Chinese Yuan are infrequent, but are worth watching in the coming years.

By forcing countries to pay in Rubles, Russia indirectly forced countries to accept Rubles as payment for their exports. Since Russia did not have access to dollars, they could pay for their imports with their own currency in this way.

Russia, following the financial sanctions imposed by the US and western Europe after its invasion of Ukraine, could not settle its trade obligations using USD or Euros. The freezing of its central bank assets and removing it from the SWIFT interbank communication system forced it to adopt other strategies, including settling nearly two-thirds of its trade and investment activities with China in RMB and Rubles.[13] In March 2022, Putin forced all "unfriendly" countries to pay for Russian gas in Rubles only.

After months of negotiations between Russia and India to revive the Soviet era Rupee-Ruble trade arrangement, it did not gain much traction and talks were suspended in May 2023, which is quite indicative of most alternative local currency trade arrangements (See Box 1).

BOX 1: The problem with Rupee-Ruble Trade

First, When the trade balance between two countries is skewed towards one side (Russia exports more to India than the other way round), they end up amassing significant surpluses of the other country's currency (rupees). Since not many other countries will accept these local currencies as payment, the country with the surplus (Russia) is forced to redirect its imports from or make more investments in the country with the trade deficit. Quite simply, when India paid for oil imports with rupees, Russia did not know what to do with the excess rupees.

Second, western sanctions on Russia deterred Indian banks from doing business with Russian counterparts. Given that Indian banks are deeply entangled with global financial system, especially SWIFT, they were cautious about clearing payments with Russia, though there was a special Rupee Vostro account set up for the purpose.

Third, the lack of a direct currency exchange rate has made trade difficult. Both countries have ended up with a double currency solution – rupee to dollars and then converted to Rubles and vice versa – which makes it more expensive and increases vulnerability to exchange rate risk.

The ASEAN countries have been exploring ways to increase local currency trade and agreed to implement such a framework in the ASEAN summit in May 2023. Thailand, Malaysia and Indonesia are part of the Local Currency Settlement Framework to promote the wider use of local currencies to facilitate trade and investment in these countries.[14] Since it is relatively new (since 2018 with all three countries), it is a bit early to assess its success.

The least convincing attempt, perhaps, is by the BRICS countries with an expanded membership. The BRICS summit held in August 2023 proposed to promote local currencies for trade, including the potential birth of a BRICS currency. Some institutional mechanisms, such as BRICS Interbank Cooperation Mechanism (to facilitate cross-border payments in local currencies among banks in the group) and BRICS Pay (a digital payment platform in local currencies) have been slowly put in place.[15]

In July 2023, the Reserve Bank of India (RBI) permitted 20 banks operating in the country to open 92 Special Rupee Vostro Accounts (SRVAs) of partner banks from 22 countries as part of efforts to promote bilateral trade in local currencies. The 22 countries include Bangladesh, Belarus, Botswana, Fiji, Germany, Guyana, Israel, Kazakhstan, Kenya, Malaysia, Maldives, Mauritius, Myanmar, New Zealand, Oman, Russia, Seychelles, Singapore, Sri Lanka, Tanzania, Uganda, and the United Kingdom. As analysed earlier, this is too early to judge the success of these initiatives.

The Maldivian government in May 2024 announced that both India and China have agreed to accept payments in their respective local currencies.[16] Maldives imports roughly USD 780 million and USD 720 million from India and China respectively and the payment for this hereon will be done via Rupees and Renminbi respectively. The challenge for Maldives will be to amass adequate reserves of these currencies as well, which is where tourism from the two countries becomes an important avenue.

The current reality: While there are a lot of announcements to move away from the use of dollars for trade, the current reality is one which is still heavily dominated by the US dollar.[17] "Indeed, data from 2022 indicated that the dollar was on one side of the trade for over 97 percent, 95 percent, 94 percent, and 88 percent of Indian rupee, Brazilian Real, Chinese Renminbi, and South African Rand foreign exchange transactions, respectively." Similarly, the dollar was on one side of the trade for nearly 90 percent of global transactions.

The main reason for the continued persistence of the dollar is simply the higher liquidity and lower transaction costs. In many instances, there is no well-established market for emerging market currency pairs, which ultimately requires dollar intermediation. Even in cases where countries trade in local currencies, they will need to exchange it for dollars to be able to use it with other countries who are not part of this arrangement. Refer to Box 1 to understand how the Rupee-Ruble trading arrangement broke down.

This explains why dollars are preferred to local currencies in emerging market trade payments and for trade invoicing. For instance, Sauradeep Bag in ORF notes that, "86 percent of India's imports rely on the US dollar invoicing, despite only 5 percent of 'India's imports originating in the US.[18] Similarly, 86 percent of India's exports were invoiced in US dollars, while only 15 percent of India's exports were to the US". Similarly, for China, Brazil and South Africa, a disproportionate amount of trade is invoiced in dollars compared to the amount of trade with the United States.

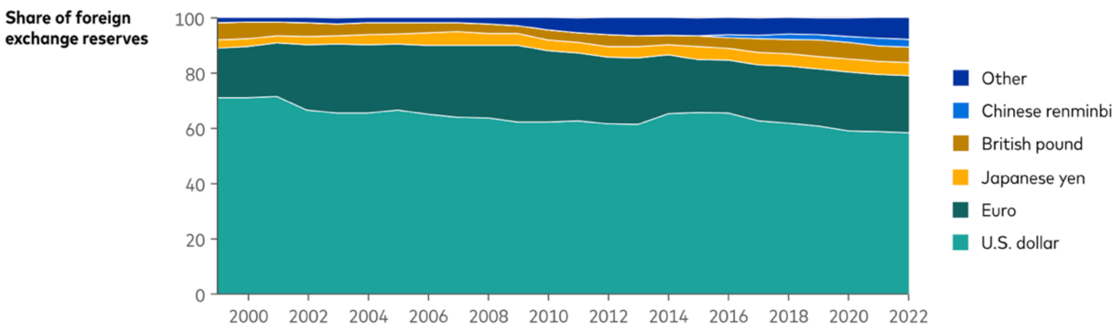
Key global commodities such as gold and crude oil are priced in dollars. Moreover, most of the debt issued in the international capital markets are issued and accounted for in dollars. Even debt that has nothing to do with the United States is denominated in dollars. According to one statistic, 88 percent of USD-denominated debt has neither a US-domiciled issuer nor borrower.[19] "Debt, which after all, is bought and sold on the secondary market by investors just like any other international commodity, is being price-indexed to a universally accepted benchmark".

Though the US dollar has not been replaced by any single currency for the purpose of trade, its market power in these use cases have been reduced. Therefore, it would be prudent to term this phenomenon as de-monopolisation of the dollar instead of de-dollarisation.

b. Central Banks holding dollars as forex reserves

Central banks have been gradually reducing their dollar holdings over the past couple of decades. USD as a share of forex reserves reached a 20-year low in late 2022 at 58 percent from a high of about 85 percent in the 1970s. The Euro, at around 20 percent of global reserves, is in second place. The rest of the decline is compensated by increases in holding of non-traditional reserve currencies, such as the Australian Dollar, Canadian Dollar, Swedish Krona and South Korean Won. The share of the Chinese Renminbi also rose.

Decline in share of U.S dollar reserves attributed to globalization



Note: The "Other" category refers to a basket of currencies dominated by the Canadian dollar, the Australian dollar, and the South Korean won.

Sources: The U.S. Federal Reserve and the International Monetary Fund. Data are as of December 31, 2022.

Figure 2: Showing the currency holdings of central banks (Source: The US Federal Reserve and the International Monetary Fund)

Central banks are also turning to gold as a safe haven and an alternative to the dollar. Central banks accounted for as much as 33 percent of monthly global demand for gold, which in turn caused sharp increases in the price of gold. In 2022, central banks purchased a record amount of gold of 1089 tons, the most since records began in the 1950s.[20] Gold held by central banks in developing countries has grown by 52 percent over the past decade to reach 338 million tonnes last year, according to IMF figures.

To note, the angst over the dollar's status, the calls for moving away from the dollar, or the actual reduced role of the dollar in the global economy is not entirely a new phenomenon. If we look at the trends, the share of dollars in global reserves was as high as 85 percent in the 1970s, which fell drastically to 58 percent by the 1980s and further plummeted to below 50 percent in the early 1990s, only to recover to 71 percent by the late 1990s and then gradually decline to the present levels (59 percent) in the 2020s.[21]

Despite all of this, note that the US dollar held as reserves is higher than all the other currencies combined.

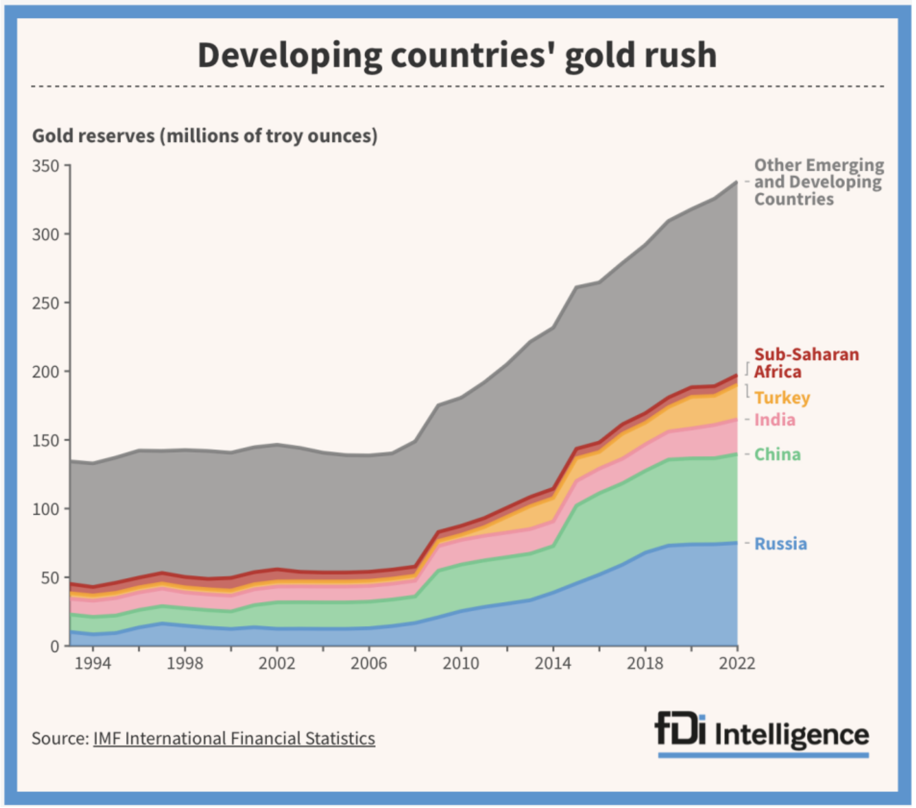


Figure 3: Showing the gold holdings by central banks of developing countries. (Source: [FDI Intelligence])

BOX 2: What makes for a good reserve currency

Necessary Conditions: The reserve currency needs to be:

- Stable and safe
- A store of value and medium of exchange
- Widely accepted and trusted.

Sufficient conditions: In addition, other important politico-economic conditions include:

- The stability of the political system of the issuing country
- The size and prospects of the economy
- Global integration of its markets and economy
- A transparent and open economic system
- A credible legal system
- The quality of its sovereign debt
- The ability to bear costs associated with a reserve currency
- The size, depth and liquidity of financial markets

Many other currencies do not qualify as they are either too small (Switzerland), operate under totalitarian regimes (Russia and China), or allow for protectionism (India). Finally, a reserve currency needs to be market-based, free-floating and, most important, stable. That rules out cryptocurrencies, which are prone to wild swings and live outside the regulatory system.

3. De-dollarisation: Drivers and Deterrents

a. What is driving de-dollarisation

In this section, we will look at the different factors driving de-dollarisation, namely the weaponisation of the dollar by the US, disproportionate importance of the dollar, geoeconomics imbalance, new technological advancements, increasing interest rates and the appreciation of the greenback. These factors are a mix of both strategic geopolitical considerations and pure economic efficiency considerations. The former may turn out to be part of a longer-term trend, while the latter is subject to economic cycles.

1. **The Russia episode as the immediate trigger**: As shown earlier, the process of reducing the dollar's significance in the global economy has been occurring for a while, the more immediate trigger was the weaponisation of the US dollar, following Russia's invasion of Ukraine. The freezing of Russian Central Bank's assets, kicking Russian banks out of the SWIFT system, and a range of financial sanctions have effectively raised the risk profile of holding dollars. For the first time since the closing of the gold window by Nixon in 1971 countries are apprehensive about holding US dollars.

Even before Russia, nearly 30 percent of all countries faced sanctions from the US, EU, Japan, and the UK, up from 10 percent in the 1990s. Then, the Russian episode sent alarm bells to countries holding dollars and created a sense of urgency to diversify their holdings. "Suddenly, it was clear that any nation could be a target," Ruchir Sharma wrote in an article for FT.[22] Even old US allies, such as the Philippines and Thailand are cutting deals to trade without the dollar.

The closing of the gold window in 1971 by the Nixon administration officially marked the end of the Bretton Woods arrangement. The Bretton Woods conference in 1944, which was responsible for establishing the World Bank (called as the International Bank for Reconstruction and Development then) and the International Monetary Fund, also established a global system of monetary management and fixed currency exchange regime. In the post war period, the US dollar had the highest purchasing power and the US had the largest gold supply, as highly indebted European nations had transferred large amounts of gold to the US. This made the US dollar the dominant currency and automatic choice for the role of global reserve currency. Under this system, all currencies were required to peg their value to the United States dollar, which in turn was pegged to gold at $35 per troy ounce of gold. This meant that all currencies could be freely exchanged with the US dollar or gold at predetermined exchange rates.

Countries have taken note of this explicitly and have made deliberate attempts to reduce their exposure to the dollar and US backed financial transactions systems. In August 2023, the South African president expressed concerns that "global financial and payment systems are increasingly being used as instruments of geopolitical contestation".[23] A report by the Reserve Bank of India's Inter-Departmental Group on Internationalisation of INR has stated that India should explore alternatives to the US dollar and the Euro as having strong foreign exchange reserves may not be a sufficient defence against the threat of sanctions in an increasingly polarised world.[24] The more obvious notes of dissent have come from China, Russia and Iran.

2. **Disproportionate role of the dollar or shrinking economic share of the US**: There is also an anachronism and an asymmetry at play with the role of the United States as the geopolitical leader of the world and the role of the dollar as the currency supreme. The share of the US in global GDP has halved to about 20 percent since the World War II and yet accounts for about two-thirds of all financial currency transactions. Simply put, the US dollar's shares in international foreign reserves, global trade invoicing, international debt securities and cross-border loans are many times greater than its share of GDP and international trade.

However, the 1960s saw higher inflation rates in the US compared to the rest of the world, which devalued the US dollar. There was a spike in gold prices (or depreciation of nominal dollar value) due to various geopolitical events (the Cuban missile crisis and other cold war events). There was a run on the British pound and the US dollar in the late 1960s and the peg to gold was no longer tenable. In 1971, President Nixon devalued the dollar relative to gold and when that led to a run on the gold reserves, he declared a suspension of dollar's convertibility to gold.

There was a run on the British pound and the US dollar in the late 1960s and the peg to gold was no longer tenable. In 1971, President Nixon devalued the dollar relative to gold and when that led to a run on the gold reserves, he declared a suspension of dollar's convertibility to gold.

3. **Interest rate changes:** Perhaps the most important reason for countries moving away (temporarily?) from the dollar is the US facing high levels of inflation and the Fed setting high rates of interest correspondingly. To curb the highest inflation that the US had witnessed since the Volcker era in the 1980s, the Federal Reserve raised rates nine times in a row between March 2022 and April 2023. This has led to geoeconomic imbalance and resentment, increased borrowing costs, and a dollar shortage, which are all intimately linked with each other.

Measured against a standard basket of currencies, the dollar's value jumped nearly 20% from right before the start of the Russian invasion to its peak in October 2022. Though it has dropped since then, it remains about 10% above the pre-invasion average. The appreciation of the dollar is triggered by both global uncertainty and increasing interest rates in the US.

The inflation rate in the US in the 1980s peaked at 14% and in response, the key policy rate of the Federal Reserve peaked at 20%. An extremely complex and interrelated set of factors led to this macroeconomic episode, which is referred to as the "Great Inflation", which stretches roughly from 1965 to 1982. This involved huge war expenditure in Vietnam, the quadrupling of oil prices by the OPEC countries (which itself was a reaction to US inflation, the closing of the gold window and a response to the Yom-Kippur war), the breakdown of the Bretton Woods foreign exchange system and the devaluation of the dollar, which made imports expensive, and a general expansionary fiscal (election time big social security programmes) and monetary policy.

In 1979, Paul Volcker was appointed as the Federal Reserve Chairman and was tasked with bringing inflation under control. His approach was an aggressive increase in interest rates and controlling the money supply, despite its effect on the real economy. The result was the peaking of policy rate at 20 percent, an induced recession, unemployment crossing 10 percent and inflation finally reducing to single digit levels.

In this scenario, investors turned to the safe asset of dollar denominated debt. This leads to a further appreciation of the US dollar and allows the US to import products cheaply. This exorbitant dollar privilege has been a point of resentment in developing countries, where the excess capital exits to reach American shores. Countries are keen to reduce their exposure to the monetary policy setting agenda of the US Fed, which makes decisions solely based on domestic conditions. The taper tantrum episodes of 2013 are still fresh in the minds of countries. The Fed's approach is largely that of "The dollar is our currency, but it's your problem."

A change in Fed rate hikes can have serious implications for developing countries, whose dollar denominated debt can suddenly become unserviceable, as Sri Lanka experienced.

The taper tantrum episode refers to a period where an announcement by the Federal Reserve chairman Ben Bernanke about decreasing its rate of bond purchases led to a global asset sell-off. In response to the global financial crisis of 2007-08, the Federal Reserve started a large-scale bond buying programme, known as quantitative easing, to infuse liquidity into the system. In 2013, when the economy started recovering, Ben Bernanke announced to Congress that the Fed will start tapering its bond purchases, if the economy continues to improve. The potential reduced liquidity started a panic among global investors and this triggered a large-scale sell-off in both bond and stock markets. The worst-hit victims were emerging markets, which witnessed large scale capital outflows as investors exited riskier markets. These emerging markets faced sharp devaluations of their currency, reduction in foreign exchange reserves, debt value appreciation and forced interest rate hikes. This highlighted the global dominance of US monetary policy and the vulnerability of other countries' economies to the US policy regime.

Cost of capital and dollar liquidity: Due to the reasons mentioned above, the relative cost of capital has changed. For the first time in 20 years, it is cheaper to borrow short term in RMB compared to USD. One Year T-bill rates indicate that borrowing in RMB is 2% points cheaper than USD. Firms that are largely dealing with China have a clear incentive to switch to RMB based trade financing. China's inflation remained largely under control during this period, which meant that PBoC could keep rates unchanged. This flip in relative cost of borrowing happened independently, but around the same time as the Russian invasion. Some part of the switch away from dollar was disproportionately attributed to the sanctions, while the interest rate factor was underestimated.

Niels Graham and Hung gives a wonderful explanation of the importance of trade financing and how that might have tilted the scale away from USD: "It's important to understand the integral role trade finance plays in facilitating global commerce. Payments are not made instantaneously; there is a gap from the time firms receive payments for the goods they ship and when they need to pay suppliers for those same goods. Firms often turn to banks to provide loans to help bridge the gaps. Because of this, firms seeking to minimize financing costs pay close attention to the relative cost of capital and available dollar liquidity. Rate hikes by the US Federal Reserve (Fed), which coincidentally began to take full effect in the months after Russia's invasion of Ukraine, have caused borrowing in dollars to become more expensive and scarcer, encouraging emerging market firms to seek dollar alternatives—namely the RMB". (Read more: Atlantic Council: https://www.atlanticcouncil.org/blogs/econographics/sinographs/dedollarization-is-not-just-geopolitics-economic-fundamentals-matter/)

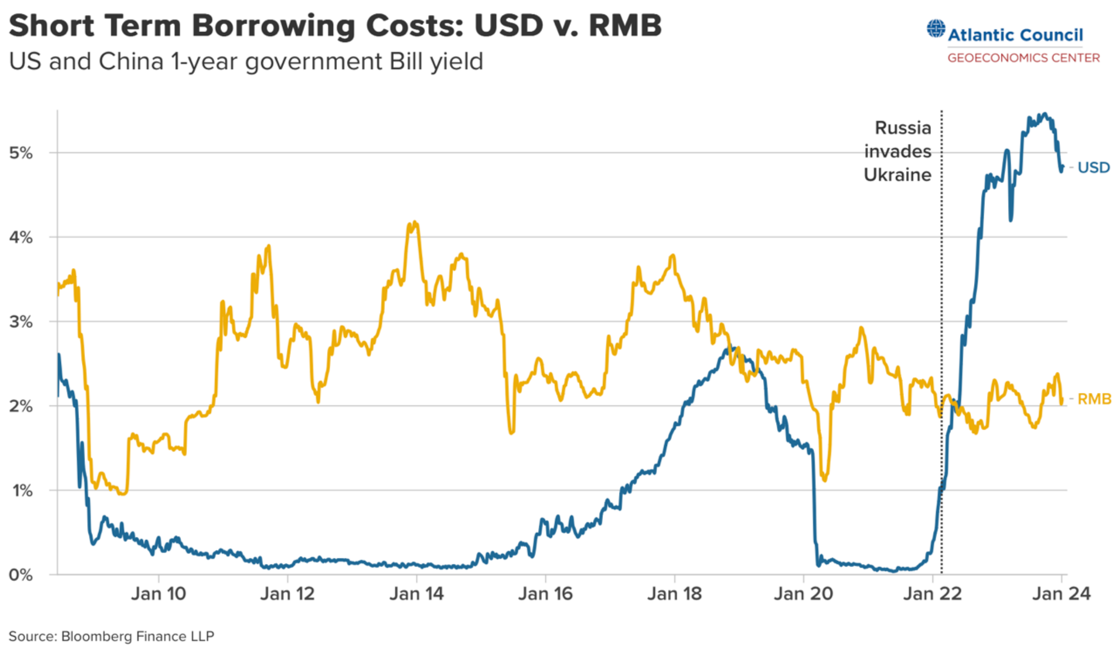


Figure 4: The sharp rise in the relative borrowing cost in USD compared to RMB (Source: Atlantic Council; Bloomberg Finance LLP).

b. Deterrents: Factors safeguarding the dollar's position

The main argument against de-dollarisation is TINA (There is no alternative). Former US Treasury secretary Lawrence Summers sums it up rather well: "Europe is a museum, Japan is a nursing home, and China is a jail." Summers' obvious bias aside, despite all the reasons for moving away from the dollar, that move has been glacial — the most inroads have been made by the Euro over a 20-year period.

The reason for this is the unique characteristics of an economy that can provide a reserve currency. Most importantly, a reserve currency country needs to have the ability and willingness to run a permanent current account deficit, just as the United States has for all these years, to issue enough of the liabilities held by non-residents as a counterpart.

In brief, the US exchanges the stability of the dollar for cheaper imports of goods and services from the world. Big trading partners, which run trade surpluses, get to hold a currency that is sounder than their own. See Box 3 for an exploration of this phenomenon.

BOX 3: The Triffin Paradox (dilemma)

By agreeing to have the dollar as a global reserve currency, there is an onus on the US to supply the world with adequate amount of currency. This is achieved by issuing government bonds, which are bought by investors and central banks around the world, which translates to providing low-interest loans to the US. This would imply a capital account surplus, which has to be balanced by a current account deficit, as the Balance of Payments always balances.

The demand for US debt benefits U.S. companies and consumers through liquidity and stability of their currency. It also decreases the borrowing rates compared to the rest of the world. According to one estimate, this can amount to about "1% in interest rate savings, which—multiplied by the roughly $8 trillion of U.S. Treasuries held overseas—translates to about $80 billion in annual savings for the U.S. government in interest payments".

To see this play out practically, issuing currency drives domestic inflation and together with the demand for dollar-denominated debt causes the dollar to appreciate in value relative to its trading partners. The increase in exchange rate makes imports cheaper and exports more expensive and therefore, uncompetitive. This causes a trade deficit for the country with a reserve currency. The US has run a trade deficit annually for almost every year after the breakdown of the Gold exchange standard in 1971 (except 1975).

The dilemma or paradox here is the position of the US policy makers, where they have to make a trade-off between the near interest free loans they get from the rest of the world and having the fiscal and monetary policy autonomy to ensure competitiveness of their domestic exporting industries.

To overcome this seeming dilemma between short-term domestic and long-term international considerations of the country issuing the reserve currency, attempts have been made to issue a global reserve currency, such as the IMF's Special Drawing Rights (SDR). While central banks do hold some SDRs as part of their reserve holdings, it is nowhere close to replacing the dollar.

Another non-trivial issue is the attractiveness of the US financial markets, which is highly deep, liquid and sophisticated. The liquidity and stability of these markets create a strong network effect, making the US dollar indispensable for global financial transactions.

Finally, one of the biggest reasons for the continued dominance of the US dollar is the trust and confidence in the US political and economic systems.

The US is a democracy with strong institutions and a big military that can guard the economic system — the probability of a sudden decline in the dollar's value due to political manoeuvres or of external threats is quite low. The freezing of the Russian central bank's assets was the first move to dent this confidence in the safety and stability of holding assets in US dollars. In the event of another Trump presidency and weakening of global institutional mechanisms (further sanctions and weaponisation of the US dollar) can give an impetus to the de-monopolisation of the US dollar.

c. Can the Renminbi replace the USD?

Though there has been a lot of excitement about the increased use of Chinese Yuan for trade and reserves, the numbers betray the magnitude of difference between the two currencies. According to the COFER data for 2022, the renminbi occupies only 2.7% of global reserves. If we remove Russia, given the exceptional circumstances the country faces, the number falls further to 1.6%.

The slightly more impressive movements have been made in using the Renminbi as a vehicle for conducting trade and for borrowing. In late 2023, China and Saudi Arabia agreed to a currency swap agreement. Although the amount could be used to settle trade neither of the two central banks has disclosed if the settlement of payment has happened in Renminbi so far.

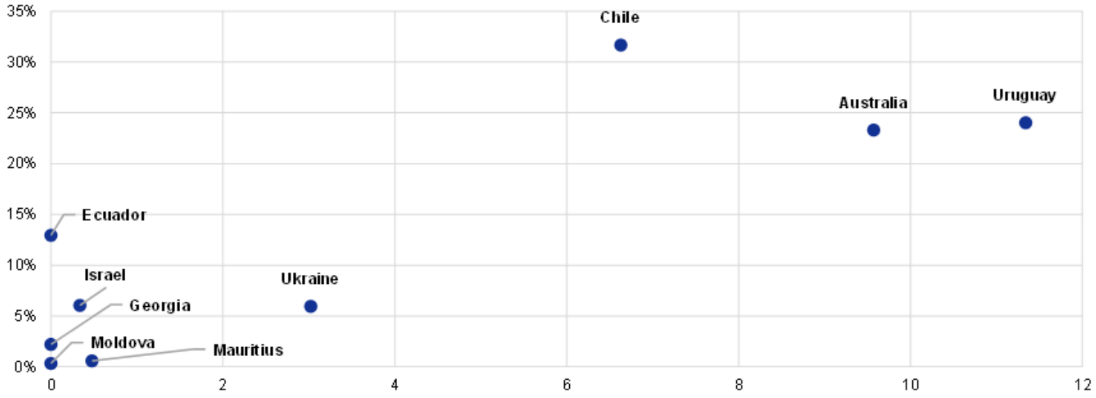
Global payment systems using RMB nearly doubled in 2023, albeit from a low base of 1.91 percent at the start of 2023 to 4.61 percent in November 2023.[25] Though nearly 80% of RMB usage outside China takes place in Hong Kong. For China itself though, about half of its bilateral cross-border payment and investment transactions are now settled in RMB, reducing its vulnerability to US financial sanctions. Confining to cross-border trade transactions, about 24% of it is settled in RMB. Analysis demonstrates that countries that trade more with China hold more RMB as reserves, as shown in Figure 5 below.[26]

Importantly, geopolitical and macroeconomic trends are also giving a fillip to the internationalisation of the RMB. China tried to use the Belt and Road initiative as a way to internationalise its currency. Particularly, it has increasingly switched to denominating the long-term financing and debt in RMB instead of dollars. Initially, when the borrowing cost of dollars was low, countries insisted on dollar denominated debt, but as that has flipped, more countries are ready to accept RMB-denominated debt. By 2020 loans in the Chinese currency overtook dollar denominated debt.

Countries that trade more with China hold more renminbi reserves

Reserves-to-imports coverage – country-level evidence

(*y*-axis: percentages; *x*-axis: months)



Source: Eichengreen, B., Macaire, C., Mehl, A., Monnet, E. and Naef, A. (2022), "Is capital account convertibility required for the renminbi to acquire reserve currency status?", *CEPR Working Paper*, No DP17498.
Notes: The chart plots the share of bilateral imports from China on the *y*-axis against the ratio of reserves held in renminbi to months of imports invoiced in renminbi on the *x*-axis for selected economies for which data on both variables are available in 2019.

Figure 5: Showing the relationship between trade and reserves (Source: CEPR Working Paper, 2022)

According to Eswar Prasad, China is "promoting the international use of its currency" by:

- Permitting the settlement of trade transactions with the renminbi;
- Easing restrictions on cross-border remittances of the renminbi for settlement;

- Allowing the issuance of renminbi-denominated bonds ("dim-sum" bonds) in Hong Kong and by foreigners in the mainland;
- Permitting selected banks to offer offshore renminbi deposit accounts;
- Setting up local currency bilateral swap lines with other central banks.[27]

In 2015, amid a massive outflow of capital, Chinese officials clamped down on residential outflows with zeal. (Read more: Bloomberg News https://www.bloomberg.com/news/articles/2016-01-27/here-s-what-china-is-doing-to-tighten-the-noose-on-capital-flows)

Despite these gains, widespread adoption of RMB is still some time away. The very reasons that work for the dollar work against the RMB. The deterrents for the use of RMB are:

1. **Capital Account Convertibility and Flexible Exchange Rate**: For a country's currency to have reserve status, the currency must be fully convertible in the capital account. This would allow any investor in that country to be able to quickly convert their RMB holdings into any other currency for whatever purpose. China, like most countries, allows for current account convertibility — exchanging RMB for trade purposes. However, China does not allow the RMB to be convertible for financial transaction purposes.

Like many other developing countries, including India, that do not allow for capital account convertibility (CAC), China is afraid of sudden flights of capital that can destabilise the domestic financial sector and cause exchange rate volatility. The experience of the Asian financial crisis of 1997 is still fresh in the minds of most developing countries.

Allowing for CAC would also require China to let go of some of its control over the exchange rate, so that it has far more control over domestic interest rates. Currently, China still has a tightly managed exchange rate, which will become increasingly hard to manage as the capital account becomes more open.

Also, significantly, CAC would require China to remove "many domestic financial controls—measures it relies on for a variety of economic and political purposes, including maintaining a repressed financial system and an undervalued exchange rate".[28]

Without full capital account convertibility, investors will not be willing to hold on to Chinese liabilities, as they will not have the assurance that they can exit at any time they want. Being locked into financial markets is a scary scenario for investors. Central banks would also be similarly averse to holding Chinese bonds without CAC.

2. **Current Account Surplus**: As mentioned earlier, countries with a reserve currency almost necessarily need to run large current account deficits, so that they have a capital account surplus. China, however, has based its entire growth model for the last 40 years on exports and having current surpluses. Though it is structurally trying to change this and rely more on domestic

consumption, this will not happen overnight. As long as China remains a factory to the world, its current account surplus will stay.

3. **Capital markets strengthening**: China would need to integrate its capital markets with the rest of the world, which would have implications for its state-owned banking system and the way that the financial system is set up to favour state enterprises.

It is important for a country that is aiming for reserve currency status to have deep, liquid, and broad financial markets with a variety of sophisticated financial assets denominated in RMB that are available for international investors. China's financial markets are still shallow and underdeveloped. The corporate and government bond market, and other derivative and securities markets are nascent and prone to excessive government interference.

4. **Institutional design and trust**: While a lot more nebulous, an equally important deterrent in the widespread adoption of RMB as the reserve currency is the lack of trust in the Chinese institutions and political systems. There is first the issue of privacy and surveillance. Firms that hold RMB or RMB-denominated assets are operating under the direct oversight of the Chinese government, whose interests may not always align with their own. Chinese legal systems also will cause pause to investors. As Chinese President Xi Jinping has centralised authority, the Chinese system has become increasingly opaque and volatile, offering little protection or recourse for

firms who are harmed by central government actions. “Foreign investors must consider the possibility that Chinese financial assets may become at once illiquid and non-convertible if Xi determines that China’s economic stability is threatened by capital outflows”, as noted by Daniel McDowell of Georgetown University.[29]

d. De-dollarisation and its interplay with other trends

De-dollarisation and Climate Change: There will be two opposite effects of de-dollarisation on climate change. First, as the international seigniorage power of the US is reduced, their need to run huge current deficits will also diminish. Therefore, American consumerism might not be required to run the world economy as much. This may have marginal positive effects on climate change. Second, de-dollarisation, along with the breakdown of WTO and the international trading order, might lead to further fragmentation of the world economy. In this scenario, it will be difficult to coordinate global efforts towards reducing climate change.

De-dollarisation and the information age: Can cryptocurrencies replace the US dollar as a global currency? Economists mostly remain sceptical of the possibility of cryptocurrencies being used widely for international trade, let alone as a reserve currency. Cryptocurrencies are notoriously volatile and are unregulated, which makes it untenable as a reserve currency. One of the known solutions to the volatility of cryptocurrencies is to use stablecoins, which are linked at par to the US dollar.

The more interesting question is whether the rise of Central Bank Digital Currencies (CBDCs) can potentially threaten the role of the US dollar. The advantage of CBDCs would be to decrease transaction costs, improve speed and overall user experience. In this case, however, the CBDC would be merely replacing the currency that it represents. A CBDC by itself cannot provide the advantages that the US dollar does (deep and liquid markets, safe assets, and so on). The current popularity of the dollar is not based on technological lines.

The other possibility is the emergence of a network of interoperable CBDCs, which can replace the dollar as an intermediary currency. In this case, there can be a shift from the use of payment mechanisms like SWIFT and at the margin may reduce the requirement of dollars for conducting international trade. Though a single CBDC may not emerge as the winner, the usual contenders may all gain a bit more market share.

China's CBDC may again suffer from the same problems as its physical currency — lack of trust, lack of safe assets, high government intervention and possibility of surveillance, and illiquid markets. At best, the digital Yuan will replace the physical Yuan. However, neither China's nor other CBDC may find a place quickly in the balance sheets of central banks.

4. Concluding Assessment and India's Options

While there is a gradual shift away from the dollar for trade related purposes and even more gradual shift for reserves, there are no contenders in the foreseeable future that can replace the dollar. The United States has made central banks and investors apprehensive with the weaponisation of the dollar as part of its sanctions strategy, but for better or for worse, it remains the most trustworthy and safest asset in the world for investment.

One of the biggest reasons for the shift away from the dollar to the Chinese Yuan is based on the relative cost of borrowing due to higher inflation and rising interest rates in the US. Crucially, however, this is a temporary phenomenon which is bound to change when inflation is brought under control in the US. Over the medium to long-run, China's inflation rate is bound to be higher than that of the US. That will shift the advantage back to the dollar.

While burgeoning local currency trade invoicing and payment systems will eat a bit into the dollar's share, this will be limited to the participating countries and still cannot replace the dollar as the reserve currency.

The depth and liquidity of US financial markets, the strength of its political, legal and economic institutions, full capital account convertibility and the ability to run large trade deficits are unique advantages that the US has enjoyed for over half a century, and which cannot be replaced by other countries, especially China.

Thus, de-dollarisation itself may be an inappropriate and inaccurate term. Some have called it "slow and bounded de-dollarisation". However, this paper would prefer terming this as de-monopolisation of the dollar. The current global scenario is introducing a bit of competition to the dollar at the margins.

For India, its own attempts at internationalisation of the rupee are floundering with a few hits and misses. The RBI governor is clear that their attempts at a global rupee is not meant to replace the dollar but complement it.[30] Despite India pushing for oil trade in rupees, no oil imports were settled using INR in 2022-23, as its trading partners are reluctant to accept rupees due to the high transaction costs, forex risk and limited acceptability of the rupee. This is the same story with Russia, as has been highlighted before.

With gradual export competitiveness and greater participation in regional trade blocs, India can try in the medium to long-term to persuade countries to accept payment in rupees, as long as those countries find Indian goods attractive and competitive. In the meanwhile, India's approach should be to diversify its forex portfolio (increase share of gold, Yen, Pound, Euro and currencies of other countries) and at the same time get into regional trading arrangements that are promoting the use of other currencies and payment mechanisms for trade.

Unfortunately, the international currency maintained by the IMF - the Special Drawing Rights - has never been a true alternative as a global reserve currency and India does not particularly gain in using it for trade purposes, as it has problems of liquidity and depth. SDRs are almost exclusively used for debt purposes with the IMF as the counterparty.

For instance, India has started currency swap arrangements with Japan to settle trade in Yen, instead of dollars. Similarly, India can be part of the Asian Clearing Union and settle trade within the Indo-Pacific region in Australian Dollars or Japanese Yen.

Despite this, some form of diversification from the dollar has benefits for India. It can increase economic stability and make it less vulnerable to US monetary policy decisions. Therefore, India can look at a combination of holding other major currencies along with the US dollar.

However, the most important short-term consideration for India should be that it should not accelerate or facilitate the rise of Chinese Renminbi as an alternative global currency, given that China is an active adversary. The attempt to circumvent US sanctions on Russia and buy oil by paying in Yuan might have afforded short-term benefits through import costs but was ill-advised as a long-term strategic move.

Similarly, while it can explore technological options to reduce dependence on SWIFT, be it India's own UPI or some other multilateral arrangement, it should not get trapped into using China's Cross-border Interbank Payment System (CIPS) or other Russia-China systems.

As a concluding wish-list, if India wants to play a bigger role in the global financial and currency market, it should deepen its financial markets, increase institutional strength, play a bigger role in world trade (no protectionism), and promote sustained economic growth.

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