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De-dollarisation would upend the global economy

By George Magnus

Currencies are important, and not just for travel and trade. As Joseph Schumpeter, the Austrian-born American economist put it in 1930: 'The monetary system of a people reflects all that the people wants, does, endures, is, and that simultaneously, the monetary system of a people exercises a significant influence upon its economic activity and its destiny in general.'[1] America's attachment to the United States (US) dollar is as key as the People's Republic of China's (PRC) is to the Renminbi (or 'people's currency'), or Britain's to the Sterling, or as Germany's was once to the Deutschmark.

Germany managed the transition to the euro remarkably well though not without controversy to this day, but it is easy to see why the political consequences of a wide range of policies affecting your own or other people's currencies can be important and even existential.

Now consider the feisty discussion that has been brewing mainly on social media platforms for several months now about 'de-dollarisation'. This is essentially the idea that for a variety of reasons, the US dollar is being challenged by countries that do not like or want the American currency to prevail in the

[1] Rudolf Richter, 'European Monetary Union: Initial Situation, Alternatives, Prospects – In the Light of Modern Institutional Economics', *Kredit und Kapital*, 2 (1998), pp. 159-191.

world's monetary system. They would like something else to take its place, something beyond the prying eyes of the US Treasury and that bypasses America's banking and financial system.

Cryptocurrency enthusiasts and people worried about both high inflation and the problems encountered earlier this year by regional banks, for example, have been propagating the idea of de-dollarisation. The frisson associated with this idea, however, is the politics that have intervened, largely because of the aftermath of war against Ukraine, which triggered a broad array of sanctions against Russia, and the risk of secondary sanctions on countries, if found to be breaching the former. The PRC was certainly spooked by the speed and unanimity of the sanctions announced by the US and the European Union (EU), and fears for itself in the event that sanctions should be applied over its bellicose actions to support its claims to Taiwan. Russia, of course, has dollar-phobia too, as do Iran and North Korea, but it is argued that several 'Global South' countries are also articulating an antipathy to the US dollar-based system.[2]

As far as the current dominant status of the US dollar as the world's principal reserve currency is concerned, there is not really any dispute, but there is also no question that there are vested interests eager to advance the case of pretenders to the US dollar's throne, or at least of currency multipolarity in the world's monetary arrangements.

Yet, most of what passes for economic and financial insight in the discussion about de-dollarisation is misinformed or misunderstood, and even sometimes self-serving. The US dollar's role in the global system cannot be changed like one might a pair of shoes or a car. And if it were ever to lose its primacy, not only would America have to be an instigator, but the entire global commercial and trading system would be upended.

Is this time different?

Dollar-phobia is not new, and it is worth noting that what is at stake here is not about whether the US dollar is strong or weak, or whether it is going through regular cycles of appreciation and depreciation. Rather, it is about the role and status of the US currency in the global monetary system. People tend to forget or do not realise that the US dollar's status in the global economy is unique. It is not part of a continuum over centuries in which other currencies have featured. It is true that Sterling was once the world's principal reserve currency but it was, for

[2] Wolfgang Münchau, 'Why China and its trading allies are well placed to topple the dollar', *The New Statesman*, 03/05/2023, https://bit.ly/3CJDILQ (checked: 27/06/2023).

the most part, pegged to gold. Before that gold and silver in different guises served as the vehicles for financing international trade and capital movements. As Michael Pettis, Professor of finance at Peking University's Guanghua School of Management, has explained, there is no relevant history of reserve currencies, as the de-dollarisation supporters often assume or state, because the role of the US dollar in the global system of trade and capital flows since 1945 is unprecedented.[3]

Countries such as the PRC, Japan, South Korea, Russia, Germany, Switzerland, Singapore and now even Brazil can persist with domestic economic policies that end up running large balance of payments surpluses only because there is another country or system on the other side, mainly the US and the its dollar, that is capable of absorbing their excess savings by giving them unfettered access – unless sanctioned – to a long list of available and tradable assets. These include public and private bonds, equities, bank deposits, commercial and residential real estate, private equity, and other forms of investment in the US.

The United Kingdom does this too on a much smaller scale, as do Australia and Canada. As Pettis notes, 'nearly 70-80 per cent of all the excess savings – from both advanced and developing economies – is directed into the wealthy anglophone economies. These in turn have to run the corresponding deficits of which the US alone typically absorbs more than half.'[4]

The US dollar's unique role, historically and in contemporary times, also provides a platform for opponents and naysayers to find an alternative voice. Dollar-phobia erupted as the Bretton Woods system was unravelling in the 1970s, and when Japan was widely predicted in the 1980s to dominate the world economy. Another bout ensued in the 2000s with the birth of the euro. The most virulent episode perhaps until recently was in the wake of the Great Financial Crisis, which caused the then Governor of the People's Bank of China to call for a new global reserve currency.[5]

Are there any realistic alternatives?

The current phobia surrounding the US dollar, therefore, is not new, but it is remarkable because it is contextualised by the PRC's various aspirations as a major economic and financial power, a country whose leadership, rightly or

[3] Michael Pettis, 'A (very short) history of global reserve currencies', *Financial Times*, 07/06/2023, https://bit.ly/3NMlOy6 (checked: 27/06/2023).
[4] *Ibid*.
[5] Jamil Anderlini, 'China calls for new reserve currency', *Financial Times*, 24/03/2009, https://bit.ly/3NpytWs (checked: 27/06/2023).

wrongly, sees the current moment in history as one in which the US is in terminal decline. Given that, Beijing would naturally assume that the US dollar's days are numbered and that the yuan would be a natural successor. It is hardly surprising, therefore, that the PRC would like to see the yuan more widely used in international finance and for trade transactions, though it certainly does not seem to be in a hurry to make it happen, and for good reasons.

While much of the focus is on the yuan itself, other ideas have drawn attention to the creation of a currency unit in which the yuan would be a component, albeit the dominant one. For example, this year, the idea of a BRICS (Brazil, India, Russia, South Africa and the PRC) currency was aired,[6] and at the same time there have been discussions and suggestions about the BRICS grouping expanding into the 'Global South'.[7] At a BRICS meeting in Johannesburg in June, invitees included Egypt, Iran, Kazakhstan, Saudi Arabia, and the United Arab Emirates. Prospective future members, if a decision is made to open the group up further, include also Algeria, Argentina, Bahrain, Belarus, Indonesia, Nigeria, and Turkey.[8]

The ambition, however, to create a currency in which nations hostile to or ambivalent about the US would invoice trade and settle accounts is rather fanciful, and all about political messaging. It is simply not feasible to graft a currency onto a disparate group of countries that is anything but an optimal currency area, with wildly different economic, balance of payments, and market structures, not to mention political and national security interests.[9]

The PRC, which accounts for about 70% of the BRICS GDP,[10] and is the only emerging country to have increased its share of world GDP in a meaningful way over the last 30 years,[11] does not even have a fully convertible currency. Capital controls are most unlikely to be lifted, and it invests the proceeds of its trade surpluses mostly in the US and other developed markets. So does Russia, in spite of sanctions. There is no single or composite BRICS currency which will provide assets for the PRC and Russia and other surplus countries in which to invest.

Russia is a sanctioned pariah state. Brazil and South Africa are commodity exporters, whose currencies are hinged to the dollar. India is the world's biggest

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[6] S'thembile Cele and John Bowker, 'BRICS Nations Say New Currency May Offer Shield From Sanctions', *Bloomberg*, 01/06/2023, https://bit.ly/3Pw1WAz (checked: 27/06/2023).
[7] BRICS was a concept introduced by Goldman Sachs in 2001 to suggest upcoming shifts in the global economy and to offer a marketing pitch to global investors.
[8] Wendell Roelf, 'BRICS meet with "friends" seeking closer ties amid push to expand bloc', *Reuters*, 02/06/2023, https://bit.ly/3pfuQdS (checked: 27/06/2023).
[9] Paul McNamara, 'Why a Brics currency is a flawed idea', *Financial Times*, 10/02/2023, https://bit.ly/3JvQl0G (checked: 27/06/2023).
[10] Aaron O'Neill, 'Gross domestic product of the BRICS countries from 2000 to 2028', Statista, 28/04/2023, https://bit.ly/3XpAPsY (checked: 27/06/2023).
[11] 'China Share of World GDP based on PPP, %', Nasdaq Data Link, 23/03/2020, https://bit.ly/3Jy3rdN (checked: 27/06/2023).

economy by population and runs trade deficits, that is it has to import capital. It also has a nationalistic streak of its own, is not exactly close to Beijing, and could hardly be expected to be enthusiastic about pooling its reserves with other countries, let alone the PRC.

Then there are important technical questions, such as to which currency a BRICS currency might be pegged or linked, whether it would be convertible – even the yuan is only partially so – and why commodity currencies linked to the US dollar would even want yuan reserves?

De-dollarisation: Easier to say than do

If a BRICS currency is a non-starter or at least little more than a notional accounting unit, the focus is back on the yuan. The PRC has sometimes blown hot and cold about the idea of internationalising the yuan, but it has remained a regular theme and talking point for over a decade now. For many, de-dollarisation is principally about both the greenback's fading role in the global system and the rise of the so-called, 'redback'.

Much of the discussion centres around the rising proportion of – or mentions about – trade that is denominated in yuan. This is certainly true of Russia, where the circumstances since its full-scale invasion of Ukraine have meant that Russia had no option but to do more trade with the PRC, and to use the yuan more to invoice and settle accounts. About a quarter, perhaps more now, of Russian imports and exports are settled in yuan, and nearly all of the PRC's oil imports from Russia are too.[12] There has also been talk this year about Saudi Arabia, Bangladesh, Iraq, Thailand, Iran, Argentina, Pakistan and Brazil possibly looking to invoice or settle more trade in yuan.[13]

At the same time, the PRC has been arranging central bank swap arrangements – where central banks 'swap' one another's currency for short but renewable periods – with other central banks as a way of making yuan available for loans or for liquidity.[14] At a bit more than US$15 billion (£11.8 billion) in swap facilities, the PRC's offerings have expanded sharply since 2015-16, when they hardly existed, and now this marketplace is worth hundreds of billions of

[12] Chen Aizhu, 'Vast China-Russia resources trade shifts to yuan from dollars in Ukraine fallout', Reuters, 11/05/2023, https://bit.ly/3r7DkUC (checked: 27/06/2023).
[13] Andrew Mullen, 'Which 8 countries are using China's yuan more, and what does it mean for the US dollar?', *South China Morning Post*, 10/05/2023, https://bit.ly/3NMo4p8 (checked: 27/06/2023).
[14] 'Central Banks Use Record Amount of yuan Via PBOC Swaps', *Bloomberg*, 16/05/2023, https://bit.ly/3XoCmiU (checked: 27/06/2023).

dollars.[15] It has also been trying to build out its own international payments system architecture (known as Cross Border International Payments System or CIPS)[16] as an alternative to the global, and heavily US dollar based CHIPS and SWIFT systems, used for payments and messaging of transactions, respectively.[17] The PRC's goal here of course is also to sanction-proof itself, if at all possible by dispensing with the need to process transactions through US and global banks.

The comparisons of the two systems reveal that the PRC's architecture can not really substitute for that of its global peer, except perhaps for a relatively small group of like-minded states. SWIFT is a system with over 11,000 participants in 200 countries and in which the US dollar, euro and yuan account for 42, 35 and 3% of transactions respectively. CIPS is a payment system with 79 direct and 1,348 indirect members in 138 countries, comprising mostly Chinese banks. It relies on SWIFT, moreover, for messaging. It is a way in which countries can avoid the US dollar system, but it is not a tool for the internationalisation of the yuan, as such.

Why the US dollar will rule (for the foreseeable future)

In this respect, there simply is not a viable alternative to the US dollar for the foreseeable future. The relative appeal of the US dollar remains robust, relying on a set of five advantages.

1. First, inertia. It takes a major upheaval to shake a reserve currency out of its role and replace it with something that is at least its equal;
2. Second, network effects. The US dollar is universally used, acceptable, tradable and mostly, trusted;
3. Third, deep and flexible capital markets. The US has mostly unparalleled capital markets, certainly outside of the Organisation for Economic Co-operation and Development (OECD) area;
4. Fourth, clear and transparent governance, and rule of law. These are indispensable qualities for a trusted global currency; and,

[15] *Ibid*.
[16] Mercy A. Kuo, 'China's CIPS: A Potential Alternative in Global Financial Order', *The Diplomat*, 25/04/2022, https://bit.ly/43ondpl (checked: 27/06/2023).
[17] Shobhit Seth, 'What is the SWIFT Banking System?', *Investopedia*, 26/04/2023, https://bit.ly/3CNP2GM (checked: 27/06/2023).

5. Fifth, low discrimination between domestic residents and foreigners. Other than those unlucky enough to be sanctioned, all participants are treated as equals.

The US dollar certainly occupies an anomalous position, accounting for a far smaller proportion of world trade and world GDP than seems to be compatible with its dominant role in global loans, bonds, foreign exchange, trade invoicing and SWIFT payment transactions. It is true that the US dollar's share of recorded official foreign exchange reserves has fallen from about 60-65% a decade ago to about 58% today.[18] Yet, this anomalous position and the reasons for the fall in the share of official reserves are usefully contextualised by the Bank of International Settlements (BIS).[19]

As the BIS makes clear, the reason for the US dollar's declining share in recent years especially has been because of the increase in those of the Australian and Canadian dollars, the Swedish Krona and the South Korean Won, but not the yuan, whose share has remained fairly stable at about 3%. It is also worth noting that official reserves may not be capturing all of the official flows into US dollars, including especially those accumulated by the PRC, due to the purchases made by state banks and also sovereign wealth funds as proxies for the central bank.

The yuan currency system, on the other hand, offers few if any of these attributes, and the Chinese Communist Party's (CCP) lurch in recent years towards greater control, politicised regulation, and clampdowns and campaigns against private firms and also some foreign enterprises has exacerbated an uncomfortable situation. Along with new data, cybersecurity and counter-espionage laws and regulations, these developments have soured the appetite for Chinese portfolio assets, and accentuated discomfort on the part of foreign enterprises, at least as far as future investment is concerned.[20]

There is little chance, moreover, that Chinese macroeconomic policies will facilitate either of the only two ways in which the yuan could become a serious rival to the US dollar.

Put another way, to have a global currency that is materially bigger, say, than the Australian and Canadian dollars, Japanese Yen, Swiss Franc and Sterling, foreigners must be able to accumulate claims on the PRC, that is, acquire substantial yuan assets.

One way this can happen is if the PRC were to run big and persistent balance of payments deficits, rather than surpluses. Yet, to do this, the PRC

[18] *Ibid.*
[19] 'BIS Quarterly Review: International banking and financial market developments', Bank of International Settlements, 01/12/2022, https://bit.ly/3NO431G (checked: 27/06/2023).
[20] George Magnus, 'The Chinese economy after the "Two Sessions"', Council on Geostrategy, 19/04/2023, https://bit.ly/441sGxq (checked: 27/06/2023).

would have to abandon the mercantilist and supply-side policies that perpetuate the running of those surpluses.

The CCP would need to change the PRC's development mode, and undertake extensive reforms to boost the consumption and income shares of GDP, reform the tax system which is highly regressive, expand the social welfare system, and redistribute income and wealth from the state to the private sector. There is not even a slim chance that Xi Jinping's PRC is contemplating such policies, or that it would.

The other way is to abandon the stringent controls over the outward movement of capital that have been in situ for a while, but which were tightened after the domestic financial turbulence in 2015-16. If that happened, foreigners would be able to acquire yuan claims as Chinese residents (firms and households) invested abroad. The likelihood of this happening is negligible for two reasons. First, large capital outflows would almost certainly lead to a sharply lower currency, which would compromise severely the CCP's craving for control and the stability of the financial system. Second, the CCP certainly does not trust its own citizens or the private sector to keep wealth in the PRC.

Since neither of these options is acceptable to the CCP or likely to be embraced in the foreseeable future, the internationalisation path of the yuan must, by definition, be strictly limited.

Conclusion

Absent a political catastrophe or international crisis that compromises America's willingness or ability to abide by the rules of the current monetary system, it is difficult to make a plausible case as to why the US dollar's dominance will not persist for the foreseeable future.

Global reserve currencies do not shift around in popularity like shares listed in the Financial Times Stock Exchange or Dow Jones. They occupy critical and pivotal roles in the monetary system, and the role the US dollar plays is unprecedented and for now at least, irreplaceable. It is possible that one day, America might decide that the reserve currency role, championed by the establishment and by Wall Street, was placing too much of a burden on the economy and on jobs. This domestic focus has become deeply embedded, for example, in the recent articulation of industrial policy and the marriage of economic and foreign policy by Jake Sullivan, the US National Security Adviser.[21] It is unlikely anytime soon that the US government would try to re-order the world's monetary system, but recent developments show at least that beliefs and priorities are starting to shift.

The main message to take away, though, is that it is not possible to upend the world's monetary system and pivotal currency without upending the entire world trading system too. If the US were to change and relinquish its role as the principal absorber of the surpluses of other countries, including especially the PRC, then everything else has to change too. US deficits would contract as US savings rose, and Chinese and other surplus countries' surpluses would have to contract or disappear because that is the other side of the global balance of payments. This would impose huge costs on and necessitate major policy reversals in the PRC and other countries with surpluses that would have unexpected and unpredictable consequences, including for political stability and governance systems.

De-dollarisation rolls off the tongue easily enough, but its supporters and advocates do not really know that they are playing with fire.

[21] Jake Sullivan, Speech: 'Remarks by National Security Advisor Jake Sullivan on Renewing American Economic Leadership at the Brookings Institution', The White House, 27/04/2023, https://bit.ly/3r3zfRB (checked: 27/06/2023).

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