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# Is the global dominance of the US dollar gradually eroding?

By Angelo Katsoras

## Introduction

The U.S. dollar has dominated trade, finance and central bank reserves since the end of World War II. As a result, the U.S. financial system is required to settle trades denominated in USD, even when both parties involved in the transaction are located outside the United States.

This grants Washington unrivalled economic and political power. From an economic standpoint, strong demand for US dollars from governments, businesses, and central banks enables the United States to borrow at lower interest rates.

On the geopolitical front, this also permits the United States to unilaterally apply economic sanctions by cutting off access to the greenback and the U.S. financial system to target the objectionable behaviour of foreign governments.

The U.S.-led financial sanctions imposed on Russia following its invasion of Ukraine are the latest examples. Key measures include the freezing of nearly half of Russia's foreign exchange reserves ($300 billion) and the removal of major Russian banks from SWIFT, an interbank service that facilitates international payments.

Some argue, however, that the more the United States uses its reserve currency as a weapon to achieve geopolitical goals, the more countries, such as China, will be motivated to gradually reduce their dollar dependency.

This report analyzes the following subjects:

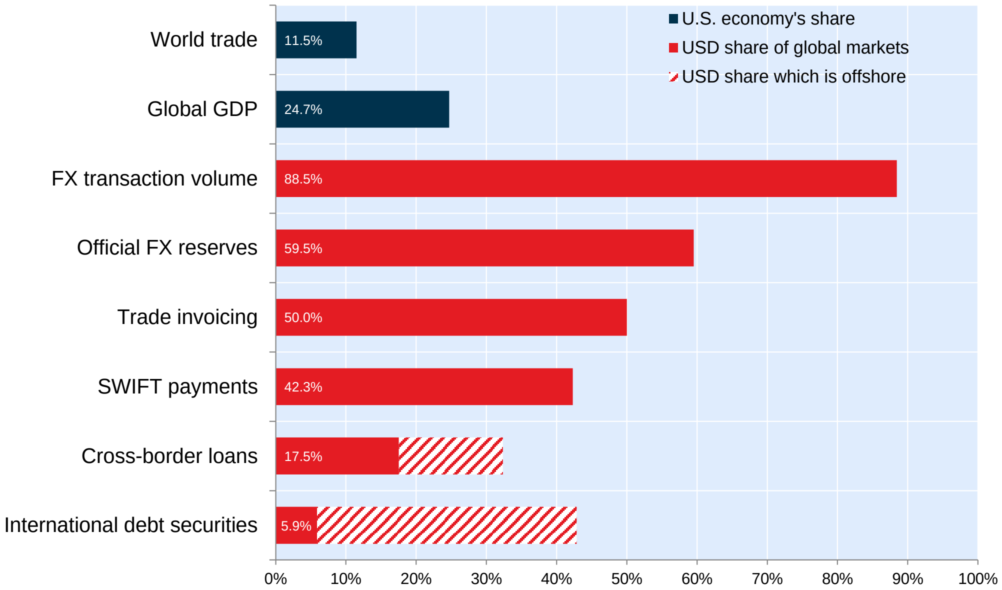
- The outsized global footprint of the U.S. dollar
- Challenges faced by China in its attempt to increase the international use of its currency
- Strategies employed by China to overcome these challenges
- Initiatives taken by other countries to trade in different currencies
- Whether the dominance of the U.S. dollar will gradually be eroded

## The outsized global footprint of the U.S. dollar

The U.S. dollar has long played an outsized role in global markets relative to the American economy's share of global output. Whereas the U.S. economy accounts for about 24% of the world's GDP and 12% of global trade, about half of international trade, loans and global debt securities was transacted in U.S. dollars in 2022. The USD was also used in almost 90% of foreign-exchange transactions over the same period.[1]

[1] "The U.S. Dollar as the World's Dominant Reserve Currency," Congressional Research Service, September 15, 2022

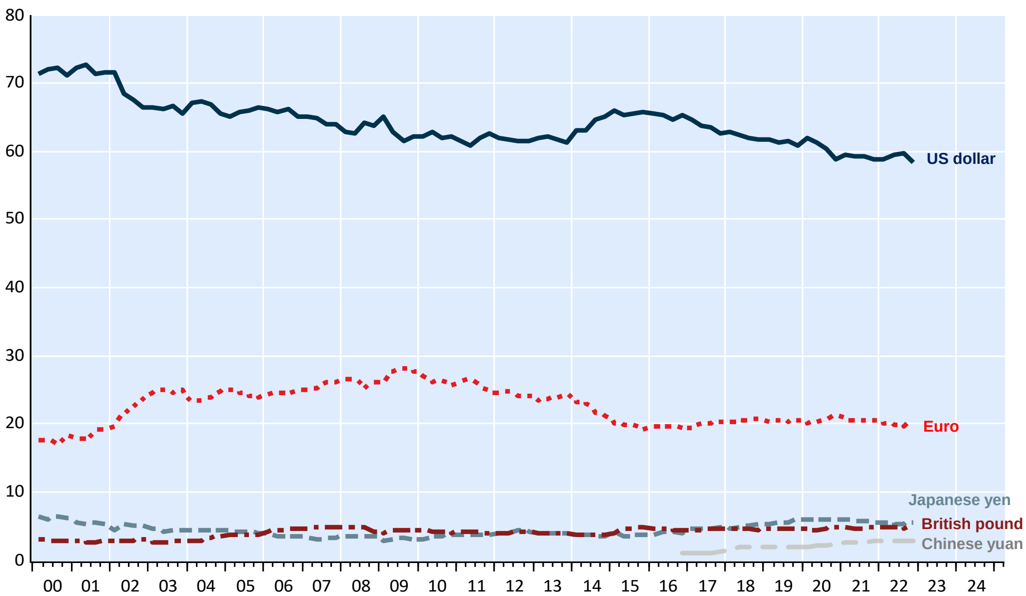
**The United States and the dollar's key role in the world**
All data as at 2022Q2




NBF Economics and Strategy (data via BIS)

As for the foreign exchange reserves held by the world's central banks, the International Monetary Fund estimated that 59% were in dollars, 20% in euros, 5% in yen, and less than 3% in Chinese yuan in 2022. It is worth noting, however, that while the greenback remains dominant, its share of central bank reserves has declined from over 70% in 1999.

**Share of international reserves**
Share of global allocated foreign exchange reserves at current exchange rates

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Some of the factors behind the U.S. dollar's dominance include the following:

- The United States does not impose controls on money leaving or entering its borders.
- The United States offers a secure environment for foreign investors with strong rule of law and protection of property rights.

## What about the euro?

While the euro accounts for 20% of the world's central bank reserves, this is up only marginally from 18% since 1999 when the currency was launched. Some of the reasons for this stagnation are listed below.

- Each of the European Union's 27 members prioritizes its own national interests, making it difficult for the EU to speak with a unified voice.
- While the EU has a single currency, the lack of a unified fiscal policy makes it difficult for the EU to respond to economic challenges in a timely and effective manner.
- Instead of the EU issuing euro bonds collectively, they are issued by individual governments with varying degrees of creditworthiness.

## Challenges facing China in getting its currency more widely used

China, meanwhile, has risen to become the world's second-largest economy (18% of global GDP and 32% of global manufacturing production). However, the prominence of its currency is not commensurate with its weight in the global economy. While the use of the yuan in FX transactions rose from 4% in 2019 to 7% in 2022,[2] this still pales against the USD's 88% share. Moreover, the yuan accounts for only about 2% of global SWIFT payments and less than 3% of global foreign exchange reserves.[3]

Many Western policy makers maintain that a significant increase in the use of China's currency would have to be preceded by the following reforms:

- Lifting of capital controls, which make it difficult to invest in the yuan or to exchange it against other currencies, particularly in periods of economic distress.
- Greater respect for the rule of law—there are significant doubts whether assets are adequately protected under China's legal system.

Finally, while holders of U.S. dollars may be exposed to sanctions-related risks, holders of yuan-denominated assets could be even more vulnerable if they upset the Communist Party.

## Strategies employed by China to overcome these challenges

Despite the yuan's low market share, China is boldly gambling on being able to gradually increase the international use of its currency without adopting the Western financial model. This bet relies on implementing the following financial mechanisms.

**Swap agreements.** Since 2009, the People's Bank of China, the country's central bank, has entered into bilateral currency swap agreements with at least 39 central banks totaling 3.7 trillion renminbi ($550 billion).[4] The goal is to build confidence that the currency can be obtained from the central bank on demand, even with China's capital controls.

**Non-dollar payment processing system.** In 2015, China established the Cross-Border Interbank Payment System (CIPS) to facilitate yuan settlements and provide an alternative to both the U.S.-based Clearing House Interbank Payments System (CHIPS) and SWIFT, the global interbank messaging network. While CIPS currently handles the dollar equivalent of only $50 billion in daily transactions, compared with $1.5 trillion for CHIPS[5] and $5 trillion for SWIFT, China's goal is to have the financial infrastructure in place to gradually expand the volume of yuan-denominated transactions conducted outside of Western-dominated payment systems.

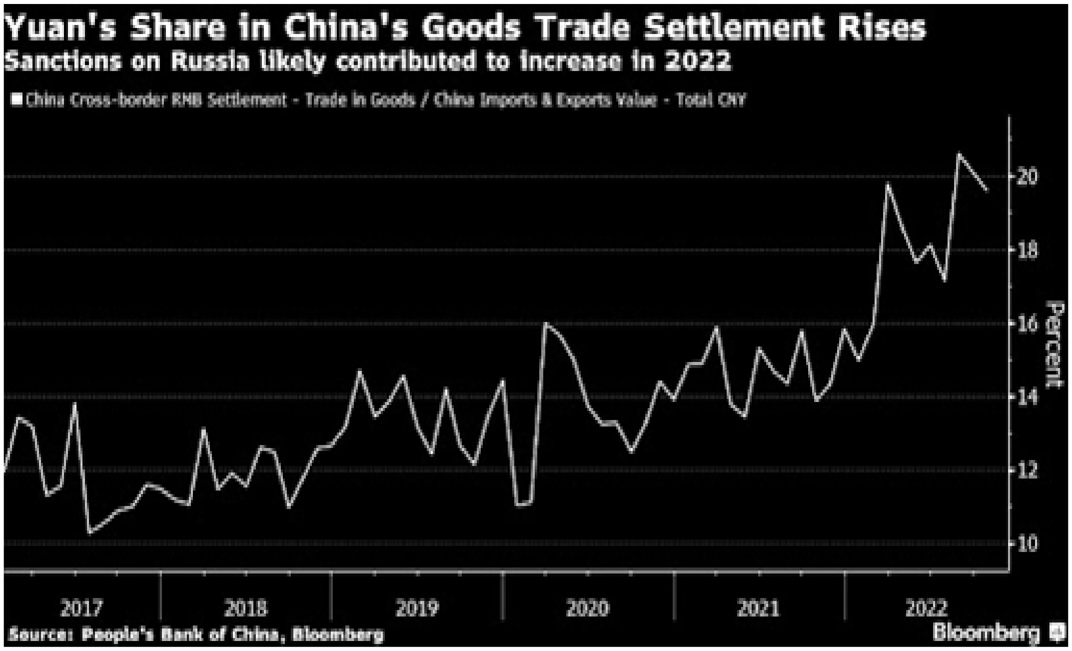
### *China's cross-border currency transactions*

One area where significant progress has been made is the yuan's share of China's cross-border transactions. In March, the yuan overtook the dollar in this regard for the first time. Its share of China's cross-border transactions surged from almost zero in 2010 to a record 48%, while the dollar's share plummeted from 83% to 47% over the same period. This figure includes all currency transactions, including those related to securities and trade.[6]

[2] "OTC foreign exchange turnover in April 2022," Bank for International Settlements, October 27, 2022
[3] IMF and SWIFT
[4] "The dollar's demise may come gradually, but not suddenly," Bloomberg, April 23, 2023
[5] "The dollar still dominates," Foreign Affairs, February 21, 2023
[6] "Yuan Overtakes Dollar as China's Most Used Cross-Border Currency," Bloomberg, April 26, 2023


Source: "Yuan Overtakes Dollar as China's Most Used Cross-Border Currency," Bloomberg, April 26, 2023

When it comes to China's merchandise trade alone, the yuan's share of transactions doubled from about 10% in 2017 to about 20% at the end of 2022.

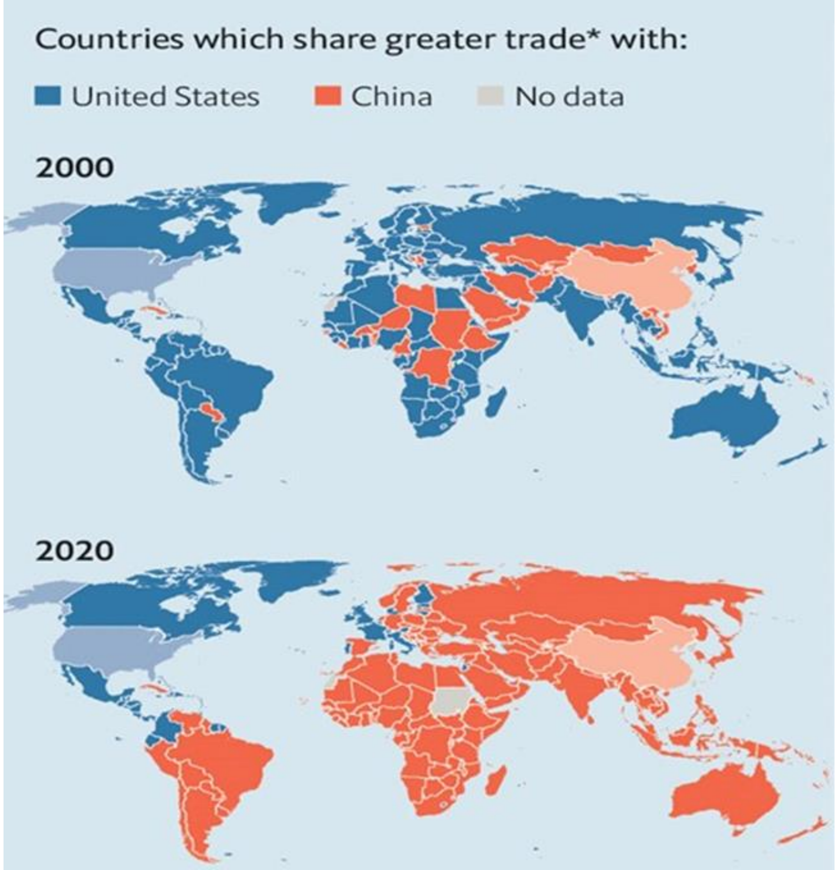



Source: "Brazil Takes Steps to Transact in Yuan as China Ties Grow," Bloomberg, March 30, 2023

Given the size of China's economy, the more it conducts bilateral trade and financial transactions in yuan, the bigger the role its currency will play in the global economy.

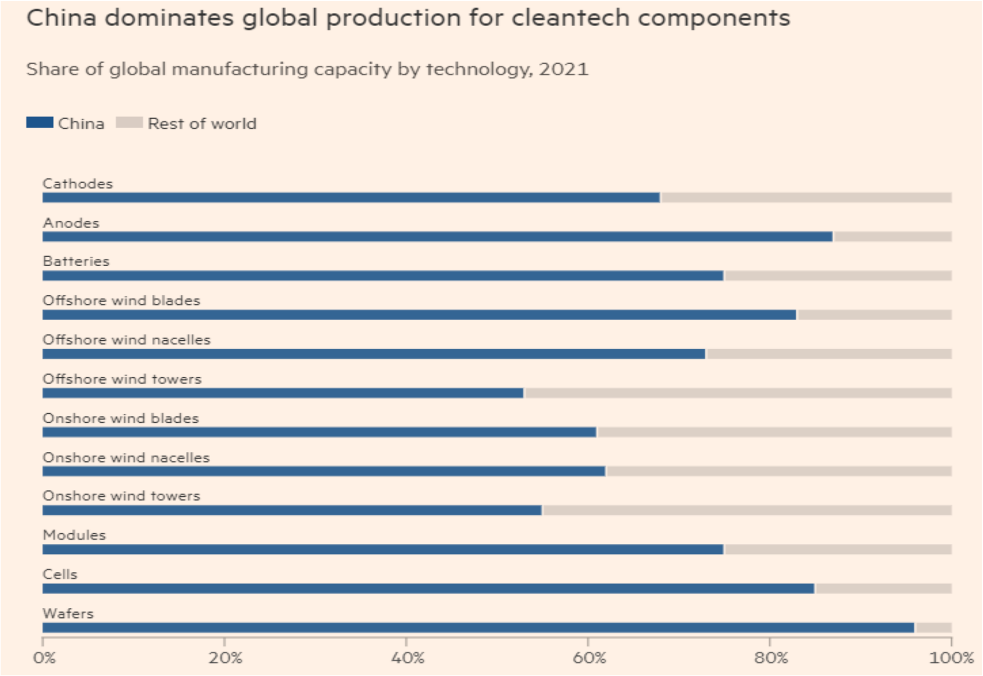
### *China will leverage its trading relationships*

China's leverage in promoting the use of its currency derives largely from its status as the top trading partner to well over 100 countries (see chart below). The greater the economic ties with China, the more intense the pressure that countries will face to switch currencies.

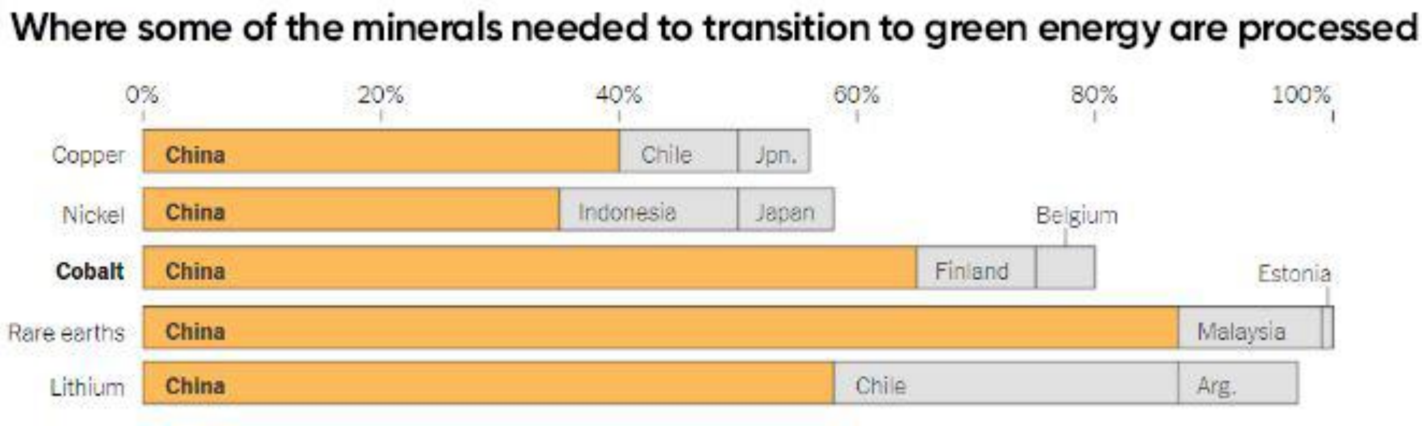



Source: "Joe Biden is determined that China should not displace America," The Economist, July 17, 2021

This leverage is reinforced by China's dominance of the world's green energy supply chains encompassing solar panels, wind turbines and electric vehicles. This dominance extends to the refining of the minerals required to manufacture these products. (See charts below.)




Source: The US plan to become the world's cleantech superpower, Financial Times, February 16, 2023




Source:" Clean Energy Metals," New York Times, February 3, 2022

### *China's digital currency*

Another of China's strategies is to create a digital currency. Among the major countries, it is the furthest along in its development. Unlike today's electronic transactions, those involving state-controlled digital currencies could theoretically take place between two parties without an intermediary, such as a US dollar-denominated central clearing platform.

## Initiatives to challenge dollar dominance among various other countries

Below are several examples of countries taking measures to become less reliant on the U.S. dollar for trade and financial-market-related transactions:

### *Brazil*

Brazil and China reached an agreement last February to promote bilateral trade using their respective currencies. Shortly thereafter, the Brazilian branch of the Industrial and Commercial Bank of China settled its first renminbi transaction. Brazilian President Lula da Silva was recently quoted as saying: "I'm thinking about the same question every night: why should all countries use US dollars for settlements and not the yuan or other international currencies."[7]

### *India*

India is taking steps to promote the use of its own currency. The Reserve Bank of India has set up a facility to allow banks from 18 countries to settle payments for transactions in Indian rupees. These include Mauritius, Kenya, Tanzania, Israel, Germany, Oman, and Singapore.[8]

Similar to digital currency, India's electronic payment system, called the Unified Payments System, could potentially be used to bypass America's financial architecture for cross-border transfers. This system allows payments to be made via text or QR scans. Hundreds of millions of Indians already use it to receive various government-related payments.

### *Bangladesh*

Because of sanctions, Bangladesh was unable to use SWIFT to make a loan payment for a $12-billion nuclear power plant being built by Russia. Consequently, Bangladesh finally made the payment to Russia in yuan via China's Cross-Border Interbank Payment System.[9]

### *Argentina*

Earlier this year, the Argentine government announced that it would start to pay for most of its Chinese imports in yuan instead of U.S. dollars. In dollar terms, this amounted to about $1 billion in April, followed by about $790 million in imports being paid in yuan on a monthly basis.[10]

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[7] "Which 8 countries are using China's yuan more, and what does it mean for the US dollar?," South China Morning Post, May 10, 2023
[8] "India Pushes Trade in Local Currency," Voice of America, April 5, 2023
[9] "Bangladesh finds way to pay Russia for nuclear plant: with yuan," Nikkei Asian Review, April 17, 2023
[10] "Move over, U.S. dollar. China wants to make the yuan the global currency," Washington Post, May 16, 2023

### *BRICS (Brazil, Russia, India, China, South Africa)*

While the headline-grabbing proposal to create a common BRICS reserve currency may seem far-fetched given the vast differences in their economies, efforts to expand the use of their respective currencies in trade among themselves may be a more achievable goal. The fact that the BRICS countries account for 40% of the world's population and 23% of global GDP means that their efforts to become less dependent on the U.S. dollar should be closely monitored.

### *Shanghai Cooperation Organisation*

Members of the China-dominated Shanghai Cooperation Organisation agreed to increase trade in their local currencies. In addition to China, the bloc includes Russia, India, Pakistan, Uzbekistan, Kazakhstan, Tajikistan, and Kyrgyzstan.

## Central bank purchases of gold are on the rise

As part of a broader trend to diversify reserve assets, which includes reducing the risk that their reserves will one day be frozen by U.S.-led sanctions, central banks purchased a net total of 1,136 metric tons of gold in 2022. This represents an annual increase of more than 152%,[11] the highest since data collection began in 1950. Central banks currently account for a record 33% of monthly global demand.[12] Emerging markets, including Russia, China, Turkey, and India, have taken the lead in significantly increasing their central bank gold reserves to more than double their 2008 levels.[13]


Source: "Central banks load up on gold in response to rising geopolitical tensions," Financial Times, April 23, 2023

A recent survey by the World Gold Council found that 58% of emerging-market central banks expected their U.S. dollar reserves to decline over the next five years and 68% anticipated a rise in their gold holdings. In contrast, most central banks from advanced economies expected the asset mix of USD and gold to remain unchanged.[14]

[11] "Central banks load up on gold in response to rising geopolitical tensions," Financial Times, April 23, 2023
[12] "What strong gold says about the weak dollar," Financial Times,
[13] "Why emerging markets are stocking up on gold," Atlantic Council, April 26, 2023
[14] "The developing world wants to escape the dollar's gravitational pull by shifting more reserves to gold," Fortune, May 31, 2023

## Conclusion

While the U.S. dollar will almost certainly remain the principal currency of international trade and transactions for the foreseeable future, there is a growing possibility that its dominance will continue to erode over the longer term as more countries begin to trade in other currencies.

Just as the United States and China are slowly moving toward separate supply chains for semiconductors and other key technologies, we are also witnessing the gradual emergence of separate monetary payment systems. The current conflict in Ukraine will probably accelerate this trend. For example, certain countries that trade with China will increasingly do so in yuan via China's Cross-Border Interbank Payment System. As noted above, China's leverage in promoting the use of its currency stems largely from its status as the top trading partner of well over 100 countries and its dominance of green energy supply chains. Or to put it another way, in exchange for access to its markets or green energy supply chains, countries may find themselves under implicit pressure to trade increasingly with China using its currency.

In the coming years, China may decide to pursue this policy aggressively before its global influence risks being weakened by projections of a slowing economy weighed down by demographic factors, rising public debt, increased government intervention, protectionism, and geopolitical tensions. This includes attempts by the West to deny it access to the most advanced Western technology.

Another indication of the gradual financial decoupling between the two superpowers is the continued decline in China's holdings of U.S. Treasuries. The U.S. Treasury reported that these fell from $976 billion to $869 billion over the 12-month period ending April 2023 (an 8% decline).[15]

Further, trading in multiple currencies could lead to higher transaction costs for certain companies. For example, if the Brazilian mining company Vale SA were to sell ore to China, it would be paid in yuan, which it would then have to convert to U.S. dollars to reimburse its debt and to pay for equipment purchases from companies such as Caterpillar.[16]

**Bottom line: While the dollar's global dominance will remain secure for many years to come, there is growing evidence that countries, led by China, are taking steps to gradually reduce their reliance on the U.S. dollar by establishing parallel payment systems. This is being done primarily for two reasons: 1) to increase their global influence to a level that these countries believe is more commensurate with the size of their economies; 2) to avoid the risk of one day being targeted by U.S. financial sanctions similar to those imposed on Russia.**

[15] "Securities (B): Portfolio Holdings of U.S. and Foreign Securities," U.S Department of Treasury, March 2023
[16] "Russia and China's BRICS economic alliance will fail at countering the West," Globe and Mail, May 26, 2023

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