Three challenges to dollar dominance

"Very few of us realize with conviction the intensely unusual, unstable, complicated, unreliable, temporary nature of the economic organization by which Western Europe has lived for the last half century. We assume some of the most peculiar and temporary of our late advantages as natural, permanent, and to be depended on, and we lay our plans accordingly."

John Maynard Keynes, *The Economic Consequences of the Peace*, 1920

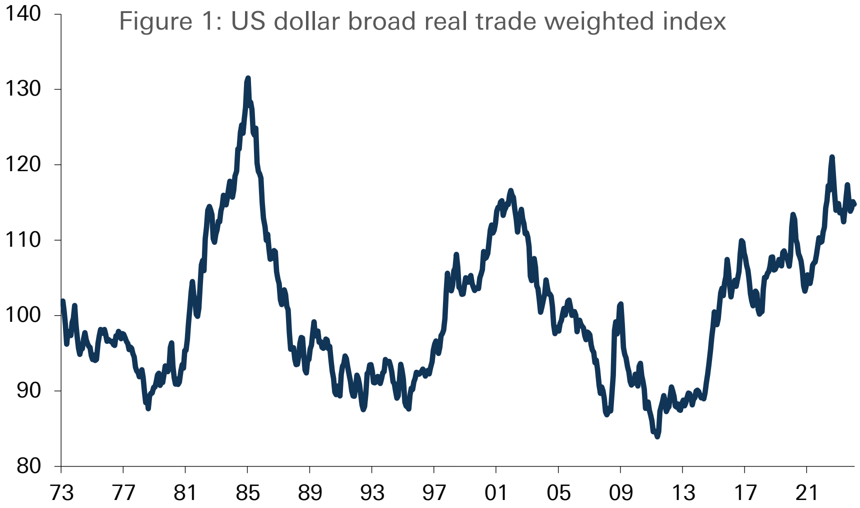
Introduction

The dollar stands at close to its highest level since the 1980s, according to the Federal Reserve's trade-weighted index that accounts for inflation differentials. It has been on a nearly unbroken upward trend since the start of 2011. Reports of the mighty dollar's demise therefore seem greatly exaggerated.

Nevertheless, this essay argues that the recent period of dollar dominance is now drawing to a close, not just with respect to its real value against other currencies but also in terms of its unquestioned centrality as the world's reserve currency.

We make three main arguments. First, the behavioural shift of emerging market reserve managers, away from the precautionary accumulation of liquid dollar assets against sudden shocks, and towards more profit-maximising allocations and hedging against political risks, will lead to further diversification away from the dollar. Second, doubts about US fiscal sustainability may increasingly temper demand for the dollar. Third, the willingness of the United States to provide the dollar-based financial ecosystem as a global public good is increasingly in question, given the widespread political focus on the US trade deficit. This latter factor may come into sharp relief with November's election.

Figure 1: US dollar broad real trade weighted index



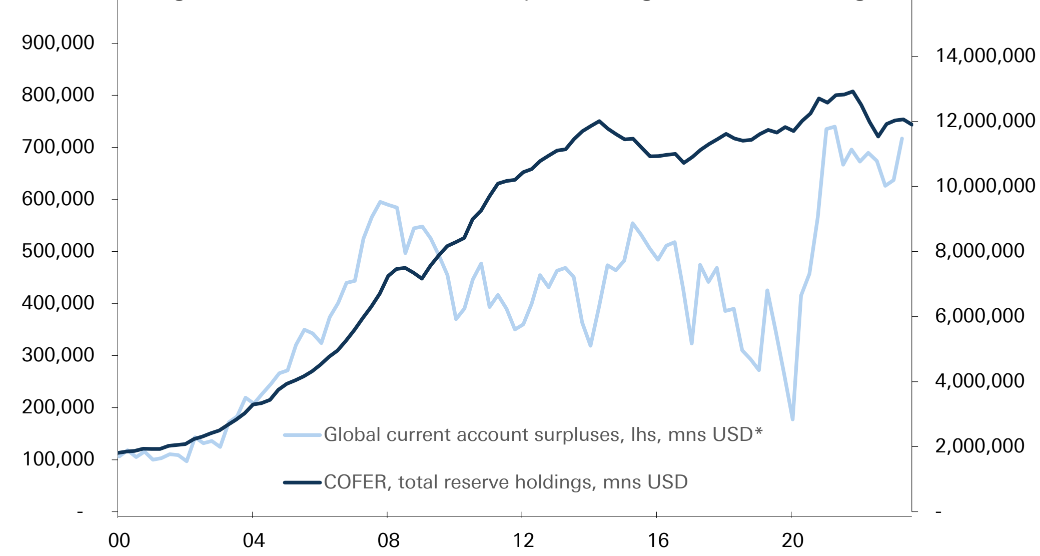
Source: US Federal Reserve

The shifting behaviour of emerging market reserve managers

The first challenge to dollar dominance is the shifting behaviour of large holders of official reserves, which are mostly concentrated in emerging markets. Data on global central bank reserve holdings is provided by the IMF's Official Foreign Exchange Reserves (COFER). This shows that the dollar value of reserves held by the world's central banks has remained steady since 2013, in sharp contrast to the material increase over the preceding decade, and despite the major reserve holders running large current account surpluses. With many emerging markets still accumulating foreign assets via large surpluses, where are these invested then?

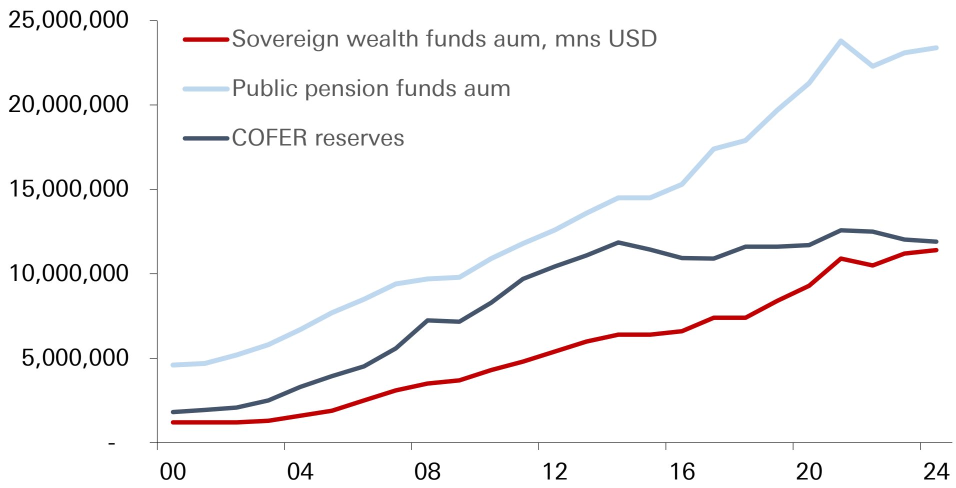
The explanation is that rather than accumulating central bank reserves, current account surplus economies have saved in other ways. Two of the largest sources of official savings have been sovereign wealth funds and public pension funds. The dollar value of savings in SWFs and PPFs has climbed USD 18.2 trillion over the same period and now exceeds that of central bank reserves by USD 6.2 trillion. Another form of official savings not captured in the second chart below – as it is difficult to quantify – is via other state entities, especially state development banks.

Figure 2: Global current account surpluses and global reserve holdings



Source: IMF, Haver Analytics, *excludes some small economies due to data availability issues

Figure 3: Selected sources of official savings



Source: Global SWF, IMF

There are several reasons for this shift in official savings. One is that emerging markets have less need for traditional central bank reserves as 'insurance' against sudden stops of capital inflows or pressure on current accounts, the types of currency crisis hitting many emerging markets in the 1990s. Financial markets in emerging markets are deepening. Among other things, this has led to greater use of borrowing in local currency and reduced dependency on foreign funding. Indeed, the share of emerging market debt in foreign currency has fallen from close to 100% in the early 2000s to around 65% today.[1] Emerging market financial systems are less vulnerable to external shocks, meaning that EM central banks have less need for reserves as insurance.

Transparency and geopolitics are among additional factors behind the shift in savings patterns. Sovereign wealth funds and other quasi–state-run entities have fewer requirements than governments do to publish the size and composition of their holdings and are less accountable to the public. SWFs and other entities such as development banks are also better placed to pursue more political or geostrategic investment goals. The Export Import Bank of China and China Development Bank are good examples: their assets have grown from approximately USD 30bn in 2009 to over USD 1 trillion today and play a large role in foreign lending, especially to developing economies, via initiatives such as Belt and Road.

What does this mean for the dollar? The asset composition of savings in SWFs and PPFs is very different from that in traditional reserve holdings. It is riskier and prioritises long-term returns over liquidity and safety. The table below shows the asset composition of some of the biggest

Table 1: Holdings of Sovereign Wealth Funds

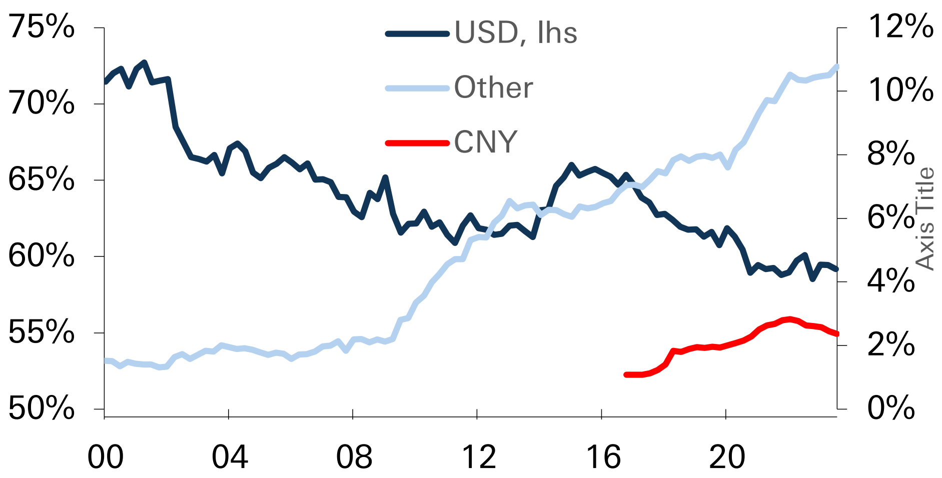
Sovereign wealth fund	AUM	Currency composition	Asset composition	Sources
Public Investment Fund	USD 595bn	N/A	20% international strategic, 3% international diversified pool, 6% international capital markets, 24% Saudi equities, 16% saudi sector development, 9% saudi real estate, 20% treasury	PIF | The Program | Public Investment Fund
Abu Dhabi Investment Authority	USD 943 (estimate from Global SWF)	N/A	32-42% developed equities, 7-15% EM equities, 1-5% small cap equities, 7-15% government bonds, 2-7% credit, 5-10% financial alternatives, 5-10% real estate, 10-15% private equity, 2-7% infrastructure, 0-10% cash	Adia annual review https://www.adia.ae/en/pr/2022/index.html
Norges Bank Investment Management	USD 1,500bn	49% USD, 18% EUR, 7% GBP, 6% JPY, 4% CHF, 16% other	70.9% equities, 27.1% fixed income, 1.9% real estate, 0.1% energy infrastructure	The fund's market value | Norges Bank Investment Management (nbim.no)
GIC	USD 770bn (estimate from Global SWF)	N/A	13% developed market equities, 17% emerging market equities, 34% nominal bonds and cash, 6% inflation linked bonds, 13% real estate, 17% private equity	GIC_AR_2022-23_PRINT.pdf,
China Investment Corporation	USD 1,240bn	N/A	28.6% public equity, 14.94% fixed income, 53.21% alternative assets, 3.25% cash products	2022EN.pdf (china-inv.cn)

[1] Scott Davis & Pon Sagnanert, "Emerging-market countries insulate themselves from Fed rate hikes," Dallas Fed, August 2023

global sovereign wealth funds. Large – and in some cases, most – allocations are to equities or private markets. Return-seeking investors generally want greater diversification in both the asset and the currency composition of their portfolios. Thus, allocations to the dollar tend to be lower than in traditional central bank reserves. Indeed, dollar allocations of Norges Bank Investment Management stand at 49%, much closer to typical private-sector currency allocations.

Even among traditional central bank holdings, there are signs of the dollar losing its lustre. COFER data shows that the dollar's share has been steadily declining over the last decade from 64% of all allocated reserves to 59%. Matching that decline has been an increase to 11% from 6% in the reserve share allocated to 'other' currencies. Among these are the renminbi, which has risen to slightly over 2% of global reserves, as well as other currencies like the Canadian and Australia dollars. These trends are consistent with the diversification hypothesis offered above. Traditional reserve managers are increasingly splitting their reserves into 'liquidity' tranches and 'investment' tranches that pursue returns and are more diversified.[2]

Figure 4: Share of allocated COFER reserves



Source: IMF

One result is that emerging market reserve managers have become more ***price sensitive***. This may have benefitted the dollar during the recent period of dollar strength and record US asset outperformance, especially in equity markets. Should US markets turn south, however, we might expect dollar allocations to shift accordingly. Those that argue for the dollar's continued dominance in reserve holdings often point to the TINA, or 'There Is No Alternative,' argument. As the data from COFER suggests, there may be no single alternative to the dollar, but there are several smaller alternatives that collectively erode the dollar's share.

Geopolitical considerations have also played a role in this shift in emerging market savings. Some countries have by necessity had to wean themselves off the dollar – most obviously Russia, which was hit by coordinated trade and financial sanctions by the US and Europe in 2022. Early that year, up to 80% of Russia's imports were invoiced in dollars or euros. That dropped to 67% by the end of the year, with the share of trade being invoiced in renminbi jumping to 20% and increasing since.[3] Much attention has been paid to the struggles faced by BRIC economies to

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[2] Agustin Carstens, "Reserve Management Challenges in the Current Economic and Financial Environment," BIS speech, September 2023

[3] Maxim Chupilkin, Beata Javorcik, Aleksandra Peeva & Alexander Plekhanov, "Exorbitant privilege and economic sanctions," EBRD Working Papers No.281, 2023

build a collectively backed dollar alternative after the organisation's summit last year. But behind the scenes, the search for alternatives has led to a striking rise in the gold holdings of BRIC central banks, no doubt in part as a hedge against reliance on a dollar-based financial system. The share of gold in BRICs' foreign exchange reserves has risen to 14% from 8% in 2015 and 11% on the eve of Russia's invasion of Ukraine.

<u>US fiscal sustainability – a new TRIFFIN Dilemma?</u>

The second challenge to dollar dominance stems from US fiscal policy. The first to raise the alarm about the dollar's status as a global reserve currency was the economist Robert Triffin in the 1950s. He argued that global demand for dollar reserve assets would outstrip US gold stocks, leading to a run on gold, and forcing the United States off gold parity. Triffin made his prediction approximately eleven years too early, but that did not prevent others from expanding upon his idea and applying it to the post–Bretton Woods financial system.

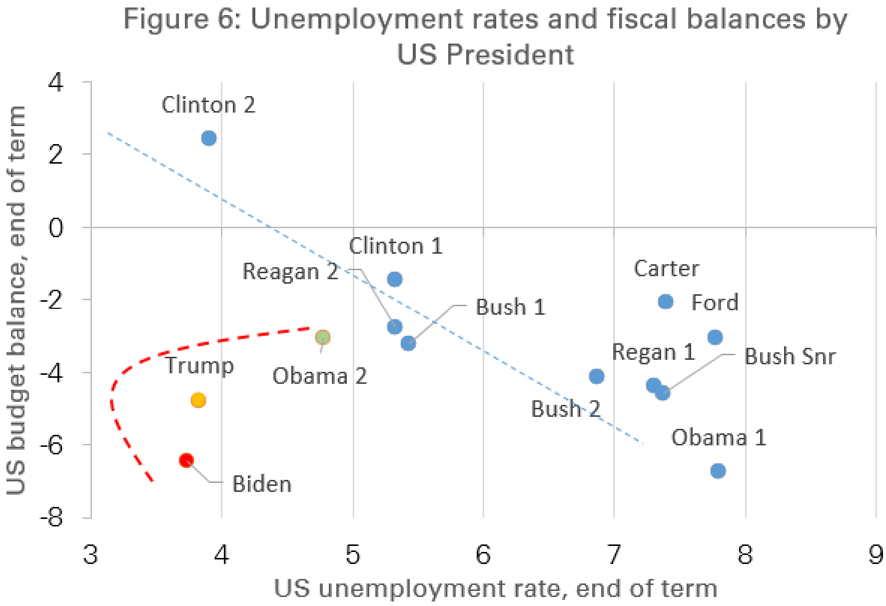
One such updated Triffin Dilemma posits that because global GDP growth typically exceeds US GDP growth, global demand for dollar assets will outstrip the US's ability to provide them over the long run. In other words, persistent demand for US government debt will exceed the ability of the United States to finance it.

This argument has been criticised on the basis that 'safe' dollar assets must not necessarily comprise only US treasuries but that they can also include bank deposits and other forms of issuance such as that by supranational institutions. Nevertheless, the US treasury market is the lynchpin of the dollar-based financial system, and any significant disruption to it would have substantial repercussions. Because of this, US fiscal facts are increasingly worrisome.

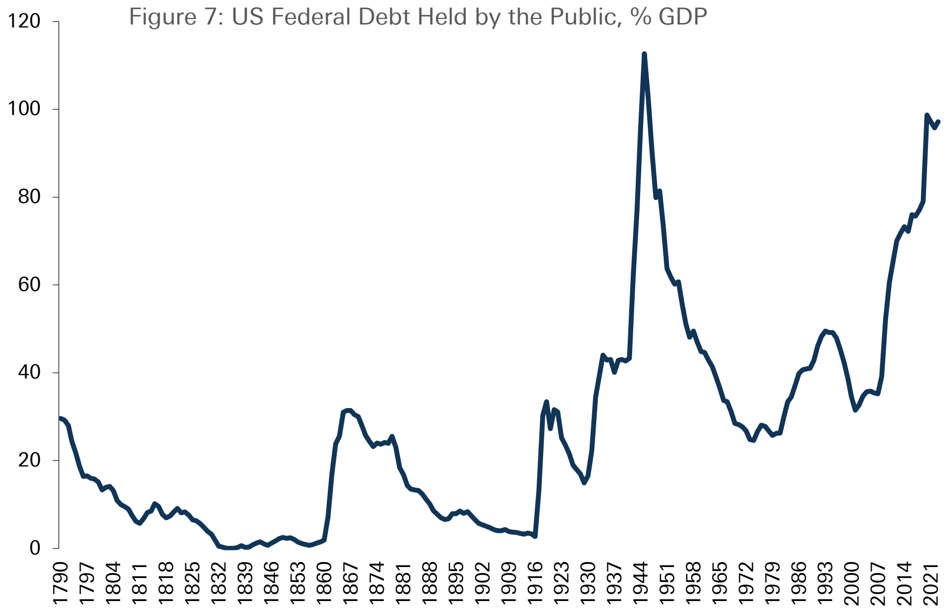
The political economy of US fiscal policy appears to have shifted in recent years. The COVID pandemic led to unprecedented post-WW2 fiscal easing across many economies worldwide, but the US still stands out as having pursued exceptionally loose fiscal policy. For example, the country's cumulative cyclically adjusted primary deficit since 2020 amounts to nearly 25% of GDP, significantly exceeding that of other large economies in both developed and emerging markets.[4] The last decade marked a caesura in US fiscal policy. Since the 1970s, US fiscal policy was typically countercyclical, as illustrated by the negative correlation between the US budget deficit and the US unemployment rate in figure 6 below. Since the second Obama administration,

[4] Data is taken from the IMF's 2023 Fiscal Monitor

however, that relationship has broken, with US budget deficits ballooning despite robust labour markets.



According to the US Bureau of the Fiscal Service, US debt held by the public (the commonly accepted economic measure of US debt) currently stands at 97% of GDP.[5] Considering primary deficits and interest-related costs, this is projected to rise to 200% GDP by 2047, a level that many consider unsustainable. Historically, the only time US debt held by the public reached a higher level than at present was in the immediate aftermath of the World War Two, when it peaked at 113%. The Bureau of the Fiscal Service also outlines projections of the necessary adjustments



Source: CBO

[5] Bureau of the Fiscal Service, 2023 Financial Report of US Government

needed in terms of primary surpluses to return US debt to GDP to a sustainable footing. If fiscal reforms were enacted today, they would require a c.4.5% increase in the primary surplus over the next 75 years, with the adjustment significantly higher if it is postponed.

Such long-run fiscal projections are subject to numerous uncertainties. Perhaps the most important are growth rates and interest rates. If nominal GDP growth exceeds interest rates, countries can afford to run small primary deficits, as was the case for the United States from 2010 to 2020. The most important variable is probably US productivity growth. Gains in US productivity have significantly outstripped those in other developed markets in recent years, and there are upside risks in the years ahead, especially in technological progress, including artificial intelligence. But downside risks exist as well, including the US's drift away from economic openness. Another factor is the savings rate. One reason that some countries such as Japan can afford to run higher debt-to-GDP ratios is high domestic savings rates, allowing most government debt to be domestically held. In the US, however, domestic savings are low. Returning to Triffin's original dilemma: a fundamental reason for low US savings is precisely that the dollar's status as a reserve currency enables the US to consume more and save less.

In summary, there is widespread agreement that given current policy settings, US fiscal policy is on an unsustainable path. But there is much less agreement on ***when*** this becomes a binding constraint. Countries can run significant budget deficits and hold high debt-to-GDP ratios for a considerable length of time without major market disruptions. The evidence for market concerns is currently rather limited. Notwithstanding the rise in US treasury yields over the last two years, foreign demand for US treasuries remains strong. But we should be wary of assuming that this will continue indefinitely. Market confidence can be more fragile than it appears, as evidenced by the market turmoil suffered by the (admittedly much smaller) economy of the United Kingdom in 2022.

Will the US continue to provide the dollar as a global public good?

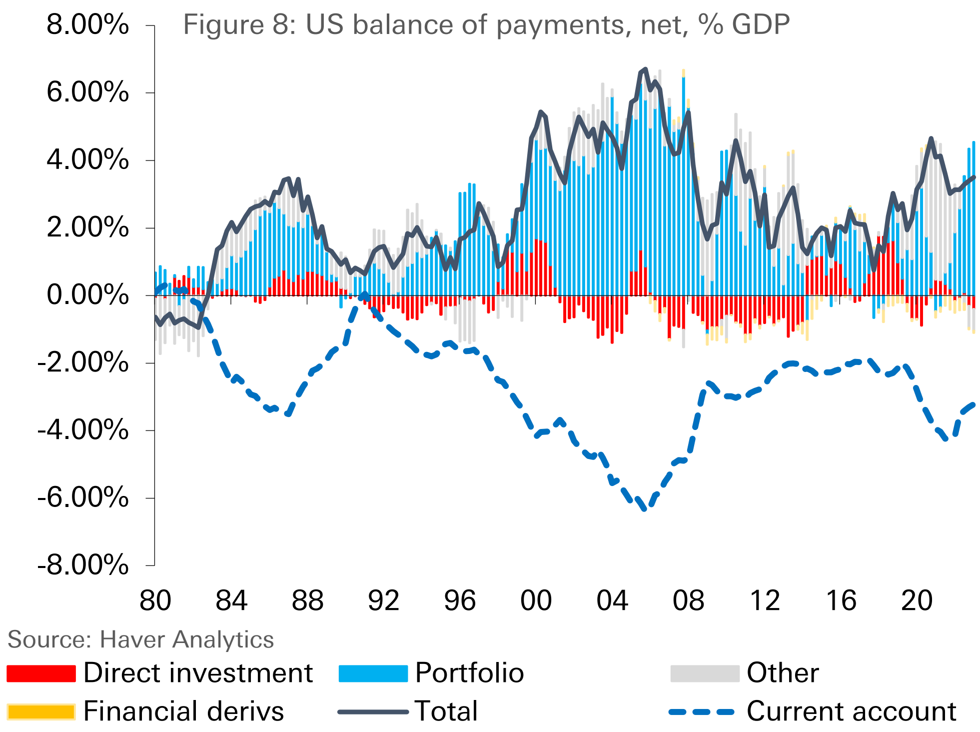
The third and final challenge to dollar dominance is politics. The role of geopolitics and strategic competition in determining the dollar's status as a reserve currency has garnered considerable attention. Most of this has been focused on the impact of sanctions on Russia's reserves and financial system as well as the efforts by the BRICs, led by China, to create an alternative, which we have addressed in part above. However, US domestic politics may prove even more critical than international affairs in deciding the dollar's reserve status.

Nowhere is this more apparent than in the US trade deficit. Political focus on the trade deficit is not new. It was a long-running bone of contention during the Reagan administration, leading to the 1985 Plaza Accord and a brief period of US protectionism. But concerns peaked under the Trump administration, which imposed broad-based tariffs on Chinese imports, threatened tariffs against other key trading partners, and renegotiated NAFTA. In a recent book, former US Trade Envoy Robert Lighthizer summarised the view of those opposed to persistent trade deficits, arguing that they have hollowed out the US manufacturing sector, caused stagnant wages for working-class Americans and transferred trillions of dollars to America's adversaries.[6]

The policy prescription of those seeking to address US trade imbalances has so far been to raise tariffs on imports; notably, the Biden administration has not rolled back the Trump tariffs. But tackling the trade deficit this way runs into a problem. The current account balance constitutes only half of the US balance of payments. Its counterpart is the financial account, or the net international demand for US assets. Globally, the US encounters an N-1 problem with the current account balance. If other economies run current account surpluses (are net savers), the US must

[6] Robert Lighthizer, *No Trade Is Free*, (Harper Collins, 2023)

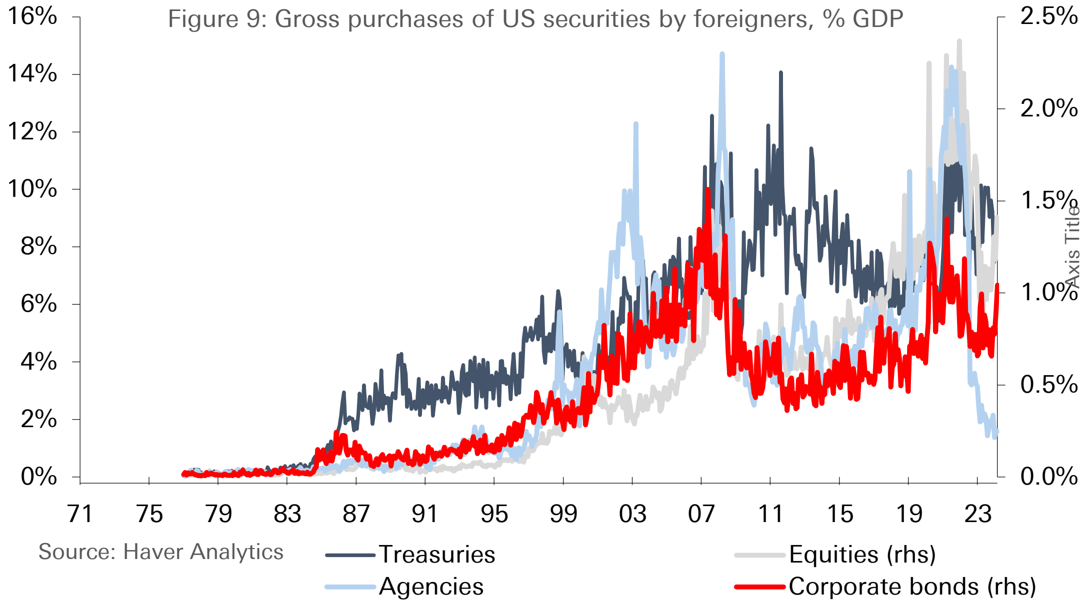
run a current account deficit (be a net borrower). This explains why recent attempts to tackle the trade deficit via tariffs have not yielded the desired results. High savings in the rest of the world, especially in China, have translated into high demand for US assets. Demand for US assets has led to a current account deficit. This is why the US current account deficit is better understood as a mismatch between savings and investment, rather than having its roots in export competitiveness.



At heart, the predicament is the trade-off between the benefits the United States accrues by holding the world's reserve currency, namely its ability to borrow cheaply from the rest of the world (often described as its 'exorbitant privilege') and the costs this incurs, namely unemployment in certain manufacturing sectors open to international competition. Should those disadvantaged by the status quo win the political argument, the US may reject its role of providing the dollar as a global public good and cease to uphold the rules of the game that underpin the world's financial system.

What would this look like from a practical perspective? One option would be measures to close or restrict the US financial account. While this might seem radical, full capital account openness in the United States dates back only to the 1970s. In the 1960s, the US deployed several measures to stem capital outflows, including investment restrictions abroad and an interest equalisation tax. More recently, the powers of the Committee on Foreign Investment in the United States were significantly expanded under the Trump administration in 2018. Among measures introduced so far are restrictions on foreign investment in sectors deemed critical to US security, followed last year by outbound restrictions on investment in China. Other softer options would be to eliminate the existing exemption on withholding tax for foreign investors.

Such measures would be designed to reduce the capital inflow and US reliance on foreign borrowing, but their implementation would likely accelerate the existing trend of reserve managers shifting away from the dollar. This essay does not suggest that the US must deterministically run current account deficits for the dollar to remain the world's reserve currency. This was not the case in the 1950s and 1960s. What matters is the gross amount of liabilities that the US offers the rest of the world.[7] But we argue that the openness of the US financial account in recent years and high savings abroad have facilitated gross foreign purchases of US securities reaching pre-2008/9 crisis highs, as can be seen by the figure below, ***and*** resulted in a continuous current account deficit that has increased domestic political tensions.



<u>Some counterarguments and conclusions</u>

In this essay we have outlined three major challenges to the dominance of the dollar. But the path forward is not predetermined. Much depends on factors such as the US's productivity performance, fiscal policy, and the political outlook.

In many areas, the dollar remains close to unchallenged in its dominance of the global financial system. It is by far the most important source of financing in international markets, for example. One such illustration is FX derivative markets, where the dollar is on one side of 88% of all FX swap and forward transactions.[8]

It is also true that there is no obvious immediate successor to the dollar. To tweak the quote in Anna Karenina, all dollar alternatives are alike, each is flawed in its own way. The euro is based on an imperfect fiscal union and lacks the depth of US capital markets. The renminbi suffers from a lack of full convertibility. Other currencies are too small.

Finally, one should not underestimate the power of inertia when it comes to the status of reserve currencies. Despite the traumatic shocks of World War One and World War Two, and the UK's relative economic decline from the 1890s onwards, the share of sterling in global reserves did not fall below that of the dollar until 1954.

But we do not argue that the dollar will be replaced in one fell swoop – more that its unquestioned dominance as the global reserve currency is coming to an end. A plausible path forward may

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[7] Michael Bordo and Robert McCauley, "Triffin: dilemma or myth?" BIS Working Paper No. 684, 2017

[8] Claudio Borio, Robert McCauley and Patrick McGuire, "Dollar debt in FX swaps and forwards: huge, missing and growing," BIS Quarterly Review, 2022

look like a continuation of recent trends, with a gradual but persistent decline in the dollar's share in reserve balances. Meanwhile, other currencies, especially the RMB, will start to challenge the dollar's use in international financing and trade invoicing, especially at a regional level. This is already the case in the euro area periphery, where most trade invoicing and financing is euro-based. China's foreign lending to developing economies is now mostly denominated in RMB rather than the previously dominant USD. Commodities like oil are also increasingly priced in other invoicing currencies (as has been true with Russian oil sales).

This 'death by a thousand cuts' of dollar dominance could be accelerated by a dramatic shock – possibly investment restrictions imposed by a US government or a buyers' strike on US treasuries. It could also be sped up by technological innovation, should efforts to decentralise the global financial system via digital currencies gain real momentum. The challenge for policymakers will be adapting to this new global financial system.

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