Research Institute - Insight

5 September 2023

7:59 minute read

#Global / #Geopolitics / #Forecast

The future of US dollar hegemony

Dissatisfaction with the USD may be on the rise in some parts of the world, but an alternative looks unlikely to emerge any time soon.

Key Takeaways

- The US dollar is the dominant currency in global trade and finance, far exceeding the US' share of global GDP, trade or banking. However, policymakers in other economies are increasingly looking to alternatives for economic and political reasons.
- Russia and China are leading these efforts, with an eye on the dollar's use in goods trade and alternative payments systems also being promoted.
- These policy efforts, the dollar's declining share of FX reserves, and the rise of central bank digital currencies could potentially signal that the currency's position is under threat.
- However, it is hard to see a shift away from the dollar as the dominant currency any time soon. Currency trading embeds a strong triangulation effect that reinforces the USD's deep & liquid FX markets. Demand for US assets remains strong, morphing from FX reserves to sovereign wealth funds.
- The Chinese renminbi may continue to gain traction in trade flows, but capital controls and geopolitical tensions imply that it is still a long way short of becoming a viable alternative. The major policy shifts required to truly internationalise the RMB increasingly seem at odds with other priorities.
- Indeed, the factors that strengthen the dollar's position, such as capital market openness, institutional quality, rule of law, and its established use as a currency of transaction, are hard to replicate.
- As such, we expect the dollar to maintain its unique role, even if we see some greater diversification regarding currencies used for trade and FX reserves over the coming years.

Dreaming of a world without the dollar

The US dollar's future role in the global economy is under scrutiny. Policymakers in emerging markets are increasingly voicing dissatisfaction with the high profile and pivotal role that the USD plays in trade and finance, due to a combination of geopolitical and macroeconomic concerns.

In particular, Russia and China appear to be leading the charge in pushing alternatives to the dollar. Russia has been forced into finding alternatives having been effectively kicked out the dollar system after the West imposed sanctions following the country's invasion of Ukraine.

This has also given impetus to Beijing's RMB internationalisation agenda. For example, China has been developing an alternative clearing system (CIPS) to the US (CHIPS), alongside an alternative to the SWIFT messaging system which facilitates cross-border banking settlement (and which Russia has been barred from).

Other countries have followed suit, although with varying degrees of enthusiasm.

There are reports of India exchanging rupees and UAE dirhams for Russian oil. Similarly, Turkey agreed to pay for 25% of its Russian oil imports in ruble. In May, ASEAN members agreed to increase trade in local currencies. This trend is not limited to emerging markets (EMs), with Australia and France also agreeing to trade deals with China denominated in yuan.

A broader de-dollarisation agenda has also been a focal point within the BRICS group, where several initiatives have been tabled. These have included not just using members' currencies in trade transactions more frequently, but also a BRICS alternative to the IMF's SDR, and even introducing a gold-backed currency.

So far only the use of local currency in trade has found support, but most members appear onboard with reducing their reliance on the dollar, at least rhetorically.

The growing economic weight of emerging markets – which we expect to rise from around 44% of the world economy to 56% by 2050 (see: Global Growth Perspective) - raises the potential for EM policymakers to have more sway on global trade and financial flows. EMs already account for around 44% and 39% of global exports and imports (see Figure 1). Thus, their potential to lead a de-dollarisation trend in global trade invoicing and broader financial flows is large.

Figure 1: EMs' growing role in global trade

Source: IMF, Haver, abrdn, August 2023

Are FX reserves a sign of what's to come?

FX reserves could potentially reflect a reduced desire to hold dollar assets. The US dollar's share of official foreign exchange reserves has been on a gradual downward trend, falling over 10pp over the past 20 years (see Figure 2).

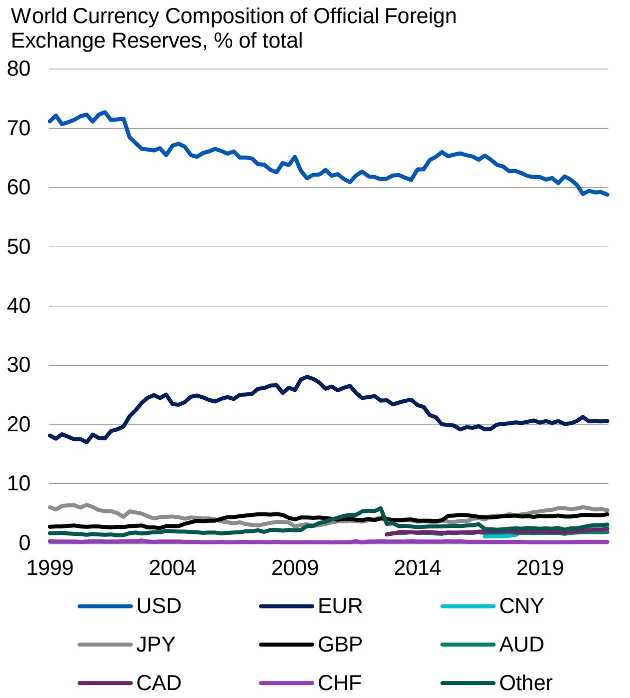
Notably, much of this shift has been driven by a rotation into other DM currencies, such as the euro, British pound, Canadian dollar and Australian dollar. The Chinese renminbi has also increased its share, but from a very low base.

However, there are limitations to looking at reserve holdings in this narrow sense and extrapolating that to reduced dollar exposures overall. The rise of sovereign wealth funds and state banks managing foreign assets has obscured the true extent of countries' holdings and, as such, FX reserves are likely downplaying overall exposure to the dollar.

FX reserve holdings also reflect the exchange rate regime being operated, with more flexible systems requiring smaller reserves as intervention becomes less common.

For example, China's official reserves have been relatively flat since 2016 at close to $3tn, reflecting a more flexible exchange rate system combined with capital account restrictions on domestic entities which has reduced the need to hold substantial USD FX reserves. Reserves as a share of total foreign assets have declined from around 70% in 2011 to 35% by 2022, reflecting this shift.

Figure 2: Dollar's share on a gradual downtrend

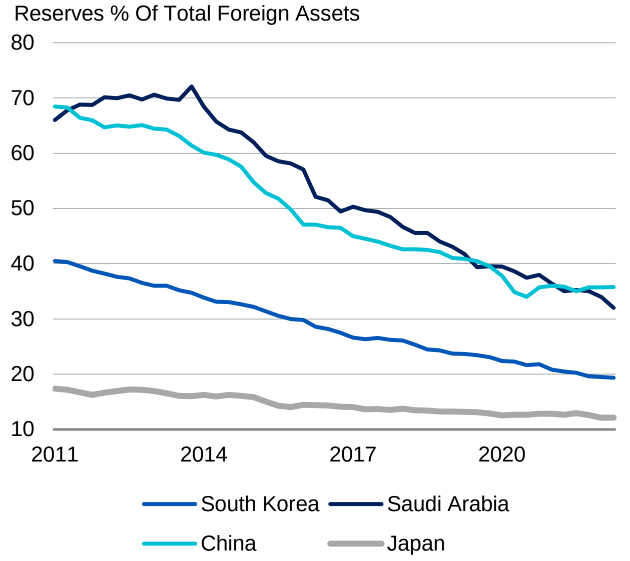


Source: IMF, abrdn, August 2023

Similar trends can be seen in other large accumulators of foreign assets (see Figure 3). And in countries like Norway, Singapore and Australia, reserves make up less than 5% of total foreign assets.

Moreover, actions taken by US policymakers in the depths of the pandemic, namely the Fed providing an increasing number of dollar swap lines and creating the FIMA repo facility, have arguably strengthened the role of the dollar in the international monetary system, even if official sector FX holdings have moderated.

Figure 3: The shifting composition of foreign assets

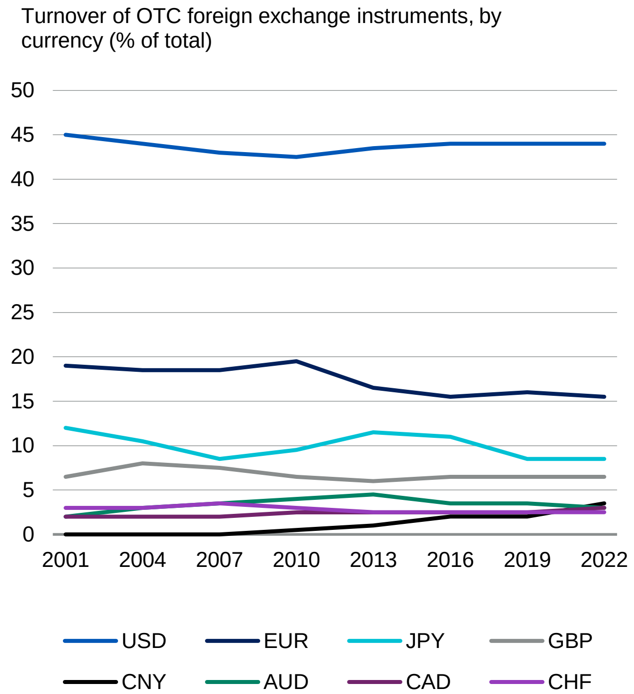


Source: Haver, abrdn, May 2023

The dollar is still dominant in financial markets

The dollar is still the dominant currency in foreign exchange and international funding. Indeed, the dollar's share of over-the-counter FX transactions has remained remarkably stable (see Figure 4). While the share of cross-border bank loans and international debt has actually risen by around 10pp to 50% over the last 10 years.

Figure 4: Dollar still dominant in financial markets



Source: BIS, abrdn, August 2023

The US also dominates equity markets. For example, it accounts for 62% of the MSCI All Country Index and around a similar share of the MSCI World Index. As such, it is likely that dollar-based assets still make up a significant share of foreign assets, despite FX reserves showing some divergence away from the dollar (primarily towards other DM currencies).

Indeed, the factors that strengthen the dollar's position, namely capital market openness, institutional quality and its established use as a currency of transaction are hard to replicate and overturn. Even with the creation of the euro – which meets many of these criteria – the dollar has maintained a dominant role globally.

FX transactions naturally lend themselves to 'triangulation', which reinforces a deep single 'vehicle' currency market. Similar to the international use of the English language within business and academia, it is often easier to transact via the USD rather than attempting bilateral exchange between country pairs. The greater ability to hedge in dollar markets, combined with the prevalence of multinational enterprises within the global supply chain, are additional factors that may slow a move towards greater diversity in trade invoicing.

The rise of the Reminbi faces major hurdles

China's rapid economic ascent and pivotal role within global trade set up the RMB as the pretender to the USD throne.

The PBOC's internationalisation efforts have delivered a more market-determined exchange rate (even if it remains somewhat interventionist at times) and central bank swap lines have been set up. As noted above, there has also been some success at encouraging trade to be priced in RMB. But despite all this, true internationalisation remains a distant prospect.

First, the RMB is starting from a low base. Its share in official FX reserves is only around 3%, compared to almost 60% for the USD. Survey research by the Official Monetary and Financial Institutions Forum (OMFIF) found that reserve managers are in no rush to expand their RMB holdings, anticipating that China's share of global reserves would grow to just 6% over the next 10 years.

Secondly, China is showing no sign of running current account deficits – which would spur greater holdings of Chinese assets – nor fully liberalising its capital account. It is true that foreign investors now have relatively free access (while the capital account remains much tighter for domestic entities), but fear that capital controls could be imposed suddenly are likely still a restraining factor. More fundamentally, there is little-to-no sign that China's high saving structure is about to change, or that trade deficits will be condoned in the near future.

Finally, the opacity of CCP policy making and weaker institutional safeguards, combined with (and potentially amplified by) geopolitical tensions damage the element of trust that helps create a global reserve currency.

Indeed, China's attempt to insulate itself from sanction risk may backfire: exposure to the dollar system may raise the odds of 'good' behaviour (at least in the eyes of investors), therefore freeing oneself from the prospect of sanctions may not in fact reduce risk premia demanded.

China has been at the forefront of developing a central bank digital currency (CBDC) and this could potentially offer a route to by-pass the dollar-based system. In theory, an importer using digital currency could transfer the required payment, negating the need for settlement through banks which requires instructions to be sent through a system such as SWIFT. It is however unclear how this would operate in practice, how an e-RMB would fit within the international system, and over what time scale this could actually be introduced.

Multi-currency future a possibility, but unlikely in the near-term

We think it is likely the dollar will remain as the prominent currency in global trade and finance as it stands. However, it is possible that greater diversification could occur within trade invoicing, where local currencies or dominant regional currencies are increasingly used.

Over the longer term, this rise in local currency trade could reduce the dollar's broader role in the global financial system. But major hurdles remain to reduce dollar hegemony.

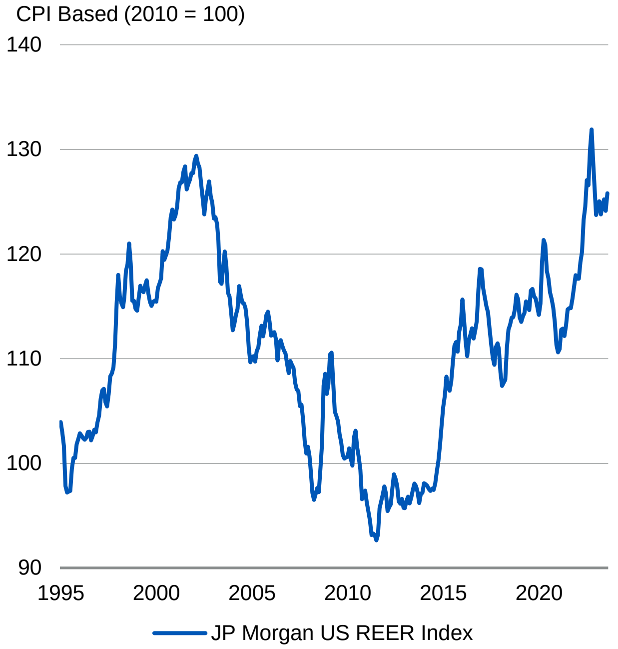
We appear to be a long way from CBDCs providing a route to by-passing the dollar-based system and there are questions around EMs willingness to undertake the reforms to develop institutional quality and capital market depth, which would increase their ability to absorb capital flows through more traditional channels. Nevertheless, were progress to be made on these fronts it could usher in something more akin to a multi-currency system.

US actions could lead to a self-inflicted demise of the dollar. A technical default – triggered by a failure to renegotiate the US debt ceiling – or a significant degradation of US institutions could weaken the dollar's position and open the door for other currencies to gain a more dominant position.

But there appears a high bar for this to threaten the dollar's position. The shine has not come off the dollar despite a global financial crisis, several debt ceiling stand-offs, political and social upheaval, and a resurgence of inflation. Indeed, the US dollar on a trade-weighted basis is close to its early-2000s peak (see Figure 5).

Those wondering each night why the dollar is so widely used, are likely to be asking themselves that question for many more nights to come.

Figure 5: Dollar close to its strongest in two decades



Source: Haver, abrdn, August 2023

Authors

Michael Langham & Bob Gilhooly

Important Information

For professional and Institutional Investors only – not to be further circulated. In Switzerland for qualified investors only.

Any data contained herein which is attributed to a third party ("Third Party Data") is the property of (a) third party supplier(s) (the "Owner") and is licensed for use by abrdn**. Third Party Data may not be copied or distributed. Third Party Data is provided "as is" and is not warranted to be accurate, complete or timely. To the extent permitted by applicable law, none of the Owner, abrdn** or any other third party (including any third party involved in providing and/or compiling Third Party Data) shall have any liability for Third Party Data or for any use made of Third Party Data. Neither the Owner nor any other third party sponsors, endorses or promotes any fund or product to which Third Party Data relates. **abrdn means the relevant member of abrdn group, being abrdn plc together with its subsidiaries, subsidiary undertakings and associated companies (whether direct or indirect) from time to time.

The information contained herein is intended to be of general interest only and does not constitute legal or tax advice. abrdn does not warrant the accuracy, adequacy or completeness of the information and materials contained in this document and expressly disclaims liability for errors or omissions in such information and materials. abrdn reserves the right to make changes and corrections to its opinions expressed in this document at any time, without notice.

Some of the information in this document may contain projections or other forward-looking statements regarding future events or future financial performance of countries, markets or companies. These statements are only predictions and actual events or results may differ materially. The reader must make his/her own assessment of the relevance, accuracy and adequacy of the information contained in this document, and make such independent investigations as he/she may consider necessary or appropriate for the purpose of such assessment.

Any opinion or estimate contained in this document is made on a general basis and is not to be relied on by the reader as advice. Neither abrdn nor any of its agents have given any consideration to nor have they made any investigation of the investment objectives, financial situation or particular need of the reader, any specific person or group of persons. Accordingly, no warranty whatsoever is given and no liability whatsoever is accepted for any loss arising whether directly or indirectly as a result of the reader, any person or group of persons acting on any information, opinion or estimate contained in this document.

This communication constitutes marketing, and is available in the following countries/regions and issued by the respective abrdn group members detailed below. abrdn group comprises abrdn plc and its subsidiaries:

(entities as at 04 September 2023)

United Kingdom (UK)
abrdn Investment Management Limited registered in Scotland (SC123321) at 1 George Street, Edinburgh EH2 2LL. Authorised and regulated in the UK by the Financial Conduct Authority.

Europe[1], Middle East and Africa
[1] In EU/EEA for Professional Investors, in Switzerland for Qualified Investors - not authorised for distribution to retail investors in these regions

Belgium, Cyprus, Denmark, Finland, France, Greece, Iceland, Ireland, Italy, Luxembourg, Netherlands, Norway, Portugal, Spain, and Sweden: Produced by abrdn Investment Management Limited which is registered in Scotland (SC123321) at 1 George Street, Edinburgh EH2 2LL and authorised and regulated by the Financial Conduct Authority in the UK. Unless otherwise indicated, this content refers only to the market views, analysis and investment capabilities of the foregoing entity as at the date of publication. Issued by abrdn Investments Ireland Limited. Registered in Republic of Ireland (Company No.621721) at 2-4 Merrion Row, Dublin D02 WP23. Regulated by the Central Bank of Ireland. **Austria, Germany**: abrdn Investment Management Limited registered in Scotland (SC123321) at 1 George Street, Edinburgh EH2 2LL. Authorised and regulated by the Financial Conduct Authority in the UK. **Switzerland**: abrdn Investments Switzerland AG. Registered in Switzerland (CHE-114.943.983) at Schweizergasse 14, 8001 Zürich. **Abu Dhabi Global Market ("ADGM")**: abrdn Investments Middle East Limited, 6th floor, Al Khatem Tower, Abu Dhabi Global Market Square, Al Maryah Island, P.O. Box 764605, Abu Dhabi, United Arab Emirates. Regulated by the ADGM Financial Services Regulatory Authority. For Professional Clients and Market Counterparties only. **South Africa:** abrdn Investments Limited ("abrdnIL"). Registered in Scotland (SC108419) at 10 Queen's Terrace, Aberdeen AB10 1XL. abrdnIL is not a registered Financial Service Provider and is exempt from the Financial Advisory And Intermediary Services Act, 2002. abrdnIL operates in South Africa under an exemption granted by the Financial Sector Conduct Authority (FSCA FAIS Notice 3 of 2022) and can render financial services to the classes of clients specified therein.

AA-181023-169677-7