

»»» The US dollar's dominance remains virtually unchallenged

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The size of the US economy, the depth of the capital market, the free convertibility of the currency and the trust placed in US institutions have helped the US dollar defend its position as a global reserve currency even after the end of Bretton Woods. To be sure, the share of currency reserves allocated in US dollars has fallen in the past decades, but at around 60% today the greenback continues to clearly assert its dominant position. In response to Russia's war of aggression against Ukraine, the dollar's dominance has been used as a 'sanctions weapon' for the first time in history, a development that will uplift the use of local currencies and alternative payment systems in Asia. However, the alternatives to the dollar as a global reserve currency are generally limited. Neither the renminbi nor the euro nor cryptocurrencies will be able to challenge the greenback for the foreseeable future.

The US dollar as a global reserve currency

With the end of World War II and the subsequent introduction of the exchange rate system of Bretton Woods, the US dollar has come to play the role of a global reserve currency which continues to this day. In this context, in the 1960s Valéry Giscard d'Estaing, then minister of finance of France, spoke of the 'exorbitant privilege' which the USA enjoyed as a result of the special position of the US dollar.¹ The fact that the greenback was able to defend its dominant position even beyond the end of the Bretton Woods system is due to the size of the US economy, the depth of the capital market, the free convertibility of the currency and the trust placed in US institutions. The US dollar continues to be the dominant global currency in this millennium as well. In the years 1999–2014, on average 40% of global trade was settled in US dollars.² At the end of 2021, more than 60% of global debt and over 50% of international loans were denominated in US dollars. The euro follows in second place, well behind with a share of roughly 20% in both cases.³

Central banks rely on US currency reserves

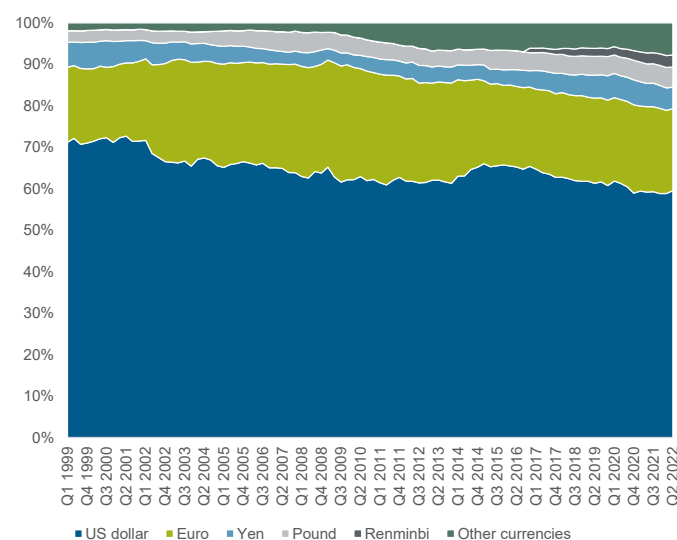
For many decades the hegemony of the US dollar in global trade and international financial markets has helped to make US government bonds a popular way for central banks around the world to park liquid funds. In this, the size of the market ensures the very good tradability of US securities. At the end of the 1990s, just under 70% of the currency reserves of central banks around the world were allocated in US dollars (Figure 1).

In the second quarter of 2022 the share of US dollars in currency reserves had slipped to just below 60%. One reason for this development is the diminishing share of the US in global value added. Whereas in 1960 around 40% of global

GDP was still generated in the US, that percentage dropped to just under 30% in 1990 and to 25% by 2020. Despite this declining trend, however, the US dollar still remains the dominant currency in global trade and international financial markets.

Figure 1: Composition of global foreign currency reserves

In per cent. (Prior to Q4 2016, the renminbi was included in 'other currencies')



Sources: IMF, KfW Research

While the proportion of currency reserves allocated in US dollars is well above the US's share of global value added, exactly the opposite is the case for the Chinese renminbi. Whereas China generated only 4% of global value added at the start of this millennium, that share already stood at 17% in 2020. To be sure, the share of foreign currency reserves allocated in renminbi during this period has increased, but it still stood at just under 3% in the second quarter of 2022. One major reason for this is that the renminbi is currently not fully freely convertible and therefore the Chinese currency still has a long way to go before it can become a global currency.

The US is using the reserve currency as a 'sanctions weapon'

In February of this year Russia unleashed its war of aggression against Ukraine and was subsequently punished with extensive sanctions. The US, the EU, the UK, Switzerland and other entities agreed to seize around USD 300 billion in Russian currency reserves.⁴ That means the foreign currency holdings kept in accounts in those countries were made inaccessible to the Central Bank of Russia, making them unavailable to support the ruble. At the time, the total reserves of the Central Bank of the Russian Federation amounted to

approx. USD 640 billion, so that seizing nearly 50% of foreign currency holdings did not remain without effect. The Russian currency subsequently depreciated by more than 40% for a short time. The Central Bank of Russia responded to the currency erosion by temporarily raising its key interest rate to 20% and introducing capital controls, which helped the ruble recover quickly to a level that is now higher than before the outbreak of the war. Nevertheless, the central bank continues to have little scope for action as a result of the seizure of a large portion of its foreign currency reserves. As part of the sanctions, the US imposed a temporary ban on trade with Russian government bonds and prevented US banks from settling payments of interest and principal.^{5 6} It was the first time in history that the hegemony of the US dollar was used as a 'sanctions weapon', and it can be assumed that other economies kept a close watch on this precedent.

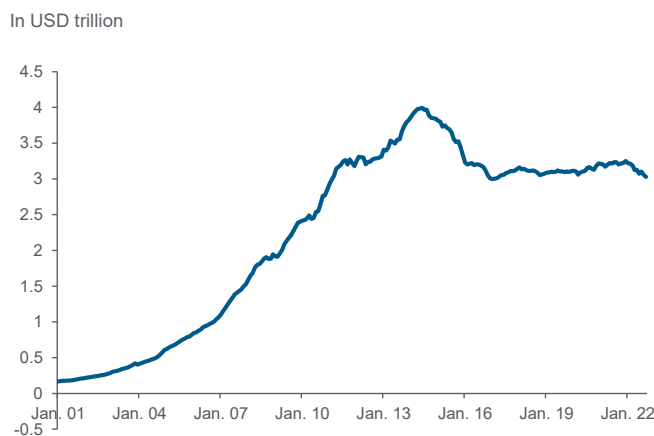
Sanctions are affecting international payment systems

As part of the sanctions imposed on Russia, ten Russian banks were excluded from SWIFT, the largest international payment network. According to the organisation, it is being used by more than 11,000 institutions in more than 200 countries.⁷ In April 2022 the US dollar accounted for 41.8% of the value of payment instructions transmitted by SWIFT, the euro 34.7%, the British pound 6.3%, the Japanese yen 3.1% and the Chinese renminbi 2.1%.⁸ The exclusion of the largest Russian banks from the SWIFT payment system might provide a boost to the Chinese counterpart CIPS (Cross-Border Interbank Payment System), which is also linked to the Russian Interbank system SPFS. CIPS is primarily a settlement system for renminbi transactions that currently processes some 13,000 transactions per day. That is just a fraction of the more than 42 million daily transactions currently being settled by SWIFT. For the foreseeable future, it therefore does not pose a serious threat to the dominant position of the western system SWIFT and the associated dominance of the US dollar.

Some regions are increasingly using local currencies

In the spring of this year, voices have been heard in China questioning the credibility of the US dollar as a global currency and invoking the imminent end of its hegemony. Realistically, however, the People's Bank of China only has a very limited number of options for parking the enormous amount of liquidity. China's foreign currency reserves currently amount to USD 3 trillion (Figure 2). The exact composition of its currency holdings is a state secret. But what is known is that around one third of the total volume is invested in US government bonds. Outside the US, only the financial markets in Europe and Japan are remotely capable of meeting this enormous demand for liquid financial investments. However, these two regions are closely aligned with the US in the current geostrategic conflict.

Figure 2: Chinese foreign currency reserves



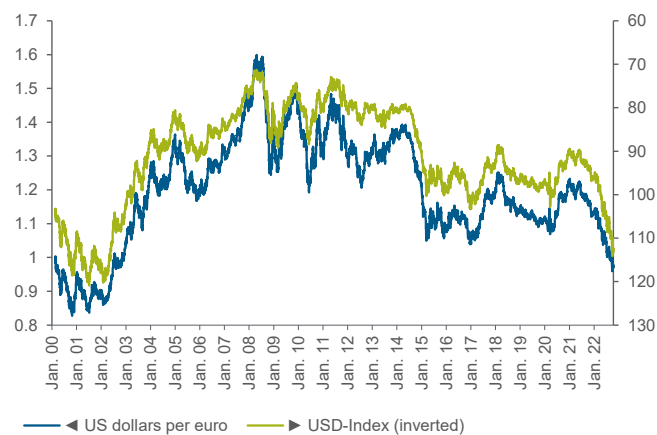
Source: People's Bank of China.

Even if a significant restructuring of China's foreign currency reserves appears unlikely, the US dollar may lose ground in Asian trade. China and Russia are increasingly settling their payments in domestic currencies, a trend that is visible from the fact that the volume of trade between the Chinese renminbi and the Russian ruble has recently reached new historic highs.⁹ A similar development can also be observed in trade between Russia and India. India's coal imports, which have recently grown significantly, are increasingly being settled in Asian currencies instead of US dollars.¹⁰ Recent research shows that the role of a currency in global trade and financial transactions also influences its position in global currency reserves.¹¹ In this context Gita Gopinath, the former chief economist of the IMF, recently pointed out that the stronger use of local currencies in global trade might also lead to a further diversification of the foreign currency reserves held by national central banks.¹² However, the absolute effect will presumably remain moderate.

US dollar is on a 20-year high

The fact that the sanctions imposed against Russia have not caused any lasting damage to the hegemony of the US dollar can also be seen from the current strength of the greenback. It broke parity with the euro in August 2022 and has now reached a level of strength not seen since autumn 2002. But it is not just against the common currency that the US dollar has recently posted gains. The US Dollar Index, which compares the value of the US dollar using a currency basket of six currencies, has recently risen to the highest level in 20 years (Figure 3). Besides the Federal Reserve's aggressive interest rate hike, what also contributed to the current strength is that the greenback seems to have lost little of its attractiveness as an international safe haven.

Figure 3: Strength of the US dollar



Source: Bloomberg.

Hardly any alternatives to the US dollar's dominance

The continuing dollar monopoly can also be explained by the fact that, there are few global currency alternatives. If we look at central banks' currency reserves, the only currency besides the US dollar in which a significant portion of currencies is invested is the euro. But because every member state of the euro area issues its own government bonds, the market for bonds denominated in euros is heavily fragmented. That means the Eurobond market is not as easily investable as the US market, and nor can the volume of its secure bonds keep up with the former. But it does not need to be this way forever. In the course of the coronavirus crisis, the EU incurred debt jointly for the first time in history. If this exception becomes the norm, a deeper, homogeneous and secure Eurobond market might develop, which would definitely strengthen the position of the euro as a global currency alternative to the US dollar.

The global use of the renminbi, on the other hand, will probably remain limited as long as it is not freely convertible. Exercising control over the domestic financial system appears to be more important to the Chinese government than challenging the US dollar as a global currency, and there is currently little to suggest that this attitude will change anytime soon.

Cryptocurrencies are hardly a threat to the US dollar

Cryptocurrencies such as Bitcoin were launched with the aim of replacing financial intermediaries such as central banks and state-mandated means of payment. Thus far, however, digital currencies still rather occupy a niche. Their price trend is extremely volatile. After the total value of all cryptocurrencies

amounted to just under USD 3 trillion at the end of 2021, it has now dropped to around USD 1 trillion.¹³ The market capitalisation of so-called stablecoins, which are often tied to the value of a fiat currency, is currently only around USD 150 billion.¹⁴ By comparison, the total volume of global currency reserves exceeds USD 12 trillion. Besides, the options for spending cryptocurrencies remain limited, and the crash of the Terra-Luna ecosystem has deeply shaken confidence in crypto markets. Terra is a stablecoin that was meant to mirror the value of the US dollar one-to-one. But instead of being backed by liquid funds, it is based on a link to the cryptocurrency Luna to maintain its price. That places it among the group of 'arithmetic stablecoins', which are far from being as stable as the US currency, as the crash in May illustrated. Stablecoins that are tied to a fiat currency are much more stable. That is typically the US dollar, which means that demand for the greenback will tend to even grow further as this type of cryptocurrency continues to spread.

Conclusion

In the past decades, the global dominance of the US dollar has weakened somewhat, but currently there is nothing to indicate that it will lose its status as a global currency for the foreseeable future. In Asia the sanctions imposed against Russia will accelerate the trend to complete trade transactions more often in local currency, and the Chinese payment system CIPS is experiencing a tailwind from the current geopolitical crisis as well. But these developments do not pose any serious threat to the pre-eminence of the US dollar. The size of the US economy, the depth of the capital market, the free convertibility of the currency and the trust placed in US institutions are a constellation of significant factors not found in any other region of the world. Serious competition could only arise in the euro area, but only under the condition of deeper fiscal integration, although it is not clear whether the EU will embark on this path, and if so, when. In addition, the widespread acceptance of the US dollar increases this currency's usability for every individual, and this in turn leads to its further dissemination. The global economy has agreed on a global currency, and today there is hardly an alternative to threaten this dominance.

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⁷ SWIFT (2022). <https://www.swift.com/de/node/10151>

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