

US Dollar Dominance

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The US dollar has been the dominant global reserve currency for 100 years. Many countries hold significant amounts of the currency for international trade, investment and storing value. Last year, the US dollar reached 20-year high, defying predictions of its decline as interest rates and global growth differentials improved in favour of the US.

The rise of the US dollar began with World War I, which left most countries in need of dollar-denominated loans and American goods. The US dollar remained linked to gold as other countries were forced off the gold standard. By the end of World War II, the US owned most of the world's gold. When the US itself abandoned the gold standard in the early 70s, the dollar's role as the world's reserve currency was solidified. Despite the fact that it was no longer convertible to gold, the rest of the world needed the US dollar because the currency was the stable standard for denominating values of goods and services. It was easily available as a means of exchange and a safe store of value. Trust in the integrity of the US dollar had not been shaken.

The longevity of the US dollar's dominance is a topic of ongoing debate among economists and policymakers and there are several factors that could potentially erode its status as the world's primary reserve currency. According to International Monetary Authority (IMF), the share of US dollar reserves held by global central banks fell to 50%, down from 60%, a decade ago. A recent World Gold Council report indicated that central banks bought 673 tons of gold in the first three quarters of 2022, compared with 454 tons for the whole of 2021. The size of the dollar bloc, a group of countries that all use the same reserve currency, declined this year to around 30-35% of global GDP, down from 50% in 2000, while the renminbi bloc climbed close to 30%, up from 15%, in the same period.

The emergence of alternate payment systems like central bank digital currencies, reserve diversification, and non-dollar regional currency blocs could also erode the US dollar's dominance. Let's consider some of the major factors at play.

Shifts in global economic power

The rise of emerging economies such as China and India could lead to a decline in the dollar's dominance as these economies become more important players in the global economy. As these economies grow and develop, they may increasingly demand greater influence over the global financial system and seek to promote their own currencies as reserve currencies. Perhaps the renminbi is one single currency which is getting ready to dethrone the US dollar dominance. Beijing has been pushing its partners to use the renminbi. Russia, the world's largest commodity exporter, has already shifted some of its trades from the US dollar to renminbi and an Australian iron ore conglomerate, BHP, made its first deal in renminbi late last year - others may follow.

Geopolitical risks

Political instability and geopolitical risks, such as tensions between the US and other major powers, could erode confidence in the dollar and undermine its status as a safe haven currency. Russia's attack on Ukraine has prompted the US to freeze much of the Russian central bank's reserves, obstructing its access to dollars. This has the potential to encourage other central banks to contemplate shifting away from the dollar. The use of the currency to wear down a rogue nation, and the fracturing of global economy likely to result, may have a similarly



taxing impact on the currency itself. Last year, the IMF noted that dollar reserves held by central banks had hit their lowest level in a quarter century, reflecting what economists saw as the US dollar's declining role. The recent pandemic and its economic aftermath, alongside other challenges, might continue to weaken the dollar's status as a global currency.

Economic policies and debt levels

High levels of debt and inflation could also contribute to a decline in the dollar's dominance. If the US continues to run large deficits and its debt levels continue to grow, this could eventually undermine confidence in the dollar and erode its status as a reliable store of value. The impact that US monetary policy will have on emerging markets compared to other advanced economies may begin to weaken, limiting the role played by the US dollar in global capital flows.

The emergence of new digital currencies

The rise of digital currencies such as Bitcoin and other cryptocurrencies, as well as digital currencies backed by central banks, could potentially challenge the dominance of traditional fiat US dollars. While it remains to be seen whether these digital currencies will gain widespread acceptance as a means of payment and store of value, they do represent a potential threat to the dominance of all traditional fiat currencies in general. The basic contradiction in using fiat US dollars as a reserve currency is that the US must run current account deficits to provide dollars to the rest of the world. This implies that the more US dollars provided, the weaker it will be as a means of international payment and a reserve currency. Essentially, this contraction may support a move to digital currencies.

In summary, while the US dollar's dominance is likely to persist for the near future, there are several risks and challenges that could challenge, or eventually erode, its status. Currently, as the dominant currency of international trade, the US dollar is used in roughly 40% of global trade transactions. It is important for investors to remain vigilant and to consider risks which may force a shift in the dominance of the dollar in their investment decisions.

Sources

Morgan Stanley Investment Management Research & Bloomberg Economics

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