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ECONOMIC AND FINANCIAL COMMITTEE

AGENDA: DELIBERATING UPON ALTERNATIVE CURRENCIES FOR GLOBAL WORLD TRADE

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ABOUT THE COMMITTEE

ECOFIN (ECONOMIC AND FINANCIAL COMMITTEE)

The US dollar has longed served as the world's reserve currency, however in the recent times its dominance has come under challenge. Over-reliance on the American currency can lead to instability in emerging markets, dampen trade flows and create global spillovers, such as when financial markets melted down in March 2020. The sanctions imposed on Russia by the United States and its allies have demonstrated the immense geopolitical power that control of the global currency system can confer. These same sanctions also make clear, however, why the governments of other countries that might one day be subject to such penalties are doing all they can to opt out and establish an alternative global currency system — one they control or one that is unlikely to be controlled by potential adversaries. That is why a vibrant debate has erupted over whether or not countries like China can establish a credible alternative to the dollar. This trend, is known as de-dollarisation of the global currency.

But while there has been much debate over whether or not the world—or at least part of the world, including countries like China, Iran, Russia, and Venezuela—can live without the dollar, there has been much less attention on an equally important issue: what the trade impact would be of a world less tied to the U.S. dollar. The two issues cannot be separated. The issue of the dollar is part of the debate over global capital flows, but capital flows are just the obverse of trade and current account flows. Savings, after all, can only be expressed as the excess production of goods and services.

REASONS BEHIND DE-DOLLARISATION

1] The over-dependence on a single currency exposes the nation to risks associated with fluctuations in the value of the dollar, changes in US monetary policy, and potential sanctions or restrictions imposed by the US. The US government has been running large budget deficits for years, and this has led to concerns about inflation and the value of the dollar.

2] The US has been involved in several geopolitical conflicts in recent years, including the wars in Iraq and Afghanistan. These conflicts have led to increased tensions between the US and other countries, which has made some countries less willing to use the dollar.

3] China is the world's second-largest economy and is becoming increasingly influential in the global trade. China has been promoting the use of its currency, the renminbi, as an alternative to the dollar.

4] Cryptocurrencies, such as Bitcoin, are a new form of digital currency that is not subject to government control. This has made them attractive to people who are looking for an alternative to the dollar.
Countries seek to reduce their over-reliance on the US dollar and enhance their economic sovereignty by diversifying their currency reserves and conducting transactions in alternative currencies. Reducing reliance on the US dollar enables countries to develop their financial systems, pursue economic policies aligned with their national interests, and strengthen their financial objectives. Furthermore, nations that are at odds with the US or face geopolitical pressures may seek to minimise their exposure to the dollar, reducing their vulnerability to potential sanctions or economic pressures. This shift towards a multipolar global financial system, where no single currency dominates, may lead to increased financial inclusivity and reduced vulnerabilities associated with currency fluctuations.

CHALLENGES OF DE-DOLLARISATION

The transition away from the US dollar as the world's reserve currency, known as de-dollarisation, can be a complex and challenging process. There are a number of potential risks and disruptions that need to be carefully considered before embarking on a de-dollarisation strategy. One of the biggest challenges is the potential for devaluation or loss of trust in the new currency. If the new currency is not seen as being as stable or as liquid as the dollar, it could lead to economic instability and hinder financial transactions. It is therefore important to build confidence and trust in the new currency before making the switch. Another challenge is that many commodities, such as gold and oil, are priced and traded in dollars. This means that shifting away from the dollar could complicate international transactions and make it more difficult to trade these commodities. This could also hamper foreign direct investment and capital flows. Countries with significant debt in USD will also face special challenges when trying to reduce their reliance on the dollar. If they suddenly move away from the dollar, their debt could become more expensive because their currency may lose value or exchange rates may fluctuate. This could lead to financial instability and make it more difficult to repay the debt.

ADVANTAGES OF ALTERNATIVE CURRENCIES

Use of alternative currencies for trade settlement has several advantages. First, it reduces the reliance on the US dollar, which can be beneficial for countries that are subject to US sanctions or political pressure. Second, it can reduce transaction costs and currency risk for companies that trade with multiple countries. Finally, it can promote economic and financial integration among countries that share a common currency or currency bloc.

The growing concerns over the stability of the US dollar are also contributing to the decline of its dominance in global trade. The US dollar is the world's reserve currency, which means that many countries hold US dollars in their foreign exchange reserves. However, in recent years, there have been concerns about the long-term stability of the US dollar. The US has a large and growing national debt, and there are concerns that the US government may not be able to service its debt in the long term.

There are also concerns about the US government's ability to maintain the value of the dollar. The Fed has been printing money at an unprecedented rate in response to the pandemic. This has led to concerns about inflation and the long-term value of the dollar. Many countries are now diversifying their foreign exchange reserves away from the dollar and into other currencies or assets, such as gold or cryptocurrencies.

In conclusion, the dominance of the US dollar in global trade is diminishing, driven by several factors, including the rise of China, the increasing use of alternative currencies for trade settlement, and the growing concerns over the stability of the US dollar. While the decline of the dollar's dominance may be gradual, it is likely to continue in the years ahead. This trend has important implications for the global economy and the future.

DOLLAR STILL RULES

However, in February Reuters published an article saying reports of dollar's demise are greatly exaggerated. Citing Bank for International Settlements' report, the news agency pointed out that the US dollar was on one side of 88 per cent of all foreign exchange trades in April last year. The Fed estimates that between 1999 and 2019 the dollar accounted for 96 per cent of trade invoicing in the Americas, 74 per cent in the Asia-Pacific region, and 79 per cent in the rest of the world.

CAN THE WORLD FIND AN ALTERNATIVE TO THE U.S. DOLLAR?

The dollar is the most widely used currency in international trade not just because of network effects, but also for other reasons that are hard for other countries, especially countries like China, to replicate. The world uses the dollar because the United States has the deepest and most flexible financial markets, the clearest and most transparent corporate governance, and (in spite of recent sanctions) the least amount of discrimination between domestic residents and foreigners. This means that, for example, for China's renminbi to compete with the U.S. dollar, Beijing would have to be willing to present the same benefits to foreigners. This includes giving up control of its current and capital accounts and substantially reducing its ability to control credit growth and the liabilities of its financial system. All of these measures, at least for the foreseeable future, are extremely unlikely. everal years.

In fact, not only has Beijing shown no inclination in recent years to accept any of these changes, but it has been moving in the opposite direction, especially with the centralisation of bureaucratic and political power and the expansion of the state sector that China has undertaken in the past several years.

There is another, more important reason for the widespread use of the dollar. The global trading system is terribly unbalanced, with several large economies—including China, Germany, Japan, and Russia—locked into unbalanced income distributions that reduce domestic consumption and force up their savings rates. Because weak consumption, along with weak investment from private businesses who depend mainly on local consumers to buy the goods they produce, leads to weak domestic demand, these economies require large, persistent trade surpluses to resolve the excess production that drives their economies. But surplus economies must acquire foreign assets in exchange for their surpluses. This is where the United States—and other Anglophone economies with similar markets and governance, like the UK—play their most important role. A country can only import net foreign savings by exporting ownership of assets, and the United States and other similar economies are the only stable, mature economies that are both willing and able to allow foreigners unfettered access to the acquisition of local assets. To put it another way, they are the only major economies both willing and able to run the permanent trade deficits that accommodate the needs of foreign surplus-running countries to acquire foreign assets. No other major economy can accept, or is willing to accept, this burden.1

It helps to consider the alternative assets surplus countries can accumulate to see why, in spite of decades of complaints in the international community, the U.S. dollar remains the dominant currency. In principle, surplus-running economies can accumulate small amounts of assets in other advanced economies, but with the exception of the European Union (EU) and perhaps Japan, none is big enough to balance more than a tiny share of the world's accumulated trade surpluses.

More importantly, Japan and the EU, along with most advanced, non-Anglophone economies, run persistent surpluses themselves, so they cannot accommodate the surpluses of countries like China and Russia. I will explain later why giving up these surpluses would be so difficult.

Some analysts have argued that surplus-running countries can instead invest their excess savings in the developing world, and while much of the developing world would welcome small persistent capital inflows, the problems with relying on them are fairly obvious. Their economies are far too small to absorb a reasonable share of global excess savings without causing significant domestic dislocations that would make repayment impossibly difficult. In fact, China has in the past six or seven years significantly reduced its already limited exports of capital to developing countries as the risks have become increasingly obvious, while Russia doesn't invest much in the developing world.

WILL ACQUIRING COMMODITY RESERVES PROVIDE AN ALTERNATIVE?

Some analysts have argued that, as a consequence of the sanctions imposed on Russia, the world is likely to see a shift in global reserve accumulation toward commodities. This, too, is unlikely. Countries like Russia, Iran, and Venezuela are all primarily commodity exporters, which makes the arithmetic of reserve accumulation very tricky. They would have to buy most aggressively when prices are high and their surpluses are large, and they would most likely have to monetise their reserves when prices are low and their economies are struggling. Not only would their reserve accumulation process thus exacerbate the volatility of commodity prices, which would be damaging for their economies, but, more worryingly, their reserves would be most valuable when they needed them least and least valuable when they needed them most. This is the opposite of what countries want from reserves.

China, of course, is the world's largest commodity importer, so at first it might seem to be in the opposite position of commodity-exporting countries like Russia, in which case accumulating commodity reserves instead of foreign assets might seem to make a lot of sense. However, as the world's largest importer of commodities by far, especially industrial commodities, it turns out that China's economic performance is correlated with commodity prices in the same way as that of commodity exporters, only with the direction of causality reversed.

When the Chinese economy is growing rapidly, its commodity consumption is likely to rise sharply, and given its disproportionate role in commodity markets, rising Chinese consumption will drive up the prices of commodities. When the Chinese economy is growing slowly, on the other hand, commodity prices are likely to drop. Commodity acquisition as a reserve strategy, in other words, would exacerbate economic volatility and leave China, like commodity exporters, with reserves that are most valuable when it least needs them and, presumably, least valuable when it most needs them. For many of the countries most determined to escape from the U.S. dollar's dominance, in other words, investing in reserves is likely to lock them into acquiring assets when prices are high and selling them when prices are low. Only smaller economies that are net importers of commodities are likely to benefit from investing a significant portion of their reserves in commodities, and even these economies have to worry about the positive correlation between global growth and commodity prices. The value of reserves should be either stable or inversely correlated with the performance of the underlying economy, and most global commodities are unlikely to satisfy that condition.

HOW WOULD THE WORLD AND GLOBAL TRADE BE AFFECTED BY AN ABANDONMENT OF THE DOLLAR?

If the United States—and presumably the other Anglophone economies—were to take steps that eliminated the role of their domestic financial markets as the net absorbers of foreign savings, by definition they would also no longer run current account and trade deficits. But because these countries account for 70–75 percent of the world's current account deficits (with the developing world accounting for most of the rest), this would also mean that, unless some other large economy proves willing to convert its surpluses into massive deficits, the world would have to reduce its collective trade surpluses by 70–75 percent.

To understand the implications, let's assume a country that runs persistent trade surpluses is forced to adapt to a world of much lower trade deficits, and hence of much lower trade surpluses. As I have explained elsewhere, in countries that run persistent surpluses, domestic savings must exceed domestic investment. Domestic savings are high, in turn, mainly because ordinary households, who consume most of their income, receive a very low share of the GDP they produce —compared to shares of businesses, the government, and the very rich.

Countries that run persistent surpluses, in other words, do so because deficiencies in domestic demand caused by distortions in the distribution of income make them incapable of absorbing all they produce domestically. To put it in another way, these distortions force up their savings rates above their investment rates. This means that, if an external event were to force a sharp contraction in a country's trade and current account surpluses, there are broadly speaking five ways (or some combination thereof) by which its economy could adjust to bring savings and investment back in line.

• A surge in unemployment: Such a country's savings would decline if a collapse in its exports caused manufacturing unemployment to surge. Unemployed workers, of course, have negative savings.

• A boost in consumer lending to spur domestic demand: The country's savings would decline if the central bank, in response to a collapse in exports, quickly forced banks to increase consumer lending dramatically so as to replace foreign demand with domestic demand. Even if it were possible to do this efficiently, rising household debt would eventually be unsustainable.

• A jump in government deficit spending to spur demand: Savings would decline if the country's government, in response to a collapse in exports, quickly expanded the fiscal deficit so as to replace foreign demand with domestic demand. Even if it were possible to do this efficiently, rising fiscal deficits would eventually be unsustainable.

• Income redistribution: The country's savings would decline if the government were able to engineer a substantial redistribution of income to ordinary households. This would be sustainable and by far the best long-term outcome for both the country and the world, but any substantial redistribution of income would be a slow and difficult process, and it would almost certainly be politically disruptive, as is clearly the case, for example, in China. • A surge of investment: The country's government could engineer a massive increase in investment. The private sector is unlikely to respond to a collapse in exports by increasing investment, and indeed private firms would probably reduce investment, so the increase in government investment would have to be enough to absorb both the contraction in the trade surplus and any reduction in business investment. This is what China did, for example, in 2009–2010.