Effect of growing Bilateral Trade in Local currencies on U.S. Dollar as reserve currency

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There is an ongoing narrative that US dollar will lose its “exorbitant privilege” of reserve currency status, the dollar will sink, US interest rates will soar. According to IMF, in the last two decades, the US dollar has lost over 16 percentage points of market share, from 71 percent in 1999 to 55 percent in 2022 and “other currencies” bucket gained to almost 10 percent of total identified reserves.

This is mainly due to the series of actions taken by China, Russia, India, and other trading partner countries with the BRICS over the last decades as under:

1. China’s effort to make Yuan a reserve currency has been going on for the last 16 years. In 2007 China first issued its Dim Sum Bond denominated in renminbi through offshore Hongkong market. In 2013, it started major initiative One Belt One Road (OBOR) initiative with 150 countries – this is mainly to help internationalize Yuan. In 2014, China founded the New Development Bank (NDB)- a multilateral development bank along with Brazil, Russia, India, and South Africa (BRICS) with the purpose of mobilizing resources for projects in emerging markets and developing countries (EMDCs). In recent times China’s experiments with a central bank digital currency (CBDC) to intermediate currency flows between local banking systems, all without referencing the dollar or touching the western banking system. This could accelerate the shift to a post-dollar world or

a “bipolar” system where the US and Western allies stay dollarized and nations in China’s sphere don’t. **Fact Check: Chinese Yen only occupies around 3% of the reserves.**

2. India is trying to make Indian Rupee an international reserve currency also for the last 12 years in line with China. In 2013 India floated Masala Bonds in Indian Rupee for International Investor followed by allowing to participate in Derivative Market in 2015. Finally, the process of liberalizing the exchange rates commenced in 2019. In December 2022, India and Russia completed their f first trade settlement in rupees, The Reserve Bank of India (RBI) in early 2023 permitted central banks from 18 countries, including Tanzania, Kenya, and Uganda, along with Bangladesh, Sri Lanka, Mauritius, Saudi Arabia, Iran and UAE to open special Vostro Rupee Accounts (SVRAs), which will allow them to settle payments in Indian rupees as part of a significant effort to de-dollarize trade**. Fact Check: Indian Rupee as reserve still holds less than 1%.**

3. Russia, after the end of cold war, always tried to break away from the reliance of US Dollars. Their alliance with China as early in 2014 for trading on their respective currencies also added fuel to this. In the wake of the USA/West’s sanctions on Russia’s assets and international trade Russia opened trades with China, India and UAE in their respective currencies. The Russian Finance Ministry raised the authorized percentage of yuan reserves in the National

Wealth Fund to 60 percent at the end of the 2021. From April 1, 2023, all Russian Gas needs to be purchased in Rubble.

4. Other countries joining the trend: Brazilian President Lula made a state visit to Beijing in April 2023 and expressed that reliance on US dollar should be reduced. As per S&P Global Intelligence Bilateral Trade in their own currencies between Brazil and China reached $150 billion in 2022, a 10% jump from a year ago. Brazil and Argentina have discussed the creation of a common currency for the two largest economies in South America. There is a call by Malaysia's Prime Minister Anwar Ibrahim for setting up of "Asian Monetary Fund" to reduce reliance on the U.S. dollar and IMF. At the ASEAN Finance Ministers and Central banks meeting in Indonesia in March, 2023 policymakers discussed the idea of cutting their reliance on the US Dollar, Euro and Japanese Yen and a move to settlements in local currencies. For the first time in 48 years, Saudi Arabia has indicated its openness. to trading in currencies other than the U.S. dollar.

Brief Background and present Reserve

Following the 1944 Bretton Woods Accord, the US dollar supplanted the previous gold standard as the world's reserve currency. Additionally, in 1973, the US mandated that OPEC (Organization of the Petroleum Exporting Countries) members limit their oil sales to US currency in return for their political and military support. It is almost 80 years of dominance of US dollar. With the changing GEO political situation and shifting of Trade Blocks, it's gradually losing its dominance as pointed out by the IMF.

At the end of Q3 2022, the dollar represented 55.5% of total reserves. Followed by Euro at 19%. UK Pound at 4.5% and Japanese yen at 5% while Canadian and Australian Dollars at 2%. As per the Bank for International Settlements' data, the dollar's share of global forex transactions hovered stable at around 45% Euro 33% and Chinese Yen at 1.3%. In fact, U.S. dollar is still a preferred currency due to the stability and confidence it carries with the Rich and the Central banks of the world.

What is changing?

Increasingly this reserve data of IMF will be becoming less important if most of the Trades between major non G8 countries are performed other than in Dollar/Euro. Probably COVID pandemic and extreme sanctions by US allies and West on Russia precipitated the political discussions. For over a decade, China made it clear that they want the yuan to be a fully internationalized currency used in half the world's transactions. This requires China to make free its capital Account flows to full capital account convertibility. This being against the core principle of Chinese communist Party, it needs to be seen to what extent they can do it.

For the time being, USA managed the dollar slide by offering highest long-term interest rates on federal notes/bonds among major developed nations which helped US dollar to continue as a more preferred reserve currencies than other currencies. In fact, Overseas investors have bought around 17 percent of Treasury notes and bonds issued in 2023 – but for the economy of USA it is not a big number to handle or for that matter accentuating economic collapse. However, it is also true that USA cannot continue paying such higher interest for long so there could be valuation loss for US Dollar in this decade, which happened couple of times in the past.

What will be the main driver for reserve currencies?

There are two main drivers for reserve currencies apart from confidence issues in the global currencies – the flows of international trade and services and International Settlements for various other purposes.

International Trade is the major main stay for currency dominance. If we break up the International Trade – Machineries and electronics account for 28%, Chemicals 11%, Transportation 10% Textile 15% and Fuel 8% so around 68% which are mainly dominated by G8 countries and hence dominance of US Dollar, Euro, UK Pound and Japanese yen continues. However, China now controls over 14% of the international Trade while other BRICS nation controls 5%. Further, around 45% of the International Trade is linked with East Asia/pacific, Middle East and Africa, South Asia, Latin America and Russia and its allies. As per CNBC analysis, mainland China was the largest trading partner to 61 countries when combining both imports and exports. In comparison, the

U.S. was the largest trading partner to 30 countries. Therefore, If the regional consolidation and China play continues it will have major impact on US Dollar and Euro.

What will be the gain for the countries indulging in Bilateral trade in their own currencies?

So far, the discussion is from the perspective of USA. Let us briefly examine from perspective of a country in Asia, Africa, Middle East or Latin America. At present, given the traditional discourse, these countries at many times are not able to strike a good trade deal only because of their poor dollar reserve position. To a significant extent they can resort to more bilateral deals with their counterpart on the basis of their other resources instead of US Dollars/ Euro. This can reduce the pressure on their currency, price stability and speed up their development agenda. According to Fitch Solutions, by diversifying their holdings reserves into a more multi-currency sort of portfolio, perhaps these countries can reduce that pressure on their external sectors. Trading in local currencies allows exporters and importers to balance risks, have more options to invest with higher yields, to have more certainty about the revenues and sales. Another benefit for countries moving away from using the US dollar/Euro as the middleman in bilateral trade, is to “help them move up the value chain.”

Given the dominance of USA, UK, EURO Zone, Japan (First Block) over International Trade and their super technology developed status it is very difficult journey **for rest of the world from the Colonization to the Globalization to the world of Regionalization**. Except China most of the countries in the rest of the world, to a various degree, have to rely upon the first block for technology, Chemical, Transportation and Capital and this need is not going to be diluted easily, it will take lot of time. Even by numbers, even if most of these countries (not in the first block) do 20% to 40% of the Trade also in local currencies, this will not be more than 10% to 15% of the international trade. As mentioned earlier, like first block, China also has their ambition to attract countries they trade with to make Yuan a reserve currency with significant portion, and they are in the right position to take advantage of this deliberation.

We have to differentiate between substance from the Geo political noise. When the world is controlled by very few countries, now many countries got the opportunity to make the noise. How these trends consolidate further needs to be seen. The first lobby will not be a mere spectator.

In the next two decades, for sure, US Dollar will be losing majority of the control (less than 50%) to a broad basket of Emerging currencies led by China, and also to digital currencies. Increasingly the currency share will be accumulating at the counter of BRICS and its emerging allies. Hegemony of US dollars will be curtailed with a new world order by the turn of this century.

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