Invesco

De-dollarisation Dilemmas

This document is not intended for members of the public or retail investors. Full audience information is available at the bottom of the page.

08

Over the last two millennia, the currency of the world's strongest state has served traders and investors as an international unit of account, means of payment and store of value. In only two instances, however, has the global currency been based on trust, or fiat money, rather than tied to gold-the Dutch Guilder in the 17th century and the USD today. While the US economy and its capital markets continue to be the largest in the world, trust in the USD has eroded as the West has used US dollar dominance of the global financial system to punish or seek to change the behaviour of other states through sanctions. At the same time, US power is increasingly being challenged by China and its allies.

This paper analyses the forces behind de-dollarisation, the prospect for the RMB to replace it either for cross-border payments or as a store of value and, finally, the potential risks to the current international monetary system from any seizure of Russia's foreign currency reserves as a form of war reparations.

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Summary

- China-US rivalry and the West's freezing of Russia's FX reserves in retaliation for invading Ukraine are intensifying doubts about US hegemony and the dollar's international dominance.
- Previous challengers, the yen (1980s) and euro (2000s), competed and lost on economic grounds. However geopolitical and economic shifts have accompanied most changes in global currency leadership.
- We therefore use a two-pronged framework across geoeconomics and geopolitics to assess the contest:
  I. Geoeconomics: The reach of international currencies can be measured by the three classical functions of money – unit of account (pricing/invoicing); means of payment (payment/settlement); and store of value (official international reserves).
     - China International Payments System (CIPS) data show China's own international transactions are shifting to renminbi rapidly. But global cross-border payments remain predominantly USD and EUR denominated, due to inertia, switching costs and strong network effects.
     - Using a single currency facilitates activity by reducing transaction, hedging and execution costs. The USD is a natural unit of account as it is freely tradable. In contrast, the RMB is a managed currency subject to resident capital controls, which raises the risk of realignments.
     - US markets alone can accommodate the depth, size and liquidity needs of large reserve holders.
  II. Geopolitics: Hegemonic stability theory suggests that global use of a currency issued by the leading economic/military power enhances global stability, growth and prosperity.
     - Macro/financial interdependence cuts across US allies and adversaries. Full decoupling/de-dollarisation seems excessively costly and unlikely in all but a full-blown conflict scenario.
     - Official reserves are concentrated: Of some US$12 trillion in global gross FX reserves, 60% are in dollars. The top 10 holders account for about 75%, split roughly evenly between US allies/friends who would probably resist de-dollarisation, and those who might prefer it.
     - A reserve-currency country must run external current or capital account deficits to finance global trade, investment and reserve accumulation. The US consistently runs large current account deficits; other democracies run smaller deficits. Surplus countries span authoritarian states and democracies, and cut across geopolitical fault lines – Eurozone, Japan, China, Saudi Arabia, Russia.
     - In proposing a shared international currency, the BRICS – Brazil, Russia, India and China – seem to be signalling unwillingness to use renminbi despite – perhaps due to – China's global heft.
     - China is in the pilot stage of launching a central bank digital currency (CBDC) and testing its interoperability with other central banks, potentially disintermediating the dollar. Yet, cross border CBDC payments face hurdles due to legal, security and information concerns more than technical issues.
- The renminbi seems poised to keep gaining ground in cross-border payments, yet the dollar's advantages suggest it will remain "primus inter pares" as the leading global pricing and reserve currency. We believe that policymakers, reserve managers and investors alike are best served by focusing on traditional macro-financial drivers, factoring in geopolitics and technology; but not banking on reserve currency substitution.
- A clear and present danger to our view of constrained de-dollarisation is the possibility of seizing Russia's reserves to pay for the reconstruction of Ukraine as a form of war reparations. Whatever the legal or moral justification, seizure would crystallize perceived threats to sovereign immunity and to sovereignty itself. It could accelerate de-dollarisation directly in payments/settlements with knock-on consequences for all western reserve currencies as a global store of value. It would probably further undermine globalization, potentially bifurcating the global economy and markets between states that share views of sovereignty limited by rules in international relations and are aligned with the West, and those that do not, or worry that they might find themselves on the receiving end of escalating financial sanctions.

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Global economic history is punctuated by changing leadership among military, technological, economic and financial powers.

I. The De-dollarisation Debate

The world is gripped by its latest bout of disgruntlement with the US dollar. Investors, central bank reserve managers, policymakers, even heads of state are discussing "de-dollarisation".

Previous de-dollarisation challenges have been about economic and financial competition. The yen (1980s) and euro (2000s) started to compete with the dollar on economic grounds. China's economic rise, desire to reconfigure the international system, efforts to internationalise the renminbi have been latent challenges to the dollar for a decade. Yet challenger reserve currencies failed to dethrone the dollar because their economies have so far failed to outcompete US.

Today's currency competition is mainly geopolitical, geoeconomic and state-led rather than market-driven. Dissatisfaction with the dollar has widened for years because of US sanctions. The West's freezing of half Russia's official international reserves in retaliation for invading Ukraine is a potential game-changer. Losses in growth, returns or efficiency from de-dollarisation may be acceptable to some governments to achieve national security and foreign policy goals, and to preserve their freedom of manoeuvre and sovereignty in international relations.

For some, then, de-dollarisation is becoming a goal, for others a threat. For all concerned, de-dollarisation could be a sea change in global markets and the international system. It could curb American/allied capacity to isolate countries that threaten global security (e.g., Iran, North Korea, Russia). It could make money laundering, terrorism finance and tax evasion harder to control. It could herald major shifts in the geoeconomic/geopolitical balance of power, conceivably relocating global economic leadership to Beijing from Washington – or contribute to the fracturing of the international financial system.

Global economic history is punctuated by changing leadership among military, technological, economic and financial powers. Changes now underway cut across many areas of the international system, calling for a multidisciplinary approach, like other shared challenges. This paper therefore aims to synthesize economic, financial and geopolitical experience and analysis. Our analysis points to limited, not full-blown de-dollarisation in a world economy experiencing "re-globalization" – a reform and restructuring rather than total deglobalisation.

II. From Geoeconomic Challengers to Geopolitical Challenges

Previous contenders – the euro in the 2000s, the yen in the 1980s – competed on economic and financial grounds, eventually falling by the wayside on the same basis. Advanced-economy democracies with liquid, open financial markets, Japan and the Eurozone were potential substitutes for the US. In principle, the yen or the euro could compete with the dollar, wresting market share within the existing international architecture.

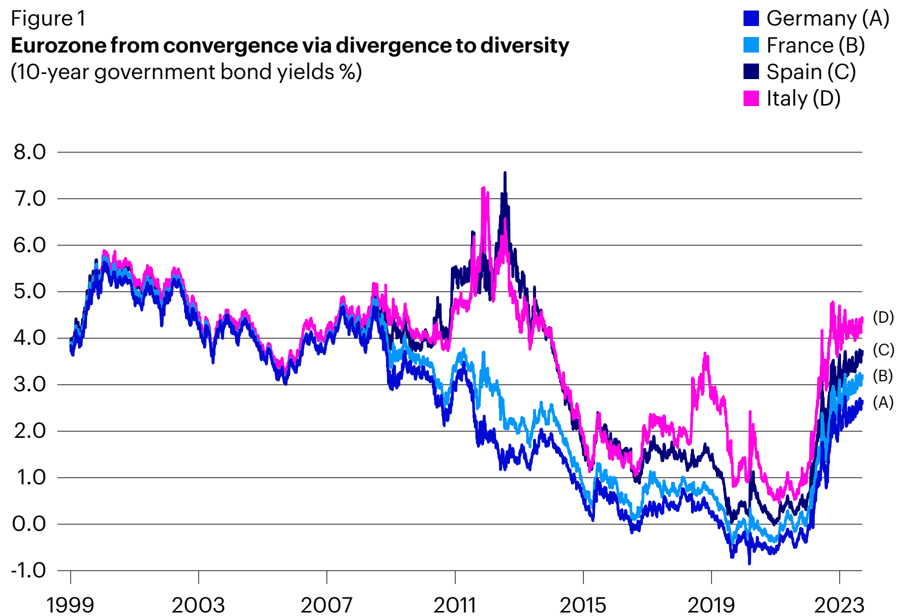
In the event, neither the yen nor euro dethroned the dollar. Neither Japan nor the Eurozone fully recovered from their systemic financial crises in the early 1990s and 2010s, at least not enough to keep pace with the US after the Global Financial Crisis in 2008-09.

Japan experienced an extended deleveraging and transitioned to an ageing, shrinking demographic. Japan remains the world's third largest national economy, but its global heft has been diminishing for three decades. Most investors would agree that Japan lacks the necessary size and dynamism for global economic/financial leadership.

The Eurozone, a large, high-income, highly productive democracy has also failed to keep pace with the US, and the euro to overtake the dollar, despite high hopes. The 2009-12 Eurozone crisis revealed an incomplete monetary union, lacking adequate economic, fiscal and ultimately political integration to manage excessive internal imbalances that threatened to tear it apart. The euro lost ground because it could not compete with the dollar. The Eurozone as a whole still lacks the fiscal structure to back government debt with the full faith and credit of the state, unlike other contenders.

Eurozone bond yields, which had converged in the 1990s, are now distinguished by pro-cyclical sovereign risk premiums, rising, and falling with perceived political, economic or financial-sector risks – especially Italy, the Eurozone's largest sovereign debt market. Without a large, liquid, unified bond market, can the Eurozone compete with the dollar and Treasuries as a global reserve asset?

Figure 1
Eurozone from convergence via divergence to diversity
(10-year government bond yields %)



Source: Bloomberg, Macrobond, Invesco. Daily data to 15 September 2023.

Eurozone Hamiltonian Moments?
Recent external shocks, such as Brexit, COVID-19 and the Ukraine war have delivered a renewed impetus towards the EU's long-standing goal of "ever-deeper union", itself recalling the US founding ideal of "an ever more perfect union". Joint Eurozone fiscal programs for the COVID shock and green transition have been praised as "Hamiltonian Moments", after the first US Treasury Secretary. So how does Economic and Monetary Union stack up against the American union? Despite some success, economic history and financial markets suggest not well enough.

A 1787 fiscal crisis in Massachusetts spread financial contagion across the US, pitting northern American debtor states against southern creditor states, threatening the new union with collapse. Alexander Hamilton led the way in remaking the US confederation into a federal political-fiscal-financial union. Among his most important achievements was the establishment of US Treasury bonds, through the 1790 federal assumption of the 13 states' legacy/wartime debt.

A decade on from an eerily similar experience also a decade after its founding, the Eurozone's fiscal union remains a work in progress. Monetary union is arguably complete with the ECB as a federal/supranational central bank, yet the EU remains a confederation with voluntarily pooled sovereignty. So far, fiscal risk-sharing has been deployed for shared crises – not "asymmetric" shocks in individual member-states.

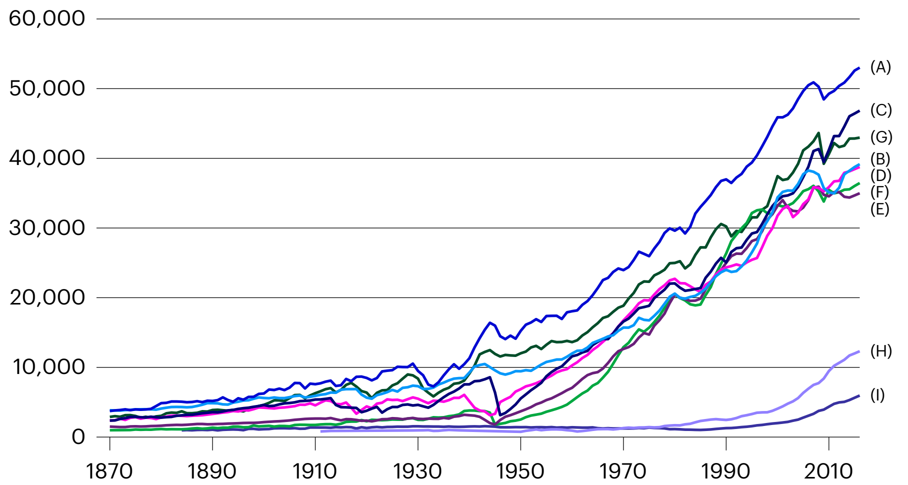
Thus, Eurozone fiscal burden-sharing still falls far short of the full-fledged fiscal/political union used by other major monetary unions to address crises or structural and cyclical challenges.

As a practical matter, the Eurozone's lack of fiscal/political federalism limits the integration and dynamism of the Eurozone – specifically banking union, by extension capital markets union and ultimately full economic union. Complete banking and capital markets union would entail common deposit insurance, bankruptcy/resolution and associated fiscal backstops that would likely be too large for individual member-states vis-à-vis pan-Eurozone banks. In its systemic crisis, the Eurozone could not deploy an equivalent to the US Troubled Asset Relief Program (TARP), a fiscal recapitalization program for the entire US banking system. Incomplete integration probably increased the need for deflationary deleveraging, contributing to subdued growth after the Eurozone financial crisis.

In stark contrast to the Eurozone and Japan, the US restored its economic, financial and technological dynamism after its 2008-09 systemic financial crisis, using fiscal support (TARP) to recapitalize its banking system. True, the US faces severe socio-economic challenges, reflected in fractured politics that constrain its internationalism. But other major economies also face social, demographic, macro/financial challenges that may also limit their global capabilities or appeal. Meanwhile, the dollar retains the powerful advantage of incumbency in the international financial system. The US retains a powerful lead in per capita income and wealth at the technological frontier, deep and efficient capital markets and a well-established legal system.

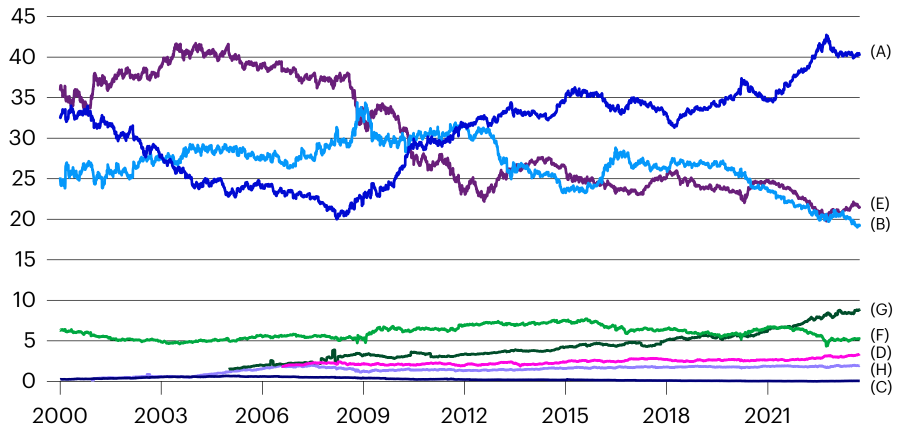
Figure 2
US per capita income and market size outstrips other major economies

Figure 2a
US per capita income in USD (constant)

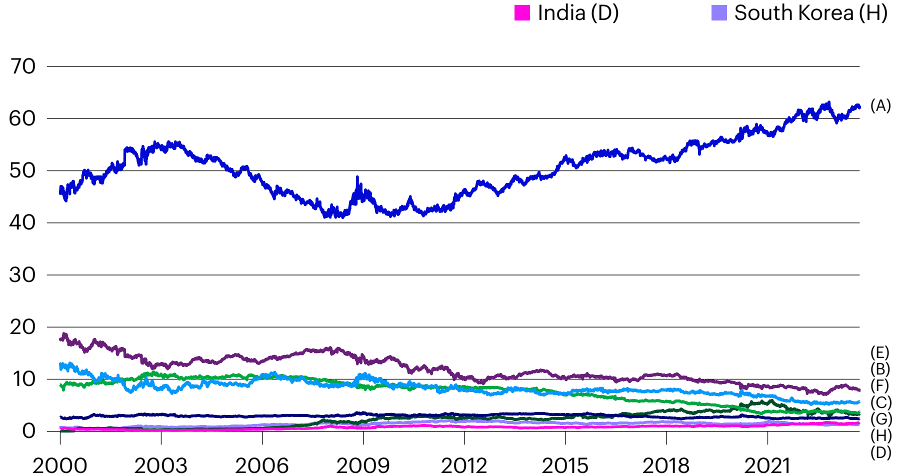


Source: Left, Maddison Project Database, Macrobond, Invesco. Annual data to 2016 as at 15 September 2023.

Figure 2b
Government bond markets
(Percentage of total)



Equity markets of major economies
(Percentage of total)



Note: Ex-US countries comprise EU countries, UK, Switzerland, China, Brazil, South Korea and India.
Source: Left, ICE BofA government bond market indices right, MSCI indices, Macrobond, Invesco.

Opposition to the dollar's dominance of international financial flows now owes more to the US government's use of its financial dominance to exercise power over other states through sanctions than its usefulness as an international currency.

Opposition to the dollar's dominance of international financial flows now owes more to the US government's use of its financial dominance to exercise power over other states through sanctions than its usefulness as an international currency. Indeed, US government sanctions are not new and have been used throughout the post-war period to impose costs for apartheid in South Africa to military incursions or state terrorism. In such instances, "third countries" – not the direct targets of these sanctions, though often affected – tended to be onboard or did not actively oppose the US, or typically judged that continued access to US markets outweighed their own sovereignty or national security considerations.

A major difference today is the rise of challengers for global or regional dominance – China and to a lesser extent Russia, which are prepared not only to push back but potentially even to seek an alternative world order. Russia was the first sizeable country to take deliberate steps to try to de-dollarise before the Ukraine war in response to US sanctions for the annexation of Crimea and destabilization of Eastern Ukraine in 2014. Specifically, Russia's central bank, The Bank of Russia (BOR) switched partly from dollars into EUR, RMB and gold. Russia's efforts to insulate BOR reserves from sanctions was part of a broader overhaul of macro policy to enhance the government's fiscal, monetary and general financial space to reduce its vulnerability to shocks. In hindsight, the plan was likely at least partly intended to increase Russia's capacity to move to a wartime footing, including insulating itself against sanctions.

Despite these efforts to create "fortress Russia", a concerted, extensive package of sanctions by the US, NATO and Asian allies, including Japan, South Korea and Singapore was used to restrict Russia's access to the international financial system, its ability to parlay exports, assets and resources for products for civilian and military use in wartime. These measures included freezing foreign financial assets and impounding real assets not just of the state, but also senior officials, firms and "oligarchs" with close links to the Kremlin or the war effort including yachts and homes.

Perhaps most surprising of all, over half of BOR reserves were successfully frozen in February 2022 within days of the invasion of Ukraine. The sanctions directly cut the Russian state, much of the economy and many individuals out of the Western financial system. In addition, they indirectly cut Russia off from much of the global economy and financial services because third countries could be subjected to secondary sanctions.

Figure 3
De-dollarisation of Russia's Official FX reserves

Figure 3a
Size of foreign currency reserves (USDeq bn)

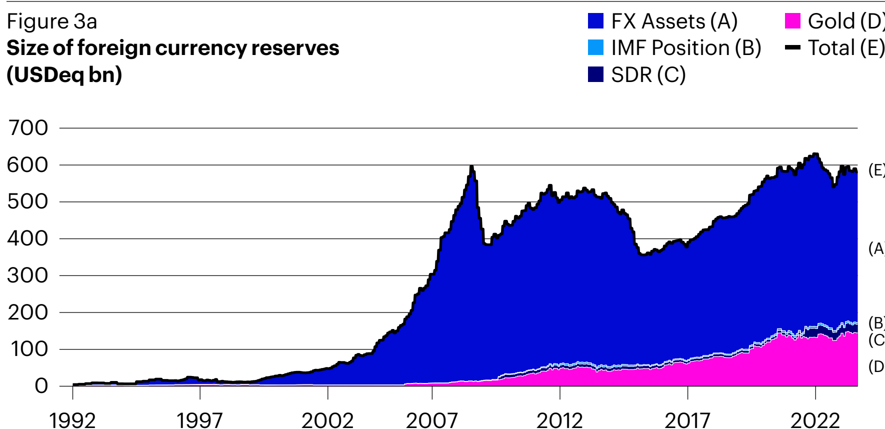
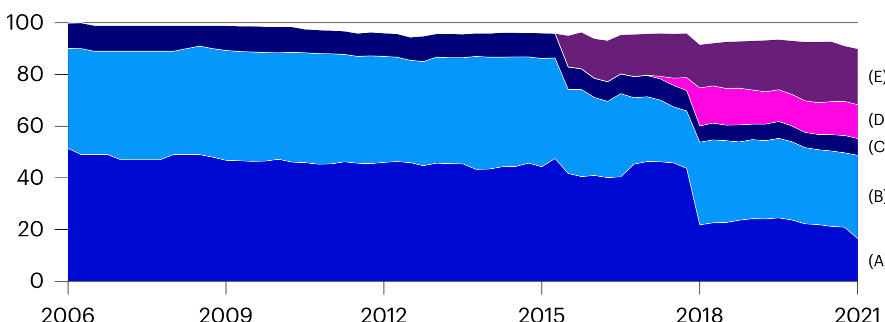


Figure 3b
Currency composition of foreign currency reserves (% of total)



Source: Bank of Russia, IMF, Macrobond, Invesco. Latest available; weekly data through August 2023, left; and quarterly to Q2-2021.

Through 2022, the sanctions continued to be ratcheted up, culminating in some direct interventions in global markets: On 5 December 2022, the US led the G7 in imposing a cap on the price of Russia's oil exports, using official regulatory authority over the Western financial system and private, oligopolistic reinsurance markets. The rationale was straightforward: Neither oil nor insurance markets are perfectly competitive; if they were, price controls would in theory create shortages. Instead, regulatory and competitive pricing distortions would allow the West to use market-based mechanisms to influence Russia's oil export prices.

The bulk of global and Russian oil shipments were insured privately, primarily through the Lloyd's insurance market in London. Western insurers would no longer be permitted to insure Russian oil shipments above US$60/barrel. The price was set well above Russia's cost of production, to incentivise continued production and export, to avoid a squeeze in global oil supply. But the US$60 cap was set well below Russia's budgetary break-even oil price, to pressure Russia to choose between spending on the war and other budgetary priorities.

The lesson was not lost on many countries, especially China, the main challenger to the US, which has responded with its own tilt toward de-dollarisation across invoicing, cross border payments and reserves. Unlike Japan or the Eurozone, China is now advancing an alternative system instead of trying to displace the US within the existing one. Motivated by national security concerns and great-power ambitions, China and other countries are mounting a more determined challenge to build the infrastructure and relationships to opt out of the dollar system. The potential implications for global payments and settlements systems are far-reaching, arguably world-changing.

The arrival and survival of a leading global currency depends on its economic and geopolitical use case.

III. A Two-Pronged Framework to Track De-dollarisation

With no global government to enforce its use, the arrival and survival of a leading global currency depends on its economic and geopolitical use case. We therefore use a two-pronged framework encompassing macro/financial and geopolitical considerations to evaluate the progress and prospects of de-dollarisation.

First, how do the dollar and renminbi compare as international currencies, using the three classical functions of money – unit of account, means of exchange and store of value. In terms of global trade, these functions correspond to the activities of global invoicing, payments/settlements and international reserves, each of which have their own incumbency bias, vulnerabilities and constraints.

For invoicing, a dominant international currency provides a common unit of account and facilitates global pricing, transparency and competition. Global payments/settlements are based mostly on a well-developed bank infrastructure, which is, however, under challenge from new financial technology, or fintech. Official international reserves represent a store of value and, with the exception of gold, are required to be held overseas to cover a country's potential foreign currency outflows or provide a bulwark against national disaster.

There are strong network effects across these three functions, which give the USD a strong incumbency advantage. China and Russia, however, are actively promoting alternative investments and payment rails in an effort to at least create an alternative to the USD and weaken its network effects, if not to supplant it entirely.

In addition to economic factors, one thus needs to assess the geopolitics of international currency competition and the potential for state-led "de-dollarisation". "Hegemonic Stability Theory" holds that a dominant global currency issued by a credible, legitimate superpower supports geopolitical and geo-economic stability, helping to boost global growth and prosperity.

Applying hegemonic stability theory to today's de-dollarisation dilemmas raises a series of crucial questions, which we address below: Is the world best served by the US dollar? Or is trust in the current dollar system so broken that global dollarisation is no longer viable, whatever the benefits of hegemonic stability? Would a challenger, most obviously the RMB, be preferred? If not, what about the recently proposed BRICS currency? And what is the role of gold today? As a classic store of value or simply a temporary placeholder as the world works through the policy challenges of CBDCs, their interoperability and the liberalization of the RMB?

IV. Currency Competition and the Three Functions of Money

Most governments legislate sole use of national currencies within their borders. This legal monopoly links and reinforces the three use cases for money – unit of account, means of payment and store of value. Firms, households, investors and governments send or receive funds, value contracts and measure wealth and debt using the same legal tender.

Effective, credible states can generally sustain domestic monopolies on money. However, instability and arbitrary gains or losses, for example, through high or volatile inflation often undermine public moneys, sometimes leading to "dollarisation" (or euroisation in some cases) throughout the domestic economy and financial system, including dollar-linked or denominated debt contracts. Thus, governments can even lose their domestic monopoly on currency, usually to an internationally trusted unit of account, store of value or ultimately even means of exchange, overriding the national currency despite its legal-tender status.

In the absence of a global monopoly over money, considerations about the three-dimensional use-case for domestic moneys in a global context may well stand out even more strongly than within a national jurisdiction, where the state can try to enforce its monopoly over money. Thus, the dollar and the renminbi need to provide sufficient usability, credibility and trustworthiness across these unit-of-account/means-of-payment/store-of-value functions of money. How do they stack up?

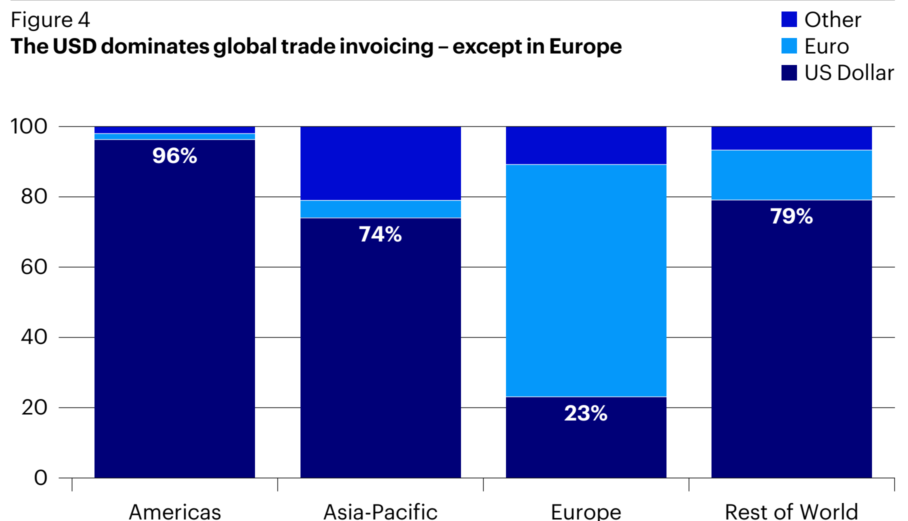
National vs International (De)-Dollarisation
Sometimes, domestic dollarisation is informal or implicit, as in many countries with very high inflation or hyperinflation: Individuals and firms indirectly link their transactions to a global store of value, unit of account, ultimately using the dollar or euro. Some countries, formally and legally adopt the dollar or the euro, as Ecuador or Montenegro for example, or as it once again proposed in Argentina.

An interesting confirmation that the RMB is as accepted globally as the dollar or euro would arrive when other countries with relatively modest trade/investment links consider "renminbi-sation" or a tight renminbi peg in place of the dollar or euro.

The domestic analogy of dollarisation in effect dethroning a national currency is directly relevant, even analogous to the current international de-dollarisation debate. Once the reputation of a global or domestic currency is sufficiently tarnished, users tend to switch to other, more reliable international moneys. The damage done to the store-of-value/official reserves function of a global money by an arbitrary inflation tax or indeed, by a freezing or potential seizing of the assets of others appears to have been enough to set off a search for alternatives.

Invoicing/unit of account
International transactions arguably gain more from a shared unit of account than domestic transactions. In fact, the benefits of a single unit of account were among the main impetuses behind the creation of the euro. Exchange-rate risk in any given transaction can be hedged (even if settlement and invoicing use different currencies), of course but it creates friction. And private economic agents prefer to use a single currency across all transactions for pricing, transparency, and competition.

Figure 4
The USD dominates global trade invoicing – except in Europe



Note: Average annual currency composition of export invoicing, where data are available. Regions as defined by the IMF. Source: IMF Direction of Trade; Central Bank of the Republic of China; Boz et al. (2020); Fed. Data from 1999 through 2019 as of 2021.

In our view, the RMB faces an uphill climb to replace the dollar as a full global unit of account, even though it is rapidly gaining ground in invoicing and settlement of China's own transactions. China maintains effective resident capital controls to manage both its exchange rate and interest rates. While helpful for domestic economic and financial stability, the RMB exchange rate is not a market price, unlike other major currencies. For third party countries, using the RMB for pricing could expose international contracts to the event risk of currency realignment, which is more difficult to hedge than exchange-rate risk. Thus, market participants and firms might use RMB in contracts, invoices and for payments for flows with China, while still using the dollar to strike the underlying deals and pricing.

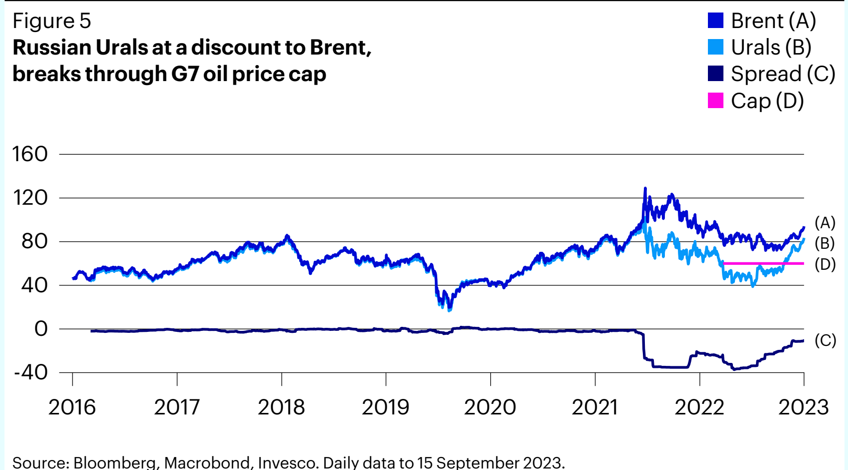
Petrodollar Persistence?
The dollar seemingly retains its role in oil pricing – even Russian oil, despite the well-publicized shift to RMB in China-Russia trade, even as oil markets are segmented by war and sanctions. Since the invasion, Russia's Urals crude oil benchmark has traded with a deep discount to Brent. The price spread went deeply negative even as the underlying oil price rose immediately after the invasion. Furthermore, the discount was much more stable than oil itself for much of 2022.

After the G20 oil price cap took effect in December 2022, the published Urals price traded below the US$60/barrel cap for many months, but has more recently surged above the cap, as the oil price has rallied, following OPEC+ coordinated production cuts, to which both Saudi Arabia as the main swing producer and Russia, were party.

Evidently, the surplus of Russian oil on the market due to boycotts by Western buyers initially drove the Urals-Brent spread deeply negative for the first time on record. The spread has been much more stable than underlying oil prices (Brent and Urals), suggesting that the market has been finding a suitable discount to allow for greater risks and costs attached to Russian oil since the invasion – secondary sanctions, self-insurance or state insurance, etc. Stepwise moves in the spread suggests off-market deals are negotiated with reference to the dollar price of Brent.

In this context, switching from dollars is a bit of a chicken-and-egg problem for many oil exporters, particularly those who peg their currencies to the dollar. Most oil producers do not have large enough economies of their own to run a freely floating currency, and so are likely to stick to the dollar until and unless the world as a whole moves away from the dollar; otherwise, they would run the risk of importing greater volatility in inflation or their financial systems through currency volatility. And many are surplus countries with a long-standing need to recycle those surpluses into investment in global markets or other economies.

Figure 5
Russian Urals at a discount to Brent, breaks through G7 oil price cap



Source: Bloomberg, Macrobond, Invesco. Daily data to 15 September 2023.

The Russia-India oil trade, which has burgeoned since the war and Western boycotts of Russian energy exports, offers an important anecdote. Reports initially indicated that Russia-India oil trade would be settled in rupees. But Russia had second thoughts: Its resulting, large surpluses could easily be used only to buy Indian exports. So Russia asked India to settle in UAE dirham – which happens to be pegged to the dollar. Even Russia seems to want the dollar as its unit of account.

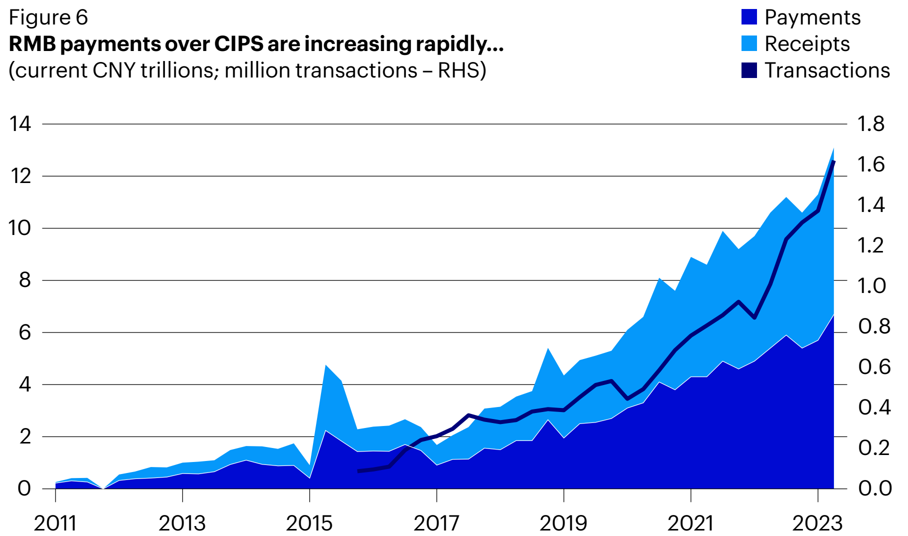
The Russia-India case illustrates the benefit of using one currency for pricing/payments/reserves and the problem with bilateral transactions. Exports and imports rarely match, credit/debit balances will build, possibly substantial and lopsided over time. If these balances cannot be used for trade generally or as reserves for intervention, switching away from a leading global money restricts national flexibility instead of increasing it – even in wartime.

Cross-border payments and settlement are where challenges to dollar dominance are likely to be most direct, driven by both geopolitics and technological change.

Cross-Border Settlement/Means of Payment
Cross-border payments and settlement are where challenges to dollar dominance are likely to be most direct, driven by both geopolitics and technological change, as many governments move to protect their ability to conduct international trade and investment free from interference by the US or the West and many private players seek are promoting more efficient payment rails. The current global payments infrastructure is dominated by international correspondent banks that move money based on secure, standardized payments instructions managed by SWIFT. Cross border payment instructions over SWIFT, which is headquartered in Belgium, can be blocked based on state sanctions as was the case in 2022 when Europe cut off Russian bank access to the SWIFT system and in the earlier case of Iran.

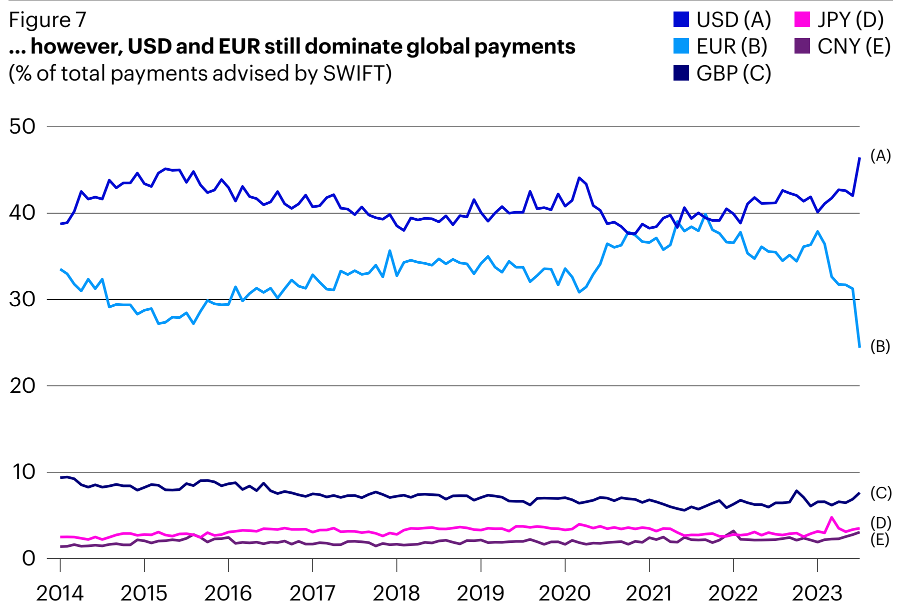
To mitigate the risk of western sanctions, China has been promoting an alternative global payments and messaging system, CIPS, for cross border RMB payments. While its domestic success can be seen in the sharp increase in volumes and transactions in recent years, RMB cross border payments still represent a very small fraction of global payments due to inertia, switching costs and USD network effects. As reported by SWIFT, whose messaging system is reportedly used by CIPs for the vast majority of its payments, global payments in RMB still represent less than 3% with the bulk denominated in USD and EUR.

Figure 6
RMB payments over CIPS are increasing rapidly...
(current CNY trillions; million transactions – RHS)



Source: CIPS – China International Payments System, Macrobond, Invesco. Quarterly data to 1Q-2023.

Figure 7
... however, USD and EUR still dominate global payments
(% of total payments advised by SWIFT)



Source: Society for Worldwide Interbank Financial Telecommunications, Macrobond, Invesco.
Weekly data to 1 July 2023.

One CBDC could be "interoperable" with others, potentially enabling seamless, rapid payment and settlement directly between central banks.

It's important to note that SWIFT messaging is a critical part of today's global payments infrastructure because it provides a universal messaging protocol used by nearly every bank in the world. This practical obstacle is a near-term advantage for SWIFT, but is unlikely to be insurmountable for long, as fintechs substitute mobile wallets for banks and as many central banks explore the potential for wholesale CBDCs.

Some governments are developing their own payments-oriented messaging systems out of necessity (Russia, Iran). The main challenge is onboarding correspondent banks or other payment providers – SWIFT has an enormous head start; but this obstacle starts to fall away if the objective is to provide an alternative to the existing system that is sanctions-insulated, rather than compete head-on with the West and its existing financial intermediaries and payment rails.

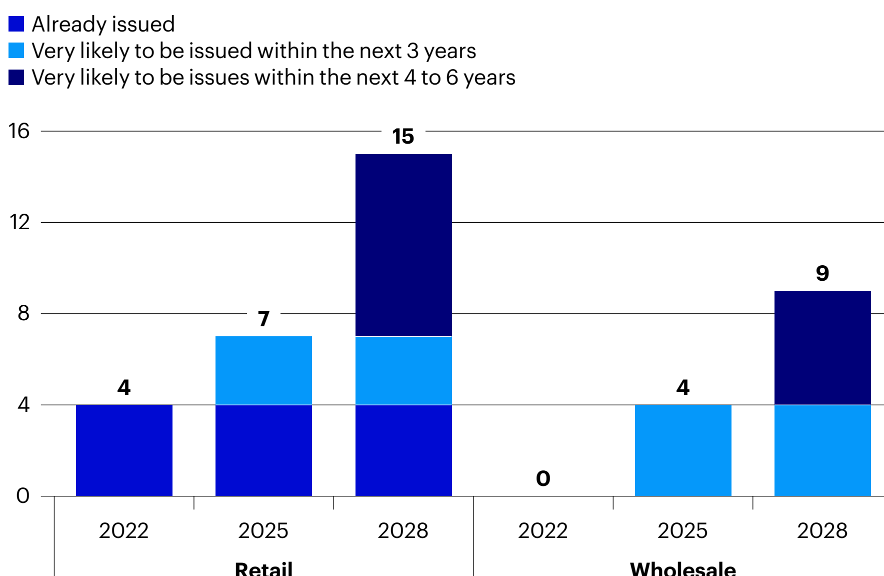
The advent of wholesale CBDCs would provide an alternative to today's payment system and would likely reduce dollar dominance. One CBDC could be "interoperable" with others, potentially enabling seamless, rapid payment and settlement directly between central banks.

The most important difference to the existing payment system is that multiple currencies would be directly connected on a single platform using distributed ledger technology (blockchain) to which many international actors would have direct access. Thus, a Singapore importer could pay a Thai exporter directly in any retail CBDC on the platform without going through the USD. Regional central banks in East Asia, Southern Africa and Europe have successfully tested the technical feasibility using a prototype digital CBDC under the auspices of the BIS innovation hub.[1]

Wholesale CBDCs are still a work in progress on a global or even regional basis. Faced with sanctions, however, the BOR is reportedly fast tracking development of an "e-ruble", aspiring to establish at a minimum, bi-lateral, digital payment rails to avoid Western sanctions.[2] And China is on the same track. Connecting these two national currencies could become the first major CBDC cross border payment rail, further integrating the two economies and providing a fast detour around the Western banking system and SWIFT. The recent expansion of the BRICS to the "BRICS+" to include several commodity-exporting emerging market economies like Saudi Arabia, could also expand RMB settlement in commodity trade.

While the tests proved successful from a technical and design perspective, important policy issues relating to governance, legal authority, resiliency, information and security are still to be resolved. CBDCs' success in supplanting the current payments system depends on a critical mass of central banks of countries with significant trading links, launching national CBDCs that are also interoperable. The BIS concludes from a recent central bank survey that fewer than ten countries are likely to issue a wholesale CBDC prior to 2030.[3]

Figure 8
BIS central bank survey (2022): most central banks are studying CBDCs but only a few plan to launch



Source: Kosse, A and I Mattei (2023): "Making headway – Results of the 2022 BIS survey on central bank digital currencies and crypto", BIS Papers, no 136, July.

1 "Project M-bridge- Connecting Economies through CBDCs", October 2022, https://www.bis.org/about/bisih/topics/cbdc/mcbdc_bridge.htm
2 "Bartering, Crypto currencies and Yuan, Russia Seeks Alternatives to Trading in Dollars", https://carnegieendowment.org/politika/87814
3 "Using CBDCs across borders: Lessons from practical experiments, BIS June 2020 and BIS Papers No 135, "Making Headway—Results of a 2022 BIS Survey on Central Bank Digital Currencies and Crypto.

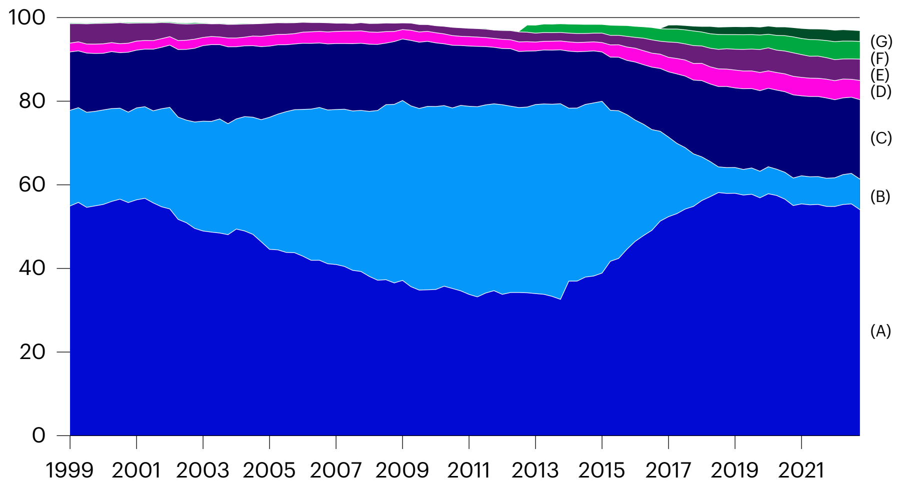
CIPS or CBDCs – could increase its chances of disintermediating the dollar, as a dominant payments currency, at least to some extent. We believe this would most likely occur through the development of a trading bloc of potentially allied trading partners that oppose the US/Western alliance or simply do not want to be exposed to sanctions risk. These countries would not necessarily seek to replace the USD per se, but to avoid it entirely, thereby weakening its dominance by reducing its network effects across invoicing, payments and reserves.

Official International Reserves/Store of Value
IMF reserves data show the renminbi slowly gaining ground, due to three factors – Russia's shift from dollars into RMB; inclusion of China's renminbi in the IMF's Special Drawing Rights (SDR) basket in 2016 at a weight of just over 12%; and the increase in RMB cross border transactions illustrated above. Despite these well publicized developments, however, the RMB share of global reserves stands at less than 3% of which the Bank of Russia is estimated to represent about half.[4]

Unallocated reserves reported to the IMF apparently were invested largely in USD, judging by the substantial increase in the dollar share and a significant, but smaller increase in the euro share since 2014, both as the unallocated share was reduced. The rise in the euro's share probably reflects greater confidence in the EUR following stabilization of the Eurozone crisis; Russia de-dollarisation; as well as a relatively small, gradual shift into RMB.

Figure 9
Dollar share of FX reserves is moderately declining (%)

USD (A)
Unallocated (B)
EUR (C)
GBP (D)
JPY (E)
Other (F)
CNY (G)



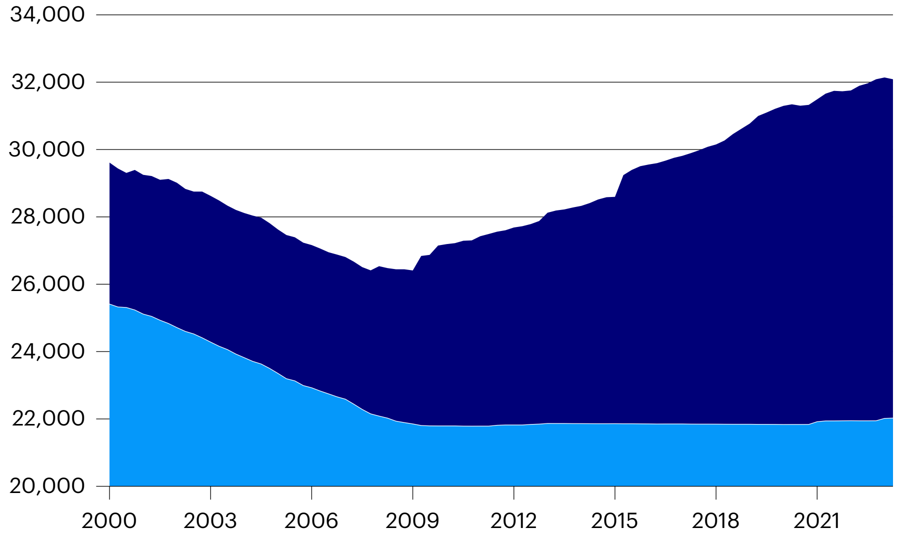
Source: IMF, Macrobond, Invesco. Quarterly data to 3Q-2022.

4 IMF, Bank of Russian Annual Report 2022.

Recent accumulation of gold appears to reflect general unease over inflation, geo-political risks and the potential to be deprived of access to reserves due to foreign government sanctions.

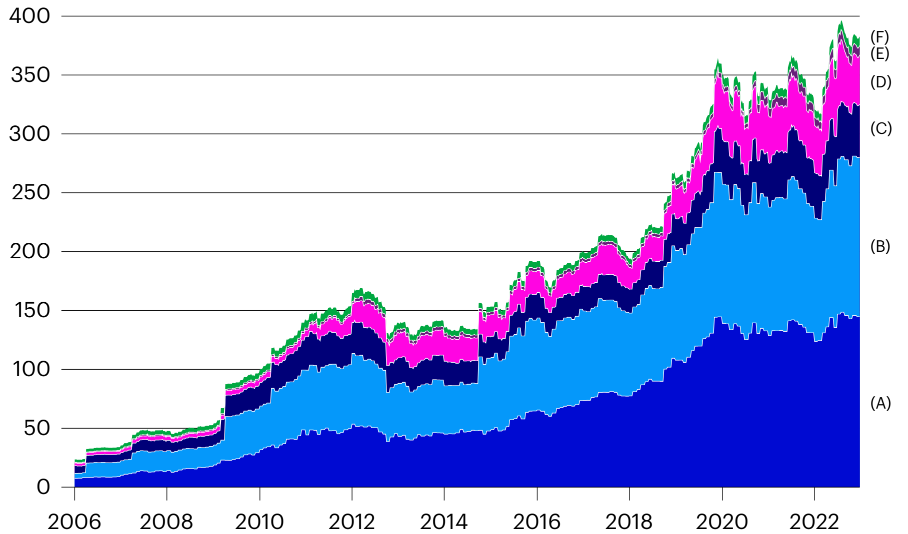
A Canary in the Gold Mine?
Gold, as a share of foreign currency reserves, has risen sharply for a subset of emerging market central banks over the last decade. Russia and China appear to have purchased gold reserves as part of deliberate policy of de-dollarisation. In other emerging markets, gold accumulation may also be for domestic purposes, such as India and Turkey, where the public often saves in gold to hedge against inflation or financial instability. Most central banks surveyed by Invesco in 2023 cited gold's role as a safe haven as the primary rationale for purchases (90%) followed by currency uncertainty (54%) and concerns over the freezing of Russia's central bank reserves (38%).[5]

Figure 10
Emerging market central banks hedge geo-political risks by building up gold reserves (tonnes)



Source: World Gold Council, Invesco. Latest available through Q2-2023

Figure 11
Russia and China are most active in gold among emerging market central banks (current US$bns)



Source: World Gold Council, Invesco. Latest available through Q2-2023

[5] Invesco Global Sovereign Asset Management Study 2023 (IGSAMS).

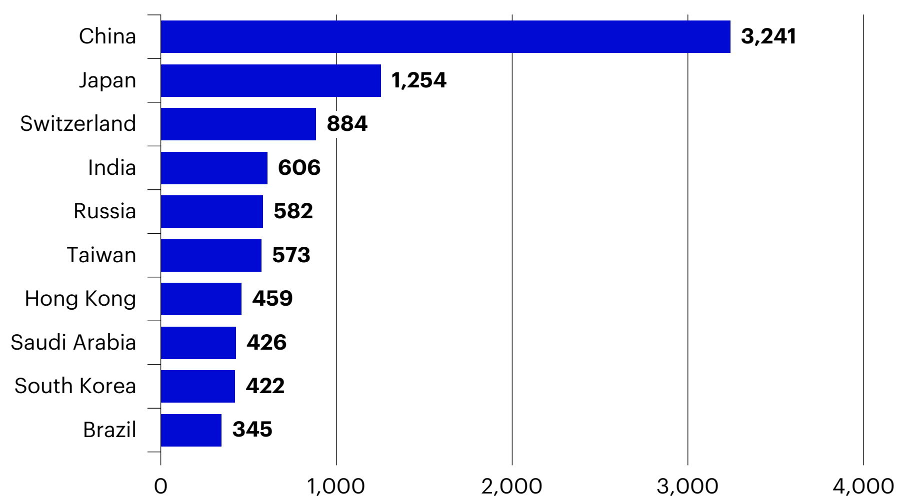
The TINA Trap: What if "There is no alternative" to dollar markets for size, depth, liquidity?
De-dollarisation is today a political phenomenon, which has seen a coalescing of countries challenging US political power and the USD as its sharp edge. Given the economic heft and international trade of countries challenging the role of the USD, why have China's efforts over the past decade to promote the internationalization of the RMB not yet gained greater traction?

From a geoeconomic perspective, the governance of international reserves is part of the plumbing of a world built around a neo-classical, liberal vision of global prosperity through a free flow of goods and capital. To ensure reserves were out of the reach of domestic politicians, national laws nearly universally endowed independent central banks with ownership of the reserves and mandated their investment for the narrow purposes of liquidity and safety. To qualify as foreign currency reserves, the IMF requires foreign currency financial assets to be held in extraterritorial jurisdictions; and, both international and national law afforded foreign currency reserves immunity from seizure to satisfy adjudicated civil claims on the country or its government.[6]

In today's international monetary system, a reserve currency must thus meet the twin objectives of: (i) liquidity, as characterized by market size and turnover, and (ii) safety from default or credit risk. In essence, this broadly limits the investable universe to countries with at least an investment grade rating and mainly to its high grade fixed income markets.[7]

Global reserves currently represent about $12tn invested in financial assets of which the top ten reserve holders represent 75%. Given the size of reserves relative to the size of investable markets, USD and EUR are the only capital markets to offer sufficient liquidity for the bulk of reserves—at least for large economies. China has the second largest fixed income markets, however, the depth, turnover and liquidity of domestic markets are still evolving. Doubts are also likely to persist about the valuation of a currency subject to capital controls. Such unresolved financial concerns may well hamper the adoption of the renminbi as a store of value.

Figure 12a
The demand for reserve assets (size of reserves for top ten reserve holders)

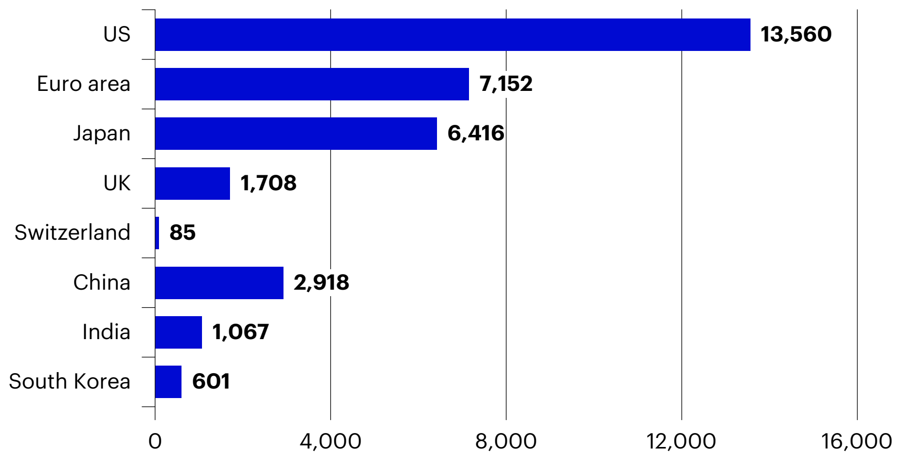


Source: IMF, National central banks, Datastream, as of July 2023.

[6] See https://www.lawfaremedia.org/article/legal-challenges-presented-seizing-frozen-russian-assets

[7] World Bank: Central Bank Reserves Management Practices, https://openknowledge.worldbank.org/search?spc.page=1&query=Insights%20into%20Central%20Bank%20Reserves%20Management%20Practices and Invesco Global Sovereign Asset Management Study 2023 (IGSAMS).

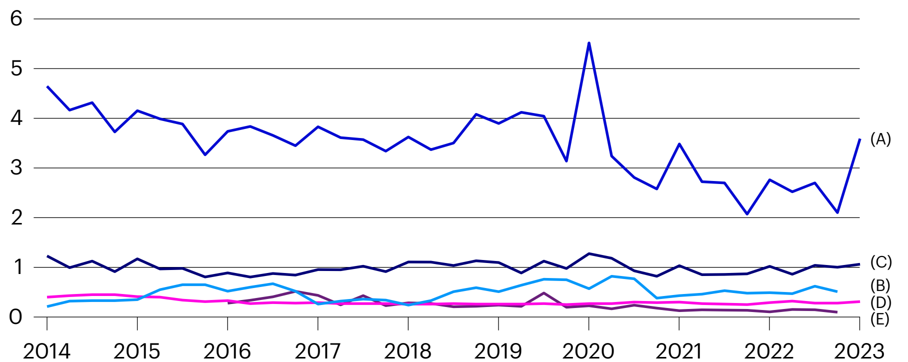
Figure 12b
The supply of investable reserve assets shown by government bond indexes (USD*, EUR, JPY, GBP, RMB, INR, KRW) – current and potential contenders
(Market capitalization, USDbn)



* The bond index market cap represents investable market size. For the US, this is less than half the outstanding stock, because it excludes intra-government and central bank holdings. The turnover figures are based on the total outstanding stock, implying that liquidity in US bonds is about twice as high relative to the stock available in the market, as shown, at present.

Source: BofA ICE government bond indexes, Datastream, as of 19 September 2023.

Figure 12c
Liquidity of government bond markets as indicated by daily % turnover



Source: SIFMA, UK Debt Management Office, AsianBondOnline, Clearing Corporation of India, Macrobond; Data to Q12023; China and India to Q42022 as at 19 September 2023.

The US and its Western allies, by freezing and contemplating seizing the BOR's reserves, have tampered with the plumbing of the post war international monetary system. Whether justified or not, it has weakened the concept of sovereign immunity of reserves and introduced geo-politics into what was a technical domain. For the first time in the post war period, central banks are considering not just credit but also geo-political risks when assessing the safety and destination of reserve allocations.

There have been only two leading international fiat currencies – the Dutch florin in the 1600s and the US dollar now.

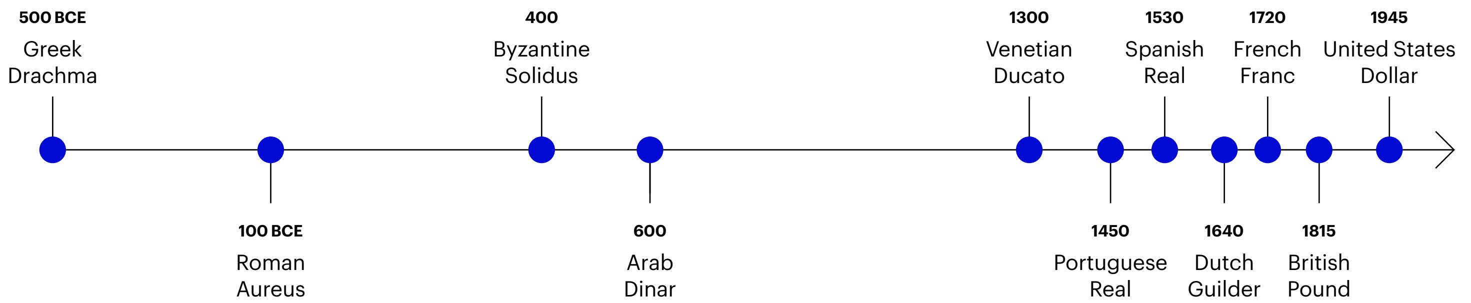
V. Hegemonic Stability Theory

The American policymaker/economic historian Charles Kindleberger helped conceive the dollar-centric, post-WWII international system using ideas now called "Hegemonic Stability Theory": The United States would underwrite a stable international framework for maintaining and promoting peace, economic stability prosperity in a virtuous circle, based on historical experience.

Several key points stand out from history. Changes in currency leadership accompanied shifts in the military/economic balance of power. Currency leadership has lasted about a century in modern times, suggesting the dollar is ageing. The Italian city-states were exceptions to the link between currency and geopolitical leadership, but were hotbeds of financial innovation.

Figure 13

International currency leadership has tended to reflect geopolitical leadership



Note: Dates represent estimated start dates of currency eras. Source: Invesco, for illustrative purposes only.

Perhaps above all, most leading international currencies were gold/metallic standard currencies. Credibility depended on sufficient gold reserves for the leading power and other states. Shifts in the balance of power were sometimes accompanied by gold flows following military defeats or interventions by a rising power – notably after WWI and again in WWII confirmed that the global balance of power had clearly shifted from warring European empires to the US.

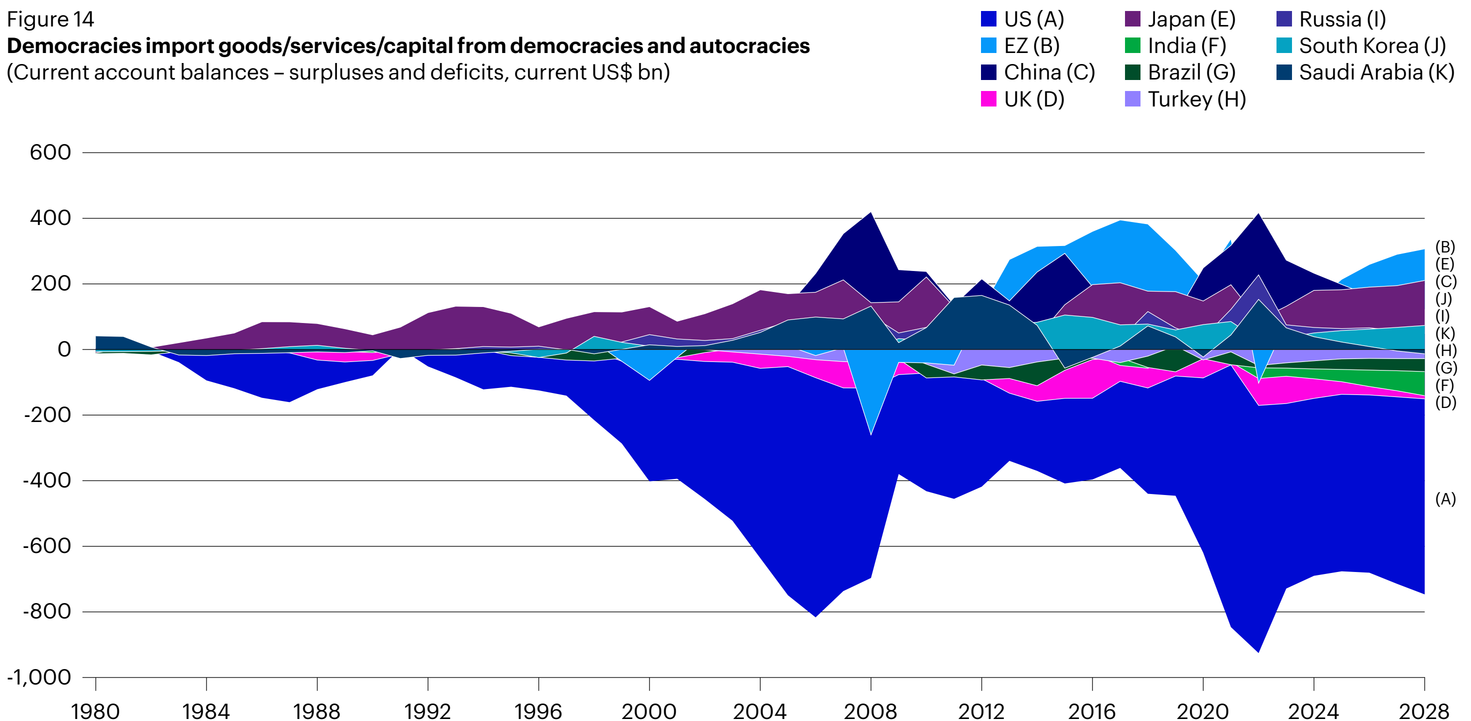
Taking current account balances and reserves together, the interdependence is striking.

There have been only two leading international fiat currencies – the Dutch florin in the 1600s and the US dollar now. In today's fiat-currency world, the credibility and authority of the state backs its currency. States without sufficient credibility tend to use capital controls or need to maintain enough reserves to manage shocks. So how does the current US fiat-dollar standard fare vis a vis global interdependence, stability and prosperity?

Figure 14

Democracies import goods/services/capital from democracies and autocracies

(Current account balances – surpluses and deficits, current US$ bn)



Source: IMF WEO including forecasts, Macrobond, Invesco. Annual data to 2022, forecasts 2023 – 2028.

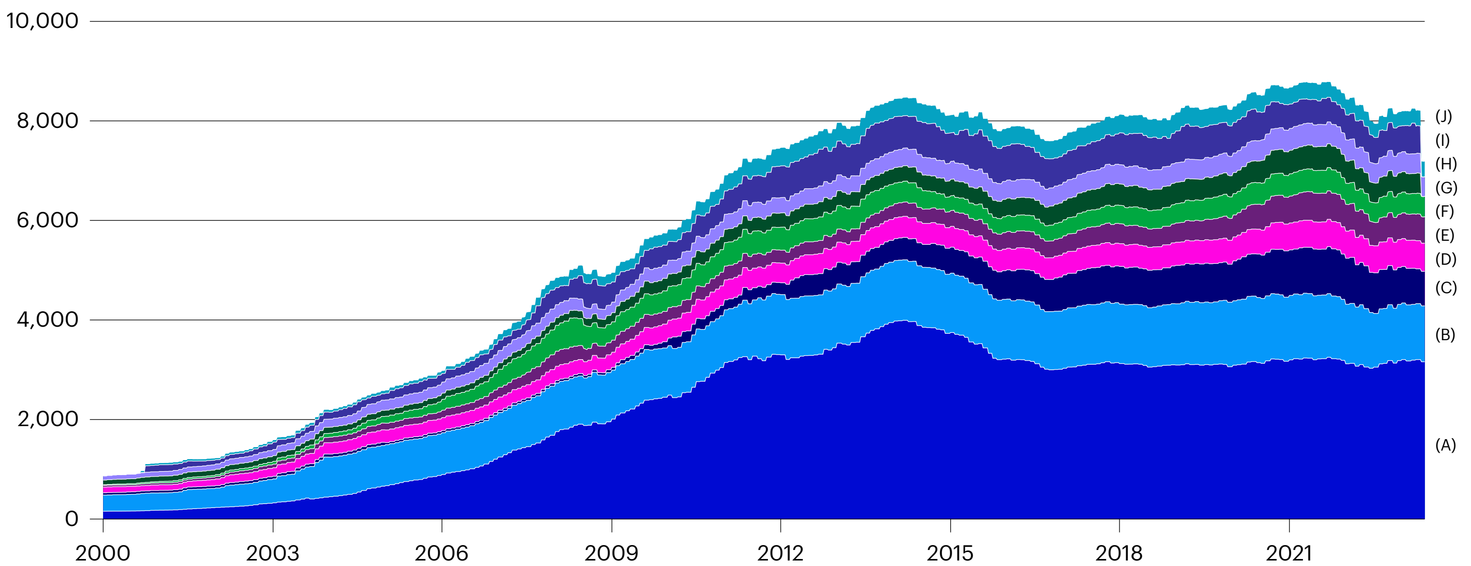
It would be extremely costly and disruptive to de-dollarise reserves or decouple current account surplus/deficit relationships.

In today's economically integrated and dollarised world economy, flows of trade/current-account balances and FX reserves stocks are linked. Major deficit economies are mostly democracies, with the US by far the largest and most consistent; many are US allies, like the UK; others, like India, increasingly friendly; some like Turkey are allied but uncertain. Major surplus economies cut across US allies (Japan, Eurozone), adversaries (China, Russia) and others arguably in the middle with strong security ties to the US and economic ties to China (Saudi Arabia).

International reserves are concentrated. The top-ten holders account for 75% of reserves of the global total of US$12 trillion in reserves, some 60% of which is in dollars. And the split is roughly even between US allies, who would probably stick with the dollar, and adversaries or others who probably would not.

Taking current account balances and reserves together, the interdependence is striking. Deficit and surplus countries are intertwined across geopolitical fault lines. It would be extremely costly and disruptive to de-dollarise reserves or decouple current account surplus/deficit relationships.

Figure 15
FX reserves are split among US allies/friends, adversaries, and those in between
(Top-10 global reserve holders, current US$bn)



Source: IMF, Macrobond, Invesco. Weekly data through August 2023, as at 15 September 2023.

There would likely be significant growth hits and financial losses from decoupling. It would be very difficult or impossible for both exporters and importers to replace trading partners across such a geopolitical divide. "Re-globalization" to diversify supply chains and protect national security seems a far more likely policy choice than deglobalisation – absent a direct trigger for open conflict.

Many countries eager to insulate themselves from sanctions risk are consistently current account surplus countries – e.g., China, Saudi Arabia and of course Russia itself – though some run bilateral trade deficits with each other. They may be able to form an integrated trading block among themselves, they would probably still need to export to the US, Eurozone, UK, etc., to sustain the levels of activity and returns on investment in productive capacity they currently enjoy. In this context, the US seems likely to remain indispensable as a reserve-currency country and source of global demand into which to both export and recycle surpluses for investment. Without this, they might well face potentially deflationary and destabilizing demand shortfalls, given the much higher purchasing power of the US than most other trading partners.

Hegemonic stability or uncertainty?
"The Global South" – emerging markets, former European colonies – opposes Russia's Ukraine war; most condemned the act in the UN General Assembly. Yet few are participating in sanctions. Some have maintained or enhanced ties with Russia, China with a "no-limits partnership."

Many worry that freezing Russia's reserves and their potential seizure to fund Ukraine's eventual reconstruction may set a harmful precedent. What if they offend US/Western preferences? Might their elites be sanctioned, their reserves frozen, their trade cordoned off?

All reasons to switch from the dollar, with China an obvious substitute. Yet, the BRICS – Brazil, Russia, India, China and South Africa, leading lights in the Global South – have proposed studying a shared BRICS currency rather than switching to renminbi.

Why a new currency instead of the renminbi – despite Russia's deep China/renminbi relationship, as well as Brazil's and South Africa's increasingly close ties to China? India probably will not use the renminbi: An unresolved border war flares up occasionally, a long-standing rivalry, a sense of encirclement given Chinese ties with Pakistan, Sri Lanka, increasingly with Russia. For India, the dollar may be a better bet on hegemonic stability than the renminbi – though it might never acknowledge such a position.

Freezing vs. Seizing Russia's Reserves
Beyond the concern outside the West about exposure to sanctions, lies the fear that their own foreign currency reserves might also be frozen, or expropriated. Indeed, debate rages in the West about seizing and using Russia's reserves to fund Ukraine's reconstruction, as a form of war reparations. Prominent lawyers, economists, political scientists have offered legal, logical, economic, and political justifications. And of course, in some countries, a sense of justice served might prevail if the aggressor were to pay.

However, for other countries, adding the injury of seizing the reserves to the insult of freezing the reserves will very likely be seen as a step too far. Legal or moral justifications might be seen as a form of Western hypocrisy, given the apparently falsified intelligence that served as a pretext to legitimise the invasion of Iraq. There were no weapons of mass destruction and Iraq has suffered enormous toll in lost life, growth and wealth. Undercutting sovereign immunity and the protections afforded to central bank reserves in particular might well be viewed as making up the rules in the rules-based order as circumstances change.

Undercutting sovereign immunity and the protections afforded to central bank reserves in particular might well be viewed as making up the rules in the rules-based order as circumstances change.

Furthermore, war reparations have often been negotiated into peace treaties. Holding the debate in advance, and of course pre-announcing confiscation might make for a longer, more destructive war by imposing an additional upfront cost upon Russia. It is true that, were Russia victorious, it would likely fund Ukraine's reconstruction eventually and at least substantially, as it has done in other wars, e.g., Chechnya. But these were policies of Russia's choosing, rather than imposed by the US or the West.

Thus, whatever one's view of the morality of the West's position in resisting the invasion and imposing as high a price as possible, a seizure of Russia's reserves would probably be seen as another sign that reliance on the dollar can increase vulnerability rather than generally enhancing stability. Many rising or would-be great powers and regional powers are already clearly perturbed by the ability of the US and its allies to impose restrictions on economic and financial activity. Crystallising the ability to both freeze and seize assets to then redeploy them would not only violate the concept of sovereign immunity, but it could convince some countries that their current official international reserves are much less worth holding than they had assumed. We therefore think that seizing Russia's reserves could accelerate de-dollarisation not just as a means of payment but also as a store of value and unit of account, as more countries opt out of the dollar system.

The likely best course of action for both policymakers and market participants is to keep a close eye on geopolitics and, above all, technology.

VI. Conclusion

Today's international system has no rules or treaties enshrining the centrality of a currency. The dollar's preeminence depends on usability and trust. Equally, any challenger must compete on its ability to support international stability, trade/investment and prosperity.

For decades, the dollar has had no head-on competitor. The yen and euro challenged the dollar on economic grounds, but neither Japan nor the Eurozone were able to keep up with the US in technology, financial or economic performance, let alone geopolitical heft. While the share of EUR currency reserves has increased, we believe the lack of a true fiscal union will continue to prevent it from displacing the USD.

Now, in part because of the muscular use of sanctions especially by the US and the West more widely, the game has changed from economic to geopolitical competition. China is a challenger with an economy as large as the US on a purchasing-power parity basis, pushing the envelope in cutting-edge technologies, the largest trading nation, and potentially capable of challenging US military prowess. In short, China now seems to be a geopolitical/geoeconomic peer.

Yet China seems less likely to directly take on the US or the dollar than to establish an alternative system, into which some countries may opt-in, at least partly. China seems unwilling to liberalise domestic capital controls, implying that exchange rates and interest rates are not market prices, undercutting the renminbi as a unit of account. Its financial markets are large, but not as large or liquid as those of the US. Its extensive trade links with reserve-using emerging economies suggests shared, not countercyclical macro/financial performance as would be ideal for reserve assets. Above all, China is shifting its state-led international payments to renminbi, and important trading partners are likely to shift to RMB settlements in an effort to create a ballast against USD dependency or gain favour with China.

On this basis, the likely best course of action for both policymakers and market participants is to keep a close eye on geopolitics and, above all, technology; to monitor activity in international payments, invoicing and reserve allocations; yet to operate on a traditional macro framework, since currency competition is likely to continue but be constrained by the need for large, deep, liquid markets.

If there is to be a major change, it is likely to occur in the international payments infrastructure, perhaps partly through the development of CIPS but more significantly through wholesale CBDCs that would create more efficient payments rails and open the way for their use for cross-border payments without using the dollar, at least on a regional basis. A digitalized unit of gold on blockchain technology and backed by verifiable gold is also under construction with potential to disrupt fiat currencies. Meanwhile, we expect to see a continued accumulation of gold at least in those countries seeking to build a bulwark against the risk that geo-political challenge results in direct confrontation and possibly as a placeholder for deeper changes in the international monetary system.

The main risks to our somewhat benign view of constrained de-dollarisation are seizure of Russia's frozen reserves or a direct, open military conflict between the US and another great power. We believe that current financial and economic realities as a practical matter will limit the scope for full-blown de-globalization in the absence of these important tail risks. Seizing Russia's reserves would probably increase the pressure among many countries to absorb higher costs and inefficiencies in international trade and investment because it would signal that their own international assets are not sufficiently under their own control to use as needed, free and clear – that they lack sovereignty in a system so heavily dependent on the US and West.

In contrast to the shock to the international financial order triggered by the US/West's response to the invasion of Ukraine, a direct military conflict involving the US and other great powers could fracture the international system as a whole – international economic relations, the financial system and geopolitical stability – potentially everywhere, all at once. Such a conflict, if it involved another major economy could push many other countries including reserve holders, to reconsider their own economic and financial exposures, as well as their national security imperatives.

Such a conflict could force a break-down in the interdependence of surplus and deficit countries around the world, perhaps along the lines of the rapid breakage of economic and financial links between Russia and the West, especially Europe. While even then, full-blown deglobalisation would not necessarily be a given, since many countries would probably prefer to remain neutral and trade with as many others as possible, they would probably need to maintain the financial flexibility to trade and invest in parallel in different systems. In short, in such a scenario of one world with many systems, central banks might find themselves needing to use more than one payment system, unit of account and hence maintain distinct stores of value, to maximise security and flexibility.

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