Date	October 27, 2020
Domain	CNBC TV 18
Link	https://www.cnbctv18.com/views/the-quandary-around-dollar-hegemony-7308611.htm

The Quandary around Dollar hegemony

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The sharp 10 percent depreciation in the value of the US Dollar (measured in terms of Dollar Index) over the past six months had again led to a concern that the greenback is on its way out as the premier global reserve currency. This debasement theory has gained momentum as US debt zoomed past 100 percent of GDP, the Fed monetized more than $3 trillion in new debt issued in 2020 and more recently adopted flexibility to its long-held inflation target of 2 percent by advocating an average inflation targeting framework.

A peek into history reveals that the US Dollar has remained an anchor currency for the global economy in the post-World War II period. The initial Dollar weakness following the collapse of the Bretton Woods' system in the early 1970s which led a transition to a floating exchange rate system had only increased the dominant role of the US Dollar in the global economy. The Dollar recent weakness is largely driven by shorter-term cyclical factors and is unlikely to overpower in the long run.

The US dollar plays a central role in the international monetary and financial system. First and foremost, around half of international trade is invoiced in US dollars and 40 percent of international payments are executed in dollar terms. Around 85 percent of all foreign exchange transactions occur against the US dollar.

Moreover, the deep and vibrant Dollar funding market plays a pivotal role in cross-border loans and international debt securities. The amount of outstanding international debt securities and cross-border loans that are denominated in US dollars is $22.6 trillion as of Q4 2019, or 26 percent as a share of world GDP, corresponding to about 50 percent of all outstanding international debt securities and cross-border loans. Given such share of Dollar funding in the global bank's balance sheet as well as the increasing length and complexity of global supply chains, the spillovers of US monetary policy to the rest of the world has only strengthened over past few decades.

Second, in part because of its prominence in trade and financial transactions, the dollar is also the main currency of intervention for central banks. The US Dollar accounts for 61 percent of the official foreign exchange reserve of $12 trillion among various economies. Not surprisingly, given its dominance, most of the central banks aim to stabilize their own currency with respect to Dollar value.

Overall, the role of the dollar as both an intervention currency and an anchor currency helps propagate US monetary policy impulses from the center to the periphery and provides a common component to the global monetary environment.

Third, the dollar is viewed as the safest currency not only because the US has – by far – the world's most liquid bond market, but mostly because investors trust the US system: its rule of law, protection of property rights and the independence of technocratic institutions. It is evident that at the time of financial and economic crises, the demand for dollar safe assets rises.

The simple reality is that we live in a dollar world –on the real side, where dollar invoicing is dominant, on the financial side, where dollar funding is important to global banks and non-financial corporations, and on the policy side, where dollar anchoring and the dollar reserves are prevalent. If anything, this dominance of the dollar has increased over time.

There is a lot of speculation that the Chinese renminbi will replace the US dollar. For that to happen, the power must spring from other dimensions, such as a sustained current account deficit creating a net export of renminbi, a vibrant liquid bond market, abolition of capital controls including managed exchange rate regime and, most importantly, the rule of law and institutional governance framework which provides comfort to the international investors.

Moreover, there are serious structural problems in China including a real estate gurgle and dominance of the state-owned enterprises which could undermine Beijing's innovation-led growth model. Though we are seeing some progress happening on Chinese capital control and development of the offshore Renminbi market, there is a considerable distance to travel before Renminbi gets positioned as a serious contender for a reserve currency.

If not the Chinese renminbi, then why not the Euro garners a larger share of global reserve? Eurozone is a monetary union but the lack of fiscal union has always haunted the common currency. Every subsequent crisis including the current pandemic has exposed the structural pressures of poor economic and social conditions between the Center nations (Germany and France) and the Periphery ones (Spain, Italy, Greece to name a few).

A new chapter of hope rekindled Euro this year when the initial experiment towards fiscal union in form of “EU recovery fund” has been adopted among EU members. However, one needs to see how this program gets implemented next year which in effect means a fiscal surplus transfer from the Center to the Periphery. Credible progress on this count may culminate into some sort of common Euro bond in the future which may propel the Euro share in global reserve management.

Any country vying for a pre-dominant position amongst all currencies like the USD would have to address one important pre-requisite. To become the reserve currency of the world would mean that the country has to be a net exporter of its currency, just like the US. This is possible only if the country runs a large current account deficit and the currency gets recycled back into their sovereign bond market, either through central bankers or by the banks of those countries with Current account surplus.

At the current juncture, this scenario seems unpalatable for Europe, Japan, or China, where strong exports (and sometimes weak currencies) are central to their economic growth model. However, the gradually declining share of the US economy in the global output will force a transition, at some point in the future to one where the dollar co-exists with one or two other global international currencies: the renminbi and possibly the euro.

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