Weekly Commentary 6 – Feb 2023

De-Dollarisation – Myths and the Path Forward

There was a lot of talk in 2020 and 2021 that the US Dollar would drop by as much as 30 percent. This was a view articulated by many serious observers of foreign exchange trends who postulated that the expansionary monetary policies adopted by the Biden Administration to cushion the US economy against the economic consequences of pandemic lockdowns would devalue the currency by that amount.

The logic of that argument is that all that money printing amounted to an effective devaluation of the currency. It seems obvious logic. You pump more money into a system with the same output of goods and services and every dollar ends up buying less. Domestically, it's called inflation, and internationally, the lower value of the dollar in terms of its purchasing power will lead to less foreigners using it. That, simply put, is de-dollarization.

Actually, to be more precise, that was what de-dollarization meant to most analysts and commentators back in 2021. It was simply a matter of too much money printing. The inflation that would inevitably follow and the loss of buying power in the US Dollar would lead to its declining usage. It actually spurred another financial phenomenon which was often thought of as a libertarian movement for people to be freed from the clutches of central banks and fiat currency – the crypto currency rebellion against financial orthodoxy.

As it turns out, it did not happen quite that way. When the lockdowns ended, the US dollar rose spectacularly. Instead of losing 30 percent, it actually went up 20 percent against the major European currencies as well as the Japanese year, and 2022 was a year of heady advances in the US currency. This was largely because for most of 2022, the US Fed Reserve turned around on zero interest rates and monetary expansion to fight raging inflation. Right up till the end of last year. By November 2022, Dollar strength looked overextended, the Fed's tough measures on inflation were lowering yields on the dollar, and by early Feb 2023, the Dollar has corrected by about 10 percent on the sentiment that high yields on the dollar would be history.

In the watershed year which 2022 turned out to be, the whole concept of de-dollarization changed. The war in Ukraine erupted. Loose monetary policy in the US was abruptly called off and replaced by a vigorous regime of rapid interest rate hikes. And the crypto currency industry collapsed.

Now in 2023, the talk of de-dollarization has become prevalent again. But this de-dollarization talk in 2023 is quite different from what it used to be just two years ago. The current de-dollarization debate has turned to geopolitics to justify its views.

Accompanying this analysis, de-dollarization is also used to predict that the dollar will crash. The 30-50% drop in the dollar talk is back. In short, there are many analysts who declare that de-dollarization is the same as saying it's time to sell the dollar.

In my humble opinion, that is not correct. While de-dollarization may indeed crash the dollar, this is not a sure thing. I don't think that de-dollarization and a depreciating dollar are one and the same phenomenon. We have to carefully delineate the two into separate processes with independent and uncorrelated results.

I will give just a simple illustration. The entire crypto currency craze was in fact an attempt at de-dollarization. Through 2020 to the end of 2021, all kinds of crooks and charlatans were waxing lyrical why bitcoin and other crypto currencies ought to be bought and held. The crux of the argument was that cryptos would protect buyers from the ravages of inflation and the loss of value in fiat currencies (principally the US Dollar). This whole argument that crypto currencies is a better store of purchasing power is in fact an argument for de-dollarization.

And in 2020-2021, that argument won a lot of adherents. Crazed fools, especially young people without investment experience, jumped into crypto currencies, swayed by the arguments made by famous influencers like Hollywood actors and sports stars, paid by crypto promoters, to essentially create a bubble of expectations that fiat currency would be replaced by these new "currencies". That movement of US currency into crypto peaked at US$2 trillion. This was as much as the total amount of US$ cash in circulation, roughly US$2.1 trillion. In other words, the crypto movement created (or shall we say, "diverted") as much "money" as there were US cash notes and coins. That was in fact a very successful de-dollarization effort in terms of crypto being sought as a store of value.

As it turned out, that crypto market was in fact a massive ponzi scheme. It eventually crashed from its peak value of $2 Trillion to less than $800billion today, and brought down many leading players in that market. The innumerable crypto faithful were even worse hit. Many retail investors lost their life savings.

Well, let's examine the crypto experience during its two best years, 2020 and 2021.

In 2020, de-dollarization of fiat currency, ie the US Dollar, was very pronounced. Bitcoin price and crypto asset acquisition exploded throughout the year. And by the time Nov 2021 came around, the crypto expansion was at its peak. It had more than US$2 trillion of assets siphoned from fiat markets. But if this was de-dollarization, it did not result in the dollar declining. As a matter of fact, having been "de-dollarized" by that US$2 trillion, the US dollar did not crash by 30%. From Nov 2021, the US Dollar started on a massive bull market that rose 20% against the Euro and an even larger amount against the Pound and Yen. It was finally only curbed by a turn in the interest rate cycle one year later in Nov 2022. Recognize that for what it was… Two trillion dollars worth of crypto de-dollarization did not tank the US dollar. Imagine that!

Through this period, de-dollarization via the crypto currency market was the hottest thing since sliced bread. Crypto capitalization, for example, went in a straight-line to about US$1 trillion in just one year, and then went on two trillion until about Nov 2021 when it matched the amount of US currency in circulation. Nearly 10,000 alternative currencies were invented, some named after dogs, cats and other things designed to endear them to investors. If this was not de-dollarization in earnest, and a massive flight from the US dollar or fiat currency to escape from the inevitable inflation that would follow, I don't know what is.

Then in 2022, the US dollar continued to rise with a vengeance. From about the end of 2021 right through the entire year of 2022 to November, the Dollar made huge advances and reached record high levels. How did that happen? You would have thought that the US Dollar was hollowed out by an invasive crypto alternative currency market.

My conclusion is that de-dollarization on its own would not doom the dollar to a 30 or 50% decline, as people are now saying. If that can be wrought, it would have happened in 2021-2022.

Both the crypto market as well as the dollar were reacting to the changes in the interest rate environment in the US, rather than each other. 2020 and 2021 were boosted by low interest rates, and bitcoin crashed in 2022 because of the end of monetary expansion. The US Dollar was not robbed of its vitality because of crypto de-dollarization. Both were affected by rising US interest rates, rather than each another.

Going forward, one should not assume that other forms of de-dollarization would crash the dollar. That is the basic thesis of this blog, based on what we have already seen in the past three years.

Let's clarify what people describe as de-dollarization today. First of all, we are already past the first wave of de-dollarization – the replacement of fiat currency by crypto. That is no longer fashionable. The failure of crypto was due to its overextended hype and unfulfilled expectations. Fundamentally, crypto did not work as a channel for de-dollarization because it failed in one of two major functions of a currency. A currency should be both a store of value (which crypto adherents promoted quite successfully) as well as a medium of transaction. Where crypto failed, it was because it did not succeed as an instrument for the exchange of goods and services. The effort to have crypto transactions started with a boast that the first bitcoin transaction was used by one of its early believers to buy pizza, until 2021 when El Salvador, led by a opportunistic president, tried to benefit from the crypto boom, and adopted bitcoin as the country's legal tender, used simultaneously with the US Dollar. Well, it didn't work. Even when backed by its laws, El Salvador's own citizens did not want to use bitcoin to engage in transactions. Bitcoin transactions were not simple enough. And it was marred by the fact that criminal elements in the world were very happy to adopt bitcoin to engage in money laundering and other nefarious activities.

And then the Ukraine war happened. From Feb 2022, Ukraine and Russia went to war, and this was shortly followed by western countries imposing the mother of all sanctions on Russia. This is now the new impetus for de-dollarization. The sanctions war has provoked a reaction from the countries that have been indirectly affected.

There are the following major developments in this new round of de-dollarization that has happened as a consequence of the Ukrainian war.

1) The western countries responded to Russia's invasion of Ukraine by freezing all its US Dollar and Euro reserves held in western banks. This is said to amount to half its total official reserves, about US$300 billion. This emerged as a big shock to a global financial system which had always regarded the holding of foreign reserves as sancrosanct, and that trust between the two countries (the country with the reserves in this case, Russia, and the provider of the banking system in which the reserves were deposited) would be above political altercation. The US broke this unwritten rule. And it was not just the reserves of the country that were frozen. An entire class of Russian citizens with significant assets overseas in the western countries were also sanctioned, and their assets were seized. This is the first time in modern history when one country would freeze the assets of the country and the money of some of its citizens. It struck fear and apprehension into all those countries in the world who have such reserves (and there are many of them) who trusted the US and left their savings in the US Dollar based system. Naturally, this is the first motivation to de-dollarise – which is to remove all reserves from the threat of a similar move by the US against them in future. In particular, all the richer countries in the world, those with sovereign wealth funds, will be among those who seek de-dollarization.

2) The second group of sanctions sought to neuter Russia's ability to finance its war. This was to remove Russia's ability to move money around the world to buy stuff that its economy needed. The collective west banned Russian banks from using the US Dollar SWIFT system, which is a messaging system among the world's banks to move US dollars around. Without the ability to move US dollars, Russia would have no ability to pay for its imports and it was thought that the Russian economy would just seize up.

3) More importantly, the expectation of a massive collapse in the Russian economy, would in turn cause popular dissent in the Russian population and bring about a regime change that would depose Vladimir Putin as its leader. It was hoped that the Russian wealthy as well as everybody else in the country would topple Putin and bring on a leader who would comply with western demands to stop the war.

4) Russia is one of the largest energy exporters in the world and was a particularly important exporter of gas to most of the EU countries. The western bloc wanted to end supplying money to Russia to fight its Ukrainian war, and also to reduce its ability to increase its coffers by being able to sell more energy around the world. Since the energy markets use the US dollar to transact, the limitation on importers to pay Russia in Dollars was thought to amount to a ban on Russian oil and gas exports. Russia outsmarted them by asking trading partners to use Rubles.

5) Another action the west took was to stop buying oil and gas from Russia. That was not all. The US tried to get all the other major importers of Russia oil and gas to stop buying its energy exports, and because Russia could no longer use the SWIFT system, it was thought that it would be the end of Russia as a major exporter of energy products. As a matter of fact, it was thought to be the end of Russia. That didn't happen. The buyers agreed to use Rubles. That use of Rubles in the Russian energy trade is de-dollarization, and for the most part of 2022, it coincided with a massive rise in the US Dollar's value.

6) And the US went to all its supposed allies and tried to persuade them to stop the energy business with Russia. India was thought to be surely compliant with this demand but the Indians told the western countries to bugger off. They have their own national interests to take care of, and this did not include removing Russia as a trade partner, especially in the important energy sector.

After eight or nine rounds of such economic sanctions (more were progressively added when earlier ones failed to work), which was supposed to crash the Russian economy and reduce the Ruble to rubble, nothing has really worked. In the last couple of weeks, a western financial institution, the International Monetary Fund, announced that the Russian economy did not break in the last one year of such severe sanctions. In fact, the Russian economy enjoyed positive growth that was comparable to growth in Germany, the most dynamic of the EU countries while the UK was worse off, bordering on recession. This was a shock to the collective west.

The state of the global economy is such that there are those on the American side, supporting the sanctions handed out to those who don't comply with the dictates of the rule-based system, ie the rules of the US empire. And then there are the others who are devising ways to avoid these threats and to survive sanctions.

That is what today's de-dollarization is truly about.

Therefore, it is the contention of this writer that the first round of de-dollarization was the crypto currency revolution, a botched attempt to protect purchasing power from the ravages of inflation brought about by excessive money printing. That round of de-dollarization failed. The crypto currency market structure blew up, and the expected decline in the use of the dollar did not happen.

Two years after the crypto de-dollarization started, there is now another wave of de-dollarization. This, as has been noted above, started from the economic sanctions levied on Russia and is an attempt to steer clear of American bullying through a regime of sanctions that are expected to bring about compliance with the global hegemon. It is more about geopolitics and the emergence of a multipolar global economy than about an escape from inflation. It is in fact an escape from the American empire and its rule-based system.

Hence it is very complicated. And it is not obvious that the dollar will decline if there is successful de-dollarization due to this geopolitical contest. If the dollar didn't fall because there was a parallel crypto market with the same size (US$2 trillion) as the amount of USD cash in circulation when it happened in 2020 and 2021, there is no reason why de-dollarization due to geopolitics will weaken the dollar. Let me explain why.

What is the form of this new geopolitical refuge from American hegemony and western economic domination of the world economy? Essentially, it begins with the fact that much of global trade is denominated in US Dollars. More than 50 percent of global trade is denominated in US Dollars. That would make most countries engaging in trade to be also subject to the rules in the Dollar-based SWIFT transaction system. Anyone who buys anything from another country need to use US Dollars. One side pays in dollars and the other side receives dollars even though neither side uses dollars in their domestic economies.

In particular, all energy trading is denominated in dollars, the result of an agreement between Saudi Arabia and the US a very long time ago.   There was a time you could not buy or sell energy products without going through US dollars.

Further, 90 percent of the world's foreign exchange transactions are based on US Dollars. One cannot buy or sell any other currency in the world without first going through US dollars.   Market quotations are generally made first in US Dollar terms.

Then there is the function of the US Dollar as a store of wealth.   About 60% of global wealth is held in US Dollar assets.   Of the remaining 40%, 20 percent of that is in the Euro, 5-6 percent is in the Yen and a slightly lower amount is in the Pound Sterling.

Among these critical functions of the US Dollar, there is now a movement among the largest economies in the world outside of the collective west that is trying to form an economic counterforce called BRICS, taking the initials of the countries that are its members - Brazil, Russia, India, China and South Africa. Many others are applying to join it. If it finally matures, it will be as big as the G7.   It is not there yet and could be in final shape in ten or twenty years. This bloc of countries want to de-dollarize and use a new BRICs currency. Here is an article from Forbes regarding this BRICS' initiative.

Follow The Yellow BRIC Road (To a New Digital Reserve Currency?)

By David G.W Birch

The Reserve Bank of India (RBI) is creating a new set of arrangements to allow companies to settle foreign trade in rupees. This means that, to use an obvious example, Russian and Indian organizations can trade goods and services without using dollars. Under such arrangements Russian banks will be required to open rupee accounts with Indian banks and Indian banks will need rouble accounts in Russia. Both countries would have to agree to hold a sum, say $1 billion, in local currencies in their respective accounts. So, Russian banks will have rupees worth $1 billion in their Indian accounts and Indian banks will have roubles worth $1 billion in their Russian accounts. Indian exporters can then be paid in rupees for their Russian exports (from the rupees held by Russian banks in their Indian accounts) while Russians get paid in roubles for their Indian exports (from the roubles held by Indian banks in their Russian accounts). Once a mutually acceptable exchange rate determined by the market is decided upon, trade between India and Russia can proceed with no dollar legs.

But what is this exchange rate? Should it be determined with reference to the US dollar? Or would it be better to have some other reserve currency that is not dependent on the value of the dollar at all?

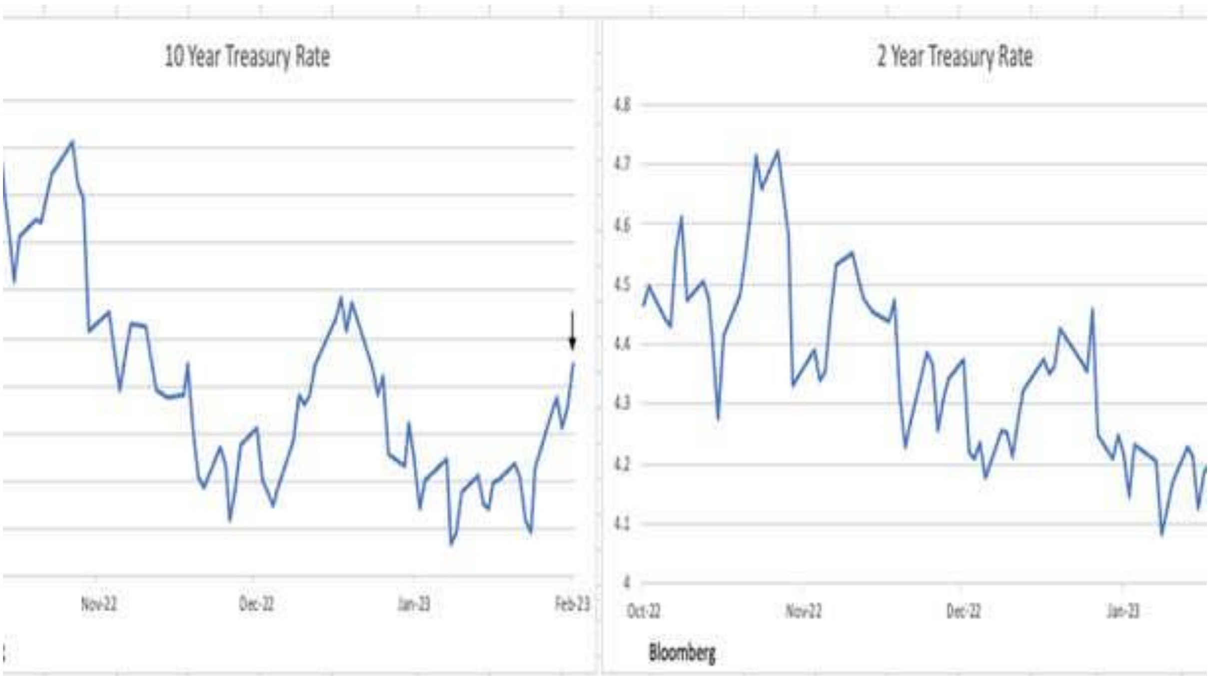
In June, President Putin (presumably stimulated by the international community's response to Russia's invasion of Ukraine) said that Brazil, Russia, India, China, and South Africa (the BRICS) are developing a new basket-based reserve currency. The presumption is that it will comprise real, *roubles, rupees, renminbi and rand to present an alternative to the IMF's Special Drawing Right (SDR). Much as Facebook's doomed Libra project wanted to, the goal is to create a stable reserve currency that can be used for international commerce. In this case, the Brics Bucks (as I call them) reserve will be independent of the dollar completely.*

Since India is importing large quantities of oil from Russia, for example, a mechanism to work out payments that are completely independent of the dollar is of great interest to both nations. Russia could price oil in Brics Bucks and obtain payment in roubles while India could price pharmaceuticals in Brics Bucks and obtain payments in rupees (although I note that Russian is not even in the top 10 of Indian export markets).

Will this have much of an impact? Not in the short term. ING analysts say that while it could be a "high-profile political statement" they doubt whether the trading nations in the BRICS sphere of influence would want to transfer valuable foreign exchange reserves, particularly dollars, into Brics Bucks and that if those nations are indeed responding to the weaponisation of the dollar, then they (like Russia) might prefer to move into gold.

It may be disappointing for the crypto fans out there, but I didn't see any mention of BitcoinBTC +0.2% or any other cryptocurrency in the BRICS announcement, so the idea of Bitcoin as digital gold may have to bide its time.

In any case, Bitcoin is nowhere near being capable of replacing gold as a reserve. For one thing, the price can be manipulated too easily: Analysis of price movements in recent times shows that whenever Bitcoin's price began to fall, TetherUSDT 0.0% was issued by Bitfinex and sent to two other exchanges, where it was used to buy Bitcoin – which would then rise in price.



(Although as the recent conviction of JP Morgan traders shows, the price of gold can be subject to similar attacks. A federal jury in Chicago convicted Michael Nowak, the former head of JPMorgan's global metals trading desk, and Gregg Smith, who worked as a trader and executive director in New York, of spoofing, wire fraud, commodities fraud and attempted price manipulation. The prosecutors had accused them of flooding the market with buy and sell orders — that represented half to three-quarters of the visible gold and silver markets at the time — that they never intended to execute, while trying to gain an edge over algorithmic traders.)

It does make you wonder, though, whether the world does need a new reserve currency. Do we need a new digital gold standard? And if so, should it be fiat or commodity-based? And if it's to be commodity-based, then what commodity? Should there be a digital gold standard?

In Their Time

Would real digital gold (i.e., tokens backed by actual gold reserves rather than cryptocurrencies) be attractive in the longer term? I have absolutely no idea, but I was thinking about this again when I listened to an episode of BBC Radio's long-running series "In Our Time" on the topic of the Gold Standard. The host Melvyn Bragg and guests (Catherine Schenk, Professor of Economic and Social History at the University of Oxford; Helen Paul, Lecturer in Economics and Economic History at the University of Southampton; Matthias Morys Senior Lecturer in Economic History at the University of York) discussed the system that flourished from mid-Victorian times when gold became dominant and more widely available, following the gold rushes in America and Australia.

Interestingly, in the introduction to the radio discussion, Mr. Bragg said that the "golden century" was from 1870 to 1970. Mr. Frisby tells me it was from 1816 following the great recoinage and Britain returning to convertibility after the Napoleonic Wars up until 1914 when Britain, France and Germany abandoned the Gold Standard to print money to pay for the Great War.

I disagree with both of them, not that it matters, but in my book on the history and future of money Before Babylon, Beyond Bitcoin, I took a more technological view and dated the golden age from the invention of electronic money in 1871 (when money became bits about atoms) to Richard Nixon ending the convertibility of gold in 1971 (when money became just bits.)

Anyway, whatever the exact dates, under the Gold Standard, national currencies around the world were tied to gold and so to each other, meaning stable exchange rates. The idea began in Britain, where sterling was seen "as good as gold", and as other countries came on to the Gold Standard the confidence in their currencies grew, and the combination of stability and confidence led to a boom in trade and prosperity. There's no need for a detailed history lesson, but the point is that that Gold Standard lasted for a while then it finished. Without getting into the whole Wall Street vs. Main Street thing, it is not coming back whether based on physical gold or the digital kind.

Monetary commentator, Charlie Crowson, recently said that what is perhaps surprising is not that the classical gold standard ended but that it lasted as long as it did and from my limited knowledge of economics I have to agree. When it comes to digital gold, I think tokens are great but that does not mean there will be a digital gold standard whether based on actual gold, Brics Bucks or Meta Money. The world has moved on.

That was actually a long history lesson on the futility of gold as a monetary standard in the 20th century. So if the new BRICS currency is going to revert to some form of a gold standard, it will run into the same problems as it did 100 years ago. So don't count on that happening.

So if not Gold, what is the basis of the exchange rate among the component currencies? Clearly that has not been decided and it will obviously take a long time to decide. In the meantime, I would not worry too much about de-dollarization even if the geopolitics of the world provide a lot of motivation to these countries to avoid American bullying and the weaponization of the Dollar.

There is also no alternative to adopt. Can the Euro be the alternative to replace the dollar as a reserve currency? That question has been posed for twenty years, and it has not got a favourable answer. In fact with Brexit and a permanent divorce with its largest energy trading partner in Europe, Russia, the EU economy will remain weak, and other than the members themselves, nobody would willingly hold the Euro as a reserve. Since it is on the side-lines of a major energy trade flow between Russia and its Asian neighbours, it is not likely to become a major transaction currency other than within the EU. As for the Chinese yuan, it has the greatest potential except for the fact that the Chinese themselves are not so keen on becoming a reserve currency. We know that they have changed their mind about this when they lift exchange controls. Until that happens, the RMB cannot be a reserve currency.

And interestingly enough, even the oil exporters like Saudi Arabia are happy to participate in de-dollarization as their biggest customer is no longer the US, but China. China wants to pay for their energy in RMB. The Saudis seem happy to cooperate. We will soon have de-dollarization of the oil trade, and it may become an RMB based system.

De-dollarization is ongoing. But it is not a phenomenon that will crash the US dollar in the short term. If that is a certain outcome, then the US Dollar should have collapsed in the great crypto expansion of 2020-2021. It didn't. Now we are into a second wave of de-dollarization, driven by the geopolitics in the world today, and the emergence of a multipolar world. Besides the BRICS and the oil exporting countries, there is a whole bunch of other smaller countries which are keen to get out of the way of the US' ability to impose sanctions on them.

But that will take a long time to set up. Don't expect a BRICS currency in the next two years that will be widely used. Even if there is one, there is no reason to expect the USD to fail as a transaction currency or a store of value – it will not be direct substitution, just like in the case of crypto. It will take at least a couple of decades for the dollar to lose its prominence as a store of value, the trade function and the foreign exchange function Most likely, the Dollar will no longer be the petrodollar, but that is unlikely on its own to cause complete and speedy dollar decline.

There is also the misconception that the loss of its functions in trade, or reserve management, will cause many people to sell the dollar. It should be recognized that out of the US7.5 trillion of forex turnover every single day, an estimated 97.5 percent of it is non-commercial and purely speculative. This speculation is not likely to be affected by changes in the fundamentals of the demand for the dollar. To expect a sell-off due to de-dollarization is to worry unnecessarily over nothing.

Then there is the problem of the US budget deficit. This deficit is sustained by the rest of the planet willing to take dollars in payment of interest and repayment of principal. Come the day when the holders of US debt don't want to take back dollars in repayment, and the US government will go bankrupt. The US government cannot allow that to happen. So a dollar weaker by 30-50 percent is not something it wants to see. It will have to keep up the prospect that the US Dollar will be a strong and stable currency. Guess what it will do to keep it that way? Since the Dollar is also a safe haven currency, stirring up shit in the world and starting wars will do it quite nicely.

Overall, it is more relevant to worry about the direction of relative interest rates in forecasting Dollar direction. That is more likely to tell us where the US Dollar will go in the next five years.

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Un-Influencer in a World full of Hubris