

Weekly Commentary 16a – April 2023

Should we be worried about de-dollarization?

Too many people are talking about de-dollarization these days and there is some concern about making investments in US Dollars. I have been writing about fears over a crashing dollar in this Weekly Commentary for two years now, and so far, I have never taken the view that the US dollar would crash in magnitudes like 30 percent, a number bandied around by top economists and currency analysts. My track record in predicting the direction of the dollar has been better, but then, who am I compared to some of these top names? So if you read what such people say, there is a natural tendency to worry that you will lose money from a crashing dollar.

And since Russia and China have intensified their efforts to break away from US hegemony, which I would say started from the first quarter of this year, more countries from around the world are jumping on board this band-wagon. The desire to distance themselves from the constant threat by the United States to force countries to be compliant with the hegemon's foreign policies, after they saw what they did to Russia with the mother of all sanctions, de-SWIFTing the country and expecting it to then crash and burn, the countries belonging to the rest of the planet are signing on to the examples of Russia and China in avoiding, if not eliminating, the consequences of basing their trade on the Dollar or keeping their reserves in that currency.

Brazil's president Lula, just a week ago, was quoted for his now famous lament: "Every night I ask myself why all countries have to base their trade on the dollar." He is not the only one. Every country's leader is asking essentially the same question. The answer is actually quite simple. The US has been the largest trading economy in the world, and the entire global system is set up to make settlements in US Dollars. That infrastructure cannot be rebuilt for every other currency because there would be no economies of scale. There is actually good reason why much of the world's trade is denominated in US Dollars. Even if the world wants to, it will be very hard to completely break free of dollar dominance. This is because most countries will still have to trade with the US, and if America is just 20% of the global economy, well, then 20 percent of the world's trade will be in dollars. And many countries currencies are backed by the dollar. That will bring all bilateral trade in Dollars to be like 50% if not another 20% higher. That is a huge base, even if every country does not want their non US trade to be in their own currencies or somebody else's like the RMB.

And let's say that Brazil and China want to settle their trade in RMB. It's not so simple. The international banking system is not wired to do that. Every bank in the world can process US dollars easily now, because they have done it for fifty years. Ask them to do RMB without going through USD first, most banks won't be able to do so. Now, China has been developing the equivalent of a SWIFT system called CIPS. But there is a scale issue. CIPS is less than 1% of SWIFT in terms of transaction volume.

SWIFT had the first mover advantage, so it was a collective effort that was created in 1977 by the United States, the EU, and some G7 countries to really secure the messaging between global financial institutions. So, it facilitates the movement of funds by providing the messaging infrastructure, but it doesn't move the funds itself.

And in contrast, CIPS [Cross-border Interbank Payment System] was, as an idea, conceived in 2012, established in 2015, and was created to really increase the efficiency and lower the costs of RMB transactions. So, it helps move funds. It clears and settles the RMB and most of the time uses SWIFT-enabled messaging to clear and settle RMB cross-border.

CIPS's closest U.S. analog really is CHIPS, which stands for Clearing House Interbank Payments System. It's the largest private sector USD clearing system in the world. And CHIPS clears and settles the USD. And really the only similarity between SWIFT and CIPS, is the networking capability.

SWIFT connects global financial institutions to each other with its messaging capability. CIPS connects mostly domestic Chinese payment systems with one another. But that's where the similarity stops.

It is important to establish the baseline of how cross-border transactions work. So cross-border payments are usually conducted with the correspondent banking model. Correspondent banks are third-party banks that act as the middleman between different financial institutions.

If a specific transaction must go through multiple corresponding banks at each step of the way, they must be communicating or messages have to be communicated through SWIFT normally before a transaction reaches or the messaging reaches the final destination accounts. Cross-border payments are very tricky because payments often include currency conversions, different tax regimes, and processing fees.

So how does CIPS fit into this cross-border payment picture? CIPS specifically works in this equation by facilitating payment orders between correspondent accounts of different financial institutions.

Financial institutions can either be direct participants of CIPS or indirect, which just means direct participants can directly send or receive financial messages and clear and settle RMB through CIPS. Indirect will just have to go through direct participants to do so.

What about the relationship between RMB internationalization or the opening of China's capital account and the adoption of that currency to replace the dollar.

CIPS in the short to medium term will not be helping with RMB internationalization. The kind of conditions that need to be present for the RMB to be an attractive currency, it doesn't lie in CIPS, but rather in the political-economic model that China offers.

The RMB really needs to become a reliable medium of exchange and store of value. As it currently stands, it's just not considered a safe asset, at least compared to so many other currencies like the U.S. dollar.

Since China's state-controlled political-economic model does not lend its way to investor confidence and we don't really need to look that far for comparison.

Even more importantly, the RMB is a controlled currency. Nobody can move any RMB in and out of the country without getting official permission the Chinese government's regulator called SAFE (State Administration of Foreign Exchange) which is an interesting acronym.

The United States has the historical and institutional advantages of having the most tradable and convertible currency in the world, helped by the United States' deep capital markets and its political economic system (at least up to now).

And also, a related and important point is that the PRC can't really afford to bear the burden of maintaining a major global currency just because the PRC can't really afford to have an appreciating RMB as its economy is still highly export reliant.

It also can't have an unrestricted capital account inside mainland China and increasingly in the offshore RMB market in Hong Kong, given the concerns over capital flight and the consequent instability, should that happen.

But while CIPS may not help with making the Chinese currency more appealing, it could help make the RMB alternative in international finance more appealing. Perhaps the Chinese government ultimately is trying to make a play for influence in the international financial system via CIPS, but for those worrying about the demise of the Dollar as the dominant trade currency, you don't have to even think about it for the next ten - twenty years.

Further, here is an article written by a finteeh company called FinLync about a year ago:

Are there alternatives to SWIFT?

Yes, there are alternatives to SWIFT and host-to-host connectivity. Here are the alternatives:

- 1. Other messaging networks*
- 2. Bank APIs*
- 3. Phone or Fax*
- 4. Blockchain or Cryptocurrency*

Let's separate the wheat from the chaff. Other messaging networks exist, but they are highly geographically limited and therefore defeat much of the purpose of a SWIFT alternative. Unless you want to return to the dark ages, we can remove phone or fax as a true alternative. Blockchain or cryptocurrency can technically do the job, but as described in the original post below, the volatility in valuation and lack of acceptance is limiting.

Where does that leave us? With bank APIs.

Bank APIs are Faster and More Secure than SWIFT

Heraclitus said "There is nothing permanent except change" and bank connectivity technology is no exception. SWIFT was founded 50 years ago, in 1973 – the US war in Vietnam was ongoing, the Sydney Opera House was opened, and the world was listening to Roberta Flack, Jim Croce and Marvin Gaye. It would be ten more years before IBM would announce its first ever laptop computer.

Since 1973, technology has advanced at lightning speed. The internet, the smartphone, bluetooth technology, and AI-backed tools have all revolutionized so many parts of our personal and business lives. But, SWIFT's technology has not materially changed from their original offering.

The revolution has arrived: bank APIs.

Bank APIs provide a faster and more secure way to move data between corporations and their banks. For treasury practitioners and their partners in IT, APIs are nothing new. Most people already use API connections in their every day life and in their work life – whether it's the weather API that pipes the forecast into their smartphone, or the API that connects the HR system to the payroll system. Most treasury teams are also familiar with real-time data – just not real-time bank data – because of the limitations of SWIFT and host-to-host bank connectivity.

Why have bank APIs taken so long?

The technology of APIs has been around for some time. So why has it taken so long for bank APIs to overtake legacy bank connectivity methods like SWIFT and host-to-host? There are two reasons:

1. Until recently, banks saw API connections as a nice-to-have. Banks likely had a project to create bank APIs on the To Do list since APIs became common. But, there was no hair-on-fire reason to prioritize them until 2013. In that year, the European Union amended regulation called PSD2 (Payment Service Providers Directive 2) which forced banks to make all the information a bank had about a client available to the client or their proxy. The way banks chose to comply with this new rule was to create open banking APIs. Other regulations similar to PSD2 have been implemented in major countries around the globe since then.

Banks have now prioritized the creation of API connectivity, and in fact, there are more than 90+ live bank APIs available and in use on the market today, and growing every day.

2. Until now, it was incredibly difficult to connect to a bank API. The instruction manual for connecting to a single bank API is hundreds of pages long and takes an army of specialized developers. Most corporations would need to connect at least 4 bank APIs (balances, transactions, payment initiation and payment status) across each of their banks. With some corporations having more than twenty bank partners, it would be an uphill battle for even the most generously-resourced treasury and IT teams, and require significant ongoing maintenance.

Making bank API connections easy

Countless treasury and finance teams have understood the value of advancing to bank APIs, and some have made a valiant effort to build connections themselves.

Enter the multi-bank API aggregator.

A bank API aggregator is a technology provider that connects to multiple banks in one integration effort. It acts as a “google translator” between all the unique formats and messages from each bank, and renders them into a single endpoint that connects to existing systems. This makes it easier for companies to connect to bank APIs and, in turn, access balances and transaction data and initiate payments all in real-time — something that was not possible before without significant development effort and resources. This type of third-party technology partner allows companies to quickly advance their bank connectivity without building out an in-house infrastructure or needing to spend months trying to connect with each individual bank’s API separately.

Basically, the international banking system has got too much momentum to continue using the US Dollar, the SWIFT system and the accompanying infrastructure to process trade flows. For that to change, even if there is the political will, it will take a generation. In things like this, nobody is motivated to change something that is working well.

And if you are the one motivated to change the world, say, by creating another system that will displace the dollar, who is going to carry that humongous cost? – we already know that the Chinese system hasn’t quite made it yet, and if you are looking to crypto-currencies, that’s like jumping from the frying pan into the fire. Forget that thought.

Then, there is the related question of why do countries hold US dollars for store of value? You know, foreign currency reserves, Sovereign Wealth Funds etc... Avoid the Russian experience of the western countries confiscating US\$300 billion of their money held in those countries...

Well, here is an opinion editorial found in the Financial Times last week on that very issue. Here is the article:

Opinion : Threats to the dollar's dominance are overblown There are no viable alternatives to the greenback, but the US must avoid self-harm

By THE EDITORIAL BOARD

“Every night I ask myself why all countries have to base their trade on the dollar,” asked Brazil’s president Luiz Inácio Lula da Silva last week during a state visit to China. It is a question on the mind of many national leaders, particularly as global trade fragments between US and Chinese spheres, and as countries evaluate exposures to western sanctions and the US economy. While paranoia about the greenback’s sticking power is mounting among some in Washington, it should not be keeping them up at night. The dollar’s demise is vastly exaggerated.

Since the 1944 Bretton Woods agreement instilled the dollar as the de facto global currency, its dominance has been sustained by America’s status as the world’s largest economy and geopolitical powerhouse. Just under 60 per cent of official foreign exchange reserves are held in the currency. It is the currency of choice for international trade, accounting for more than four-fifths of trade finance and half of trade invoices. It also dominates foreign exchange and debt markets. This drives high demand for dollars, allowing the US to borrow at a lower cost. Usurping these network effects is not easy.

It’s true that there are threats to the dollar. As Chinese trade and lending has expanded in recent years, renminbi use has risen. Its share of the trade financing market has more than doubled in a year to 4.5 per cent now — just shy of the euro’s share. Much of this is linked to increased trade with Russia as sanctions last year cut Vladimir Putin off from the west’s financial system. But, with China’s share of global goods trade now around 15 per cent, the renminbi’s reach will expand. Prior to Lula’s visit, China and Brazil agreed to settle trades in each other’s currencies, reflecting their growing mutual trade. France also recently conducted its first liquefied natural gas sale in renminbi.

US Treasury secretary Janet Yellen warned on Sunday that the west’s economic sanctions on Russia could also undermine the dollar’s hegemony. More nations may be spooked into considering alternatives to dollar-based financing to mitigate their threat. Putin has already pledged to use the renminbi more. For others, diversification makes economic sense too. Many emerging markets are growing frustrated by the dollar’s hold on their economies, from recent banking turmoil to the US Federal Reserve’s historic interest rate rises — which has raised indebtedness. Asean members are exploring how to promote the use of local currencies in their bilateral trade.

But these threats to dollar supremacy lack potency. While renminbi-backed trade may pick up, the currency still only accounts for about 3 per cent of central bank reserves. The greenback’s eminence is reinforced by its enormous liquidity, America’s openness to trade and investment, and trust in its supporting institutions. China’s financial system is by contrast less developed, its currency is not fully convertible due to capital controls, and it lacks the true rule of law. Global economic activity is still dominated by the US and its allies, which makes it difficult to avoid the dollar. The greatest threat may come from central bank digital currencies, which can provide more efficient ways to settle transactions. The US is finally waking up to this danger, but should accelerate efforts on digitising the dollar.

Given there is no viable alternative to replace it, rumours of the dollar's decline are exaggerated. This means the biggest risk to the currency could ultimately come from unforced errors. Bolstering confidence in the US financial system after recent banking turmoil and, above all, averting a debt ceiling crisis are vital. It is important to guard against complacency; after all, Britain's pound sterling was the dominant currency once.

You may not trust the FT on their assessments about the progress of the war in Ukraine especially on the issue of who is winning it, but they are good at assessing issues like the role of the dollar in the international economy. I tend to agree with them that views on the dollar's decline are exaggerated. Hell, I have said that like a broken record for two years in this very blog.

Then there is that famous historian called Niall Ferguson, who writes extensively on issues about the history of money, including a best seller called *The Ascent of Money*. Last week, he expressed his views on de-dollarisation in a Bloomberg article:

"Every night," the president mused, "I ask myself why every country needs to trade in the dollar. ... Who decided it was the dollar after the disappearance of the gold standard? ... Today, countries have to chase after dollars to export, when they could be exporting in their own currencies."

The president in question was Luiz Inácio Lula da Silva of Brazil, and the venue was the New Development Bank in Shanghai on April 13. There was a great deal of interest in this latest news about Lula when I visited Sao Paulo last week. To me, however, the striking thing was how un-new it was. Lula's words immediately brought to my mind the musings of another president more than half a century ago:

The convention whereby the dollar is given a transcendent value as an international currency no longer rests on its initial base. ... The fact that many states accept dollars ... in order to make up for the deficits of [the] American balance of payments, has enabled the United States to be indebted to foreign countries free of charge. Indeed, what they owe those countries, they pay ... in dollars that they themselves can issue as they wish. ... This unilateral facility attributed to America has helped spread the idea that the dollar is an impartial, international [means] of exchange, whereas it is a means of credit appropriated to one state.

The speaker then was President Charles de Gaulle of France, and the date was Feb. 4, 1965. It was de Gaulle's broadside against the dollar that prompted his finance minister, Valéry Giscard d'Estaing, to coin the memorable phrase "exorbitant privilege," which encapsulated the French complaint.

Being fed up with the dominance of the mighty dollar is, in other words, old hat. Indeed, it is such a recurrent theme of financial journalism that one can identify cycles in the use of the phrase "exorbitant privilege." Recent peaks, according to Google, were in 2007, 2011 and 2014. The Google "Ngram" for "de-dollarization" follows a similar path.

*I first wrote an article on the subject nearly two decades ago, in June 2004. I was then an occasional contributor to *The New Republic* and my theme was the grave challenge to dollar dominance posed by the creation of a single European currency.*

“For the United States,” I wrote portentously, “the question is: How long can [the] dollar standard last? As long as the dollar is ascendant, the United States can continue to run huge trade deficits and budget deficits, without having to worry about serious economic fallout. But if the dollar were to lose its status as the world’s reserve currency, and suffer a more precipitous slide, that could have grave consequences. Unfortunately for Americans, the sheer magnitude of the imbalances, along with the emergence of suitable alternative — the Euro — have made this a distinct possibility.”

Fortunately for me, a man is not under oath when writing such stuff.

Readers will therefore understand why my initial response is one of skepticism to any new claims that the demise of the dollar is imminent. But here they come again — not just Lula but a cluster of widely respected economic commentators. According to Peter C. Earle of the American Institute for Economic Research, “the dollar’s fate as the lingua franca of world commerce over the long haul may already be sealed.”

For Earle, it is American overuse of financial sanctions that is to blame. The more the US exploits its power to shut adversaries’ economies out of the dollar payments system, the more other countries want to reduce their exposure to that risk. Hence recent agreements between China and Brazil, China and France, and India and Malaysia, to settle trades in one another’s currencies.

“Prepare for a multipolar currency world” was Gillian Tett’s message in a recent Financial Times piece. Earlier this month, while Chinese president Xi Jinping was in Moscow, Russian President Vladimir Putin pledged to adopt the renminbi for “payments between Russia and countries of Asia, Africa and Latin America” to reduce Russian exposure to “toxic” dollar-denominated assets. Because of such trends, according to Stephen Jen of Eurizon SLJ Capital, the dollar has already “suffered a stunning collapse.” “The USD is losing its market share as a reserve currency at a much faster rate than is commonly believed,” Jen wrote in a recent research note quoted at length by Robin Wrigglesworth in the FT. “The main driver of the collapse in USD’s reserve status in 2022 may have reflected a panicked reaction to property rights being jeopardized” by the freezing of Russia’s foreign currency reserves following its invasion of Ukraine. “What we witnessed in 2022 was sort of a ‘defund-the-global-police’ moment.”

That’s a nice line, but so was the euro-trashing of the dollar 19 years ago. So, let’s take a closer look at the data. It’s true that, conventionally measured, the dollar now accounts for a smaller share of international reserves than it did in 1999 — down from just above 70% then to 59%. However, as Brad Setser of the Council on Foreign Relations has pointed out, if you take the X-axis back to 1995, you can see that the dollar share of international reserves is higher today than it was back then.

Yet this is not to suggest that gold is another, more ancient rival to the dollar. It is far from clear that accumulating gold will solve the Russian — and Chinese — problem of vulnerability to US sanctions. It is just a good illustration of how slowly the global monetary system changes.

The year before de Gaulle’s diatribe against the dollar was when my favorite James Bond film was released. Goldfinger remains a wonderful cinematic achievement, from the villain’s first victim — the actress Shirley Eaton, clad only in gold paint — to the exquisite exchange between Bond and Gert Frobe as a laser beam inches towards Sean Connery’s groin:

007: Do you expect me to talk?

Goldfinger: No, Mr. Bond. I expect you to die!

But, aside from the almost unmitigated sexism, one aspect of Goldfinger has dated absurdly. It's the moment when the man from the Bank of England explains why Goldfinger's suspicious accumulation of gold is a problem requiring 007's attention:

We here at the Bank of England are the official depository for gold bullion. Just as Fort Knox, Kentucky, is for the United States. We know the amounts we each hold and the amounts deposited in other banks. We can estimate what is being held for industrial purposes. Thus, both governments can establish the true value of the dollar and the pound.

Those days were over within seven years, when President Richard Nixon broke the link between gold and the dollar that had been the anchor of the Bretton Woods System. Since then, the currencies of the world have fluctuated against one another and against gold, sometimes quite violently, sometimes barely noticeably.

Hardly a Currency Crisis

Source: Bank for International Settlements

Just look at the trade-weighted real effective exchange rate of the dollar since the "Nixon shock." There's a 32% plunge from July 1971 to October 1978. Then there's a 49% rally to March 1985. Another 36% plunge to August 1992. Then up 33% to February 2002. Back down 26% to July 2011. And all the way up 53% to October 2022.

You can say what you like about the dollar, but it sure is bouncy. And it is precisely this lack of rigidity that explains the persistence of the post-1971 monetary system. Unlike the gold standard, the dollar system has an elastic anchor — a fiat dollar, the supply of which is primarily determined by domestic economic considerations.

Other currencies are very welcome to compete: the euro, the renminbi — and (who knows?) maybe the future "BRICS currency" imagined by Lula in Shanghai. But do not expect "de-dollarization" to follow the Hemingway two-stage model. The world changes its monetary anchor only one way. Gradually.

Well, Mr Ferguson and I feel the same way. We have recognized that there is indeed de-dollarization but that does not mean that the dollar will go to zero tomorrow. For those following my weekly commentaries, my point is that de-dollarization will not happen so rapidly that it will affect us in any way for the foreseeable future. The institutional infrastructure will not move against the principle of "if it's working, don't try to fix it...".

So even if there are political justifications for doing so, de-dollarisation will take twenty years for the banks to figure out. Bitcoin has now been around for 14-15 years, and there is no sign that such an invention will take dollars out of the international economy. At the end of that time, the Dollar may be lower by 20 percent, which is at worst, one year's return at Spread Analytics. It's all about risk vs returns. The US dollar will never go to zero. It's worth the risk holding dollars. Period.

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Un-Influencer in a World full of Hubris