A ‘third way’ in currency dominance

Description

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Surging geopolitical risk and growing global conflicts, along with a concomitant search for economic security, are combining to challenge what has long been a pillar of the global financial system: the US dollar’s hegemony.

This confluence is prompting countries to prize financial diversity over even efficiency, which is one of the reasons no single currency is likely to emerge as the dollar’s successor. Instead, the global financial system is likely to employ a “third way,” featuring multiple alternatives, without anyone dominating.

That will be a stark change: The dollar has been the most-sought currency for trade, financial flows and foreign exchange reserves since the end of World War II, and especially since the Bretton Woods system broke in 1971 and the US abandoned the gold standard. A recent European Central Bank paper confirmed that the dollar remains the currency of international choice, with the euro a very distant second.

The US and the world have both benefited from this system. The Federal Reserve has enjoyed the “exorbitant privilege” of being able to borrow cheaply and without any financial constraints. In exchange, it ensured a supply of dollars sufficient to cover global transactions while the US guaranteed the dollar’s intrinsic value. Further, during times of crisis, the Fed provided liquidity assistance to ensure trade and financial continuity.

Rising geopolitical fragmentation is incrementally challenging this hegemony. The dollar remains the preferred store of value around the globe, with gold recently surpassing the euro as the second largest reserve asset.

Its place as the world's preferred payment mechanism is under siege, however, thanks in part to the US reaction to Russia's invading Ukraine in 2022. The West cut Russia off from the international financial system in response, essentially weaponizing their currencies. That spurred global interest in alternatives ways to finance trade as a hedge against the mere possibility of facing similar sanctions in the future.

At the start of 2022, only 15 countries had pilot programs for Central Bank Digital Currencies – a figure which has at least tripled since. These instruments, which should allow any two Central Banks to settle any transaction without the need to use either the US or the EU central bank (currently the case) could potentially provide an alternative method for cross-border wholesale payments. Non-state alternatives are also materializing, including the first-generation cryptocurrencies, like bitcoin and, increasingly, stablecoins. Cryptocurrencies provide alternatives for those wishing to insure against the possibility of sanctions because they avoid the sovereign money structure. Stablecoins are based on dollars and so will not bypass sanctions but would allow easier access to the US currency. In this respect they have the potential to be used more extensively in cross-border wholesale transactions globally.

None of the state-based alternatives to the dollar are positioned to replace it. The European Central Bank could provide sufficient euros to facilitate global payments if, as expected, it decides to pursue greater internationalization of its currency. With just over 6 trillion worth of debt rated at the highest level (AAA or AA+), however, there are not sufficient safe assets to back up greater usage. The central bank would also need to be more willing to actively address financial stresses through larger currency swaps than it has deployed, and ones which do not rely on the Federal Reserve, which it historically has.

The Chinese yuan, the only other sufficiently large contender, also has critical impediments. China has become more willing in recent years to support global liquidity with currency swaps, a move designed to undermine US hegemony by bolstering foreign exchange reserves and facilitating trade settlements away from the dollar. But the yuan is not traded and is therefore only partially convertible. And the market for Chinese government bonds available to foreign investors is also small, about 7% of outstanding government bonds.

All this adds up to a multipolar future financial system. This '*third way*' in payments will occur at the cost of efficiency and will add to global financial fragmentation. But with no single currency positioned to succeed dollar dominance and nonstate alternatives evolving unconvincingly, the answer to the clear desire to diversify payment solutions will be multiple currencies coexisting in the pursuit of reducing dependencies on any single one.

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