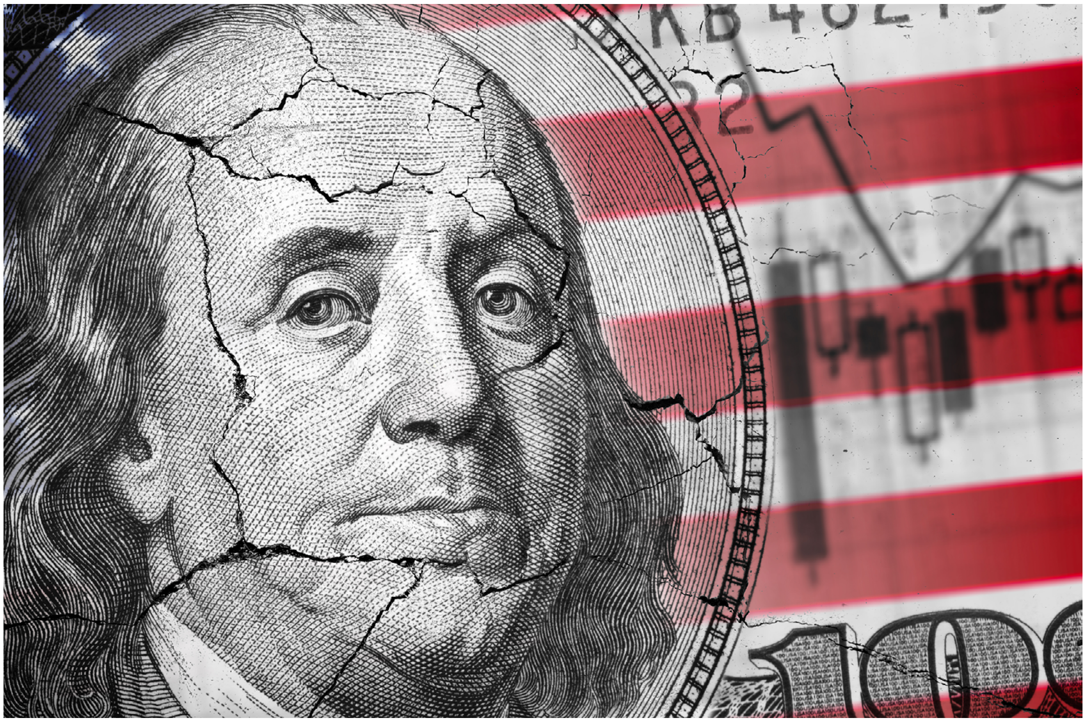
Dollar Disintermediation Gathering Steam: the How and the Why

Bill Campbell | May 2023



A raft of research papers has recently appeared on the coming end of the U.S. dollar as the world's dominant reserve currency. Some of these have made hyperbolic calls for the dollar's demise as a reserve currency. I disagree. Let's take a page from history. In the mid-20th century, when the U.S. dollar supplanted the British pound as the primary basis for international settlement, sterling did not disappear from trade all together. It just went on to play a less and less meaningful role.[1] The same fate is in store for the dollar. With that historical nuance in place, dollar disintermediation is a fact, and an accelerating fact at that. I will cover recent significant encroachments on the dollar's reserve kingship, the reasons for challenges from multiple corners to the dollar standard and the implications for national and regional economies and the investment landscape as the world transitions away from a dollar-based system to a multipolar system.[2]

King Dollar and the Lèse-Majesté of Global Reserve Challengers

For 75 years, global trade and commerce have functioned primarily on the dollar-based system with the buck underpinning the vast majority of global transactions. This system went hand in hand with America taking the lead role in redevelopment of the global economy after World War II, its preponderant share of global gross domestic product (GDP) and the United States' status as a superpower underwriting global security and leading the development of many multinational institutions. For most nations, the dollar fulfilled the roles needed in a currency: a store of value, a liquid and safe medium of exchange and worldwide acceptance as legal tender.

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Today, we are in a period of rapid global change, much of it to the detriment, or relative decline, of the United States. The U.S. share of global GDP has been falling, from 30% in 2000 to 24% as of the end of 2021, according to the World Bank.[3] *(Figure 1)* In the past two decades, standards of living and GDP per capita have increased rapidly in many emerging market countries, most notably China. Many nations have developed their economies to the stage where the dollar no longer serves their best interests. This has led to nations seeking to escape the dependence on the dollar as they pursue national objectives that often deviate from the objectives of the United States. Policymakers are taking concrete, effective steps to fashion a new trade-and-commerce system that disintermediates the dollar in favor of their own currencies and baskets of currencies weighted to their international trade and finance relations.

U.S. and China Share of World GDP
As of December 31, 2021

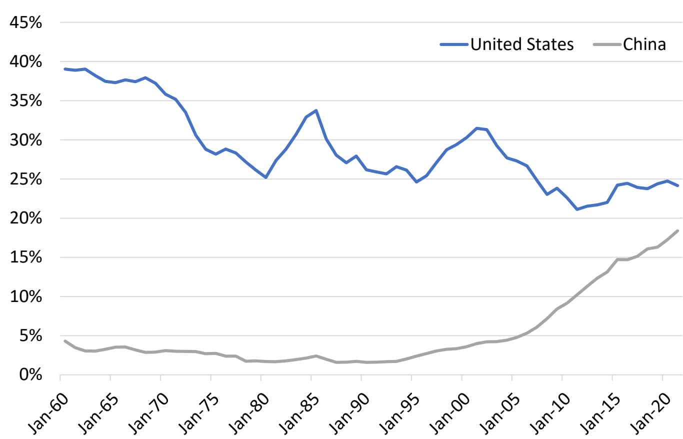

Figure 1
Source: World Bank, Bloomberg

Recent examples abound. Brazil, on March 31, announced that Chinese-Brazilian Bank of Communications BBM, a subsidiary of China's fifth largest bank, will be connected to the Chinese Cross-Border Interbank Payment System. In addition, China and Brazil's central banks have signed a memorandum of understanding to settle trade bilaterally, between their own currencies, disintermediating the dollar from these transactions.[4]

Malaysian Prime Minister Anwar Ibrahim on April 5, 2023, told his country's Parliament that Chinese President Xi Jinping is open to discussions on creating an Asian Monetary Fund. Anwar also stated, "There is no reason for Malaysia to continue depending on the (U.S.) dollar." Indeed, the central banks of Malaysia and China are working on a bilateral agreement that would allow trade between the two nations to be settled in their respective currencies, the ringgit and yuan.

Russia is ready to switch to settlements in yuan in trade with other countries in an expanded format, Russian President Vladimir Putin said during China-Russia talks at the end of March. "We are for the use of Chinese yuan in settlements between Russia and the countries of Asia, Africa and Latin America. I am sure that these forms of settlement in yuan will be developed between Russian partners and their counterparts in third countries," said Putin. He drew attention to national currencies already actively being used in Sino-Russian trade. "It is important that national currencies are increasingly used in mutual trade. This practice should be further encouraged, as well as the mutual presence of financial and banking structures in the markets of our countries should be expanded," he said.

China National Offshore Oil Corp. on March 28 completed China's first renminbi (RMB)-settled purchase for 65,000 tons of imported liquified natural gas (LNG) via the Shanghai Petroleum and Natural Gas Exchange. (The LNG was from the United Arab Emirates and bought from French energy company TotalEnergies.) Saudi Aramco announced on March 28 that it would acquire a 10% stake in China's petrochemical company, Rongsheng Group, at a cost of RMB 24.6 billion. Whether Rongsheng's oil purchases will be settled in dollars or renminbi has become a point of focus of the deal, especially after Saudi Arabia and Iran reestablished a diplomatic relationship under China's mediation earlier that month. In a phone call to Saudi Arabia's Crown Prince Mohammed bin Salman, Xi pledged China's support for the future improvement of Saudi Arabia-Iran relations, and said the relationship between China and Saudi Arabia was in its "best period in history."

Why Dollar Disintermediation Is Happening

As I noted in November 2021, a host of developments had begun converging to one day bring an end to the dollar's 75-year reign as the world's dominant reserve currency. These developments include America's declining share of the global economy, massive monetization of the U.S. national debt and the development of new monetary and payment systems, enabled and accelerated by the application of blockchain technology. Writing at the time, the move toward dollar disintermediation was not a question of if but when.[5] The answer came hard on the heels of the G-7 sanctions against Russia over the invasion of Ukraine. In March 8, 2022, I wrote that not only did the sanctions accelerate formation of the China-Russia economic bloc, the rest of the world "has seen how quickly the West was able to freeze Russia's G-7 assets. Some countries might look to diversify away from G-7 holdings in favor of assets beyond the long arm of G-7 law."[6]

Even if the United States had not weaponized the dollar (the European Union and United Kingdom have not weaponized their currencies), dollar disintermediation, as I noted in 2021, has been as close to a sure thing as one can count on in financial markets. The currency debasement policies that started in earnest with the quantitative easing (QE) programs in developed markets following the 2007-08 Global Financial Crisis have allowed governments to expand their fiscal deficits by effectively printing money as central banks bought the debt issued by their respective governments. John Taylor at Stanford University has found a strong correlation between a currency's tendency to depreciate with large increases in the central bank reserve balances caused by QE.[7] In effect, QE can be thought of as a policy of deliberate currency debasement. *Ceteri paribus*, the implementation of these policies has eroded confidence in developed market currencies as a store of value.

Several decades ago, the United States and Europe composed the largest economic bloc in the world as measured by their combined contribution to global GDP. That predominance is a thing of the past. The BRICS countries (Brazil, Russia, India, China and South Africa) have taken over as the largest contributing bloc to world GDP. *(Figure 2)* Once the United States weaponized the dollar-based system to financially remove Russia from much of international commerce, China stepped up its efforts to increase geopolitical, financial, economic and trade relationships with the BRICS and other countries, even NATO member Turkey. These nations are moving to secure their economic interests by ending the complete dependence on the dollar and moving to a multipolar system.

Largest Contributors to World GDP
As of December 31, 2021

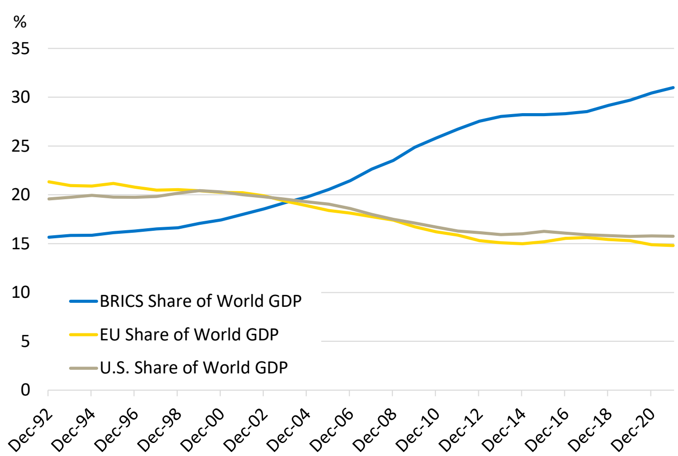

Figure 2
Source: International Monetary Fund, Bloomberg

After World War II, Europe and Japan were dependent on U.S. investment and the U.S. consumer to rebuild. Emerging economies would follow suit. This led to decades of the United States underwriting global growth, increasing standards of living and GDP per capita. But with any trend there comes an inflection point, and the world appears to have reached it, with Washington's effort to make Russian a commercial pariah having furnished an accelerant.

One of the major flaws of the dollar-based system of trade and international commerce is that this system precludes national autonomy of international policy. This was underlined by French President Emmanuel Macron during his visit to China in early April. In a comment to reporters at the end of this trip, Macron said the dominance of the dollar in foreign trade has essentially deprived France and other nations of the ability to implement independent foreign policy. They have been stuck with the policy of the United States, as the dollar is the main currency of global trade, commerce and finance.

Furthermore, as recently as a decade or two ago, many nations ranked very low on the standard-of-living scale and depended on the United States for their growth and development. This model of U.S.-led investment worked for these nations when their early-stage economies relied heavily on selling natural resources and cheap labor. Today, many of these nations are seeking to broaden and deepen their domestic financial and capital markets. This will aid in their development as new sources of domestic financing emerge to support the idiosyncratic development of nations based on their unique characteristics. The corollary of domestic self-finance will be greater autonomy from U.S.-led investment agendas.

More Writing on the Wall: The Dollar's Shrinking Share of Global Trade

The dollar's percentage of global trade is falling, with the dollar declining from 66% of global foreign-currency manager reserves in 2015 to 58% at the end of 2022. *(Figure 3)* One argument advanced on disregarding the decline of the dollar's trade share is the absence of a frontrunner among rival currencies to become the next single-currency standard, much as the dollar replaced the pound in the middle of the last century. Having cited respect for historical precedent at the beginning of this paper, I must say that here's a situation where history is unlikely to repeat itself. The data shows a rise in almost all large economies' currencies as a percentage of the global trade basket. This broad-based trend spans both developed and emerging markets. Furthermore, as noted above, sovereign states outside the G-7 are concluding agreements and building infrastructure to settle transactions in their and their trading partners' currencies, i.e., outside the dollar and other G-7 currencies. These trends support the idea advanced in my January 2021 paper that the dollar would not be replaced by a single currency but by a matrix of bilateral agreements whereby countries actually hold the currencies of the countries with which they trade and invest.[8]

U.S. Dollar % of Global Reserves
As of December 31, 2022

U.S. Dollar Share of Payments via SWIFT
As of March 31, 2023

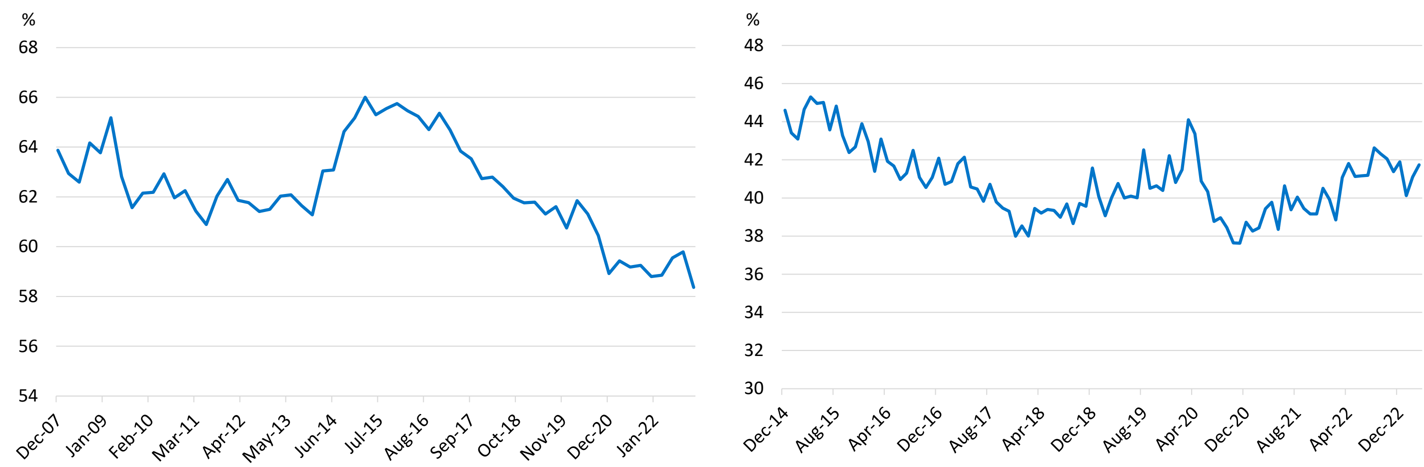

Figure 3
Source: International Monetary Fund, Bloomberg

Western Property Rights: Diminished Credibility

Another factor undermining confidence in the dollar is the erosion of property rights. In the wake of the Ukraine invasion, the West sanctioned all Russian debt, both local and external. Although the intention was to punish Russia and deny it sources of financing for its economy, the practical impact also hurt Western savers as retirement accounts in the U.S.-held Russian debt forming a large percentage of investment indexes used by these accounts. One could argue that the sanctions on Russian debt were a confiscation of Western wealth. Russian borrowers were ready to service the debt, but this was restricted by the sanctions. Many of the Russian accounts that were to be used to service the debt remain frozen. Policymakers in the G-7 now are investigating whether these accounts can be legally seized to fund a rebuilding of war-ravaged Ukraine. While a rebuilding of Ukraine would be a worthy cause, to do so with these seized accounts effectively amounts to a wealth transfer to Ukraine from Western savers who held this debt.

In addition, governments in developed markets have engaged in mandatory loan-forbearance programs that have allowed borrowers to slow or even stop their payments to lenders. It can be argued that rent and mortgage forbearance programs implemented under emergency measures during the pandemic lockdowns allowed borrowers time to find new sources of income to eventually service their agreements. The Biden administration's student loan forgiveness program, however, is a blanket forgiveness program. Although the cost of this program would be borne by the government (if it clears legal challenges) via its revenues (taxes received), increased usage and implementation of such programs should be watched for carefully. Another signal case that drew investor criticism: the wipeout of Credit Suisse's AT1 debt while the bank's common equity retained value. Although technically legal under the passage of an emergency law, this upending of the debt-equity pecking order in bankruptcy might further erode confidence that property rights will be respected, no matter the circumstances, in the West.

The New Currency Bloc

To be sure, the lack of property rights in many of the nations in the China-Russia-Saudi Arabia-Iran bloc is well documented, creating a headwind to aggressive adoption of their currencies. These countries are aware of the deficiency. To make their currencies more enticing for trade settlement and savings, these countries are moving to transactions being backed by gold and potentially other commodities. For example, Shanghai Petroleum and Natural Gas Exchange has introduced gold-backed contracts. This will help to make the countries' currencies more attractive against debasement, albeit the property rights issue will still remain.

This further helps the central banks. As inflation has picked up globally due to a falling supply of resources, countries that produce these commodities hold assets of real value, whose price should increase in line with any debasement of the currency or trade settlement currency.

Saudi Arabia is the kingmaker in international trade settlement, as it exports the most valuable commodity on the plant: oil. In the past, the country has preferred the dollar and pound for its settlement currencies. By settling its exports in dollars, Saudi Arabia is left with a large stockpile of dollars that needs to be either sold or invested. With the investment of these dollars and pounds into financial assets of the same denomination, the receiving economies have had access to additional sources of credit that have allowed for more economic development and growth, benefiting the United States and United Kingdom. This "petrodollar," as it is colloquially known, has underpinned the strong investment and savings in both countries. Saudi Arabia has recently expanded its preference for currency settlement to include the Chinese yuan. If yuan settlement of Saudi oil purchases continues, this will support further growth of the Chinese economy and financial system. This currency shift is being accelerated by U.S. energy independence and China's growing demand for energy imports.

Conclusion

Savers, businesses and investors will have to weigh a more complex set of trade-offs in the coming years due to the end of King Dollar. No longer are Western currencies (led by the dollar) the default mediums of exchange and savings. As a colleague and I reiterated in a paper in February, the dollar probably will not give way to a single currency but rather to a system of bilateral settlements between countries with each of those trading partners keeping a basket of reserve currencies more closely matched to their trading relationships.[9] The transition to this multipolar order is underway.

While the dollar still sits atop the king's throne as a percentage of global currency reserves, this privileged position is an artifact of past decades whose end is giving way to an order in which the dollar will have a declining if still material place among many reserve currencies. This transition was presaged by America's declining share of global GDP and now is reflected in the rear-view mirror of the dollar's declining share of global reserves and trade settlement. As countries increasingly accept currencies outside the dollar, pound, euro and yen as settlement for trade, this will deliver second-order benefits to the issuers of those currencies. Among these will be increased reciprocal investment by trading partners as the settlement currencies will need to be invested. This will promote the growth of the financial markets and the economies of many nations, further increasing the incentive for money to enter these countries via the savings and investment channel. Obviously, this will also complicate the post Second World War order of Western countries underwriting global security and, hence, the direction of geopolitics, which we would also expect to lead to a much more volatile geopolitical environment going forward. ■

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Mr. Campbell joined DoubleLine in 2013. He is a Portfolio Manager for the DoubleLine Global Bond Strategy and is a permanent member of the Fixed Income Asset Allocation Committee. He covers Developed Markets, Central & Eastern Europe, Middle East and Africa (CEEMEA), and China. Prior to DoubleLine, Mr. Campbell worked for Peridiem Global Investors as a Global Fixed Income Research Analyst and Portfolio Manager. Previous to that, he spent over five years with Nuveen Investment Management Company, first as a Quantitative Analyst in their Risk Management and Portfolio Construction Group, then as a Vice President in their Taxable Fixed Income Group. Mr. Campbell also worked at John Hancock Financial as an Investment Analyst. He holds a BS in Business Economics and International Business, as well as a BA in English, from Pennsylvania State University. Mr. Campbell holds an MA in Mathematics, with a focus on Mathematical Finance, from Boston University.

Endnotes

1 The British pound in fact remains the world's oldest paper currency in circulation. See "Economic terms explained," BBC News, Nov. 12, 2007 http://news.bbc.co.uk/2/hi/programmes/bbc_parliament/7090665.stm

2 I first wrote of the countries and central banks building the infrastructure to replace the U.S. dollar standard with a matrix of bilateral currency settlements more than two years ago. "Taking Aim at the U.S. Dollar, the World Builds a Multipolar Trade-and-Payments Order," January 2021 https://doubleline.com/wp-content/uploads/2021/12/Taking-Aim-at-the-Dollar-in-a-Multipolar-Order-January-2021.pdf

3 Comparisons of GDP between countries with different currencies vary based on the method of conversion of exchange rates. Figure 1 reflects nominal GDP data. Another approach uses the purchasing power parity (PPP) exchange rate. PPP determines the rate at which the currency of one country would have to be exchanged into that of another country to buy the equivalent sum of goods and services in each country, rather than translating the respective nominal GDPs at an exchange rate at discrete points in time. PPP is not without controversy. Proponents state that PPP is more useful when the exchange rate is tightly controlled and deviates from its longer-term equilibrium. Skeptics point to many flaws in the construction of the comparable baskets, especially when constructed for very different economies. In addition, differences in accounting norms between the countries, including provision for bad debts, can overstate the PPP GDP calculation for countries that do not allow debt defaults to occur freely. For the record, PPP GDP as calculated by the International Monetary Fund shows China has surpassed the U.S. while nominal GDP shows the U.S. has the larger economy. For our point, that difference amounts to splitting hairs. Both calculations show America's declining share and China's growing share of global GDP.

4 "China, Brazil to trade in local currencies," State Council Information Office, People's Republic of China, March 31, 2023 http://english.scio.gov.cn/internationalexchanges/2023-03/31/content_85203377.htm

5 "King Dollar Risks Being Dethroned as Blockchain Breaks Down Barriers to Entry," Bill Campbell, November 2021 https://doubleline.com/wp-content/uploads/2021/12/King-Dollar-Risks-Being-Dethroned-November-2021.pdf

6 "G-7 Sanctions Accelerate China-Russia Axis," Bill Campbell, March 2022 https://doubleline.com/wp-content/uploads/2022/03/Campbell-G-7-Sanctions-Accelerate-China-Russia-Axis_3-8-22.pdf

7 "A Rules-Based Cooperatively Managed International Monetary System for the Future," John B. Taylor, chapter 12 of "International Monetary Cooperation: Lessons Learned From the Plaza Accord After Thirty Years," Peterson Institute for International Economics, 2016 (In particular, see page 228 under the subheadline "International Transmission of Quantitative Easing and the Threat of Currency Wars")

8 "Taking Aim at the U.S. Dollar, the World Builds a Multipolar Trade-and-Payments Order," Bill Campbell, January 2021 https://doubleline.com/wp-content/uploads/2021/12/Taking-Aim-at-the-Dollar-in-a-Multipolar-Order-January-2021.pdf

9 "DoubleLine Views on the Dollar," Bill Campbell and Chris Stegemann, February 2023 https://doubleline.com/wp-content/uploads/DoubleLine-Views-on-the-Dollar_2-2023-f.pdf

G-7 (Group of Seven) – Forum of the seven countries with the world's largest developed economies whose government leaders meet annually on international economic and monetary issues. The member countries are: Canada, France, Germany, Italy, Japan, the United Kingdom and the United States.

Quantitative Easing (QE) – An unconventional monetary policy used by central banks to stimulate the economy when standard monetary policy has become ineffective. A central bank implements quantitative easing by buying specified amounts of financial assets from commercial banks and other private institutions, thus raising the prices of those financial assets and lowering their yield, while simultaneously increasing the monetary base.

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