Foresight

Is the dollar done?

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Schroders

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We assess whether the freezing of Russia's FX reserves could ultimately cool long term dollar dominance as a reserve currency

Last month the Russian government missed a payment on a Eurobond because financial sanctions meant that it was unable to service its debt. Russia managed to evade a default by making a payment shortly before a 30-day grace period elapsed. It is believed Russia used some of its now limited foreign exchange (FX) reserves to make this payment. Whereas Russia started the year with FX reserves sufficient to cover all of its external debt tenfold – both public and private – sanctions imposed by the US and its allies have rendered those assets useless.

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We recently argued that, outside of a handful of frontier markets, the near term spillover from a Russia default and tighter global financial conditions in general are manageable in the rest of the emerging world.

What about the longer term implications of recent events? There are likely to be some reserve managers worried that they could suffer a similar fate in the future to Russia. As the chart below shows, the US dollar's share of global reserves has been inching lower over the past couple of decades. Will the decision by the US to freeze the Russian central bank's assets accelerate the recent diversification of reserves and spell the end of the US dollar's dominance as the global reserve currency? And if there is a move away from the US dollar, is it going to have significant, long-term implications for global financial markets?

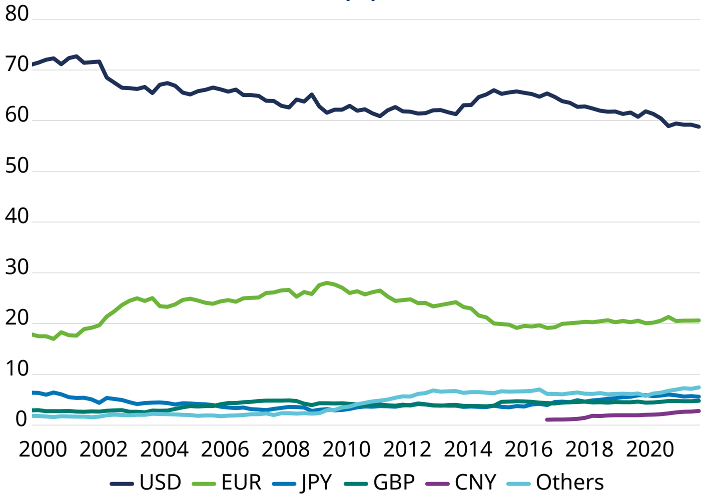
Which countries might want/might not want to move away from US dollar assets?

Perhaps the best place to start in answering these questions is to identify the major holders of global FX reserves that might – and might not – want to move away from US dollar assets.

It is probably easiest to start with those countries that are unlikely to move their reserves away from the US dollar as a result of recent events. Most obviously, while attention has focused on the role of the US in freezing Russia's reserve assets, it should be remembered that the decision has been mirrored by many of its allies. Indeed, Russia's reserves that are denominated in euros, Japanese yen, British pounds, Canadian dollars and Swiss francs have also been frozen. According to Treasury International Capital (TIC) data, these countries, along with other allies such as Australia, account for about half of all foreign holdings of US Treasury securities worth in the region of $3.5 trillion.

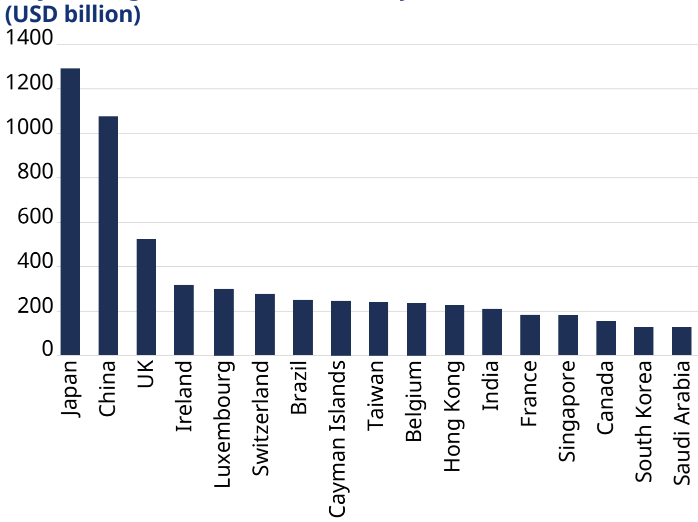
The picture is more clouded in emerging markets (EM). For example, Hong Kong Special Administrative Region (SAR) operates a currency board against the US dollar, meaning that all units of Hong Kong Dollars must be backed by US dollars. Until Hong Kong SAR decides to change the way it manages its currency, it will not be able to diversify away from the US dollar. There are also many other EM that are allies of the US and other G7 nations that are unlikely to feel threatened by recent actions.

Share of allocated FX reserves (%)



Source: IMF COFER, as at Q4 2021.

Major foreign holders of US Treasury securities in 2021 (USD billion)



Source: Refinitiv Datastream, US TIC, as at end 2021.

However, there are other EM that could clearly feel threatened by recent US actions. Most obviously, China is already locked in a trade war with the US, and issues of long term strategic competition are unlikely to disappear. Washington has also raised concerns about human rights, and rhetoric regarding Taiwan has heated up on both sides. According to data published by the IMF, in 2020 China was the largest single holder of FX reserves in the world with official assets just shy of $3.5 trillion. In reality, that figure is closer to $4.5 trillion once foreign assets held by state-owned banks are taken into consideration. According to TIC data, China is also the second largest foreign holder of US Treasury bonds, with assets worth around $1 trillion.

For want of a better approach, one way to try to identify other countries that might consider diversifying away from the US dollar is to look at the breakdown of votes for a US-sponsored resolution at the UN on 7 April 2022 to remove Russia from the Human Rights Council.

A motion in the UN General Assembly to remove Russia from the Human Rights Council passed with 93 votes for, 24 against and 58 abstentions

Afghanistan	Central African Republic	Georgia	Liberia	Oman	South Africa
Albania	Chad	Germany	Libya	Pakistan	South Sudan
Algeria	Chile	Ghana	Liechtenstein	Palau	Spain
Andorra	China	Greece	Lithuania	Panama	Sri Lanka
Angola	Colombia	Grenada	Luxembourg	Papua New Guinea	Sudan
Antigua-Barbuda	Comoros	Guatemala	Madagascar	Paraguay	Suriname
Argentina	Congo	Guinea	Malawi	Peru	Sweden
Armenia	Costa Rica	Guinea-Bissau	Malaysia	Philippines	Switzerland
Australia	Cote D'ivoire	Guyana	Maldives	Poland	Syrian Arab Republic
Austria	Croatia	Haiti	Mali	Portugal	Tajikistan
Azerbaijan	Cuba	Honduras	Malta	Qatar	Thailand
Bahamas	Cyprus	Hungary	Marshall Islands	Rep of Korea	Timor-Leste
Bahrain	Czech Republic	Iceland	Mauritania	Rep of Moldova	Togo
Bangladesh	Dem PR of Korea	India	Mauritius	Romania	Tonga
Barbados	Dem Rep of the Congo	Indonesia	Mexico	Russian Federaion	Trinidad-Tobago
Belarus	Denmark	Iran	Micronesia (ES)	Rwanda	Tunisia
Belgium	Djibouti	Iraq	Monaco	Saint Kitts-Nevis	Turkey
Belize	Dominica	Ireland	Mongolia	Saint Lucia	Turkmenistan
Benin	Dominican Republic	Israel	Montenegro	Saint Vincent-Grenadines	Tuvalu
Bhutan	Ecuador	Italy	Moroccoi	Samoa	Uganda
Bolivia	Egypt	Jamaica	Mozambique	San Marino	
Bosnia-Herzegovia	El Salvador	Japan	Myanmar	Sao Tome-Principe	
Botswana	Equatorial Guinea	Jordan	Namibia	Saudi Arabia	
Brazil	Eritrea	Kazakhtan	Nauru	Senegal	
Brunei Darussai	Estonia	Kenya	Nepal	Serbia	
Bulgaria	Eswatini	Kiribati	Netherlands	Seychelles	
Burkina Faso	Ethiopia	Kuwait	New Zealand	Sierra Leone	
Burundi	Fiji	Kyrgyzstan	Nicaragua	Singapore	
Cabo Verde	Finland	Lao PDR	Niger	Slovakia	
Cambodia	France	Latvia	Nigeria	Slovenia	
Cameroon	Gabon	Lebanon	North Macedonia	Solomon Islands	
Canada	Gambia	Lesotho	Norway	Somalia	

In Favour: 93 Against: 24 Abstention: 58

Voting Started 07-Apr-22, 12:48:47

Source: The UN, 7 April 2022.

This is unlikely to be a perfect methodology, but it is notable that of the 24 votes against the motion, along with 58 abstentions, the list of countries included China, along with several major holders of FX reserves such as the other BRICS economies and most countries in the Middle East. According to TIC data, the larger countries where data is available had combined holdings of US Treasury securities worth an average of $2.2 trillion in the year to January 2022, equivalent to 30% of foreign holdings.

"Cryptocurrencies have been mooted as a solution to all of the world's financial angst, but frankly this option is a non-starter for China in the foreseeable future."

What are the options for China?

On the face of it, that is a pretty big chunk of US dollar denominated reserves that could be on the move. But where are they likely to go?

In considering this question, it makes sense to deal with China separately from other markets given the sheer size of its reserve holdings.

There has for a long time been concern that as relations with Washington deteriorate, Beijing will bring its holding of US Treasury bonds, currently worth about $1.1trillion, into play. The story goes that China could dump its holdings of Treasury bonds on the market in order to cause dislocation in US financial markets and push bond yields higher. The obvious push back against this theory has been that in doing so, Beijing would shoot itself in the foot by causing the value of its own reserve assets to plunge and driving up interest rates in its main export partner therefore sowing the seeds of a slowdown in its own economy.

It is entirely possible that concerns about financial sanctions could override economic sense. But even then it is not clear where Beijing could actually park its money. The fact that other ally nations have mirrored US sanctions appears to rule out diversification into euros, yen, sterling, Swiss franc and the dollars of Canada, Australia and New Zealand.

So where else could Beijing go?

Reserves could in theory be moved into sovereign bonds of friendlier issuers. But there are at least a couple of issues that make this unlikely. For a start, holding what would largely be relatively poorly rated EM debt would introduce huge volatility into reserves. After all, the average credit rating of the 81 other countries identified above is BB- on an equal-weighted basis. Riskier EM bonds tend to go down in value during times of crises, the opposite to what usually happens to safe haven assets such as Treasury bonds.

In addition, these bond markets are not big enough to absorb China's enormous reserves. According to data published by Bank of America, the 25 largest sovereign issuers that China might invest in have combined investable sovereign debt in both local and foreign currencies of $5.5 trillion. China would have to buy almost all of the outstanding debt in order to reallocate its total reserve assets of about $4.5 trillion.

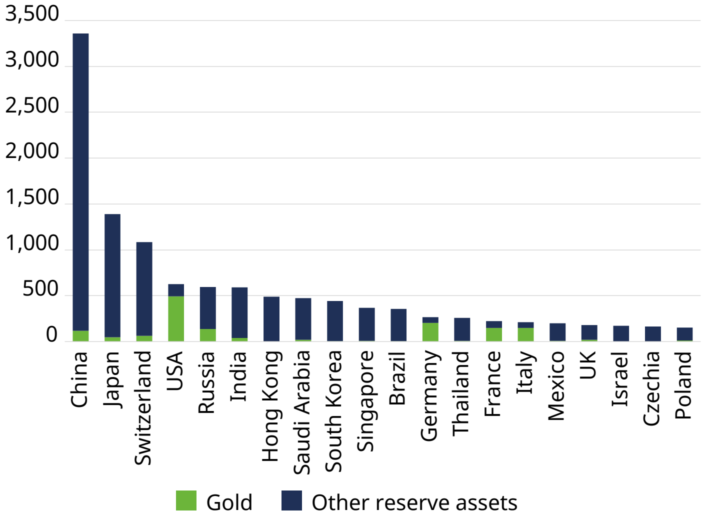
Cryptocurrencies have been mooted as a solution to all of the world's financial angst, but frankly this option is a non-starter for China in the foreseeable future. As things stand, the five largest cryptocurrencies have a market cap of roughly $1.4 trillion. This may rise in the future, but as things stand cryptocurrencies are probably not large, or liquid enough to absorb a meaningful chunk of China's reserves.

Cryptocurrencies have historically tended to be even more volatile than more traditional EM sovereign bonds and currencies. It is also notable that cryptocurrencies have become increasingly correlated with risky assets, which casts doubt over their ability to function as a relatively safe reserve asset.

In any case, the authorities in China have banned the use and mining of cryptocurrencies. What's more, only one country has so far adopted a cryptocurrency for official use; and it is worth noting that El Salvador's recent foray into using Bitcoin quickly resulted in it being downgraded by the rating agencies.

That seems to leave only physical assets such as commodities, particularly gold which has historically been a popular reserve asset. Gold accounts for only a small share of China's reserves and this is one obvious area where assets could be moved to. Indeed, this has driven theories that there will be a long term, structural central bank bid into gold that could support prices.

Total reserves in 2020 (USD billion)



Source: IMF, as at end 2020.

There are question marks about its efficacy as a sanction-proof reserve asset. In order to be effective as a means of exchange, gold reserves need to be held in a central location (historically the Bank of England) such that it can be easily exchanged with counterparts. In essence, transactions are completed by moving gold on a trolley from one country's pile to another country's pile, all in the same vault.

However, keeping gold reserves in another country's central bank leaves them vulnerable to being seized. Indeed, the UK Supreme Court has blocked Venezuela from repatriating reserves held at the Bank of England due to political issues. And by keeping gold reserves at home in order to avoid sanctions they will be difficult to mobilise in order to make and receive payments.

In other words, there aren't may options for China. It may stop accumulating US Treasury securities, and those of US allies, as quickly as it has in the past, but it is unlikely to dump them or significantly diversify away to other assets.

Elsewhere, it may make some sense for other EM to diversify their reserve assets.

Could it make sense for other EM to diversify their reserve assets?

It seems unlikely that any EM, apart from perhaps Russia given that it has little choice, would switch all of its reserves into renminbi. There is at least as much risk, if not more, that Beijing could arbitrarily freeze a nation's reserve assets because of a souring of bilateral relations, and holdings of US dollars are still likely to be useful in times of crisis.

However, in addition to a fear of sanctions, there are more orthodox economic reasons to diversify, given that many EM conduct large amounts of trade with China, often running bilateral deficits. If China continues to accept more payment for exports in its own currency, then EM central banks (and indeed others) may start to accumulate CNY reserves. This would also be consistent with Beijing's desire to internationalise the renminbi.

> **"It seems unlikely that any EM, apart from perhaps Russia given that it has little choice, would switch all of its reserves into renminbi."**

It is not easy to put numbers on the potential impact of all of this on markets. Stripping China out of the TIC data, there are 26 countries on the list which we identified as candidates for diversifying their reserves. These had combined US Treasury securities holdings worth an average of $1.1 trillion in the year to January 2022, equivalent to 15% of foreign holdings. It is unlikely that these countries would abandon the US dollar all together, given that it is likely to remain the most reliable and liquid reserve asset for the foreseeable future. But it seems reasonable to think that they could reallocate something like a quarter of their reserves away from the US dollar, worth about $250 million.

What are the implications for the US Treasury market?

In terms of the impact on the US Treasury market, the lively debate around the impact of Quantitative Tightening (QT) is probably a good place to start. Fed Chair, Jerome Powell, recently stated that $95 billion of QT is estimated to be equivalent to a 25bps increase in the Fed funds target rate. Using this rule of thumb, the diversification of reserve assets could add about 65bps to Treasury yields. But this is probably a worst-case scenario, and it is worth noting that other FOMC members expect the impact of QT to be much smaller.

Such a reallocation would be unlikely to have much impact on other markets either. For example, data from Bank of America shows that China's tradeable government bond market is worth something in the region of $7 trillion. Meanwhile, according to the World Gold Council, the daily turnover in the global gold market is just over $100 billion. This casts doubt over the notion that a shift in reserve assets will add a significant structural bid into precious metals.

The bottom line is that this is all fiddling around the edges. There might be some marginal price changes but probably not enough unless diversification out of the dollar really gathers pace – particularly by China. History tells us that this takes decades.

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