

# RESEARCH INSIGHTS



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## World Reserve Currencies Can the USD be overtaken?

The USD has been the go-to currency for international transactions. The reliance on the USD has even brought about the de-dollarization movement by some countries hoping to rely less on the USD and the US in general. However, is it even possible for this to happen or will the USD stay as the World's Reserve Currency?

### What are Reserve Currencies?

Reserve currencies are a basket of currencies and cash equivalent assets held by financial institutions and central banks around the world as defined by CITY INDEX, a financial services provider. These currencies are held in order to conduct financial transactions and trade while reducing the costs derived from the settlements in different currencies. Holding onto reserve currencies can also reduce the costs of unfavourable movements from the market exchange rates thereby reducing exchange rate risks.

According to CITY INDEX, these currencies are normally held in large quantities for various other reasons stated below:

#### 1. To fixate or lower the domestic countries' currency's exchange rate against other currencies

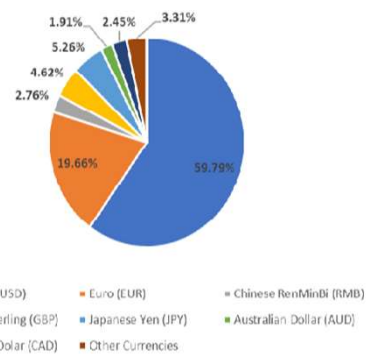
For example, China pegs the RMB to the USD. China buys more USD to lower the value of their domestic currency, the RMB against the USD. This way, Chinese goods and services exports will be cheaper as compared to the Americans'.

#### 2. To maintain Liquidity in case of an economic crisis

In case of an economic crisis, the domestic currency may be volatile and unsafe for investors to trade in. With a foreign currency reserve, central banks can facilitate trades made in local currencies by exchanging them for foreign currencies. Transactions can still be made in other currencies that are in demand, allowing smooth transactions for local exports and imports to stay competitive even during an economic crisis.

#### 3. To meet international financial obligations

These could include debt, investments and other contractual obligations made in a preferred currency. The preferred currency may be due to convenience where the transaction can be made directly to the other party in their currency or because the currency has less volatility and is considered safer than either of the party's domestic currency.



#### 4. To fund internal projects

Infrastructure or industrial projects are sometimes funded using foreign currency reserves as cash.

#### 5. To diversify their portfolio

Holding different currencies and cash equivalent assets can diversify risks into different currencies and commodities such as gold as a protection should there be any fall in value of the investments.

### Why is the USD the World's Reserve Currency?

The USD has been the World's reserve currency ever since the 1940s and has stayed so throughout many years. As seen from the pie chart above, central banks held a significant amount of USD (59.79%) as their reserve currency. These reserves are in the forms of cash or bonds such as US Treasuries and Bonds reaching a whopping level of \$13.4 trillion as of mid 2022. This implies the importance and reliance of the USD in the global context. So why is the USD the most sought-after currency?

#### Gold Standard

The history of the reliance started off with the gold standard where currencies are pegged to gold to ensure its reliability and stability. Most developed countries followed the gold standard and leading economies such as the United Kingdom (UK) and the United States of America (US) followed suit. However, during World War I, the gold standard was abolished by many countries to pay using paper money to cope with military expenses. The abolishment caused the currencies to devalue. The UK, on the other hand, stuck to the gold standard and eventually looked to borrowing money due to depleting and insufficient funds.

These reasons led to the rise of the US as a lender and countries looked to buy USD denominated bonds. Even though the UK put an end to the gold standard in 1931, the US had already overtaken the UK as the leading economy and the USD rose to become the leading reserve currency.

### **Bretton Woods Agreement**

During World War I and II, the US was the main supplier of firearms and other supplies. Most of these supplies were paid in gold, which contributed to the large gold reserve that the US had. By the end of the wars, the US owned most of the world's gold. Many of the war-torn countries were depleted of gold and the gold standard could not be maintained. On the other hand, due to the wars, USD could still be pegged with the gold due to the large gold reserve.

On 1 July 1944, 44 countries met up at Bretton Wood, New Hampshire for the agreement that would allow the countries to peg their currencies to the USD. The agreement was to create a foreign exchange system that could allow international growth and prevent currency devaluation from competition. Central banks will also be responsible for the exchange rate of the USD and their domestic currency by maintaining a fixed rate.

Through the Bretton Woods agreement, the USD officially became the world's reserve currency due to the backing of the large gold reserve. Countries bought USD as reserves, and many used the dollar to buy US treasury securities as a reliable and safe investment.

### **Present day functions of the USD**

Even after so many years, the USD has still been regarded as the World Reserve Currency. Countries around the world still regard it as a safer currency to store as reserve and continue to buy USD which results in many international transactions being conducted in the USD. It will also be easier to transact in a recognised currency throughout the world. According to SWIFT, the main facilitator of messaging service for financial transactions internationally, around 40% of the world's transactions are conducted in USD. Since most transactions are conducted in USD, it is presumably the safe currency for transactions and liquidity.

The strong economic background of the US has also made it a buy for the USD. The Russian-Ukraine war badly affected the European nations and caused high inflation and slowed growth caused by the rise in energy prices. Unlike the European nations, where the economy was badly affected by the war, the US seemed relatively healthier in comparison.

As mentioned before, countries such as China and Japan are also large owners of the USD and USD denominated bonds and treasury securities. These countries buy the currency of their main exporters so that exports will become reasonably priced. Since the US is the largest exporter of Chinese and Japanese goods, Japan and China intend to buy more USD for that purpose. By buying up USD, the yen and RMB will be cheaper against the USD and exports from Japan and China will cost less.

### **A new World Reserve Currency and its possibilities**

However, even though the USD has always been the world's reserve currency, many countries have shown dismay and want to overturn the current predicament. Countries such as China and Russia have been proposing a new currency to replace the USD since 2009 and have discussed the possibilities of overturning the USD's throne. The heavy reliance on the USD for international transactions may pose danger to the world if the US economy were to fall just like the economic crisis back in 2008.

Moreover, the nature of the rivalry between US, China and Russia could only mean that if the US were to sanction anybody, the strong reliance of the USD could threaten their economy. The recent Russian-Ukraine war is a prime example of how the sanctions can threaten Russia. With the ongoing tensions in Taiwan, the US could also make it difficult for China by introducing sanctions. Therefore, by allowing other forms of payment other than the USD, countries can have more diversification and stability while having less reliance on the US. With that said, is it possible for a new world reserve currency given the influence and the history of the USD?

### **How does a currency become the World Reserve Currency?**

A brief summary of the history of World Reserve Currencies could bring a better insight as to whether another currency can take over the USD. During the 17th and 18th century, the Dutch Guilder was the first ever currency that became widely used. The Dutch boasted strong global presence and influence in the economies that even strong militaries such as the France and Spain were not capable of matching. The Guilder's widespread usage could only be toppled by the GBP after the First Industrial Revolution where the GBP was more commonly used and became the world's most bought currency. After World War II, the USD came to take the spot as the world reserve currency as we know it today.

International transactional activities that these countries made during their reigning periods was the main criteria for the currencies to reach the peak. This makes sense as there must be enough global presence for the country to be influential enough and the currency to be recognised and used. During the 17th and 18th century even though Spain and France had the largest military presence, the financial and economic focus of the Netherlands made the Dutch Guilder the choice of currency circulation. The same can be said during the 19th century when the US had a stronger military but because the UK was the world's trade and financial center, the GBP was able to dominate for nearly a century. Eventually, when the USD was recognized, it was not due to the military presence of the US but also due to the large gold reserve that the US had which caused the rise of the USD to the world reserve currency status.

History has proven that the military prowess of a country does not determine the universal usage of their currency but in fact the economic and financial status of the country is the determinant. In the past, these currencies were able to thrive due to the influence and size of their economy. Can the US stay at the top of the global economy, or will they lose their economic and world reserve currency status to another competitor?

### **Possible candidates of the world reserve currency**

To answer this question, probable candidates for the replacement are listed below.

#### **Euro**

The first competitor right after the USD is the Euro and without a doubt the European nations have a strong economic influence around the world. According to Eurostat, a provider of Europe's data and statistics, the European Union (EU) contributed to 4300 billion euros in global trade just below China in rankings. The EU also accounted for 14% of the world's trade in goods which shows the economic impact the EU has in the world. The Euro is also the 2nd most reserved currency in the world at around 19.66%. The reliance on Euro for international transactions is also significant given the fact that the EU has a large share of global trade.

However, that does not mean that the Euro is able to compete with the USD. The recent high inflations and slowed growth from the Ukraine war affecting the EU region has only proven to be scaring off investors of the currency. The Euro has seen prices drop as low as 1 Euro per USD a historic low that last happened in 2002 where the Euro fell below 1 Euro per dollar. The fall in exchange rate signifies the weakness of the European economies and the reliance on Russian oil and gas exports. European nations have seen inflation go as high as 8.9 percent back in July 2022 after Russia cut back on exports to Europe. Oil prices soared for fears of Russia, the 4th largest oil and gas exporter in the world cutting back on the oil exports. Especially after the sanctions, Russia has proven to be an important exporter of oil and the EU cannot stop relying on them immediately. The imports of Russian Liquefied Natural Gas (LNG), an important resource used for heating, cooking and generating electricity has seen a rise by 20% when comparing March to October 2021 to the same period in 2022. Europe and the UK are still relying on Russia for LNG import as Russia contributes around 15% of their imports of LNG. However, due to the threat of sanctions from Europe, Russia has retaliated by threatening with a supply cut and reducing the supply of LNG through the pipelines to Europe. With the ominous threat looming over Europe, there may be chances of inflation due to the increasing gas and electricity prices of households. This effect may deter investors and institutions from buying more Euro due to its instability caused by the imminent weakening of the European economy.

### BRICS Reserve Currency

Another possible candidate for a reserve currency is the new BRICS currency. BRICS, an abbreviation for the countries involved namely Brazil, Russia, India, China and South Africa, was created to form economic relations and support for one another. These countries will meet up annually for the BRICS summits to discuss cooperation and global issues.

Due to the heavy reliance on the US, countries may be greatly affected if the US were to threaten their economy with financial weapons such as sanctions. This is especially prominent when the US-China trade war happened in 2018 and the Russian sanctions due to the war in Ukraine. As a result, BRICS decided on establishing a more reliable and diversified currency as a means of deviating away from the USD. The new currency will be backed by a basket of the members' currency which may seem like a better form of payment.

The BRICS member nations are economically impactful too. The members hold around a quarter of the World's GDP (\$24.7 trillion USD) and show huge potential in the labour market, making up two-fifths of the world's population at 40.5% (3.2 billion people) as of 2021. The emerging economies have shown huge growth since the formation of the BRICS partnership, and they look to develop their relationship in the future. The improvements and partnerships have been noticed by several countries who seek to join BRICS. Prospective candidates include Saudi Arabia, Egypt, Iran, Turkey, Argentina, Algeria and Indonesia who have shown interest in joining with Algeria, Argentina and Iran sending formal applications to join. Many potential members who attended the BRICS expansion dialogue included Kazakhstan, Nicaragua, Nigeria, Senegal, Thailand and the United Arab Emirates. With the inclusion of these possible new members, the influence of BRICS will be immense as around 50% of the global population and 60% of global gas reserves are in control by the members.

As such, the potential of BRICS cannot be overlooked. Global influence is also part of what makes a currency more used and bought. If BRICS begins to expand further, most of the world will be transacting with a BRICS member. If the BRICS currency begins to take place and its members are transacting in it, there may be a chance for the currency to contend as the world's reserve currency.

### Chinese RMB

The RMB on the other hand is an emerging contender that has not been overlooked. Even though the weightage of the RMB in the reserve banks is ranked 3rd, the economic outlook of China cannot be ignored.

China being the second largest economy in the world has one of the largest global presence in the world. According to World Integrated Trade Solutions, as of 2020, China was topping the charts at 2.68 trillion USD in global exports (15.3%) and second in global imports at 1.7 trillion USD (10.01%). Overtaking the US in global exports and 2nd to only US in global imports even though the US is the largest economy in the world. Based on the speed of China's growth and economical presence throughout the world, it is hard to rule out the possibility that there will be a global shift towards Chinese products and the usage of the RMB. To put it into retrospect, in 2001 China was only 13% of the US GDP but in 2021, China's GDP caught up to 77% of US GDP. At the rate at which China's economy is growing, there may be a chance for them to take over the US as the leader in the global economy. China managed to grow at a rapid pace, and it was estimated by the Centre for Economics and Business Research that China may even overtake the US by 2030. The estimation suggests that China will grow 5.4% annually till 2025 and 4.7% annually till 2030 eventually outgrowing the US economy and taking the 1st place as the largest economy in the world. However, the recent Chinese regulatory requirements may be slowing down China's growth.

The zero covid policy that has been put in place by Chinese authorities have formed fears that the Chinese government will not reopen its economy if covid restrictions stay. Given the multiple lockdowns in the cities with infections, China seemed unwilling to open its cities to anyone while businesses have been impaired by the constant lockdowns. Fortunately, Beijing has lifted the restrictions and lockdown approach early January 2023, a sigh of relief for investors and citizens' suffering due to the strict policy. China has shown willingness to improve the situation and cooperate with the rest of the world to curb covid infections but look towards endemic. Travelers can enter China without quarantine in a government facility. Preparations of medical facilities and services have also been made in case of rising infections while also creating a channel for higher-risk patients called the "green channel". The reopening not only benefits China as Chinese citizens can finally travel out of China boosting tourism of other countries. Countries like Australia who were highly dependent on Chinese tourists and students could see an increase of approximately 1% growth in their economy.

Before the pandemic, Chinese tourists accounted for 15.3% of visitors to Australia and students accounted for 26% of total enrollment, a significant figure that was missed due to the lockdown. With the reopening of borders coupled with safety precautions, China seemed to be ready to reopen their borders and get their growth back on track. Tourism can also increase their global presence as Chinese tourists look to travel out of their country once again while tourists travelling into China will also be able to enter without as many restrictions.

The second regulatory change that scared off investors was the regulatory crackdown on tech companies that began in 2020. The regulations suggest an improvement in data protection which could see many tech companies being affected. The first shock came when the highly anticipated Ant group failed the regulatory requirements and was abruptly stopped from its IPO into the market. The move halted the historical IPO of \$37 Billion into the stock market and spooked potential investors. Chinese regulators then proceeded to investigate 13 other large tech firms including Tencent, Baidu, JD.com and many other well-known companies. This prompted the selloff by many international investors of the Chinese tech companies as soon as they saw the crackdown threatening their investments from the Chinese government's strict regulations. The tech crackdown may have threatened to slow growth and deter investors, but recent signs of investments and assurance from the government has boosted confidence in the big tech firms again. A meeting held in May with top technology executives suggests easing of the regulatory requirements. China's Vice Premier Liu He even spoke out on supporting tech companies and their plans to go public. The move regained investors' confidence in the market as China looks to focus on investments and future growth especially in the tech sector.

The mindset changes in China's policymakers could play a huge role in the current economic climate and if China were to progress and get back on track to economic growth, the possibility of overtaking the US in economic ranking may play a part in increasing its reserve currency status. As mentioned before, the global influence and economic prowess of a country determines the number of investors in a currency. If history repeats itself, China's RMB may possibly dethrone the USD's world reserve status in the long run.

Additionally, China has spoken up about the RMB's reserve currency status and hopes to achieve higher grounds. Even though China has a large trade and economic advantage compared to other regions, central banks and institutions are not holding enough RMB as a reserve currency compared to the Euro and USD. Despite being the 2nd largest economy and 3rd largest in trading, the RMB was only used in 3% of global trade. The USD on the other hand, stands at 87% of global trade. Therefore, China plans to boost the RMB's profile.

In hopes of building the RMB's reputation, a RMB liquidity arrangement was set up together with Indonesia, Malaysia, Singapore, Hong Kong and Chile last July. These countries made 15-billion-yuan contributions into the arrangement that aims to provide liquidity support to participating countries during market volatility periods. Russia has also made the RMB its default reserve currency after sanctions came from the West for the Ukraine war. More transactions are also said to be exchanged in RMB as China builds connections with investors. Recent talks between Saudi Arabia and China spell a change in the willingness to trade in the Chinese yuan, a unit of RMB. The talks suggested some transactions to be made in RMB and included yuan denominated futures contracts. Saudi Arabia being one of the World's largest oil exporters making the bold statement will foresee a huge change in transactions made in another currency other than the USD.

The global shift towards China's RMB suggests a possible growth in its reputation and usage around the globe.

### Writer's opinion

There are no clear signs that the USD can be taken over as of now. Most countries are holding onto the USD in huge portions and any rapid change in the currency's status may cause an economic crisis of global scale. Therefore, even if there is a change, it must be gradual and can only happen in the long run. The next reason for this has to do with the economic vulnerabilities of the potential candidates.

Firstly, the European nations are poised for high inflation and slower growth. The possible recession in the European region due to the increasing oil and gas prices may pose danger to its economy. Decreasing value in the Euro will only lead to the USD strengthening against the Euro and more people will look towards the stronger dollar than the weakening Euro. Future chances of beating the USD depends on how the European economy increases their global presence.

Secondly, even though the BRICS reserve currency has its potential as a form of diversified and stable investment, the countries involved have proved otherwise. China is the only capable country in BRICS to bring about a change, having more than double the economic size of the BRICS counterparts combined. The currency coming into fruition may not seem like a possible outcome given the current prospects of the BRICS nations' economy. The reliance on the USD has a strong history and is deeply rooted to every country of the member nations (except for Russia). For the currency to lose its value as the reserve currency will take a long time. However, due to the US using the USD as a financial weapon towards other countries (e.g. Russia), many countries are seeking ways to diversify their currency stance seeing how Saudi Arabia is starting to use yuan for oil trades with China. Additionally, having the potential members can help elevate BRICS into relevance and global economic presence. Therefore, the new reserve currency replacing the USD may be a possibility.

Thirdly, China may have grown significantly through the years, the slowing population, tech innovation and quality in goods and services must be improved further for the US to be dethroned. If China's economy slows down and progress is not made, there will not be any way for China to become the largest economy. The influence of China's RMB must also be more than 3% of global trades for it to be close to being the next reserve currency.

However, considering the growth of China's economy and the policy changes towards investments and future growth, I believe China can be the world economic leader and the RMB can dethrone the USD as the dominant currency in the future. The global presence of China is without a doubt significant and increasing as investments and partnerships internationally boost their economy. Historically, the global economic presence of a country is the most important factor for a currency to be worthy of the "world reserve currency" title. If China continues growing as predicted and even overtaking the US economy, that may signal the start of the RMB rising into power. As global reliance on China's exports and imports increases the more likely the yuan can beat the USD. Just like the USD winning the UK in the past, the RMB may snatch the 1st spot in the future.

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