TD Global Investment Solutions

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Dedollarization and the Rise of the RMB as a Global Currency: Part II

There is a risk that when we use financial sanctions ... that it could undermine the hegemony of the dollar.

– Janet Yellen, U.S. Treasury Secretary, April 2023

The reinvention of globalization and derisking of supply chains have become key investment themes during the last couple years. We have written extensively about two markets where this transformation is still in early-innings, energy and semiconductors, with this note introducing a third, the USD-based financial system.

Regarding our first example, energy security has long been recognized as critical to national security. America learned this lesson way back in the 1970s during the OPEC embargo. This occurred at a time when U.S. oil imports had increased fivefold from 1960-1978, creating a gaping vulnerability. Fortunately, this historic example of "weaponized interdependence" resulted in America becoming not just energy independent but a major exporter. To the contrary, Europe seemed to have missed that '70s show, and quadrupled their fossil fuel imports from Russia over the two decades leading up to last February. It wasn't until the Ukraine invasion that Europe discovered how vulnerable it had become and is now belatedly scrambling to diversify its supply chain and boost green energy production.

Our second example of supply chain derisking concerns semiconductors, which many pundits refer to as the new oil. The sector has become geographically concentrated, particularly in graphics processing unit (GPU) design for AI, extreme ultraviolet (EUV) lithography equipment and advanced node fabrication. The latter comprises an especially critical chokepoint, with 90% of the world's leading-edge chips produced in Taiwan. To reduce this vulnerability the bi-partisan $280 bn Chips and Science Act was passed last

August with the explicit aim of turbocharging domestic production of semiconductors and derisking the strategic sector's supply chain.

This brings us to our third example, global financial markets, which have become unreasonably USD-centric, at least from the perspective of China, Russia, India, Brazil, and other emerging markets (EMs). Similar to what is occurring with energy and semiconductors, these countries are determined to derisk their excessive dependency on the USD. The first catalyst for this transition is the stark inconsistency between the USD's dominant role and China's commanding stature in exports, contribution to global growth and manufacturing prowess **(Figure 1)**. As President Xi is fond of repeating, we're living in a period of "profound historical change," as China and its allies promote "the multipolarization of the world," with one key pillar being global financial markets.

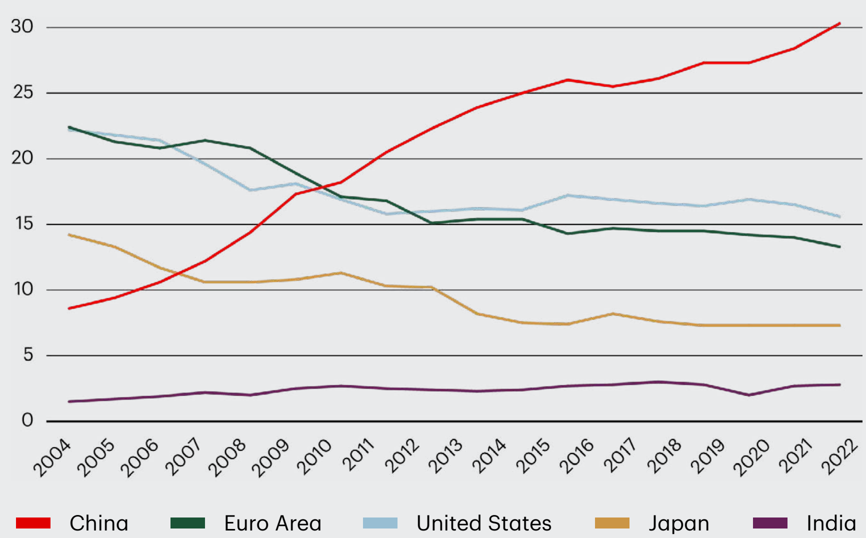
Second, China and its allies chafe at America's relentless deployment of financial sanctions, most notably those against Iran in 2018 and Russia in 2022. The USD has proven to be a potent weapon, reflecting the dominant role it plays in global commerce, but excessive use has reduced the greenback's reputation as an international store of value and medium of exchange. The chief consequence is a rising chorus of EMs calling for accelerated renminbi (RMB) internationalization, both for economic and geopolitical reasons.

Moreover, as Brad Setser of the Council on Foreign Relations emphasizes, the world is increasingly bipolar with labyrinthine financial and trade connections between the blocks.[1] With the transition from the unipolar world, the two blocks are actively reinventing the quality and quantity of these interconnections. However, it is costly and complex to move away from the old equilibrium, so there's a gnawing tension between the world as it is and the world compelled by the emerging bipolar order.

Part one of this note examined the USD's historical rise to prominence, explained the two-sided network effects that allow it to punch well above its weight, and demonstrated five features of the RMB's unconventional route to reserve currency status (including invoicing, offshore RMB markets, official swap loans, lender of last resort (LOLR) bailouts, and the potential of digital-payments systems). Part two discusses America's incessant deployment of stringent financial sanctions, particularly against Iran and Russia, but also the targeting of Chinese persons and entities. U.S. overreach has forced China to develop its own payments system and accelerated momentum towards a larger global role for the RMB. The transition is likely to prove positive for gold as an alternative reserve currency, but presents challenges for the U.S. bond market and America's ability to fund its massive deficits. We conclude with implications for investors.

FIGURE 1 – World Manufacturing Value Added (% share)

China's share has risen steadily and is now twice America's.



Source: World Bank

[1] Brad Setser, Twitter, June 2023

> **We aren't ditching the dollar; the dollar is ditching us.**
>
> **– Vladimir Putin, 2019**

Sanctions: Weaponized Interdependence

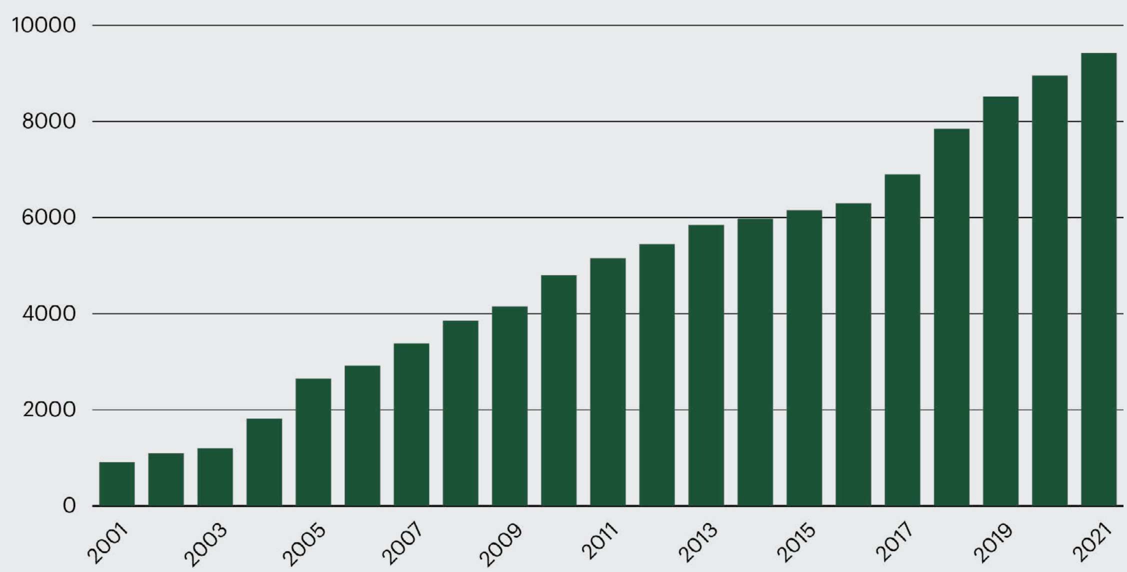
The world's overreliance on the USD is the source of America's devastating sanctions capabilities and provides Washington with broad discretion to target individuals, entities and states. However, overusing sanctions and weaponizing the U.S. financial system gives targeted and at-risk governments meaningful incentives to derisk and reduce their dependence on the dollar. As a result, the list of countries seeking to dedollarize their economies is long and getting longer.

To illustrate, the Biden administration has averaged 1,151 new designations per year to the Office of Foreign Assets Control's (OFAC) list of specially designated nationals (SDNs). That's up from an average of 975 during the Trump administration, and 544 during President Obama's first term **(Figures 2 and 3)**. And these sanctions sting, as the inclusion of a person or entity on the SDN list implies the immediate freezing of all their assets under U.S. jurisdiction and makes it illegal for a U.S. person to conduct any type of economic transaction with them.

Further, the U.S. is increasingly relying on secondary sanctions, which extend the enforcement to non-U.S. financial institutions. For example, in 2018 European banks were effectively prohibited from dealing with Iranian entities when the U.S. unilaterally withdrew from the 2015 Joint Comprehensive Plan of Action (JCPA). This infuriated America's European allies and fueled resentment against the USD's dominance. More broadly, the extraterritorial nature of secondary sanctions is always highly controversial and strenuously criticized by U.S. allies and foes alike.[2]

FIGURE 2 – Number of U.S. Treasury OFAC Sanctions Designations (existing plus net new)

The last twenty years has witnessed a tenfold increase in the number of financial sanctions in place.

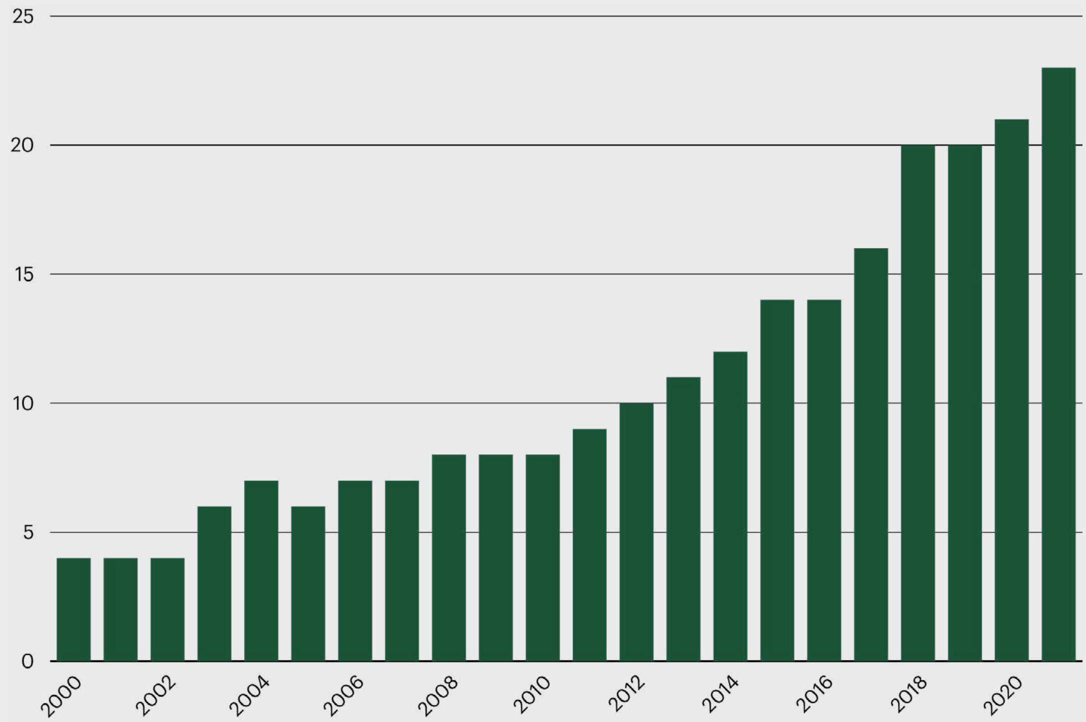


Source: U.S. Treasury

[2] For highly readable discussions of the U.S. sanctions regime see "Bucking the Buck: U.S. Financial Sanctions and the International Backlash against the Dollar," by D. McDowell, 2023 and "Backfire: How Sanctions Reshape the World Against U.S. Interests," by A. Demarais, 2022. Also see the U.S. Treasury's "2021 Sanctions Review" and the Center for a New American Security's "Sanctions by the Numbers: 2021 Year in Review."

FIGURE 3 – Number of States Actively Targeted by U.S. Sanctions

Since 2000 the number of states targeted by the U.S. Treasury has increased from 4 to 23.



Source: U.S. Treasury

It is inexplicable for a country to have 900 sanctions placed on it, because another country doesn't like it.

– Brazil's President Lula (referring to the U.S. sanctions imposed on Venezuela), May 2023

Examples of sanctions imposed over the last decade include those placed on Venezuela in 2017, 2019 and 2020 (for repression of democracy and human rights abuses) and on Iran in 2018 (because of concerns over Tehran's nuclear program). More recently since February 2022 the Treasury's OFAC has added over 2,500 Russia-related individuals and entities to the SDN list.[3] Sanctioning Russia in this manner was a very big deal, as it was the first time Washington had used the dollar as a weapon to directly target a major power. The extent of these sanctions and the degree to which America's allies have eagerly collaborated has raised fears in many countries that they might be next, with China especially concerned.

[3] However, America has not placed secondary sanctions on countries like India which still trade with Russia, because it rightfully fears the backlash that would result.

If you weaponize your currency enough times, others will stop using it.

– Elon Musk, April 2023

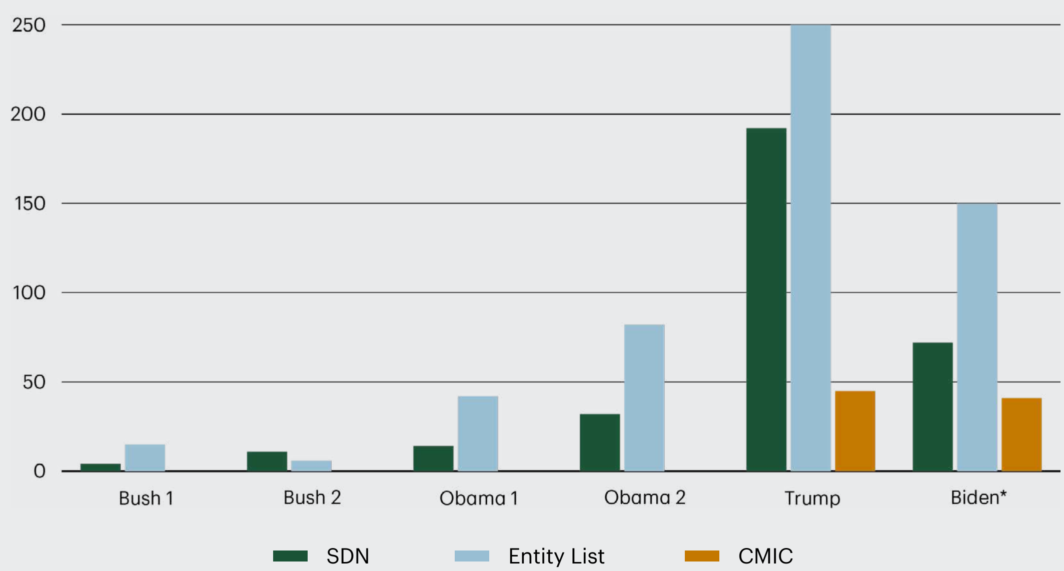
Backfire: Sanctions impacting Chinese persons and entities

There is a growing unease in Beijing that the U.S. might one day use the dollar as a weapon against China. In fact, America has already levied a large number of sanctions against Chinese entities and persons **(Figure 4)**. The majority have been under the Chinese Military-Industrial Complex Companies List (CMIC), which was established under the Trump administration in 2020 (and updated by President Biden the following year). Sanctionable activities include the use of Chinese surveillance technology outside of mainland China, as well as the use of this technology to facilitate repression or serious human rights abuses. So far, the Treasury has issued 68 designations on Chinese targets pursuant to CMIC-related programs.

Additionally, the Treasury has imposed 30 designations on China-related targets under various other sanctions programs. These include seven designations related to the quelling of democratic protests in Hong Kong and two Chinese government officials were sanctioned for human right abuses against Muslim Uyghurs. Further, OFAC has designated two Chinese individuals and 10 related entities under the 2016 Global Magnitsky Sanctions program for engaging in human rights abuses and designated one Chinese entity for providing support to a designated Russian entity. There have also been sanctions on China and Hong Kong–related targets for providing designated terrorist groups (including Hezbollah and Iran's Islamic Revolutionary Guard) with financial assistance and money laundering services.

FIGURE 4 – U.S. Sanctions and Entity List Designations of Chinese Persons

Media reports and White House statements suggest additional sanctions are likely in 2023 and 2024.



Source: U.S. Treasury, U.S. Commerce Department

*The data for President Joe Biden's administration is through December 2022.

Note: The Department of Commerce's entity list imposes trade restriction. It was initially established in 1997 with a focus on weapons of mass destruction but has since been expanded. Chinese companies on this list are mainly involved in military technologies or China's military-civil fusion.

The Biden administration remains focused on China and media reports regarding export controls and outbound investment restrictions suggest we will see additional China-related sanctions in 2023 and 2024. Moreover, these numbers could skyrocket if evidence appears of Chinese entities systematically helping Russia evade sanctions or import weapons, or if tensions with Taiwan escalate. Bottom-line: America has been aggressive in its use of sanctions which means RMB internationalization is no longer desired just for reasons of economic efficiency; it has also become viewed by China as critical to its sovereignty.

Escaping the dollar trap: China's cross-border interbank payment system (CIPS)

America's sanctions are so effective because of the way they weaponize the SWIFT messaging system and the CHIPS correspondent bank network.[4] Access to SWIFT allows the Treasury to monitor most high-value cross-border payments that occur worldwide. Moreover, America's authority over CHIPS provides authorities with enormous power to prevent designated states, entities and persons from accessing the U.S. financial system, cutting them off from using dollars for cross-border trade and freezing dollar-denominated assets. One key consequence is that China has been compelled to create and actively promote its alternative to SWIFT and CHIPS.

China's CIPS network was launched in 2015 and now includes 1,430 participants, with more than half of them based outside China. While transaction volumes grew by 75% in 2021 and CIPS processed over $50bn a day last year, that is still a tiny fraction of what goes through CHIPS. However, with the growth of CIPS, the RMB's role in trade finance and other activities has risen markedly. Further, Iran, Turkey, Russia and others have a direct interest in the success of CIPS as their economies have also been subject to a barrage of U.S. sanctions. Regardless, China has much work to do, including developing a robust alternative to SWIFT, if it intends to contest the dollar's supremacy in payments as a means of diminishing Washington's sanctions capabilities.

Bucking the buck: Momentum towards the RMB is accelerating

> **Every night I ask myself why all countries have to base their trade on the dollar. ... Why can't we do trade based on our own currencies?**
>
> **– Brazil's President Lula, speaking in Shanghai, April 2023**

Beijing is taking steps to make the yuan a more powerful currency, thereby extending its global influence and limiting the potential impact of U.S. sanctions. The list of countries that are similarly distrustful of the USD system is long and can be proxied by those that have decided not to participate in the Russian sanctions program. In addition to China, the list includes India, Turkey, Mexico, Brazil, Argentina, Indonesia, and almost all of Africa. These countries represent two-thirds of the world's population and six of the ten countries with the largest FX reserves.

During a visit by President Xi to Moscow in March, Vladimir Putin pledged to adopt the RMB for "payments between Russia and countries of Asia, Africa, and Latin America," in a bid to displace the dollar. Earlier Russia had confirmed that all gas supplied to China via Siberia would be settled in rubles and yuan rather than dollars and 16% of Russia's exports are now paid for in RMB, up from almost none before it invaded Ukraine. Many other countries are moving in a similar direction, for example: On March 29, Brazil and China announced they had reached an agreement to settle trade, including iron ore, in their own respective currencies; On April 27 the Argentinian government announced they will pay for Chinese imports in yuan instead of USD; and Saudi Arabia has committed to selling an undisclosed quantity of oil and gas to China in yuan. Each individual example is small, but the cumulative impact is undeniably significant.

One can think of the RMB's momentum as being driven by three factors: America's excessive use of sanctions, China's dominance in exports and as a driver of global growth, and the emergence of new technologies (CIPS, digital payments, e-CNY).

[4] Although only 18 of the 44 CHIPS member banks are American, all have a physical U.S. presence and are subject to its laws and regulations. America has been equally aggressive in expanding its influence over SWIFT, which is based in Belgium.

However, the RMB also faces three hurdles: the SWIFT and CHIPs infrastructure are already well-established and widely used; the USD benefits from entrenched two-sided network effects; and China's capital account is relatively closed (although we expect Beijing to gradually relax currency restrictions over the medium-term). An additional factor, geopolitical developments, is more of a wild card. For example, if America's next president renounces multilateralism and adopts policies that alienate the EU and other allies (as happened with the change in Iran policy in 2018), then momentum away from the dollar would likely accelerate.

Implications for gold: A barbarous relic no more?

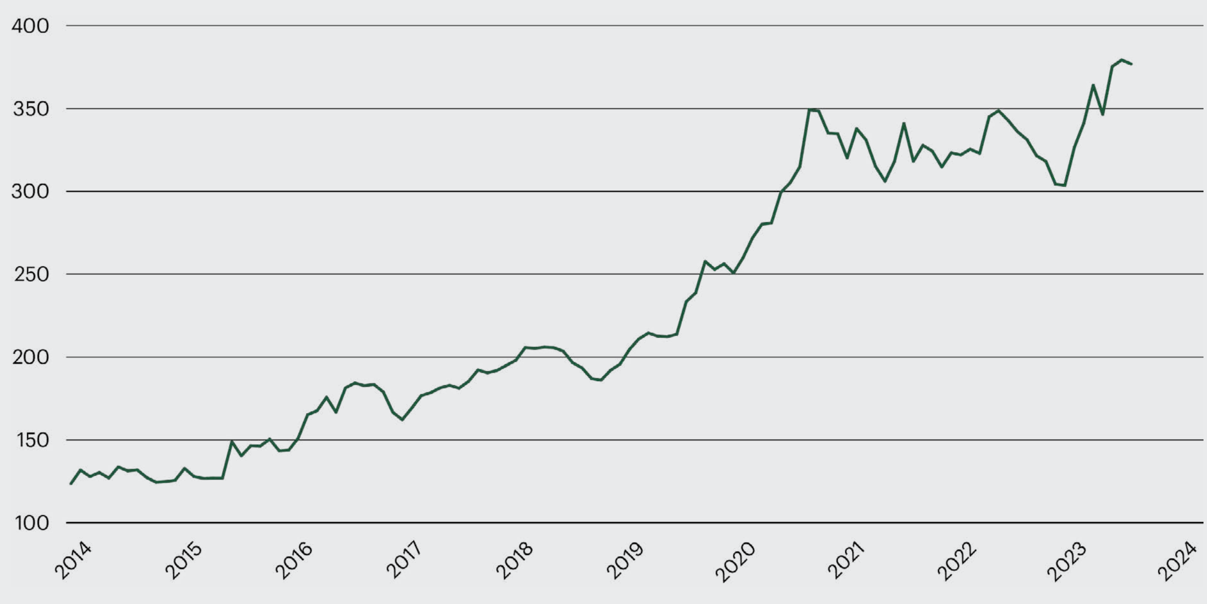
The consensus view is that, while many countries would like to reduce their USD exposure, the transition will proceed glacially because there's no legitimate and compelling competitor. This perspective also implies the shift to a bipolar currency order will prove positive for gold as an alternative reserve currency and safe haven hedge. To illustrate, since 2014 reserves held in gold have increased by 256% in Russia, 211% in China and somewhat less in India and Turkey **(Figure 5)**. During this period the price of gold rose by only 58% and the reserves ex-gold of China, Russia and Turkey actually declined. We believe this shift tells us less about the virtues of gold than it does about the defects of the dollar.

The Great Power Competition comes to currencies: Impact on the U.S.

In the bipolar world we are transitioning toward, the U.S. is likely to face moderately higher interest and less stable financing, which could come as a shock to policymakers given how much external financing America needs. We expect the broad USD to weaken by about 20% over the longer term and various financial models provide a wide range of estimates for the impact on Treasury yields. For example, a 2021 Journal of Finance paper estimates 1.8 ppts higher while a 2018 Journal of International Economics article suggests only 20-30 bps. Regardless of the exact amount, this implies a reduction in the dollar's "exorbitant privilege"—that is, the currency's dominance which has allowed the U.S. to run persistent twin deficits and still enjoy relatively low interest rates **(Figure 6)**.

FIGURE 5 – Demand for Gold by Select Central Banks (USD bn)

Since 2014 the combined gold holdings of China, Russia, India and Turkey have more than tripled.



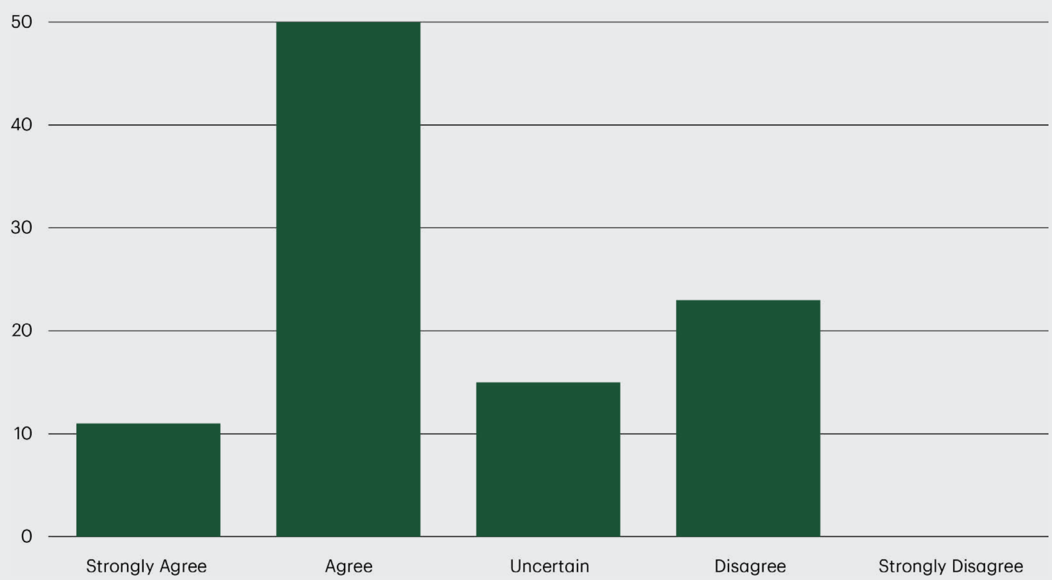
Source: Bloomberg, IMF

The dollar's position as premier reserve currency allows the US to extract significant resources from the rest of the world; losing this ability would have substantial negative implications.

– Larry Samuelson, Yale, April 2023

FIGURE 6 – The views of elite economists (%)

A shift to a more multi-polar international monetary system would have substantial negative implications for the US economy.



Source: University of Chicago, Center for Global Markets, Panel of economic experts, April 2023

To illustrate how a bipolar currency order could result in USD outflows, a recent Fed paper examined a number of feasible circumstances that could reduce the dollar's share of global FX reserves below 50%.[5] For example: if Hong Kong abandoned its peg, divesting of $170 bn in Treasuries; or EMs reduced their share of reserves held in dollars to levels consistent with their export invoices; or China decreased the dollar share of its reserves by 10%, or $320 bn. Together these actions would slash the dollar share of reserves from around 60% today towards 40-50%.

The process of transitioning toward a bipolar currency world is likely to be gradual, but as the RMB infrastructure improves and the currency begins to benefit from network effects, the pace of change could be quite dramatic. Further, gradual dedollarization assumes the U.S. maintains its current diplomatic alliances, which is not guaranteed, especially if the next American president chooses a unilateral path and antagonizes its allies. Moreover, a majority of the world's ten largest economies are currently U.S. allies; but that will not be the case a decade or two from now. Dedollarization could also accelerate as America's influence wanes at global multilateral institutions such as the International Monetary Fund (IMF) and World Bank. This suggests the international financial and monetary architecture is likely to become less institutionalized, less rule-bound and less transparent.

[5] See "Geopolitics and the U.S. Dollar's Future as a Reserve Currency," by C. Weiss, Federal Reserve Board, 2022.

The long historical era of the dominance of the American dollar is coming to an end. I think that the time has come when China will gradually remove currency restrictions. China understands that they will not become world economic power number 1 if they keep their yuan as a non-convertible currency.

– Andrei Kostin, CEO of state-controlled VTB (Russia's second largest bank), June 2023

A global currency with Chinese characteristics: Investment implications

Globalization as we knew it is over. Since the end of the Cold War the U.S. has been unrivalled in both the economic and geopolitical realms. However, as we move into a bipolar world, with previously hidden vulnerabilities fully exposed, companies must proactively derisk global value chains, particularly in the energy and semiconductor sectors. Previously we've explained why this implies higher inflation, real yields and macro volatility, as well as an increased cost of capital and margin compression, especially for multinational companies in tech and manufacturing.

Investors also need to prepare for the rise of a second global currency, although we are not predicting the dollar's demise. It will likely retain the largest share in global financial markets for another decade or two, but its dominance is clearly waning. Further, history suggests the speed and scale of change are as likely to be driven by major geopolitical events and realignments as by economic trends. That is, the direction of dedollarization might be clear, but the timing and slope are impossible to forecast. Moreover, given the labyrinthine financial and trade connections between the blocks, Stanford's Niall Fergusson stresses that "the law of unintended consequences is the only real law of history."

The transition to a new currency order implies a substantially weaker USD and moderately higher U.S. interest rates. The transition will also likely prove positive for gold as an alternative reserve currency, operating as insurance against potential U.S. sanctions. Further, a bipolar world implies increased benefits from diversification beyond DMs, as China and other locally-impacted economies become even less correlated to Western markets.[6]

Finally, this paper's core prediction has many skeptics, and perhaps that's unsurprising given the dollar's long reign and entrenched status. However, when China first joined the World Trade Organization (WTO) few expected it would expand into the export superpower it has become today, capturing meaningful market share from America and other G7 countries. We surmise something similar is now unfolding with the rise of the RMB. President Xi emphasizes we're living in a period of "profound historical change." We agree and believe we've entered a new investment regime, one which requires a modification or recalibration of investment strategies, including those that have worked well over recent years.

[6] This is a point emphasized by my TDAM colleagues Jafer Naqvi and Nicole Lomax.

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