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

The transition toward a bipolar currency world is accelerating, driven by two pivotal developments. The first is an increasingly assertive China, insisting its economic heft merits a commensurate voice in defining the rules and institutions of the new bipolar global order. Second, America's incessant deployment of stringent financial sanctions, particularly those against Iran in 2018 and Russia in 2022, which are viewed as capricious and sectarian by China and its allies. The U.S. Dollar (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 critical consequence of these two developments is a rising chorus calling for accelerated RMB internationalization, both for economic and geopolitical reasons.

With America's more frequent weaponization of its grip on the global financial system, China, Russia, Iran, Turkey, India, Brazil, and others are seeking ways to extricate themselves from the dollar system. This is best viewed as a form of "derisking," which the Financial Times has already nominated as the word of the year for 2023. We've previously written extensively about supply-chain derisking, especially in semiconductors, energy, and other "chokepoint" sectors, to illustrate how globalization is being reinvented amidst the transition to a bipolar world order. From this perspective, Beijing's RMB internationalization policy is part of a broader geo-economic rebalancing, focused on limiting economic and financial vulnerabilities.

China aspires to reduce its dependence on the dollar by encouraging the use of the yuan in cross-border trade and investment, as well as ensuring continued access to global financial markets during future geopolitical crises. Beijing senses both a need and an opportunity to further internationalize the RMB to protect its economy from future U.S. sanctions and weaken Washington's coercive capabilities in the process. With the dominance of the dollar out of kilter with the increasing multipolarity of the world economy, China and its allies are in the early innings of creating a bipolar global financial system.

For investors, the transition to a new currency order implies a substantially weaker USD and moderately higher U.S. interest rates, and will likely prove positive for gold as an alternative reserve currency. It also

It has been proven time and again that sanctions are a boomerang and a double-edged sword. To politicize the global economy and turn it into one's tool or weapon, and willfully impose sanctions by using one's primary position in the international financial and monetary systems will only end up hurting one's own interests.

– President Xi
2022

implies increased benefits from diversification beyond developed markets (DMs), as China and other emerging markets (EMs) become even less correlated. The remainder of this note examines the USD's historical rise to prominence and then explains five features of the RMB's unconventional route to global currency status. Part two demonstrates that America's increased use of financial sanctions has turbo-charged momentum towards dedollarization and concludes with implications for investors.

A brief history of global currencies

In the modern era there have been only two global currency systems - sterling and USD.[1] The British pound emerged as the primary international currency in the late 18th century and early 19th century.[2] Sterling remained dominant for the next century, with over 60% of world trade invoiced, financed, and settled in pounds, even though the U.S. rose to the number one position in both GDP and exports around 1870.

The transition to the greenback in the early 20th century was triggered by two events. First, the Federal Reserve Act of 1913 which, among other things, allowed U.S. banks to deal in USD trade credit (through "bankers acceptances") and second, by World War I, which was relatively more disruptive to Britain and British trade. After several decades with two contending global currencies, the USD's position was officially affirmed with the 1944 Bretton Woods agreement, by which time the American economy was about four times larger than Britain's.

Economists love to generalize, but with just two data points and only one loosely comparable transition, caution is definitely warranted. However, that hasn't stopped pundits from insisting it's not yet the RMB's time as a global currency requires a current account deficit and an open capital account, even though neither the pound nor the dollar exhibited those features when they first took on the mantle. Bottom-line: The scant historical experience is likely to prove only a rough guide as we transition into the new bipolar world order. Moreover, as explained below, we expect the RMB to tread an unconventional route to global currency status.

The USD: Punching way above its weight

The USD has been the world's pre-eminent currency for almost a century now and continues to exert an almighty gravitational pull on the world economy. It has a weight of 43% in the SWIFT (Society for Worldwide Interbank Financial Telecommunication) payments messaging system, 50% in trade invoicing (this share has been relatively stable for decades), 60% among FX reserves (down from 72% in 2000), 44% for FX transactions, and 49% for cross-border loans and debt securities **(Figure 1)**. Across these six metrics the USD's share averages about 50%, which is 4.5x America's 11% weight in global trade. The greenback's liquidity is so advantageous that if you want to swap euros for Swiss francs, or Canadian dollar (CAD) for Mexican Peso (MXN), it can be cheaper to trade via dollars than to do so directly.

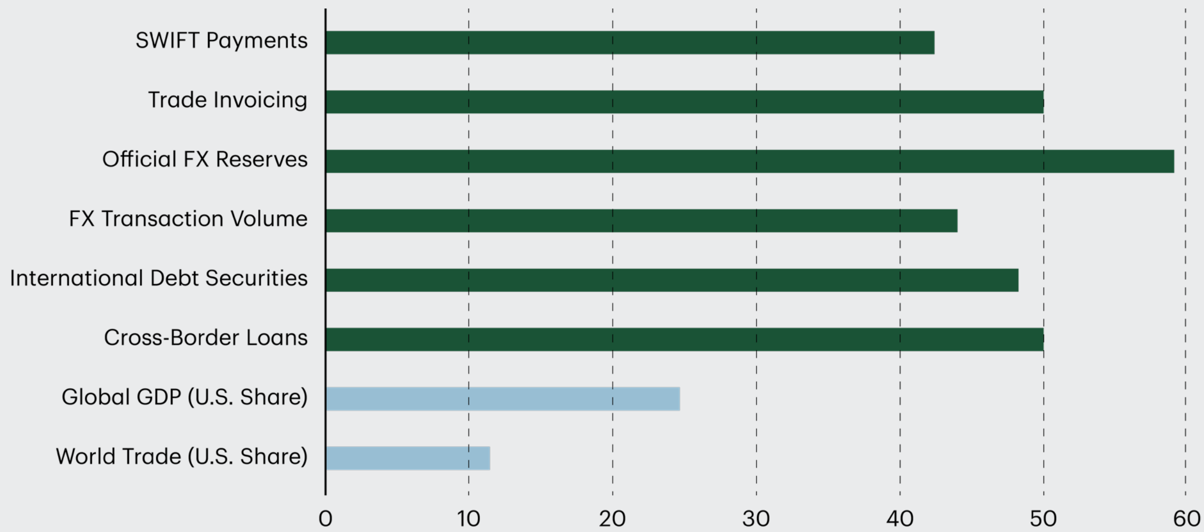
The dollar plays far too dominant a role in global finance.

– Jim O'Neill, former chief economist Goldman Sachs (who coined the term "BRIC" in 2001), March 2023

[1] Previous currencies such as the Dutch florin (or guilder), Spanish dollar, Venetian ducat, and Florentine florin were only used regionally not globally.

[2] The two key events in sterling's ascension were victories in the fourth Anglo-Dutch war of 1780-84 (triggered by Dutch support for rebels in the North American colonies) and the Napoleonic Wars of 1803-1815.

FIGURE 1 – International Role of the USD (% share)



Source: BIS quarterly review, December 2022

If the gap between Chinese and U.S. shares in world exports widens far enough, we could eventually get to a point where a renminbi-dominant equilibrium becomes inevitable. At this point, the dollar's share in global trade and finance could potentially decline quite sharply.

– "Banking, Trade, and the Making of a Dominant Currency," by G. Gopinath (Harvard) et al,2021

Why the greenback is so dominant: Network effects

Being the world's principal currency creates self-reinforcing network benefits, as people profit from using the same currency as everyone else.[3] For example, there is a strong correlation between the dollar's prominence in a country's import invoicing, and its role in that country's banking system. Further, when more internationally traded goods are invoiced in USD, there will be greater demand for dollar deposits or more broadly USD-denominated financial assets or safe dollar claims. And this ultimately is what has cemented the greenbacks prominence in global banking and finance.[4]

These network effects suggest a logical sequencing of steps in internationalizing a currency: first, encourage its use in invoicing and settling trade; next, promote its use in other financial transactions such as lending; and finally, establish its role as a reliable store of value. This progression helps explain events in the early 20th century when the dollar first displaced pound sterling as the dominant global currency. Further, as Gopinath et. al. demonstrate, it also sheds light on the strategy currently being undertaken by the Chinese government in their efforts to internationalize the renminbi. Reflecting China's commanding role in global trade, an initial focus has been increasing the share that is invoiced and settled in RMB.

[3] Two-sided network effects are especially pronounced in digital business models, such as social media, e-Commerce, and smart phones. However, the experience over the last few decades has shown us how frequently the once-mighty have fallen and been replaced by new titans.

[4] See "Banking, Trade, and the Making of a Dominant Currency," by G. Gopinath (Harvard) et al, 2021.

> **The renminbi can play a more important role in the future, even in the absence of full financial liberalization. This process would involve trade invoicing and settlements, central bank swap lines, and offshore renminbi markets.**
>
> **– "The Renminbi's Unconventional Route to Reserve Currency Status," A. Naef (Berkeley) et al, 2022**

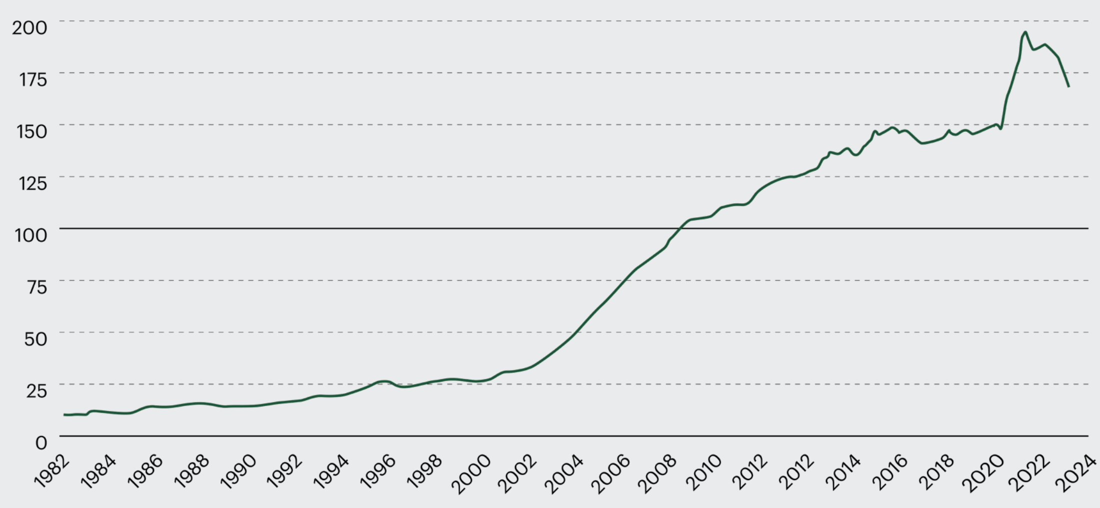
The RMB's path to global currency status: Salami slicing tactics

In 2007 exports from China first overtook those from the U.S. (Figure 2). Further, China has continued to pull ahead and today is the number one trading partner for 128 countries (out of a total of 190). The shift over the last two decades has been stunning: In 2000, over 80% of countries traded more with the U.S. than they did with China, but by 2020 that number had dropped sharply to just 30%. Moreover, this rebalancing away from the U.S. is not about to reverse or even slow, regardless of the ratcheting down in China's trend growth rate (from 8%+ to something south of 5%). To illustrate, exports are up 17% yoy, partially due to booming electric vehicle sales as China moves up the value chain. Moreover, in its analysis of global growth over the next five years, Bloomberg expects China to contribute 23%, well ahead of India at 13% and more than twice the U.S. at 11%. Bottom-line: China will continue to be the key driver of global GDP and export growth for at least the next couple of decades.

In 2008 the Global Financial Crisis wreaked havoc across the planet, revealing the fragility of the USD-based financial system and the acute risks it posed for an overly exposed China. This realization jolted policy makers in Beijing, who immediately adopted the imperative of RMB - internationalization and actively promoted a bipolar global order. The first step toward this goal involved pressing China's trading partners to invoice in RMB.[5] Although currency invoicing data are fragmentary, it appears the RMB's share as a settlement currency in China's trade has gone from 0% in 2010 to 29% in 2023, making it the world's second-most frequently used currency for invoicing international trade. As this

FIGURE 2 – China exports (as % of US exports)

China pulled ahead in mid-2007



Source: BIS quarterly review, December 2022

A multipolar pattern could come as a shock to American policymakers, given how much external financing the US needs. So investors and policymakers alike need to watch the geeky details of trade invoicing in the coming months.

– Gillian Tett, Financial Times, March 2023

share rises and the RMB becomes more widely used, it is likely that other countries with strong trade and financial links with China will join the parade and begin to invoice and settle their transactions directly in the currency.

To illustrate the type of impact this would have, a recent paper from the Fed examined a scenario in which emerging markets and developing economies (EMDEs) switched the invoicing currency for trade amongst themselves from the USD to the RMB. The analysis demonstrated that a move away from the USD in trade invoicing among EMDEs would lead to substantial divestment, although the USD would still represent the largest share of FX reserve assets **(Figure 3)**. By contrast, RMB holdings would benefit significantly and, as a result, move into third place among reserve assets.

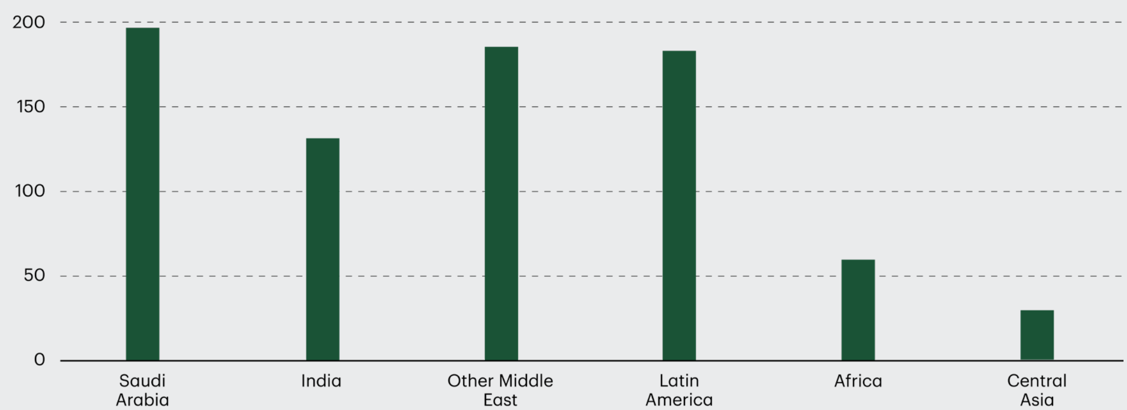
In addition to invoicing trade in yuan, developing offshore RMB markets and central bank swap lines are also key to internationalizing China's currency. Official swap lines engender confidence that RMB can be obtained when needed, while the offshore market reassures companies and investors that they can convert RMB into dollars at stable and

A move away from the U.S. dollar in trade invoicing among EMDEs would likely lead to substantial divestment from U.S. dollar FX reserves."

– "Geopolitics and the U.S. Dollar's Future as a Reserve Currency," by C. Weiss, Fed, 2022

FIGURE 3 – Predicted USD reserves lost in a scenario in which EMs switched export invoicing from USD into RMB (USD bn).

FX reserves held in USD would decline by about $800 bn or 12% with the RMB benefiting correspondingly.



Source: "Geopolitics and the U.S. Dollar's Future as a Reserve Currency," by C. Weiss, Fed, 2022

[5] See "The Renminbi's Unconventional Route to Reserve Currency Status," A. Naef (Berkeley) et al, 2022, which argues the rise of the RMB may unfold in a very different manner than the pound and USD. They emphasize China does not need full financial liberalization, including an open capital account, to increase the international use of its currency.

> **If we compare RMB usage in 10 years my guess is that it will be higher, but not nearly enough to have overtaken the dollar.**
>
> **– Anil Kashyap, U of Chicago, April 2023**

predictable rates. Since 2010, when China first authorised RMB trading in Hong Kong, offshore markets have opened in 24 other cities. At $200 bn these markets remain small compared to offshore markets for dollars (or Eurodollars), suggesting they still have a long way to go. The scale can also be compared to China's government bond market, which is the third largest in the world, far behind the U.S. and a little smaller than the EU's but larger than Japan's.

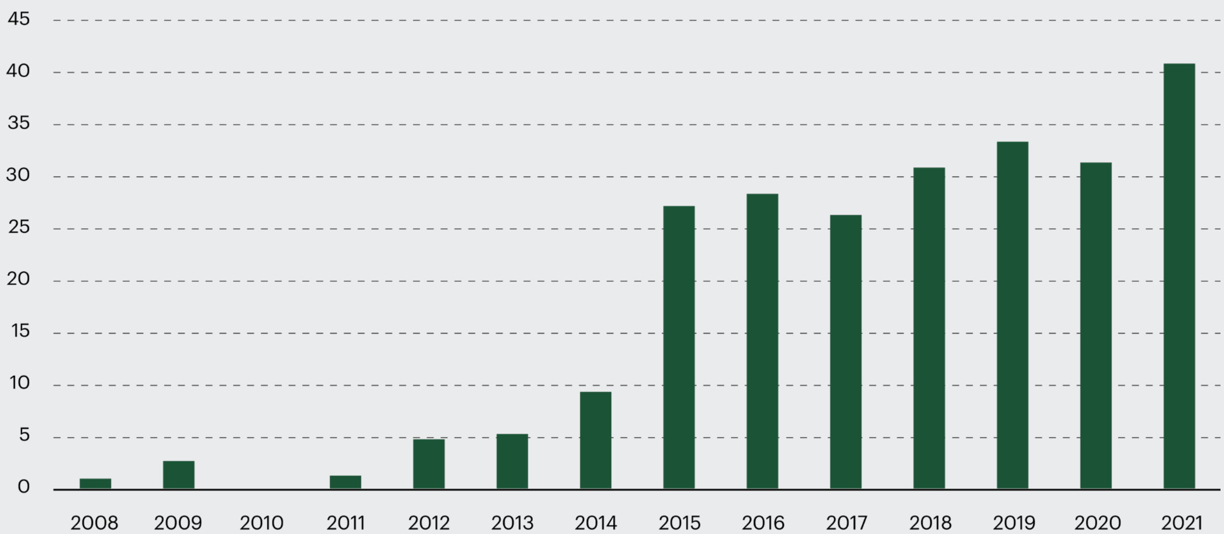
The People's Bank of China (PBOC) has negotiated bilateral currency swap agreements with 39 central banks, totaling some RMB 3.7 trillion ($550 bn).[6] This program can be viewed as a type of financial rescue mechanism and is part of China's strategy to be a new "lender of last resort," especially with EMDEs who are significant trade partners. So far 17 countries have drawn on the PBOC's swap lines.

Lender of last resort: Bailouts on the Belt and Road

Expanding on that theme, a recent paper argues persuasively that China has emerged as a key lender of last resort (LOLR) for a growing number of developing countries.[7] It demonstrates that China's role as an international crisis manager has grown exponentially in recent years following its long boom in overseas lending. This new system involves cross-border lending to countries in debt distress, with almost all Chinese rescue loans going to low- and middle-income Belt and Road Initiative (BRI) countries with significant debts outstanding to Chinese banks. China's overseas bailouts correspond to more than 20% of total IMF lending over the past decade and the bailout amounts are growing fast **(Figure 4)**. The authors also note historical parallels

FIGURE 4 – China's bilateral bailouts - yearly amounts of cross-border rescue lending (USD bn).

22 countries have been recipients, including Argentina, Venezuela, Nigeria, Egypt, Turkey, Russia, Pakistan, and Sri Lanka.



Source: China as an International Lender of Last Resort," S. Horn et al, NBER, 2023
Note: Includes both swap line drawings ($170 bn) and loans from Chinese banks ($70 bn)

[6] Countries include Argentina, Nigeria, Egypt, Turkey, Russia, Belarus, Mongolia, Pakistan, Sri Lanka, Thailand, and Malaysia.

[7] "China as an International Lender of Last Resort," by S. Horn (World Bank), C. Reinhart (Harvard) et al, 2023.

> **The eCNY has tremendous potential to transform international payments from the correspondent banking model to one based on direct electronic movement of digital monetary instruments."**
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> **– "Ukraine, Sanctions and Central Bank Digital Currencies: The Weaponization of Digital Finance and the End of Global Monetary Hegemony?" by D. Arner (U of Hong Kong) et. al., 2023**

to the era when America started its rise as a global financial power, using the U.S. Ex-Im Bank and other institutions to provide rescue funds to countries with large liabilities to U.S. banks and exporters.

Might digital finance reduce the world's dependence on the dollar?

We'll now discuss a step in the RMB's internationalization that is more hypothetical, the anticipation that digital-payment platforms will help reduce dependence on the USD-based financial system, including the SWIFT messaging system and the CHIPs (Clearing House Interbank Payments System) network of correspondent banks. For example, China has developed its own cross-border interbank payment system (CIPS) which boasts 1,430 participants (more than half outside China).[8] CIPS transaction volumes are growing rapidly (up 75% in 2021), although processed payments remain a fraction of what passes through CHIPS and it remains overly reliant on SWIFT.

Further, Douglas Arner of the University of Hong Kong thinks that central-bank digital currencies (CBDCs), where China's e-CNY is leagues ahead of everyone else, could pose a bigger threat to the USD by creating a new standard for cross-border payments and using a distributed ledger to settle these transactions. Moreover, China is even further ahead when it comes to online payment platforms, many of which already have a large international presence, and Stanford's Darrell Duffie believes that, rather than CBDCs, is the key digital technology to watch. While compelling, these arguments are highly speculative and we won't be able to tell if they're gaining traction until 2028 or later.

That brings part one of our note to a close. We've examined the USD's historical rise to prominence, discussed the 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, LOLR bailouts, and the potential of digital-payments systems). Part two explains how America's incessant deployment of stringent financial sanctions has promoted momentum towards dedollarization and a larger role for the RMB, and concludes with implications for investors.

[8] See "Could digital-payments systems help unseat the dollar?" The Economist, May 15, 2023

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