

## CAN THE DOLLAR BE DETHRONED?

The U.S. dollar is widely considered the global reserve currency due to its widespread acceptance and use in international trade and finance. It can be contended, however, that the dominance of the dollar as a global reserve currency should decrease over time, and in the process make way for other currencies.

In order to trace the emergence of the US Dollar as the Global Reserve Currency, one must travel back to July 1944, towards the end of World War II. Delegates from all 44 Allied Nations met together in Bretton Woods, New Hampshire, to establish a new international monetary system in the ensuing destruction of the Axis powers. By late 1944 Germany, Italy, and Japan were all but destroyed, and Europe, while victorious, had effectively bankrupted itself in its war efforts. Emerging relatively unharmed from WWII, and certainly a good deal wealthier than the rest of the world, was the United States. Much of the supplies used by the allied forces during WWII had been financed by the US, which gave America a great deal of financial bargaining power coming out of the war.

What would become known as “The Bretton Woods Agreement” essentially established the dollar as the global

reserve currency, replacing the gold standard. Under this system, other currencies were pegged to the US dollar, which was in turn pegged to gold at a fixed rate of \$35 per ounce. This system ensured that currencies were convertible into US dollars at a fixed rate, and that the US government could maintain the value of the dollar by buying and selling gold at the fixed rate (it certainly didn’t hurt that at the time the US held 70% of the world’s gold bullion).

The new system worked very well for the global financial system, even after the dollar became untethered from the gold price in the 1970’s. The strength and relative stability of the US economy, coupled with the confidence of investors and central banks has maintained the dollar as a safe and reliable store of value, merrily making the US even richer in the process.

## THE DOLLAR TODAY

Moving forward to today, many market participants argue that the days of dollar dominance should be drawing to an end, or that at the very least we should see the dollar lose a portion of its control over global currency markets.

Looking at the world economy in aggregate, America currently accounts for roughly a quarter of total global GDP at market exchange rates, a number that has been fairly constant since the 80’s. By comparison, China has experienced marked economic growth over the same time period, more than tripling its share of global GDP in the last 40 years. As a result, China currently accounts for around 18% of global GDP, well ahead of all other Emerging Markets as well as several Developed Markets.

Does this point to a change in global currency markets and a new king, financially speaking?

China and Brazil earlier this year agreed to settle trades in each other’s currencies. France, in a similar move recently conducted its first liquified natural gas sale in Yuan. Vladimir Putin, who has been effectively blocked from using the dollar, has also pledged to use the Yuan more. China itself has also become a global leader in many areas of commerce as well as global trade. All these factors feed the narrative that we should see growing Yuan dominance going forward.

## THE DOLLAR TODAY CONTINUED

To put things into perspective it is helpful to look at the actual trading volumes of different currencies to get a sense of their relative global demand. In terms of interest rate derivative trading (essentially the buying and selling of financial instruments whose value is derived from changes in interest rates of two countries), the Chinese Yuan sees trades worth roughly \$30bn on a daily basis. The US Dollar, by comparison, does the same amount of trading every 20 minutes. In other words, at current levels it would take the Yuan 77 years to trade as much as the dollar trades in 1 year. Clearly China has some way to go...

Currently almost 90% of all foreign exchange transactions across the world have the dollar on either the buy or sell side, an estimated \$6.6 trillion in turnover every day! By

comparison, the Yuan currently accounts for only 7% of global currency trades, despite the significant growth it has seen to its global share of GDP. Even if we add the remaining BRICS countries to China's share of global currency trade, the combined share of the global currency market only moves to 10%.

When looking at central bank reserves held by different countries globally, one of the primary tools used for setting the monetary policy of a country, again the use of the dollar far outshines that of the Yuan. It is estimated that nearly 60% of all official foreign exchange reserves globally are held in dollars, significantly ahead of the mere 3% held in Chinese Yuan.

## STRUCTURAL DIFFERENCES BETWEEN THE DOLLAR AND YUAN

More than the considerable difference in trade volumes between the dollar and the Yuan, there are also several important structural differences between the US and China which affect the use of each currency.

A primary reason for the dominance of the dollar is due to the superiority of the US Financial Institutions in terms of depth, scale and transparency. The dollar and USD-denominated foreign currency reserves are protected by both the military and US legal system, which guarantees the rights of the holder. In addition to the strength of the US financial system, the US is also a real democracy. Peaceful handovers (for the most part) of power from election to election and between parties are bedrock principles in America. Moreover, a fair ballot box is a foundational pillar on which the American political system is built. China, by comparison, is a communist state with a much less developed financial system. The Yuan is not fully

convertible to all other currencies due to strict capital controls enforced by the Chinese government. Furthermore, Chinese president Xi Jinping was unanimously reappointed as China's president for an unprecedented third term in March 2023, effectively cementing his position as lifelong Dictator. For many trading partners and central banks, these factors alone are sufficient to dissuade the use of the Yuan and direct their trading through the dollar.

While there is credence to the narrative that the dollar is due to decline somewhat, or that alternative currencies will rise in strength, the lack of a viable alternative makes most rumours exaggerated. Even the Euro, which came into being through the unification of Europe, has done very little to displace the role of the dollar in global currency markets. The dollar remains the global reserve currency and during periods of global market and political turmoil, the dollar is still firmly held as the safe-haven asset of choice.

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