Subcommittee on Financial Institutions and Monetary Policy of the House Committee on Financial Services

Dollar Dollar Dominance: Preserving the U.S. Dollar's Status as the Global Reserve Currency
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Dear Committee Members, thank you Chairman Luetkemeyer and Ranking Member Beatty for inviting me to testify on the important topic of dollar dominance and the preservation of the dollar's status as a global reserve currency. I am honored.

Introduction

Despite numerous challenges, dollar dominance has persisted for nearly 80 years. Why does the dollar continue to play such a prominent role, is the dollar likely to reign supreme over the long term, what are the most important threats on the horizon?

The extent of US dollar dominance and its preservation has become a principal theater for the great power struggle between the United States, China and Russia placing the future of liberal international order in the balance. The dollar is the only truly global currency in the world, and is widely used for transactions, pricing, settlement and investment by governments and private actors outside the United States. These roles offer the US economic, political and social privileges. Economically, Americans benefit from the ease and convenience of transacting in dollars, from seignorage, monetary flexibility and safe-haven benefits in times crisis. Politically, the dollar offers the United States a non-military instrument of coercion with which to police international order. Socially, the United States gains status and prestige. Preserving the dollar's status as the global currency is therefore in the United States' interest, and potentially in other countries' interest.

Dollar dominance refers to the disproportionate use of dollars in the world economy, a condition which has prevailed during the entire postwar era. The absolute dominance of the dollar is unlikely to change in decades to come, though the dollar's relative dominance has receded from peak levels. Even though the dollar remains dominant, a relative weakening of the dollar's status is considered a harbinger of the long-term power shift to the east, hastening the onset of a multipolar order in which the United States is less capable and less influential.

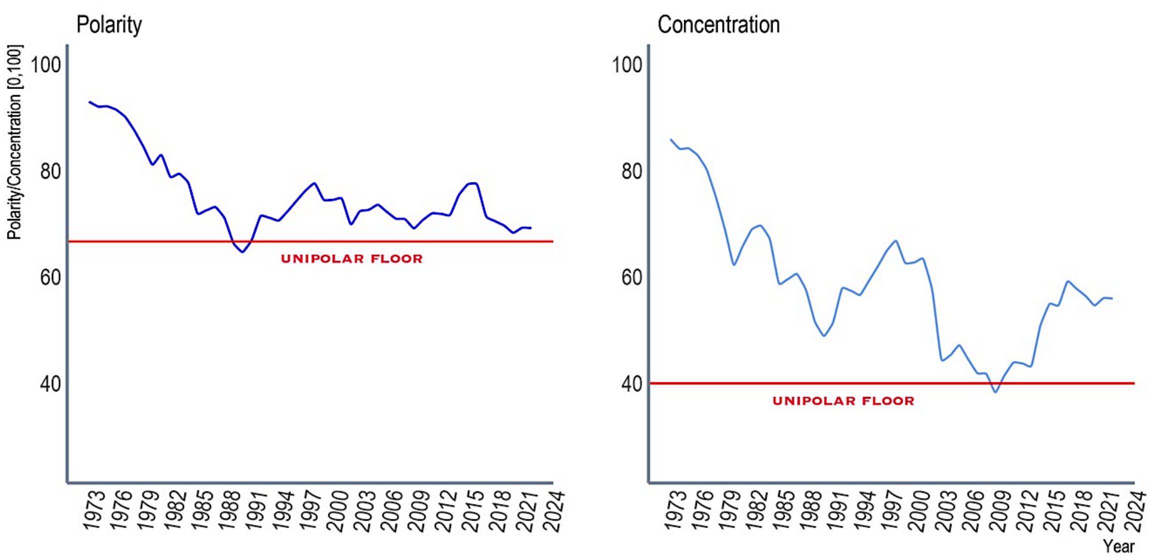
Assessing dollar dominance …

The precise meaning of dollar dominance in this regard remains unsettled. How strong must the dollar be relative to other currencies used for international purposes for the international currency system to be characterized by dollar dominance—a question rarely tackled head on. The lack of a common focal point makes it very difficult to determine whether dollar dominance is truly threatened and how to discern a multipolar currency system if, and when, one comes to pass. Using metrics over the various functions of an international currency, for example, the reserve currency function, it is possible quantify dollar dominance according to established criteria—for instance polarity or systemic concentration (see Figure 1).[1] Polarity is a term traditionally used by international-relations scholars to assess the international balance of power based on military might. But the concept is sometimes used to describe the international distribution of economic power. Polarity is particularly well-suited for characterizing the international currency system because great-power currency capabilities can be used to enforce international agreements and police international order.

Strictly speaking polarity is the number of great powers in the international system. In a unipolar currency order, one great power enjoys preponderance and has no close rival. In a bipolar currency order, two great powers predominate and have distant rivals. And in a multipolar currency order, more than two great powers wield relatively equal influence. Yet this still leaves open the question of how to measure polarity.[2]

Figure 1. Dollar unipolarity

Two measures of reserve currency hierarchy, 1973-2022



Source: Norrlöf calculations based on IMF COFER data

[1] Carla Norrlöf, 'Currency, Conflict, and Global Order', *At Arms,* PS Quarterly, New York, Summer 2023.

[2] To determine whether a system is unipolar, the left-hand panel in Figure 1 relates all the major powers accounting for 5 percent of currency reserves to the major power accounting for the largest share of currency reserves. A unipolar floor is drawn at a level where reserves in the leading currency are twice as large as reserves in other major currencies. This standard offers a clear-cut abstraction of unipolarity. Being twice as powerful as any counter-coalition clearly renders a balance of power impossible and thus creates stability by muting opposition. Unipolarity can also prevail without this exacting standard, as in the right-hand panel of Figure 1. Here, the unipolar line is based on system-wide changes in currency shares. A unipolar floor is drawn at a concentration index of 40. Below that point, the system no longer is considered unipolar, but rather bipolar or multipolar.

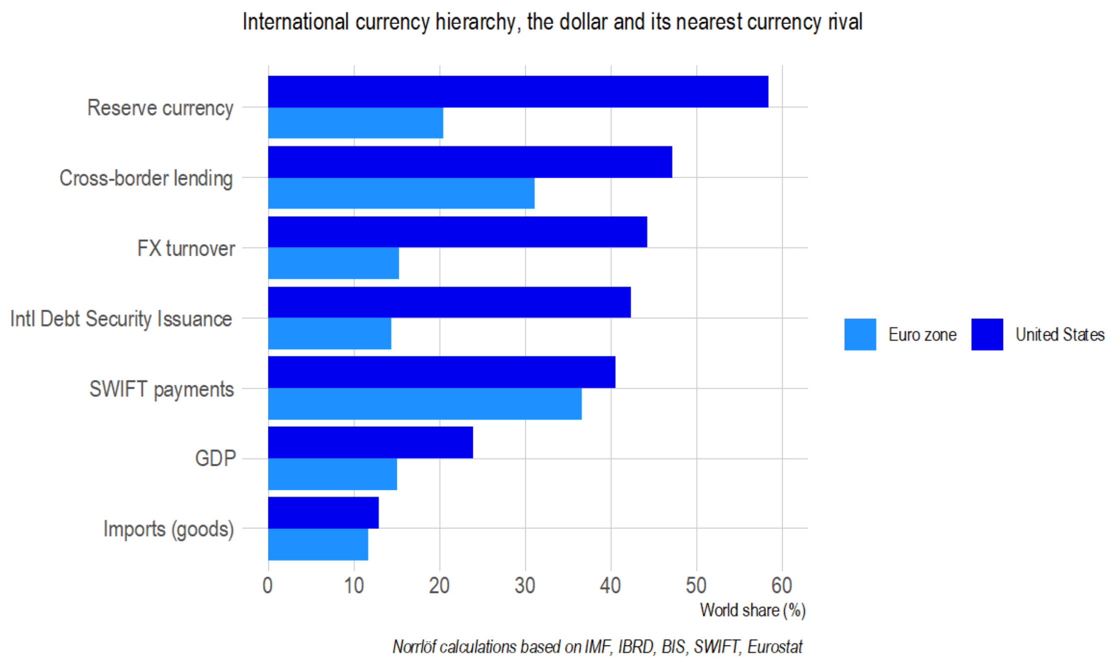
Over the course of half a century, the dollar's reserve currency role was strongest in the years following the collapse of the Bretton Woods dollar standard when President Nixon abandoned the promise to convert dollar reserves into gold –the 1971 Nixon shock. Regardless of which measure of dominance is used—polarity or systemic concentration—the dollar is significantly lower today than it was in 1973. However, the dollar's reserve currency role is stronger than it was in 1990 when the Cold War ended. In a fifty-year perspective, the dollar reached a low point at that time, a period otherwise considered to mark the onset of America's unipolar moment.[3] Clearly, the level of reserve currency holdings in a single year, or within a limited time frame, is not a good predictor of US ascendancy or decline in any broader sense. Point estimates of reserve currency holdings are not a good predictor of dollar dominance either. That is because the liquidity creating role, assumed by the issuer of the first international currency, requires adjustment of expansionary policies, resulting in cycles of trade deficits when demand for dollar assets is typically high and deficit adjustment when dollar demand tends to fall. Depending on the measure used to assess dollar dominance, the most recent downward dollar cycle began in 2016 (polarity) or 2017 (concentration). According to both measures, an upward cycle began in 2020 and stabilized despite the 2022 sanctions against Russia.

The dollar's many international roles

The dollar's reserve currency role is used synonymously with the dollar's ability to fulfill the range of currency functions—as medium of exchange, unit of account and store of value—for governments and private actors. This shorthand reflects the view that governments' willingness to accumulate dollar reserves is a condition for the longevity of the dollar system. For example, in times of crisis, when dollar shortages occur, private actors rely on their central banks to supply them with dollar assets, sometimes via swap lines extended by the Federal Reserve. Private actors' willingness to use and hold dollars is necessary for the dollar system's reach and entrenchment, but private entities coexist within a decentralized system. Their actions are not as consequential as those of official actors because each single entity typically holds a small slice of dollar assets. Even the considerable dollar assets held within large financial institutions consist of deposits by separate entities without any means or incentives to coordinate actions apart from inadvertently via the price mechanism. Unlike official actors, private actors' choice of foreign currency is exclusively an economic decision. Moreover, they are unlikely to act collectively with the aim of disrupting the system. As shown below in Figure 2, the reserve currency role is where the US has the biggest lead relative to its nearest currency rival, the euro-zone.

[3] Charles Krauthammer, 'The Unipolar Moment', *Foreign Affairs* 70:1, 1990.

Figure 2. Full-spectrum dollar dominance



How the dollar became dominant

The dollar rose to the top of the international currency hierarchy after WWI, superseding the British pound which regained its number one position in the interwar years before permanently losing currency primacy to the United States after WWII.[4] After WWI, devastated European countries began relying on the United States for loans to rebuild their war-torn economies. The United States gradually became banker to the world with New York emerging as a financial center on a par with London. The stock market crash of 1929 and the ensuing Great Depression hit the US hard, and the international role of the dollar declined between the two world wars. The 1944 Bretton Woods Agreement created a dollar-based system in which all currencies were pegged to the dollar and the dollar was pegged to gold, convertible at the rate of $35 an ounce. WWII decimated European industry, which the United States helped rebuild through the Marshall Plan with large-scale investments and merchandise exports to Europe.

The United States' strong economic lead after the two world wars, Europe's dependence on the United States to resuscitate its ailing economies along with the 1944 Bretton Woods agreement on the dollar-gold standard created the conditions for dollar dominance. Dollar primacy continued even as the United States broke away from the system which established the dollar's prominent role. The Bretton Woods system capped US trade deficits at levels compatible with the United States' ability to liquidate foreign dollar holdings through gold conversion. When the United States shook off the constraints reflected by gold conversion, the dollar system did not end. The 1971 Nixon shock simply decoupled the

[4] Barry Eichengreen and Marc Flandreau, 'The Rise and Fall of the Dollar (or when did the Dollar Replace Sterling as the Leading Reserve Currency?)', *European Review of Economic History* 13, 2009.

dollar from gold and replaced the gold constraint on US trade deficits with inflation and dollar depreciation.

The role of trade & oil

The dollar's international role initially coincided with US trade surpluses as European countries absorbed American goods. As the European economies grew, demand for US assets grew, and the trade dynamic was reversed. US trade deficit pressures started to undermine the Bretton Woods dollar standard as predicted by the economist Robert D. Triffin.[5] In his testimony to the US Congress, Triffin pointed to the contradiction between the United States' liquidity provision and confidence in the dollar. The United States exported dollar assets, which were held abroad as foreign reserves, creating the liquidity needed to fuel economic growth. Dollar exports generated foreign investment in the United States leading to trade deficit pressures. In this case, the large supply of dollars undermined confidence in the dollar, particularly the United States' ability to honor dollar conversion into gold, potentially jeopardizing the dollar standard. On the other hand, had the United States not accepted to run trade deficits the main source of international liquidity would run dry, which risked undermining international economic growth with destabilizing consequences. The United States' liquidity provision was required for continued growth but in conflict with the long-term prospects of the dollar's international role. Triffin predicted the breakdown of the Bretton Woods dollar system, and the dilemma remains relevant for the relationship between the United States' liquidity creating role and confidence in the dollar. In the 1970s, oil and other commodities began to be priced in dollars, creating incentives for official and private actors to settle payments in dollars and therefore store value in dollars.

Threats to dollar dominance

The dollar remains dominant due to economic fundamentals and the history of using dollars, favoring future use because everyone else is using dollars. Supporting the dollar's international role are factors such as the size of the US economy, its commercial and financial markets (see Figure 2), the liquidity, depth, breadth and openness of US financial markets, the dollar's convertibility, relative stability and sound macroeconomic policies. The economic policies underpinning issuance of the primary international currency has not been flawless, but the historical record does not need to be perfect for the historical record to support the dollar's continued use. The network effects of plugging into the dollar system due to the liquidity, depth and breadth of the market for dollars creates an incumbency advantage, which is hard to overcome. In the absence of major economic or geopolitical upheaval, inertia disincentivizes a major switch to alternative currencies. Political factors could also impinge on the dollar's role. For example, strong political institutions and property rights protection contribute to shoring up confidence in the US economy. Security ties to the United States are also said to have favored dollar use in the early Cold War days. US sanctions to uphold the liberal international order invite dollar support from states backing the order. On the flip side, an erosion of US political institutions, a weakening or reduced need for US security guarantees, or alternatively a sanctions backlash would likely reduce dollar support.

Unless political developments within the United States, or US foreign policies, radically shake confidence in the United States and access to dollars, economic factors are more likely to determine the fate of the dollar system.

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[5] Robert Triffin, *Gold and the Dollar Crisis* (New Haven: Yale University Press, 1960).

US decline …

America's relative economic decline has been debated for at least 60 years. In the 1960s, Organski predicted China's inevitable rise as a systemic leader and noted India's likely emergence as a great power.[6] In the 1980s, Paul Kennedy famously predicted that the United States would lose the superpower competition with the Soviet Union due to military overstretch.[7] And an emphasis on competition in the era of economic interdependence led to repeated warnings about the United States' ability to maintain its edge over rising economic powers, notably Europe and Japan.[8]

The US has declined relative to other great powers along various dimensions but remains the absolute strongest power across most dimensions. China's GDP is nearly 80 percent of US GDP, and its goods imports are roughly equivalent to US goods imports. However, China's financial markets are nowhere near the size or sophistication of US financial markets and China's yuan accounts for less than 3 percent of foreign exchange reserves. The euro area is a closer competitor to the dollar. Euro area GDP is approximately 60 percent of US GDP, goods imports account for some 90 percent of US goods imports and euro area financial markets are both advanced and large. The euro is the second strongest reserve currency, accounting for approximately 20 percent of foreign exchange reserves compared to the dollar's 60 percent share.

US domestic economic policies

While the dollar enjoys an extraordinary lead over other international currencies, it is not invincible. Poor domestic policies could shake confidence in the dollar. Structurally, the United States' liquidity creating role, providing dollar assets to the rest of the world and the ability to invest in the United States can interact unfavorably with low savings in the United States, resulting in large deficits, rising public and, or private debt. Unlike the euro-zone, however, the United States does not face the prospect of involuntary sovereign default because the dollar is a convertible sovereign currency. The recent specter of US default, a possibility which arises periodically, is entirely voluntary and due to a self-imposed debt ceiling. In the United States, the upper bound of the debt limit is rather determined by foreigners' willingness to hold dollars, at worst resulting in inflation and depreciation. Although the United States cannot be forced to default, such an adjustment process may not be benign.

Geopolitical challenges

There have been few deliberate attempts to unseat the dollar as the first international currency. In the early 21st century, Iraq and Iran discussed switching oil pricing from dollars to euros with a view to reducing dependence on the dollar system, a response to US sanctions and interventions in the Middle East. More recently, an anti-dollar counter-coalition centered around the BRICs countries has emerged. The inclusion of China and Russia, and large emerging economies, presents a more potent challenge to dollar dominance than in the past. If sanctions backlash, or some other development, leaves other countries dissatisfied, the counter-coalition could grow and pose a more acute defiance against the dollar system.

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[6] A. F. K Organski, *World Politics* (New York: Alfred A. Knopf, 1968 [1958]).
[7] Paul Kennedy, *The Rise and Fall of the Great Powers: Economic Change and Military Conflict from 1500 to 2000* (New York: Random House, 1987).
[8] R. Rosecrance, *The Rise of the Trading State* (New York: Basic Books, 1986) Lester Thurow, *Head to Head: The Coming Economic Battle Among Japan, Europe and America* (New York: William Morrow, 1992).

Rising US public debt, high inflation and other key developments are unfolding in a strategic setting reminiscent of the Cold War environment. The most striking parallel is the return of great-power rivalries and policymakers' preoccupation with security concerns, which are taking precedence over economic efficiency. Fears about economic decoupling, deglobalization, and fragmentation abound. On the monetary front, the worry is that countries anticipating US sanctions will move preemptively to reduce their dependence on the dollar.

China and Russia have been especially energetic in pushing alternative currencies and building a multinational financial infrastructure for trade and investment in renminbi and rubles. For example, China's Cross-Border Interbank Payment System (CIPS) acts as a clearing house similar to the US Clearing House Interbank Payments System (CHIPS).[9] CIPS processes a mere 15,000 transactions per day, amounting to the dollar equivalent of $50 billion, whereas CHIPS processes 25,000 transactions per day, with a value exceeding $1.5 trillion. The CIPS initiative has nonetheless laid the groundwork to clear and settle more cross-border exchange in renminbi. When China launches a financial messaging system capable of working independently from the Society for Worldwide Interbank Financial Telecommunication (SWIFT), it will have its own complete, autonomous architecture for settling cross-border transactions denominated in its own currency.

For its part, Russia has already taken steps to bypass SWIFT, creating its System for Transfer of Financial Messages (SPFS) after its illegal annexation of Crimea in 2014. Russia's central bank claims that demand for SPFS has increased significantly since last year's full-scale invasion of Ukraine. At the time, however, the system had only around 400 users.

Still, owing to new payments infrastructure and various bilateral agreements, pursuing trade and investment in non-Western currencies has become somewhat easier. Russia and China have agreed to trade in renminbi; and, reviving the Cold War-era rupee-ruble mechanism, Russia and India were planning to trade in their own currencies following Russia's invasion of Ukraine. However, that effort was recently discontinued, with both countries settling on using the United Arab Emirates' dirham instead. All told, such use of alternative currencies by third countries remains small. While the renminbi is being used to settle a Russian investment in a nuclear-power plant in Bangladesh, other examples are scarce.

Governments are also making plans to move away from pricing oil in dollars, although the significance of this development is easily overstated. Oil may be one of the world's leading export products, but it ultimately accounts for a small share of global trade.

More broadly, because international currencies are, by definition, used by third countries, adopting a trade or investment partner's currency will not necessarily raise that currency's international role, even if it does reduce the greenback's relative role in cases where those transactions were previously denominated in dollars.

Those predicting the end of dollar hegemony also point to China's own use of bilateral swap lines to allow foreign central banks to acquire renminbi in exchange for their own currency. Making renminbi available to foreign governments is a prerequisite for its use by public and private actors, and the ability to act as lender of last resort in times of crisis is a key reserve-currency function.

[9] Emily Jin and Lizzi C. Lee, 'CIPS vs. CHIPS: China's alternative to the U.S.-dominated financial system | Live with Lizzi Lee', The China Project, New York, October 31, 2022.

China has also been maneuvering to expand its institutional footprint, such as by introducing an emergency renminbi liquidity arrangement under the auspices of the Bank for International Settlements (BIS). Similarly, the basket of currencies underpinning the International Monetary Fund's special drawing rights (SDR, the IMF's reserve asset), now includes the renminbi, alongside the dollar, yen, euro, and pound sterling. And the BRICS (Brazil, Russia, India, China, and South Africa) have also discussed ways to push back against dollar hegemony, such as by issuing a joint reserve currency to bypass the dollar and other major Western currencies (as well as offering an alternative to SDR).

Finally, one of the most eagerly anticipated technological developments in this area is China's creation of digital payment alternatives. China's central bank introduced a digital currency, the e-CNY, in 2016 and offered this payment option to participants at the 2022 Olympics in Beijing. When fully implemented, the e-CNY will function independently of other payment and financial-messaging systems. By offering cheaper, faster, and safer transactions, a Chinese digital currency could make the renminbi more attractive and therefore more widely accessible and liquid. Promoting the e-CNY for trade and investment could accelerate renminbi internationalization.

But underlying trade and investment patterns must change before the global currency hierarchy does. Here, the China-centered Regional Comprehensive Economic Partnership, as well as China's Belt and Road Initiative, could help internationalize the renminbi by multiplying economic interactions and encouraging renminbi use in third-country trade and investment. Still, in the medium term, renminbi internationalization is likely to encounter substantial hurdles, owing to China's maintenance of capital controls and broader balance-of-payments constraints.

Why sanctions are an unlikely tipping point for dollar dominance

Following Russia's invasion of Ukraine, geopolitical blowback is widely seen as threatening dollar dominance. To fully grasp what today's turbulence means for the dollar system, we must however move beyond the motivations of countries targeted by sanctions. Many countries benefit from US currency coercion because they share the core principles behind US sanctions. Countries supporting sanctions on Russia have strong geopolitical incentives to continue holding and using dollars for international reserve and payment purposes. Supporting the dollar reinforces the constraining impact of the sanctions and helps ensure their future effectiveness. The economic incentives these governments previously had to diversify away from traditional currencies, particularly the U.S. dollar must now be weighed against their geopolitical incentives to hold dollars. Together, the coalition arrayed against Russia accounts for more than 90 percent of global currency reserves, approximately 80 percent of global investment, and 60 percent of world trade and world economic output. Overcoming that dominance would be difficult even if every country that has declined to sanction Russia fell in line behind an organized anti-dollar coalition. Moreover, countries not participating in sanctions against Russia do not necessarily disagree with the goals behind them: ending the war in Ukraine and deterring future territorial aggression. The coalition behind the sanctions against Russia is broad, wealthy, and militarily powerful, and its objective of ending Russia's barbarous war is widely shared, even by those not participating in the sanctions. Geopolitically induced dollar support is rather likely to stabilize dollar holdings.[10]

[10] Carla Norrlöf, 'Will Economic Statecraft Threaten Western Currency Dominance? Sanctions, Geopolitics, and the Global Monetary Order', Atlantic Council, Atlantik-Brücke, September 2022 Colin Weiss, 'Geopolitics and the U.S. Dollar's Future as a Reserve Currency', International Finance Discussion Paper Federal Reserve, October 2022.

Having noted the relationship between sanctions and dollar dominance a decade ago, I am not suggesting there is no possible scenario in which sanctions threaten dollar hegemony, simply that the Russia sanctions are highly unlikely to represent such a tipping point.[11] Sanctions should be designed to prevent the unipolar currency order from further eroding. For example, by building broad sanctions coalitions in which participation is strictly voluntary and without forcing countries to choose sides. Sanctions can be costly for third parties. Whenever possible, steps should be taken to alleviate unintended consequences. In addition, sanctions should be reserved for clear-cut cases in which the international order is under threat, as in Ukraine, and should not be used for parochial purposes, as when sanctions were reinstated against Iran in 2018, even though Iran had not broken the terms of the nuclear deal, or when the Trump administration imposed overly harsh sanctions on Cuba. Imposing sanctions to pursue narrow U.S. interests raises legitimate fears among countries that they could be targeted next, motivating them to find alternatives to the dollar. Using sanctions to preserve the central elements of the liberal international order is a goal many countries can subscribe to, or at least tolerate, leaving the dollar as their continued currency of choice.

Other geo-political drivers …

Sanctions risk is not the only geopolitical factor shaping dollar use. In today's fraught international environment, countries question the wisdom of system-wide economic interdependence and privilege economic ties with friends. As security concerns eclipse economic concerns, the United States and Europe are limiting their economic dependence on foreign adversaries and pushing to relocate manufacturing and supply chains to allied nations in what has come to be known as "friend shoring." Just as countries are beginning to source goods and inputs from friendly nations, they may very well adopt the currencies of friendly nations. We should therefore expect a return to the Cold War logic in which economic relations more frequently align with security relations. With the United States at the bullseye of the largest security network in the world, the dollar stands to benefit from this shift. As during the Cold War, US security provision may induce allied dollar support.

Concluding remarks

In short, the size of the sanctioning coalition, the number of nonparticipating sanctions supporters, and the number of countries under the U.S. security umbrella, make large-scale currency diversification away from the dollar unlikely, at least in response to the Russia sanctions. To preserve the existing currency hierarchy and limit the long-term trend towards currency multipolarity, the US must adopt sound economic policies and use economic statecraft to promote the public good of international order from which most countries stand to benefit. The US cannot afford to alienate key allies, or a large portion of the international community, and simultaneously preserve the unipolar dollar era over the long term. For the first time since the collapse of the Bretton Woods gold standard, we are seeing a systemic limit on the dollar centered economic order and US foreign policy.

[11] Carla Norrlof, 'Dollar Hegemony: A Power Analysis', *Review of International Political Economy* 21:5, 2014.