De-dollarisation in Russia & China: Implications & Challenges

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Abstract

De-dollarisation refers to the reduction in the dominance of the US Dollar in the international market. Under this, the US Dollar is replaced by other currencies for the purpose of carrying out trade, maintaining forex reserves, negotiating and implementing bilateral trade agreements, etc.

Due to the current geopolitical risks, central banks around the world are resorting to de-dollarisation in order to ensure the smooth functioning of their economies and reduce the impact of external shocks on their respective economies. Russia and China- the leading rivals of the United States have started the process of de-dollarisation to enjoy economic autonomy and to reduce the effects of sanctions imposed by the US. China and Russia are about to introduce a new payment system that will combine the Russian System for Transfer of Financial Messages (SPFS) with the Chinese Cross-Border Interbank Payment System (CIPS).

This paper aims to analyse the impact of de-dollarisation on the popularity of the US Dollar as the world's reserve currency. It also focuses on the challenges that Russia and China are likely to face in convincing their trade partners to switch to alternative currencies for trade and maintenance of forex reserves.

Keywords: De-dollarisation, US Dollar, Russia, China, currency, forex reserves

Methodology

This research paper is qualitative in nature. Qualitative approach has been chosen as the scope of the research was mainly theoretical and explanatory. Secondary data sources like research papers, articles, policy papers, IMF reports and data published by People's Bank of China and Russian central bank have been used.

Literature Review

Dr Chandra Rekha in her paper titled 'De-Dollarisation, De-Offshorisation and Diversification' de-dollarization, if it succeeds will have a major impact on US currency value in Russia. This will in turn devalue the US dollar position which will dethrone the 'petrodollar' (means for settling international trading in oil). Alongside Russia, countries like China are intended to weaken the petrodollar by promoting the use of their own currencies for trading oil and for other commercial transactions which will come in the form of bi-lateral currency agreements.

According to Mihaela Papa (The Anti-Dollar Axis: Russia and China's Plans to Evade U.S. Economic Power, Mar 2022), China is committed to diversifying its foreign exchange reserves, encouraging more transactions in yuan, and reforming the global currency system through changes in the International Monetary Fund further buttresses Russia's strategy. Deteriorating US-China relations incentivize Beijing to join with Moscow in building a credible global financial system that excludes the United States.

De-dollarization emerged as a priority for Russia in 2014 in response to the imposition of Western sanctions following the annexation of Crimea that limited the ability of state firms and banks to raise financing in Western markets. China also began seeing value in this initiative after the onset of the US-China trade war in 2018 and the use of punitive financial measures by the US (Russia and China: Partners in Dedollarization; Mrugank Bhusari and Maia Nikoladze).

In the opinion of Todd J. Stein (How Western sanctions could make China the winner of the war in Ukraine, Mar 2022), China need not replace the dollar with the yuan to achieve its goal of weakening U.S. influence over the global economy. Its foreign currency reserves, its dominating position in global manufacturing and its access to raw materials, including rare earth, may give it sufficient leverage to assert the yuan as a reserve currency capable of at least standing alongside the dollar and breaking its 78-year run of preeminence.

Zongyuan Zoe Liu and Mihaela Papa ('Can BRICS De-dollarize the Global Financial System?', Cambridge University Press, February 2022) have stated that there have been clear leaders within BRICS attempting to steer the group toward a de-dollarization coalition, namely Russia and China. The followers in BRICS de-dollarization coalition are neither passive nor silent. Brazil, India, and South Africa have all supported BRICS joint statements on reforming the existing dollar-centered global financial system over the past two decades. Moreover, they each have also sought opportunities to promote the use of local currencies in international trade and development financing. Their consensus and practices concerning de-dollarization suggest that de-dollarization does not only take place in countries that are in geopolitical competition with the United States or under US sanctions. Rather, de-dollarization is important for developing countries that are price takers in global markets and lack autonomy in controlling their own economic security. Therefore, it is a real priority for these countries to diversify and reduce their risk exposure to exogenous shocks and exchange volatilities due to the US dollar's dominance.

Introduction

Under the Bretton Woods System, countries expressed the value of their currency in terms of dollars. The parity value of currencies, in turn, determined the exchange rate. The currencies were convertible into gold through the US Dollar at $35 per ounce of gold. Thus, the dollar became the official reserve currency globally in 1944. Therefore, the countries demanded an increased amount of dollars to maintain it as a reserve. This led to increased deficits for the US. Countries had to maintain the exchange rate within a narrow band fixed by the IMF and hence needed dollars to intervene in the forex market to maintain exchange rate stability.

However, countries became doubtful about the ability of the US to convert dollars into gold. France became the first country to convert its dollar reserves into gold in 1962. This further raised doubts about the stability of dollars, due to which more countries demanded the convertibility of their dollar reserves into gold.

The convertibility of dollars into gold was suspended by the US in 1973 because of an inadequate supply of gold to back the number of dollars in circulation. This led to the fall of the Bretton Woods System and the rise of the flexible exchange rate system, which exists today. Most of the countries started pegging their currency to dollars post the fall of the Bretton Woods System.

The dollar has become the world's reserve currency due to the US economy's strength, stability, and size and the domination of US financial markets in the world. According to 2021 estimates of the IMF, central banks worldwide hold around 61% of their forex reserves in dollars, followed by euros. Around 80% of international trade is done in dollars. It also serves as a dominant currency in international finance. Around 40% of global debt is denominated in dollars.

The dollar's global significance reflects the United States' sustained economic and financial leadership. The Fed has repeatedly proved its ability and readiness to shoulder the costs of bolstering the global financial system, especially during crises. During the COVID-19 epidemic, the Fed's actions to provide dollar liquidity to the global economy stabilised international markets.

However, there has been a fall in the share of dollars in the forex reserves of central banks worldwide. This is partly due to competition from other currencies like the Chinese Yuan, Japanese Yen, etc., used by central banks for international transactions. Risks due to the geopolitical conflicts and the rising disputes between the US and its rivals serve as other significant reasons.

This research paper seeks to answer two critical questions:

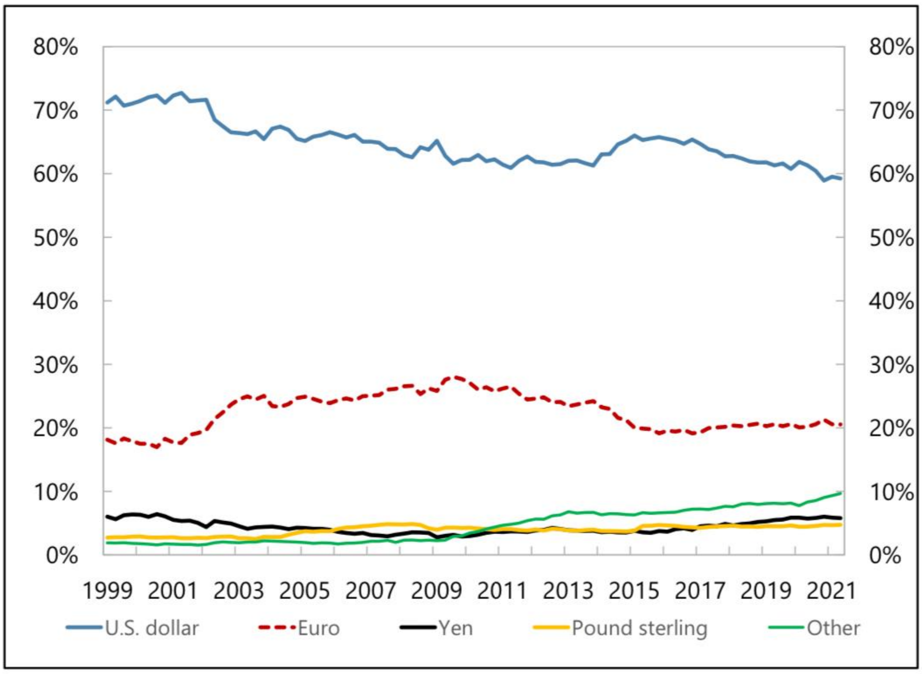
- What are the challenges faced by Russia and China in their de-dollarisation efforts?
- What impact would de-dollarisation have on the eminence of the US Dollar?

Dollarisation Trend

Dollarization can be defined as the holding by residents of a significant share of their assets, in the form of foreign currency-denominated assets. It represents the situation of a foreign currency being used alongside the domestic currency as means of exchange (for transaction purposes, i.e., as currency substitution) or as means of saving in hard currency (i.e., as asset substitution)[1].

- According to the IMF's Currency Composition of Official Foreign Exchange Reserves Survey, there has been a 12 percentage point drop in the share of the US Dollar in the reserves held by central banks globally, since 2000. Its share was 71% in 1999 and then fell to 59% in 2021.

Currency Composition of Global Foreign Exchange Reserves 1999–2021 (in percent)



Sources: IMF Currency Composition of Official Foreign Exchange Reserves (COFER).
Note: The "other" category contains the Australian dollar, the Canadian dollar, the Chinese renminbi, the Swiss franc and other currencies not separately identified in the COFER survey. China became a COFER reporter between 2015 and 2018.

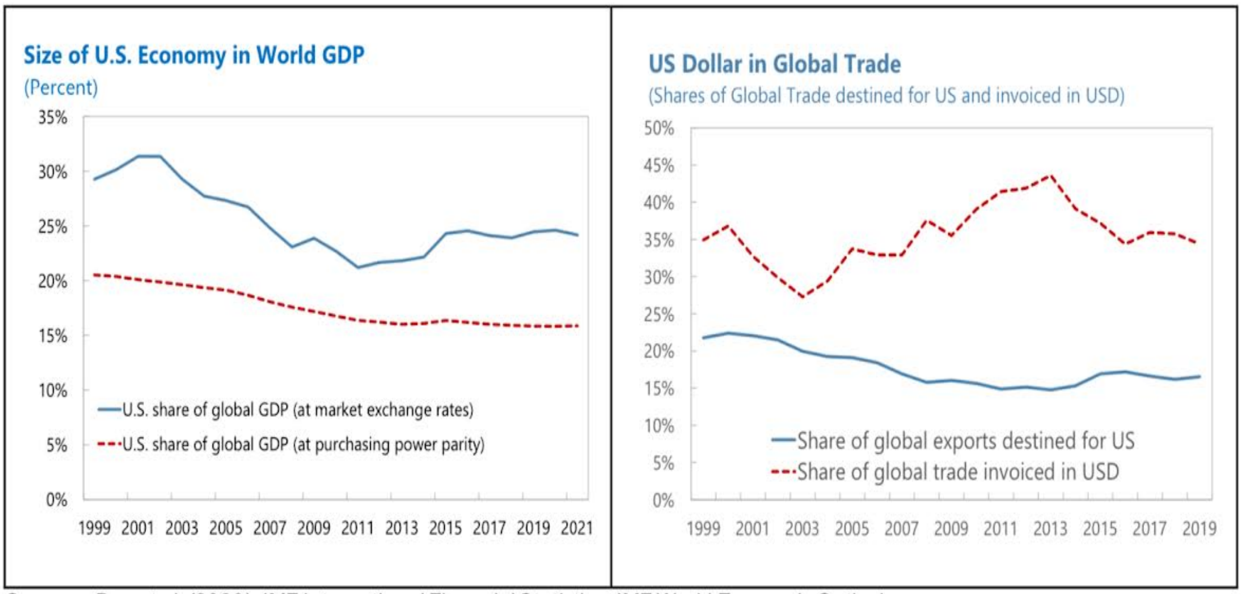
[1] https://www.bbvaresearch.com/wp-content/uploads/mult/WP_0808_tcm348-212943.pdf

However, it can be seen from the figure that the decline in the share of the US Dollar has not been matched by an increase in the share of euros, the British Pound Sterling and the Japanese Yen. Rather, the decline in the share of dollars has been matched by a 10% rise in non-traditional currencies like the Chinese Yuan, the Canadian dollar and others.

This rise has been due to increased liquidity of these currencies, diversification of the portfolio of assets by central banks, increased network of currency swaps and search for higher yield alternatives by central banks worldwide.

- There has been a fall in the share of the US Dollar in global GDP both at the market exchange rate and purchasing power parity since 1999. However, its share in GDP at the market exchange rate rose slightly after 2015. The share of global exports destined for the US fell over this period along with a fall in its share in the global forex reserves. However, there has been some rise in exports to the US during the period 2015-17 as the share of US Dollar increased in global reserves during the same period.

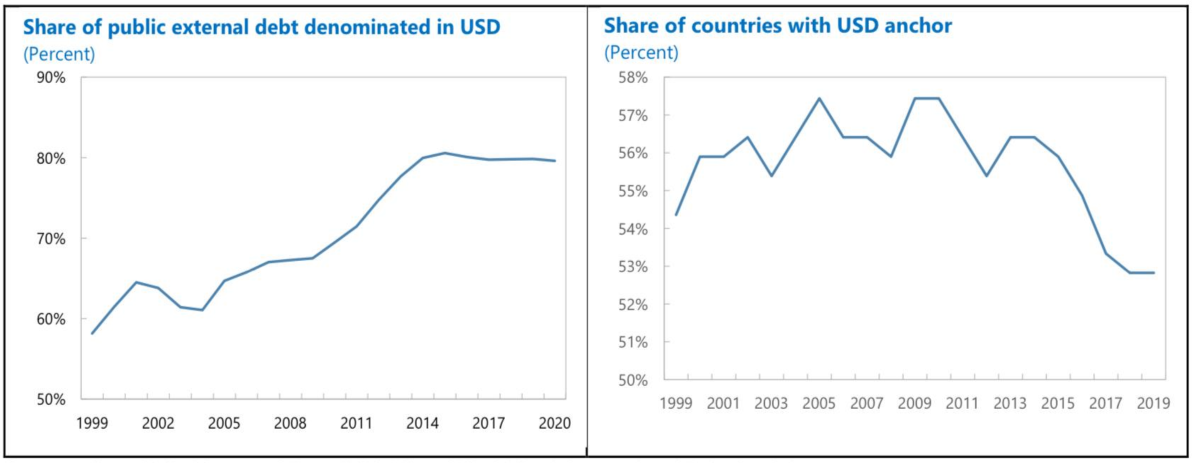
Standard Determinants of US Dollar Share of Reserves



Sources: Boz et al. (2020), IMF International Financial Statistics, IMF World Economic Outlook.
Note: The share of the US dollar in global trade is based on calculations using the Boz et al. (2020) dataset and the IMF's International Financial Statistics.

- The share of public external debts denominated in US Dollars has risen post 2012. However, there has been a decline in share of countries pegging their currencies to US Dollar post after 2014.

Additional Determinants of US Dollar Share of Reserves, 1999–2020



Sources: Ilzetski, Reinhart and Rogoff (2019) and World Bank International Debt Statistics.
Note: The share of global external debt denominated in US dollars is calculated from the World Bank International Debt Statis tics. The share of countries with a US dollar anchor come from Ilzetski, Reinhart and Rogoff (2019).

De-dollarisation wave

Various factors have led to de-dollarisation around the world. Some of these reasons include-

- The US uses its currency as a tool to achieve its foreign policy objectives. The US restricts access to its financial and payment mechanism by the rival countries, which affects the stability and growth of these countries.

- Trade sanctions are being used by the United States as a substitute for military action to affect its adversaries. Thus, to reduce the impact of these trade sanctions on their respective economies, central banks of various countries have started resorting to alternative payment settlement mechanisms which involve use of currencies other than the US Dollar.

- Rise of economies like China and India in Asian region have raised the importance of these countries. Share of the Chinese Yuan in global reserve currency has risen significantly since 2016.

- To protect themselves from geopolitical risks, de-dollarisation efforts have been undertaken by the countries globally.

- Because US sanctions affect around 10% of countries and a quarter of the global population, the de-dollarization idea is gaining traction around the world.

What is SWIFT?

The Society for Worldwide Interbank Financial Telecommunications (SWIFT), which was founded in 1973 and now has 239 members from 15 countries, is not a payment system, but rather an international language for banking communications that allows banks from different countries to communicate with one another. SWIFT solely manages the transmission system of banking information exchange-only communications from a legal standpoint. SWIFT will have around 11,000 institutional members from over 200 countries and territories by 2022.

SWIFT outperforms competing transaction systems due to its widespread adoption and ever-evolving platform, which combines ease of use with security. The great majority of SWIFT transactions are settled in US dollars, bolstering the dollar's position as the world's reserve currency. It also gives the US an unfair advantage over SWIFT.

De-dollarization efforts by Russia

The G7 nations have imposed various severe economic measures against Russia in response to Russia's military operation in Ukraine in February 2022. The Russian economy has entered an unparalleled economic depression as a result of additional economic sanctions, limitations, and high-tech export bans. With the depreciation of the rouble and the freezing of a significant portion of the Central Bank of Russia's forex reserves, Russia faces the threat of high inflation as well as divestment by foreign entities. Thus, to reduce the impact of these financial sanctions on its economy, the Russian government has accelerated its de-dollarisation efforts.

Russia has emerged as the country with the most aggressive de-dollarization policies. When the United States imposed sanctions on Russia in reaction to Russia's invasion of Ukraine in 2014, the Russian government expedited its de-dollarization efforts. Russian President Vladimir Putin has advocated for the dedollarization of the Russian economy to protect it from current and future US sanctions.

Following steps have been taken by Russia in the direction of de-dollarization:

- Russia's government cut its own dollar holdings. Between 2013 and 2020, Russia's central bank reduced the share of its reserves denominated in dollars by more than half. In July 2021, Russia's finance minister announced plans to remove all dollar-denominated assets from the country's sovereign wealth fund, which accounted for almost a third of the $186 billion fund[2].

- In 2019, then-Russian Prime Minister Dmitry Medvedev encouraged Russia's allies to work together on a system to move to the use of national currencies in transactions between Shanghai Cooperation Organisation countries (SCO).

- Russia has also taken the lead in this effort, developing its own financial messaging system, SPFS (System for Transfer of Financial Messages), as well as a new national electronic payment system in 2015, when payment processing businesses based in the United States refused to provide services to certain Russian banks subject to US sanctions.

- While US dollars accounted for 80 percent of Russia's overall exports in 2013, they now account for just over half of the country's total exports. Its trade with China absorbed the most of the drop.

- Efforts are being made to introduce a new Russia-China payment system that would bypass SWIFT and combine the Russian SPFS (System for Transfer of Financial Messages) with the Chinese CIPS (Cross-Border Interbank Payment System).

- In the sphere of digital currency, Russia has made significant progress, with the Russian digital financial assets law taking effect in 2021. These advances

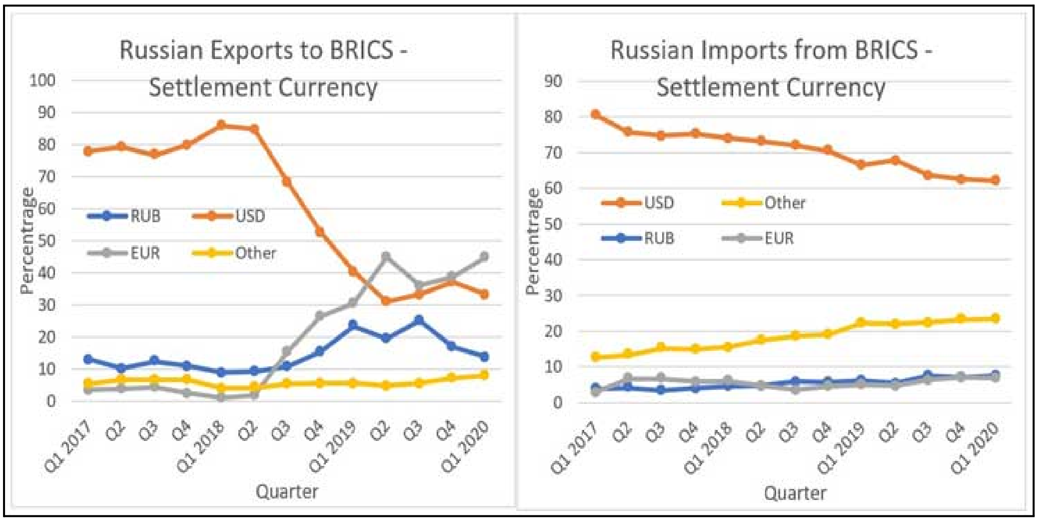
[2] https://crsreports.congress.gov/product/pdf/IF/IF11885

will aid Russia's de-dollarization efforts by allowing it to acquire certain advantages in digital currency.

- To evade economic sanctions under the Countering America's Adversaries Through Sanctions Act, India and Russia have established a rupee-ruble exchange mechanism to settle Russian weaponry purchases to India (CAATSA). According to the Stockholm International Peace Research Institute, Russia accounted for 49.4 percent of Indian arms purchases between 2016 and 2020, while India consumed roughly 23% of Russian arms exports. In 2019, Russia and India agreed to settle India's acquisition of Russian S-400 air defence systems for more than $5 billion via a rupee-ruble transfer in order to avoid CAATSA sanctions[3].

- Russian enterprises that aren't immediately affected by US sanctions have been working hard to build other payment systems as a hedge against the dollar's supremacy. Since 2018, Alrosa PJSC, the world's largest producer of rough diamonds in terms of carats, has successfully tested ruble payment with international clients from India and China.

- The percentage of Russian exports to BRICS nations that are settled in dollars has dropped from over 80% in Q1 2018 to 33.2 percent in the first quarter of 2020. While Russian exports to the BRICS have recently de-dollarized, it is clear that the Euro has supplanted the dollar as the major export settlement currency.

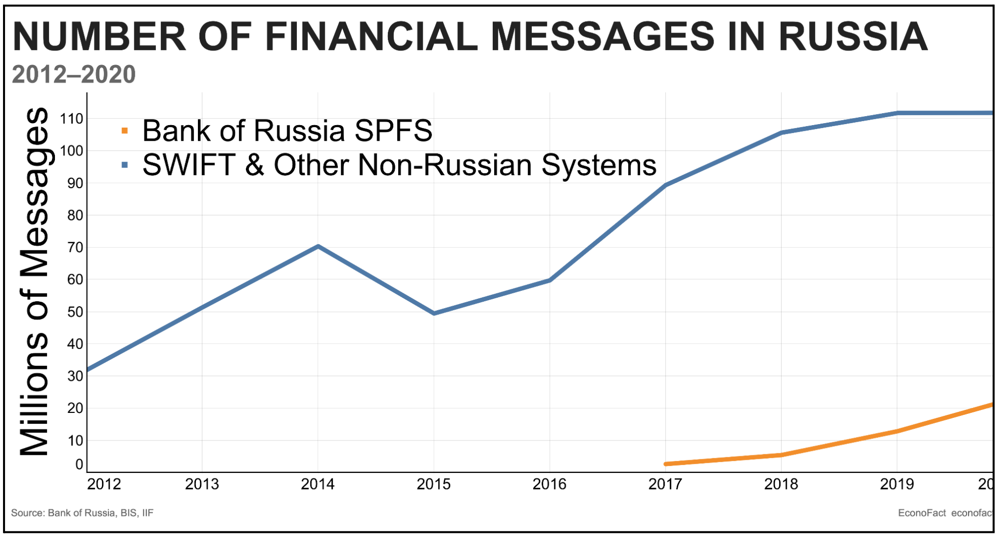


Russian System for Transfer of Financial Messages (SPFS)

Because several Russian banks had been cut off from the SWIFT global payment system due to US and European Union sanctions after Russia invaded Crimea in

[3] https://www.cfr.org/blog/besides-china-putin-has-another-potential-de-dollarization-partner-asia

2014, Russia's central bank had decided to allow its domestic payment system to go worldwide. Despite Russia's second-largest number of SWIFT customers behind the United States, the Bank of Russia's Financial Message Transfer System (SPFS) is gaining traction.



The Russian Central Bank built the payment system, which had previously solely served domestic users, in 2014 after the US threatened to cut Moscow off from the SWIFT system. Belarus, which shares borders with both Russia and Ukraine, has started detaching its banking systems from the SWIFT network.

The SPFS network already has over 399 users, and Russia is in negotiations with China to join the SPFS. Over 20 Belarusian banks, the Armenian Arshidbank, and the Kyrgyz Bank of Asia have also joined it. The SPFS also boasts of conducting over 2 million messages monthly in 2020, which would place it 20.6% ahead of SWIFT.

The Russian government is also in talks with developing countries like Turkey and Iran to promote SPFS. The SPFS system is viewed as a last option rather than a replacement for the SWIFT network because of its shortcomings. Since 2019, a number of agreements have been negotiated to link SPFS to the financial systems of other nations, including China, India, Iran, and countries within the Eurasian Economic Union that aim to use SPFS directly.

De-dollarisation in China

Growing imports and exports, Belt and Road Initiative, a global network of renminbi currency swaps and official clearing banks, and the renminbi's inclusion in the Special Drawing Rights (SDR) basket has assisted China's currency internationalisation.

Rather than promoting the Chinese national currency, the Renminbi (RMB), Beijing is attempting to become the first country to launch a sovereign digital currency, which would allow China to conduct cross-border transactions without relying on US financial institutions. As a result, virtual currency appears to be China's path to combating dollar supremacy while also enhancing its own clout by paving the way for a new global financial system based on digital currencies.

In designated zones, China is testing the use of foreign exchange and RMB in companies' cash management and as cross-border finance for technological firms.The government has shut down private bitcoin activities and tightened operating restrictions for financial technology service providers such as Alibaba and Tencent ahead of launching the PBOC's digital currency. These companies are part of a select group to which the People's bank of China has entrusted the distribution of its digital currency[4].

The People's Bank of China made a proposal to the Bank for International Settlements in 2021 titled "Global Sovereign Digital Currency Governance" in order to influence global financial norms using their digital currency, the e-Yuan.The director of the PBOC's Digital Currency Research Institute said that the bank intends to be the first major central bank to issue a sovereign digital currency to boost RMB internationalisation and minimise reliance on the dollar.

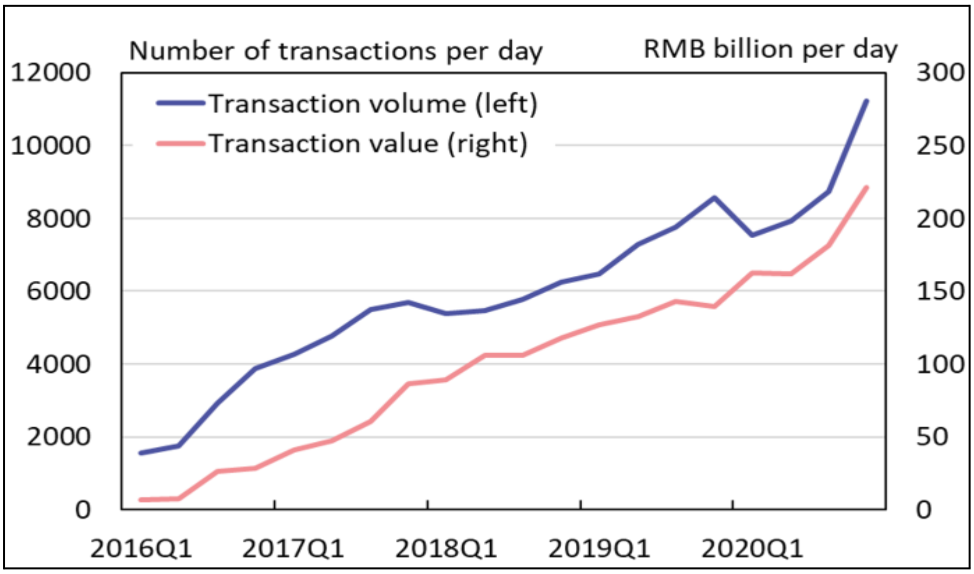
In 2016, the International Monetary Fund (IMF) included Yuan in its SDRs basket (Special Drawing Rights). The Yuan's reserve currency status might climb even further as the globe de-dollarizes. Its proportion of reserve currencies will reach 5% by the end of 2025, meaning a demand for over $300 billion in Yuan. The value of the Yuan could rise if demand for Chinese assets rises, thanks to the yield advantage China government bonds have over their SDR counterparts. De-dollarization could be accelerated as a result of US trade policy, particularly in the Middle East and Russia.

Over the next decade, the Yuan may overtake the pound and the Yen as the world's third-largest reserve currency.

Chinese Cross-Border Interbank Payment System (CIPS)

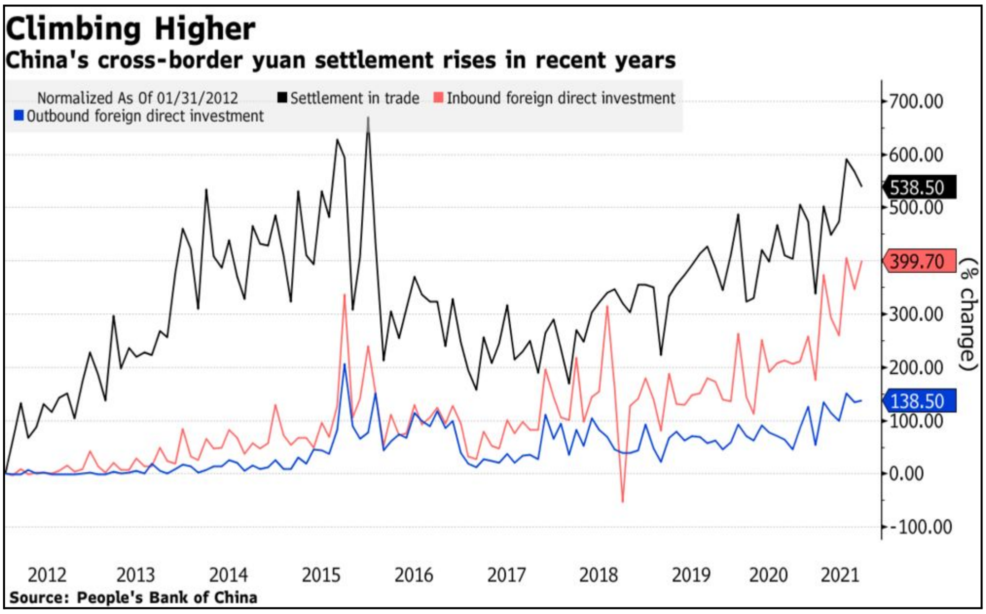
The CIPS system is China's version of the SWIFT system. It enables cross-border yuan settlement and clearing between member banks. It allows members to settle commerce in goods and services, direct investment, finance, and remittances in onshore and offshore yuan without using the SWIFT system.

[4] https://crsreports.congress.gov/product/pdf/IF/IF11885



The Chinese government designed CIPS to promote RMB clearing and settlement onshore and offshore and help them achieve their goal of making the RMB more appealing. It is only concerned with improving China's economic and financial capabilities. Chinese policymakers began working on the CIPS in 2012, and the mechanism was launched in 2015 with the support of SWIFT.

The stated goal of CIPS is to increase RMB internationalisation, but following the SWIFT sanctions on Iran in 2012 and the threatened but never implemented SWIFT



sanctions on Russia in 2014, experts in China's policy community considered CIPS to be even more important as a national security imperative[5].

Challenges faced by Russia and China in their de-dollarisation efforts

The dollar's role as the world's reserve currency allows the U.S. government to refinance its debt at low-interest rates while also giving it foreign policy clout. Approximately 60% of central bank foreign exchange reserves and 70% of global commerce are currently denominated in USD. The USD's reputation as a safe-haven asset includes a psychological component. People continue to regard the currency as a relatively risk-free asset, as they did in the past. Because of this, the USD will continue to be favoured as a store of value and medium of exchange. Furthermore, central banks' rapid dumping of dollar assets will put their balance sheets in danger.

There are various demerits of Russian SPFS. SPFS supports a limited range of financial messages. This means that discussing a full-scale solution at this point is essentially worthless. When linking to SPFS, banks must go through a lengthy process of signing agreements with the Bank of Russia and individual agreements with each system member. Due to technological challenges in connecting to SPFS, the time between signing the agreement and completing the first transaction could be more than a year and a half. Weekends and public holidays and outside of business hours are not permitted for transaction processing.

Russia and China have chosen to use blockchain technology for their central bank-issued and regulated digital currencies. These Central Bank Digital Currencies have no intrinsic advantage over electronically transferred denominated quantities in paper fiat currency counterparts in international trade. CBDCs might conceivably help avoid U.S. financial sanctions. However, another party's willingness to accept the CBDC is not always assured. Whether digital or paper, the value of a currency is determined by how broadly it is accepted, which is currently an unknown variable.

The central bank purchases bonds and bills issued by another country's government by keeping a currency as Forex reserves. Furthermore, a proper foreign exchange. reserve currency should come from a country with a significant current account deficit. Its liabilities must exceed its assets, effectively making it a debtor by choice. The rest of the world is willing to lend to the U.S. because of its trust in its government and economy, which allows it to consume more than it produces. In fact, the United States' continuous current account deficit serves as a source of global liquidity in this way. For decades, China has had a current account surplus. In general, the Chinese economy cannot be a net supplier of liquid assets, at least not at this time.

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[5] https://www.lawfareblog.com/why-chinas-cips-matters-and-not-reasons-you-think

The lack of capital account convertibility in China is another crucial factor that precludes central banks throughout the world from keeping the Yuan as a primary reserve currency. Thanks to capital account convertibility, investors can freely convert their Yuan holdings to foreign currencies and vice versa. For financial transactions, the reverse is true. Due to stringent capital regulations, investors cannot be confident that their money will be safe. They are free to leave the country whenever they want, with no interference from the authorities. During a crisis, China's government can easily put severe limitations on Yuan convertibility.

Due to the reluctance of other central banks to use a digital currency, long-standing international acceptance of reliance on the U.S. dollar in particular sectors (oil and gas), and national security concerns in other countries, China's efforts to develop an alternative currency and financial network may not immediately challenge the dollar's global role.

Analysts at Morgan Stanley said only 1.9% of international payments are made in the Chinese currency, against around 40% for U.S. dollars, which limited the effectiveness of CIPS as a method for funding cross-border trade.

India's Scenario

India is preparing to buy Russian oil at a discount and is exploring using the Chinese Yuan as a reference currency in a payment settlement mechanism between the two countries. According to a recent SBI research, this is a moment of reckoning for the Indian currency (Rupee) and potential for internationalisation of the INR, as countries propose trading in their fiat currencies to circumvent the western world's economic sanctions.

Whether the financial world is governed by SWIFT and the U.S. dollar or by CIPS and the Yuan in China, India will always remain at the mercy of another country. China's financial hegemony is more likely to be terrible for India. Pakistan, Sri Lanka, Nepal, and Bhutan are all heavily influenced by China's economic might. India needs to bolster the defence of its financial systems in the same way that it has strengthened its military. India must expand its financial arsenals to safeguard its sovereignty. Developing India's own SWIFT alternative and a sovereign cryptocurrency could be the most exemplary initial steps.

Conclusion

Even though the dollar's role in the global monetary system has deteriorated in recent years, it isn't easy to swiftly replace it as a reserve currency. However, the United States' exploitation of the dollar's standing has planted seeds of distrust, prompting other countries to rush the development of alternative global financial payment systems. According to analysts, the dollar's global dominance is likely to be weaker than it appears, and a more diverse international monetary system is unfolding.

China and Russia's multi-year, multi-pronged de-dollarization efforts have had modest results. However, if they are able to considerably lessen their reliance on the dollar in the future, such as by growing non-dollar transactions or adopting a digital currency, this could have consequences for the U.S. The dollar's worldwide stature benefits the United States by cutting borrowing costs for the government and giving the country more power in foreign policy.

The goal of the countries may be limited to controlling the dangers associated with dollarization without explicitly attempting to reduce dollarization. Some dollarization may be good. Indeed, in a sufficient prudential environment, countries with credible monetary policies may contemplate liberalising dollar accounts for efficiency reasons.

Countries that allow dollarization but do so in a limited and steady manner only need to ensure that the internal credit risk of dollar loans is adequately controlled. On the other hand, countries with significant dollarization should explore a purposeful de-dollarization approach as a policy alternative.