Thematic Insights

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بنك أبوظبي التجاري
ADCB
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De-dollarization: hard or soft?

- **Thanks to a range of attractive features of the US economy and the USD itself, the greenback has remained the dominant global reserve currency.**
- **As fragmentation and deglobalization risks rise, the dollar dominance is increasingly being questioned.**
- **A hard de-dollarization is almost impossible at this stage, but a soft de-dollarization – in line with the rise of a multi-polar world – is underway.**
- **Even the diminishing-not-disappearing dollar dominance has profound implications for investors over the long-term.**

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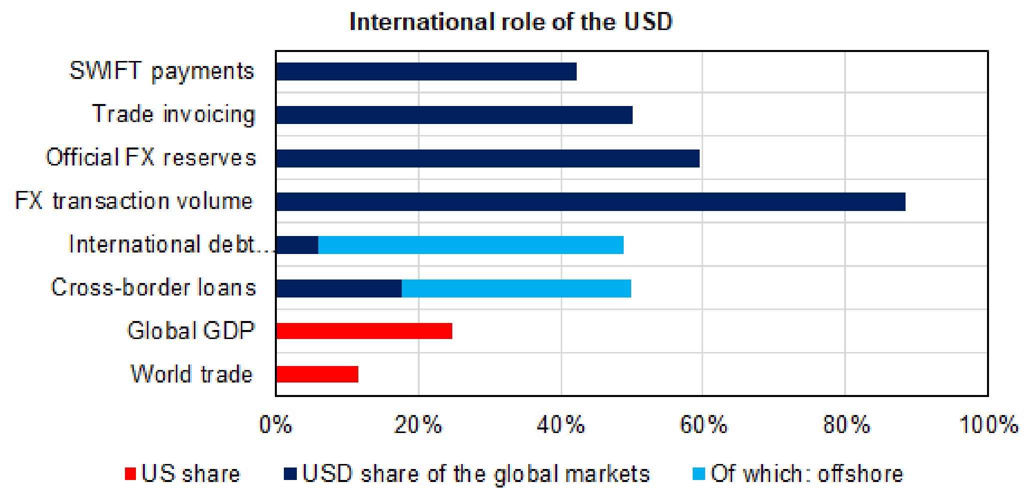
Dollar dominance…

Since the end of the World War-II, the USD dominated the FX landscape by becoming the currency of choice as other countries increasingly held their assets and denominated their liabilities in the US currency. Over 80% of global FX transactions and more than 50% of global trades and payments happen in USD. Half of the cross-border loans are in USD and more than 45% of international debt securities are issued in USD. In both trade invoicing, and SWIFT payments, USD has more than 40% share of the global markets. Further, c60% of official FX reserves are held in USD. All this takes the USD share of the overall FX transaction volume to well over 80%. This extensive use of the USD compares with just under 12% share of US in world trade and its c25% weight in global GDP (exhibit 1).

Exhibit 1: USD share of the global markets dwarfs the US share of global GDP and world trade



Source: Bank for International Settlements, and ADCB Asset Management

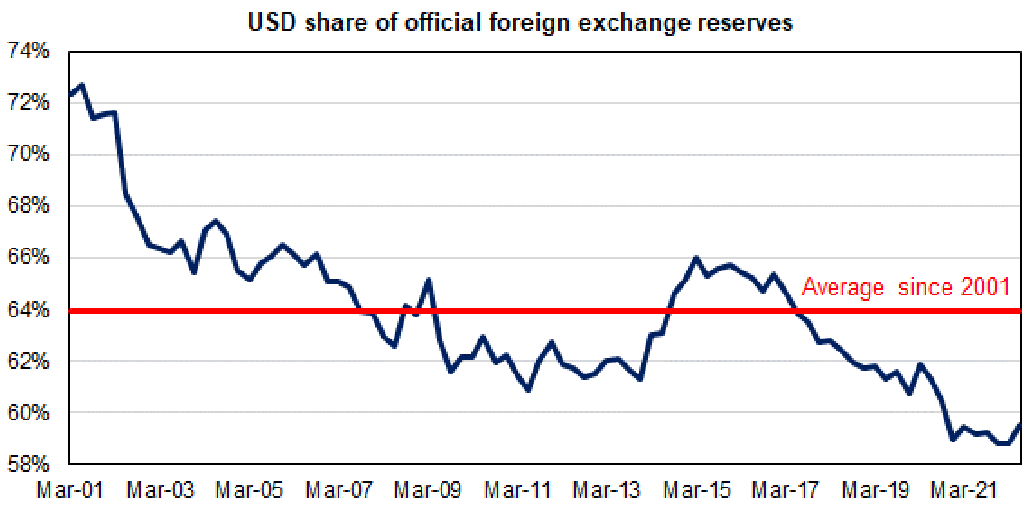
This dollar dominance was facilitated by a range of factors. The dominant size of the US economy: while increasingly producing a shrinking share of global output over the last two decades, the US remains the largest economy. Sizable, liquid, and deep financial markets in the US: the US Treasury market is considered the deepest and most liquid bond market in the world. US treasuries are considered as risk-free and safe-haven assets for investors. In equities, the weight of US in MSCI All Country World Index is c60%. Prudent US macro policy: historically, US policy had major influence on the global economy through various channels – interest rates, trade etc. Convertibility of the USD. Robust property protection rights in the US. US banking system that has deep and wide international networks. Further, trust in the US military power could have contributed too.

…is diminishing…

The dollar dominance is now coming under increasing scrutiny as more emerging market countries have voiced their opinion to de-dollarize their trade. Very recently, the presidents of Brazil and China signed 15 new trade agreements covering an extensive array of industries including agriculture, communications, and semiconductors. With China being Brazil's number one destination for key commodities, bilateral trade between the countries is estimated (by various think tanks) to exceed USD200bn in 2023. This agreement ditched the USD as an intermediary. Dealing another blow to dollar hegemony, in December 2022, China and Saudi Arabia signed a new partnership agreement with future energy purchases paid in Chinese Yuan.

Other examples of Yuan usage include UAE sales of natural gas, and a yuan-denominated contract between French oil giant Total Energies and China National Offshore Oil Company. Russia has increasingly embraced the Yuan amid Western sanctions, triggering considerations that the Petro yuan may have arrived on the stage next to the Petrodollar. De-dollarization has been underway for a considerable time now. The USD share of official global foreign exchange reserves fell from 72% in 2001 to under 60% in 2022 (exhibit 2).

Exhibit 2: The USD share of official Global foreign exchange reserves fell from 72% in 2001 to under 60% in 2022



Source: Bank for International Settlements, and ADCB Asset Management

There are a range of reasons behind the recent rise in de-dollarization talk. De-globalization in general and the US-China fragmentation in specific is creating a necessity for countries to consider currencies other than USD. Weaponization of the USD by applying sanctions without multi-lateral acceptance, and the conduct of the US foreign policy in recent years has been another push factor. Pull factors like the increasing availability of alternatives to USD and deepening bond markets in China may also be shifting the interest away from the greenback. More short-term factors like concerns around the banking crisis and debt ceiling issues in the US and positive interest rates in Europe after many years of negative rates, are other attractions pulling focus away from the USD. (At times, markets may conflate short-term trends with long-term trends). Also, to some extent periods of cyclical weakness in the USD tend to feed the narrative of de-dollarization. For the context, broader USD has fallen c11% over the past 7 months.

… not disappearing…

We think the concept of de-dollarization is being used in a very loose sense and without a strict definition. At this stage, we would think of this change in the USD usage under two scenarios – soft de-dollarization and hard de-dollarization.

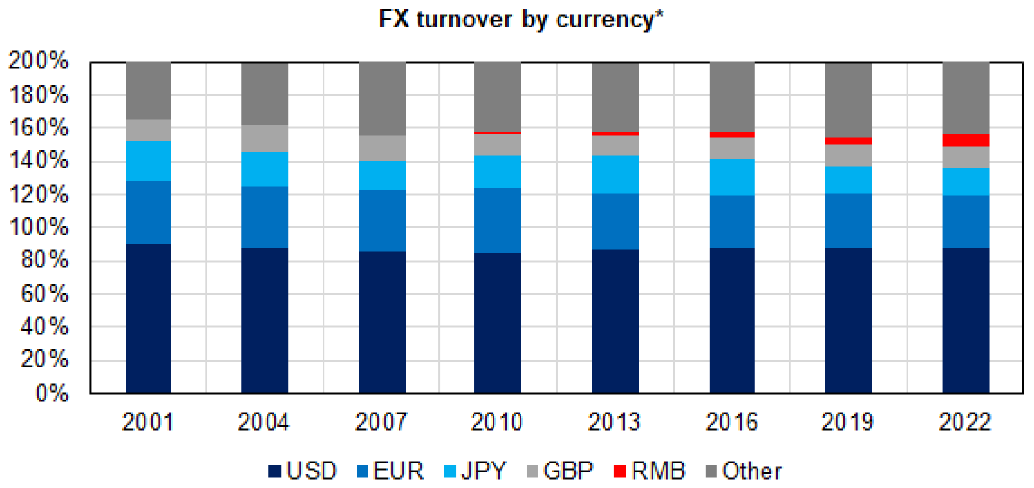
- Soft de-dollarization is the scenario under which countries adopt an increasingly diversified approach in managing their reserves and the currencies they transact in. This scenario sees USD still being important but with reduced dominance over time.
- Hard de-dollarization sees the complete and abrupt replacement of the USD as the global reserve currency.

On our assessment, we see a higher probability of soft de-dollarization which is consistent with our thesis of the rise of a multi-polar world (see our note A deglobalising world and our 'Yellow brick road'). To us the chances of hard de-dollarization appear exceptionally low at the moment. Any complete change would need motives but also means. In the previous section of this report, we discussed the motives. But a hard de-dollarization lacks the means. That is, there are no credible alternatives for the USD yet (exhibit 3). Here we discuss the possibility of a few:

- EUR: Eurozone boasts a monetary union that is based on a non-fiscal union. Potential fragmentation risks keep enthusiasm under check.
- JPY: Japan lacks a liquid treasury market (c60% of JGBs are owned by BoJ). Broadly, most JGBs are owned domestically resulting in a limited participation of international investors.
- CNY: Capital controls, and regulatory uncertainty, are key concerns. Further, China lacks other attractions which US had that facilitated USD to become a reserve currency.

- CAD/AUD: the dollar bloc currencies may bring stability but lack broader relevance given the commodity-orientation of their economies.
- Gold: is usually considered a worst-case scenario asset in reserves. While it provides good diversification, it is not an asset that would replace USD completely in our view.
- Cryptocurrencies: are still lacking the stability and wider acceptance which are the two most essential features of a global reserve currency.

Exhibit 3: USD still lacks credible alternatives



Source: Bank for International Settlements, and ADCB Asset Management. Notes: *shares add up to 200% reflecting two currencies involved in an FX transaction.

Diversification is key

We see the soft de-dollarization scenario materializing over the coming years. Just as a reminder this scenario sees the dominance of USD fade gradually over time but not a complete replacement of the USD as the favored reserve currency. We see extremely low risks of hard de-dollarization happening anytime soon. After all, it is not easy to deleverage a USD12trn debt system that is anchored to the USD. Further, we consider soft de-dollarization as slow-moving and gradual but important risk that investors should keep in mind as they allocate for the long-term.

Here are some potential milestones that we would be watching to measure the extent of de-dollarization.

- Rise in the use of alternative currencies by the commodity exporting countries.
- Countries where their currencies are pegged to the USD move to more flexible regimes.
- Use of CNY outside China and in those transactions that do not involve China.
- Countries stop making USD claims and increase alternative claims.
- Non-commodity economies adopt currencies other than the USD.

- International investors should consider slowly diversifying their FX holdings across a broad range of strong alternatives. Currencies of those countries that boast strong fundamentals like stable inflation, interest rate levels, fiscal deficits, trade balances, terms of trade, economic openness, and labor productivity should be on investors' radars. Of course, these fundamentals may not remain the same over time and this calls for active management of the FX exposures too. As such, currency selection alongside country and security selection might be essential.
- For multi-asset investors, gold might be worth considering. But sizing the yellow metal exposure in portfolios is particularly important to balance stability with opportunity costs.
- For equity investors, diversifying across companies transacting in other currencies vis-à-vis the US dollar may be prudent. Companies with low cross-border revenue-asset mismatch could outperform in a scenario of hegemonic-instability. Emerging market companies that have high internal growth rates should have reduced external financing needs and therefore outperform the broader market.
- For bond investors, having a healthy balance between hard currency and local currency debt may be worth considering looking ahead.
- Investors who use FX hedges should take a holistic assessment and actively monitor the overall currency exposure of their portfolios.

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