

The US dollar will remain the only global reserve currency

The countries whose currencies are considered as the most likely contenders to end dollar dominance are the ones which run large current account surpluses; how can they provide liquidity to the rest of the world?

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(Representative Image)

Since the start of the Russia-Ukraine war, reports are abuzz with the imminent rise of the Chinese yuan as an international reserve currency. This urgent need to end or weaken the dominance of the US dollar in international exchanges perhaps stems from the fear of enforcement of politically motivated US-led sanctions on countries, thereby abruptly plunging them into economic crisis. While this may be a legitimate concern, economic considerations of an international reserve currency cannot be overlooked.

Foremost is the size of the economy and its ability to produce and sell goods and services, and more importantly, provide a large market to absorb exports from the rest of the world. The US was best qualified to do so at the end of the Second World War. While it made sense for the rest of the world to run trade surpluses with the US as the dollar was convertible to gold at a fixed rate under the Bretton Woods system, the question arose as to why would they want to hold dollars after the gold window was closed in 1971 and the dollar was no longer backed by gold.

The reason for reserve accumulation was because the dollar wasn't merely a 'reserve' — meaning something useful for future use. It was something more. It gave a country the possibility to remain competitive (the only option being to continuously raise productivity) in spite of running current account surpluses by buying the dollar and keeping their domestic currencies undervalued. By this they could export their goods and services — and the US provided a large market to do so — attaining high levels of growth without depending on domestic demand. Of course, the politics of the US accommodation for current account deficits was not based on benevolence. The Cold War was perhaps the motivating force to wean countries away from erstwhile USSR.

An important reason for China's exceptional growth since the 1970s has been its export-led strategy with massive positive net exports to the US and also with Europe. Its accumulation of reserves to undervalue the yuan is well-known. Moreover, almost 85 percent of its foreign exchange reserves are held in dollars and euro. While the share of dollars may be declining, this could be because of the substantial trade between China and the EU, with large portions of trade being invoiced in euro. So, China's accumulation of euro reserves may be more to do with undervaluing the yuan against it than

breaking away from dollar dominance per se. China, presently, is said to be holding about 20 percent of its reserves in euros, which alone accounts for 25-30 percent of total euros held as reserve currency.

Japan follows a similar strategy and even other large reserves holders like India, Switzerland, Vietnam and South Korea have been accused by the US of being currency manipulators. The declining share of the US dollar is possibly arising not from a lower dependence on the dollar for a large part of the world but rather the accumulation of euros by China and others like Japan, which alone hold 40 percent of total international reserve currencies, as they run large current account surpluses with the EU.

Meanwhile, the US-led sanctions on Russia have given new impetus to the Central Bank of Russia to accumulate yuan as a reserve currency. Although Russia's switch to the yuan is because of its inability to access dollars, it is also clear that Russia now runs a trade surplus with China so that accumulation of yuan could also be to prevent the ruble's appreciation against the yuan, making its exports uncompetitive. Such specific trade imbalances, as well as political factors, may induce countries to maintain multiple reserve currencies.

Interestingly and paradoxically, the countries whose currencies are considered as the most likely contenders to end dollar dominance are the ones which run large current account surpluses — the EU, Japan and China — amounting to a total of some \$700 billion. This obviously raises questions of how these challengers to the US can actually provide liquidity to the rest of the world for settlement of international trade and capital flows.

For instance, if the EU alone runs a current account surplus of €350 billion, how can the rest of the world have sufficient euro liquidity? Put differently, if the EU were to be running perpetual current account surpluses, it will be accumulating financial assets in the rest of the world and the latter accumulating the corresponding financial liabilities. At some point, when the rest of the world has to deleverage to pare euro debt, there would be a dearth in available means of settlement.

It is therefore imperative that we distinguish between international and global reserve currencies. While the euro, yen, yuan and even others like the Australian and Canadian dollar may serve as reserve currencies between specific nations depending on quantum of trade, trade imbalances and geopolitical configurations, they cannot serve as a global reserve currency. Only the US dollar at present qualifies to take the position of global reserve currency, given the overall size of its economy and its ability to run persistent current account deficits over more than four decades.

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