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Breaking the Mold? The Quest for Currency Diversification in a Multipolar World

by Nicola Bilotta

"Every night I ask myself why all countries have to base their trade on the dollar. Why can't we do trade based on our own currencies? Who was it that decided that the dollar was the currency after the disappearance of the gold standard?"

(Lula, Shanghai, 13 April 2023)

During a recent speech at the New Development Bank, Brazil's President Luiz Inácio Lula da Silva questioned why all countries have to rely on the US dollar for trade and suggested using their own currencies instead.[1] Since the beginning of the war in Ukraine, Lula's statement has been part of a chorus rather than an isolated voice. Emmanuel Macron has also urged the EU to reduce its dependence "extraterritoriality of the U.S. dollar",[2] while several countries, ranging from Argentina to Saudi Arabia, are promoting the Chinese yuan to be used for trade settlements with China. In this framework, US Secretary of the Treasury Janet Yellen has warned about the risk of financial sanctions linked to the dollar undermining its hegemony.[3]

Nothing new on the financial system front

Nothing new, one may say. Despite the erosion of the US dollar having been predicted, challenged, envisioned and discussed for the last two decades, the greenback has continued to remain the dominant currency in the international financial system.

Why might this time be different, though?

[1] Joe Leahy and Hudson Lockett, "Brazil's Lula Calls for End the Dollar Trade Dominance", in *Financial Times*, 13 April 2023, https://www.ft.com/content/669260a5-82a5-4e7a-9bbf-4f41c54a6143.

[2] Jamil Anderlini and Clea Caulcutt, "Europe Must Resist Pressure to Become 'America's Followers,' Says Macron", in *Politico*, 9 April 2023, https://www.politico.eu/?p=2889354.

[3] AFP, "Yellen Says Sanctions May Risk Hegemony of US Dollar", in *Barron's*, 16 April 2023, https://www.barrons.com/news/yellen-says-sanctions-may-risk-hegemony-of-us-dollar-479c564f.

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Although previous efforts to lessen reliance on the US dollar were unsuccessful, the convergence of geopolitical tensions, economic dislocation and digital transformation may create an ideal environment for a gradual fragmentation of the global monetary system in the long run.[4]

According to a recent article in *The Economist*, the 25 largest "non-aligned" countries – those that have not imposed sanctions on Russia or wish to remain neutral in the Sino-American conflict – represent 45 per cent of the global population and have seen their share of global GDP increase from 11 per cent in the 1990s to 18 per cent today, surpassing that of the EU.[5] Although these countries hold significant economic power, their diverse national interests make it unlikely for them to act as a cohesive unit. However, they may find common ground on specific issues, as evidenced by OPEC's recent decision to reduce oil production despite Western opposition.[6]

Another area where they might be incentivised to find common ground is in reducing global reliance on the US dollar and the Western-dominated payment system. In the past two decades, the US has significantly increased the use of economic sanctions as a tool of foreign policy. Since the year 2000, the number of sanctions imposed by the US has skyrocketed by 933 per cent.[7] This trend has prompted many countries around the world to seek alternative means of conducting international transactions, free from the risk of being targeted by US sanctions.

Petrodollars: Signs of fragmentation?

The global market for oil trading provides a notable example of the exceptional status of the US dollar. Since the early 1970s, major oil-producing countries, especially those in OPEC, have exclusively priced oil in dollars. However, recent developments suggest small-scale efforts to move away from the dollar in this domain.

In December 2022, China made an invitation to Saudi Arabia and other Gulf countries to settle their bilateral oil-trade transactions in yuan. Similarly, India and Russia are currently renegotiating to establish rupee-ruble arrangements for settling their oil-trade transactions, driven by the impact of Western sanctions. Countries like Russia, Iran and Venezuela, which collectively hold 40 per cent of the OPEC+ proven oil reserves, have strategic incentives to consider switching to yuan-denominated oil.[8]

[4] See: Nicola Bilotta and Fabrizio Botti (eds), *Digitalisation and Geopolitics. Catalytic Forces in the (Future) International Monetary System*, Rome, Nuova Cultura, 2023, https://www.iai.it/en/node/16701.

[5] "Can the West Win Over the Rest?" in *The Economist*, 13 April 2023, https://www.economist.com/leaders/2023/04/13/can-the-west-win-over-the-rest.

[6] Maha El Dahan and Ahmed Rasheed, "OPEC+ Announces Surprise Oil Output Cuts", in *Reuters*, 3 April 2023, https://www.reuters.com/business/energy/sarabia-other-opec-producers-announce-voluntary-oil-output-cuts-2023-04-02.

[7] US Department of the Treasury, *Treasury Sanctions Review 2021*, October 2021, p. 2, https://home.treasury.gov/system/files/136/Treasury-2021-sanctions-review.pdf.

[8] Rana Foroohar, "A New World Energy Order Is Taking Shape", in *Financial Times*, 3 January

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Moreover, an additional 40 per cent of proven oil reserves belong to the Gulf Cooperation Council whose members, while historically close to the US, have been more assertive in voicing their own stance on important regional and global issues.[9]

The potential effect should not be overestimated, though. For instance, even if all China's oil imports were denominated in yuan, it would only account for 15–20 per cent of the future global contracts.[10] However, it is a prominent example of a broader megatrend in which countries are seeking alternatives to the US dollar in their trade arrangements. In another development, the People's Bank of China recently announced the signing of a Memorandum of Understanding (MoU) to establish Chinese yuan clearing arrangements with the Banco Central do Brasil.[11] Furthermore, Brazil and Argentina have initiated improbable discussions about developing a common currency, indicating their interest in closer economic integration.[12] Of greater significance, the BRICS countries have announced their intention to engage in discussions regarding the launch of a new currency during the upcoming August summit.[13]

Digitalisation and diversification

While these examples may not encompass large-scale agreements, they highlight growing trends of shifting away from the exclusive reliance on the US dollar in trade agreements, indicating increasing interest in diversifying currency options.[14] Although no alternatives to the US dollar currently exist, digitalisation processes have the potential to ease and accelerate such ambitions in the long-run.

The possible implementation of Central Bank Digital Currencies (CBDCs)[15] worldwide may decrease the costs associated with cross-border transactions and establish a new international payment infrastructure. If

2023, https://www.ft.com/content/d34dfd79-113c-4ac7-814b-a41086c922fa.

[9] Danielle Pletka, "The Qatarization of the Middle East", in *Foreign Policy*, 4 May 2022, https://foreignpolicy.com/2022/05/04/arab-gulf-countries-iran-us-relations-qatar; Gerald M. Feierstein, Bilal Y. Saab and Karen E. Young, "US-Gulf Relations at the Crossroads: Time for a Recalibration", in *MEI Policy Memo*, April 2022, https://www.mei.edu/node/84155.

[10] Ingvild Borgen and Kelly Chen, "Crude Indicators for Dollar's Dominance", in *Financial Times*, 3 April 2023, https://www.ft.com/content/de2a1d15-97f2-4daa-920a-770047d606c3.

[11] "China Says It Will Set up Yuan Clearing Arrangements in Brazil", in *Reuters*, 7 February 2023, https://www.reuters.com/markets/currencies/china-says-it-will-set-up-yuan-clearing-arrangements-brazil-2023-02-07.

[12] "Argentina and Brazil Propose a Bizarre Common Currency", in *The Economist*, 26 January 2023, https://www.economist.com/finance-and-economics/2023/01/26/argentina-and-brazil-propose-a-bizarre-common-currency.

[13] S'thembile Cele and John Bowker, "BRICS Nations Say New Currency May Offer Shield from Sanctions", in *Bloomberg*, 1 June 2023, https://www.bloomberg.com/news/articles/2023-06-01/brics-nations-say-new-currency-may-offer-shield-from-sanctions.

[14] Alain Naef et al., "The Renminbi's Unconventional Route to Reserve Currency Status", in *VoxEU*, 31 October 2022, https://cepr.org/node/424397.

[15] CBDC is a liability of a central bank, being generally described as a digital form of a country's sovereign currency issued by a central bank and backed by central-government credit.

multiple national CBDCs are developed in the future, bilateral and multilateral CBDC agreements could pave the way for a new payment-system network that is based on multi-CBDC arrangements. This would significantly reduce exchange risks while making nodes more independent of the US dollar as they would not require the multi-layered clearance and settlement infrastructure that lies behind current transactions. However, realising this potential requires some degree of cooperation to establish shared standards and protocols that ensure interoperability between CBDC systems as countries would need to accept each other's currencies as the currency of trade.

Furthermore, the emergence of automated and electronic trading platforms has substantially reduced transaction costs, enabling central banks to access foreign currencies more easily and inexpensively, thereby encouraging diversification of their reserves. This trend is reflected in the global decrease in foreign reserves held in US dollars, from approximately 70 per cent in the early 2000s to 59 per cent in Q3 2021.[16] An IMF study shows that a quarter of this shift is towards the yuan, while the remaining three-quarters are invested in currencies of smaller countries. This suggests that central banks are adopting a portfolio diversification strategy driven by market forces. With the recent weaponisation of the US dollar, this diversification trend could accelerate, further incentivised by a "de-risking management" strategy.

The paradox of financial digitalisation

While inertia and friction are key forces that tend to consolidate the dominance of the US dollar, the process of financial digitalisation can be a crucial force for change in pushing currency and payment-system diversification. Although one might have assumed that digitalisation would have led to the emergence of "universal currencies", eliminating obstacles while streamlining processes, digitalisation presents the ultimate paradox. As digital transformations in finance are deeply intertwined with fundamental aspects of digital networks, infrastructure, data management and regulations, they will face new technical, economic and political frictions.[17]

Indeed, financial digitalisation may actually further fragment the global monetary system, mirroring the increasing multipolarisation and geoeconomic fragmentation of the contemporary world. On the pessimistic side, the risk is that financial and geoeconomic fragmentation could lead to the formation of regional blocs or alliances, where digital interoperable systems could reinforce regional economic and trade interdependence while undermining

[16] Serkan Arslanalp, Barry J. Eichengreen and Chima Simpson-Bell, "The Stealth Erosion of Dollar Dominance: Active Diversifiers and the Rise of Nontraditional Reserve Currencies", in *IMF Working Papers*, No. 22/58 (March 2022), p. 5, https://www.imf.org/-/media/Files/Publications/WP/2022/English/wpiea2022058-print-pdf.ashx.

[17] Harold James, Jean-Pierre Landau and Markus Brunnermeier, "Digital Currency Areas", in *VoxEU*, 3 July 2019, https://cepr.org/node/360616.

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connectivity with other regions or countries outside the bloc. In this scenario, global economic cooperation and coordination could significantly diminish, potentially producing negative spillover effects – such as a reduction of trade and cross-border capital flows, limited market access and weakened economic cooperation among countries. This fragmentation could hinder global economic growth, redirect supply chains and lead to an uneven distribution of resources and opportunities across different regions.[18] It is a lose-lose scenario.

It is not too late to prevent this scenario, though. In effect, there is still space to harness the potential of digitalisation to establish a more efficient and fairer rules-based international monetary system. It is high time to advance and articulate the G20 effort on financial digitalisation to define clear, common and neutral rules of the game, guiding the adoption and implementation of digital currencies and finance infrastructure worldwide.[19]

A well-functioning digitalised international monetary system may play a pivotal role as a public good, laying the foundation to effectively steer and manage the stability and growth of the world economy.

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[18] Mario Catalán et al., "Geopolitics and Financial Fragmentation: Implications for Macro-Financial Stablity", in *Global Financial Stability Report. Safeguarding Financial Stability amid High Inflation and Geopolitical Risks*, Washington, International Monetary Fund, April 2023, p. 81-101, https://www.elibrary.imf.org/display/book/9798400233241/CH003.xml.

[19] Bank for International Settlements et al., *Options for Access to and Interoperability of CBDCs for Cross-border Payments. Report to the G20*, July 2022, https://www.bis.org/publ/othp52.htm.

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