

US Dollar: Dominance at Risk?

- ▶ This is the second in a series of two articles that seek to explain the US dollar's recent strength and future prospects. In this report we investigate whether there is a trend pointing to the currency's loss of its dominant status in multiple spheres, including as a reference for fixed and controlled exchange rate regimes, denomination of foreign debt, international transactions and composition of foreign reserves.
- ▶ The dollar dominance *status quo* has been frequently challenged because of potentially relevant alternatives — such as the euro (EUR) and the yuan (CNY), as well as gold and cryptocurrencies— or because internal policies (fiscal and/or monetary expansion) and external policies (sanctions) may reduce the attractiveness of the US currency.
- ▶ In fact, the dollar and other traditional reserve currencies (such as the euro, the sterling and the yen) have been losing space in central bank's international reserves. It turns out that only about 30% of this migration can be attributed to the rise of the yuan, a low percentage given the strong relative growth of the Chinese economy in the period —the remaining 70% comes from “non-traditional” reserve currencies. Such migration seems associated with major events, especially those related to fiscal and monetary expansions in countries holding traditional currencies.
- ▶ Looking ahead, we see a scenario that favors a slower decline —or even a recovery— of dollar-denominated international reserves. Key factors that have been shifting in a favorable direction for the dollar and are likely to endure include the current scenario of “American exceptionalism” in terms of growth and the increased cost of carry of diversification into alternative currencies.
- ▶ On the other hand, there is evidence that the risk of the US imposing sanctions on other countries partially explains the recent migration of international reserves towards gold and possibly cryptocurrencies. While this motivation creates space for these assets in certain portfolios, the difficulties in obtaining from them all the basic functions of a currency (store of value, unit of account and stable medium of exchange) indicate that they do not represent a threat to dollar dominance.

In addition to the circumstantial topics addressed in our first report in the series (See Macro Vision: [Strong Dollar scenario likely to persist and could intensify](#)), a frequently mentioned risk for the dollar is the possibility that the currency is losing its dominant status, whether as reference in international transactions or as a store of value.

The academic literature argues that the dollar maintains its disproportionate international status due to a lack of alternatives. This lack of worthy competitors would explain why international loans, foreign trade settlements, and central banks' international reserves are all, to a large extent, dollarized.

At the moment, other currencies, when compared to the dollar, do not offer sufficient volume of safe assets, and/or show limited liquidity and availability due to regulations and capital controls, while also lacking the advantageous synergies typically provided by the large volume of international dollar-denominated transactions.

However, this benign scenario for the dollar has been challenged recently, especially since the emergence of potential relevant rival currencies such as the euro and the yuan. At the same time, there is a perception that the US has been abusing the “exorbitant privilege” of holding the world's main reserve currency, whether through significant fiscal and monetary expansion in the country in recent years, or through the imposition of sanctions (which tend to reduce the attractiveness of the dollar for countries that are not geopolitically aligned with the US). In this context, alternatives such as gold or cryptocurrencies could also gain traction to the detriment of the dollar.

1. Measuring the dollar's status as the dominant currency

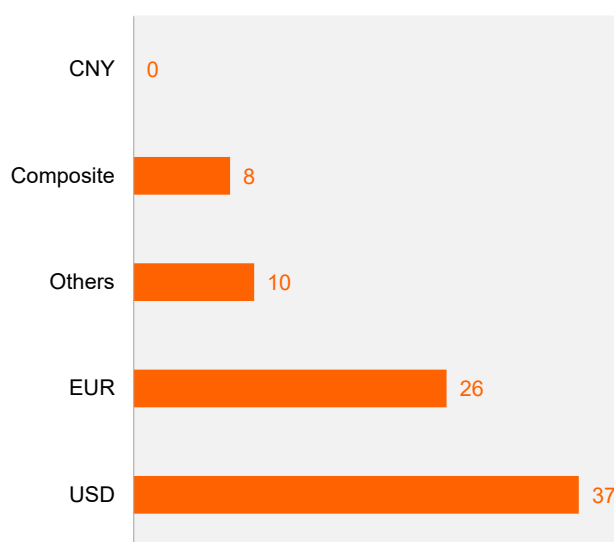
We assess below the relative relevance of the dollar compared to other currencies in terms of its main functions in an international context: (1) as an anchor currency to which other currencies can be pegged in fixed or controlled exchange rate regimes, (2) as a denomination currency for foreign debt and (3) in international transactions. Additionally, given its relevance, we thoroughly examine in a separate section the dollar's function as a store of value, using the composition of central banks' international reserves as proxy.

1.1. Reference for fixed or controlled exchange rate regimes

The dollar continues to be the most important reference for fixed/controlled exchange rate regimes, well ahead of the euro, which comes second. The yuan, in turn, is no reference currency for any IMF member country, despite the strong expansion of the Chinese economy in recent years and its large participation in global trade.

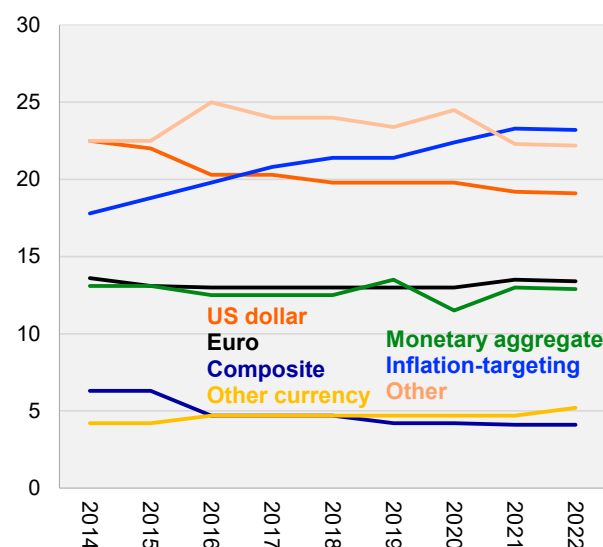
Among the IMF member countries in 2022 (latest information available), the dollar was the main reference for fixed or controlled exchange rate regimes (37 countries), followed by the euro (26 countries). No country had a fixed or controlled exchange rate regime with the yuan, not even countries that are anchored to a currency basket (see 1st chart below).

Number of countries with fixed/controlled FX regimes by reference currency



Source: IMF

Evolving shares of monetary and fixed/controlled FX regimes by currency (%)



Source: IMF

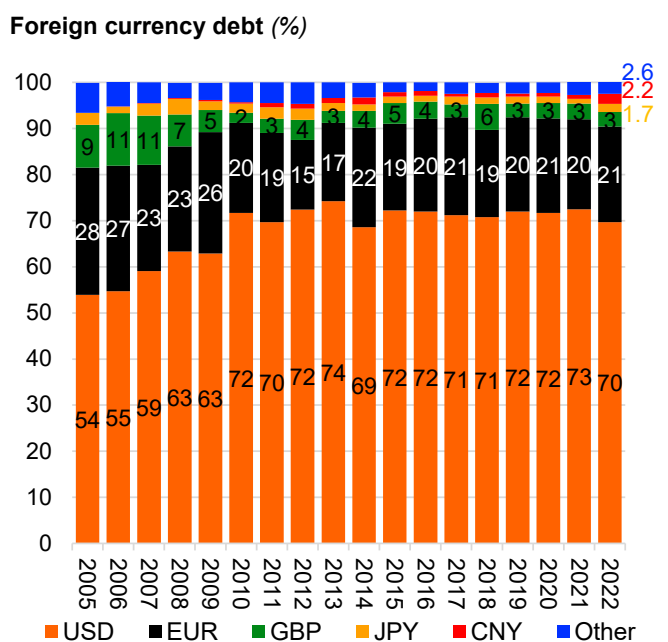
In broader terms, considering fixed or controlled exchange rate regimes and monetary regimes (inflation target or monetary aggregates), regimes pegged to the dollar represented 22.5% of countries in 2014. This measure declined modestly to 19.1% in 2022, certainly affected by the shift seen in several countries to inflation target regimes, whose percentage rose from 17.8% to 23.2% in the same period (see 2nd chart above).

The percentage of countries with a fixed or controlled exchange rate in relation to the euro remained virtually stable at around 13%, a similar percentage to that of countries with regimes pegged to monetary aggregates.

1.2. Denomination of foreign debts

As a benchmark for denomination in international debt markets, the dollar also maintains a clear lead against other currencies.

Dollar-denominated foreign debt increased its share after the 2008 financial crisis, stabilizing at around 70%. Again, the euro comes second, at around 20% of foreign debt denomination, below the share observed during the period that preceded the PIIGS crisis in 2010. Yuan-denominated foreign debt, despite having advanced at the margin, represents only 2.2% of the total, lower than debts denominated in sterling (2.6%) and slightly above those pegged to the yen (1.7%).



Source: Federal Reserve

1.3. International transactions

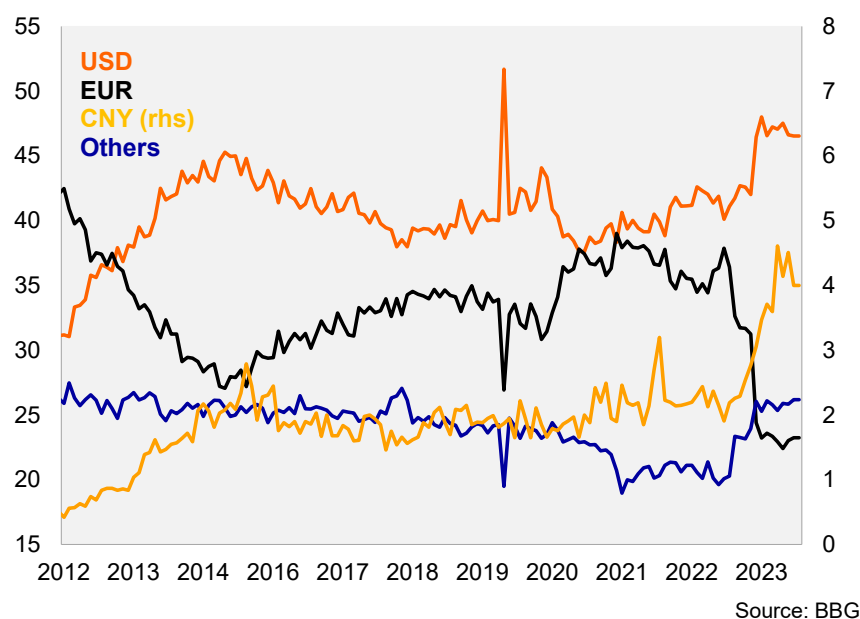
From the perspective of international transactions, the dollar also retains its dominance, with no signs of risk to this leadership. We can see below the share of each currency in international transactions in the SWIFT system. The volume of euro transactions had been rivaling the volume in dollars. However, technical changes resulted in a significant drop in the share of euro transactions compared to total transactions in the SWIFT system from March 2023 onwards.¹ These changes increased efficiency in liquidity management and payment practices, but some transactions were excluded from the SWIFT indicator, resulting in a relatively artificial, and potentially misleading, reduction in the share of the euro in international payments.

An alternative way to measure the euro’s role as a global currency is to look at the percentage of payments in euros when the instructing bank and/or beneficiary bank is located outside the Eurozone. The T2 system – like its predecessor, TARGET2 – allows banks around the world to make cross-border payments in euros. This indicator of global euro payments did not show a significant change after March 2023, confirming that euro payments involving at least one bank located outside the Eurozone have remained stable (further details in Furtuna et al., 2024).

This means that the data in the chart below underestimates the share of euro-denominated international transactions and overestimates the share of international transactions in yuan, dollars, and other currencies. Nevertheless, the chart clearly shows that the dollar retains its dominance in international transactions, while it is also clear that the percentage of yuan-denominated SWIFT transactions is small (to the point that we chose to depict them on another axis in the chart), although it has expanded at the margin.

¹ The two main technical changes were: the introduction of the new European payment platform T2-T2S and the migration to the new SWIFT network standard.

Share of financial transactions on SWIFT, by currency (%)



It is also worth mentioning that the recent growth of the yuan's participation in international transactions would be larger if data from the Cross-Border Interbank Payment System (CIPS), launched by China in 2015, and other alternative payment systems to SWIFT, were included. That said, despite having increased its scope since its creation, CIPS is still far from the approximately 45 million daily transactions through SWIFT in more than 200 countries.

2. The dollar as a store of value: What do international reserves show?

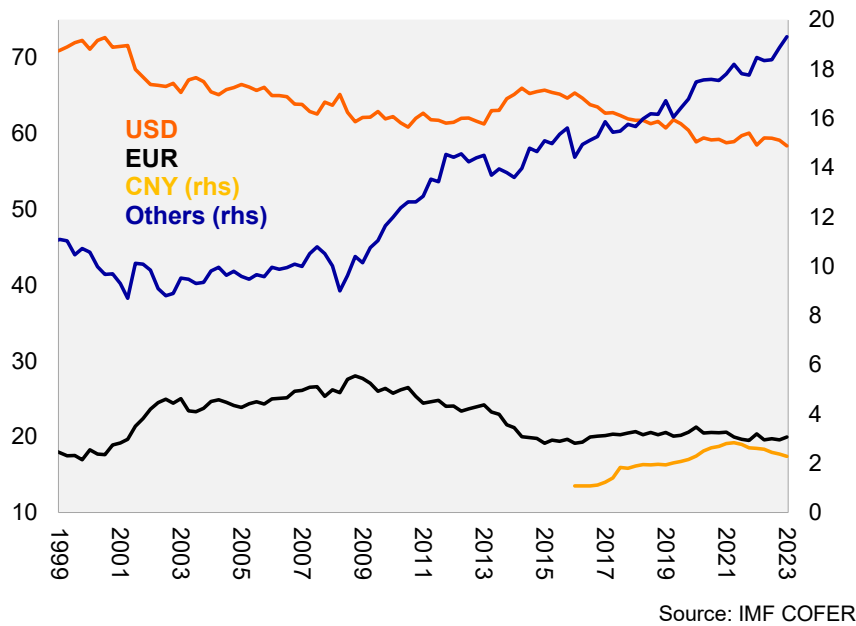
One of the most important aspects of the dollar's historical dominance is its function as a store of value. This section analyzes the relative use of major currencies as stores of value, using as proxy the composition and recent changes in central bank's international reserves.

2.1. Comparing the dollar to the euro and yuan

The dollar still represents the largest portion of international reserves, but its share receded from 71.0% in 1999 to 58.4% in 2023 (see chart below). However, this decline —particularly over the past 10 years— does not result from a shift towards the euro, which remains stable at around 20%, neither is it explained by the increase in yuan-denominated reserves, which have seen some recent growth, but remain at a low level, slightly above 2%.

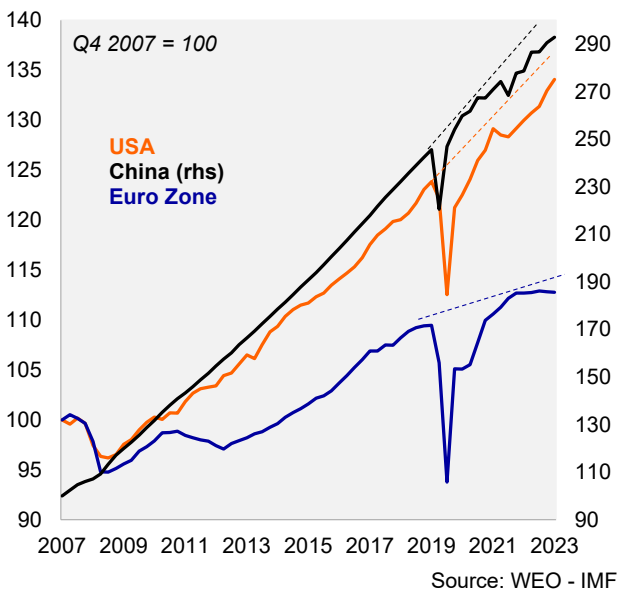
The decrease in the dollar's share was initially associated with an increase in the euro's share, shortly after its creation in 1999. At the time, there appeared to be a tangible possibility of the euro "dethroning" the dollar, as the economy of the Eurozone was large enough to compete with the US economy and boasted heavy foreign commercial transactions. However, the increase in the euro's share in reserves was not sustained: following the debt crises experienced by countries in the monetary zone (PIIGS in 2010, Cyprus in 2013), the share of euro-denominated reserves, which had peaked at 28% in 2009, declined and stabilized at around 20%.

Share of international reserves by currency

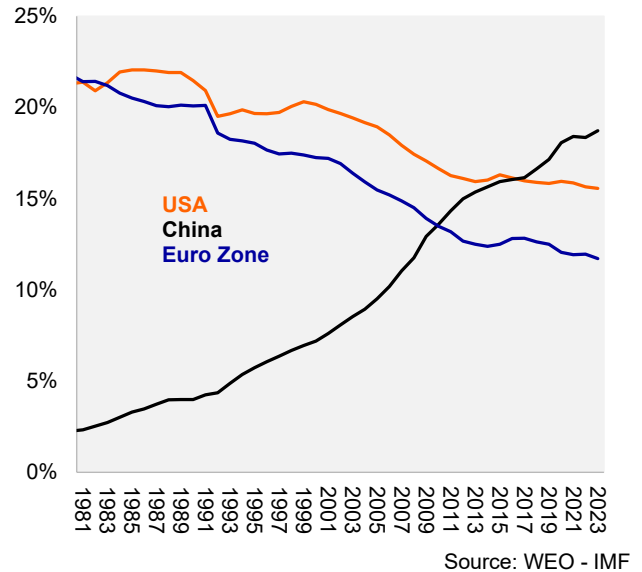


Going forward, a relatively lower potential growth in the Eurozone (charts below) and higher vulnerability to geopolitical risks weigh against the use of the common currency and suggest that its share of international reserves is unlikely to rise again anytime soon.

Real GDP vs. pre-Covid trend



Share of global GDP



In the case of the yuan, with China's strong growth in recent decades, allowing the Chinese economy to surpass the US and the Eurozone (considering purchasing power parity), it would be reasonable to expect growth in the Chinese currency's international use. This has, in fact, happened with international reserves, but at a slower pace than China's relative growth would suggest: between 2016² and 2023, while the share of China's GDP in world GDP advanced by 2.6 percentage points (from 16.1% to 18.7%), the yuan's participation in international reserves climbed by 1.2pp (from 1.1% to 2.3%).

² The sample of the yuan's share in international reserves is shorter – the data was only available from 2016 onwards, as the yuan had previously been included in the 'others' category of the IMF's currency composition of foreign exchange reserves (COFER).

In other words, the Chinese currency has unarguably gained importance, but the peak of 2.8% of total international reserves reached in 2022 shows that only a small part of the drop in the share of dollar reserves can be attributed to the rise of the yuan. Also, the portion of reserves in yuan has recently declined and now stands at around 2.3%.

Such modest growth in the yuan's share of international reserves, despite efforts by the Chinese government to promote the international use of its currency, has several plausible explanations. Frankel (2023) argues that China's currency has only two of the three necessary conditions to be a relevant international currency: economic size and relative value stability. It still lacks the third (and crucial) condition: deep, liquid, and open financial markets –something unlikely to change in a context of capital controls and financial repression that is still seen in China, with no signs of change for now. Additionally, as highlighted by Eichengreen (2021), all currencies that have become stores of value in history have come from democracies or republics, with effective checks and balances (and, typically, with independent central banks in place).

Neither can the reduction in the share of dollar reserves be justified solely by the relative loss of relevance of the US economy. In fact, the US share of world GDP fell by 0.5pp between 2016 and 2023 (from 16.1% to 15.6%), while the decline in the dollar's share of reserves was much sharper, at 7.0pp (from 65.4% to 58.4%).

Finally, the decline in the dollar's share of international reserves cannot be explained by a relevant migration to the sterling or the yen – currencies that have historically played a significant international role and, together with the dollar and the euro, are known as the “Big Four”. It is important, therefore, to analyze the increasing relevance of other non-traditional currencies.

2.2. The rise of non-traditional currencies

The table below shows that the participation of the Big Four has been declining, while the participation of other “non-traditional” currencies has increased significantly. The yuan shows the largest increase, which is to be expected given the strong growth of the Chinese economy during this century. But as mentioned earlier, the rise of the yuan accounts for about 30% of the Big Four's decline, while the rise of non-traditional currencies accounts for about 70%.

Currency composition of international reserves (%)					
		Variation 2023x2016	2016	2023	
Big Four			USD	65.4	58.4
			EUR	19.1	20.0
			GBP	4.3	4.8
			JPY	4.0	5.7
CNY	1.2		CNY	1.1	2.3
Non-traditional			AUD	1.7	2.1
			CAD	1.9	2.6
			CHF	0.2	0.2
			Others	2.3	3.9

Source: FMI

This diversification into non-traditional reserve currencies is both relevant and widespread. Arslanalp et al. (2022) identified 46 “active diversifiers,” defined as countries with a percentage of official reserves in non-traditional currencies of at least 5% by the end of 2020.

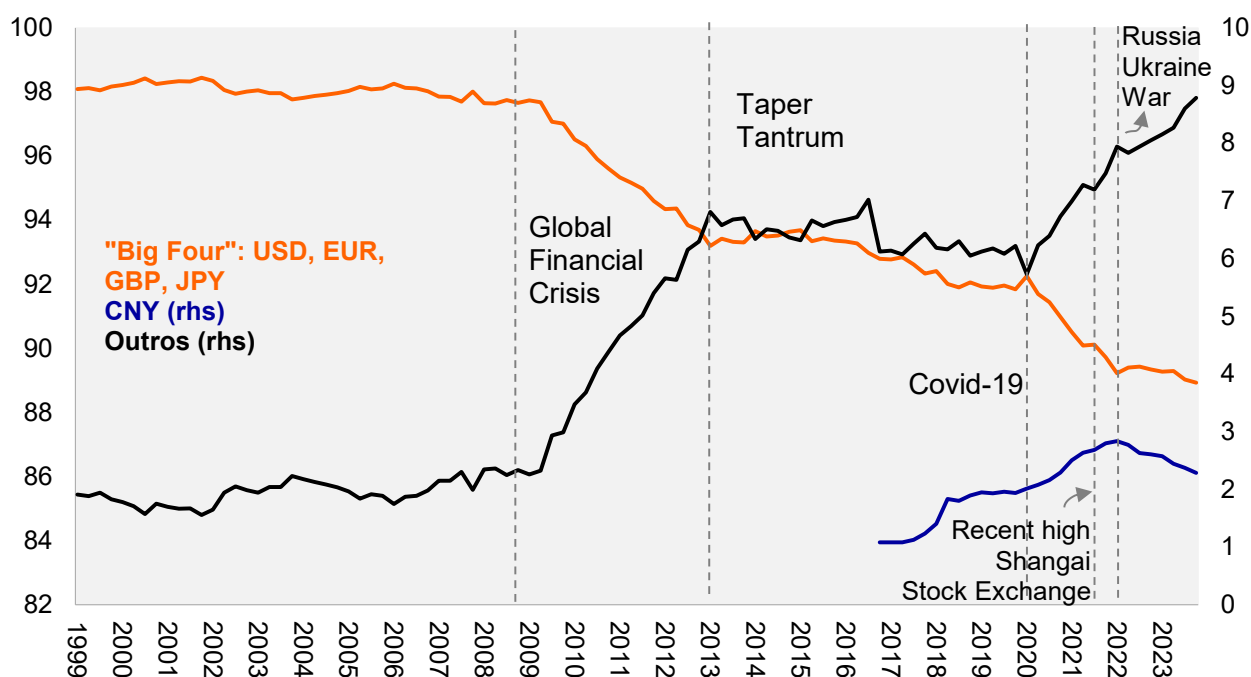
Three main factors have contributed to the growing presence of non-traditional reserve currencies. First, increased liquidity in these currencies has expanded the number of deep and liquid markets for national currency assets open to the rest of the world. Transaction costs that did not involve the Big Four tended to be high, discouraging allocation to other currencies. However, the emergence of electronic trading platforms and automated liquidity management (ALM) technologies has brought down the costs associated with FX transactions involving non-traditional currencies.

A more active stance by international reserve managers is another factor behind this scenario. Higher accumulation of international reserves, often exceeding adequate level metrics, allows the diversification into less liquid assets in the portion of reserves that does not need to be available as a liquidity buffer.

Finally, the long period of near-zero or nominally-negative benchmark interest rates in the main developed economies may have intensified the search for alternatives with higher yields (and/or perceived as having lower inflationary risk) by international reserve managers.

To evaluate these and other explanations for changes observed in the composition of reserves, we show below the time series of each group of currencies' participation, with dates of relevant events that may have impacted central bankers' decisions.

Composition of international reserves by currency (%)



Source: IMF

The chart shows that the share of non-traditional reserve currencies increased from insignificant levels at the turn of the century to around 9% of total identified reserves in 2023. It is also clear that some events had a particular influence on the rise of these non-traditional currencies.

Firstly, the Great Financial Crisis (GFC) of 2008 marked the beginning of the decline in the share of the Big Four and the rise of alternative currencies. The diversification observed at that time was likely driven by the strong fiscal and monetary expansion in the US from 2008 onwards, which increased the perception of inflationary risk, as well as concerns about financial stability in the country. Subsequently, the PIIGS crisis in 2010 has led to increased uncertainty over the euro's future, adding another pro-diversification factor. Interest rate cuts in these economies to near-zero levels during this period also decreased the cost of carry associated with diversification into alternative currencies.

Interestingly, the Taper Tantrum in the US marked the beginning of a lasting stabilization in alternative currencies' share of reserves, which remained in the 6-7% range until the onset of the Covid-19 pandemic in 2020. At the time, fiscal and monetary stimuli in the Big Four once again reduced the expected cost of carry of diversification, and intensified the search for protection against inflation risks in countries with more expansionary policies in the period, such as the US.

Subsequently, the start of the war between Russia and Ukraine seems to have led to a slowdown, but not an interruption, in the migration to alternative currencies, triggered by higher risk aversion and increased search for safety. This moment also marked the beginning of the decline in yuan-denominated reserves, probably motivated by the increased interventions by the Chinese government in the economy from 2021 onwards and the perception of waning dynamism in the Chinese economy. In fact, the chart shows that the beginning of the decline in yuan-denominated reserves coincided with the beginning of the slide in the Chinese stock market.

The discussion suggests that the composition of international reserves is greatly influenced by relevant events that are associated with fiscal and monetary expansion in countries holding traditional currencies.

Such expansion movements, in turn, were associated with periods of higher perceived inflationary risks, lower cost of carry and/or emergence of existential doubts about the currency (as was the case with the euro at certain times). All of these factors may be relevant explanations for the migration of reserves to non-traditional currencies.

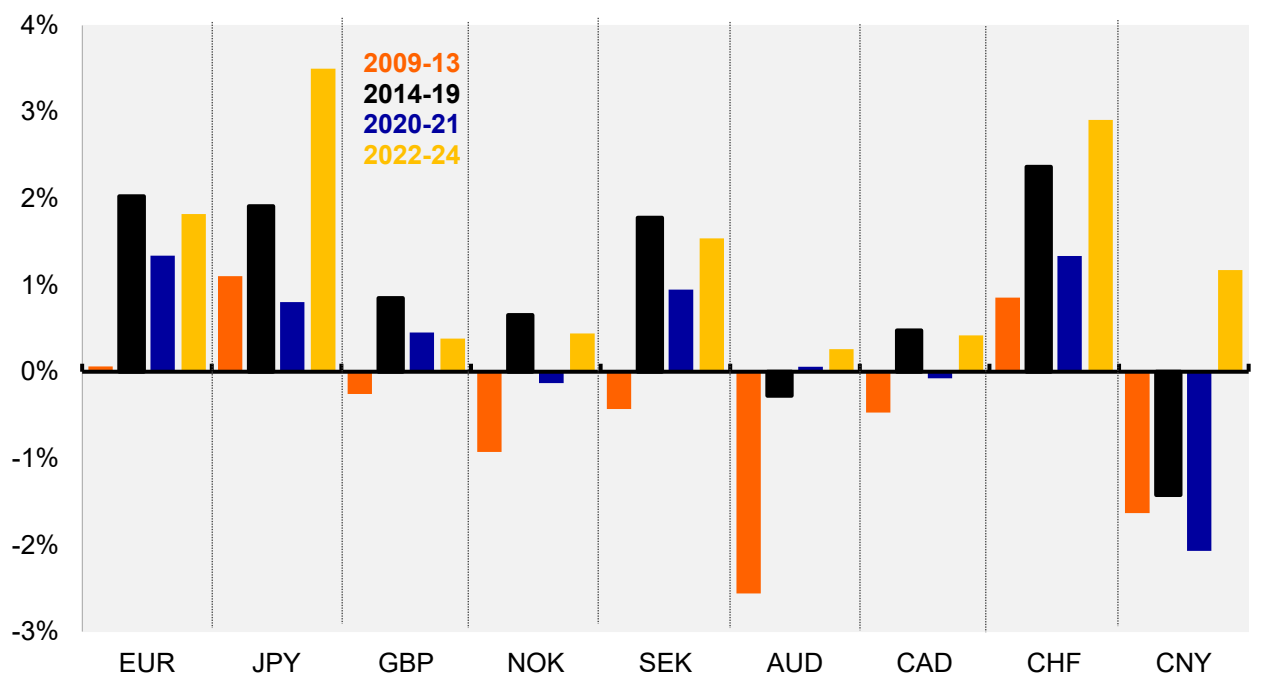
2.3. What to expect from now on?

We see a scenario that favors a slower decline – or even a recovery – in dollar-denominated international reserves.

The dollar is particularly favored by the current scenario of “American exceptionalism” in terms of growth, which tends to last, especially in a context of low growth prospects for Eurozone economies and waning dynamism in China, which generates excess capacity in several sectors.

Additionally, in terms of the cost of carry of diversifying into alternative currencies, the current situation has turned positive for the dollar once again. The chart below shows that, with the recent advance in US interest rates, the cost of carry is currently very favorable to the US currency³. In particular, while the period marked by a higher presence of alternative currencies in the composition of international reserves (2009-2013) was characterized by a historically low, if not negative, interest rate differential between the dollar and other currencies, this measure in the most recent period (2022-2024) has become clearly favorable to the US currency.

US yields gap to other countries (5-year bonds)



Source: Bloomberg

³ We used yields on 5-year government bonds, which approximates the usual average maturity of international reserve assets.

3. Alternatives to national currencies

Economist John Maynard Keynes once referred to gold (or, more accurately, the gold standard) as a relic of a barbaric past. More recently, banker Jamie Dimon referred to Bitcoin simply as a fraud. Lately, however, several countries (mainly in Asia) have been actively buying gold and, in many cases, cryptocurrencies. What explains these movements? Could they indicate a possible new threat to the dollar's dominance?

3.1. Gold: GFC and the risk of sanctions

Central banks have been adding gold to international reserves since the Global Financial Crisis (GFC) of 2008 (see chart). The reduction in the opportunity cost of holding gold (interest rates at record low levels), together with concerns about a possible surge in inflation resulting from heavy currency printing during this period, were likely important drivers of higher gold purchases, similar to what took place with purchases of non-traditional currencies, as previously mentioned. But, by the same token, the recent rise in interest rates in developed economies would tend to reduce this vector of demand for gold going forward.



There are, however, different motivations for holding gold despite its negative carry. One of them is the possibility of sanctions: Ferranti (2023) showed that, from 2016 to 2021, countries with higher risks of suffering US sanctions increased the share of gold in their international reserves more than those that face lower risks.

This factor may have gained momentum recently, with the announcement of global financial sanctions against Russia following the invasion of Ukraine in February 2022. The country has had its assets frozen by the US, European Union, United Kingdom, Switzerland, Japan, Canada, Australia, and South Korea.

Comprehensive and broadly coordinated sanctions, such as those imposed on Russia, create incentives for countries that are not geopolitically aligned with the holders of the world's main reserve currencies to seek alternatives, including gold and, possibly, cryptocurrencies.

3.2. Cryptocurrencies: a role in diversification, but no potential to replace the dollar

Ferranti (2023) explores Bitcoin's potential as an alternative hedge against the risk of sanctions. Given that US authorities would struggle to block or impose sanctions on Bitcoins, there is no need to make optimistic assumptions about its future price to see that the risk of sanctions on dollar reserves gives the cryptocurrency a place in certain portfolios, thus reinforcing its long-term fundamental value (and that of gold).

However, this does not mean that cryptocurrencies could become the foundation of an alternative monetary and financial system. The very advantage of serving as hedge against the risk of sanctions demonstrates that it would be difficult to block illicit activities in such a system. Obtaining the basic functions of a currency (store of value, unit of account, and stable medium of exchange) would also be a challenge, among several other disadvantages addressed, for example, in the BIS annual economic report (BIS, 2022).

In short, the dollar's dominance is also not threatened by these diversification alternatives.

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