

Is Dollar Losing its Status as a Reserve Currency?

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Summary: *The writer explains why the dollar is losing its lofty status as a reserve currency and if there is a possibility of it being replaced by any other currency in the near future.*

“Money is my military, each dollar a soldier. I never send my money into battle unprepared and undefended. I send it to conquer and take currency prisoner and bring it back to me.”

Towards the end of World War II, the US dollar was given the status of reserve currency by international treaty following the Bretton Woods Agreement. There was no other currency that could match the dollar, despite the fact that it was ‘delinked’ from gold. The phrase ‘full faith and credit of the United States Government’ was sacrosanct throughout the world.

A few years later, a number of governments are calling for the replacement of dollar as the world’s principle reserve currency. Reserve Currency is a currency that is held in significant quantities by governments and institutions as part of their foreign exchange reserves. It is commonly used in international transactions and often considered as safe-haven currency.

A definite trend in the direction of ‘de-dollarization’ can be easily seen from the decline in the percentage of dollar denominated securities in the world’s reserves (i.e. from 90% to 62%). China, which holds \$1.3 trillion of U.S. treasuries and other debt instruments, has been calling for the end of the dollar as the world’s reserve currency for years. Furthermore, China and Japan have executed bilateral agreements to conduct trade with one another in their own currencies, and so has Russia. Recognizing the emergence of the Yuan, Australia recently announced it would transfer 5% of its currency reserves into Chinese bonds.

The Governor of the Russian Central Bank has shown keenness in discussing, with China and its ‘BRICS’ partners, the establishment of a system of multilateral swaps that will allow the transfer of resources from one country to another. China has also offered the

European Union to deal with it directly through their respective central banks’ currency swaps, thereby avoiding the usage of the dollar which up till now has been used dominantly as a universal currency.

Why has the dollar started to lose favor? The dollar is susceptible to losing its vaunted position as first reserve currency to any major trading country that stops inflating its currency. There is evidence that China understands what is at stake, and therefore it has increased its gold holdings and has instituted controls to prevent gold from leaving China. If the world’s second largest economy and one of the world’s greatest trading nations tie its currency to gold, demand for the Yuan would increase and demand for the dollar would decrease. In practical terms this means that the world’s great trading nations would reduce their holdings of dollars, and dollars held overseas would flow back into the US economy, causing prices to increase.

Although steps have been taken to diversify global currency requirements, and despite calls for change by China and other nations, the fact remains that the dollar is likely to retain its lofty status as the world’s reserve currency in the immediate future. The U.S. has the largest economy, the most liquid and accessible financial markets and a readily traded currency and despite financial problems, is still considered a ‘safe-haven’ in periods of turmoil. The US economy is the dominant player in global trade.

So, will the dollar lose its reserve currency status at some point? Yes. In fact, it’s already starting to lose its reserve status to Europe and China. Will it cause everyone to suddenly ditch the dollar? Probably not. It just means that the US will produce a lower proportion of global output and therefore, as a matter of accounting, the rest of the world will hold a lower percentage of US dollar denominated financial assets as a percentage of global output. We all know that all good things eventually do come to an end, and as T.S. Elliot once wrote, “What we call the beginning is often the end. And to make an end is to make a beginning. The end is where we start from.”