



ANALYSIS WORLD

## Why News of the Dollar's Demise is Greatly Exaggerated

In spite of de-dollarization and new found love for gold in recent times, the US dollar and the economy are showing no signs of weakness.



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Recently, numerous **articles have been written** on the demise of the dollar. The argument is that China, the second largest economy after the US, is increasingly convincing the world's largest suppliers of energy, including Russia, Saudi Arabia, Iran, and Venezuela, to trade in Chinese yuan. This, according to the commentators, will usher in the demise of the 'petrodollar'. It would then be a matter of time before the US economy crumbles, they argue.

The term 'petrodollar' refers to the revenue earned in dollars by the oil-producing countries from the sale of oil, which was used to trade with other countries. In the early 1970s, during the Yom Kippur war, the Organisation of the Petroleum Exporting Countries (OPEC), of which Saudi Arabia is a member, implemented an oil embargo. The price of oil

per barrel went up from \$3 in 1973 to \$12 in 1974, and the OPEC member countries earned dollops of money.

The then American President, Richard Nixon, struck a deal with Saudi Arabia ensuring that all oil deals across the world would take place in US dollars. Other oil producing nations in the OPEC joined Saudi Arabia, depositing a large portion of their money in the US banks, thus marking the beginning of 'petrodollar'. In the world of flexible exchange rates, the US dollar became the most sought-after currency.

Fast forward, circa 2023, China and Russia are now trying to break this US hegemony. Other emerging market economies such as **Brazil**, **India**, and **Iran**, have now agreed to trade in their own currency.

BRICS – an economic grouping comprising Brazil, Russia, India, China and South Africa – is expected to meet in August in Durban, South Africa, to discuss **new global reserve assets** instead of the US dollar. Russia is already trading energy with India and China in rupees and yuan, respectively. Saudi Aramco **is building** a \$10 billion oil refinery in China, and according to the *Wall Street Journal*, Saudi Arabia is considering selling oil to China in yuan.

Meanwhile, France and China **have finalised** their first-ever deal on 65,000 tonnes of liquefied natural gas in yuan.

Central banks around the world, in particular from China, Russia, India, and Turkey are stacking up gold reserves. As per the World Gold Council (WGC), demand for gold **went up** by 18% in 2022, taking the world's gold demand to 4,741 tonnes, the highest for any year since 2011. That was the time of the US financial crisis. Central Banks were buying gold to hedge against an uncertain dollar.

Even during the first quarter of 2023, figures suggest that this trend is continuing. Economies such as China, Russia, France, Japan, and the UK have turned out to be **net sellers** of the US treasury notes, and buying gold.

The doomsayers feel that the immediate impact of shunting out the US dollar and replacing it with yuan or with any other currencies and assets such as gold can be drastic. The immediate impact is dollar losing values.

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In fact, something similar happened during the early 1970s. Prior to 1971, the value of the US dollar was tied with gold reserves. This means that the dollar could be exchanged for gold at a fixed rate. However, because of economic pressures, such as inflation and the costs of running a war in Vietnam, the US government printed more money than what it had to back it up in the form of gold reserves. "Petrodollar", therefore, came as a respite, and President Nixon abandoned the "gold standard".

## No signs of weakness for the US economy and the dollar

However, in spite of de-dollarization and new found love for gold in recent times, the US dollar and the economy are showing no signs of weakness. As per the latest estimate from the International Monetary Fund (IMF), 59.8% of the global exchange reserves holding **are still in US dollars**. The distant second is the euro with 19.7% of the global exchange reserves holding, followed by the Japanese yen with 5.3%, British pound with 4.6%, and China with 2.8%. At least 90% of the world trade happens in dollars.

Interestingly, considering the last two years, the yuan **continued to depreciate** against the dollar. Despite frosty relations, US-China trade hit **record high** in 2022, and given this situation, it is expected that a higher bout of inflation in the US will make the yuan appreciate. According to the **'law of one price'**, if inflation in the US is higher than its trading partner, then the real exchange rate will reflect that – that is, the dollar will depreciate against the yuan. However, this is not the case.

Between Q1FY2021 and Q1FY2023, yuan per US dollar **depreciated** from 6.45 to 6.87.



That means that there are other factors at play. For instance, the productivity level in the US is still ahead of China. The **US chip embargo on China** is a testimony to the fact that the US government wants to keep its economy ahead of China. Although, during the early 2000s, China was able to import technology by opening up its economy but it has a long way to go to catch up with the US.

As per ILO estimates, China is producing an output of \$7,318 per worker, much below the US standard which is \$98,990 per worker.

There is no indication of the US GDP contracting. Latest figures suggest that the US economy **grew** by 3.2% and 2.6% in the last two quarters of 2022. Furthermore, the **job market data** – another metrics for gauging recession in the US – is looking strong. **Unemployment rate** of 3.6% is still below the natural rate of unemployment which is at 4.6%. According to Fed Chair Jerome Powell, there are 1.9 **vacancies** for every unemployed person.

The recent blip in the US banking sector (read **Silicon Valley Bank and Signature bank crisis**) had only made things work in the right direction. Investors and depositors are now

shifting their money to large banks. Large banks with assets holding more than \$250 billion **are mandated** to take the '**stress tests**' (ability to withstand adverse economic conditions) conducted by the Fed, unlike SVB and Signature bank.

Then why this new-found fad to give up dollars?

The West and the US are increasingly moving away from fossil fuel. In fact, both the EU and the US are bringing in new regulations that will make it harder for emerging economies in Asia, Africa, and Latin America to trade with the EU and the US. Take for example, the **Carbon Border Adjustment Mechanism** in the EU and **Inflation Reduction Act** in the US, both of which are aimed towards aligning trade rules with climate change mitigation policies pursued by the developing countries.

In fact, the Russia-Ukraine war has nudged the West to move towards adopting green energy. On the other hand, China alongside emerging economies in Latin America and Africa still **continues to remain** as a big market for fossil fuels, which oil producing nations cannot afford to neglect.

It is going to take a while before the yuan can replace the dollar. The US dollar still enjoys dominance in terms of acceptability in the world capital market. Traders prefer dollars relative to yuan, as the latter **is more unstable**. Many of China's trading partners accuse Beijing of keeping the yuan **artificially devalued**.

Additionally, there is strict capital control in place that restricts the ability of businesses to move money in and out of China. This affects the yuan gaining traction as a global currency. In the best case scenario, given the supply chain that China has built in Asia, it may be possible for yuan to dislodge the Japanese yen but not dollar.

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