Opinion **US dollar**

Will financial innovation dethrone the dollar?

The evolution of a truly multi-polar currency market depends on governments' willingness to embrace technology and fortify markets

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The People's Bank of China building in Beijing. China's renminbi internationalisation has stalled as its government maintains capital flow restrictions © Bloomberg

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By all logic, the dollar's dominance in global finance ought to be collapsing. Rising public debt, concerns over the erosion of central bank independence and weaponisation of the dollar through financial sanctions should encourage diversification away from the currency. Policymakers around the world talk incessantly about ditching the dollar.

Indeed, many new rivals to the dollar have sprung up in recent years, while the share of gold in central banks' international reserves has risen sharply. The dollar's share in foreign exchange reserves is now 57 per cent, compared with 71 per cent in 2000. Dollar privilege, which allowed the US Treasury to issue debt at relatively favourable interest rates, has all but disappeared. This surely sets the stage for multi-polarity.

But in new research presented at the Jackson Hole symposium, my colleagues and I depicted an alternative, less comforting possibility. Rather than a stable multi-polarity that underpins beneficial currency competition, we document extensive fragmentation among putative rivals to the dollar. Traditional reserve currencies such as the euro, Japanese yen and British pound sterling have lost ground as payment and reserve currencies. The Australian dollar, Canadian dollar and Swiss franc have increased their collective shares of cross-border payments and reserves but are ultimately backed by small economies and shallow financial markets. China's renminbi internationalisation has stalled as its government maintains capital flow restrictions.

What could yet disrupt entrenched dollar dominance is technology.

The plumbing of cross-border payments is being rebuilt before our eyes. Many central banks are experimenting with blockchain and other solutions to make international payments faster, cheaper and more efficient. At the same time, technologies that reduce frictions in cross-border transactions will make it easier for private investors, including firms and households, to acquire foreign assets and search for funding in global capital markets. This ought to have a levelling effect, giving every currency a chance to compete on a level footing.

But the reality might prove rather different. The larger size of US capital markets relative to other countries, along with US first-mover advantage in enabling private sector innovations to settlement technologies, may well reinforce the dollar's dominance.

Consider stablecoins, which are rapidly gaining traction in cross-border payments. The overwhelming majority of stablecoins in circulation are dollar-denominated, partly because of the crypto-friendly approach of the US government and also because much of the world still hankers for dollars. Our analysis shows that the interaction between reduced frictions and market depth could favour issuance of and demand for dollar-denominated debt instruments and other securities.

Financial innovation is certainly intensifying competition and giving currencies of smaller countries an edge. But in practice, many emerging market and developing economies now face even greater dangers of being overrun by easy access to foreign currency assets and payment systems, threatening their monetary and financial sovereignty. Countries that try to wall themselves off from these new technologies, rather than doing the hard but essential work of fortifying their markets and institutions, will be the most vulnerable. Instead, they need to develop broad and well-regulated financial markets, maintain disciplined monetary and fiscal policies, and promote the rule of law.

In short, financial innovation could produce one of three outcomes. The first is true multi-polarity in currencies built on strong foundations with competition that rewards well-governed countries and sidelines currencies issued by poorly governed ones. The second is greater dollar dominance, leaving the global economy and financial system ever more vulnerable to shifts in US policy. The third is a fragmented system with no widely trusted currency or central bank.

On present trajectories, the second outcome seems likely. Reckless US policies might yet lead to the third, perhaps the most worrisome of all. With no currency to anchor the trust of global investors, financial market stress could spiral into unstoppable turmoil.

Much depends on governments and central banks' willingness to embrace innovation and strengthen their financial markets and regulatory frameworks. If dollar dominance persists and results in disaster, other countries will only have themselves to blame.

Gordon Liao of Circle and Tony Zhang of Arizona State University contributed to this column.

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