Opinion **US dollar**

We are stuck in a currency doom loop

Without the dollar, bad situations could be made even worse

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A clerk sorting $100 notes at Hana Bank's HQ in Seoul. The dollar accounts for roughly 57 per cent of global foreign exchange reserves and international payments © Yonhap News/Avalon

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The structure of global currencies is supposedly on the threshold of change, with the US dollar on the verge of losing its position as the dominant global payments and reserve currency. This narrative reflects other countries' desperate desire to escape the dollar's clutches and "de-risk" from the United States.

Surely, they argue, more balanced competition without a single dominant currency would promote efficiency and stability, with each country incentivised to implement good domestic and international policies to support its own currency.

But the harsh reality of our imperfect world is that the absence of a dominant currency would risk making bad situations worse. Those who seek regime change should be careful what they wish for.

It is no wonder that other countries' leaders rail against the dollar and talk incessantly about diversifying away from it. The US has used dollar dominance to punish both rivals and allies by restricting access to global payments. The policymaking process in Washington is broken, public debt is high and rising, and President Donald Trump has attacked the Federal Reserve's independence and is gutting the rule of law and other institutions.

But the dollar still accounts for roughly 57 per cent of global foreign exchange reserves and international payments, and dominates other aspects of international finance. Capital inflows into dollar assets, including US Treasuries, remain strong. True, the premium on Treasuries relative to other countries' government bonds has declined, but that on other risk-free US dollar assets has not.

Meanwhile, the dollar's potential rivals are still struggling. The Eurozone lacks a unified financial system and political cohesion. China's renminbi remains constrained by capital controls, a tightly managed exchange rate and a weak institutional framework. The pound and Japanese yen have lost ground as a lack of dynamism saps their economies. The push for diversification has resulted in rising shares of gold and a raft of smaller currencies in international reserves.

The dollar will thus remain the pre-eminent global currency, at least in relative terms, even if it loses some of its shine. Meanwhile, the second tier, comprised of all other currencies, is fragmenting into a set of middle-sized and small players, each with its own limitations and weaknesses.

What if this resulted in greater parity, with the dollar ceasing to be dominant but no other currency taking its place? We would then have multiple currencies competing, none of them particularly sound or trusted. In a moment of crisis, investors wouldn't know which currency to turn to, swinging sharply from one to another and adding to instability. With no anchor currency that everyone was familiar with and trusted, no central bank would be in the position of providing abundant liquidity to global markets, as the Fed did during the great financial crisis.

The world thus faces two options, neither of them ideal. A dollar-dominated system that allows America to continue to wreak havoc on markets, or a fragmented currency system that works decently but would intensify financial panics. A true doom loop.

Some have touted Special Drawing Rights, international reserve assets created out of thin air by the IMF, as a source of global liquidity. The SDR is neither a currency nor a liability of the IMF. A country can use its SDR balances as collateral to borrow real money, such as dollars or euros. However, even if everyone trusted the IMF, the SDR's value and its wide acceptability are still tied to trust in the underlying currencies.

There is a way out. Other countries need to improve their macroeconomic policies, develop their financial markets and strengthen their institutions. This would fortify the foundations of other reserve currencies and could even reduce the need for reserves to protect emerging market economies and small countries from capital flow volatility. With international co-operation, better mechanisms could be devised for providing liquidity insurance in place of reserves. The overwhelming dominance of a single currency would then make little sense.

For now, though, the world we live in features pervasive financial market fragilities and a scarcity of trust and co-operation. Dollar dominance really is everyone's fault. And when compared to a system in which the foundations of practically every currency are weak, having one dominant currency — even one the world has a love-hate relationship with — might be the least bad option.

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