Atlantic Council
GEOECONOMICS CENTER

FRANKFURT FORUM on US-EUROPEAN GEOECONOMICS

ATLANTIK-BRÜCKE

Will Economic Statecraft Threaten Western Currency Dominance?

Sanctions, Geopolitics, and the Global Monetary Order

By Carla Norrlöf

Frankfurt Forum

This paper is one of four publications launched at the inaugural Frankfurt Forum on US-European GeoEconomics held in Germany from September 27 – 29, 2022. Co-hosted by the Atlantic Council GeoEconomics Center and Atlantik-Brücke, the Frankfurt Forum anchors critical work on transatlantic economic cooperation. The war in Ukraine, and the G7 response, reminded the world of the impact of transatlantic coordination. As part of the Frankfurt Forum, this new research aims to advance transatlantic dialogue from crisis response to addressing the key economic issues that will underpin the US-EU partnership over the next decade. The goal of the Frankfurt Forum is to deliver a blueprint for cooperation in four key areas: digital currencies, monetary policy, international trade, and economic statecraft.

Atlantic Council's GeoEconomics Center

Launched in 2020, the Atlantic Council's GeoEconomics Center has become the go-to place at the intersection of economics, finance, and foreign policy. The Center bridges the divide between these oft-siloed sectors and helps shape a better global economic future for the US and its allies. The Center is organized around three pillars: 1) The Future of Capitalism; 2) The Future of Money; and 3) The Economic Statecraft Initiative.

Atlantik-Brücke

Founded in 1952, Atlantik-Brücke is a non-profit and non-partisan association committed to deepening cooperation between Germany, Europe and America. Transatlantic cooperation remains pivotal for global order and stability, now more than ever. With nationalist tendencies gaining popularity worldwide, Atlantik-Brücke has doubled down on its mission to solidifying relations across the Atlantic among policymakers, industry leaders, journalists, academics, and civil society by offering a platform for different perspectives and lively debate. Atlantik-Brücke also fosters ties between young professionals and representatives of civil society through annual conferences and exchanges. The approximately 500 members of Atlantik-Brücke are decision-makers from business, politics, science and the media on both sides of the Atlantic.

TABLE OF CONTENTS

A money changer sells U.S. dollar bills at a currency exchange office in Ankara, Turkey September 24, 2021. REUTERS/Cagla Gurdogan

INTRODUCTION

The security drivers of the Cold War have returned to brace global economic relationships in a more competitive economic environment in which great-power rivals are fully integrated. During the Cold War, geopolitically like-minded states supported one another economically. Geopolitical allies provided each other with assistance ranging from direct aid to currency support to containing economic competition. Economic considerations are once again taking a backseat to security goals. States are moving away from the demands of the market and embracing the demands of geopolitics. Wary of the security consequences of their economic engagement, states are increasingly reluctant to interact commercially and financially with the enemy.

Different from during the Cold War years, great-power rivals today are ambitious participants in the global economic order. Espousing alternative economic arrangements, they seek to upset the prevailing hierarchy in order to gain greater policy flexibility. Preventing Western economic dominance has become more urgent due to their intensified use of economic levers of power to exert geopolitical influence. The frequency with which economic coercion is practiced is widely anticipated to generate pressures to reduce dependence on the economic instruments and relationships that can be used to inflict harm.

Over the long term, the United States and Europe, therefore, face geo-economic constraints on the extent to which they can wield economic power for geopolitical ends without pushing targeted states, as well as prospective targets, to nurture connections and institutions where geopolitical differences are not an economic liability. Many experts today believe economic coercion is already being overused and that a heavy price awaits the most enthusiastic users. By providing incentives to create alternative systems and privilege other networks, the use of economic power to realize foreign policy objectives undermines the economic basis for exercising economic coercion.

Concerns about geo-economic backlash are particularly acute when it comes to the use of financial sanctions. Owing to their frequency, swiftness, and impact, they have the power to cause severe economic distress. The number of countries targeted by financial sanctions grew rapidly as the Cold War drew to a close, widely surpassing growth in the use of other tools of economic statecraft such as trade restrictions. However, not until the early twenty-first century did the absolute number of countries subject to financial sanctions exceed the number of countries subject to trade measures.

No country is more closely associated with financial retribution as a response to policy divergence than the United States. The sheer magnitude of countries against which the United States has levied financial sanctions exceeds the number of countries against which any other country levies sanctions in any given year throughout the postwar era. Similar to the system-wide trend, following the end of the Cold War, the number of countries targeted by US financial sanctions grew at a faster pace than the number of countries targeted by US trade controls.

The United States' proclivity for using financial sanctions to exert influence in the international system is, however, not a new phenomenon or even a post-Cold War phenomenon. Since the mid-1970s, more countries have been battered by US financial sanctions than by commercial barriers. Among countries able to apply economic coercion on any significant system-wide scale, European Union countries, as well as Canada, Japan, and Switzerland, also have a greater tendency to impose financial as compared to export and import controls. In common, these countries have extraordinary financial clout, explaining their preference for using financial leverage as a means of influence over other countries. They also issue the world's primary reserve currencies.

Possessing a reserve currency is of great importance for economic statecraft because major currencies, especially dollars, play an outsized role in payments systems and within financial institutions. Financial sanctions by reserve issuers can drastically limit a country's ability to settle trade and financial payments and result in the freezing of large portions of a country's private and official assets. The freezing of official foreign exchange reserves, as in the recent case of the foreign exchange reserves held by Russia's central bank, is unusual because foreign exchange reserves are supposed to be "safe". If reserve issuing countries can make the safety valve a country has built up for hard times disappear, countries will instead hold currencies issued by countries that have no reason, or lack the capacity, to sanction them, or they will switch to non-currency reserves, unsettling the currency order.

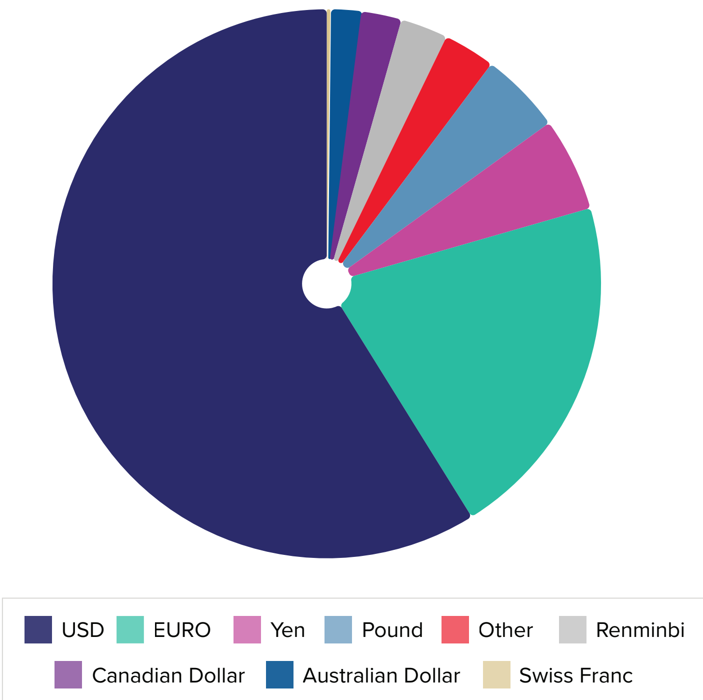
A few days after the start of Russia's invasion of Ukraine on February 24, 2022, Rana Foroohar, associate editor of the *Financial Times*, rang the bell for a post-dollar world, further financial decoupling, and the emergence of a bipolar financial system centered on the US dollar and the Chinese renminbi.[1] The *Financial Times*' chief economics commentator, Martin Wolf, shared Foroohar's vision of a more disorderly currency order, bifurcated into a Western and a Chinese system, accelerating de-globalization.[2] Gita Gopinath, First Deputy Managing Director of the International Monetary Fund (IMF), sees a more fragmented currency system with the sanctions fallout ushering in a multipolar order with alternative currencies used between multiple groups of countries.[3] Credit Suisse banker Zoltan Pozsar foresees the possible closing of an era.[4] He predicts power shifts based on alternative currencies and gold as well as a greater reserve role for other commodities such as oil and wheat. Calling time-out on the existing currency order, he anticipates the coming of Bretton Woods III, making "Our currency, your problem" history, and "Our commodity, your problem" the new future.[5] Under this scenario, the shortage of commodities caused by the war and the demand for secure reserves combine to create inflationary impulses rocking the price stability underpinning the international role of the dollar and the euro.

The relationship between geopolitics and currency hegemony has regrettably been of limited interest to international political economists despite early attention to the significance of geopolitics for currency hierarchy.[6] The question is raised anew with Russia's invasion of Ukraine and the blistering wave of sanctions leveraging the dollar and euro system with the participation of other central banks. This report discusses the geopolitical drivers of transatlantic currency dominance and the currency consequences of making financial sanctions a cornerstone of national security policy. First, the report provides a brief overview of the hierarchy within the global currency order. Second, it considers how military might and security alliances affect currency support. Third, it probes the impact of sanctions on international currency choice and currency polarity. Dollar reserves declined marginally after Russia's attack on Ukraine in February 2022 whereas Chinese renminbi reserves grew. The international currency system has however become less unipolar since the launch of the euro in 2002. The sharpest decline in the dollar's reserve centrality coincides with the rise in the number of countries sanctioned by the US since 2017.

1. THE GEOPOLITICS OF TRANSATLANTIC CURRENCY HEGEMONY

The dollar is the *only* global currency and the euro is first amongst the currencies with international reach. At the end of 2021, governments held 59 percent of their reserves in dollars and 21 percent in euros.[7] No other currencies are nearly as popular with governments. The nearest competitor to the dollar and euro, the Japanese yen, accounted for less than 6 percent of governments' currency reserves. Other leading currencies, the British pound, the Chinese renminbi, the Canadian dollar, the Australian dollar, and the Swiss franc, individually account for less than 5 percent of known reserve holdings. Together, all other currencies in the world only add up to 3 percent of reserves held by foreign governments.

Figure 1. **Distribution of Foreign Exchange Reserves by Issuing Currency**



Source: International Monetary Fund

There simply is no imminent, or medium-term, threat to the dollar's status as the preeminent global currency, nor to transatlantic dominance of the currency scene. Even under a drastic scenario in which the eurozone project was to fail in the medium term, transatlantic currency dominance would continue. A breakup of the eurozone would imply a return to the eurozone's legacy currencies and restore a prominent role to the German Deutsche mark and to a lesser extent, the French Franc.

Despite this ironclad case for the persistence of transatlantic currency dominance, there is constant speculation about its demise, particularly the demise of dollar hegemony. While an end to the dollar's dominance in the global economy is unrealistic, there are signs of dollar weakening, a trend coinciding with geopolitical rivalry and the intensified use of sanctions. The next section discusses the geopolitical drivers of currency dominance in a longer-term perspective than the current crisis before turning to the constraint sanctions could potentially place on the structure of the global currency order.

Geopolitical strength and security alliances

Economic factors predominantly shape the reserve status of a country's currency. The determinants are the size, sophistication, and growth of the issuing country's economy; asset liquidity; the government's commitment to internal and external price stability; and economic openness. Beyond these determinants, quasi-economic factors also matter, such as the currency's track record, its history as reserve currency, also known as incumbency advantage. Network externalities raise the likelihood of existing and additional users continuing to use the currency because of the advantages of interacting with many users.[8] Dollars, in particular, are traded with great ease, in massive, liquid, and deep markets, resulting in a high degree of stickiness and path dependence. The longer a currency has held a dominant position the more likely it will continue to occupy a central position due to inertia and the pain of switching to an alternative currency. While stable, this equilibrium can be upset. The British pound's loss of international currency supremacy in the 20th century suggests adverse economic and geopolitical trends can combine to knock a currency off its perch. In a research note published in March 2022, Goldman Sachs' Cristina Tessari and Zach Pandl warn about the similarities between the dollar and the pound, notably "a small share of global trade volumes relative to the currency's dominance in international payments, a deteriorating net foreign asset position, and potentially adverse geopolitical developments."[9] However, they see the US economy as more stable than the British economy was, with better prospects to slow inflation, depreciation and the deterioration of the net international investment position.[10]

Geopolitical factors also matter. Since the 1970s, scholars of international political economy have suspected that security considerations shape global currency status.[11] When the euro was formally launched in the early twenty-first century, questions began to surface as to whether it could one day rival the dollar. In a widely read article, economists Menzie Chinn and Jeffrey Frankel provided reasons for "Why the Euro Will Rival the Dollar".[12] Adam Posen retorted, "Why the Euro Will Not Rival the Dollar", arguing geopolitical considerations would interfere with international currency substitution.[13]

Fifty years after the British political economist Susan Strange's seminal work, we still lack good evidence of precisely how and when security variables influence reserve currency status. Theoretically, three broad processes have been identified to raise a currency's attractiveness. First, countries are generally seen as having more confidence in a currency issued by a strong military power.[14] The argument is not one of degree but applies to dominant military powers. Countries infer currency strength from overwhelming military strength.

Second, defense commitments are said to increase a currency's appeal. Countries benefiting from military protection have incentives to hold and transact in their ally's currency as a way of offering economic support. Because economic gains can be used to improve military capability, allies have an interest in bolstering each other economically, particularly the principal power underwriting their security. By using their ally's currency, they enhance the ally's ability to spend on defense, implicitly weakening their common enemy and thereby improving their own security.

The third geopolitical mechanism is a variant of the second. Countries enjoying military protection offer compensation by adopting their security guarantor's currency for reserve purposes. Such a quid-pro-quo is not necessarily motivated by attempts to enhance an ally's economic capability in order to strengthen their own security. Allies are merely trading economic for security guarantees, which they may do voluntarily or be coerced into.

In sum, a strong security position can give rise to enhanced international currency support for several reasons. Beyond economic considerations, countries are understood to be more likely to hold a currency if the issuing country is better able to militarily defend its borders, assets, and institutions against destabilizing attack, or committed to defend other countries' borders, assets, and institutions. To the extent that these geopolitical considerations incentivize reserve holdings, they give rise to a "security premium."[15] The bonus to the reserve issuing country arises from foreigners' willingness to hold their currency at a higher cost than what is warranted on purely economic grounds. These processes are difficult to substantiate empirically.

Qualitative work has documented the quid pro quo between Germany and the United States during the Cold War, trading military support for currency support.[16] In exchange for stationing 200,000 of its troops in West Germany, the United States asked Berlin for currency support in order to reduce balance of payments pressures under the dollar-exchange standard, resulting in German deposits with the US Federal Reserve. Since American security costs were offset economically by Germany, the bargain is known as the "offset agreement."[17] The best quantitative work has shown how countries are likely to peg to the currency of their ally, in order to confer benefits on friendly countries, boosting their own security.[18] While data on who pegs to which currency is publicly available, we have much more limited knowledge of which country holds which currency and in what proportion. A quantitative proof of how military power or defense alliances or some other geopolitical feature defines reserve currency holdings is, therefore, far more difficult. For instance, Barry Eichengreen, Arnaud Mehl, and Livia Chițu have tried to show that defense pacts enhanced currency support in the late nineteenth and early twentieth centuries, but they leave out crucial economic controls and provide results based on unconventional levels of statistical significance and weak instruments.[19]

To the extent that geopolitics is recognized to influence currency support at all, the security impact is assumed to work through military might and defense commitments. Defense commitments are strong geopolitical ties. Their expected effect on currency support is anticipated to be stronger than other political ties, including other types of alliance commitments. The implicit assumption behind the "defense-for-dollars" argument is that security matters when the stakes are sufficiently high. Alliances, in general, are not considered significant enough to affect international currency choice. Economic considerations are presumed to overwhelm weaker types of alliances, for example, nonaggression pacts,

A U.S navy vessel carrying naval officers is seen at sea as it prepares to dock in the eastern city of Port Sudan, Sudan March 1, 2021. REUTERS/El Tayeb Siddiq

which do not provide enough incentives for pecuniary support. Economic factors are also likely to play a larger role in certain contexts. The salience of defense commitments in international currency choice should not only depend on the level of protection, i.e., the type of alliance commitment, but the level of threat reserve holders experience. For example, some scholars believed the “defense-for-dollars” deal would crumble as defense against the threat of Soviet invasion became less urgent after the Cold War, diminishing support for the dollar, thus weakening its international role.[20]

Countries may also covet other forms of security, for example, freedom from large-scale threats or other third-party conflicts. Even if countries are not covered by a defense guarantee, they benefit from a secure international environment where rivalries are settled amicably, not through war, and where economic exchange is unfettered by conflict. For example, a smaller country like Switzerland may value a stable context for open exchange to a higher degree than France and therefore view the United States as crucial to securing a peaceful context within which economic transactions occur. This would cause Switzerland to support the United States by holding dollar reserves in greater proportion than France in spite of US defense guarantees for France and Switzerland’s neutral position.

Standard models of international currency choice do not include defense alliances because even strong political ties of this form are not considered to be of any real significance. The currency a country adopts for reserve currency purposes is presumed to be an economic affair. A country’s primary motivation for holding currency reserves is to provide foreign currency to the domestic financial system and to stabilize their currency through interventions in foreign exchange markets during both normal and crisis times. Currency interventions occur toward a specific currency, to maintain a hard peg (a fixed exchange rate), a soft peg, or to loosely align with a foreign currency. The deeper underlying reasons for the currency intervention, and their frequency, vary. The country may be prone to crisis, seek an export-led growth strategy, or chafe under financial inflows unless foreign demand for its currency is neutralized. Countries hold reserves for economic reasons, not to fight wars—or so everyone assumed before Russia’s invasion of Ukraine on February 24, 2022.

Geopolitical animosity

Geopolitics, short of military dominance, and alliances may play a larger role than our current understanding of the global currency order suggests. The lesson from the above section is that countries support currency issuers if they are willing and capable of providing some form of security. Countries favor currency issuers that have both the wherewithal to defend their own homeland as well as defending them militarily.

If security reassurances from the currency issuing country contribute to reserve success, destabilizing actions such as sanctions could negatively impact the desire to hold the reserves of the issuing country. Over time, and depending on the viability of alternatives, this could impact a country's reserve currency status. Not all forms of insecurity will reduce countries' willingness to hold a reserve currency. The expected effect of insecurity depends on context. For instance, making allies insecure about US defense commitments may cause them to respond with enhanced reserve support if the overall defense-for-money bargain remains intact. Threats to reduce defense commitments may just be teasers to extract greater monetary concessions. If pushed too far, they may have unintended effects. If haggling over security commitments causes allies to believe there is a real prospect of losing protection, any incentive to hold reserves in exchange for protection will be lost. The precise moment when the bargain is likely to collapse is hard to pin down. But at some point, allies will lose confidence in their ability to secure stronger defense commitments, and conclude that the benefits from the security arrangements, which were the precondition for their currency support, are too low to merit ongoing transfers. Threats to revoke security commitments can enhance allies' security and currency contributions but may also backfire to reduce currency support (see figure 3).

If countries are unable to neutralize the effects of insecurity, they may seek to reduce their dependency on the global currency order, either by diversifying currency holdings in the immediate term or by creating alternative payment systems over the long term. The security premium risks becoming a security penalty.

A freight train moves along a railway, following Lithuania's ban of the transit of goods under EU sanctions through the Russian exclave of Kaliningrad on the Baltic Sea, in Kaliningrad, Russia June 21, 2022. REUTERS/Vitaly Nevar

2. THE IN(SECURITY) OF SANCTIONS

Sanctions punish behavior inconsistent with the norms espoused by the sanctioning state. They are threatened in order to deter a wide range of behavior, from human rights abuses to terrorism to war. If the sanctioning state's demands are not met, punitive measures are imposed. In some cases, entire countries are effectively embargoed, but in many cases specific individuals, especially government officials, including facilitating banks, are sanctioned. Even when sanctions are "smart" and "targeted" to hit specific individuals and entities, the consequences for the country where the targeted parties reside can be significant. Because of the human suffering they inflict, sanctions are sometimes described as "economic weapons" and their imposition, therefore, understood to amount to "economic warfare."

For leaders who have no intention of reforming their policies, because their political survival depends on policy continuity, or because they fundamentally disagree about the legitimacy of what they are asked to refrain from doing, aggressive use of sanctions spreads insecurity. Such leaders live in fear that their actions will be met with sanctions and must find ways to weather the storm. They have incentives to fight back, and even undermine the hierarchy and order which make the sanctions possible.

There is another part of the equation because security is a double-edged sword, greater insecurity for one country can bring greater security to other countries. Sanctions enhance the security of the sanctioning coalition, and of countries that do not implement sanctions but fundamentally agree with the goal behind the sanctions. Understanding the long-term impact of sanctions on the global currency order, as well as the immediate impact of the Russia sanctions, requires calculating the net effect of currency actions as the result of both the greater insecurity and security that countries experience when a policy, for instance a sanction, is implemented.

Sanctions and Currency Choice

The currency choices of countries that feel insecure as a result of sanctions will differ from those that experience greater security as a result of sanctions.

Countries that fear sanctions must find coping strategies. One such strategy is to neutralize the impact of the sanctions by building up currency buffers. For example, prior to its invasion of Ukraine, Russia had built up an impressive reserve currency arsenal, to the tune of $630 billion.[21] This strategy effectively reinforces the power of the sanctioning parties since it implies pent-up demand for Western currencies, the main reserve currencies. However, Russia moved a sizeable portion of its foreign exchange reserves offshore, perhaps anticipating sanctions on its central bank. Central bank assets had been frozen before, though in a more limited way. In 2019, for example, the US Treasury Department blocked the assets of Iran's central bank and the National Development Fund used for "terror financing."[22] In 2020, Treasury helped Venezuela's parliament transfer central bank funds from Venezuelan President Nicolás Maduro to his rival, Juan Guaidó.[23] And in August 2021, Treasury froze assets of Afghanistan's central bank in a bid to make them unavailable to the Taliban.[24] However, these cases do not begin to compare with the size and breadth of the West's Russian asset freeze. On February 24, the day of Russia's invasion of Ukraine, the US and its allies announced sanctions on Russia's most prominent financial institutions, comprising 80% of Russia's bank sector, as well as Russia's central bank.[25] The scope of the coordinated transatlantic freeze on Russia's foreign exchange reserves is unprecedented. Russia responded by requesting ruble-denominated energy payments, a logical consequence of not being able to settle in Western currencies.

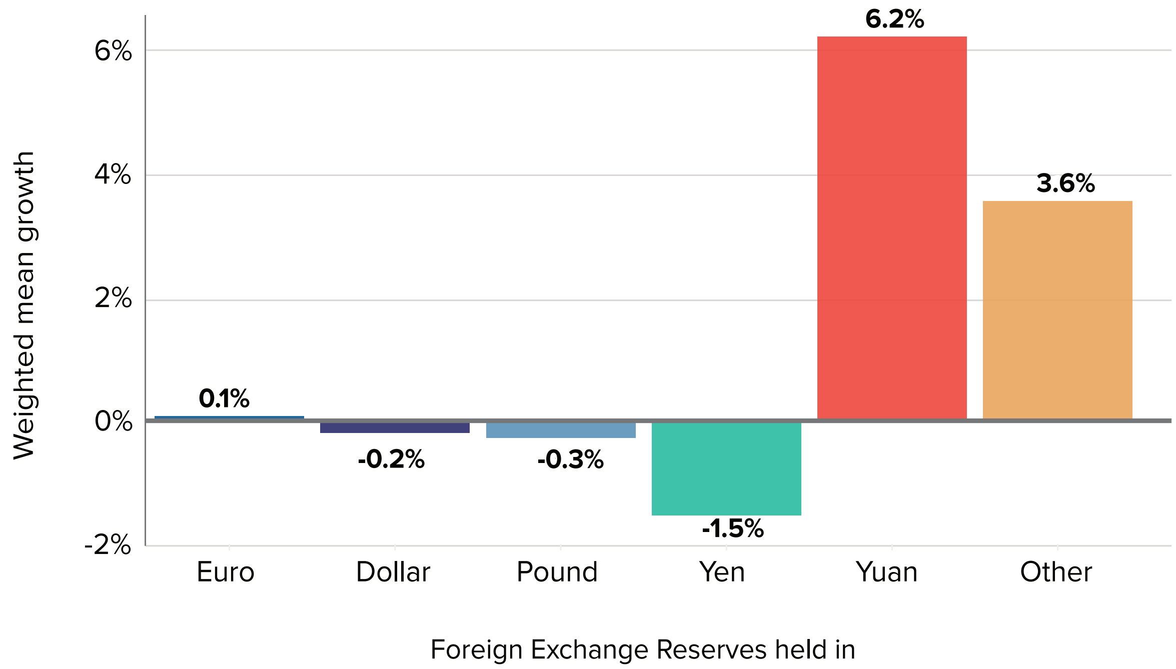
As a coping strategy, building up a reserve safety valve will no longer be considered a safe strategy by countries who expect profound policy conflict with the United States, and may even scare countries who are uncertain about the degree of policy conflict tolerated by the United States.

Diversification and its limits

Russia pursued de-dollarization in the years leading up to the war in Ukraine.[26] Diversification partly reflected planned contingencies for relative economic autonomy during the 2022 land grab as well as preexisting dissatisfaction with US sanctions. Following its first invasion of Ukraine in 2014, and annexation of Crimea, Russia started to diminish dollar-denominated reserves, holding more euros and renminbi instead. Though large in absolute terms, Russia's reserves are a small fraction of global reserves and insufficient to dent the dominance of either the dollar or the euro. A coordinated move with other countries, particularly China, which is the world's single largest reserve holder, could substantially reduce the dollar and the euro's dominance. Even though their rank order will not change over the foreseeable future, increased use of sanctions, and the intensity of the crackdown on Russia, is already causing other potential targets to consider alternatives to the dollar.

Based on a small sample of thirteen countries (see Figure 2), the report finds some diversification away from the dollar between the beginning of the war in February 2022 and June 2022. This modest shift amounts to some twenty basis points. Diversification is primarily occurring into the renminbi and to other minor currencies, and a lesser extent euros. The sample does not include China or Russia, which have geopolitical incentives to continue diversifying out of Western reserve majors, nor does it include Western countries, such as France, Italy, or the United Kingdom, which have incentives to diversify into Western reserve majors in this new geopolitical context. While caution must be exercised when inferring system-wide changes from limited data, these trends suggest sanctions are not causing countries to scramble out of the major Western reserve currencies.

Figure 2. Reserve Diversification after the Start of the Russian War on Ukraine



Source: International Monetary Fund.

Notes: Calculations are based on official reserves held by a sample of thirteen countries in February 2022 and June 2022.

Diversification trends give us some insight into where the wind is blowing, but are insufficient to assess future trends. Even if diversification is much larger than what this sample shows, temporary changes in the composition of official holdings are not sufficient to declare the end of dollar hegemony or the dominance of other Western currencies. However, they could portend larger upcoming changes, which must accompany diversification in order for bigger shifts in the global monetary order to occur.

Three things need to change for a multipolar currency order to become entrenched. First, the cross-border commercial and financial exchange for which international currencies are used must increase between countries keen on using alternative currencies. Second, alternative currencies must be easy to access with open economies and payment systems to enable cross-border transactions. Third, the carrying capacity of other reserve issuers must increase. While there is little indication that the biggest reserve contender—China—is capable of absorbing capital inflows consistent with a challenge to the prevailing currency hierarchy, developments on the first and second conditions for an end to the West's dominance are taking place and worth tracking.

Toward currency multipolarity?

International currencies facilitate commerce and investment. They are used to trade goods, services, and assets, including commodities such as oil, and to acquire less widely used currencies.

The oil-for-dollars, or petrodollar, mechanism central to dollar hegemony is being challenged by Russia as well as Middle Eastern and South Asian countries, and is one example of how cross-border exchange could result in greater use of the renminbi and other currencies. In order for developments such as these to pose a threat to the global currency order, it is not sufficient for currencies to be used to clear and settle economic transactions bilaterally, they must also be used by third parties.

Decades ago, the United States' shaky relations with Middle Eastern states, for example Iraq and Iran, prompted both countries to devise plans to request oil payments in euros. Today, cooperation between Saudi Arabia and China includes provisions for oil debits in renminbi. Both Saudi Arabia and China rightly fear they could become targets of US sanctions. Saudi Arabia's relationship with the United States has been under strain, most recently, due to the murder of Saudi journalist Jamal Khashoggi in 2018 and the kingdom's broader human rights violations. Financial sanctions have already been imposed against China for its human-rights abuses against ethnic minorities in the Xinjiang region. The US has also used other tools of economic statecraft, delisting Chinese firms on US stock exchanges, and preventing Chinese firms from investing in the US, on national security grounds. In 2021, China's crackdown in Hong Kong was widely criticized by US officials short of punishing sanctions.

A 2019 bilateral treaty between China and Russia includes provisions to privilege their respective national currencies to settle trade between them, a step in their plans to de-dollarize.[27] Beyond oil, a number of countries are promoting the use of alternative currencies in trade and finance. For example, India has created a mechanism, a Special Rupee Vostro Account, to encourage settlement in Indian rupees. After crediting the account, customers can either purchase Indian goods, make larger greenfield investments, or purchase Indian government securities.[28] A reintroduction of the Cold War era rupee-ruble mechanism was proposed a month after the Russian invasion of Ukraine, which resulted in Western sanctions that banned Russian banks from processing Indian payments via the Society for Worldwide Interbank Financial Telecommunication (SWIFT). Under this alternative scheme, settlement would occur directly between Russian banks holding rupees in India and Indian banks holding rubles in Russia. Volatility in the ruble's exchange rate, as a result of the war, has, however, put the brakes on the rupee-ruble mechanism.

Bilateral agreements to prioritize the use of national currencies in cross-border exchange, such as the aforementioned ones between China and Russia or between Russia and India, will not increase the international currency role of the respective national currencies. However, if multiple pairs of countries adopt the renminbi in oil invoicing, the dollar's use in oil markets will de facto decline, and therefore also its global appeal.

Moreover, if Russia or Saudi Arabia make oil available to other countries in exchange for renminbi, international use of the renminbi will increase and weaken a major reason for holding dollars, with potentially important consequences. Russia and Saudi Arabia may seem like obvious partners to such an oil-for-renminbi coalition. Competition between them for oil market shares however inhibits collaboration. In 2020, Russia upended a three-year agreement with Saudi Arabia to restrict oil supply aimed at maintaining high prices. Predictably sending oil prices into free fall, the move upset Saudi Arabia.[29]

To displace dollars in the oil market, renminbi invoicing must be actively encouraged over dollar invoicing. Given how many countries settle oil in liquid dollars, restricting the choice for dollar invoicing will initially be unpopular. Caught between a rock and a hard place, Russia will have to choose between alleviating sanctions pressures and plucking dollar customers in the price war with Saudi Arabia.

Initiatives also exist to facilitate purchases in minor currencies, with international currency implications for those currencies. For example, Russia recently ousted Saudi Arabia as the second-largest oil exporter to India, after Iraq.[30] The United Arab Emirates' currency, the dirham, is being promoted for oil settlement between Russia and India. Gazprombank and Rosneft have already started invoicing oil in dirhams.[31] Acquiring dirhams is attractive for Russians seeking to bypass the dollar, promote a more multipolar currency order, and recycle Russian wealth in a sanctions haven. Dubai has become the go-to destination for Russian investors looking to evade sanctions with Russian real estate investment in Dubai doubling in the first half of 2022 as compared to the first half of 2021.[32] Dubai has also emerged as a financial hub for the Middle East, Africa, and South Asia, offering investment opportunities beyond the real estate market, resulting in the Financial Action Task Force (FATF) placing the United Arab Emirates on its "gray list" of countries facilitating dirty money transactions.[33]

An important dimension of understanding the use of alternative currencies in trade and finance are the choices made by the private sector. One indication of a currency's attractiveness is the extent to which it is used to denominate financial assets, for instance, when issuing bonds outside the home country. Data is not yet available to measure the sanctions impact after Russia's February invasion of Ukraine. However, existing data reveals that the dollar has grown significantly in popularity with financial institutions since Russia's 2014 invasion of Ukraine when Russia began gathering support for a new global monetary order. Use of the euro declined. Other private actors increased their international use of dollars in bond issuance. Their use of euros increased to an even greater extent. Monitoring such trends can provide clues about the underlying financial and commercial structure relevant for future international currency trends.

China has taken steps to increase the use of the renminbi for reserve purposes. Since 2016, the renminbi has been included in the IMF's reserve basket of Special Drawing Rights. China began extending bilateral swap lines in 2009 in the wake of the financial crisis. The largest bilateral swap line is with Russia, to the tune of $24 billion. More recently, China has collaborated with the Bank for International Settlements (BIS) to create a Renminbi Liquidity Arrangement (RMBLA) to support contributing central banks in times of crisis. The central banks of Chile, Hong Kong, Indonesia, Malaysia, and Singapore have pledged $2 billion each in renminbi or dollars to the reserve pool which will be housed with the BIS in Basel, Switzerland. Though China's reserve and liquidity provision volumes remain modest, they are likely to grow. These measures are the kinds of steps required for the renminbi to play a role as an intervention currency, for countries to start aligning their currency with the renminbi, and for China to assume lender of last resort functions in times of crisis. The more easily accessible, and liquid, the renminbi becomes, the greater the likelihood it will emerge as an alternative settlement currency.

Significant international currency issuance requires investors and governments to have easy access to the currency at low cost and in high volumes. The Chinese government has been reluctant to embrace full currency convertibility and capital account convertibility for domestic political reasons. It has, however, taken decisive action to create its own clearing and settlement mechanism—China's Cross-Border Interbank Payment System (CIPS)—to promote the use of the renminbi commercially and financially. Similar to the US Clearing House Interbank Payments System (CHIPS), CIPS facilitates transactions, allowing funds to be moved and settled. It is different from SWIFT, both in terms of use and scale, which boasts nearly ten times as many users (around eleven thousand) as CIPS (around one thousand three hundred). Like CHIPS, CIPS relies on SWIFT for financial communication. Eventually, China may devise its own messaging system for complete financial independence in cross-border settlements. The payments initiative plays an important supporting role in China's aspiration to gain financial clout, with more users

Chinese President Xi Jinping and Russian President Vladimir Putin attend a ceremony dedicated to the 70th anniversary of the establishment of diplomatic relations between Russia and China, in Bolshoi Theatre in Moscow, Russia June 5, 2019. Sergei Ilnitsky/Pool via Reuters

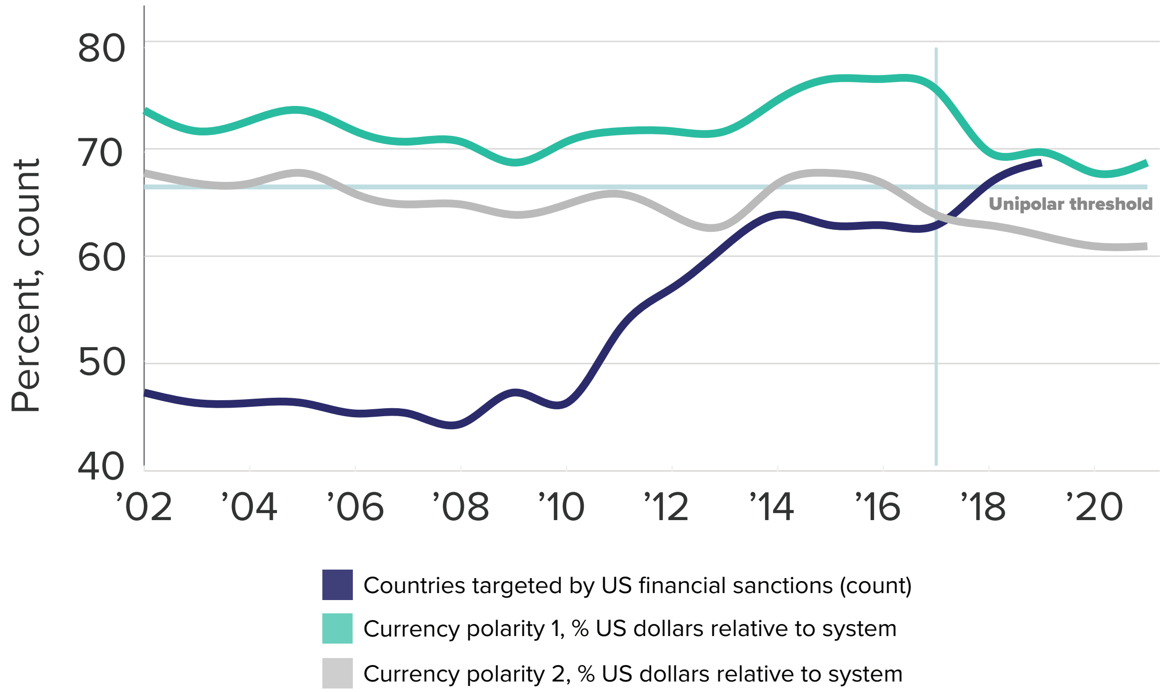
likely to sign on with time. Similar to SWIFT, the Bank of Russia created a financial messaging system—FMS—to bypass SWIFT after the 2014 Ukraine crisis. Here, the scale is even smaller, comprising only four hundred users.

Lastly, balance of payment constraints impede large-scale currency diversification because no other country is willing or presently capable of absorbing large capital inflows in exchange for liquidity creation. Purchasing assets denominated in alternative currencies from other countries, instead of US dollar denominated assets, implies those countries must be prepared to absorb the trade deficit associated with the capital inflow. In the postwar era, no country, or group of countries, has been willing to run large-scale deficits to support currency dominance on the scale that the United States has tolerated current account disequilibrium.

Figure 2 above showed minimal diversification away from the US dollar, the euro and the British pound, and some diversification away from the Japanese yen, between February 2022 when Russia invaded Ukraine and the summer of 2022. In a longer term perspective, countries have diversified away from the US dollar, particularly after a credible alternative to the dollar became available following the euro's launch in 2002. The trend was interrupted with the fallout from the 2008 financial crisis which resulted in the sovereign debt crisis of 2009 in euro-zone countries. Since 2009 and up until 2017, the dollar gained ground vis-a-vis the euro. These trends can be seen in Figure 3 below, which show the number of countries sanctioned by the United States every year between 2002 and 2019 along with two different measures of currency polarity.

Polarity is usually used to describe the distribution of military power in the international system but can also be applied to analyze the distribution of currency power in the international system. A pole is a great power with extraordinary capability within the substantive area under consideration. For example when the "unipolar moment" was declared at the end of the Cold War, Russia, Great Britain, Japan, and France were still considered to be great powers, though not of the same caliber as the United States.[34] The disparity between them was far too large for them to be considered similar types of great powers.[35]

Figure 3. **Currency Polarity and Financial Sanctions**



Source: International Monetary Fund, Global Sanctions Database.

Notes: The first measure of polarity is the share of reserves held in US dollars relative to the reserves held in the currencies of the core major issuers (the USA, Euro-zone and Japan) and in US dollars. The second measure of polarity is the share of reserves held in US dollars relative to the reserves held in all reserve majors including US dollars.*Unipolar threshold represents the minimum US dollar share of the system in order for the US dollar to be considered a unipolar currency, accounting for two-thirds of the system's reserves.

Some method is needed to determine how much relative power is needed to qualify as a great power. The first, and more accurate, measure of currency polarity assumes the system of great power reserve issuers should only comprise countries issuing core reserve majors—the US dollar, the euro and the Japanese yen.[36] Core majors are reserve currencies which account for at least 5 percent of foreign exchange reserves.[37] The second measure of polarity assumes the system of great power reserve issuers includes any country issuing a reserve major, regardless of how widely their currency is used for reserve purposes. In this measure, small issuers accounting for less than 1 percent of foreign exchange reserves, such as Switzerland, are also part of the system of great power reserve issuers. Regardless of how the system of great power reserve issuers is defined, polarity is quantified as the share of US dollar reserves relative to the system.

How much "more powerful" must a great power currency issuer be in order to qualify as a unipole? Figure 3 defines unipolarity as a system where one great power's reserve issuance is twice as large as the reserves issued by the other great powers in the system. This definition of unipolarity applies to both measures of polarity, and represents a clear-cut case of unipolarity. The cut off point is conservative. A case for unipolarity could be made at lower levels of power disparity between a leading provider of reserves and providers of other currency majors in the system. When the reserve issuance of one great power is twice as large as the amount of reserves issued by other great powers in the system, the unipole issues two-thirds of all the reserves in the system. Figure 3 therefore draws a line, the unipolar threshold, at the point where the international currency system is unipolar, with reserves in US dollars accounting for at least two-thirds of all reserves in the system. Below this floor, the international currency system is either bipolar or multipolar.

As shown in Figure 3, it is possible that factors quite apart from financial sanctions may be driving the decline in dollar unipolarity. When the number of countries targeted by US sanctions stayed constant before 2010, dollar unipolarity declined on both measures. As the number of countries facing US sanctions increased as of 2010, the first, more accurate, measure of dollar polarity, increased up until 2015. It also bears underlining that if sanctions matter for currency polarity, it is not just the number of countries that is of relevance. After Russia's first invasion of Ukraine in 2014, the number of countries hit by US financial sanctions stayed the same, but dollar unipolarity decreased on the second measure, which accounts for a greater number of currency majors when evaluating polarity. The implication is that smaller reserve issuers grew in importance during this time. When the number of countries met by US financial sanctions rose sharply as of 2017, and a President threatening to revoke alliance commitments was elected, dollar unipolarity declined on both measures, with the first measure reaching its lowest point in two decades and headed below the unipolar threshold.

CONCLUSION

A more fraught international environment is having negative repercussions on countries' willingness to remain economically interdependent. Geopolitical rivalry has rejigged the neat separation between economic and security affairs. Countries still seek gains from open economic exchange, but are wary of their national security ramifications. Reminiscent of the Cold War era, governments are paying more attention to ensuring countries they support economically are countries they support geopolitically. In this new context, international economic relationships risk becoming subordinated to geopolitical relationships. Several analysts believe that the international role of the dollar was in part a function of the United States' geopolitical role, particularly during the Cold War years. When the threat of the Soviet Union dissipated, some believed an important incentive to hold dollars beyond its economic appeal, was removed. The euro's launch in 2002, and the creation of a viable reserve alternative, made it possible to reassess reserve holdings in dollars. Fears about dollar collapse started to surface.

Today, these qualms have returned with a vengeance. This time, the worry is not that allies no longer have security reasons to support the dollar. Instead, states dissatisfied with the current international order are possibly cultivating economic alternatives to the Western-led economic order. Endowed with the world's largest financial institutions and the world's first currencies, Western countries, particularly the United States and Europe, are increasingly using financial sanctions as a way of policing international order. Countries with which they have fundamental disagreements will reconsider pursuing policies that may be met with heavy sanctions and feel less secure about using Western currencies. So far, countries have not diversified away from Western currencies to any great extent in response to Russia's 2022 invasion of Ukraine, but developments are underway to bypass the dollar and the euro. Greater use of Chinese renminbi, and more minor currencies, will not put an end to the Western centric currency system, but if unchecked, it could accelerate the slide away from the dollar's unipolarity, reinforcing a longer term trend. Dollar hegemony has however bounced back from previous downward cycles. The large lead to competitor currencies suggests this time is unlikely to be different as long as the US maintains a strong economy, open markets, and ties to allies.

ANNEX

Glossary

BIS	Bank for International Settlements
CHIPS	Clearing House Interbank Payments System
CIPS	Cross-Border Interbank Payment System
RMBLA	Renminbi Liquidity Arrangement
SWIFT	Society for Worldwide Interbank Financial Telecommunication

ENDNOTES

1 Rana Foroohar, "China, Russia and the Race to a Post-Dollar World," *Financial Times*, February 27, 2022, https://www.ft.com/content/e5735375-75df-4859-bbf0-ae22e4fe2ff6.

2 Martin Wolf, "A New World of Currency Disorder Looms," *Financial Times*, March 29, 2022, https://www.ft.com/content/f18cf835-02a0-44ff-875f-7de7facba54e.

3 Jonathan Wheatley and Colby Smith, "Russia Sanctions Threaten to Erode Dominance of US Dollar, Says IMF," *Financial Times*, March 31, 2022, https://www.ft.com/content/3e0760d4-8127-41db-9546-e62b6f8f5773.

4 Zoltan Pozsar, "Money, Commodities, and Bretton Woods III," Credit Suisse, March 31, 2022, https://media-exp1.licdn.com/dms/document/C4D1FAQHBG1Gbbc-RTQ/feedshare-document-pdf-analyzed/0/1648801229665?e=2147483647&v=beta&t=kD-MzNr1SycLOMmbOEjQsDikK3CPAAirWIDYKhs7Me94.

5 Ibid.

6 Susan Strange, *Sterling and British Policy: A Political Study of an International Currency in Decline* (London: Oxford University Press, 1971).

7 IMF (2022): "Currency Composition of Official Foreign Exchange Reserves (COFER)," International Monetary Fund: Washington D.C.

8 Charles P. Kindleberger, "The Politics of International Money and World Language" in *Essays in International Finance* 61 (August 1967), International Finance Section, Department of Economics, Princeton University, Princeton, New Jersey, https://ies.princeton.edu/pdf/E61.pdf.

9 Cristina Tessari and Zach Pandl, "Global Markets Daily: Lessons for the Dollar from the Fall of the British Pound," Goldman Sachs, March 30, 2022.

10 Ibid.

11 Janet Kelly, "International Monetary Systems and National Security," in *Economic Issues and National Security*, eds. Klaus Knorr and Frank N. Trager (Kansas: University Press of Kansas, 1977) 231–59; and Strange, *Sterling and British Policy*.

12 Menzie Chinn and Jeffrey Frankel, "Why the Euro Will Rival the Dollar," *International Finance* 11 (1): 49–73, DOI: 10.1111/j.1468-2362.2008.00215.x.

13 Adam S. Posen, "Why the Euro Will Not Rival the Dollar," *International Finance* 11 (1): 75–100, DOI: 10.1111/j.1468-2362.2008.00217.x.

14 C. Fred Bergsten, *The Dilemmas of the Dollar: Economics and Politics of the United States* (New York: New York University Press, 1975); and Strange, Sterling and British Policy.

15 Carla Norrlof, *America's Global Advantage: US Hegemony and International Cooperation* (Cambridge, United Kingdom: Cambridge University Press, 2010).

16 Hubert Zimmermann, *Money and Security: Troops, Monetary Policy, and West Germany's Relations with the United States and Britain, 1950–1971* (New York: Cambridge University Press, 2002).

17 Carla Norrlof et al., "Global Monetary Order and the Liberal Order Debate," *International Studies Perspectives* 21 (2): 109–153, https://doi.org/10.1093/isp/ekaa001.

18 Quan Li, "The Effect of Security Alliances on Exchange-Rate Regime Choices," *International Interactions* 29 (2): 159–193, https://doi.org/10.1080/03050620304600.

19 Barry Eichengreen, Arnaud Mehl, and Livia Chițu, "Mars or Mercury? The Geopolitics of International Currency Choice," *Economic Policy* 34 (98): 315–363, https://doi.org/10.1093/epolic/eiz005.

20 David P. Calleo, *Follies of Power: America's Unipolar Fantasy* (New York: Cambridge University Press, 2009).

21 Joseph Zeballos-Roig, "The US rolls out fresh sanctions meant to block Putin from accessing a $630 billion 'war chest' he could use to prop up a battered economy," February 28, 2022, Business Insider: New York

22 US Department of the Treasury, Treasury Sanctions Iran's Central Bank and National Development Fund, press release, September 20, 2019, https://home.treasury.gov/news/press-releases/sm780.

23 Agence France-Presse, "Venezuela Slams US Over 'Vulgar' Central Bank Funds Seizure," *Barron's*, April 17, 2020, https://www.barrons.com/news/venezuela-slams-us-over-vulgar-central-bank-funds-seizure-01587160807.

24 Saleha Mohsin, "U.S. Freezes Nearly $9.5 Billion Afghanistan Central Bank Assets," Bloomberg, August 17, 2021, https://www.bloomberg.com/news/articles/2021-08-17/u-s-freezes-nearly-9-5-billion-afghanistan-central-bank-assets.

25 Carla Norrlöf, "The New Economic Containment: Russian Sanctions Signal Commitment to International Order," 18 March, 2022.

26 Mrugank Bhusari and Maia Nikoladze, "Russia and China: Partners in Dedollarization," Atlantic Council, February 18, 2022, https://www.atlanticcouncil.org/blogs/econographics/russia-and-china-partners-in-dedollarization/.

27 Ibid.

28 PTI, "RBI Announces Measures for International Trade Settlement in Rupees," *Deccan Herald*, July 11, 2022, https://www.deccanherald.com/business/economy-business/rbi-announces-measures-for-international-trade-settlement-in-rupees-1125701.html.

29 Alex Ward, "The Saudi Arabia-Russia oil war, explained," March 9, 2020, Vox

30 Nidhi Verma, "Russia becomes India's second biggest oil exporter, trade sources' data show," June 13, 2022, Reuters: London

31 Nidhi Verma, "Exclusive: Russia Seeking Oil Payments from India in Dirhams," Reuters, July 18, 2022, https://www.reuters.com/business/energy/exclusive-russia-seeking-oil-payments-india-dirhams-sources-document-2022-07-18/.

32 Natasha Turak, "Villas by the Sea: Rich Russians Fleeing Sanctions Are Pumping Up Dubai's Property Sector," CNBC, July 8, 2022, https://www.cnbc.com/2022/07/07/rich-russians-fleeing-sanctions-are-pumping-up-dubais-property-sector.html.

33 Ted Kemp and Natasha Turak, "UAE Is Placed on Money Laundering Watchdog's 'Gray List,'" CNBC, March 5, 2022, https://www.cnbc.com/2022/03/05/uae-is-placed-on-money-laundering-watchdogs-gray-list-.html.

34 Charles Krauthammer, "The Unipolar Moment," *Foreign Affairs*, 70, 23-33, 1990.

35 William C. Wohlforth, "The Stability of a Unipolar World," *International Security*, 24, 5-41.

36 Cohesive entities such as the euro-zone countries are also included, but not the category "other" issuers since it includes disparate countries and not a cohesive group of countries.

37 To be more precise, more than 5 percent of all allocated reserves are held in these currencies. Allocated reserves are foreign exchange reserves for which the currency breakdown is know

Dr. Carla Norrlöf is a nonresident senior fellow with the Atlantic Council's GeoEconomics Center. Her research is on theories of international cooperation with a special focus on great powers particularly US hegemony in the areas of money, trade and security. Her academic work has been published by Cambridge University Press, MIT Press and Oxford University Press, the Canadian Journal of Political Science, Conflict Management and Peace Science, Cambridge Review of International Affairs, Cooperation and Conflict, International Affairs, International Political Science Review, International Security, International Studies Perspectives, Review of International Political Economy and Security Studies. Her opinion pieces have featured in Foreign Affairs, the Monkey Cage (Washington Post), Newsweek and the Globe & Mail.

Norrlöf is professor of Political Science at the University of Toronto, and a research associate with the Graduate Institute of International Studies (Geneva). She is the author of America's Global Advantage, an analysis of America's commercial, financial and military hegemony (Cambridge University Press), and Dollar Hegemony (Review of International Political Economy).

Acknowledgements
The authors would like to thank the leadership and staff of the Atlantic Council GeoEconomics Center and Atlantik-Brücke including Mrugank Bhusari, Sophia Busch, Ananya Kumar, Kathy Butterfield, Katharina Draheim, Franka Ellman, Robin Fehrenbach, Julia Friedlander, Niels Graham, Cate Hansberry, Charles Lichfield, Josh Lipsky, Ole Moehr, and Maia Nikoladze.

Atlantic Council

The Atlantic Council is a nonpartisan organization that promotes constructive US leadership and engagement in international affairs based on the central role of the Atlantic community in meeting today's global challenges.

Please direct inquiries to: Atlantic Council
1030 15th Street, NW, 12th Floor Washington, DC 20005
(202) 778-4952
www.AtlanticCouncil.org