Universe
Scientific Publishing

The Decline of Dollar Hegemony and its Effect

Linteng Ni

The Australian National University, Canberra 0200, Australia

Abstract: Amidst the ongoing Russian-Ukrainian war and the receding COVID-19 pandemic, a noteworthy and unusual trend has emerged, revealing a shift in global economics. The hegemony of the US dollar, once dominant, is now accelerating its decline. Related reports have exacerbated my growing concerns about asset stability and currency volatility.

Keywords: Dollar; Hegemony; decline; implications; asset; stability; currency volatility

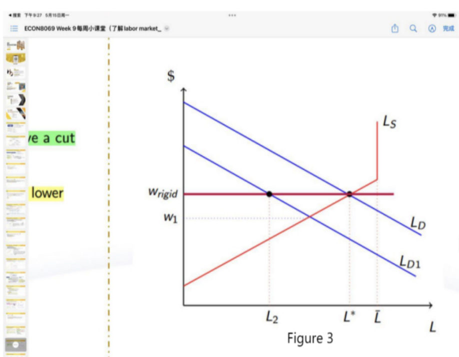
The Decline of Dollar Hegemony

As Zoffer (2012) mentioned, "Since the mid-twentieth century, the dollar has enjoyed almost unrivalled status as the world's preferred reserve currency". Given its dominant role in international trade and its close association with petroleum, the dollar exerts a decisive influence on the functioning of the international monetary system. The dollar hegemony has hardly been disrupted since the end of World War II (Zoffer, 2012). However, Bertaut (2021) of the Federal Reserve announced a decline in the dollar's share of global official foreign exchange reserves from 71% in 2000 to 60% in 2021, indicating a decline in the dollar's dominance and a growing trend of currency diversification. Russia's and China's initiatives to strengthen local currency settlements and lessen reliance on the dollar serve to highlight this trend even more (Lawrence, 2023)

Unravelling the Implications of US Dollar Hegemony

According to Kurt (2022), "today's fiat money is backed entirely by social agreement and faith in the issuer". The Federal Reserve (2023) estimates that the production cost of a $100 bill is only 17 cents. However, the US government's credibility has been questioned due to its extensive money printing during economic crises. This practise of creating wealth out of thin air allows the US to generate seigniorage globally. These excess dollars contribute to global inflation. The Fed's rise in interest rates to combat inflation leads to capital outflows from other countries into the US market, resulting in currency depreciation, financial system instability, and effects on import-export trade, potentially leading to crises. Furthermore, other countries are compelled to purchase US Treasury bonds to maintain the value of their own currencies, while the US invests these absorbed dollars at lower prices. In essence, the US operates similarly to a commercial bank. Over the past few years, the US has employed similar strategies to exploit global wealth, even weaponizing the dollar to kidnap foreign politics and freeze foreign assets.

By employing the Solow-Swan model (Solow, 1956; Swan, 1956), we can assess the detrimental effects of dollar hegemony on a country. We assume that the country starts at a steady-state level. The US buys its physical capital with over-issued dollars; physical capital is actually bought cheaply because the impact of inflation is often not immediately recognised. With capital outflows, as depicted in Figure 1, the country's capital reduces from k0 to k1, resulting in a decline in GDP to y1 as the capital decreases. Figure 2 illustrates the gradual process of returning from y1 to the previous level, y0, which takes time.



Inflation can trigger recessions by driving up prices and reducing consumers' purchasing power, leading to a decline in demand for goods and services. Phillips (1958) shows that inflation and unemployment have an inverse relationship, implying that inflation can boost short-term growth and employment. However, this relationship breaks down in the long term (Phelps, 1967) or during stagflation (Friedman, 1978). Moreover, downward wage rigidity may exacerbate the impact of inflation. When employers are unable to lower wages in response to inflation, their costs increase, causing a decrease in production and hiring to match the low demand, particularly during an economic downturn. As a consequence, the labour demand curve shifts to the left from LD to LD1. Figure 3 demonstrates the consequences of this situation, as firms are only willing to hire L2 numbers of workers due to the inability to adjust wages but have L* numbers of workers in supply, resulting in involuntary unemployment.

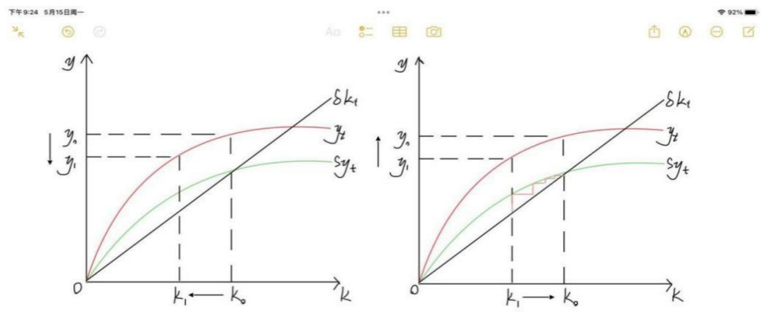


Figure 1 Figure 2

The Dilemma: The Inevitable Acceleration of Currency Diversification

The US has been trapped in a cycle where rising interest rates lead to accelerated de-dollarization by countries seeking to avoid exploitation. Once everyone sells US dollars, it creates a surplus on the international market. To solve this surplus, the Fed must further raise interest rates, thereby hastening the de-dollarization process. Alternatively, lowering interest rates could reignite inflation in the US, causing the US dollar index to plummet and further accelerating de-dollarization. The US's aggressive interest rate hikes are exposing the world to increasing financial risks. Notably, the decline in China's US Treasury holdings, reaching a 12-year low in 2022 (Chu, 2023), exemplifies the trend of bondholders reducing their investments in Treasury bonds.

Personal Implications: How the Decline of Dollar Hegemony Affects Me

The collapse of US dollar hegemony will reshape the global economy, causing inflation, price fluctuations, increased trade and financial risks, and significant geopolitical implications. Affecting nearly everyone, especially families that are closely linked to the financial markets like mine. I am particularly concerned about the stability of assets tied to the US dollar, such as the Hong Kong dollar. The system maintains a stable exchange rate of 7.75–7.85 Hong Kong dollars per US dollar (2019, Hong Kong Monetary Authority). If the US dollar's hegemony collapses, the stability of Hong Kong and its financial system will be challenged, prompting me to reconsider investment options for Hong Kong assets in favour of more stable alternatives.

Numerous investors have divested from the US Treasury and have chosen to buy gold to protect their assets as the likelihood of a US debt default rises. On May 10, COMEX gold futures hit 2038.33 US dollars per ounce. Investors flocked to gold as a safe-haven asset, driving its price close to an all-time high (Chen, 2023). In times of increasing financial market uncertainty, it is important to prioritise cash reserves to safeguard assets. Thus, it becomes crucial to liquidate uncertain assets and patiently await favourable opportunities. Once the dollar's hegemony collapses, possible exchange rate fluctuations will affect my spending abroad. A new global economic system could bring opportunities,but if it leads to a further recession, my employment prospects will be more bleak, especially as a finance student.

Conclusion

In this report, I discussed an unusual trend, the accelerated disintegration of the US dollar hegemony, and analysed how it affects countries and its potential effects on me.

References

[1] Bertaut, C., Beschwitz, B. von, & Curcuru, S. (2021, June 10). The international role of the U.S. dollar. The Fed - The International Role of the U.S. Dollar. https://www.federalreserve.gov/econres/notes/feds-notes/the-international-role-of-the-u-s-dollar-20211006.html

[2] Chen, Z. (2023, May 10). The U.S. debt default crisis strikes, the rich family office urgently adjusts its positions to avoid risks. nited States_Sina Finance_Sina.com. https://finance.sina.com.cn/roll/2023-05-10/doc-imytiazr0180096.shtml

[3] Chu , D. (2023, February 16). China's US Treasury Holdings Fall to a 12-year low in 2022 as crackdown fuels impetus to diversify away from dollar-backed assets. Global Times. https://www.globaltimes.cn/page/202302/1285581.shtml.

[4] Friedman, M. (1978) Inflation and unemployment the new dimension of politics. London: The Institute of Economic Affairs.

[5] Hong Kong Monetary Authority. (2019, August 25). linked exchange rate system. Hong Kong Monetary Authority. https://www.hkma.gov.hk/gb_chi/key-functions/money/linked-exchange-rate-system/

[6] Kurt, D. (2022, July 8). How currency works. Investopedia. https://www.investopedia.com/articles/investing/092413/how-currency-works.asp

[7] Lawrence, D. (2023, April 25). Russia and China increase trade settlements in local currencies, reducing US Dollar Reliance: CoinMarketCap. CoinMarketCap Alexandria. https://coinmarketcap.com/alexandria/article/26ccf031-6bdb-4ca9-9238-1a86bc2399e7

[8] Phillips, A. W. (1958). The relation between unemployment and the rate of change of money wage rates in the United Kingdom, 1861-1957. economica, 25(100), 283-299.

[9] Phelps, E. S. (1967). Phillips curves, expectations of inflation and optimal unemployment over time. Economica, 254-281.

[10] Solow, R. M. (1956). A contribution to the theory of economic growth. The quarterly journal of economics, 70(1), 65-94.

[11] Swan, T. W. (1956). Economic growth and capital accumulation. Economic record, 32(2), 334-361.

[12] The Federal Reserve Board. (2023, May 6). How much does it cost to produce currency and coin?. Board of Governors of the Federal Reserve System. https://www.federalreserve.gov/faqs/currency_12771.htm

[13] ZOFFER. (2012). Future of Dollar Hegemony: The Dollar's Role After the Euro Crisis. Harvard International Review, 34(1), 26–29.

About the author:

Ni Linteng (2001.01-); male; Han; Fujian; postgraduate student; The Australian National University; Research direction: Finance.