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What Russia-Ukraine conflict may imply for the future of dollar-centered monetary system

Opinion by The Manila Times

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A GLOBAL financial summit held in Paris some days ago reached a "new" global pact to help developing countries deal with poverty, climate change and debt. Part of the solution? More "funds," that is, debt. Ironically, nobody at the Paris summit questioned the current monetary system, which is at the root of the debt problem.

Coincidentally, a recent article in the journal Real-World Economics Review (http://www.paecon.net/PAEReview/issue104/Spano) argues that one of the potential consequences of the Russia-Ukraine war could be the demise of the US dollar as the international unit of account. If this materializes, the international monetary system may change significantly. This could be one of the most important events of the 21st century.

How system works

In this article, I elaborate on how the actual system, centered around the dollar, works, how it may change, and what this means for developing countries.

The current monetary system was established in 1971. From that year on, the dollar became the "international unit of account and store of value" as the international monetary system switched from the gold standard to one built upon the availability of treasury bills issued by the US Treasury. The US banking and financial system became the headquarters of the entire global capitalist world.

The United States was able to impose the dollar as the international unit of account by forcing oil and internationally traded goods to be denominated in dollars. Crucially, the system has become linked to the supply of fossil energy sources, particularly oil, since the 1973 oil crisis. The dollar as an international unit of account was secured by an agreement between the US and Saudi Arabia, in which the former ensured that oil prices would be denominated in dollars (implying that anyone purchasing oil would need to acquire dollars), while the latter obtained military protection. The US also pursued an aggressive policy of international credit and the removal of barriers to the free movement of financial capital. This way, the pool of US debtors expanded to include the governments of emerging countries. Developing countries in need of dollars to pay for imports are forced to run trade surpluses and keep domestic demand undersized compared to their productive capacity. A second option is to have millions of workers abroad send home remittances. The need to import many goods (and pay dollars) and to have to export to pay for them, is the balance-of-payments constraint that sets the ceiling on how fast developing countries can grow without incurring balance-of-payments problems.

IMF, World Bank

The IMF and the World Bank claimed during the recent Paris summit that they were taking steps to boost crisis financing. This is ironic as these two institutions have transformed from multilateral agencies into instruments of the US Treasury throughout the past decades, and they are appendages of the US banking system.

Under the current monetary system, while other countries have to earn dollars by producing products that have to be exported, the United States simply has to print the bills. As a consequence, claims that the United States "finances" excess demand thanks to foreign credit are misleading. China, in particular, does not finance the current account deficit of the United States. The story has to be told the other way around, that is, it is China's desire to accumulate dollars that forces it to export to the United States in exchange for dollars.

Somewhat paradoxically, many politicians and even economists today still analyze the monetary system as if it were based on the gold standard, despite the fact that this ended in 1971. Today's currencies are not backed by any precious metal. They are not backed by any commodity. Modern economies operate with "fiat currency." Its value is largely based on the public's faith in the currency's issuer, which is normally that country's government or central bank. It is accepted by all citizens because we need it to pay taxes and other obligations. What are the potential consequences of the Russia-Ukraine war for the monetary system? Since 2014, there has been a significant reduction in global dollar reserves. This can be attributed to different factors. One of them is Asia-centered: although the current account surpluses of Asian countries have remained stable, Asian central banks began arresting the accumulation of dollar reserves around 2014-2015. China, being the world's largest economy, has played a significant role in driving these changes. Also, in many Asian countries, institutional investors, such as life insurers and pension funds, seeking higher yields, have displaced central banks as the major buyers of US government bonds.

The increasing concentration of dollar-denominated assets in the hands of private entities in Asia poses a risk to the US because of the rise of alternative hubs in global private finance that rival the dominance of its financial system. The protectionist retreat of the US under the current and previous administrations is a reaction to the gradual rise of new economic, industrial and commercial powers, primarily China, from the hegemony of the dollar. The progressive reduction of the stock of US Treasury bills held as reserves by the Chinese central bank is a deliberate act. This has triggered a reallocation of financial assets that has endangered the centralization of capital in American hands, fueling US protectionist measures. In this scenario, the conflict in Ukraine has set off a sequence of events that could potentially undermine the US hegemony over international financial markets.

In March 2022, the US decided to freeze $630 billion of Russian reserves and assets abroad and impose an embargo on Russia's access to the Swift international payment system. In doing so, the US has put into question the prompt exchangeability of dollar reserves, a fundamental premise that has underpinned international trust in the dollar for almost 80 years. This has raised many questions and caused a loss of trust in the current system in some parts of the international community.

US protectionist retreat

Following the sanctions, Russia reacted by requesting to be paid in rubles for its gas supplies. The purpose is clearly to break out of the dominance of the dollar. This is a significant step that has given impetus to a series of attempts to reorganize international payments. Saudi Arabia, for example, now sells oil to China and is paid in yuan, with which it buys Chinese goods or holds currency reserves. India entered into agreements with Russia to buy Russian weapons, paying for them in rupees, a currency that Russia now uses as a reserve by purchasing Indian securities. The Brics group of countries has received recent requests for membership from Argentina, Iran and Algeria. This reveals how a group of countries that represents a third of the world's landmass (thus exercising enormous market power over natural resources and fossil energy sources) is getting attention from other countries trying to break free from dependence on the US monetary system. The bloc is holding discussions to establish an international currency anchored to a basket of national currencies.

The above indicates that it is possible that the Russia-Ukraine war prompts a significant detachment from the monetary, financial and commercial circuit centered around the dollar. A departure from the dollar may materialize in the anchoring of national currencies, primarily the yuan, to natural resources. From a strategic standpoint, the race for natural resource procurement is a competition between rival powers to secure potential production. From a monetary perspective, it would signify a return to a commodity-money system. Finally, from a developmental point of view, these shifts stress the importance of "increasing monetary independence," understood in this context as having a national currency that others accept as payment and that other nations want to accumulate. Not all currencies in the world command the power that the US dollar does. There is a spectrum, with the currencies of the developing countries at the bottom. Higher monetary independence is acquired by producing and exporting products that others want to buy (with a high income elasticity of demand), which confers on the seller country increasing power to decide how it wants to be paid. Developing countries need to change their development models to increase their independence. This requires moving away from a development model based on attracting FDI by giving tax breaks, improving the ranking in the World Competitiveness Report and ease of doing business, reducing the budget deficit, or reforming "everything" to look good in the eyes of the rating agencies and international organizations. Instead, developing-country governments should focus on transforming the structure of their economies. Unless this is understood, the Paris financial summit will be another trap for the developing world. Asian countries like Pakistan and Sri Lanka are in this dire situation, both at the mercy of international institutions.

The crux of the matter is: how far would the United States go to preserve the current monetary system, from which it benefits enormously?

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