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Russia Sanctions Won't Doom the U.S. Dollar

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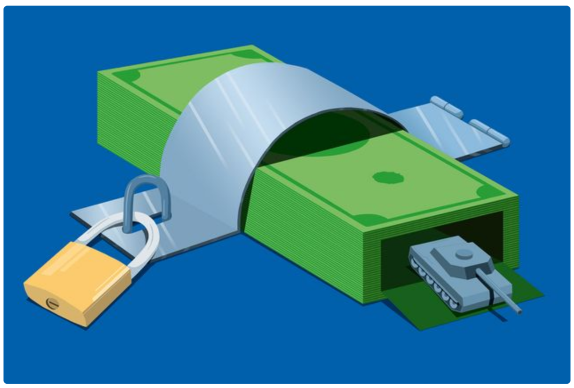

Illustration by Alexander Glandien

*About the author: **Eswar Prasad** is a professor in the Dyson School at Cornell University, a senior fellow at Brookings, and author of The Future of Money: How the Digital Revolution Is Transforming Currencies and Finance.*

The U.S. and other Western economies have deployed a set of potent financial weapons against Russia with remarkable speed. Cutting off access to global financial markets and to Russia's war chest of foreign-exchange reserves has dealt Russia's economy a crippling blow.

Will these actions come back to haunt the West? Speculation is rife that when the dust settles, China, Russia, and others will intensify efforts to unshackle themselves from the dollar-dominated system and reduce their financial vulnerability.

The reality is likely to be far less dramatic. Some changes already under way as a result of new financial technologies could gather steam. But the fundamental structure of global finance, including the status of the major reserve currencies, will not be easily shaken. That would require deep-rooted reforms that China and Russia have long scorned.

Financial sanctions are a powerful tool of economic warfare. They can bite deeper and more quickly than economic sanctions, such as trade barriers that limit the flows of goods and services. Their potency reflects continued Western, and particularly U.S., dominance of global finance, even as the locus of global gross domestic product has shifted toward emerging market economies.

The power of this set of tools relies on the U.S. dollar's status as the world's pre-eminent currency for international payments and also for foreign-exchange reserve holdings of central banks. The U.S. also has outsize influence over the Swift messaging system.

Could China and India allow Russia to evade sanctions? The relatively modest financial footprint of those economies and their exposure to secondary sanctions limit the viability of this escape route. But surely the lesson that these countries will take away is the need to reduce their vulnerability to sanctions. That will be feasible in some dimensions but not in others.

International payments and messaging systems are ripe for change. New financial technologies are making it easier to conduct financial transactions directly between pairs of emerging market currencies. Directly exchanging rubles, rupees, or renminbi for one another without first exchanging those currencies into or out of dollars is becoming cheaper and quicker, reducing the reliance on dollar-based finance.

Swift's messaging system obviates hurdles related to differences in operating language, technological protocols, and regulatory requirements between banks in various countries. Innovations such as Bitcoin's blockchain technology could render Swift's business model obsolescent within a few years.

Country-level initiatives will expedite these changes. China's Cross-Border Interbank Payment System, set up in 2015, will soon facilitate direct payments and settlement with those of other countries, including Russia's. The CIPS also has messaging capabilities that could bypass Swift.

In short, the dollar's dominance in international payments will inevitably erode, although it will probably remain the most important payment currency, and the relevance of Swift will fade.

What about the configuration of global reserve currencies? Russia had accumulated a war chest of foreign-exchange reserves—mostly in dollars, euros, pounds sterling, and Chinese renminbi—to protect the ruble's value at times of economic or geopolitical turmoil. The freezing of the Russian central bank's accounts in Western financial capitals has effectively sealed this war chest.

Surely this will lead not just Russia but also other countries to shift out of dollars and euros, and into the currencies of friendlier countries like China. But as Russia is discovering, at crunch time, renminbi reserves are of limited help in preventing the ruble's collapse.

The renminbi remains a nonconvertible currency. The Chinese government might not appreciate Russia dumping renminbi to buy dollars and euros and using those "hard currencies" to prop up the ruble. Unless China drops restrictions on capital flows across its borders and the tight management of its currency, the renminbi will not become a major reserve currency.

Moreover, private investors are unlikely to place their trust in a reserve currency that is not backed up by a strong institutional framework. Such frameworks—which encompass independent central banks, open and transparent governments, an institutionalized system of checks and balances, and the rule of law—remain the trump card of the U.S. and other Western nations.

The aftermath of Russia's invasion of Ukraine will have repercussions for the international monetary system. Unless the rest of the world is willing to adopt some of the key traits of liberal democracies, however, these changes are likely to be modest evolutionary ones rather than the radical transformation that China and other U.S. rivals would dearly like to see.

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