Currency warrior: why Trump is weaponising the dollar

Businesses in countries such as Russia are testing the power of the reserve currency but it could benefit from any global instability

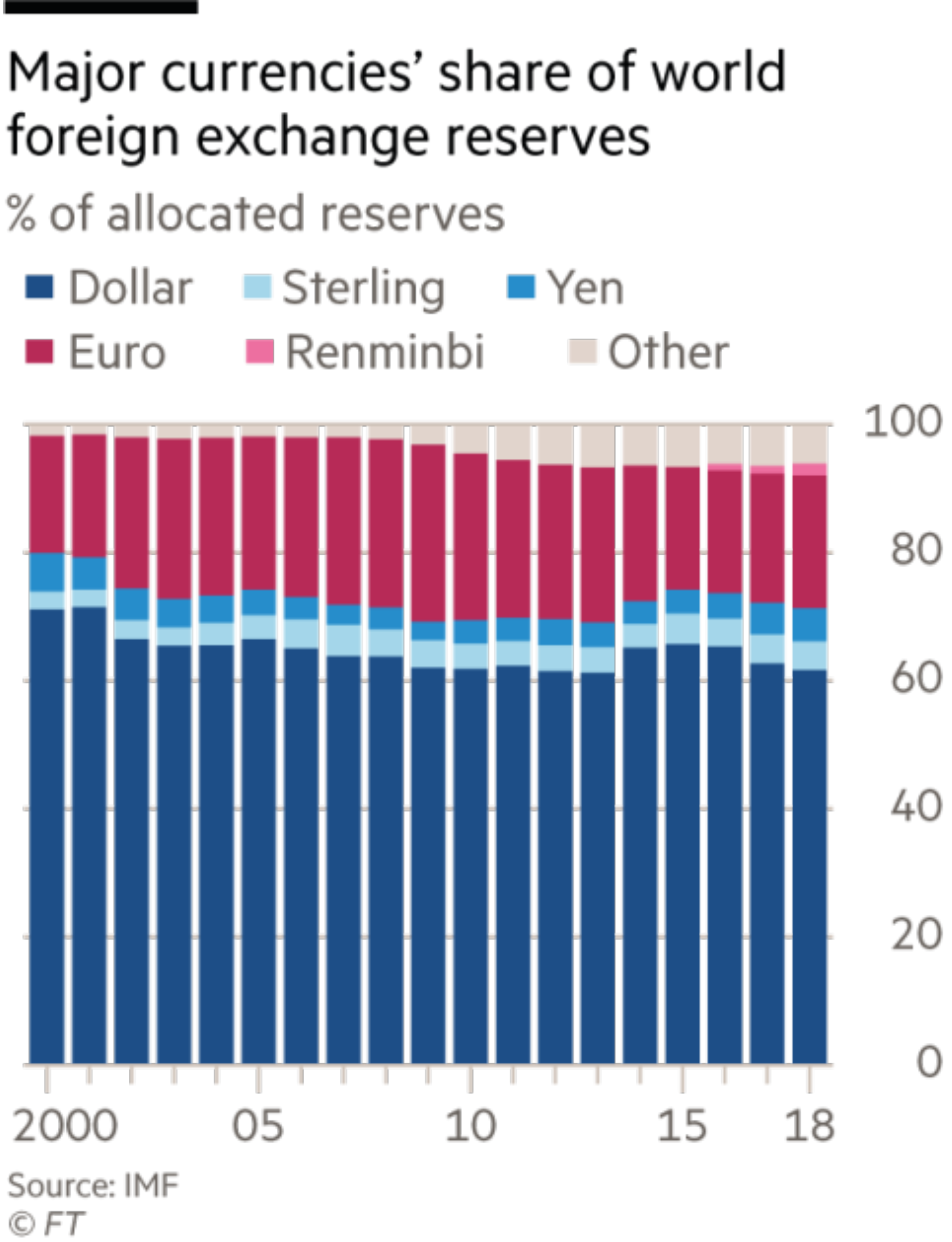
In an industry long dominated by the dollar, it was a move that carried obvious symbolic weight.

Last summer Russian diamond miner Alrosa tested a new system for selling its rocks in roubles to clients in countries such as China and India, as an alternative to the US currency.

Since then the company has conducted about 50 transactions under the mechanism, using a range of currencies, says Evgeny Agureev, Alrosa's director of sales, who says avoiding dollar conversion allows transactions to be conducted more speedily.

"The number and volume of these transactions is relatively small . . . but we think it is valuable for our clients to have a variety of options for settlement to choose from," he says in an email, adding that the "world changes and we need to respond".

Though under consideration for several years, the initiative by the partly state-owned miner is a sign of a growing appetite to find ways to shake off the stranglehold the US dollar has long held on global commerce and finance. Those efforts have taken on high urgency given Donald Trump's increasingly aggressive use of US economic and financial weaponry to get his way in foreign affairs.



The president has thus far engaged in minimal military conflict, but he has proved an unusually pugnacious currency warrior, as he pairs a tendency to talk down the dollar's value in his quest for a smaller trade deficit with an unusual willingness to use the currency's global heft as a tool of foreign policy.

Critically, sanctions, which can block foreign officials or corporations from accessing vast swaths of dollar-dominated commerce and finance, are being deployed against Russia, Iran, North Korea, Venezuela and a host of other countries, alongside tariffs and other restrictions on key companies such as telecoms manufacturer Huawei. As a result, economies including China and Russia are examining mechanisms to curtail their reliance on the dollar, while European capitals are seeking ways to circumvent America's new barriers on dealings with Iran.

To date the initiatives amount to less than a pinprick in the US currency's hegemonic status, as underscored by the modest scale of Alrosa's foreign exchange innovation. But Mr Trump's unilateralist approach has unquestionably unleashed a phase of experimentation elsewhere, prompting some analysts to ask whether, in the longer term, the US dollar's supreme position in the global financial system could be shaken as other nations revolt against what they see as Mr Trump's arbitrary use of American power.

Adam M Smith, a former US Treasury and White House official who is now a partner at the law firm Gibson, Dunn & Crutcher, says the manner in which Mr Trump is wielding America's economic power is unprecedented, as he uses sanctions, tariffs, trade negotiations and export controls interchangeably.

"He is using the importance and attractiveness of the US market to the rest of the world as a coercive tool to get others to bend to his will," says Mr Smith. "Does the very aggressive use of these economic tools make it more urgent for countries to find ways to avoid the US market? Probably. However, the urgency may not mean that most countries will be successful in finding effective workarounds."

Chief economist at the IMF Gita Gopinath points to the decline of the euro rather than the dollar, with a reduction in euro invoicing and international financial transactions

America has long enjoyed a singular economic arsenal thanks to the ubiquity of the dollar and the centrality of its economy and financial system to global commerce. Although America's share of global gross domestic product may have declined, its currency still accounts for over 60 per cent of international debt, European Central Bank official Benoît Cœuré said in a speech in February, and leads the euro both as a global payment currency and in foreign exchange turnover. It dominates pricing of commodities such as oil and metals and accounts for about 40 per cent of cross-border financial transactions.

The dollar's share of global foreign exchange reserves has slipped in the 10 years since the financial crisis, but at 62 per cent of the total it still dwarfs all rivals. The euro has lost greater ground over the same time, now standing at just over 20 per cent. The Chinese renminbi is just a few per cent of global reserves, and a mere 2 per cent of international payments, according to **the global transfer network** Swift.

This unique place at the heart of the global economic system gives the US government enormous power. Using the dollar almost invariably means touching a US financial institution, says Eswar Prasad, a professor of economics at Cornell University. This immediately puts you within the reach of US government and regulators.

The US toolkit is particularly potent thanks to the use of "secondary" sanctions. Normal US sanctions aim to prevent American citizens from dealing with a given country or party, but secondary measures allow the government to penalise third parties that do business with a sanctioned country.

The consequences for non-US institutions of failing to comply with US rules can be severe. In 2014, for example, BNP Paribas was hit by a penalty of nearly $9bn by the US authorities in connection with sanctions violations, as well as being forced to temporarily suspend part of its US dollar clearing work.

Republican senator Marco Rubio wants to examine closely China's ready access to US finance

While Washington's use of sanctions has been on the rise for decades, Mr Trump has emerged as a particular enthusiast. Data compiled by Gibson Dunn show 1,474 entities were subject to sanctions designations in 2018 — 50 per cent higher than in any previous year for which it has kept records.

The power of these tools has been felt across markets. The Treasury's decision to place sanctions on metal groups Rusal and parent company En+ led to a surge in aluminium prices, before it agreed to ease its stance if its major shareholder, Oleg Deripaska, gave up control. The sanctions were lifted in January.

Last August Turkey was plunged into a currency crisis as the US imposed swingeing tariffs on its steel and aluminium exports, on top of sanctions on senior ministers.

The US Congress has been equally aggressive in pushing sanctions. In April a cross-party group of senators led by Republican Marco Rubio and Democrat Bob Menendez demanded sanctions against senior Chinese Communist party officials in response to alleged human rights abuses against Uighurs and other Muslim minorities in the northwestern province of Xinjiang.

This month senators demanded the more rigorous enforcement of US regulations against Chinese companies that seek access to US markets. Hawks such as Mr Rubio want to take matters further and more closely examine China’s ready access to US finance.

A worker at Alrosa inspects a diamond. Last year the Russian mining company tested a new system for selling its rocks in roubles rather than dollars © Bloomberg

“China poses the greatest long-term threat to US national and economic security. At a minimum, American investors should be aware of where their money is going when it comes to Chinese investments,” said Mr Rubio.

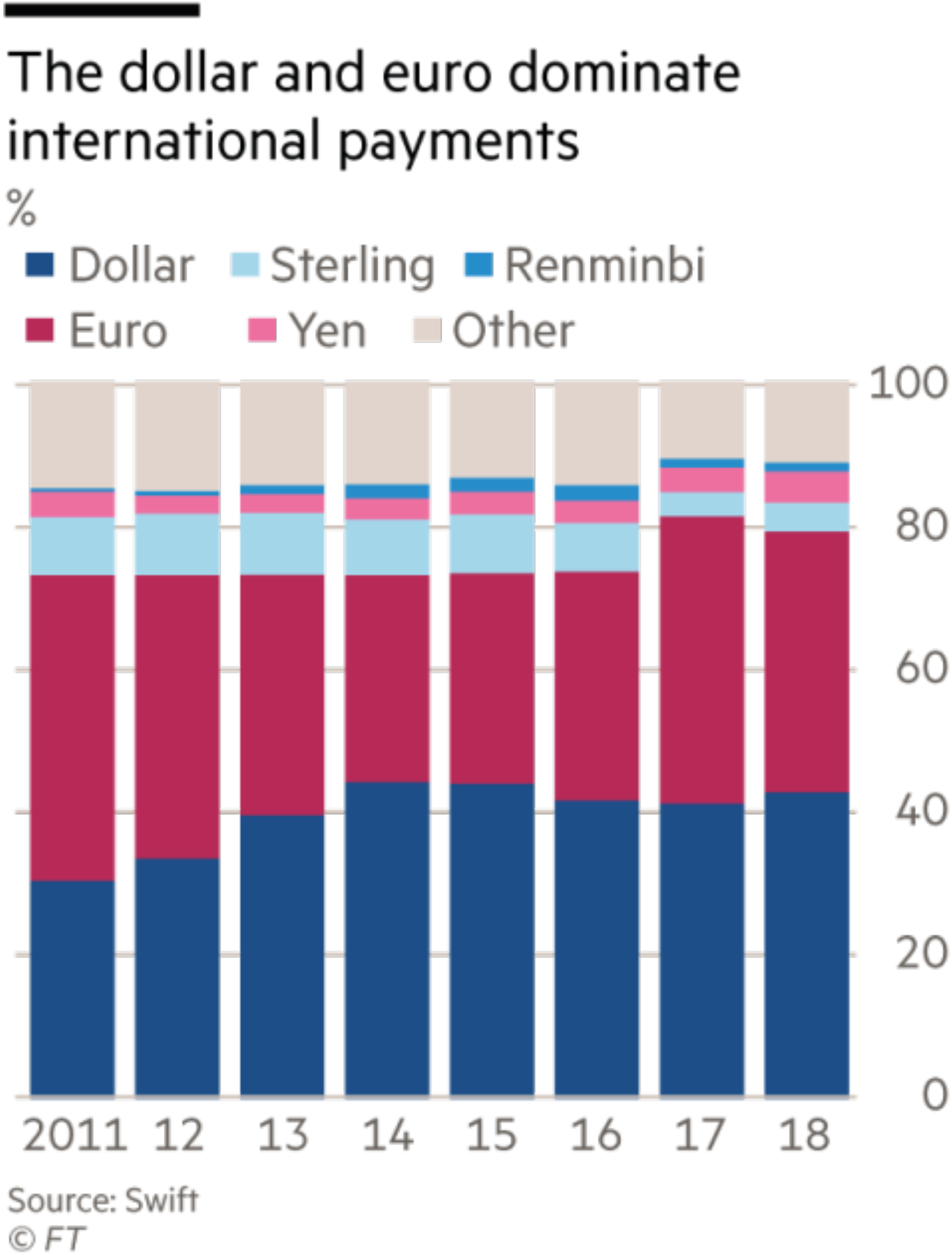
The Trump administration’s aggressive use of sanctions carries multiple risks. It is not only rivals who are upset: the US has at times also incensed close allies, which for decades have viewed Washington as a reliable steward of orderly global markets.

In the longer term it could accelerate a trend in which other countries wish to reduce their reliance on the dollar for its main three purposes — as a store of value, a unit of account and a medium of global exchange. In the very long run, some specialists fear the US dollar's totemic status at the centre of the global economy could be eroded, or even supplanted, just as the British pound was by the dollar during the interwar period.

Richard Nephew, a former US government sanctions specialist who is now programme director at Columbia University's Center on Global Energy Policy, says that for at least the next five to 10 years the world is locked into the dollar as the default currency.

But he argues there will be an evolution towards a system where the US is not the sole significant trading currency. US policy today "will increase the speed with which that transition takes place".

A recent report from the Center for a New American Security think-tank argues that a host of factors could conspire to weaken the impact of America's economic policy arsenal over the longer term. Critically, it says that if the US attempts to reduce its economic, financial and trading connections with key overseas economies, "over time US coercive economic leverage over those economies will diminish".



Russia has been at the forefront of attempts to de-dollarise, spurred on by the punishing impact of US sanctions on its economy. “We are not ditching the dollar, the dollar is ditching us,” Russia’s president Vladimir Putin said late last year. “The instability of dollar payments is creating a desire for many global economies to find alternative reserve currencies and create settlement systems independent of the dollar.”

Russia’s central bank last spring sold $101bn worth of dollars from its reserves, shifting the holdings into renminbi, euros and yen, according to official data published in January with a six-month delay. Fifteen per cent of Russia's reserves were in the Chinese currency last summer, the data showed, three times the proportion at the end of the first quarter of 2018.

For its part, China has experimented with denominating oil futures in its currency as well as working on its own international payments system.

In June, Russia agreed with China at a summit between Xi Jinping and Mr Putin to do more trade in their respective currencies. The rouble and renminbi's share of Chinese imports into Russia edged up from 17 per cent in 2017 to 24 per cent in 2018, according to the economist Dmitry Dolgin at ING.

Xi Jinping and Vladimir Putin after a summit at the Kremlin in June in which both presidents agreed to do more trade in their respective currencies © AP

Yet for all the political attention, the two countries' attempts to reduce the dollar's role remain in their infancy. For example, China and Russia set up a non-dollar direct settlement plan to help with their gas pipeline deals around 2015. However, in practice, the Chinese side uses it as little as possible, in part because of the risk of rouble volatility.

China has also harboured aspirations to turn its Belt and Road Initiative into a platform for boosting the international use of the renminbi. But it would in practice have to dramatically liberalise its capital controls to gain widespread acceptance as a reserve currency.

In Europe, frustrations have been growing at the continent's faltering attempts to boost the euro's global role alongside the dollar. Top French officials including François Villeroy de Galhau, governor of the Banque de France, have called for greater use of the euro in international transactions in a bid to challenge the dollar's dominance. European Commission president Jean-Claude Juncker last year said it was an "aberration" that the EU paid for more than 80 per cent of its energy imports in dollars, despite only 2 per cent of imports coming from the US.

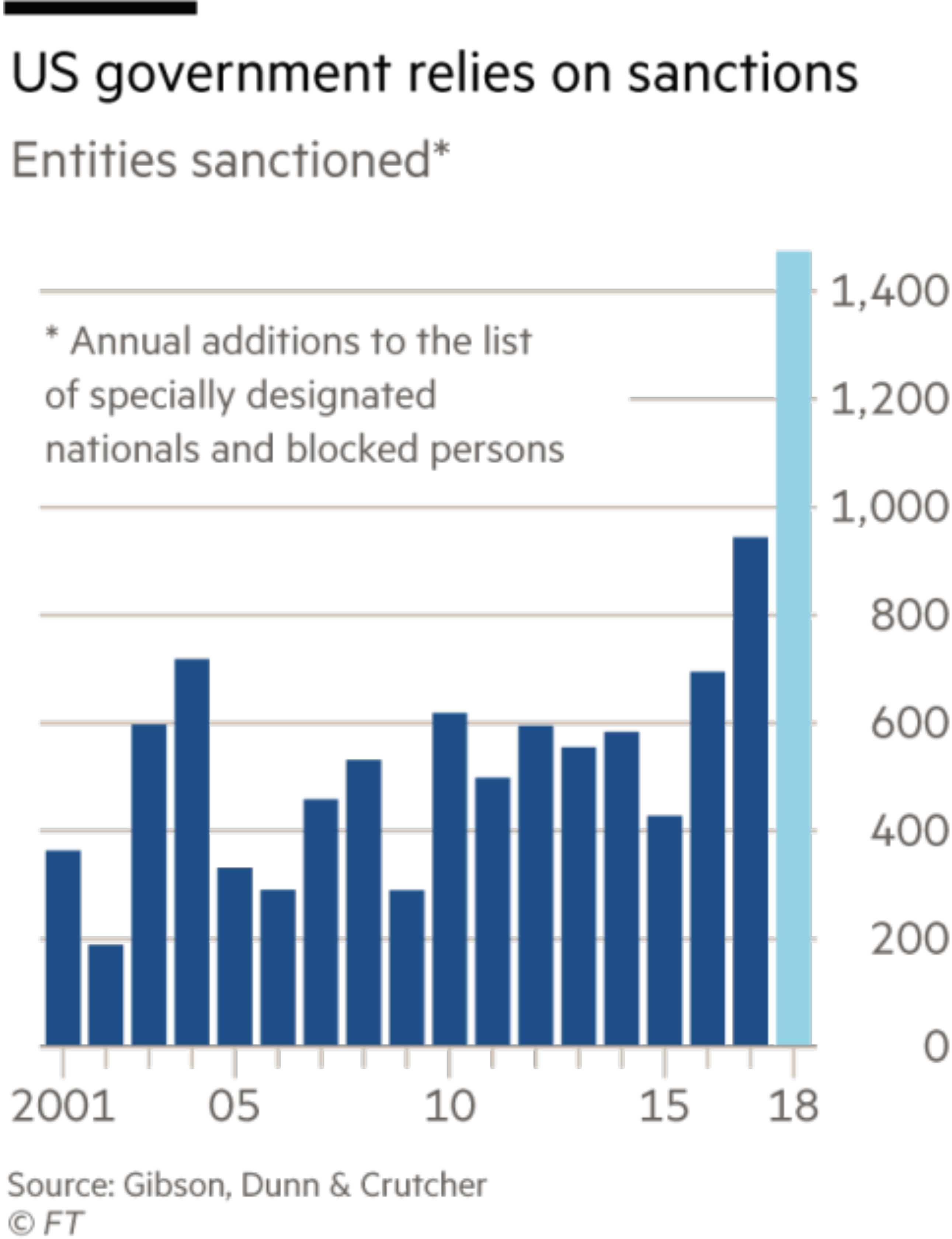
Yet the pattern since the financial crisis has if anything been a decline in the euro's international role. Gita Gopinath, the IMF's chief economist, points to a reduction in euro invoicing and international financial transactions. "The dollar on the other hand has gained relative to the euro in the last 10 years," she says.

Meanwhile progress on a high-profile mechanism backed by major European countries that aims to sustain trade with Iran despite newly imposed US sanctions has been painfully slow.

Sigal Mandelker, the Treasury official in charge of enforcing sanctions, points out that despite European efforts to keep their businesses invested in Iran following Mr Trump's withdrawal from the nuclear deal, the companies "got out in droves".

"There are people out there who argue we have overused the tool," says Ms Mandelker, "[but] if you look at our objectives and how we are using the tool, you will see that what we have been doing systemically is to change behaviour, to disrupt the flow of bad money, and to go after entities and individuals who pose national security and illicit finance risk."

For all the warnings that the US will undermine its own currency by being so aggressive, there is little sign of any diminished appetite for using the greenback. Kevin Hassett, the outgoing chairman of Mr Trump's Council of Economic Advisers, says: "If you thought that the Trump policies were imperilling the status of the dollar, then your case would be stronger if you showed that the dollar had collapsed a lot under Trump policies . . . But the move in the dollar has been kind of the opposite of that."



Ms Gopinath is sceptical about the chances of near-term change. “You are hearing more noise right now for other currencies to become truly global currencies. But the data do not show a more forceful dynamic in this direction and it would take a lot more than what we’re seeing now for there to be a switch.”

Indeed, the irony is that if the president ends up triggering global instability via his policies, investors may end up flocking all the more enthusiastically towards dollar assets. That was after all the phenomenon during the financial crisis, when a mortgage meltdown that was made in the US prompted global investors to scamper for the safety of government bonds, and it has been the same story more recently as Mr Trump's trade wars drove down US bond yields.

"Anything Trump creates to foment uncertainty and instability will only end up strengthening the dollar," says Mr Prasad. Over time, other countries will indeed get tired of this and shift away from the dollar as a unit of account and a medium of exchange, he adds, but "in the foreseeable and longer future the dollar's role as the dominant store of value is unlikely to be challenged."

Additional reporting by Lucy Hornby in Beijing and Henry Foy in Moscow