The economic 'nuclear bomb' and global reserve assets

Weekly - Regional View Emerging Markets

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The global reserve asset landscape continues to evolve. The latest IMF survey on the currency composition of global foreign exchange reserves from late 2021 reveals that the share of US dollars held by central banks has fallen to 58.9%—the lowest in over two decades and down from 71.3% since the euro was launched in 1999 (Fig. 1). Interestingly, the share of the euro has remained around 20% in the past two decades, meaning other currencies have been gaining ground and now enjoy a combined share over 10%. These include the Australian dollar, Canadian dollar, and Chinese renminbi.

Although shifts in global reserve holdings typically take place at a glacial pace, rising geopolitical tensions could trigger more rapid adjustments. The Russian invasion of Ukraine is undoubtedly one of the largest shocks in decades, one that motivated the US and its allies, in the words of the writer Thomas Friedman, "to use the economic equivalent to a nuclear bomb." The West unleashed the most rapid and comprehensive economic sanctions on a single country in modern times. Nearly two-thirds of Russia's international reserves were frozen overnight.

The US dollar will remain the main international reserve currency for years to come. As we wrote recently, the American currency continues to dominate financial markets and international trade; it takes up the lion's share of daily trading in foreign exchange markets, and more global exports are invoiced in US dollars than what is sold to the US. In addition, changes in the world's dominant currency have historically taken a long time to materialize. As Ray Dalio writes in his book "The Changing World Order," even as great economic and geopolitical powers have risen and fallen in the past, their currencies' reserve status survived well past the peak of their influence.

Yet it would be utterly naïve to expect no impact on the way many countries think about how to invest their international reserves from the ongoing weaponization of finance. We should not lose sight that, despite the remarkable alliance the West managed to orchestrate in terms of imposing financial sanctions on Russia—including the US, the EU, the UK, Switzerland, Canada, Australia, Japan, South Korea, and Singapore—many other countries decided not to take action. China, India, Indonesia, Mexico, Brazil, South Africa, Turkey, and Saudi Arabia have so far imposed no financial sanctions against Russia, and they are home to a large bulk of global international reserves.

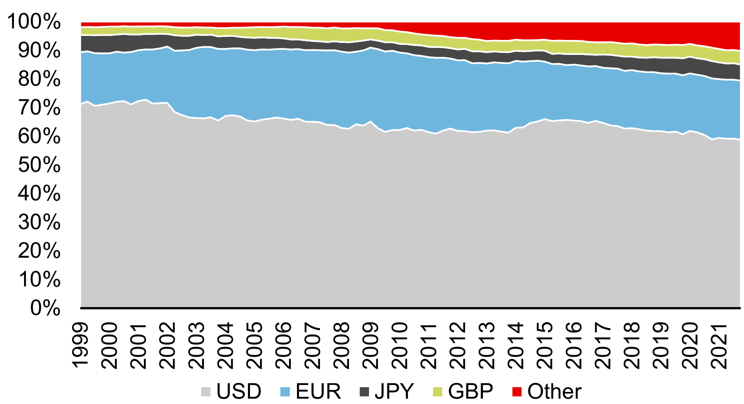
Data on international reserve allocations is published infrequently and often months old, so we do not yet have a clear indication of where they are headed since Russia's invasion of Ukraine. Yet it seems realistic to expect the global reserve composition to become more diverse going forward, with several currencies and even commodities playing critical roles, as reserve managers contemplate the "geopolitical resilience" of their reserve holdings in addition to other desirable properties such as liquidity and stability.

Commodities such as gold could be considered more actively, as they could be deemed more geopolitically agnostic. The renminbi could also gain ground due to China's growing economy and central role in global trade, the opening up of its domestic capital markets, and its policy initiatives that support the renminbi's internationalization. The emergence of digital currencies, from cryptocurrencies to central bank digital currencies, could speed up the transition to alternative reserve configurations, although the volatility and limited market size of the former are clear limiting factors (Fig. 2).

We will be watching incoming data closely for a better gauge of where this brave new geopolitical world is taking us.

Fig. 1: Changing global reserve currency landscape

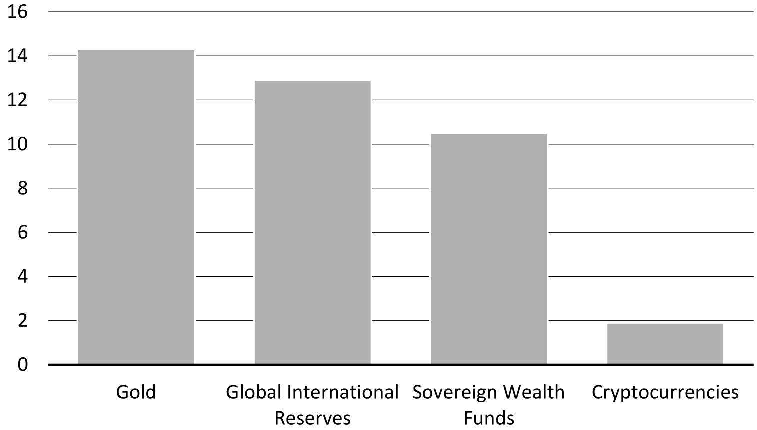
Currency composition of global foreign exchange reserves, % of total allocated reserves



Source: IMF, UBS, as of 4Q21

Fig. 2: International reserve universe in context

Market value of various segments, in USD trillions



Source: Bloomberg, IMF, Global SWF, World Gold Council, Coinmarketcap, UBS, as of April 2022

Appendix

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