

USD and the Rise of Cryptocurrency

A World Reserve Currency is a foreign currency that is held by the national banks of every country. It is used for international transactions, investments and other movements of capital in the global economy. Currently, the US Dollar is the world reserve currency, for various reasons that are discussed in this article. However, with the advent of cryptocurrency and the instability of the global economy itself, there is a need to look at the viability of the US Dollar continuing to be the reserve currency. Do we have any prospective contenders for the same?

The Context

The Federal Reserve Act of 1913, to establish the Federal Reserve Bank thus removing the instability and unreliability in the system (individual banks issued their own notes). At that time- all currencies pegged to gold & the majority of transactions were conducted in British pounds.

During World War I, the US was willing to lend to countries that accepted dollar-denominated bonds. In 1919, Britain had to abandon the gold standard and borrow from the US. Now, the US dollar had become the world reserve currency.

During World War II, the US gave supplies to the allies and got paid back in gold. It then became the largest holder of gold.

Since weapon manufacturing was at its peak in the USA, everyone traded gold for weapons.

At the end of the war in July 1944, the USA had 70 per cent of the world's gold reserves. In 1919, Britain had to abandon the gold standard and borrow from the US.

The US Dollar became the standard from 1947 to 1971 the majority of the trade was done in US dollars. So, the 44 allied countries met in Bretton Wood, New Hampshire to decide that all currencies would be linked to the US dollar which will be linked to gold (Bretton woods agreement).

But, should the US Dollar continue to be the World Reserve Currency in the age of Cryptocurrency?

Here, we present to you the popular divide of opinions .

In Favour

- **US Dollar is the safest bet**

Around 90% of forex trading involves the U.S. dollar. Almost 40% of the world's debt is issued in dollars. The financial crisis made the dollar even more widely used. In 2018, the banks of Germany, France, and Great Britain held more liabilities denominated in dollars than in their own currencies. Despite the large foreign debt and deficit spending, there is still confidence and trust in the US government that they'll pay off their debts. That is why it'll still hold its position as the leading world reserve currency.

The UBS report noted that the dollar remains the "ultimate safe-haven currency" and during periods of intense global risk, investors flock to U.S. Treasuries. The Swiss bank also cited the dollar's role as a global anchor for prices and interest rates, which can force central banks to hold excessive U.S. dollar reserves to match the significant dollar exposure from trade and borrowings of their respective economies. One cannot simply set up a reserve currency. We can dismiss an International Monetary Fund-style 'special drawing right' as lacking liquidity. The euro is a genuine contender, but has to sort out its structural problems first – it needs a centralized fiscal management system before it can be deemed viable in the long term.

Against

- **US Dollar has already exceeded the average time period**

Before the US, only five powers had enjoyed the coveted "reserve currency" status, going back to the mid-1400s: Portugal, then Spain, the Netherlands, France, and Britain. The opposers of the Dollar as a world reserve currency argue that The USD has already surpassed the average amount of time a currency remains as the world reserve one. It has held this position for over a hundred years now, while the other previous currencies have lasted about 94 years on average.

Another reason is that the position of the USD is troublesome as even a minor uprising in the US could be catastrophic for the United States. It could destabilize the dollar and delegitimize its role as a reserve currency. Since printing USD in exchange for real goods and services is critical to functioning of the US economy (a privilege of being the world reserve currency), it would also set off a domino effect that would end in economic disaster. This threat is very real when we take into account how the US politics was highly unstable in Trump's presidency, which ended with a brutal attack on the Capitol. The USD losing its standing in the global financial system and possibly its status as the reserve currency seems like an inevitable product of blockchain's accessibility and decentralization.

In Favour

- **Problems with cryptocurrency as the world reserve currency:**

Blockchain technology is a well trusted and booming sector right now. Investments in the same from IBM (for Trade Lens) and Maersk's joint Blockchain investment speak for the growing trust. However, this sector may take off without crypto, which might prove risky for the digital currency market. There is a lack of regulation concerning crypto, even if it comes under the authorities of the countries there are problems of user protection. There are requirements for the improvement of blockchain technology- it needs to be made interoperable on the internet dedicated to cryptocurrency. Until then only illegal ways of bitcoin mining will prevail. Bitcoin processes blocks of transactions around every 10 minutes. This remains a big constraint because only 4.6 transactions are conducted per second while Visa conducts 1,700 transactions per second. Another hurdle is the restricted usability of the technology which has a difficult security procedure for it to be adopted as a means of exchange. Conversion remains a huge issue for crypto, as it is not a fiat currency and can only be exchanged for cash. Such a system stops transactions of goods and services from happening via this.

- **Disadvantages of the alternatives available**

Obstacles to a multi-polar reserve system: Problems with the Chinese renminbi - it is not fully convertible, and China doesn't issue renminbi-denominated safe assets the countries can hold. Such assets have an interest rate and are considered more convenient. For the Yuan to become the world reserve currency, at least \$700 billion dollars worth of Yuan must be held by central banks all over the world. The PBOC (People's Bank of China) must remove the peg of Yuan to the US dollars. The financial markets in China need to become more transparent. The Eurozone crisis or the Euro debt crisis highlighted the fragility of the currency. Before this, it was a serious contender for the US dollar. Even as recently as in 2018, the Turkish economy was in major debts, hinting towards another Eurozone crisis. Even removing such countries from the EU only weakens the Euro. The lack of a common Treasury and a unified European bond market limits its attractiveness as a reserve currency.

Another reason is that the Eurozone doesn't produce enough safe assets for other countries to hold.

The limit of the amount of gold that the banks can hold is the main reason why the gold standard cannot be brought back. The economic growth has outrun the global supply of gold.

Another alternative talked about is that of using SDR(Special drawing rights) which is a basket of five currencies, as a world reserve currency making IMF the world reserve bank. However, such a scheme is difficult to be adopted due to the large bureaucratic obstacles and the resulting fluctuations in the US exchange rate and interest rates.

Against

- **Increased use of Cryptocurrency**

On the other hand, supporters of cryptocurrency view its chance to be a potential world reserve currency propose that bitcoin has one particular advantage, critical mass. It is the most popular coin, and thus it has the greatest network effect. Bitcoin miners also have the ability to update and upgrade the bitcoin protocol. This capability will help tackle future challenges such as quantum computers hypothetically capable of cracking bitcoin's algorithm. Bitcoin's ability to reach such a large mass of population led to its price quadrupling since March, making it one of the hottest investments of 2020.

Cryptocurrencies have become extremely popular. According to a survey, approximately 18% of students based in the US own at least one digital currency or have owned one in the past. The estimated cryptocurrency market capitalization during the month of January 2018, varied between 400 billion USD and 800 billion USD, which was at 566 billion USD at the beginning of the year 2018 and finally settled at 128 billion USD by the end of the year 2018. In terms of transaction volumes, bitcoin alone had the highest number of 200,000 average daily transactions. The global cryptocurrency market size stood at \$754 million in 2019 and is projected to reach \$175 million by 2027, exhibiting a CAGR of 11.2% during the forecast period.

Another reason is that bitcoin derives its value from network effects. The algorithm is simple. If just one person used Twitter, its value or utility will be negligible compared to when it has millions of users. The same is true of Bitcoin. If no one was using Bitcoin, then no one would assign any value to it, thus not leading to it being in a position where it can become an all-powerful manipulator. Also, while Bitcoin may never be as easy to use as a transactional currency, but it is quite plausible as a reserve asset.

- **Surmounting US Debts**

After decades of mounting, U.S. debts to the rest of the world surpassed 50% of its economic output last year. According to the International Monetary Fund (IMF), this is a threshold that often signals a coming crisis.

While the supporters of dollar view this as an indication of support from other countries, nearly every country in the world is experiencing rapid rises in consumer debt levels. Debt is essentially taking future cash flows (income) and spending them today. Consumer-credit fueled growth cannot be sustained long term and therefore, at some point, the debt will need to be repaid.

Countries like Venezuela, Argentina, Turkey, and Syria are already experiencing problems with inflation. In each of these affected countries, the purchasing power of their citizens is being destroyed. As citizens continue to lose faith in their currency, they naturally look towards alternative means of exchange.



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In Favour

• Support of a strong US economy

Market forces play an important role in determining the reserve currency as well. They not only see the stability and strength of the individual currencies but also the reputation of the economies behind them. They also look at the popular currency choice of other market participants and the availability of various kinds of financial instruments in a given currency. Thus the reserve currency should be such that it is used for international transactions, trade and saving purposes and it should have a stable purchasing power.

The International Monetary Fund (IMF) recognizes eight world reserve currencies: U.S. dollar, euro, Chinese renminbi (yuan), Japanese yen, British pound, Australian dollar, Canadian dollar and Swiss franc. Of these, USD is by far the most widely used in global FX reserves. Nearly 60 per cent of the world's FX reserves are denominated in dollars. There is a claim that the US dollar's position as global forex confers an 'exorbitant privilege' to the country- the ability to borrow at lower costs. However, this doesn't come with costs such as the status hampering the US exporters and its higher exchange rate leading to problems in domestic growth while ensuring stability in the functioning of the world economy.

• Political and Economic stability

This is something that should be quite self-explanatory. Countries with a stable economic and political environment usually end up becoming safe havens for investors whose own currency is riskier. US treasury securities are considered to be the safest investments in the entire world and are used as a benchmark against which the risk/return of other investments is compared.

• Foreign reserves and trade

The amount of trading that a country does directly impacts the strength of its currency. For example, the vast majority of crude oil across the world is traded in USD. Because of this, countries need to maintain sufficient reserves of USD in order to be able to purchase crude oil when they require it.

The need to maintain reserves in a particular currency increases its demand, thereby increasing its price as well as strengthening it relative to other currencies. On top of this, it is in the interest of the countries that hold a particular currency as a reserve to prevent its value from plummeting. As such, the vast majority of the world buys the USD during a crisis as upholding its value is as important for other countries as it is for the United States.

• Size of the economy

A currency is simply a representation of the economy of a particular country. Usually, the larger the economy, the stronger the currency. In 2017, the US had more than 24% of the entire world's GDP.

Against

In the fourth quarter of 2020, the U.S. debt-to-GDP was 129%. Over \$21 trillion of this debt is public debt, which is what the government owes investors. On March 1, 2021, it hit a new record by exceeding \$28 trillion and it has increased by at least \$1 trillion each year since 2007. The national debt is greater than what the US produces in a whole year. This high ratio of the debt to gross domestic product (GDP) tells investors that the country might have problem repaying the loans. That's a new and worrying occurrence for the U.S. In 1988, the debt was only half of America's economic output. Over the past 15 years, Congress has made several attempts to lower the debt but they haven't been able to reduce the growth of what the US owes. Congress knows a debt crisis isn't far away. In less than 20 years, the Social Security Trust Fund won't have enough to cover the retirement benefits promised to people born from 1946 to 1964. That could mean higher taxes once the high U.S. debt rules out further loans from other countries.

Fortunately for the U.S., it is technically impossible for the nation to ever default. The reason is that U.S. debt is denominated in its own currency, the USD. If push came to shove, the United States could just print more dollars to service its debt and bail itself out. However, by doing so, it would destroy the purchasing power of its citizens and any USD holders. If the U.S. government were ever to take such drastic action, the most likely outcome would be hyperinflation.

• Cryptocurrency is the future

Supporters of bitcoin view claim that as we are seeing the causality of the US global economics politics conducted in the past 20 years and its effect on the situation now, there is a good chance that 20 years from now we will have Bitcoin as the reserve currency of the world simply because it will not be controlled by any one nation and its financial system. A digital currency in which transactions are verified and records maintained by a decentralized system using cryptography, rather than by a centralized authority, is currently seen as an unbiased currency, having the potential to replace the US Dollar. Since its launch in 2009, Bitcoin's builders have aspired to establish it as "digital gold," a trusted store of value that offers a safe haven in tumultuous times. Operating on peer-to-peer networks, bitcoin is being pitched its champions as a decentralised, democratic alternative.

According to Deutsche Bank, the current money system is fragile. Deutsche Bank sees that by 2030 digital currencies will rise to over 200 million users, growing by almost four times in the next ten years. This growth is almost the same as that of the Internet in its first 20 years. In the "Imagine 2030" report, Deutsche Bank suggests that digital currency could eventually replace cash one day, as demand for anonymity and a more decentralized means of payment grows.



In Favour

- **A shift will cause problems to the world economy**

We also observe systemic inertia when a shift from one world reserve currency to another happens. The private sector companies are slow in changing their preferences and the central bank is skeptical about the risks associated with changing the foreign exchange assets.

There are some costs and risks associated with the change of reserve currency as well. For the issuing country, it can lead to a current account deficit due to the demand for its currency. This happened in the US during the Bretton woods system and is referred to as the 'Triffin Dilemma'.

Even if a global reserve currency is established under a global monetary institution (other than the IMF), it will bring along economic and political controversies along with it - voting patterns in the institution and its degree of independence, forecasting models related to global outputs and inflation, demand for the global reserve. Also, there would be a need to create demand for the same in the private sector.

Against

The parallels between the Internet and crypto are remarkable. Until Mosaic, the Internet was publicly funded and primarily used in an academic setting. However, policymakers decided to legalize commercial activity on the Internet. While, the Internet's commercial use started with most people and businesses not knowing how to connect or use the Internet, the rails were put in place that would eventually change the future of everything.

The breakout years of simplified usage and huge user growth are not far away. The talent is abundant, the capital is here and the conditions like economic inclusion and freedom are ripe.

Crypto regulation could be just around the corner, which can prove to be the final stepping stone to legitimize cryptocurrency. As regulatory hurdles are surmounted, cryptocurrencies may become legitimate substitutes for fiat currency. Libra and other stablecoins may ultimately provide the road map to more widespread adoption, with stronger oversight by government regulators.

Crypto offers a unique solution that renders fiat currency obsolete. It empowers people to be their own bank and payment method. Therefore, cryptocurrency is the future.

The Conclusion

It is to be noted that changing the world reserve currency will not be an easy feat to achieve. A lot of deliberation and thought must be put in before taking such decisions that could even put the world's economy at stake. At one side, the US has increasingly contributed to the world's GDP, while on the other side the trust in the strength of its economy is holding on to a thin thread. With the advent of cryptocurrencies reaching a lot of households in the world, and the self-sustaining system that shapes this sphere, strong opinions that support the crypto as the reserve currency are emerging. As much as other currencies in the race would want the status of the world's reserve currency, the international bodies that govern such matters will need changes in its structure to make it plausible for it to happen. Until then, the US Dollars would still remain a comparatively safe haven for countries across the world to invest in.



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