



De-dollarization

Description

Theme:

- The de-dollarization trend is accelerating in an increasingly multipolar world. It has not gone unnoticed by Indian policymakers, who are now exploring ways to reduce their country's reliance on the U.S. dollar. The dollar's dominant position in the global economy has the potential to create both economic and geopolitical risks for many countries including India. Let us discuss the trend towards de-dollarization and the challenges associated with it.

What is de-dollarization?

- De-dollarization refers to the process of reducing or eliminating the use of the U.S. dollar in international transactions or the economy of a country. The goal is to reduce dependence on the U.S. dollar and mitigate risks associated with a dominant global currency.

Why de-dollarize?

- To reduce economic dependence on the dollar: When a country uses the U.S. dollar, it is essentially giving the United States control over its economy. This can be a problem if the United States decides to take economic actions that are harmful to the country, such as imposing sanctions or raising interest rates.
- To protect against inflation: The U.S. dollar is not immune to inflation. In fact, the value of the dollar has declined in recent years. This can make it difficult for countries that use the dollar to plan their economies and budgets for the future.
- To promote economic growth: Some economists believe that de-dollarization can lead to economic growth. This is because it can make it easier for countries to trade with each other and invest in each other's economies.



Concerns for India:

- Sanctions against Russia raised concerns among Indian policymakers about the vulnerability of the country's economy to U.S. sanctions.
- India's reliance on the dollar for most of its imports makes it susceptible to U.S. sanctions, as was seen in the case of Iran.
- India is concerned about the potential impact of Federal Reserve rate hikes on its economy. As India holds a significant amount of its foreign exchange reserves in dollars, a decline in the value of the dollar can lead to a decline in India's purchasing power and hurt its economy, as was seen recently. Therefore, India is taking steps to reduce its reliance on the dollar.

How to de-dollarize:

- Diversify foreign exchange reserves: A country can reduce its reliance on the dollar by diversifying its foreign exchange reserves into other currencies, such as the euro, yen, or yuan.
- Promote the use of local currency in international trade: Encouraging the use of local currency in international trade can help reduce the demand for dollars and increase the use of other currencies.
- Sign currency swap agreements: Signing currency swap agreements with other countries can allow for the settlement of trade in local currencies, reducing the need for dollars.
- Promote gold reserves: Investing in gold can provide an alternative to holding foreign exchange reserves in dollars, thereby reducing reliance on the dollar.
- Develop local financial markets: Developing local financial markets, such as bond markets and stock markets, can reduce the reliance on foreign capital and foreign currency borrowing, which can help to de-dollarize the economy.

The challenges of de-dollarization:

- The US dollar is the most commonly held reserve currency. Most of the international trade happens in US dollars. The euro is currently the second most commonly held reserve currency, representing about 20% of international foreign currency reserves. So, practically it takes so many years for the second most dominant currency to reach the US dollar's position. Even though the world is moving towards de-dollarization, the pace is very slow.
- The cost of switching currencies: It can be expensive for countries to switch currencies. This is because they need to buy new reserves of the new currency and they need to convert their existing debt into the new currency.
- Currency volatility: Moving away from the dollar can increase currency volatility as other currencies may be less stable or more volatile than the dollar.
- Limited alternatives: There may be limited alternatives to the dollar as a reserve currency, as the dollar is widely accepted and trusted globally.
- Market liquidity: Markets for other currencies may be less liquid than the dollar market, which can make it harder for countries to sell their reserves.



- The lack of trust in other currencies: Some countries may not trust other currencies as much as they trust the U.S. dollar. This is because they may be worried about the stability of other currencies or the political influence of the countries that issue those currencies.
- The resistance of the United States: The United States may resist de-dollarization because it would reduce its economic power. The United States could try to pressure countries that are trying to de-dollarize by imposing sanctions.
- Dependence on the US economy: De-dollarization can also have consequences for countries' dependence on the US economy, as it may be harder to access US markets and US dollar funding. The United States is one of the largest markets in the world, with a high level of purchasing power. By reducing their reliance on the dollar, countries may find it harder to access US markets and US dollar funding.

Steps taken by India towards De-dollarization:

- The Reserve Bank of India (RBI) announced in 2022 that it would begin buying gold directly from foreign sources. This move would help diversify India's foreign exchange reserves and reduce its dependence on the dollar.
- The RBI has been promoting the use of the rupee in international trade.
- In 2023, the RBI signed a currency swap agreement with Russia that allows India and Russia to settle trade in rupees and rubles.
- One of the steps India is taking towards de-dollarization is exploring the use of alternative banking mechanisms, such as Nostro and Vostro accounts. These accounts allow for international transactions between banks in different countries, enabling India to diversify its currency holdings and reduce its reliance on the U.S. dollar. While Astro Vostro accounts may have different fees and regulations than domestic bank accounts, they offer several benefits, including the ability to make payments and transfer funds between banks in different countries, hold deposits in the currency of another country, and settle debts between banks.
- At present, discussions are underway among the BRICS countries regarding the possibility of introducing a common currency to facilitate trade and commerce among themselves.

Conclusion:

It is still too early to say whether de-dollarization will be successful. However, the trend towards de-dollarization is clear. More and more countries are looking for ways to reduce their reliance on the U.S. dollar. If de-dollarization is successful, it will have a major impact on the global economy. If this trend continues and de-dollarization efforts are successful, it will have far-reaching implications for the global economy, both positive and negative.

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