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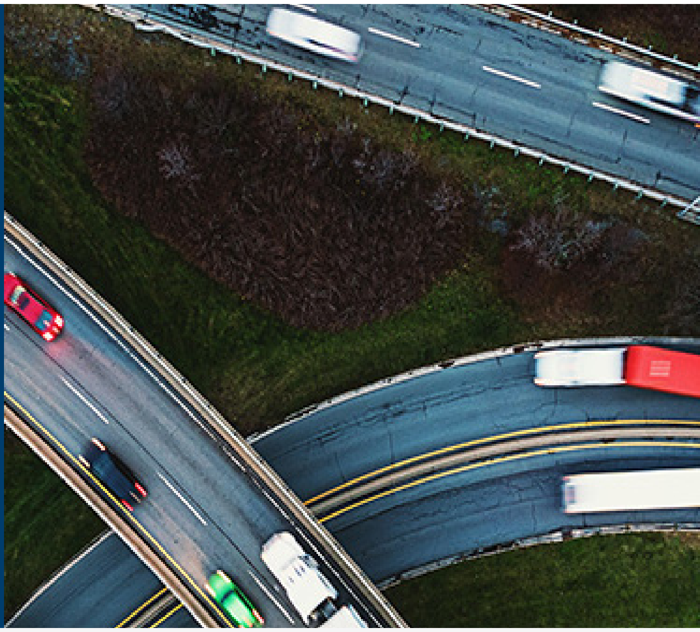
The 10-10-10 proposition: The gradual decline in the share of U.S. dollars in foreign exchange reserves

January 30, 2025 | Gary Smith, CFA, Client Portfolio Manager, Fixed Income

The gradual decline in the U.S. dollar is reshaping global currency dynamics and creating new investment opportunities.



KEY POINTS:

1. Over the next decade, the U.S. dollar is expected to lose another 10% share of global foreign exchange reserves, with 10 different currencies benefiting from this decline.
2. Smaller currencies like the Japanese yen, UK sterling, Australian dollar, Canadian dollar and Swiss franc are expected to continue growing as the U.S. dollar's share declines. The South Korean won and Indian rupee are also potential beneficiaries.
3. The launch of a gold-backed BRICS currency is considered unlikely due to the heterogeneous nature of the BRICS nations and their differing objectives.

Over the next decade, the U.S. dollar is expected to lose another 10% share of global foreign exchange reserves. However, there won't be a single beneficiary; instead, 10 different currencies could see their allocations grow.

According to the latest data from the IMF's Currency Composition of Official Foreign Exchange Reserves (COFER), the U.S. dollar's share of global foreign exchange reserves fell to 57.4% in Q3 2024. This is the smallest share since 1994 and represents a decline of almost 9% over the past decade.

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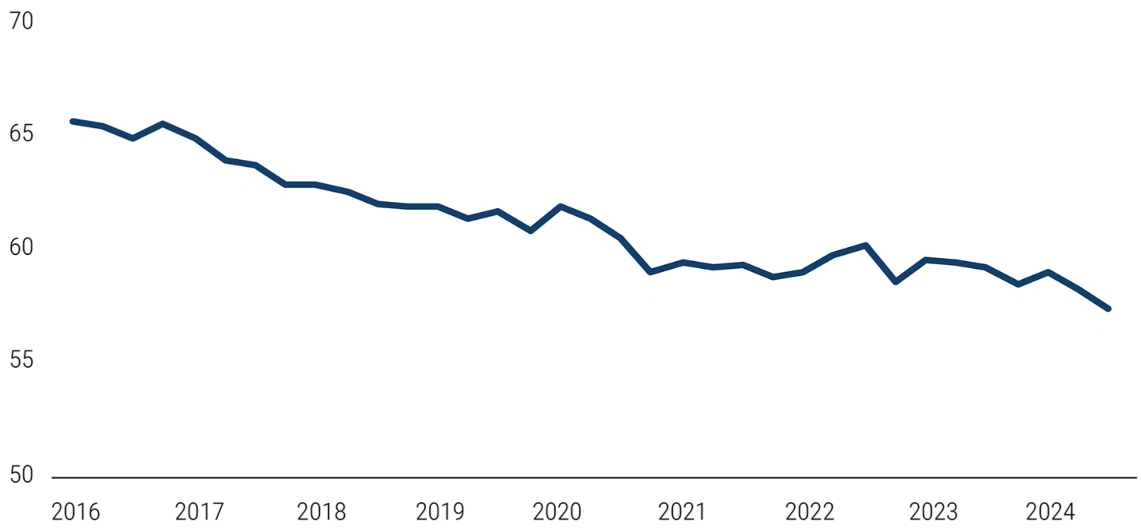
The U.S. dollar has been losing share as a global reserve currency

U.S. dollar as a share of global reserve currencies (% quarterly basis)



Source: IMF COFER, as of January 2025.

The primary driver of this decline has been the increased "weaponization" of the dollar. This concept, tied to the "exorbitant privilege" of the U.S. dollar as the primary reserve currency,[1] has allowed the U.S. to use financial assets to achieve foreign policy and military objectives without deploying soldiers. This trend has grown in importance since the 9/11 terror attacks and peaked in 2022 following the full-scale Russian invasion of Ukraine.

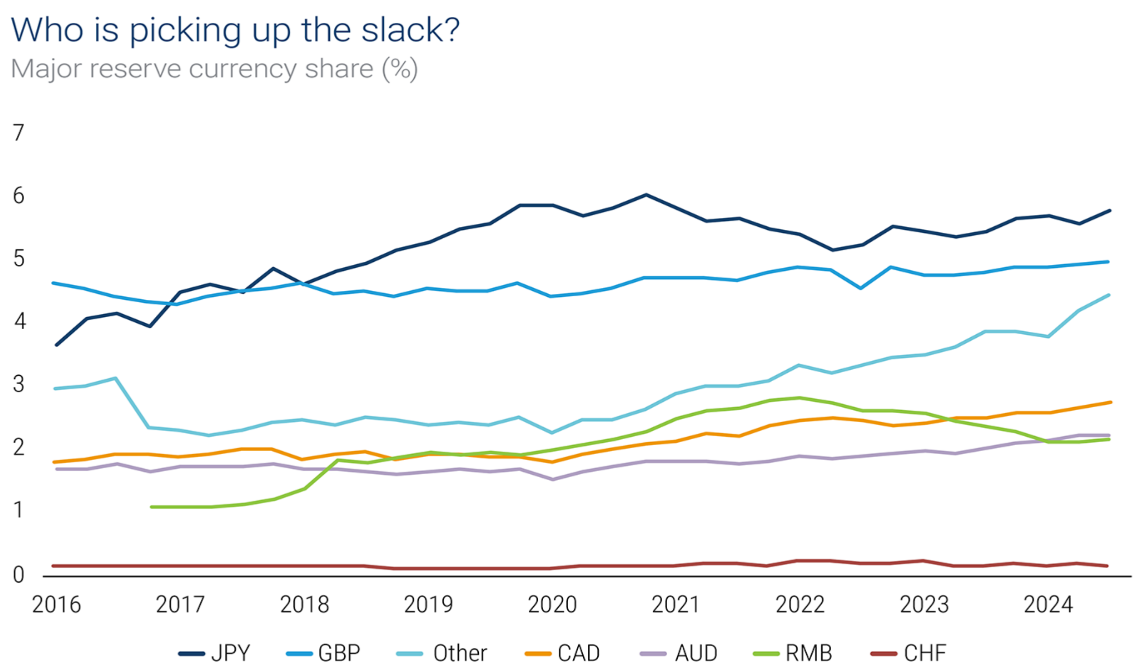
The weaponization of the dollar will continue to drive its decline. As early as 2017, then-U.S. Treasury Secretary Jack Lew acknowledged that this strategy would push some players to avoid the dollar in the future, reducing its dominance.

Academics have successfully forecasted the gradual decline in U.S. dollar dominance since 2000 but have struggled to predict which currencies would benefit. Many sought a single winner, but the reality has seen a wide array of currencies benefiting. This pattern is expected to continue.

Over the next 10 years, another 10% of the dollar's weight within IMF COFER statistics is likely to erode, benefiting 10 different currencies.

The currencies that are positioned to benefit

In the past decade, smaller currencies have taken up most of the slack. The Japanese yen, UK sterling, Australian dollar, Canadian dollar and Swiss franc, all named in the IMF COFER report, will continue to grow as the U.S. dollar's share declines.



Source: IMF COFER, as of January 2025.

A non-traditional currency that stands to gain is the **South Korean won**. Although it is included in the COFER report, it is not measured individually and falls under the "Other" category. This category has seen the most significant gains in the past three years. South Korea is economically and geopolitically connected. It is the 12th largest nation in terms of GDP and plays a crucial role in the U.S. association of like-minded nations. In May 2024, South Korea was in discussions about joining the AUKUS[2] military security partnership with the U.S., U.K. and Australia. Security agreements and trade flows support the argument for the won.

Another currency that could emerge in the next decade is the Indian rupee. India is the world's fifth-largest economy and its most populous nation. Size matters in this debate, as seen with the initial adoption and enthusiasm for China's renminbi a decade ago. India is "non-aligned"[3] and maintains cordial relations with many nations. It is part of the Quad security arrangement with the U.S., Japan and Australia, as well as a key member of the BRICS (Brazil, Russia, India, China and South Africa) group.[4] Despite land border tensions with China, India's diverse alliances make the rupee a strong contender.

Comparisons to the internationalization of the renminbi are instructive. The Chinese currency began to be held as a reserve currency by central banks from 2010 onward, despite a lack of currency convertibility. Large FX reserves help dampen currency volatility, and in the case of the rupee, they may provide comfort to global central banks looking to diversify their currency exposure.

The top 10 currencies that can benefit

- Australian dollar
- Canadian dollar
- Chinese renminbi
- Euro
- Indian rupee
- Japanese yen
- Singapore dollar
- South Korean won
- Swiss franc
- U.K. sterling

The euro and renminbi: Modest winners

At the turn of the century, the newly launched euro was expected to rival the U.S. dollar. However, the euro's weight in FX reserves has barely changed due to the lack of capital market union and a single issuer bond market to rival the U.S. Treasury market. Nevertheless, the euro, as the principal alternative to the U.S. dollar, is expected to take a small extra slice of the pie and remain in clear second place.

In 2016, the forecasted winner was the **Chinese renminbi**. Despite a promising start, its success has been modest. The renminbi currently holds around 2% of global FX reserves, but its share has declined since the Russian invasion of Ukraine. As a result, Eastern European central banks, such as the Czech National Bank and the Central Bank of Lithuania, have liquidated their Chinese holdings.

The renminbi's story has been hampered by capital market reforms that have fallen short of expectations and recent sharp declines in Chinese bond yields. However, geopolitical fracturing means that for some nations, China will be a friend rather than a foe, and the renminbi will appeal to the managers of those reserves. China is the largest trading nation for more than 120 countries and trading flows are potential payment flows for the renminbi. So, despite headwinds the renminbi should continue to gain a modest FX reserves share over the next decade.

The **Singapore dollar** already has a small slice of the FX reserves pie and could grow modestly from here. The currency is likely to benefit from large renminbi trade invoice flows through Singapore, which have led to rapid growth in demand for Singapore dollar FX swaps.

The unlikely BRICS currency

There has been speculation that a desire to avoid the U.S. dollar might encourage the launch of a gold-backed BRICS currency. However, the BRICS nations are a heterogeneous group with differing objectives and significant rivalries, which we believe make a shared currency project unlikely. The issues involved in establishing any kind of BRICS currency (gold linked or otherwise) would be enormous. The recent additions to the BRICS group may only add to the complexity and likely reduce the probability of a new currency arrangement.

What it means for investors

The dominance of the U.S. dollar will continue to erode due to its weaponization. Even if the U.S. dollar's weight falls to 50%, its primary dominance will be maintained because there won't be a single challenger. Instead, the next decade will see 10 currencies take a small slice of the next 10% wave of dollar erosion.

We will also see the internationalization of up-and-coming currencies as bond market reforms improve and encourage access for foreign investors. This should trigger an evolution of the leading global bond indices. Investors could benefit by positioning for these opportunities through broad-based products benchmarked against emerging market and global aggregate indices.

ABOUT THE THOUGHT LEADER

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Gary is a client portfolio manager on the Fixed Income Team. He joined Columbia Threadneedle Investments in May 2024. Previously, he ran a consultancy business working with central banks and sovereign wealth funds, in addition to working in fixed-income distribution at Morgan Stanley and Merrill Lynch.

To find out more,
visit columbiathreadneedle.com

[1] Source: OMFIF, Giscard d'Estaing: Architect of euro and sdr, December 3, 2020
[2] Source: Reuters, "South Korea discusses joining part of AUKUS pact with U.S., UK and Australia." May 1, 2024
[3] The Non-Aligned Movement (NAM) is a forum of nation states not formally aligned either with or against any major power bloc and is dedicated to representing the interests and aspirations of developing countries.
[4] In 2024, BRICS was expanded to include Egypt, Ethiopia, Iran and the United Arab Emirates.

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