MARKET ANALYSIS

The US Dollar & Implications of BRICS Expansion

Philip Blancato, Chief Market Strategist, Osaic

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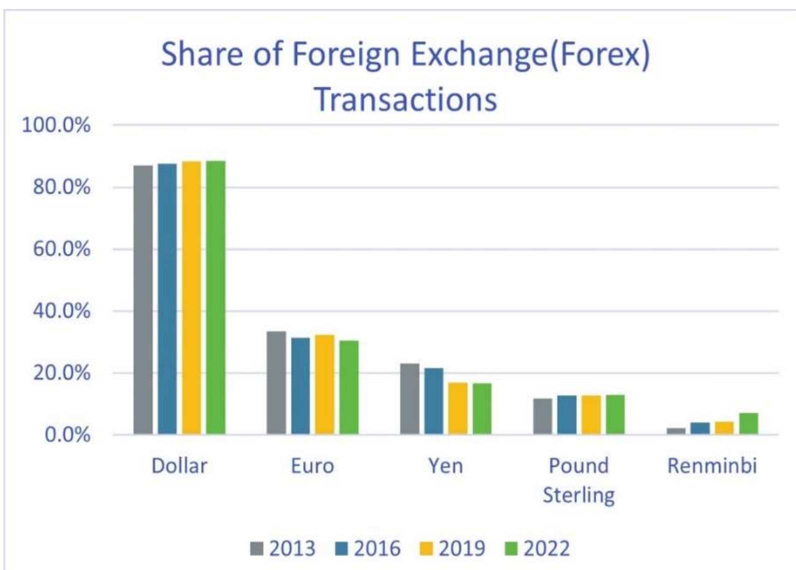
BRICS Expansion and the Recent De-Dollarization Efforts

The commonly used acronym BRICS is a multi-nation economic bloc consisting of the initial members Brazil, Russia, India, China, and South Africa. The organization, founded in 2009, recently added four new members in January 2024, including the United Arab Emirates, Iran, Ethiopia, and Egypt. Saudi Arabia, which received an invitation to join the group in 2023, has still not made a final decision,[1] and dozens of other emerging market nations have either applied for membership or expressed interest in joining. With the addition of four new members, the group's economic influence has expanded. The bloc's combined economies comprise an estimated 27.7% of global GDP, 29.4% of global oil production, and 45% of global population. In comparison, the G7 countries account for 26.5% of global GDP.[2]

Over the last year, BRICS has started initiatives to become less dependent on the dollar by using local currencies in trade and purchasing fewer dollar-denominated assets to hold as reserves. In response to Russia's invasion of Ukraine in February 2022, the United States and European allies imposed economic trading sanctions, restricted hundreds of billions of dollars and euro foreign exchange reserves owned by the Russian Central Bank and removed several Russian banks from SWIFT (Society for Worldwide Interbank Financial Telecommunications). Banks and other financial institutions use SWIFT to quickly, accurately, and securely send and receive information, primarily money transfer instructions. The rapidity and impact of these economic sanctions amplified concerns of BRICS members and other nations that an over-reliance on dollar-based financial systems and dollar assets held by their central banks could become a liability. BRICS looked to begin diversifying their exposure to the dollar and started conducting more trade in the Chinese renminbi (RMB). In 2023, the renminbi accounted for 50% of all cross-border transactions in China, surpassing the dollar, and total global payment settlements using the RMB almost doubled last year. However, the RMB still only makes up 4.61% of all global payment settlements, and its international use is low. The efforts put forth by China for the RMB to gain significant international traction outside of emerging markets will be hindered in part because it is not fully convertible; China's sovereign bond market is less liquid and smaller in issuance than the United States treasury bond market, there have been recent concerns over the stability of their economic conditions and policies, and China has more restrictions on capital flows within their economy.[3]

Is the Dollar's Dominance Fading?

The US dollar's role as the world's reserve currency began after World War II, with the establishment of the Bretton Woods System in 1944. This agreement created a fixed exchange rate system where the dollar was directly convertible to gold and other currencies were pegged to the dollar. Additionally, beginning in the early 1970's the dollar has been the primary currency that oil is priced in, commonly referred to as the petrodollar. This has helped make the dollar the leader in foreign exchange transactions where the dollar was involved in 88% of currency trades according to the latest official data published in 2022. However, unofficial data last year shows an estimated 20% of the world's oil trade was settled in non-US dollar currencies driven by trade among Russia, Iran, China, and India. China has also made advancements in establishing currency infrastructure to pay for oil purchased from Saudi Arabia in RMB instead of dollars. China is Saudi Arabia's largest oil customer with an estimated 17% of oil production from Saudi Arabia sold to China.[4] However, no oil contracts between those countries have been paid outside of the dollar yet.



The dollar as a percentage of foreign exchange reserves held by central banks has ranged from 70% in 2000 to 59% currently.[5] This decline has been partly due to the increased purchasing of gold from other central banks in emerging markets and purchases of other currencies including the Australian and Canadian dollars to diversify away from the US dollar. Despite the decline in foreign exchange reserves, the dollar is still the leader relative to other currencies. The second most held foreign exchange reserve is the euro, which is currently at 20%. The Chinese RMB has just a 2% share. Across emerging markets, the dollar remains the preeminent medium of cross-border trade and remains integral to financial markets. Additional concerns over spending and debt levels, higher inflation, and increased borrowing costs in the US from the Federal Reserve's monetary tightening cycle have not led to any significant declines in the dollar's role as the primary global reserve currency.

Could a BRICS Currency Replace the Dollar?

Following the last BRICS Summit in August 2023 there was renewed speculation about a new currency that BRICS members would use for international trade, which led to several headlines about the downfall of the dollar. Speculation about the new currency included a fiat currency backed by gold and a blockchain powered currency. New details about a currency have been vague in recent months and it does not appear that a new BRICS currency is imminent. The next BRICS Summit will be held in October where additional details and updates are expected. The most likely scenario in the near term is a continuation of the trend of BRICS nations increasing trade in local currencies with more reliance on the Chinese RMB than the dollar. The BRICS group would also like to strengthen their economic integrations and soften the dollar 's stance as the global reserve currency.[6] A new currency would most likely take several years to form and even then, the dollar would be difficult to remove as a trading partner. Exports and imports are the goods and services a country sells to and buys from other nations. When a country exports more than it imports, it has a trade surplus, Conversely, when a country imports more than it exports, it has a trade deficit. Countries with account surpluses (net-exporters) like many in the BRICS group, often rely on the U.S. dollar because it's the primary currency for international trade and reserves. They accumulate dollars through their trade surpluses and invest them in dollar-denominated assets, which creates a cycle where they need the dollar for trade and to manage their reserves, reinforcing its global dominance. This reliance on the dollar can make it challenging for new currencies, like those proposed by BRICS countries, to replace it as the primary global currency.

Potential Implications for Portfolios

When thinking about the implications of the dollar losing its title as the world's reserve currency or de-dollarization, it's important to frame it in the context of long term rather than short term. Many financial media headlines and stories like to focus on the potential for big price moves in a short timeframe, such as "the dollar is doomed and will lose its reserve currency status in two years." Rarely do macroeconomic moves of this caliber occur and certainly not when the dollar has been entrenched as the leader in the global monetary system as referenced earlier. If we do expect to see further de-dollarization from BRICS over time with the possibility of a new currency, we would likely see a depreciation of US financial assets, including equities and the dollar. Bond yields would be expected to rise, and inflation could potentially move higher as import prices rise. Internationally, it would be expected that emerging market equities, bonds, and currencies would be viewed as favorable.

Conclusion

In the near term, unless the geopolitical landscape between the US and Russia, China, and other countries changes, it appears very unlikely that the dollar's role will vary much, apart from continued declines in reserves. The Chinese RMB will likely grow in global reserves and foreign exchange transactions, but with such a small share currently, it would take decades to catch up to the dollar. Even then, capital controls in China would need to be removed, which are against current Chinese Communist Party policies. The concept of a BRICS currency could become a reality in the years ahead but will likely face obstacles given that many countries have different economic growth plans, and some currencies are currently pegged to the dollar. Therefore, while the continued trend of de-dollarization is probable, particularly if emerging economic blocs continue expanding to other countries, a sudden decline of the dollar seems unlikely.

Economic Definitions

GDP: Gross domestic product (GDP) measures the final market value of all goods and services produced within a country. It is the most frequently used indicator of economic activity. The GDP by expenditure approach measures total final expenditures (at purchasers' prices), including exports less imports. This concept is adjusted for inflation.

BRICS: BRICS is an intergovernmental organization comprising Brazil, Russia, India, China, South Africa, Egypt, Ethiopia, Iran, and the United Arab Emirates.

Renminbi (RMB): The renminbi is the official currency of the People's Republic of China.

United States Dollar: The United States dollar is the official currency of the United States and several other countries.

The Society for Worldwide Interbank Financial Telecommunications (SWIFT): The Society for Worldwide Interbank Financial Telecommunications powers most international money and security transfers. SWIFT is a vast messaging network used by financial institutions to quickly, accurately, and securely send and receive information, such as money transfer instructions.

Euro: The Euro is the official currency of most of the countries in the European Union.

Federal Reserve (Fed): The Federal Reserve System is the central banking system of the United States of America.

Disclosures

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[1] https://www.reuters.com/world/saudi-arabia-has-not-yet-joined-brics-saudi-official-source-2024-02-01/
[2] https://www.visualcapitalist.com/visualizing-the-brics-expansion-in-4-charts/
[3] https://www.atlanticcouncil.org/blogs/econographics/dedollarization-is-not-just-geopolitics-economic-fundamentals-matter/
[4] https://www.reuters.com/markets/currencies/china-saudi-arabia-central-banks-sign-local-currency-swap-agreement-2023-11-20/
[5] https://www.atlanticcouncil.org/programs/geoeconomics-center/dollar-dominance-monitor/
[6] https://www.nasdaq.com/articles/how-would-a-new-brics-currency-affect-the-us-dollar-updated-2024