**OPINION**

# Why the U.S. dollar remains the West's best economic weapon against Putin

**BRIAN MILNER** >
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Russian President Vladimir Putin and his minions must have thought they were ready for whatever new sanctions the West might throw at them in response to their full-scale invasion of Ukraine.

Mr. Putin calculated, correctly, that Europe would do nothing to stop the flow of essential natural gas and oil or the cash to pay for it. And he was convinced the financial system could weather any storms coming from the West, thanks to protective measures such as the creation of an efficient domestic payments system and deeper, more diversified central bank assets.

But the financial punishment turned out to be harsher, broader and more effective than expected, partly because the Kremlin has yet to find a way to counter the biggest weapon in the Western arsenal: the global dominance of the U.S. dollar and its critical role at the heart of international banking and cross-border commerce.

Lose access to the world's leading reserve currency and preferred method of payment in many trade and securities transactions, and your banks, capital markets and traders can end up in a world of hurt, as the Russians are discovering.

The Kremlin has worked hard to reduce Russian reliance on the greenback, turning to euros for energy deals and striking bilateral trade and investment pacts with countries such as China and India that call for settlements in local currencies. The central bank has slashed the portion of U.S. dollars and Treasury bills in its reserves, while boosting its holdings of euros, yuan and pounds.

This diversification is a growing trend among most central banks. But a handful of governments are going further to reduce their dollar risk.

The Saudis, for instance, are talking about accepting yuan for some of the oil they ship to China, their biggest customer. That would mean ending nearly 50 years of dollar-only oil trading and replacing part of their vast reserve holdings of U.S. assets with the Chinese currency. Even countries that haven't embarked on a flight from the greenback are grumbling. But that's nothing new.

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The dollar remains "by far the pre-eminent international currency in all respects – as a unit of account, medium of exchange and store of value," Eswar Prasad, an economics professor at Cornell University, writes in his latest book, *The Future of Money*.

It has managed to retain this exalted status, even as the American share of the global economy has fallen. Key commodities continue to be priced in dollars, and the currency still accounts for about 40 per cent of international payments.

"Much of the world sees this as an objectionable situation, with good reason," Prof. Prasad writes, noting that Washington has "not shied away from wielding the dollar's clout as a powerful geopolitical tool against its rivals."

Every five years or so, some monetary economist, think-tank denizen or geopolitical analyst decides that the dollar is about to be toppled from its throne – only to be proved wrong.

In the early 2000s, the euro garnered support as the likeliest challenger. Less than a decade later, the European financial crisis nearly led to the demise of the bold single-currency experiment.

Then it was the rise of China, whose superpower status would surely lift its currency to at least equal rank with the mighty buck.

The International Monetary Fund certainly thought so, adding the yuan in 2015 to the greenback, euro, pound and Japanese yen as world reserve currencies.

Yet dollar-denominated assets still make up just under 60 per cent of the more than US$12-trillion in foreign currency reserves held by the world's central banks – down from more than 70 per cent of a smaller pie two decades ago. The euro sits at about 20 per cent and the yuan below 3 per cent.

Any currency aspiring to major reserve status needs a large, liquid and well-regulated domestic securities market. China doesn't qualify yet.

Now, it's the very effectiveness of the financial sanctions against Russia that will apparently spell the end of the dollar's decades-long reign. Goldman Sachs and Barclays warned clients last week that the financial pain meted out by Washington has prompted some governments to reassess their hefty exposure to the currency.

Goldman suggested the greenback could go the way of – horrors! – the British pound, which ruled the monetary roost for the better part of a century before the First World War.

This gloomy assessment was made in the wake of the Saudi announcement. And now Russia says it is looking at accepting digital currencies and demanding payments in euros from countries that publicly oppose Mr. Putin's war. Which sounds like an empty threat, considering that this would violate long-term contracts with European customers, and he has nowhere else to peddle that much gas anyway.

Barclays posits that the world could turn from the dollar to "a broad set of alternative currencies."

Central banks for the past decade have been adding Canadian, Australian and Singapore dollars, South Korean won and Swedish krona to their asset mix.

Not everyone sees sanctions ultimately harming the dollar or other Western currencies. Zach Meyers, a senior research fellow at the Centre for European Reform, argues that the sanctions "do little to undermine Western predominance in the global financial system." In fact, he wrote in a recent report, "the opposite is true."

As the Kremlin wields a heavier club at home, forcing Russian exporters to sell foreign currency to the central bank or demanding that Europeans pay for their gas in rubles, "the greater the protection offered by Western currencies will be," Mr. Meyers says. "Countries like Russia and China have few good options to cut out the West entirely" without greatly increasing their risk.

The U.S. dollar's position "as the dominant reserve currency will likely persevere even if its status as a payment currency erodes," Prof. Prasad tells me in an e-mail exchange.

Not even the inevitable rise of digital currencies is likely to alter that reality. "Private stablecoins backed by U.S. dollars might well gain more acceptance worldwide than those backed by other currencies, implicitly bolstering the dollar's prominence," he says.

During a media teleconference last June, Mr. Putin bemoaned that Russia had to resort to non-dollar methods to conduct business with other countries because Washington was using "its national currency for various kinds of sanctions." Why, the autocrat asked, "do U.S. political authorities do this? They're sawing the branch on which they sit."

Yet that branch remains sturdy enough, and it would be a mistake to assume it's going to fall any time soon.

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