Jaseem Ahmed
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DOLLAR DOMINANCE AND HEGEMONY AFTER "LIBERATION DAY"

The dollar's dominance is rooted in the unmatched liquidity and depth of the US Treasury market. Additionally, the economic and political ties between the US and its allies are critical to the dollars' global role. De-dollarisation is difficult, especially in the absence of cost-effective alternatives; however, the factors that underpin dollar dominance are now facing challenges.

The trade war launched by President Trump on 2 April 2025 has introduced unprecedented uncertainty to prospects for the US dollar's (USD) dominance. In repudiating the rules-based global trading system the US appears to aim at incompatible goals: retaining reserve currency status for the dollar, deemed essential to financing its fiscal deficits, while at the same time engineering the dollar's depreciation to strengthen competitiveness and promote re-industrialisation[i].

The bilateral trade negotiations with individual countries, and the unprecedented tariffs on China, suggest that the goal is a re-ordering of international trade and global supply chains with a view to reducing China's economic power, and undermining its challenge to US hegemony.

At issue is economic and political power wielded by the US. The wide acceptance of the dollar enables the US to project influence, impose sanctions, and shape global economic policies. Conversely, the geopolitical power of the US reinforces demand for its currency.

But geopolitical power alone is insufficient. Currency dominance requires strategic intent, institutional credibility and economic depth. It requires deliberate institutional and economic choices in which competition matters. A dominant currency will fail if rivals offer better financial and payment systems, or if investors lose confidence in the fiscal prudence and policy credibility of the authorities.

The recent turmoil in financial markets has been damaging to the USD. The currency's unexpected depreciation indicates a lower appetite for dollar assets that adversely affects its reserve currency status, amid further evidence that US Treasury markets are less resilient to big shocks[ii].

Historical Foundations of the US Dollar's Dominance

The USD has long been the cornerstone of the global economy, serving as the world's primary reserve currency, medium of exchange, and unit of account. Its dominance is rooted in historical, economic, and geopolitical factors that have solidified its position as the most widely used currency in international trade, finance, and investment.

"*The primary element that generates currency dominance is the supply of safe and liquid short-term government-backed liabilities*"[iii]. At a value of $29 trillion, with daily turnover of $900 billion, the US Treasury market is the deepest and most liquid in the world. But this is not the result of a policy of *laissez faire*. Rather, the USD's rise to global prominence is the result of strategic intent, reflected in a long collaboration between the US Treasury and Federal Reserve to develop deep and liquid capital and debt markets.

The objective of this uniquely successful "monetary and fiscal entanglement" was to provide a resilient institutional foundation for US government financing[iv]. Additionally, the US sought to escape from the irksome need for US firms to rely on London and British payment and settlement systems for their external trade. Geopolitical objectives were an early and enduring feature of US policy. Two critical measures were the establishment of the Federal Reserve in 1913, and the Fed's provision of subsidised lending facilities for trade. This created an ever-increasing demand for trade invoicing and settlement in dollars.

The path to currency dominance was achieved through continuous improvements to the institutional infrastructure of financial and bond markets, culminating in the primary dealer system which ensured Treasury market liquidity in the early 1950's. This led to a decisive shift in the demand for dollar reserves. Thus, in 1950 the dollar accounted for 30% of global reserves, but this increased to 60% in 1960. Today, this share is almost unchanged at 58%.[v]

In addition, the Bretton Woods Agreement of 1944 paved the way for the dollar's ascent. Under this system, the US dollar was pegged to gold, and other currencies were pegged to the dollar. This arrangement established the dollar as the central pillar of the international monetary system. The Bretton Woods system also led to the creation of the International Monetary Fund (IMF) and the World Bank, institutions that further entrenched the dollar's role in global finance. The US dollar became the primary currency for international trade and reserves, and its dominance was reinforced by the economic and military power of the United States during the Cold War.

The Dollar's Role in the Global Economy

Today, the US dollar plays a multifaceted role in the global economy, encompassing trade, finance, and investment. Its dominance is evident in several key areas (Figure 1):

1. International Trade: The US dollar is the most widely used currency for international trade. Commodities such as oil, gold, and agricultural products are predominantly priced and traded in dollars. This practice, known as "dollar invoicing," reduces transaction costs and exchange rate risks for businesses engaged in global trade.
2. Foreign Exchange Reserves: Central banks around the world hold significant portions of their foreign exchange reserves in US dollars. According to the IMF, the dollar accounts for approximately 60% of global foreign exchange reserves, far surpassing other currencies like the Euro, Yen, and pound Sterling.

3. Global Finance: The US dollar is the dominant currency in global financial markets. It is the primary currency for international loans, bonds, and derivatives. The dollar's liquidity and stability make it the preferred choice for investors and financial institutions. A key market that relies critically on dollar liquidity is the FX swap market used for hedging by pension funds, life insurers and asset managers.
4. Safe-Haven Currency: US Treasuries, and the dollar, have been a crisis safe haven. Thus, the demand for dollar denominated assets rises during economic and geopolitical shocks, reflecting a "flight to safety" during both the Global Financial Crisis in 2008 and in March 2020 at the onset of the Pandemic. However, 2020 saw a new phenomenon: the panic selling of US Treasuries as well as a "dash for cash" to the dollar.

Benefits of the Dollar´s Dominance

The dominance of the US dollar confers several benefits to the global economy and the United States itself:

1. Economic Stability: The widespread use of the dollar provides a stable and predictable framework for international trade and finance. It reduces exchange rate volatility and facilitates smoother cross-border transactions.
2. Lower Transaction Costs: The dollar's ubiquity reduces the need for currency conversions, lowering transaction costs for businesses and consumers. This efficiency promotes global trade and investment.
3. Seigniorage: As the issuer of the world's primary reserve currency, the United States enjoys significant seigniorage benefits. Seigniorage refers to the profit earned by a government from issuing currency. The global demand for dollars allows the US to borrow at lower interest rates and finance its deficits more easily.

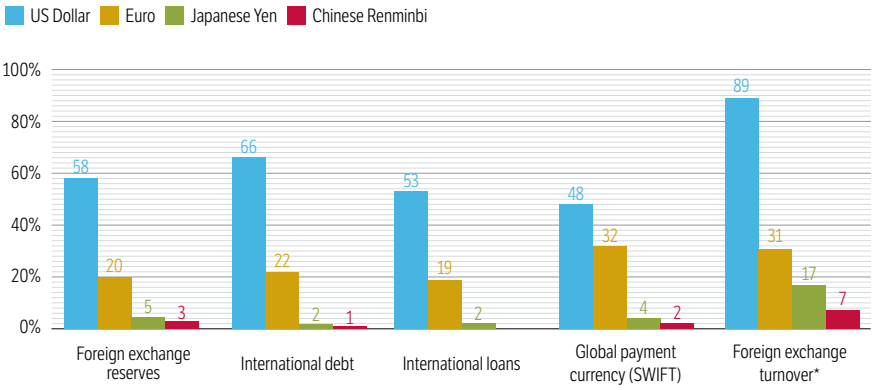
Drawbacks of the Dollar´s Dominance

While the dollar's dominance offers numerous advantages, it also presents certain drawbacks and risks:

1. Global Dependence on US Monetary Policy: The global reliance on the US dollar means that US monetary policy has far-reaching implications. Decisions made by the Federal Reserve can have significant spillover effects on other economies, leading to financial instability or currency crises in emerging markets.
2. Trade Imbalances: The dollar's role enables the U.S. to sustain large deficits, but this could lead to long-term vulnerabilities if confidence erodes.
3. Vulnerability to US Economic Shocks: The global economy's dependence on the dollar makes it vulnerable to shocks originating in the United States. For example, the 2008 financial crisis had widespread repercussions due to the interconnectedness of global financial markets.
4. Sanctions and Weaponisation of the Dollar: The United States has increasingly used the dollar as a tool of economic statecraft, imposing sanctions on countries that it views as violating international norms. While often effective in achieving policy objectives, this practice has led to concerns about the weaponisation of the dollar.

FIGURE 1. USD IS KEY CURRENCY ACROSS MULTIPLE FUNCTIONS GLOBALLY

Sources: BIS, IMF, Society for Worldwide Interbank Financial Telecommunication (SWIFT) and ECB calculations. Data as of December 31, 2022.
Notes: the latest data for foreign exchange reserves, international debt and international loans are for the fourth quarter of 2022. SWIFT data are for December 2022. Foreign exchange turnover data are as of April 2022.
*Since transactions in foreign exchange markets always involve two currencies, shares add up to 200%.



Threats to the Dollar´s Dominance

Despite its entrenched position, the US dollar faces several threats that could undermine its dominance in the global economy. These threats stem from economic, technological, and geopolitical developments:

1. Rise of Alternative Currencies: The emergence of alternative currencies poses a potential challenge to the dollar's supremacy. The Euro, introduced in 1999, has become the second-most important reserve currency, accounting for around 20% of global reserves. China's Renminbi is also gaining traction, particularly in Asia and Africa, as China promotes its use in international trade and investment.
2. Digital Currencies and Cryptocurrencies: The advent of digital currencies and cryptocurrencies represents a disruptive force in the global financial system. Central bank digital currencies (CBDCs) are being developed by several countries, including China, the European Union, and the United States. These digital currencies could facilitate cross-border transactions and reduce reliance on the dollar.
3. Geopolitical Shifts and Multipolarity: The global balance of power is shifting towards a more multipolar world, with the rise of China, India, and other emerging economies. As these countries gain economic and political influence, they may seek to reduce their dependence on the dollar and promote their own currencies in international trade and finance.
4. De-Dollarisation Efforts: Some countries are actively pursuing de-dollarisation strategies to reduce their reliance on the US dollar. For example, Russia and China have increased their use of local currencies in bilateral trade and established alternative payment systems to bypass US-dominated financial networks. The BRICS nations (Brazil, Russia, India, China, and South Africa) are said to have discussed creating a new reserve currency to challenge the dollar's dominance.
5. Technological Advancements: Advances in financial technology (fintech) are transforming the global payments landscape. Innovations such as blockchain technology, instant payment systems, and digital wallets are making it easier to conduct cross-border transactions without relying on traditional banking systems or the US dollar.

Alternatives to Dollar Dominance: Old and New

US policy has long supported a "strong dollar" and "dollar dominance" while also opposing the development of alternatives. US opposition to an Asian Common Currency and to the Asian Monetary Fund, proposed by Japan following the 1997 Asian Financial Crisis, was decisive in their failure. President Trump's recent threat of 100% tariffs on BRICS, and any country trying to "de-dollarize", demonstrates continuing determination to deter the development of alternative currencies and payments systems that could undermine the dollar's dominance.

However, it has also proved extremely difficult to make even small inroads to the use of the dollar for trade financing and other functions in East Asia or elsewhere[vi]. This reflects the absence of deep financial and local currency bond markets, and limited regional infrastructure of payment and settlement systems for cross border financing, in much of the world. This underscores the singular nature of the US achievement in ensuring such deep and liquid financial markets for itself.

The US views China as most likely to seek to displace the dollar and expects it to follow a similar path through increasing Renminbi trade invoicing and internationalisation. However, China's multiple initiatives, which increase its global economic footprint, may not aim to mimic the US but to challenge it (Figure 2).

China's Challenge

China has developed a central role in international trade and in global supply chains. It is the leading manufacturing centre of the world and is the largest trading partner for 120 countries, reflecting a global system of bilateral and regional free trade agreements. The greater role for the Renminbi in the global economy to support these developments is being pursued through the following four elements.

First, to finance its bilateral trade China established subsidiaries of its development banks in countries across the world to assist in Renminbi as well as dollar financing. It aims to replace this system with an alternative messaging and payments and settlements system called Cross-Border Inter-bank Payment System (CIPS), that is already functional.

FIGURE 2. CHINA'S CHALLENGE TO USD REFLECTS GLOBAL STRATEGY
Source: Elaborated by the author.

- China launched Belt and Road Initiative infrastructure program supported by its policy banks in 2013, like World Bank.
- Swap lines for trade settlement also provide FX Reserves support, like IMF.
- Renminbi internationalisation slow progress, but infrastructure for cross-border transactions settlement in place. Developing digital currency e-CYN.

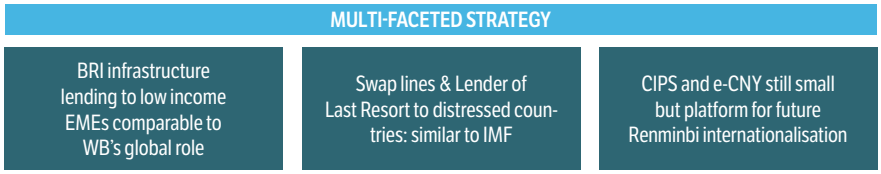
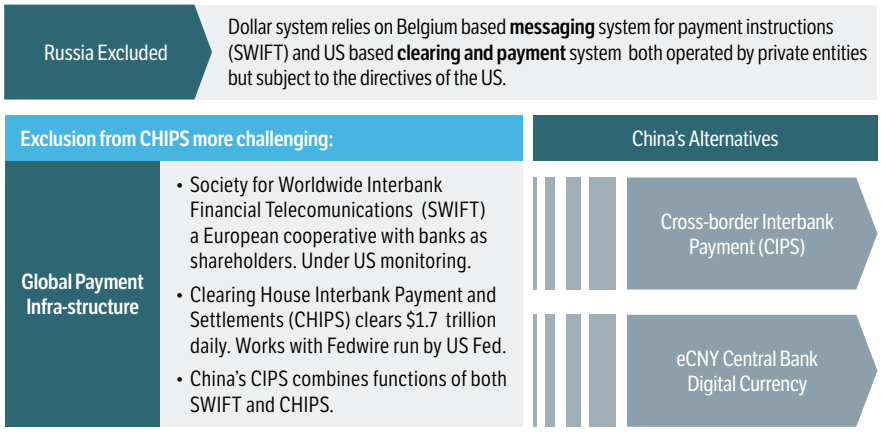


FIGURE 3. CHINA'S ALTERNATIVES TO DOLLAR-BASED PAYMENT AND SETTLEMENTS: INCLUDES DIGITAL CURRENCY
Source: Elaborated by the author.



Second, China established a system of bilateral swap lines (BLS) that assists countries in need of balance of payment financing as well as for trade financing[vii]. Not all BLS have been utilised, indicating that they play a contingent or "insurance" role, similar to lines of credit provided by the IMF. As the Renminbi is part of the IMF's SDR basket of currencies, BLS can be used to repay IMF loans.

Third, China's Belt and Road Initiative (BRI), which is the largest infrastructure financing program in the world, is being supported by the above financing mechanisms. China's BLS, in parallel to the $1 trillion committed to BRI infrastructure investments, have given China an institutional role that is comparable to the IMF and the World Bank in the global economy[viii]. They have enhanced China's ability to shape the geopolitical context in the face of US dominance.

Finally, China is developing a digital currency which it has tested in a trial cross border project with three other central banks (CBs) – the M-Bridge project[ix]. While this project requires considerable further development for it to be fully operational, it has the potential for providing a fast and cheap alternative to the current US monitored SWIFT (Society for Worldwide Interbank Telecommunication) messaging and complementary settlement systems in the US and Europe (Figure 3).

It should be noted that China has considerable need for dollar financing of its own for trade financing as well as to support BRI projects. Nor is China necessarily inimical to the USD's global role. This explains why China still retains about $700 billion in US Treasuries and perhaps another $2 trillion in various US securities.

The Future of Dollar dominance

Amongst the key factors shaping the dollar's prospects three are noteworthy.

First, the continued unmatched liquidity of US Treasury and financial markets, and confidence in the safety of US assets. These are grounded in the fiscal strength of the US combined with the independence of the Federal Reserve and confidence in the rule of law in the US.

Second, the lack of viable alternatives with comparable liquidity and low transaction costs has reinforced global reliance on the USD.

Third, dollar dominance is supported by US military and geopolitical alliances. US allies are major holders of USD reserves and major investors in US financial and real sector assets, resulting in a mutually reinforcing "Entrenched Equilibrium" of USD dominance and US hegemony[x].

While US allies hold about 75% of global dollar reserves of $6.5 trillion, their investments in US equity and bond markets are close to $30 trillion[xi]. The scale and scope of these investments in the US makes them difficult to unwind.

A US debt crisis and loss of confidence in the dollar would involve heavy US equity market losses and losses on Treasury bonds. This would also adversely affect US allies. Hence, the US and its allies are bound together through economic and financial ties. No quick decoupling is possible without massive market and economic turmoil.

But, the underlying basis of the dollar's dominance is changing.

First, US Treasury markets are under strain from rising debt issuances. Thinly capitalised market intermediaries are increasingly unable to ensure smooth market functioning. Essentially, the massive volume of debt the US issues to finance its deficits are now too large for the current market structure to efficiently manage[xii].

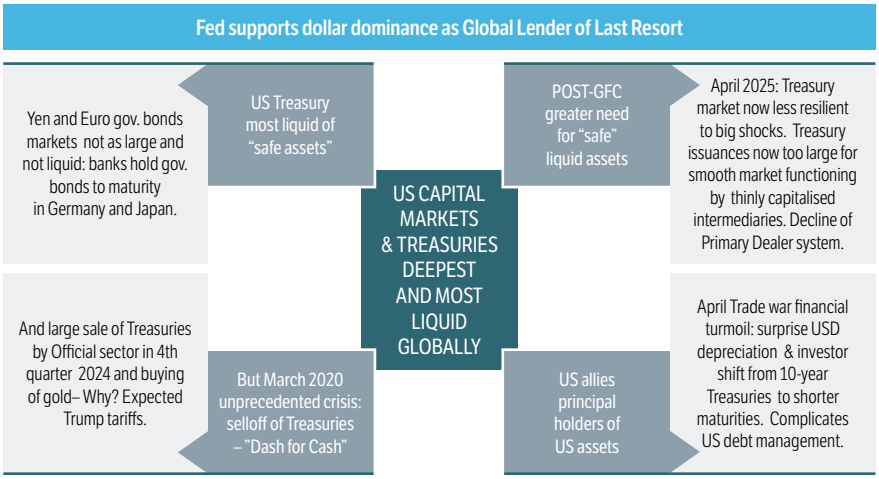
Second, alternatives have emerged to US controlled payment and settlement systems. The digital currency & payments and settlement system developed by China and other central banks are active in cross-border payments settlement and could be scaled up in a multi-CBDC system that would bypass both the SWIFT messaging and US or EU payment and settlement systems. Many countries view such alternatives as a means to avoiding the widening scope and frequency of US sanctions.

This process is likely to be slow. But parts of the wide-ranging systems in place are accelerating. Thus, while the value of global trade denominated in Renminbi has increased from about 2% to 4% in the two most recent years, cross-border financial transactions of China-based entities in Renminbi have accelerated from virtually zero in 2013 to about 50% of transactions by value in 2023[xiii].

Third, a more transactional foreign policy stance by the US could leave the dollar adrift, unmooring it from its supporting political and security foundations.

FIGURE 4. US TREASURY MARKET & FEDERAL RESERVE SUPPORT UNDER STRAIN

Source: Elaborated by the author.



Given the potential for sharp financial losses and market dysfunction from a rapid economic separation of the US from its military and security allies, this scenario is likely to unfold slowly, if at all. Loss of Fed independence would aggravate the dislocations and would weaken confidence in the swap lines the Fed established with 14 systemically important CBs. While these CBs have about $2 trillion in dollar reserves, their ability to support the $8 trillion daily FX swap market – the largest dollar-based market in the global financial system – would be weakened without the presence of the Fed which alone has the power to create dollars[xiv].

Conclusion

US economic and fiscal strength, and its military and geopolitical dominance, underpins demand for the dollar.

The Petro-dollar system and demand from geopolitical allies ensures USD reserve currency status. Like 19th century Britain, investors tolerate higher US debt because its military power and alliances deters conflicts that disrupt trade

However, this system is now strained. The combination of rising US Debt at $36 trillion, with the debt-GDP ratio approaching the peak level of 1946, and political gridlock over debts and deficits could undermine investor trust. Disruptions to the global economy, which previously led to a "flight to safety" in dollars that reinforced its safe haven status have recently had the opposite effect. The dollar depreciated after 2 April 2025, with evidence of a flight from 10-year Treasuries to shorter maturities which could complicate US debt management[xv].

In this context, the changing and sometimes contradictory narrative of policy proposals by the US introduces potentially damaging uncertainty. Thus, the stated objectives of burden-sharing with allies for the US security umbrella and for the cost to the US resulting from the USD's reserve status looms as a source of continuing policy uncertainty. The view that these objectives can be achieved "*without material adverse consequences*" seems unrealistic[xvi].

Sustaining US global hegemonic status will be challenging in these circumstances. This suggests not the end of dollar dominance, but rather the start of a process that will not be easy for the US to manage or the global economy to navigate. ●

Notes

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