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Dollar Dominance Is Here to Stay for the Foreseeable Future—The Real Issue for the Global Economy Is How and Why

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Dollar Dominance Is Here to Stay for the Foreseeable Future—The Real Issue for the Global Economy Is How and Why

Steven B. Kamin and Mark Sobel

January 14, 2024

Abstract

In this paper, we examine the prospects for, and implications of, the dollar's continued pivotal role in the international financial system. We find, first, that the dollar remains dominant by a wide margin and will likely retain its dominance for the foreseeable future—none of the other contenders possess the liquidity, safety, and investor protections that are required for the currency world's top job. We then evaluate the benefits that the United States derives from the dollar's dominance. On the geopolitical side, the United States derives material benefits from the dollar's dominance, as it makes sanctions against bad actors around the world more effective. But contrary to the criticisms that the United States enjoys an “exorbitant privilege,” we doubt that the economic benefits of the dominant dollar for the United States are very large or that this dominance imposes large costs on our trading partners. In fact, the widespread use of the dollar has likely promoted global trade, international investment, and economic growth by providing a common unit of account, means of exchange, and store of value. We conclude by noting that the direst threat to the dollar emerges from the United States itself, with partisan divisions, political dysfunction, and the resultant inability to cope with the nation's challenges posing important risks to the country's economic and financial prospects. Were those risks to materialize, the loss of the dollar's dominance would be the least of our problems.

About the Authors

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Introduction

With the world's attention focused on US/China tensions, possible fragmentation and decoupling, Russia's invasion of Ukraine, the United States' polarized dysfunction and the increased use of financial sanctions, news reports abound on the future of the dollar's dominant role in the international monetary system. Typical headlines include "De-dollarization: Is the US dollar losing its dominance," "Calls to move away from the U.S. dollar are growing — but the greenback is still king," and "Will the dollar keep its global dominance? The US needs to get its act together."¹ Despite a constant stream of exciting stories, however, the reality is far more prosaic: dollar dominance is going nowhere for the foreseeable future.

In this essay, we first review the evidence on the role of the dollar in the international financial system and we find that the dollar remains the most dominant currency by a wide margin. We then evaluate the future prospects for the dollar and conclude that it is likely to retain its dominance for the foreseeable future. None of the other contenders for the job, such as the euro or the renminbi, possess the liquidity, safety, and investor protections that are required for the currency world's top job. The following sections evaluate the benefits that the United States derives from the dollar's dominance, both economically and geopolitically, and the costs of that dominance to the rest of the world. On the geopolitical side, we believe the United States derives material benefits from the dollar's dominance, as it makes sanctions against bad actors around the world more effective. But contrary to the criticisms that the United States enjoys an "exorbitant privilege," we doubt that the economic benefits of the dominant dollar for the United States are very large or that this dominance imposes large costs on our trading partners. In fact, the widespread use of the dollar has likely promoted global trade, international investment, and

¹ J.P. Morgan (2023), CNBC (2023), and Eichengreen (2023).

economic growth by providing a common unit of account, means of exchange, and store of value. Those are the same reasons why money is viewed as an improvement over barter, but merely applied on a global scale.

We conclude our essay by noting that the key question is not whether the dollar's dominance will be sustained, but rather will the factors that have supported the dollar's dominance, and that have provided benefits to the global economic and financial system as well as the United States, be sustained? We note that the direst threat to the dollar emerges from the United States itself, with partisan divisions, political dysfunction, and the resultant inability to cope with the nation's challenges posing important risks to the country's economic and financial prospects. Were those risks to materialize, the loss of the dollar's dominance would be the least of our problems.²

1. The Dollar Continues Firmly as World's Dominant Currency

The US dollar continues to serve as the world's dominant currency. Whereas the United States accounts for roughly 25% of global GDP³, international dollar usage across a range of measures is on the order of 60% or higher. These data are well documented by the staff at the Federal Reserve.⁴ Global exports remain heavily denominated in dollars, except in Europe.⁵

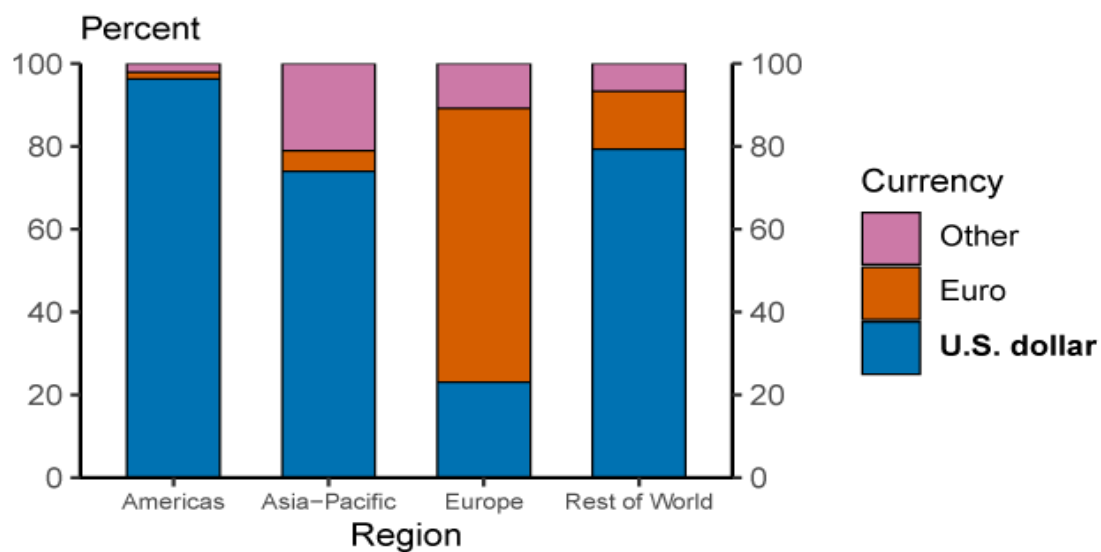
² We quote Larry Summers at his Richard N. Cooper lecture at the Peterson Institute: "It's my quite high conviction belief that the day the dollar loses its major role in the world monetary system, the loss of that role will be the least of our problems." (Summers, 2023)

³ Using market exchange rates, not purchasing power parity. Global finance is transacted through market exchange rates. One cannot buy a Big Mac with a PPP dollar.

⁴ The charts on the dollar's role in export invoicing, international bank claims, and securities are copied from Bertaut et al. (2023).

⁵ The value for Europe is overstated insofar as it includes within-euro area trade

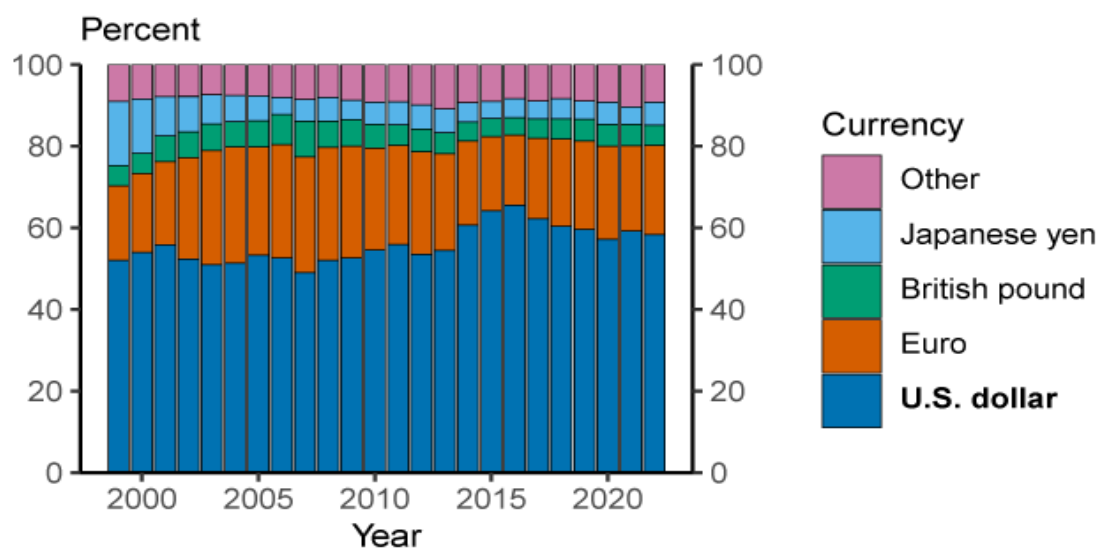
Figure 1: Currency Denomination of Trade



Source: Bertaut et al. (2023).

Dollar usage also continues to dominate international banking transactions.

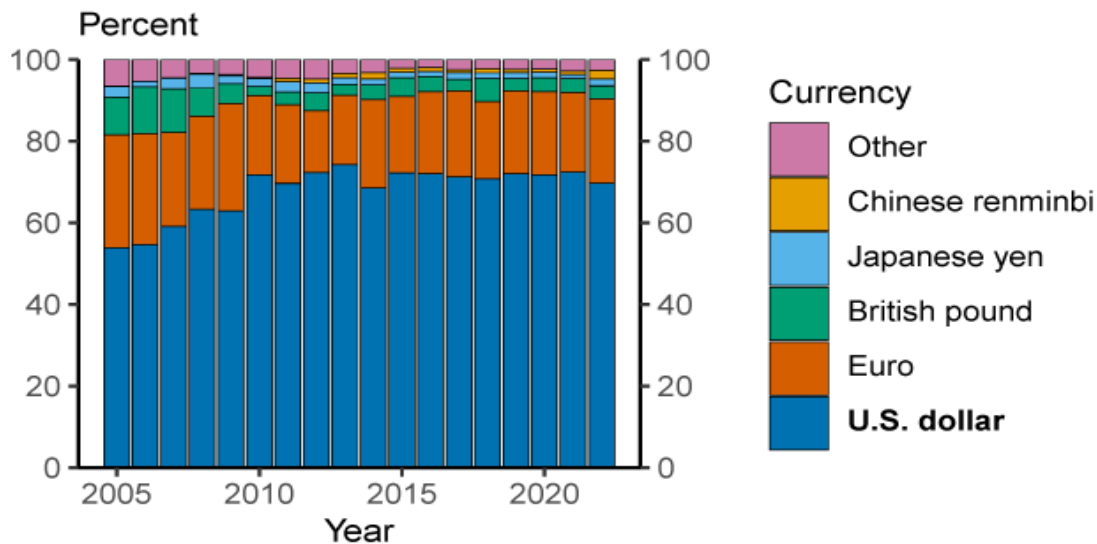
Figure 2: Currency Denomination of Cross-Border Bank Claims



Source: Bertaut et al. (2023).

Similarly, international debt securities issuance is heavily dollar denominated.

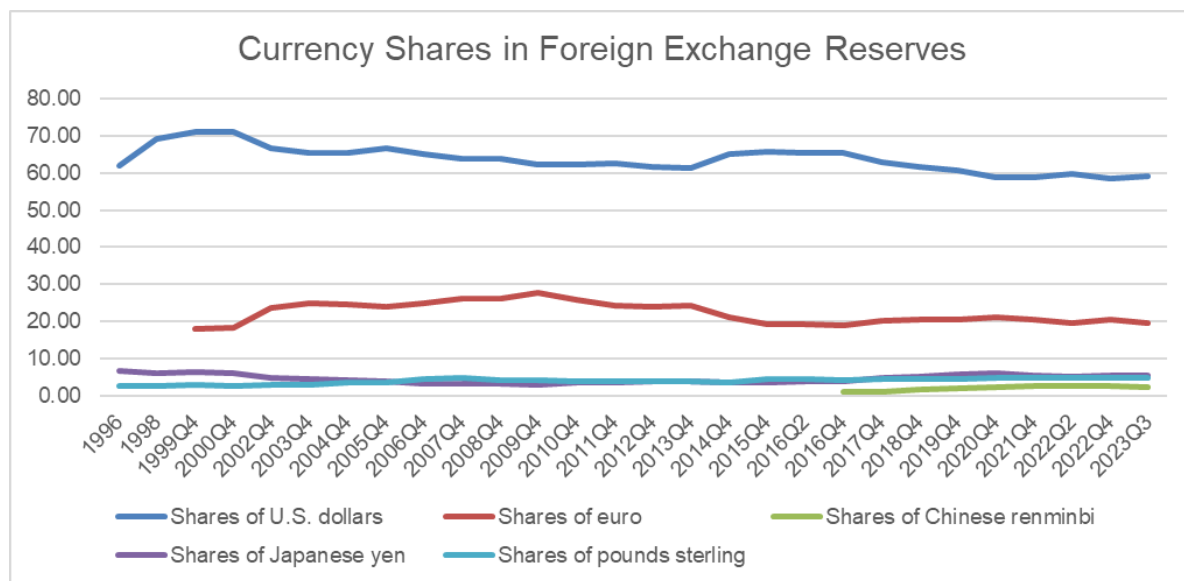
Figure 3: Currency Denomination of International Debt Securities



Source: Bertaut et al. (2023).

The above measures relate to the dollar's financing role in global markets. A traditional measure of dominance is the dollar's share in global central bank reserves.

Figure 4: Currency Denomination of Foreign Exchange Reserves



Source: IMF (2023)

Broadly speaking, the dollar's reserve share has remained around 60% since the mid-1990s, having moved up toward 70% around the early 2000s at a time of dollar strength and the euro's introduction and back toward just under 60% currently. The euro's share has broadly hovered around 20% since its inception in 1999. Sterling and the Japanese yen remain around 5%. While much attention is focused on the Chinese RMB as a possible alternative reserve currency, its share at this time is around 3%.

Some of the decline in the dollar's share in recent years is also associated with increased holdings at the margins of Swiss francs and Canadian and Australian dollars.^{6, 7} Central bank gold holdings have also increased, though these are not incorporated in the IMF data.

2. The Dollar Will Remain Dominant for the Foreseeable Future

Nor is dollar dominance likely to disappear in the foreseeable future, even if the dollar's role might ebb somewhat and its value in exchange markets fluctuates up and down. The dollar retains overwhelming strengths as a unit of account, medium of exchange and store of value, reflecting many features inherent to the US political, economic and financial systems.

The United States came out of World War II as the global economic heavyweight and hegemon, and the postwar international monetary system placed the dollar at its center. Since then, the US economy has remained far and away the largest, at least measured at market exchange rates, notwithstanding China's recent rise. Over the ensuing decades, despite periodic

⁶ Arslanalp et al. (2022).

⁷ The reserve data fluctuate in response to valuation effects. China only began reporting the composition of its reserves to the IMF in 2015, significantly diminishing the amount of unallocated reserves and vastly increasing the coverage of the reporting.

lapses especially on fiscal policy, the US economy has generally delivered sound macroeconomic performance. US capital markets are the most open, deep and liquid in the world, offering US and foreign investors a wide array of financing instruments – including Treasuries, the world’s risk-free safe asset. Large amounts of capital flow in and out of the US market with limited price impact and transaction costs. The economy is open and the dollar convertible. Rule of law is robust: The US legal system protects property rights, enforces contracts and uses the court system to settle disputes. US residents and foreigners receive the same investor protections, subject to national security considerations

The impact of these properties on dollar dominance are buttressed by network effects and inertia. In essence, people accept dollars in payment because they know other people will accept dollars in payment. This makes it difficult for a challenger to the dollar to build up the scale of transactions needed to encourage people to switch currencies. Moreover, the challenging currency would need to overcome the advantage of the large infrastructure built around dollar use. The large US megabanks power the global payments system, connecting the world’s financial system via a vast and established hub and spoke network of correspondent banking relations. The sheer size and efficiency of this network reduces transaction costs for international payments. With this system up and running, inertia reigns with investors having little practical incentive to change.⁸

While recent US economic and political developments may weaken the underlying properties supporting dollar dominance, other currencies also face challenges of their own. The second-most widely used international currency is the euro. The Euro area is a vast and open economy like the United States. But despite some early optimism that the euro might overtake

⁸ Of course, malign actors will not be dissuaded from paying more to undertake transactions beyond the US net.

the dollar as a dominant currency, many analysts now argue that the euro's global financing share has not risen significantly because of the lack of a deep, liquid sovereign Eurobond market, as distinct from German bunds, French OATS etc.⁹ Europe's capital market union project remains in a fledgling state. US economic performance remains more dynamic than Europe's.

Market participants have shown an appetite for Australian and Canadian dollars and Swiss francs. But the respective financial systems and capital markets are relatively small, capping the diversification potential into these currencies.

In recent years, many analysts have asked whether the RMB could become a major global financial and reserve currency. The RMB's role could well rise to some degree, including from its roughly current 3% reserve threshold, in the foreseeable future. But it has many challenges to overcome. The RMB is not convertible. Capital controls abound. The economy faces massive headwinds, due to demographics, leverage including housing sector woes, a possible middle-income trap, and heavy-handed state intervention in directing resources which weakens confidence in the private sector. China's "rectification" campaign has eroded trust in the rule of law. Capital inflow, at least for the time being, has slowed if not stopped.

That said, the RMB is increasingly used for trade settlement within Asia. Over one-quarter of China's trade is now settled in RMB. China is reinforcing the RMB's international financial use with swap lines for many countries and also striving to build out its Cross-Border Interbank Payments System. The People's Bank will seek out opportunities to liberalize the financial system. Russia will also lean heavily on RMB usage to circumvent Western sanctions. Taken together, these factors may support a somewhat larger global RMB financing and reserve role in coming years.

⁹See Chinn and Frankel (2008), for a discussion of scenarios in which the euro becomes dominant.

More recently, there have been fanciful discussions about creating a BRICS (Brazil, Russia, India, China, South Africa) currency. But while these nations may share a common wish to see a less prominent global dollar role, that is quite different than offering a viable alternative.¹⁰ There is little chance that these countries would abandon their own currency for the most likely alternative—the Chinese renminbi—and even less chance that they would adopt an entirely new currency.

Some analysts wistfully believe that the Special Drawing Right (SDR) – a reserve asset allocated by the IMF -- could play a more prominent global role. But it is used only in official transactions, its allocation requires an 85% majority vote of the IMF, and the Fund is not a global lender of last resort even if it is a key pillar of the global financial safety net.

Finally, arguments are increasingly heard that improved payments systems, use of stablecoins/crypto assets, and the advent of central bank digital currencies (including in China) could seriously erode dollar dominance. It is possible that improvements in the technology and administration of cross-border payments could reduce the dollar's role as a vehicle currency for international transactions. But it is unlikely that the dollar's more general dominance in international finance would be greatly threatened. First, crypto assets (besides stablecoins) are highly volatile and unsuitable either as a medium of exchange or especially as a store of value; moreover, they are often exchanged absent a legal underpinning, and governments will be loath to tolerate their illicit use. Second, although stablecoins have more potential to be widely used, the key stablecoins such as Tether and Circle's USDC are tied to the dollar and backed by US dollar assets, so demand for dollars might actually rise; any new stablecoins that enjoy

¹⁰ Sobel (2023) addresses this issue in some depth.

widespread takeup likely will also be backed by dollar assets.¹¹ Finally, improving the usage of vehicles as mediums of exchange does not change questions related to the underlying properties of a country (e.g., trust in a regime, rule of law etc.), which are relevant for store of value considerations. People are unlikely to use Chinese CBDCs at scale if they cannot safely store their savings in that asset.¹²

3. Even if the Dollar Were to Lose its Dominance, That Would Not Be All That Adverse for the U.S. Economy

As discussed above, we believe the most likely scenario is that the dollar retains its dominant position for the foreseeable future in the global financial system. But this is not a foregone conclusion per se, and thus it makes sense to evaluate the benefits that the United States derives from the dollar's dominance.

Geopolitical benefits

We believe the most tangible benefits to the United States of the dollar's global role may be in the geopolitical sphere rather than the economic sphere. The United States remains the world's dominant superpower and the size and strength of the US's military, political and economic heft allows it to project power across the globe. The US has strong alliance and diplomatic relationships with countries throughout the world accounting for a large majority of global GDP.

The US's political and military clout and alliance structure, on top of its economic and financial power, reinforce and tamp down challenges to the dollar's global role. Some three-

¹¹ It is possible that a stablecoin could proliferate that is not fully or largely backed by dollar assets. However, that would more likely be a reflection of an already established decline in dollar dominance than a cause of that decline.

¹² Sobel, 2021a.

quarters of foreign government holdings of US safe assets are by countries with some form of military tie to the US.¹³ US allies are more inclined to rely on the dollar and less prone to diversify given close ties with the US.¹⁴

At the same time, the dollar's dominance reinforces the US's geopolitical power. As will be discussed below, foreign holdings of US Treasuries reduce Treasury yields to some extent and thus allow the US to finance its sizable military spending more cheaply.¹⁵ Further, the ability of the U.S. government, either by itself or in coordination with its allies, to impose sanctions on bad actors around the world depends importantly on the international financial system's dependence on the dollar. Because so many transactions take place and/or assets are held in dollars and are cleared either by the Federal Reserve or by internationally active financial institutions supervised by U.S. authorities, the U.S. government has the ability to exclude entities from much of the global financial system. Below is a list of some of the sanctions imposed by the US and other G7 countries on Russia since it invaded Ukraine:

- *Financial sanctions*
 - *Freezing \$300 billion in Russian international reserves*
 - *Prohibiting US/Russia transactions in IMF SDRs*
 - *Removal of prominent Russian banks from SWIFT*
 - *Freezing US assets of some Russian banks*
 - *Prohibiting US institutions from process Russian debt payments*
- *Trade restrictions and export controls*
- *Oil price cap*

¹³ Weiss (2022).

¹⁴ Eichengreen et al. (2017).

¹⁵ Kirshner (2008).

Not all of these sanctions depend on the dominance of the dollar in the international financial system, but many of them do. In particular, actions that cut Russia off from dollar transactions or freeze its dollar assets can exert material harm on its economy, and are a helpful complement to other US and Western diplomatic and strategic instruments.

Some critics have complained that such a “weaponization” of the dollar by the United States risks diminishing the dollar’s dominance by pushing countries to use other currencies in order to evade the sanctions.¹⁶ Financial sanctions have increasingly been used by Administrations, particularly in the wake of 9/11. Policymakers view financial sanctions as a strong and useful ‘stick’, short of warfare, that complements the ‘carrot’ of diplomacy. Recourse to excessive or abusive use of financial sanctions could accelerate foreign propensity to use alternatives to dollars – for example, Europe’s effort to build an alternative payments mechanism in the wake of US abandonment of the Joint Comprehensive Plan of Action against Iran.

But again, America’s extensive alliance structures significantly mitigate such a development. Moreover, when financial sanctions are imposed multilaterally in coordination with our allies rather than pursued unilaterally, and applied with restraint and only in response to egregious actions and in furtherance of strategic objectives, any adverse impact on the dollar’s financing and reserve role should be substantially minimized. In contrast, we would argue that excessive US use, if not abuse, of financial sanctions will weaken the effectiveness and ability to use this tool in the future.¹⁷

In short, concerns about the use of financial sanctions significantly hurting the dollar’s stature are overstated. First, as noted above, only a small fraction of countries are likely to be

¹⁶ See Roubini (2023), among many observers making this argument.

¹⁷ McDowell (2023).

motivated by sanctions to seek alternatives to the dollar. Most advanced economies have close ties with the United States, either through political/military arrangements such as NATO, through largely economic arrangements such as the G7 or the OECD, or through shared values such as respect for democratic norms. Many emerging markets and developing countries also have close political ties with the United States, even if some of them choose to also maintain relations with countries that have tense relations with the “West”. Finally, for all of these countries, the enormity of the US economy as a market for goods, services, and investment cannot be underestimated. Very few countries would be prepared to run the risk of losing significant access to the US market. These considerations both buttress the effectiveness of US sanctions and ensure that use of these sanctions will not jeopardize the dominance of the dollar.

Second, if not now, then when? That is, if we are not to impose sanctions in response to the invasion of a sovereign country, when should we?

And finally, insofar as the main benefits of the dollar’s dominance may be to enhance the benefits of sanctions, it makes no sense to forswear sanctions in order to preserve the dollar’s dominance if sanctions are used judiciously.

Economic benefits of dollar dominance

Most of the alleged benefits to the US from dollar dominance can be wrapped up in the phrase “exorbitant privilege”. This term was coined in the 1960s by the French¹⁸, who bristled at having to accumulate unlimited sums of US dollars under the Bretton Woods system.¹⁹ That system of fixed exchange rates is long gone, of course, but the dollar remains the fulcrum of the world currency system, and critics continue to argue that the system allows the US to live

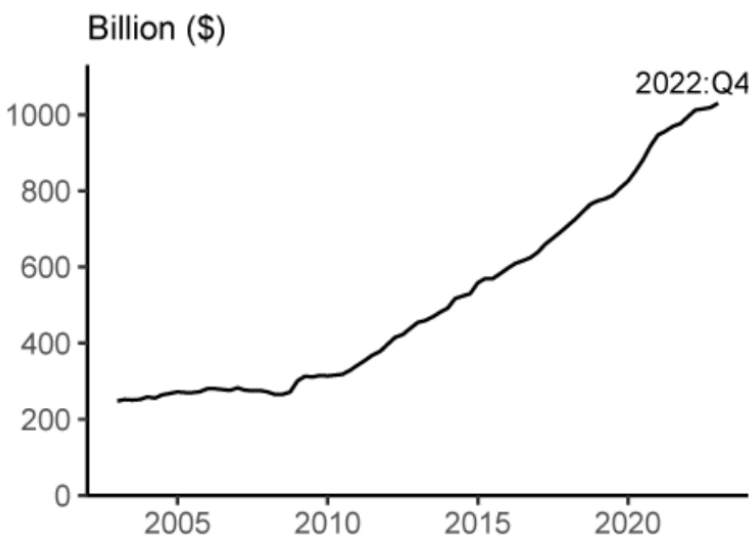
¹⁸ Valerie Giscard d’Estaing, then French Finance Minister, is generally cited as the author of the term. It was not meant as a compliment.

¹⁹ Eichengreen (2011).

beyond its means. Below, we consider some of the main elements of our purported “exorbitant privilege”.²⁰

Seigniorage: The most obvious economic benefit from the dollar’s dominance is the revenues from seigniorage on the use of US cash dollars abroad. As indicated in the chart below, again from Bertaut et al. (2023), about half of the total stock of US dollars outstanding are held by foreigners, amounting to \$1 trillion. As long as this cash is held outside the country and not used to buy U.S. goods and services, it constitutes a permanent interest-free loan to the United States from the rest of the world. If those foreigners were holding 10-year US Treasury bonds instead, at the cost to the Treasury of the current yield of about 4 percent, that would cost us an additional \$40 billion. That is hardly chump change, and would be a helpful source of financing for the federal budget, but it is only 0.15 percent of US GDP.

Figure 5: Holdings of U.S. Cash Abroad



Source: Bertaut et.al. (2023)

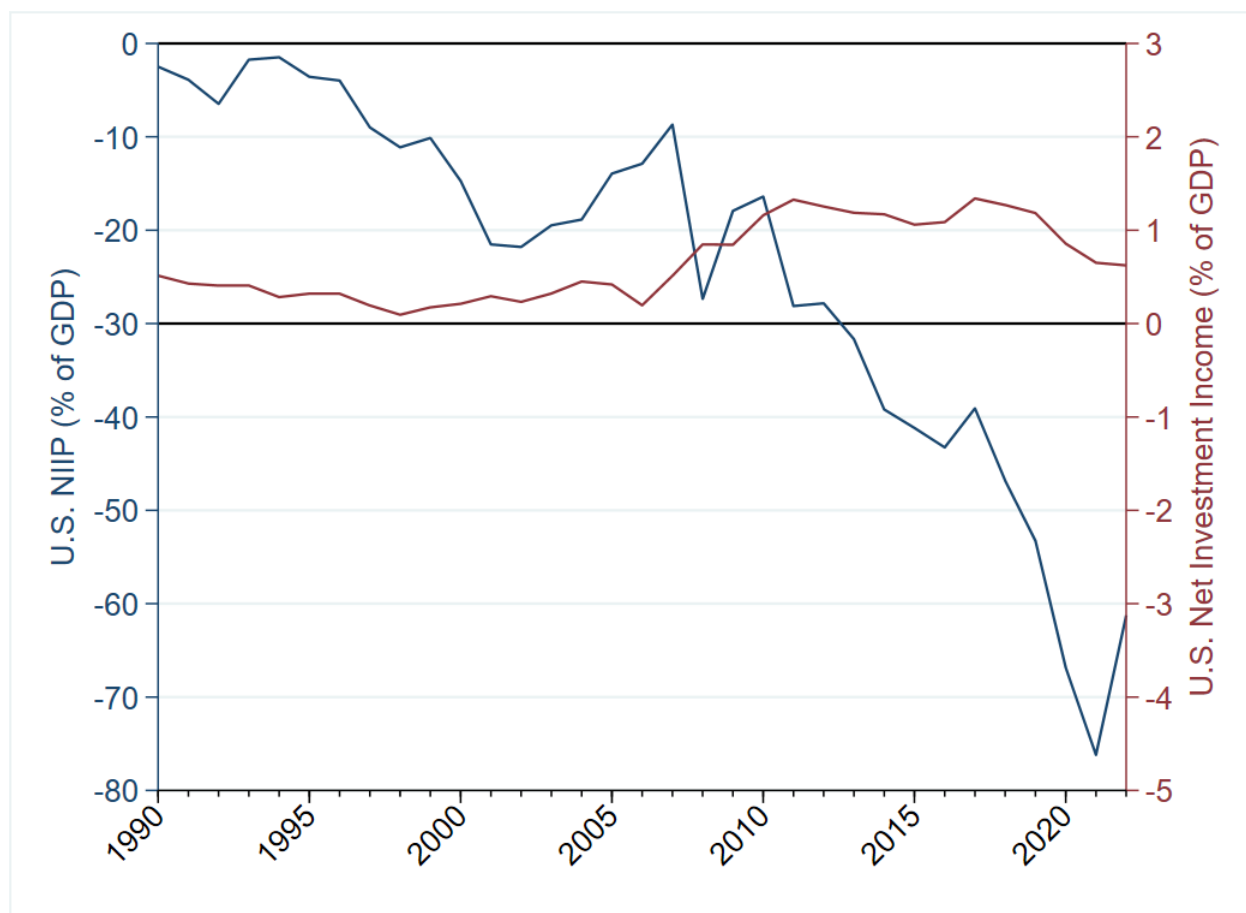
²⁰ See also Goldberg (2011) for a comprehensive review of the implications of dollar dominance for the US economy, which comes to similar conclusions as those described in this note. And Sobel (2021b).

Lower interest rates. If there is indeed an exorbitant privilege, it is more likely to show up in the second benefit of the dominant dollar: lower interest rates. It stands to reason that given the safety and liquidity of US Treasuries, the US government would be able to borrow globally at lower rates. But how much lower? Despite a plethora of academic studies on the topic, nobody knows. And, indeed, the discount of Treasury borrowing may well change over time as risk aversion, capital flows, currency interventions, and other determinants of the demand for dollars evolve.

One approach to this issue starts with the observation that the US net international investment position—the difference between US claims on foreign entities and liabilities to those entities—has grown very negative over time with the accumulation of current account deficits. Even so, U.S. net investment income is positive, indicating that the US earns more on its assets abroad than do foreigners on their assets in the US. This is taken to suggest, again, that interest rates on US liabilities must be unusually low. But deeper research into this issue suggests a different explanation for this phenomenon: a large share of assets held abroad by US residents are invested in higher-earning direct investment and equities, whereas a large share of foreign-owned assets in the US are in the form of lower-earning bonds.²¹ When yields on US bond liabilities and claims on foreigners are compared, they are not all that different.

²¹ See Curcuru et al. (2013) for a very thorough analysis of this issue. Additionally, some of the net investment income surplus apparently reflects mismeasurement due to the shifting of profits to low-tax countries by US corporations, as described by Guvenen et al. (2022).

Figure 6: The U.S. Net International Investment Position (NIIP) and Net Investment Income



Source: FRED, BEA

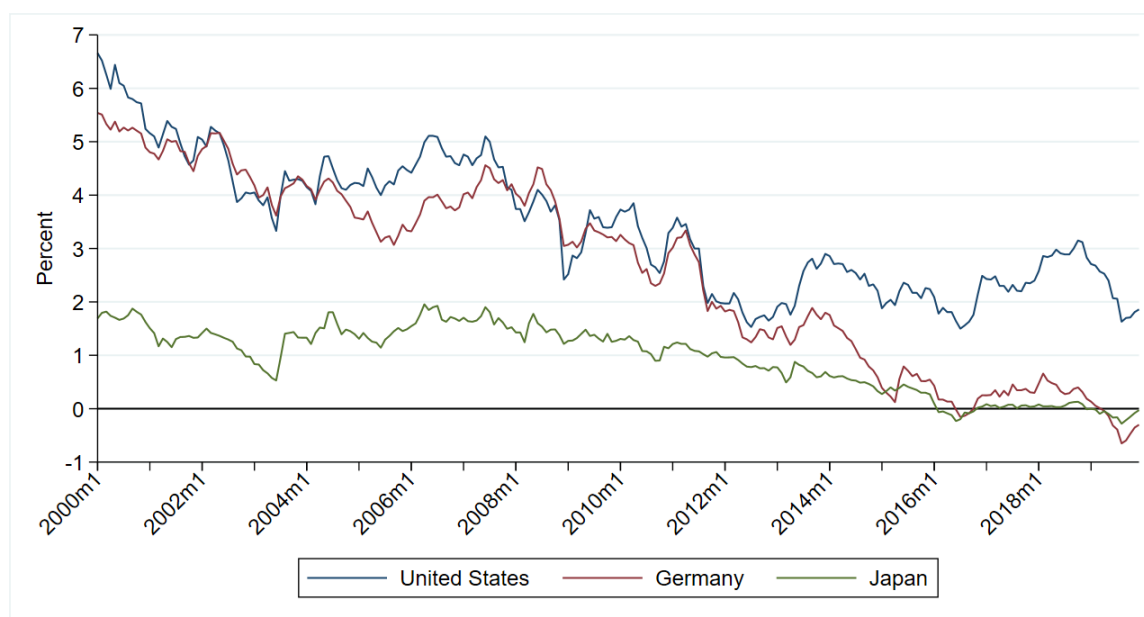
One issue in comparing yields on US and foreign liabilities is the need to correct for expectations of changes in exchange rates. An alternative approach to this issue focuses on measuring the “convenience yield” offered by US liabilities compared to foreign, that is, the benefits of holding US fixed income assets compared with holding foreign ones. This is frequently measured by analyzing deviations in covered interest parity – that is, the return on US dollar bonds is compared to the return from investing in foreign bonds and then hedging the exchange rate risk in the forward currency market. But no strong consensus on the benefits of issuing dollar liabilities has emerged from this approach. Some estimates suggest that US

Treasury bonds enjoy a funding advantage over foreign bonds of 2 percentage points or more.²²

Other estimates put the convenience yield associated with US Treasuries in the middle of the pack of advanced-economy sovereign bonds.²³

Cutting through the complexity of different measurement issues, a simple comparison of yields on different government bonds suggests that whatever the advantage U.S. Treasuries enjoy from the dollar's dominance, it probably is not all that great and likely is swamped by other factors. This chart shows that nominal yields on US Treasury bonds were comparable to or, later in the period, well above those in Germany over the last two decades.

Figure 7: 10-Year Sovereign Yields for US, Germany, and Japan 2000-2019



Source: CEIC, FRED, German Federal Statistical Office

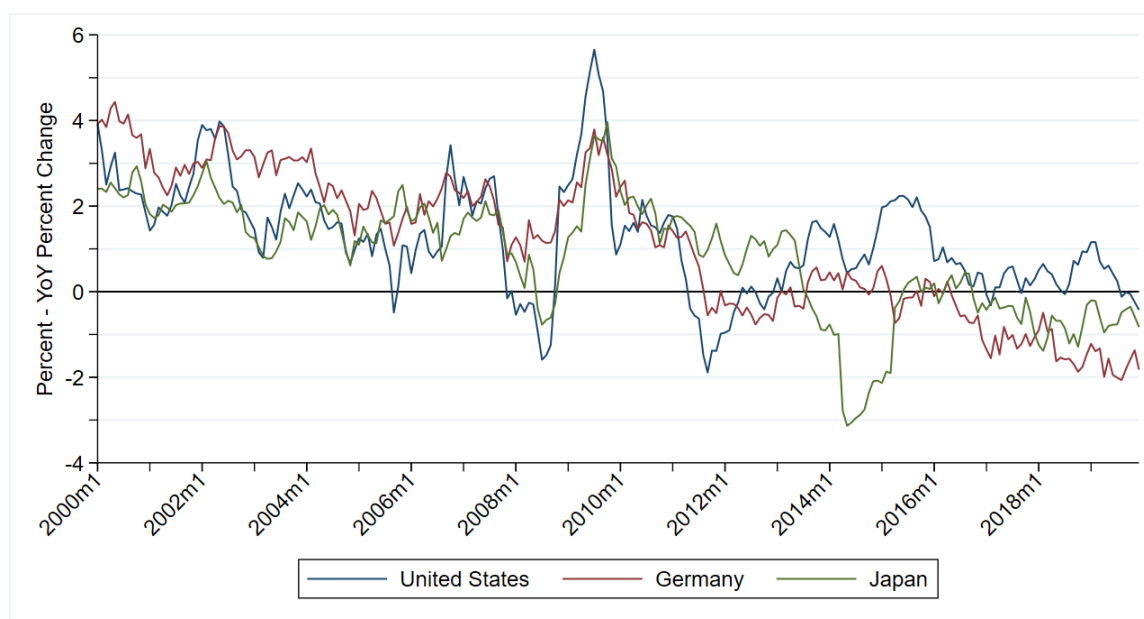
The chart below repeats the exercise, but deflating yields by realized 12-month inflation rates. The real yields of the three economies generally clustered together over the past two

²² See, among other papers by these authors, Krishnamurthy et al. (2019).

²³ See Diamond and Van Tassel (2021).

decades, with US yields higher toward the end of the pre-pandemic period. So, again, to the extent that the US Treasury has enjoyed a discount on its borrowing on account of the dollar's dominance, that discount has either been small or offset by other factors.

Figure 8: Real (CPI-deflated) 10-Year Treasury Yields 2000-2019



Source: CEIC, FRED, German Federal Statistical Office

Finally, it is worth noting that whatever funding advantage is enjoyed by the US Treasury reflects the intrinsic safety and liquidity of its bonds as well as the dominance of the dollar in global markets. A decline in the dollar's dominance should not, by itself, reduce the safety of Treasury bonds and should only partially reduce its liquidity. Therefore, even if the dollar's role in the global economy were to diminish, it is unclear to what extent that would boost the cost of borrowing for the United States.

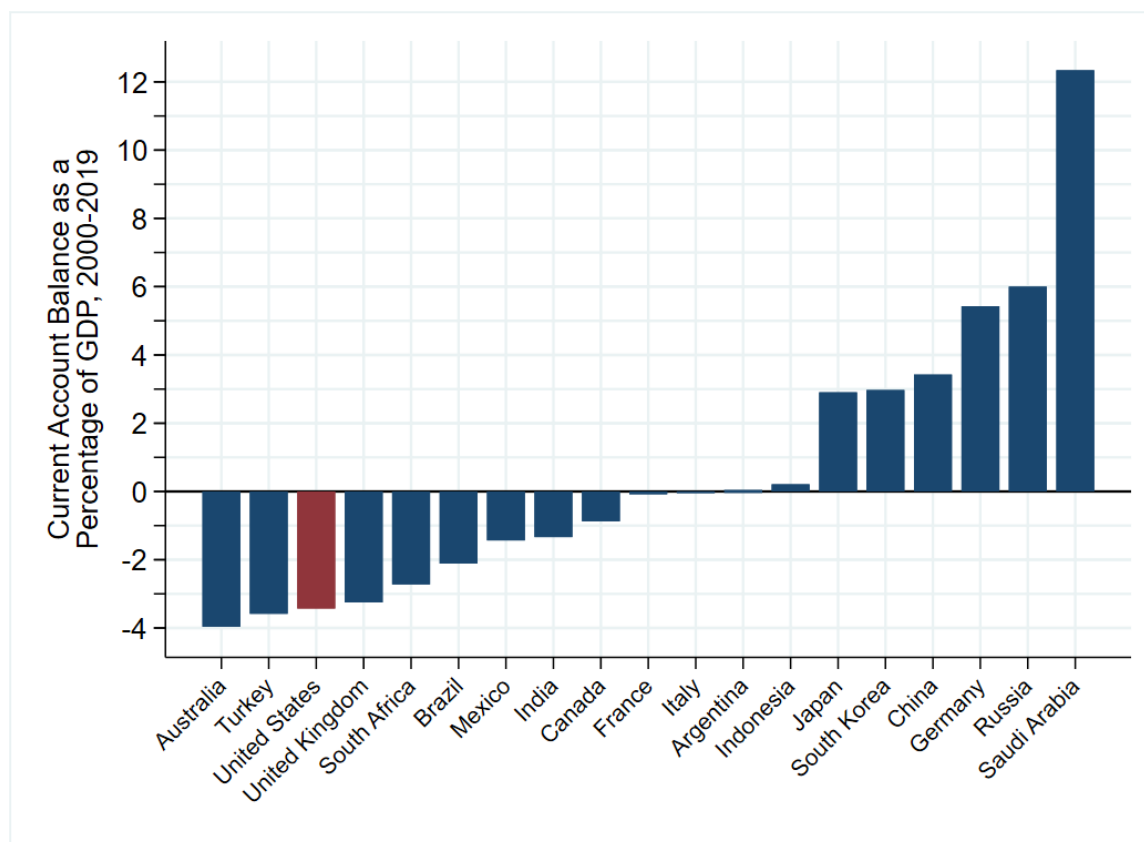
Exchange rate overvaluation: A third consideration in evaluating the exorbitant privilege argument is that the desirability of holding U.S. dollar assets not only lowers the interest rates that Americans must pay on their borrowing, but also boosts the value of the dollar. And the

stronger dollar and cheaper credit, in turn, lead to persistent current account deficits. This is potentially concerning, since not only do current account deficits imply the US is spending beyond its means, but also, historically, significant widenings in the US current account deficit have been associated with increased US protectionist pressures.

Again, the argument that dollar dominance leads to current account deficits makes sense directionally, but the magnitude of the effect is in question. Certainly, the US isn't the only country to have run persistent deficits in recent decades. As may be seen, in the past two decades, the US economy has not been the only one of the G20 to run persistent large deficits. Moreover, some of the surpluses among G20 countries reflected foreign exchange market intervention, protectionist policies, export led growth models dependent on US domestic demand, and/or excessive government savings perhaps more than overvaluation of the dollar stemming from its dominance in the global financial system.²⁴

²⁴ Gagnon and Sarsenbayev (2021a) find a large role for exchange rate intervention in determining differences in current account balances across countries and over time.

Figure 9: Current Account Balances of G20 Countries 2010-2019



Source: IMF World Economic Database

Insulation from external shocks: The US is a largely closed economy and self-sufficient in energy, thus providing considerable insulation against real shocks. Some observers also argue that a dominant dollar helps insulate the US economy from external shocks. Again, that makes sense, but the benefits of that insulation are a mixed bag. On the one hand, having much of world trade and finance invoiced in dollars means that changes in the dollar exchange rate have less impact on our import prices or the value of our debt to foreigners²⁵. Moreover, because the dollar is a so-called flight-to-safety currency, during times of global economic or political

²⁵Goldberg (2011) has an especially informative discussion of the dollar, import prices, and insulation for external shocks.

adversity, capital inflows to the US tend to push up the dollar and push down Treasury yields, and this helps support asset prices and balance sheets in the US. But, on the other hand, that same rise in the dollar makes US exporters less competitive and also lowers the dollar value of US investments overseas.

Increased demand for financial services: The global use of the dollar likely increases the demand for dollar-based financial services, including (but not limited to) correspondent banking and trade financing. It is unclear, however, how much these services contribute to overall US economic activity. Moreover, many dollar-based financial services are provided by foreign financial institutions, and so the benefits do not accrue exclusively to the US economy.

Conclusion: Summing up, the effectiveness of the US government's ability to prudently impose financial sanctions on bad foreign actors appears to benefit materially from the global dominance of the dollar. The United States probably benefits economically from dollar dominance as well, but there are costs as well and the extent of the net benefits are uncertain. Our guess is that whatever privilege there is in issuing dollar-denominated debt, it isn't exorbitant.

4. If the Dollar Were to Lose Its Dominance, It Would Not Be Very Beneficial for the Rest of the World

We now turn to the other side of the coin, which is the implications of dollar dominance for the rest of the world. Unsurprisingly, any hegemon will attract criticism, and critics argue that dollar dominance gives the United States too much influence over global economics and politics. Indeed, the buzz around so-called "de-dollarization" has gotten all the louder with the US sanctions on Russia and with Brazil's president calling for BRICS countries to create their own

currency. We will argue that currency dominance is not a zero-sum game: Whatever the moderate advantages the United States gains from the dominant role of the dollar, the loss of that dominance would not confer equal gains on the rest of the world.

Geopolitical implications of dollar dominance for the rest of the world

As discussed previously, the use of the dollar reinforces and/or benefits the United States and its geopolitical power. But is it a geopolitical – as distinct from economic – benefit for others? The answer is that it depends. Distributional issues matter.

The US's key military allies obviously benefit in terms of generally being able to depend on US leadership and its military umbrella, at the same time minimizing their defense spending – an increasingly contentious issue, especially in light of Russia's invasion of Ukraine. But at the same time, to the extent that they share the same goals as does the US, they benefit from the fact that dollar dominance increases the effectiveness of a multilateral coordinated sanction strategy such has been applied to bad actors such as Russia.

For many non-aligned emerging markets, the answer is more balanced. The economic benefits of the dollar's global reserve and financial role are clear in allowing current and capital account transactions to be financed far more efficiently and providing investment opportunities, even if these nations are more prone to express concern about spillovers emanating from the US. These countries benefit from the openness of and access to the US market. Continued widespread dollar usage helps cement relations with the US. Put differently, certainly if they sought to diversity abruptly or in large scale, that would attract unwanted adverse attention from the United States. Possible US use of financial sanctions are not a salient issue for them, though the possible threat of financial sanctions might constrain potentially "bad" behavior.

A good case can be made that dollar dominance is not beneficial for countries with whom the US and/or West maintains difficult relationships. The Western blocking of Russian central bank and oligarch assets is the clearest example. China benefits from being able to invest its large dollar holdings in US paper, but undoubtedly took note of the Western actions vis-à-vis Russia and is obviously wary of secondary sanctions. The US has deployed sanctions against Iran, Venezuela, North Korea and others.

On balance, continued significant use of the dollar is of geopolitical benefit to the rest of the world, save for a handful of problematic actors, and further strengthens the case for dollar dominance continuing for the foreseeable future.

Economic implications of dollar dominance for the rest of the world

On the economic side, critics of the current global monetary system make two related arguments. First, because of dollar dominance, the monetary policy decisions of the Federal Reserve exert an undue influence on the rest of the global economy.²⁶ The Fed certainly does influence foreign economies, although whether that influence is undue or not is less clear. As a simple example, in the scatterplot below, the X axis plots the change in 2-year Treasury yields from before to after each Fed policy meeting in the prior decade; the Y axis plots the change in local currency bond yields in emerging market economies (EMEs). Clearly, increases in interest rates after Fed meetings lead to higher yields abroad. Your next chart shows that increases in interest rates after Fed meetings also lead to higher credit spreads on dollar-denominated bonds

²⁶In a highly influential paper, Rey (2013) argued for the existence of a “global financial cycle” driven importantly by Federal Reserve policies.

issued by EMEs. A large body of research confirms the importance of so-called spillovers of US monetary policy to the rest of the world.²⁷

Figure 10: Changes in U.S. Treasury Yields and EME Local-Currency Bond Yields after FOMC Meetings

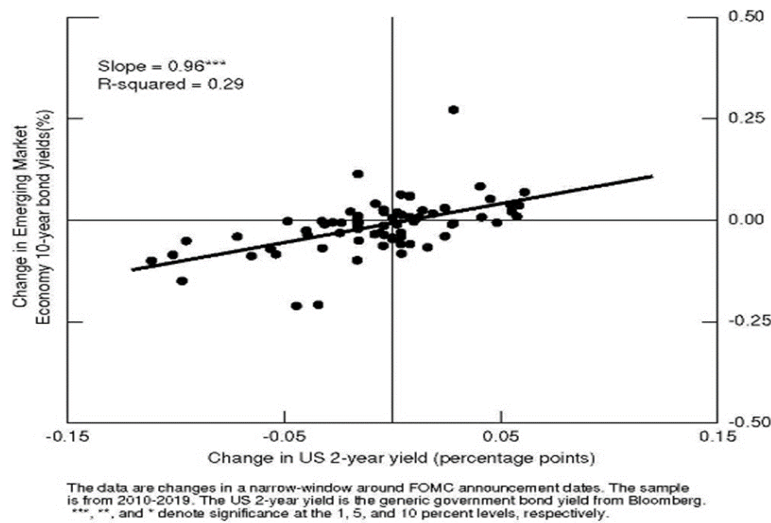
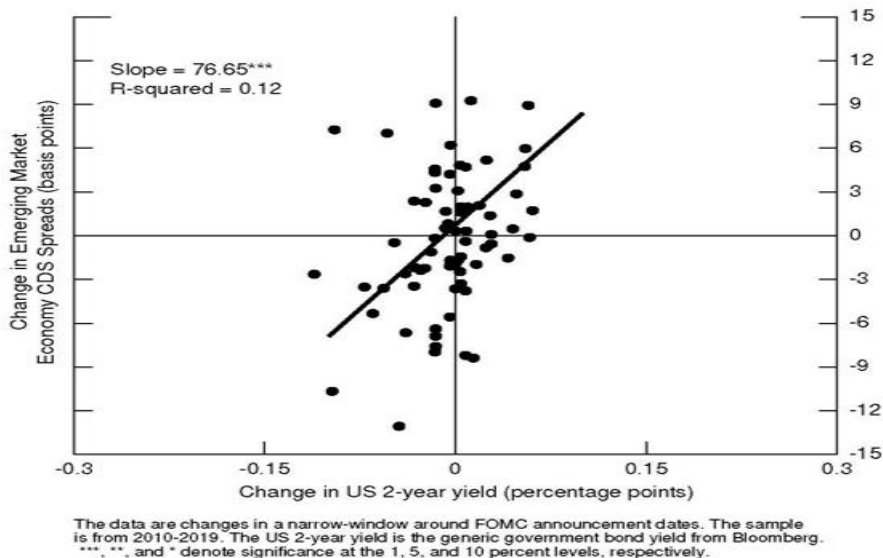


Figure 11: Changes in U.S. Treasury Yields and EME CDS Spreads after FOMC Meetings



²⁷ See the appendix in Arteta, Kamin, and Ruch (2022) for a review of the copious empirical literature on spillovers of Federal Reserve policy, especially to emerging market economies.

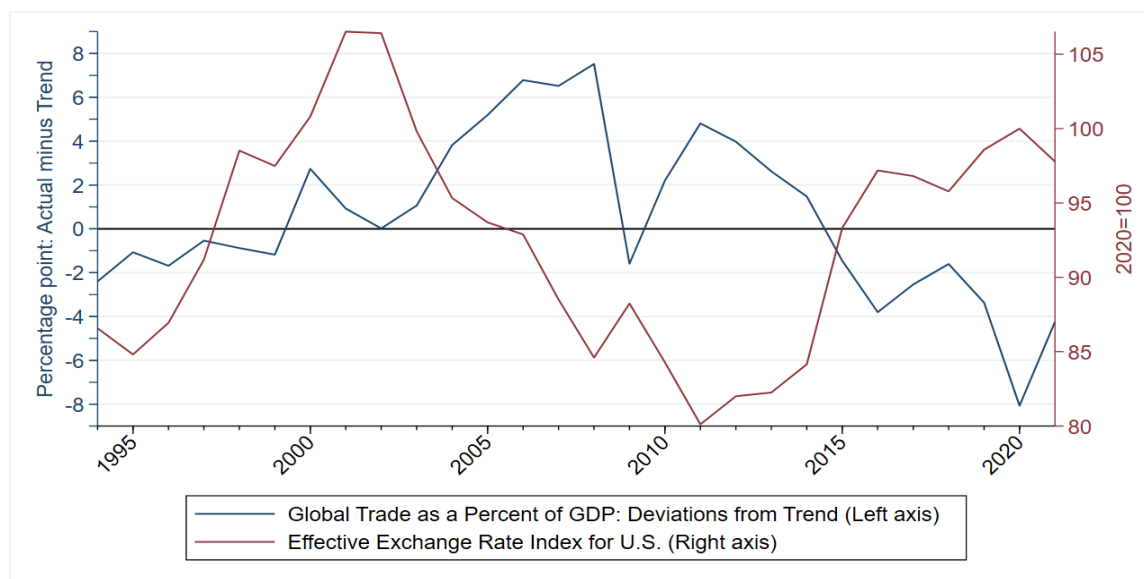
A second and related criticism of dollar dominance is that because so much of world trade is invoiced in dollars, movements in the foreign exchange value of the dollar have unwanted effects on world trade.²⁸ In particular, because the prices of many exports of non-US countries to other non-US countries are set in dollars, when the FX value of the dollar rises, these exports become more expensive when measured in local currencies. This, in turn, means that world trade may drop off when the dollar rises.

This argument should not be taken too far. Research suggests that over time, emerging market exporters do adjust their prices to support their sales – it just takes longer than might be expected in the absence of dollar dominance.²⁹ Additionally, we are skeptical that these considerations provide a solid rationale for foreign exchange intervention or capital controls. That said, there is indeed some evidence for at least a transitory negative effect of a rising dollar on world trade, as shown in this simple chart relating the value of the dollar to the quantity of world trade.

²⁸See, among others, Gopinath et al. (2020).

²⁹ Gagnon and Sarsenbayev (2021b) argue that even this overstates the importance of dollar dominance in reducing the sensitivity of trade prices to exchange rates.

Figure 12: The Dollar and World Trade as a Percentage of GDP (Deviation from Trend)

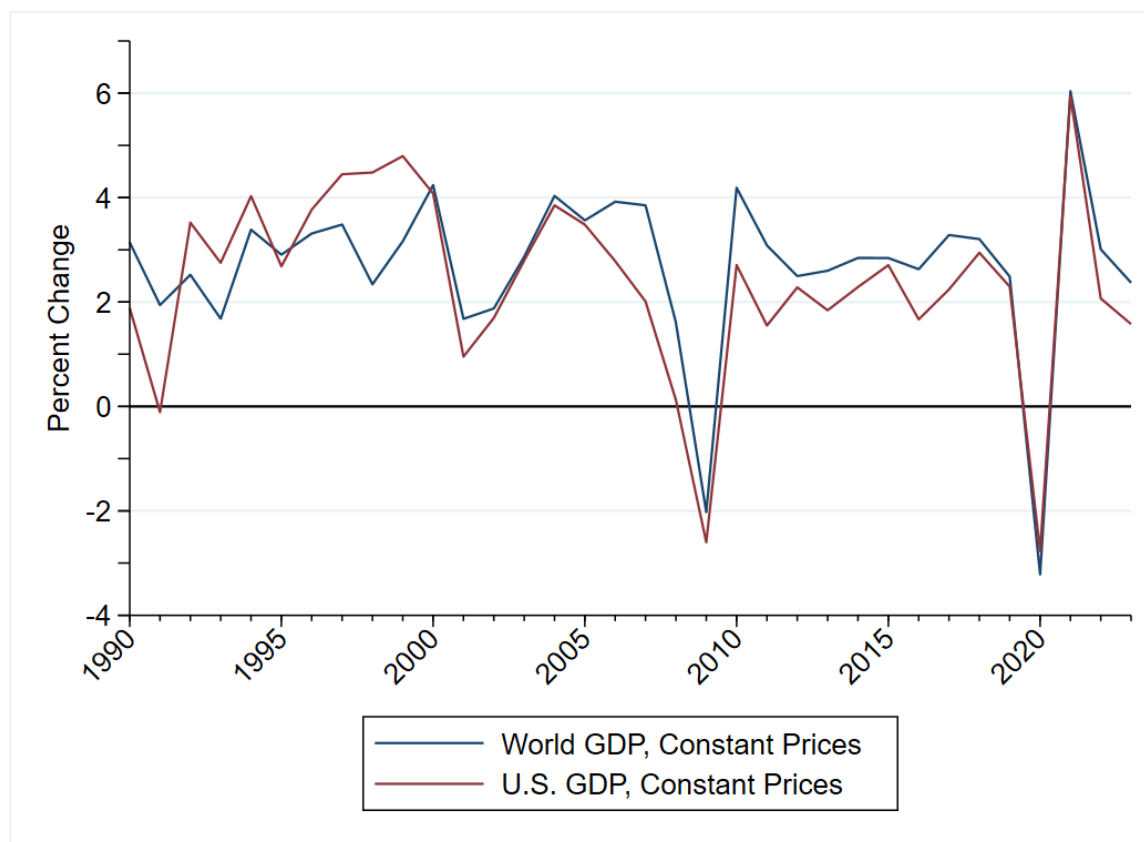


Source: Our World in Data, Bank of International Settlements

So it is clear that developments in US monetary conditions do have large impacts on the rest of the world. This is concerning in situations where, for example, US monetary conditions are tightening when other countries need conditions to be loosening. But we are not convinced this is a first-order problem.

First, as indicated in the chart below, the growth of the US and world economies tend to be quite correlated, so when the Fed is responding to global shocks such as the 2020 covid pandemic, for example, that helps the rest of the world as well.

Figure 13: Global and U.S. GDP growth Are Highly Correlated



Source: IMF World Economic Outlook Database

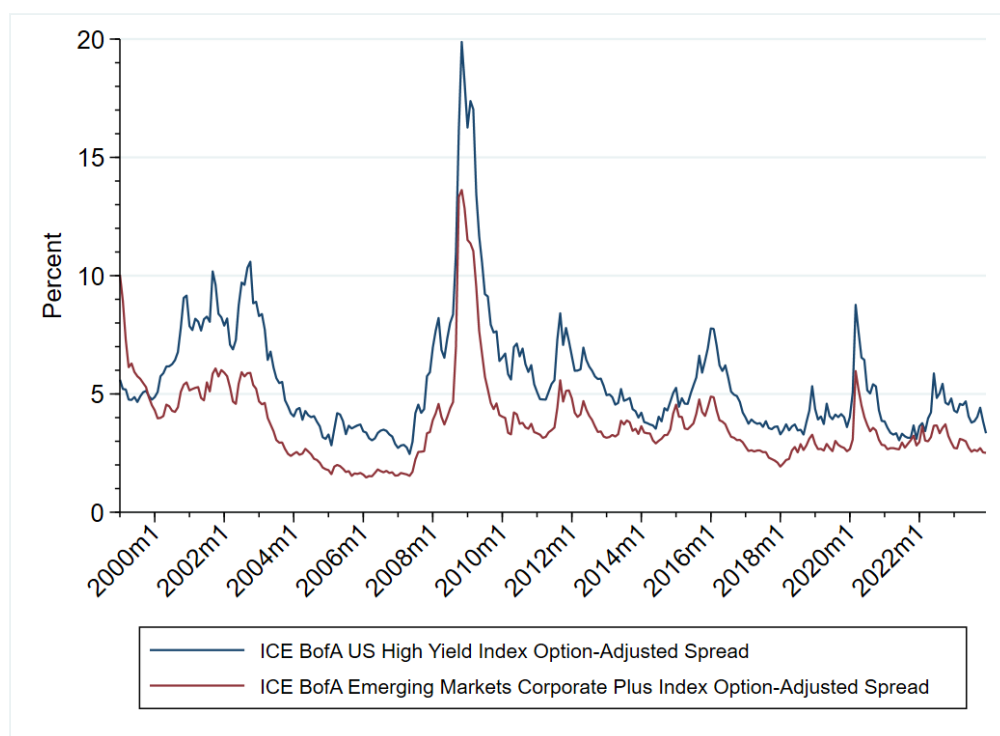
Second, while some economists have argued there is a “global financial cycle” that drives the world economy, considerable research indicates that Fed policy accounts for only a small share of the volatility of the global financial system.³⁰ This same research tends to find that shocks to US corporate credit spreads play a larger role in global financial developments – that is evident in the tight correlation between US and emerging market credit spreads shown below. However, it is unclear how much these spillovers reflect the special role of the dollar, the large

³⁰ See Obstfeld and Zhou (2023) and Rogers et al. (2023).

size of US private credit markets, or even, given the tight integration of global financial markets, shocks originating from elsewhere in the world.

Third, economies with prudent policies and strong fundamentals tend to have built up buffers and be adept at managing their policy stances in the presence of changes in Fed policies, whereas those most affected by tend to be those with weaker policy frameworks and greater structural deficiencies.³¹ Thus, during the Fed’s most recent tightening cycle, most emerging market economies have managed relatively well, whereas those “frontier market” economies that gained access to private capital markets only in the past decade and borrowed excessively have experienced financial turbulence and debt distress.

Figure 14: U.S. Corporate High Yield Spreads and Emerging Market Spreads



Source: FRED

³¹ See, among others, Ahmed et al. (2017) and Hoek et al. (2021).

Fourth, it is unclear how much of the spillovers of US monetary policy abroad depend on the dominance of the dollar, and how much on simply the importance of the US economy and capital markets to the global financial system. Clearly, when actions by the Fed change the cost of servicing dollar debt by foreign borrowers, that is a transmission channel attributable to the dollar's dominance. However, the spillovers of the developments in US credit markets to foreign financial conditions, as discussed above, may reflect the outsized share of global credit activity accruing to US entities more than the role of the dollar itself. And it is notable that changes in US interest rates tend to be highly correlated with rates in foreign currencies that are fully floating.

Finally, to the extent that the US economy is subject to shocks that are not being experienced by the rest of the world economy, the spillovers of US conditions abroad may boost global volatility to some extent. But this should not depress the average level of global economic activity over time. In fact, there's a reason why the dollar is used so extensively in global trade and finance: it reduces transactions costs and reduces uncertainty by providing a common unit of account, means of exchange, and store of saving. Those are the same reasons why money is viewed as an improvement over barter. And so, presumably, having a dominant currency has actually encouraged a higher level of global trade, international investment, and economic activity.

Consequences of a loss of dollar dominance for the rest of the world

If the dollar were to lose its dominant position, the consequences would depend on the reasons for that loss. If it owed to improvements in financial technology that reduced the need for the dollar in cross-border payments, that would likely be a plus for all parties, although as we have noted, such improvements might not diminish the dollar's dominance all that much. By the

same token, if the reduction in the dollar's role reflected rapid economic growth elsewhere in the world that boosted transactions in other currencies, that scenario would also redound to everyone's benefit.

Conversely, a number of plausible scenarios for the dollar's decline would be a decided negative for the US and global economies. One such scenario is a broader geoeconomic fragmentation of the global economy into isolated trading and financial blocs associated with the US, China, and perhaps Europe. In that case, global trade, productivity and economic growth would likely be depressed, and implications for the international political and military stability would also be adverse.

An even more dire scenario would be that the dollar loses its preeminent position because of a severe deterioration in the US fiscal, financial, and economic situation. Given the political polarization of the country, the dysfunction of the US Congress, and the disinterest of politicians of all stripes in curbing the widening US budget deficit, this is hardly unthinkable. And should the result be a sustained rise in inflation, crowding out of private investment, heightened financial volatility, and reduction in the dynamism of the US economy, then the loss of dollar dominance would be the least of our worries. And those of the rest of the world.

5. Conclusion

Over the past year, there has been a spate of articles about the dollar's future – will it be dethroned and lose its dominant reserve currency role, will financial sanctions undo the dollar's role, will it be replaced by the RMB, will a loss of dollar dominance deliver a major blow to America's economy, power and prestige?

Our review of the evidence and arguments suggests that these claims are overwrought. To begin with, the dollar remains the dominant currency in the global financial system, and that dominance is here to stay for the foreseeable future. It is possible that over time, other currencies will enjoy greater use as reserve managers and investors seek to diversify portfolios, financial innovations reduce dependence on the dollar for cross-border transactions, and China's encouragement of the use of the renminbi gains traction. But the dollar will still with a very high probability remain the single most important global currency -- there is no feasible or realistic alternative.

Second, even if the dollar were to lose some of its dominance in the global financial system, the implications for both the US and global economies would be less profound than many have argued. To be sure, a loss of dollar dominance would probably reduce the effectiveness of sanctions on bad actors around the world, and that would entail some loss of geopolitical power for the US and its allies. But the power to control access to US markets and finances would continue to add teeth to US sanctions, even in the event that the dollar became less pivotal. And on the economic side, the extent to which the US economy benefits from "exorbitant privilege," as well as the extent to which the rest of the global economy pays for that privilege, has been much exaggerated.

But asking whether the dollar will remain dominant is tantamount to posing the wrong question. The right question is: Will the factors that have supported the dollar's dominance, and that have provided benefits to the global economic and financial system as well as the United States, be sustained? The dollar's role is not externally ordained, but is a reflection of global investor choices in view of the unique properties of the US economy: its dynamism, investor protections, rule of law, and safety and liquidity of its capital markets. The key to maintaining

these benefits for the United States and world economy is to preserve the unique characteristics and properties of the US economic and financial system, run sound US macroeconomic policies, avoid the unilateral abuse of financial sanctions, and uphold worldwide trust and confidence in America's ability to act responsibly and fulfill its special responsibility for the smooth management of the international monetary system.

If the United States and other countries perform well in meeting their many challenges, overall global economic performance will be healthier even if the dollar's global role ebbs. Conversely, if the US proves incapable of performing well and tackling its economic challenges, then the dollar's global role could quickly decline, and the US and global economies would be the worse for it,

The United States is ultimately the biggest threat to global dollar dominance. Dollar dominance is not a means in and of itself. It is instead a critical reminder of the need to run sound policies, behave responsibly at home, and maintain the world's trust.

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