Dollar dominance will persist in a world without alternatives

28th April 2025

Exactly a century ago today, Winston Churchill announced the return of sterling to the gold standard at its pre-war value of $4.86 per pound. It was a controversial, and ultimately unsuccessful, attempt to restore confidence in sterling after the First World War had shattered Britain's financial standing and cleared the way for the US dollar's rise to global dominance.

One hundred years on, financial markets are gripped by speculation that the dollar's position as the world's dominant currency may now be under threat.

NOT JUST A RESERVE CURRENCY

Renewed speculation around the currency's status has been triggered by a major sell-off in dollar assets, driven by concerns over the damage to the US and global economies from Donald Trump's aggressive policy agenda – and its chaotic implementation. The currency's weakening has been taken as a sign that traditional holders, such as Chinese reserve managers, are finally abandoning the dollar.

But talk of the demise of the dollar's global role is too narrowly focused on its status as the world's dominant reserve currency. This overlooks a crucial dimension: the dollar's primacy in cross-border transactions. Roughly 90% of cross-border transactions are denominated in dollars – far more than the US's share of global output or trade would imply. This means that at some point most international transactions will touch the US banking system. In effect, the US provides the financial plumbing for the global economy. This gives it enormous influence. The sweeping financial sanctions that the US has imposed on its adversaries, from North Korea, to Iran and, most recently, Russia, have only been possible because of the dollar's unique role.

The dollar's global grip has not quelled persistent speculation that another currency could supplant it – in fact, its dominance has fueled this speculation, as frustration over its outsized role has boosted hopes for a viable challenger. In the late 1980s, the yen was seen as a contender for global pre-eminence. Then hopes were pinned on the euro. More recently, Beijing has sought to elevate the renminbi's global status. Despite their respective boosters, none of these currencies were able to mount a sufficient challenge – the yen was thwarted by the comparatively small size of Japan's economy and its current account surpluses, the euro was hobbled by regional imbalances and the lack of fiscal and banking union, and the renminbi's progress has been stunted by China's closed capital account and high savings rate.

On the other side of the ledger, America's economic scale and strong network effects have helped to preserve the dollar's global dominance. The dollar benefits from what economists call 'path dependence': its long history as a dominant currency creates established norms that become self-perpetuating. Companies have become accustomed to using the dollar, and shifting to another currency requires overcoming significant inertia and adjustment costs. Financial institutions and payment systems are now optimised for the dollar, making it more convenient for users. And the existence of a wide range of dollar-denominated financial products, covering not just bonds and stocks, but also credit and derivatives, reduces transaction costs and reinforces the use of the dollar. All of this creates positive feedback loops that will make the dollar difficult to dislodge.

A DIFFERENT TYPE OF THREAT

Difficult, but not impossible. What's different now is that the threat to the dollar's status is increasingly coming from within. Rather than being displaced by a rival, it may be the US itself that pulls back from the burdens and benefits of global monetary leadership. Some in the Trump administration argue that capital inflows tied to the dollar's dominance inflate its value and hurt American manufacturers. The idea that the US might introduce some form of tax on capital inflows is no longer unthinkable. Meanwhile, Trump's "flooding the zone" strategy of rapid fire moves to overhaul the bureaucracy, scrap long-standing foreign policy norms and test the limits of executive authority have shaken investor confidence in the government as some of the institutions that underpin the dollar's position come under near-daily assault.

Although the worst of the dollar selling appears to be over, the unpredictability of this administration could still result in policy blunders that trigger recession, capital flight, and a sharp, disorderly dollar drop. Even then, the dollar's global dominance would likely persist because the constraints that stymied earlier challengers still apply. The dollar supplanted sterling as the globally dominant currency during and after the First World War precisely because it was a viable alternative. None exists today.

SWAPPING ONE PROBLEM FOR ANOTHER

Critics in Washington may talk of the costs to the US economy that come with dollar demand, but they often overlook the benefits that come with the currency's status. As the issuer of the world's reserve currency, the US enjoys what late French President Valéry Giscard d'Estaing once described as an "exorbitant privilege." Demand for dollar assets lowers borrowing costs – some studies have suggested by around 50-60 basis points – and helps finance persistent current account deficits. In other words, the global appetite for dollars allows Americans to consume more than they produce.

Undermining the dollar's role may appeal to those focused on trade competitiveness or fiscal sovereignty. But a diminished role for the greenback would also entail a diminished capacity to fund the excesses that have long underpinned the American economic model. It would also reduce Washington's enormous financial leverage in an increasingly fractured global economy.

In seeking to weaken the dollar's global role, policymakers may find they are not solving a problem so much as swapping it for another. Years after the economic damage wrought on the UK economy by Britain's return to gold, Winston Churchill privately admitted the decision was "the biggest blunder of my life".

It's a good bet that Trump administration officials would come to view any serious effort to reduce the dollar's global role in much the same way.

In case you missed it

Our US Economics team will have far more to say about the macro impact of Trump's policies in their Drop-In marking the first 100 days on Wednesday. Register here for the 20-minute session.

Given the formidable US barriers now in place to deter China's goods, could the Chinese consumer instead absorb that supply? China Economics head Julian Evans-Pritchard explains why that's unlikely.

While some measures of financial conditions have tightened as a result of volatility in equities markets, our own Financial Conditions Indices, which have been built to overcome this discrepancy, show an ongoing loosening. CE Advance clients can explore and download the data.