



World Transformations #4

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Dollar – Stability under tension Hegemony in question

The position and role of the dollar have long been a subject of debate.

After the Second World War, the Bretton Woods agreements enabled the establishment of a stable monetary system. This followed the long period of monetary instability that had prevailed in the interwar period.

However, very quickly, its dominant position and its consequences generated criticism. Jacques Rueff spoke of the “deficit without tears,” prompting General de Gaulle to speak of the exorbitant privilege of the dollar during a press conference on February 4, 1965.

Jacques Rueff implicitly drew a parallel with the game of marbles, where the winner lends the marbles he has just won to the child who systematically loses them. The game can continue for a long time, but it is not fair.

For the French economist, the United States, issuer of the greenback, could always issue currency while maintaining a deficit balance through the conquest of foreign markets by direct investments.

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Today the question is posed differently, even if the problem raised by Jacques Rueff remains relevant. There are two dimensions. The first is the rapidly changing global macroeconomic framework. The rivalry between the United States and China is also monetary, as the Chinese have understood that economic and political autonomy without monetary autonomy is an illusion. The other aspect is Donald Trump's position on the dollar. Should it be strong or weak? What will be the long-term status of the central bank? These are all elements that have been discussed since the presidential elections of November 2024, without, however, offering a clear answer.

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Questions about the role and status of the dollar are almost constant features of the international monetary system. The arrival of the euro at the beginning of the 2000s and the recent emergence of the yuan have not yet challenged the preeminence of the greenback. Therefore, the question focuses on the factors that could shift investors' choices toward another currency.

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Globalization began as a financial phenomenon at the start of the Reagan presidency. The dollar and financial markets then became the structuring factors of global development. Since the Bretton Woods Agreements, the greenback has been an international public good, the asset to which investors worldwide turn in times of uncertainty.

The dollar and US assets have thus acquired the status of risk-free assets. It is the asset of choice for investors when times are turbulent, and all eyes turn to the Federal Reserve when a solution is needed.

Because of this very particular status, all economic actors hold significant dollar portfolios, both as assets and liabilities. Therefore, given the very high outstanding amounts, a shift in the international currency benchmark must be understood as a long-term process.

An investor can switch between the dollar and another currency when taking a position on an asset. But their dollar-denominated asset holdings won't be adjusted instantaneously.

To illustrate this point, US public debt held by non-resident investors represents more than \$9 trillion, or 25% of the total public debt and 30% of US GDP. This outstanding amount cannot be liquidated in a very short time.

On another note, it could be pointed out that foreign exchange reserves in dollars are still close to 60% of the total. The trend is gently downward, but this is partly linked to the emergence of the euro. Central bankers are proceeding at a snail's pace on this issue of the reserve currency.

Another example is the amount of US dollar liabilities owed by non-residents to the United States. According to the BIS, in 2024, these dollar loans amounted to approximately \$13 trillion. Here too, the ability to disengage can only be a long-term process.

For both assets and liabilities, the additional question that investors are asking is that of the alternative currency.

Is there a market deep enough to shift towards this one in the event of a withdrawal from the greenback? Does the American institution that lent me money have an equivalent in another country for such a long period? In other words, the anti-Gresham's Law, which applies to international finance, states that good money drives out bad money.

To switch to another currency, you really have to be convinced that today's good currency won't be tomorrow. It's a bold gamble.

The shift from one currency to another on an international scale is a long process. To take a historical example, the period between the two world wars is associated with the shift from the British monetary standard to the American monetary standard.

Over this long period, the dollar replaced the pound sterling, culminating in the signing of the Bretton Woods Agreements, which established the dollar as the international reserve currency.

This long transition of power was marked by a unique situation: from 1931 onward, the Bank of England was no longer able to fulfill its role as lender of last resort. At the same time, the US Federal Reserve lacked the resources to assume this role. This period is associated with what has been called the "Kindleberger Trap," named after the economist and historian Charles Kindleberger, who highlighted this period and configuration to explain the difficulties in regaining stability during the 1930s.

This clearly raises the debate regarding the questioning of the greenback as an international public good. The episode of the 1930s indicates that to ensure financial stability, another country must have the means to guarantee it, it must have a credible central bank to act as lender of last resort, robust institutions to fulfill this role, and it must gain the confidence of investors.

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Since Donald Trump's return to the White House, significant questions have arisen about the status of the dollar, both in Washington and among investors.

Stephen Miran, whom the US president appointed to the Fed, is advocating for a rapid and sharp fall in the greenback to rebalance the US trade balance.

However, at the same time, the **development of stablecoins**, recognized by a law last summer, the Genius Act, should increase the attractiveness of US public debt, thus arguing for a strong dollar in order to attract savings from around the world.

The White House's vision lacks clarity on its objectives and on what it wants to do with the Fed and its independence.

In other words, the usual behavior and status of the United States in monetary matters were not questioned by the American authorities. They are now being questioned, and it is this point that is creating a different framework today.

Investors, too, have grasped this issue. While they generally focus on the greenback when the economic and financial environment is unclear, this was not the case last April on Liberation Day when the American president announced the various tariffs.

That day, the dollar fell.

The White House's option instilled a question about American trade policy that deviated from the rather collective framework that prevailed.

Nevertheless, we must not rule out the scenario of a return to normal.

Chinese separatist ambitions, its desire to go it alone, clashing with the realities of a battle that the United States would ultimately win.

American success strengthens the dollar and their ability to finance their economy. This possibility is unlikely, however, as the balance of power between the two countries is shifting daily.

Understanding which other currency investors might turn to is a kind of puzzle. Several reasons

1- We must lose faith in the dollar.

This will inevitably be a long intellectual process to overcome the idea that the United States could be permanently weakened and to stop imagining that it can rebound within a limited timeframe. It will also be a long process because managing outstanding assets and liabilities will be a lengthy undertaking.

2- A replacement currency must be found.

This currency must achieve the status that Christine Lagarde hopes to achieve for the euro. It must also serve as a central hub for financial flows, with liquid and deep markets. Financial life was centered in London during the era of sterling dominance; it is in New York today, and has been for a long time.

Which countries are capable of combining these two statuses?

3- China is not convincing for two reasons. The first is that it is in a process of differentiating itself from the United States but without yet having sufficient and convincing economic and political power.

Its financial markets are not sufficiently developed to transfer assets held in New York or Chicago to Beijing or Shanghai. However, it does have the advantage of having forged financial links with numerous emerging countries. This gives it a robust foundation. But it does not yet grant it the status of a financial giant.

4- The Eurozone has a currency that has established itself over time, even if its status is not that of the dollar. However, it suffers from insufficiently integrated financial markets, preventing it from having a European public debt market. This is a major challenge that European authorities are aware of, but it must be addressed in order to create a truly deep debt market.

Its stock market is also inadequate. Currently, the strength of the American market lies in its tech sector. This is not present in Europe. This echoes the Draghi report, which finds that Europe is not innovating enough. This is a crucial point.

Great Britain dominated the world because it spearheaded the industrial revolution. The United States succeeded it because that country was at the heart of post-World War II innovations.

In this battle for innovation, Europe is lagging far behind and is not on equal footing with either the United States or China.

What story can be told to attract massive amounts of capital from around the world to European stocks? Do LVMH or Siemens inspire as much dreams as Nvidia's AI?

5- The emergence of a polarized global economy.

China and the United States continue to trade extensively, but their economic cycles are no longer as closely aligned. They are two economies operating in different spheres, each with its own distinct country.

In that case, would China and its allies benefit from using the US dollar? Undoubtedly, there would be a search for a substitute currency, but the process will be lengthy.

6- Cryptocurrencies like bitcoin are not based on any tangible element, except for a vague idea that private and public currencies should compete with each other.

Cryptocurrencies, particularly stablecoins, have the advantage of extending the dollar's reach. Firstly, through inexpensive and global transactions. Secondly, stablecoins (95% dollar-denominated) only increase demand for US public debt, which the White House is unwilling to curb. Stablecoins are a way to distribute forms of private US dollars (private because they are not guaranteed by the Fed) worldwide.

7- The main source of doubt about the dollar will come from the decisions that will be made at the White House.

Spontaneously, distrust of the United States would only manifest itself as a long and slow process. The only way to accelerate it is to break the implicit trust we all have in America.

This may reflect choices made on the Fed, on the security of transactions when the White House demands X% of the revenues on such and such a transaction, thus resembling what is seen in corrupt countries.

The most significant phenomenon will be the triggering factor of distrust in US assets and in the dollar itself. This will concern the White House's objectives for the greenback, but also the Federal Reserve's ability to regulate it.

Therefore, it is primarily the choices made in Washington that will determine the direction of the American currency.

If the White House makes choices that lack consistency with the usual framework, we can be sure that we will enter a period resembling a Kindleberger trap. The dollar would be challenged without any substitute.

This uncertainty likely explains part of the rise in the price of gold. The precious metal has seen its share of central bank reserves and portfolios increase rapidly. This is a measure pending which side to take and how quickly the uncertainty will subside.

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