The downfall of King Dollar

In the era of Trump's tariff war, the sources of American economic hegemony will also contain its undoing.

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As long as a global trade and financial system exists, it is likely to operate through the medium of one leading currency. For the country that prints it this is a source of enormous power and wealth. The United States only has to print dollars and exchange them for food, oil, smartphones or automobiles. It is as if all these goods materialise out of thin air the moment new dollars are added to the central money ledger – with no more than a click of a mouse – because everyone in the world wants and needs dollars and so is happy to exchange them for their hard-produced goods. Try to play the same trick with Argentinian pesos. Impossible, of course. People will demand dollars.

Not everyone is happy with this state of affairs. A white paper published by the Chinese Ministry of Foreign Affairs in 2023 noted that "it costs only about 17 cents to produce a $100 bill, but other countries had to pony up $100 of actual goods in order to obtain one. It was pointed out more than half a century ago, that the United States enjoyed exorbitant privilege and deficit without tears created by its dollar, and used the worthless paper note to plunder the resources and factories of other nations." Since most money exists in electronic form, the Chinese ministry actually overestimated the cost of obtaining $100 of goods. You can do it for free.

Over the last few centuries, the cycle of great powers has corresponded almost exactly to the cycle of reserve currencies, with at most a lag of two or three decades. If America ever stops being the world's leading power, then the dollar would also cease being the global reserve currency. Such a momentous reversal might take place after a world war or a catastrophic financial crisis. One might think, however, that a hegemonic power should be able to prevent those outcomes, if only to preserve the privilege of holding, in its printing presses, the key to something far better than the gold of the alchemists. But this is where things get both more interesting and more complicated.

The truth is that for a country to hold the global reserve currency is both a privilege and a curse. Remember the internet-meme aphorism: good times breed weak men. The dialectic was well explored by classical thinkers such as Polybius or Ibn Khaldun. It applies to money no less than people.

If a country can become prosperous just by printing money it will likely lose interest in producing actual goods. There could be a psychological dynamic at play here, but even in its absence there would always be a monetary mechanism. If the whole world wants to hold assets in the global reserve currency, in order to save or invest or speculate, then that currency will be grossly overvalued. It will no longer reflect demand and supply in global trade markets and will no longer allow for trade deficits to balance. The country with the global reserve currency will find it very hard to sell its artificially inflated goods in global markets and, as a result, manufacturing and agriculture and even many services will move elsewhere. It might end up specialising in financial services, the management of money, at the expense of almost everything else.

When Donald Trump complains about the large trade deficits persistently sustained by the United States, he fails to understand that the root cause of these deficits is not the tariffs or other obstacles placed by other countries in the way of American exports, but the large flows of money heading towards the US and the class making trillions from them. If he wants to eliminate the deficits, he should try to reduce or limit these flows – against the interests of Wall Street. That might prove difficult.

Let us admire the dialectic, the dance of history, which is the exact opposite of the "end of history": by holding a global reserve currency role, a country sets off the mechanisms by which it may later become impossible to continue playing that role. If deindustrialisation is an inevitable consequence of being the keeper of the reserve currency, and if manufacturing is necessary for war, it may even find itself in a position where it can no longer defend its hegemony on the battlefield.

Stephen Miran, who heads Trump's Council of Economic Advisers, explained in a much-discussed paper from last year that the dialectic tends to get worse with time, until the moment when the status quo becomes radically unsustainable. As the US shrinks relative to the global economy, it must export a larger share of financial assets to sustain global trade and investment, thereby necessitating larger deficits and imbalances. In the process, the consequences for its own real economy, manufacturing and exports also become more difficult to bear. Reading his paper one image came to mind: if Russia is a gas station with nukes, America risks becoming Wall Street with nukes.

We know that Trump and his advisers are consumed by the fear of losing "steel", both physical and metaphorical. The desperate plan to tariff the whole world was an attempt to reverse these trends, but then something happened. The dilemma reappeared. It turned out to be impossible to reverse the consequences of the global reserve currency role without chipping away at that role. As soon as the goal was enunciated that America would no longer have trade deficits with the rest of the world, the market for dollar assets started sending alarms. The rout in US Treasury securities deepened every time Trump opened his mouth, until he finally reversed course, but with no visible impact in the spooked bond market.

Trust in the dollar has started wavering, with many investors looking for alternatives. On 10 April, after Trump's announcement of a tariff pause, we witnessed some of the most violent moves in currency markets in a decade, with the dollar devaluing by large margins against the euro and the Swiss franc, and US Treasury yields rising a lot faster than German government bond yields. None of this was supposed to happen. In times of turmoil, everyone should be flocking to safe dollar assets. What is going on?

A number of things – but they are all connected with the dialectic of privilege and burden. Yes, some esoteric trades in bond markets leveraged and then accelerated the rout, but they were not the fundamental reasons behind it. There were concerns about a recession and inflation in the US as a result of the tariffs. That was one factor. At the same time, investors were grappling with the possibility that the American economy is about to de-link from the world, or at least to become less central to global exchanges. In that case the dollar will be less central as well, undermining the very reason it is so appealing to hold dollars. After all, in a world without deficits, other countries would not be accumulating dollars from their surplus of exports over imports. And if other countries will not be accumulating dollars, why should you? Conceivably, if Trump got his way and America came to enjoy trade surpluses, Americans would be buying foreign bonds instead.

Last but not least, what happens if Donald Trump decides to limit the flow of capital to America or, worse, decides to tax dollar assets and US debt? Not long ago, these risks were dismissed. Not anymore. The president has even made a number of strange comments that some of that debt may be fraudulent – such remarks are a possible prelude to a default, perhaps imposed selectively against unfriendly countries. Trust in the dollar is being eroded at a vertiginous pace.

For a long time we have discussed whether China would be able to develop a real alternative to the dollar. That is not how changes to the global monetary order take place. Reserve currencies collapse from within, victims of their own contradictions and the political struggles feeding on those contradictions.

While China may have capital controls, America now has widespread financial sanctions regularly applied against unfriendly countries, but also against friends who violate the primary sanctions. Can the US truly boast that it does not discriminate between assets held by residents and assets held by foreigners, the kind of openness often presented as a condition for a currency to become an international reserve currency? Chinese companies would disagree – and many around the world now wonder if they might be the next target of America's economic warfare. It is not possible to both create the rules of the game and act like one of the players.

Every time the rule of law is replaced by a system of political favour, investors take note. Their assets might be safer outside of the US, and good alternatives seem to be emerging in Europe and Japan, particularly as new debt will be necessary to fund their announced rearmament.

Finally, as the painful costs of issuing a global reserve currency continue to grow, Donald Trump will find it impossible to resist the need to address these costs. His voters demand action and now dream of a new industrial golden age. Trump may well believe that he can bring it about without sacrificing dollar dominance, but the last few days prove that every action has a reaction. After the recent fracas, he will surely try other ways to implement his agenda, and perhaps with renewed ferocity. King dollar will struggle to survive.