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Trump’s tariff gambit sparks dollar dominance debate

Donald Trump's renewed tariff threats underscore the United States' deep concern over the dollar's global dominance. While such threats may temporarily disrupt efforts to reduce dependence on the dollar, they could also hasten the search for alternatives

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MARCH 21, 2025 / 09:03 IST

US President Donald Trump has once again threatened to impose a 150% tariff (up from 100%) on any nation that even hints at disrupting or undermining the US dollar. Trump also tauntingly commented that the “BRICS states just broke up. I don’t know what the hell happened to them.” Recognizing the dollar's vital role in maintaining its hegemony, the United States sees any reduction in its use as a significant threat to its global dominance, even as it reluctantly acknowledges a multipolar world.

While such threats may temporarily hinder efforts to find alternatives to the dollar, they are unlikely to completely eliminate them. In fact, these threats might prompt the global community to recognize the more urgent need for an alternative. Nevertheless, any potential replacement for the dollar as an international currency encounters substantial challenges that must be thoroughly and fully comprehended.

In popular discussions, the dollar is often seen merely as a medium of exchange in international trade or as a reserve currency. It might surprise some that in 2022, only 50% of international trade was invoiced in dollars. Additionally, of the total foreign exchange reserves, only 60% were dollar-denominated, with the rest held in assets including the euro, yen, and gold. More importantly, the dollar's influence extends beyond these functions, particularly in the realms of financial markets and financial stability.

Before exploring these aspects, it's crucial to understand how the dollar became accepted as an international currency. Until 1971, under the Bretton Woods system, the US promised the dollar's convertibility into gold at a fixed rate of $35 per ounce for international balance of payments settlements. However, in 1971, President Richard Nixon closed the gold window, making the dollar an international fiat currency no longer convertible into gold. Why would countries be willing to hold dollars as a reserve currency then? If they did, there was a good chance that the US would over-issue dollars, causing depreciation and a reduction in its international purchasing power.

Simultaneously, in the absence of gold or any other international currency, international trade would devolve into a barter system where countries would aim to balance trade and capital flows with partner countries on an individual basis. This, coupled with beggar-thy-neighbour policies, would effectively lead to a race to the bottom, reminiscent of the pre-Bretton Woods era.

Moreover, a far more serious concern than the trade in goods and services between Western economies existed at that time – oil. With OPEC's share in global oil production surpassing 50% in 1973, and the disruptions caused by rising oil prices in the early 1970s, it became necessary for Middle Eastern oil exporters to accept the dollar as the international currency for payment settlements from all countries. Facing structural balance of payments surpluses, Middle Eastern countries had to hold these surpluses in dollar reserves. Various threats were employed by the US for this purpose, including curbing food and raw materials supplies from the international community, developing alternative energy sources to reduce petroleum usage, and as recently revealed in declassified documents, even considering a military seizure of Middle Eastern oil.

A significant issue with holding dollar reserves, particularly for Saudi Arabia, which was not only the leading OPEC exporter but also held the highest proportion of dollar-denominated reserves (over 80%), was the depreciation of the dollar. In 1977-78, the dollar depreciated by around 40%, effectively eroding the purchasing power or value of Saudi's oil exports by the same amount. As Saudi Arabia considered diversifying its reserves into yen, Deutsche marks, and the International Monetary Fund's Special Drawing Rights (SDRs), the US responded by offering Saudi projects and committing "to a strong dollar and to reducing the budget deficit … [and] easing of interest rates only when there [were] signs that the effort to curb inflation [was] succeeding." Consequently, the Volcker Shock that began in 1979 and the shift in macroeconomic policy focus from unemployment to inflation may have stemmed from the need to ensure the dollar's position as the primary international currency. More broadly, a prerequisite for international currency status is stringent control over inflation. This was also evident in the rise of the euro as a reserve currency, where fiscal deficit targets of 3% were mandated to curb inflation.

Another question that needed to be addressed was "petrodollar recycling," i.e., the investment of surplus U.S. dollars earned by oil-exporting countries through the sale of oil. It is often argued that these petrodollars deposited in Western (U.S. and European) banks were lent out in private capital markets and eventually found their way to deficit countries, particularly the less-developed economies (LDCs) at the time. However, closer scrutiny of petrodollar flows reveals that only a small percentage went to LDCs; the majority were invested in industrialized countries in the West, as well as newly industrializing countries (NICs) that borrowed large amounts for capital investment. This was because the risks associated with default made private banks wary of lending to the poorest countries, which had to rely more on official sources, including foreign aid and international organizations, for their foreign exchange borrowing.

To address the issues of secrecy and risks, the US entered into an "add-on arrangement" with Saudi Arabia in 1974, allowing its central bank, SAMA, to purchase Treasury securities outside the auction. By the end of 1977, Middle Eastern oil exporters held 65% of US Treasury bonds and notes issued. While this arrangement facilitated the safe recycling of petrodollars and prevented the depreciation of the dollar, it also pushed the US into trade deficits. This situation presents an important lesson for aspiring international currencies to consider.

The failure of Bankhaus I. D. Herstatt and Franklin National in 1974 highlighted the importance of liquidity for interbank transactions, particularly in the petrodollar or Eurodollar market. Today, the development of repo markets, foreign exchange derivatives, and related forwards provide essential liquidity management tools. Dollar transactions dominate this space, accounting for 90% of global FX transactions, with an average of $6.6 trillion per day on one side of a transaction.

Lastly, the provision of countercyclical long-term lending by the US Federal Reserve to financial institutions and other central banks – acting as a dealer or lender of last resort – during the 2008 Global Financial Crisis and more recently, the pandemic of 2019 has become a critical necessity for maintaining the dollar as the international currency. For example, currency swap lines, where the Fed exchanged US dollars for foreign currencies with other central banks, ensured that financial crises were effectively mitigated.

For an alternative currency to achieve the dollar's status as an international currency, these functions are crucial in addition to it being just a medium of exchange or a reserve currency.

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