



PIIE PETERSON INSTITUTE FOR
INTERNATIONAL ECONOMICS

The role of diminished alliances in de-centering the dollar

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Does changing the trade regime change the dollar regime?

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Foreign policy implications for the role of the US dollar

There are (were) two open secret components to US dollar dominance

1. The lack of viable alternative (“Least Ugly Contest”)
2. The security regime which was tied to the US

Limited deviations around either aspect had self-correcting forces

- Even when US caused problems, money flowed into the US for relative safety

Changing the underlying regimes – domestic and international – **reverses the sign of the capital flows** when the US is the cause of problem

- Recent Treasury/dollar co-movements are necessary but not sufficient indicator

Alliance and security ties previously supported the dollar

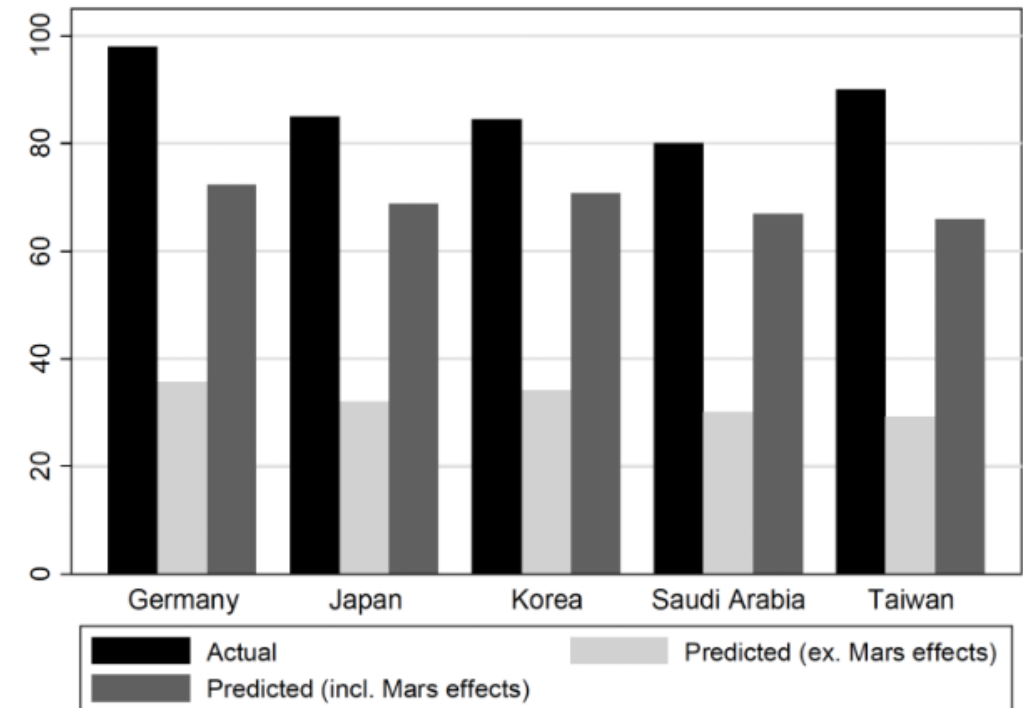
- Dollar reliance far outstrips economic/financial explanations
- Reserves and de facto exchange rate pegs responded little to variations in economic factors
- Missing mass is security ties
 - Posen (2008), “Why the Euro will not Rival the Dollar”
 - “Other governments' reserve currency holdings and exchange rate management are importantly influenced by security ties, and thus decisions to link to the dollar (and to accumulate dollar reserves for intervention) from Taiwan to Saudi Arabia to Panama depend as much on foreign policy as economics.”
- “If the dollar is displaced from its global role either now or in the coming couple of decades...this significant dependence of the dollar's future role on political as well as economic factors, however, suggests that the dollar's global role is vulnerable to foreign policy failures...not just to current account imbalances and financial turmoil. ”
- “[C]ausality runs as much from security leadership to economic leadership as in the other direction, meaning that some apparently disparate aspects of US global hegemony will tend to rise or fall together...”

Alliance and security ties previously supported the dollar

- Dollar reliance far outstrips economic/financial explanations
- Missing mass is security ties
 - Eichengreen, Mehl, and Chitu (2019), “Mars or Mercury? The Geopolitics of International Currency Choice”

When added to the intellectual portfolio of economists, this second hypothesis helps to explain some otherwise perplexing aspects of the currency composition of international reserves. It helps to explain why Japan holds a larger share of its foreign reserves in dollars than China. It helps to explain why Saudi Arabia holds the bulk of its reserves in dollars, unlike another oil exporter, Russia. It helps to explain why Germany holds virtually all of its official reserves in dollars, unlike France. Germany, Japan, and Saudi Arabia all depend on the US for security. China, Russia, and France, on the other hand, possess their own nuclear weapons as deterrents. Comparing nuclear weapon states and states dependent on the US for their security, as in Figure 1, suggests that the difference in the share of the US dollar in foreign reserve holdings is on the order of 35 percentage points.

Figure 3 Importance of geopolitical versus pecuniary factors in reserve currency choice: Now



Dollar switching examples based on security

- CFA France zone developed by Gaullist France
 - Mali, Madagascar, Mauritania all exiting with security shifts
- Germany's varying sense of threat relates to EMU
 - Blessing Letter of 1967 and no real sales of dollar holdings until 1979
 - Agreeing to proceed with EMU in 1992 with withdrawal of Russian troops
- Egypt swapping Rubles for Dollars with Aswan and Aid
- Japan acquiescence in Nixon Shock 1971 and Plaza 1985
- Break up of the Rouble-zone against IMF advice in 1991
 - Economics of terms-of-trade shock opposite to Baltics vs. Stans
- Denmark, Sweden, and UK both staying out of euro and having the most independent defense postures

Now go from Europe without to Europe with a security role

- Seen in 2008 as one reason why the euro would not rival the dollar
- “[G]iven the limited desire and ability of the eurozone members to project security relationships beyond their immediate neighborhood, there is little incentive for other countries around the world to shift their pegging, formal but also informal, from the dollar to the euro...even at the post-Cold War lows of the mid-1990s, US military spending was double that of the eurozone, and of course it has surged...But the point is that while some economic arguments would suggest that this defense spending differential would likely hasten the euro's displacement of the dollar, through eroding savings and the current account balance, the political view would suggest that at least some of that differential supports the dollar's global role.”

- Now put all of that into reverse...
 - Especially against the shift in Europe
 - See Kirkegaard (2025) on future EU defense spending



What to watch for in a reinforcing step-down for \$

This is about the eroding quality of insurance that US security and financial relationships *combined* provide – prompting a move to alternatives including self-insurance

- Narrowing of the gap in EU versus US defense spending
- Rise of the digital euro explicitly to keep payments away from US sanctions, monitoring and security (Lagarde, 2025)
- Divisions over security EU vs US
 - Ukraine, Gaza, Iran
 - EU domestic vs US imported weapons system purchases
- US capital inflow/outflow taxes or forced maturity swaps, etc.
- Testing of the depoliticized/unconditional Fed swap lines
- Rise of alternative swap lines, rebirth of AMF/Chiang Mai...



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Thank you.

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