10th June 2025

GEOPOLITICAL RUCTIONS[1]

Implications for the international monetary system and central banks

Introduction

Central banks now face profound challenges. The foundations of the current international monetary order are in jeopardy if the policies of the new US administration undermine the US dollar as the ultimate means of settlement for international financial transactions and as the primary international reserve asset. To understand these challenges, it is useful to consider three questions:

1. How real are the risks of decline of US Dollar hegemony and how quickly could it happen?
2. What are the key risks arising during any transition to an uncertain alternative system?
3. What priorities does this suggest for central banks?

Disintermediation and decline of the dollar?

The radical change in the approach of the new US Administration towards policy making constitutes a fundamental reset in international economic relations. There is no discernible intellectual underpinning for the change, and it could easily have a range of unintended consequences. The capricious approach to tariffs, taxes and trade as well as the avowed aim of weakening or removing US defence support could erode confidence in the US as an ally and trust in the dollar as the anchor for the international monetary system.

Pressures for change have been building for a long time (see annex), but what is happening now is dramatic and forbodes a secular shift. The emergence of risk premia on US government debt and a new tendency to sell dollar assets in the face of economic and financial uncertainty not only raise the cost of the growing US government deficit, but they also make the international financial system more brittle.

Failing to appreciate that it is excess demand, unleashed by a combination of excess private credit and growing public deficits, that has generated their current account deficits, the US administration is targeting multiple economic, political and defence objectives by engaging in tactics of deliberate disruption. It is unclear to others, and perhaps to the administration itself, just how those objectives fit together and whether the actions taken will help to achieve them. Whatever the intent, the approach of moving forward and then backing off when imposing differentiated import duties will fragment markets and disrupt supply chains. It may also imperil

[1] Synopsis of themes considered at roundtable discussions on 30 April 2025. The views expressed do not necessarily reflect those of the participants. Roundtable discussions take place semi-annually. Participants have included Vitor Constancio, Sir Jon Cunliffe, Stefan Ingves, Jacques de Larosière, Erkki Liikanen, Donald Kohn, Guillermo Ortiz, Raghuram Rajan, His Highness Mohammed Sanusi II, Andrew Sheng, Masaaki Shirakawa, Sir David Walker and Dr Zeti Aziz. The discussions are moderated by Dr Gavin Bingham and Sir Andrew Large.

the existing international monetary order based on the US dollar. The situation can be summed up in the proposition that Tax Americana is replacing Pax Americana.

The ultimate consequences of this are unclear, but the following developments are evident:

- Extreme events become more likely so that even the idea of a risk-free interest rate ceases to be meaningful; this complicates monetary policy both in the US and elsewhere.
- A declining dollar, combined with tariffs and corresponding supply disruptions, is likely to fuel renewed US inflation and lower growth, with spillovers to many countries, not least the 38 countries that the IMF classify as having a US dollar peg of some sort. Disruptions to trade and supply chains will harm growth.
- There are already moves afoot to settle international obligations in some jurisdictions without recourse to the dollar. These are likely to gain momentum.
- Demand for gold and other physical assets is rising; central banks are estimated have added 1000 tones to gold holdings in the past three years.
- The arbitrary imposition of highly punitive tariffs followed by their partial removal creates enormous uncertainty that could easily lead to the fragmentation of the trading system, with the prospect that the international financial system will in turn be fractured.

What are the key risks?

A disorderly flight from the dollar would be catastrophic for the global economy and perhaps just for this reason it may well not happen, but it is an eventuality that is no longer fanciful. Rates on ten-year Treasury bonds jumped 50 basis points in the wake of the US tariff announcement. At the same time the dollar exchange rate continued the fall that had started in anticipation (losing nearly 10% vs the euro between 1 January and its mid-April low). Global funds are overweight in the US dollar, and increased uncertainty of US policy could lead to a longer-term secular decline in the use of the dollar

Reduced demand for dollar-denominated assets could be self-reinforcing once values start to decline. The US trade deficit was over 3% of US GDP in 2024, and the fiscal deficit over 6%, making the dollar – and US bond prices - vulnerable to an abrupt change in sentiment regarding capital flows. The Government debt ratio stands at around 125% of GDP and is set to rise. Government interest expenditure (both gross and net) exceeds total US military expenditure and could increase significantly if investors begin to demand a higher risk premium. Increased issuance of government debt to fund the growing deficit presumes both domestic and foreign investors will be prepared to maintain or even boost the share of dollar assets in their portfolios.

Classic crisis prevention and management rely on liquidity being made freely available when needed. In the post WW2 order such liquidity has been reliably provided by the IMF, by countries acting together (GAB, Chiang Mai, etc) and, most importantly, through swap lines from the Federal Reserve. Given the present attitude displayed towards the international community by the US Administration, the question arises as to whether such LOLR liquidity can be relied on looking ahead.

A further risk is that increased weaponisation of the dollar will ultimately deprive it of its role as the primary reserve asset. The US obtains enormous amounts of information about transactions, and it has used it to combat crime and terrorism. Unlike any other country, it has an alternative to military action in the form of payments sanctions. Because of the centrality of the dollar, the US can sequester assets held within its jurisdiction more easily than other countries. By imposing secondary sanctions on vassal states, it can leverage this power. However, over-use of this part of the arsenal will ultimately lead to the development of substitutes, reducing its relevance,

The proposal emanating from the Chairman of the Council of Economic Advisers to compel foreign holders of US Treasury paper to swap their claims into ultra long, low interest instruments illustrates this type of thinking. It would amount to the first default by the United States since it became the world's principal reserve currency (see annex). The budgetary legislation before the US congress (Section 899) could reduce the attractiveness of dollar claims as it would empower the administration to impose withholding taxes ranging from 5 to 20 percent on residents of "discriminatory foreign countries"

Priorities for central banks: handling the transition

Near term issues

Central banks need to attend to:

- Direct challenges to central bank independence from populist governments who may wish to use monetary policy for political ends.
- Risks of larger fiscal deficits e.g., from greater military expenditure, lower tax receipts and greater interest expenditure. Fiscal dominance could effectively compromise independence and central bank policy objectives, even if the latter are not explicitly constrained.
- Greater uncertainty and frequent shocks to both the real economy and the financial sector arising from erratic political decisions could complicate both monetary and financial stability even if independence and the commitment to low inflation are not formally revoked or otherwise compromised.
- Promotion of meme coins, cryptocurrency and other substitutes for bank and central bank money could undermine the ability of central banks to respond effectively to shocks, whatever else happens.

In the short-term it behoves central banks to engage in contingency planning, thinking of the worst case where the Fed could not - or would not - provide US dollar swap lines during an international liquidity crisis. Altogether, central banks have almost USD 2 trillion in US dollar assets. If they could mobilise them quickly, this should suffice for managing liquidity needs in most conceivable liquidity crises. But having USD denominated bonds is not the same, and not as useful, as having cash. Only the Federal Reserve can supply USD cash in unlimited quantities.

Many reserve assets are held in custodial arrangements with US banks in the US and subject to US jurisdiction. By shifting the custody agreements to non-US banks, central banks would reduce the risk of actions by the US administration to hinder efforts to draw on such assets in a crisis.

Beyond that there is nothing to stop central banks and sovereign wealth funds from diversifying away from the dollar and amassing reserves in a multitude of currencies issued by smaller countries, though the scope for this is limited by size and depth of markets in these currencies.

Furthermore, the loss of trust in the dollar is likely to strengthen demand for holdings of real physical assets such as gold held in central banks' own vaults.

In addition, central banks could establish mutual credit lines among themselves along the lines of either the GAB (which in fact was a specific obligation to lend more than a general agreement to borrow) or the European Monetary Cooperation Fund (EMCF) set up in 1973 to pool European Monetary System central bank reserve holdings. The EMCF received administrative, legal and technical support from the BIS.

Central banks have a long and productive track record of cooperation which could be at risk as other cooperative arrangements are weakened or disappear entirely. The Basel Accord may be especially at risk. US commitment to the IMF may become increasingly uncertain. There could also be a more general lowering of standards as previous agreements or even international treaties, are ignored or repudiated. Because the stability and resilience of the international financial system depends on the well-established ability of central banks and financial regulatory authorities to cooperate in normal times in order to be able to react swiftly in a crisis, it is more important than ever for them to continue to do so if the United States scales back its engagement in this area as it has in others.

Long-term issues

Currently there is no real alternative to the US dollar as the main international reserve asset and numeraire, and other nations will need to minimise disruption by engaging constructively with the US. The "exorbitant privilege" is for the US to lose. There are at present none that seek to appropriate it. Still, in the longer term it is advisable to plan strategically, to find alternative ways to ensure the effective operation of a global payments system and to provide a reliable store of value for the assets underlying monetary liabilities issued by central banks.

Means of Payments: Ensuring robust international payment and settlement systems

The replacement of the dollar as a means of payment and settlement in commercial transactions between third countries is easier than its replacement as the principal reserve asset. The US accounts for about 10 % of global trade, less than either China or the Euro-area, which each account for about 15%. China is developing both CIPS and digital RMB clearing. Ten Asean and six middle eastern countries are participants in the latter, which notionally could replace 38% of settlements going through SWIFT. In principle, fintech can streamline payments in any currency or set of currencies, potentially reducing the need for a fiat currency such as the US dollar. For payments, if not for finality of settlement, cryptocurrencies or central bank digital arrangements could prove to be effective substitutes for the dollar as a currency in international payments

Store of Value: Holding suitable reserve assets

Incumbency provides significant advantages, particularly in the absence of credible alternatives. It permitted the dollar to retain its position after the US unilaterally renounced the link with gold in 1971 (viz John Connally: "The dollar is our currency, but your problem") in large part because of the unquestioned creditworthiness of the US government. Government debt was then only 35% of GDP and falling, compared with 125% now and rising - US

Treasuries were risk free, and the Fed's swap lines were eventually developed to become the ultimate source of emergency international liquidity assistance in a crisis.

Contenders to replace the dollar

The absence of a means to provide ample amounts of liquidity at short notice in the face of a crisis – the capacity to serve as a Lender of Last Resort - means that cryptocurrencies are not currently a suitable substitute for the dollar or other fiat currencies. The only two credible potential candidates are the Euro and the Renminbi. In neither case is it likely that they could replace the US dollar as the primary reserve asset quickly.

For the time being the Euro is not a viable substitute. Europe is still too fragmented; there is not enough common Euro government debt outstanding, and the secondary market in such debt is not large or deep enough. To be sure individual Member states issue Euro-denominated debt (ca 14 trillion in total), but their credit worthiness varies. Only Commission borrowing is guaranteed by the EU budget and constitutes an unconditional legal obligation of all Member States under the EU Treaties. The total stock of such debt is less that EUR 0.5 trillion, which is too meagre to absorb significant transfers from US dollar holdings. Total foreign exchange reserves of the world amounted to USD 12.36 trillion at the end of 2024.

Recent US actions have been a rude awakening for Europe. The change in the global security landscape now underway could over time enhance the role of the Euro. European countries are likely to increase their military expenditure, and this will need to be funded. EU issued debt could increase substantially if there were a shift from reliance on NATO towards a more autonomous European defence strategy less reliant on US security guarantees.

The Renminbi could also become a credible rival to the dollar as a reserve asset but only if the Chinese were to liberalise capital controls and promote deep and liquid secondary markets in risk-free RMB assets. This would not happen overnight even if the PRC were to decide that it sought the exorbitant privilege now being forsaken by the US. However, it could happen. And if it did, China would then gain significant information on payments and transactions that would supplement its vast amount of personal data (facial recognition; geolocational info, etc) and enable it to expropriate the power to impose sanctions now enjoyed by the US.

Annex

The implications for the international monetary system wrought by the change in the United States approach to international relations needs to be understood in the context of broader sweep of history. A global system for payments emerged only in the second half of the 19th Century in the wake of the development of steamships, telegraphs and a corpus of commercial and corporate law that provided for predictability in economic relations and finality in settlement of transactions. Partly because "Britannia ruled the waves" at that time, Sterling became the first fiat currency to provide the underpinnings for globally integrated payments. It was gradually replaced by the US dollar over a period of decades in the middle third of the 20th Century.

To serve as a reserve currency, a country must be:

- *Large:* accounting for a sizeable amount of international commercial and financial transactions and have deep and liquid markets in its currency.
- *Strong:* able to produce and sell goods and services abroad at an exchange rate higher than it would otherwise be.
- *Credible:* not abuse its power to issue debt in the face of higher demand.
- *Wise:* know when and how much liquidity to provide in the event of a crisis and to show restraint when imposing sanctions and sequestering assets.

One reason Sterling and the US dollar were trusted is that the governments behind the currencies had avoided serial defaults on their sovereign debt over centuries. Other large, strong and wise countries with a global geographical reach defaulted repeatedly on government debt and their currencies never became the primary reserve asset:

Country	Years of Sovereign Default (1775–2008, as per the book's main dataset)
United States	1790, 1814, 1933
Britain	No formal sovereign default since 1688 (Glorious Revolution)
France	1788–1797, 1812, 1814, 1815, 1830, 1831, 1832, 1836, 1848, 1870, 1932
Spain	1809, 1820, 1831, 1837, 1851, 1867, 1872, 1882, 1885, 1936–1939

Source: Reinhart and Rogoff: "This Time is Different"

NOTES
The United States experienced defaults or technical defaults in 1790 (post-Revolutionary War debt), 1814 (War of 1812 payment suspension), and 1933 (abrogation of the gold clause). Britain is notable for its absence of sovereign defaults in the modern era, with no episodes listed in the Reinhart and Rogoff dataset for the last 250 years. However, the suspension of the gold standard in September 1931 can be seen as analogous to the US action two years later and to the Nixon shock of 1971

Benefits of the ‘exorbitant privilege’ of issuing a reserve currency:

- Lower interest rates, benefiting both the government and net debtors.
- Better terms of trade and cheaper imports.
- information on transactions and payments not available to others.
- The mechanism to impose financial sanctions (although its actual use generates risk).
- The soft power that accrues to a hegemon.

This is not the first time that actions of the US have had profound and sometimes unintended consequences for the global monetary and financial system. Decisions to freeze the assets of foreign holders and to ban the payment of interest on demand deposits spawned the Eurodollar market and made the dollar the currency of choice for offshore and international financial operations.

The ‘Nixon shock’ decision of 15 August 1971 to sever the dollar’s link with gold (and to impose an across-the-board tariff of 10 percent) led to a shift from reliance on capital controls to greater exchange rate flexibility to deal with payments imbalances. In so doing, it permitted the significant expansion of a globally integrated financial market based on the dollar, despite a trend decline of the share of the US in global GDP (from a third in 1970 to a quarter now) and in global trade (from 13 to 8 percent). A regime which was designed to foster free trade and free movement of capital (but not of labour) is at risk of being compromised by policies that fluctuate from day-to-day and are explicitly intended to be disruptive and transactional.