U.S. Dollar Dominance: A Blessing or a Curse?

The international dominance of the dollar has benefitted the U.S. economy, but not without risks.

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The views expressed in this article are not necessarily those of the Federal Reserve Bank of Philadelphia or the Federal Reserve System.

When it comes to the global economy, typically one currency is widely used for invoicing international trade, denominating global financial contracts, and serving as a reserve asset. For 80 years, that currency has been the U.S. dollar. This helps the U.S. economy but also creates risks. In this article, I discuss how the U.S. dollar became the dominant international currency, the benefits and risks associated with being the dominant international currency, and challenges to the dollar's dominance.

The Rise and Fall of the British Pound

To understand how the U.S. dollar became the dominant means of payment for international transactions in goods and assets, we must first revisit the story of the currency that preceded dollar dominance: the British pound.

The Industrial Revolution, which started in the United Kingdom, vastly expanded the international flow of goods and capital. The international network created by British firms, banks,

and other financial institutions made London the main financial center of world commerce. The bulk of international trade was settled through transfers of bank deposits among London banks. Thus, the era of British pound dominance was born.

Network effects played a major role in the rise of the British pound.[1] Network effects occur when the value a user derives from a product or service depends on the number of users of compatible products and services. As the number of users increases in a network, the value or importance of the products and services also increases. So, as more exporters adopted the British pound as their preferred currency for receiving payments, importers were increasingly compelled to use the British pound as their means of exchange in international transactions, too.

As of 1900, the British pound was accepted as a means of payment in 100 percent of international markets, whereas the U.S. dollar was accepted in only 25 percent.[2] By then, U.S. gross domestic product (GDP) had surpassed that of the United Kingdom, but network effects ensured that the international network centered on the British pound would remain largely intact until World War I. Once global trade resumed after the war, the pound regained its dominance. But the global economy had changed, and with that change came the opportunity for another currency to challenge the British pound.

As New York City became a leading global financial center in the 1920s, Federal Reserve officials and U.S. banks mounted a global campaign to promote the internationalization of the U.S. dollar.[3] By 1929, the U.S. dollar represented 56 percent of aggregate foreign currency holdings, whereas the British pound represented only 41 percent (Figure 1).[4] The British pound, it seemed, was on its way out.

However, the Great Depression dealt a blow to the dollar's rise on the global stage. To deal with the downturn, policymakers everywhere focused on boosting domestic production and employment, even at the expense of international trade. As international trade declined in the 1930s, so too did the rationale for an international network built around the U.S. dollar. The outbreak of World War II at the end of the decade further delayed the reestablishment of global flows of trade and finance.

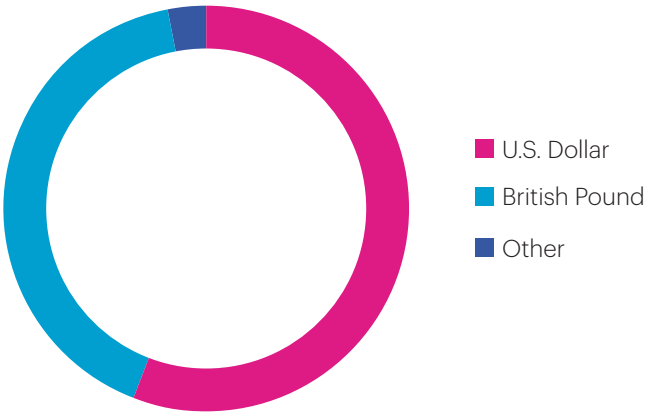
This history teaches us three important lessons about dollar dominance. First, only one currency tends to dominate an integrated market at a time. Second, the dominant currency is not necessarily the currency of the world's largest economy. And third, network effects explain why a currency can remain dominant even after another economy has grown larger.

FIGURE 1

By 1929, the U.S. Dollar Represented 56 Percent of Aggregate Foreign Currency Holdings

The British pound represented only 41 percent.

Aggregate foreign currency holdings of 16 countries, 1929



Data Source: Eichengreen et al. (2018)

The Rise of the U.S. Dollar

As World War II neared its end and the world economy prepared itself for the resumption of international trade, the Bretton Woods conference established the U.S. dollar as the central currency in a new, postwar international monetary system. Under Bretton Woods, the U.S. dollar was the only currency convertible into gold. Other countries had to peg the value of their currencies to the U.S. dollar, resulting in a system of fixed exchange rates. For example, the Bank of England maintained its assigned peg of $4.03 to the British pound by buying and selling U.S. dollars every day on the foreign exchange market. In other words, the Bretton Woods system of fixed exchange rates depended on governments exerting capital controls over international asset flows. Otherwise, speculative capital flows would eventually force a country to abandon its peg and allow its currency to devalue.

This became a problem as the total value of U.S.-issued convertible liabilities surpassed available gold reserves in the United States. Foreign central banks held their reserves in U.S. dollar-denominated assets, which they needed for managing their pegs to the U.S. dollar. If all foreign holders of U.S. dollar-denominated assets decided to redeem their claims to obtain gold, the U.S. government would not be able to make good on all its payments. If, however, the U.S. government were to abandon its commitment to convert U.S. dollars into gold at a predetermined exchange rate, as many feared was likely to happen, all investors would suffer large losses. This gave investors an incentive to exchange their U.S. dollar-denominated assets before the United States abandoned its commitment. As investors exchanged these assets, the U.S. dollar price of gold in the London market rose. The situation had become unsustainable by 1971, so President Richard Nixon ended the U.S. obligation to convert U.S. dollars into gold.

Since 1971, the exchange value of the U.S. dollar has been determined by market forces, which reflect fiscal and monetary policies adopted by the U.S. government and its trading partners. And yet, the U.S. dollar remains the dominant international currency.

Why U.S. Dollar Dominance Survived

Why were foreign investors and governments still attracted to the U.S. dollar (and U.S. dollar-denominated assets) after the

end of Bretton Woods? As with the British pound earlier in the 20th century, network effects allowed the dollar to maintain its dominance even as the global economy changed. Moreover, the U.S. dollar benefited from two additional circumstances: a lack of a competing alternative and the emergence of newly industrializing nations that unilaterally pegged their currencies to the U.S. dollar.

See ***The Path to Network Effects***

First, since the end of Bretton Woods, none of the currencies that seemed poised to supplant the U.S. dollar—the Japanese yen and the German deutsche mark in the 1980s and the euro after 1999—managed to do so. Although Japanese firms and banks played a major role in international markets in the last quarter of the 20th century, Japanese policymakers were reluctant to promote a greater international role for the Japanese yen for fear of overvaluation of the yen and deterioration of the Japanese trade balance. Although Western European countries established a fixed exchange rate regime centered on the deutsche mark following the collapse of Bretton Woods, the German government, like the Japanese government, feared overvaluation of its currency and the deterioration of its trade balance.[5] In both cases, the issuing country was unwilling to adopt the policies that would enable its currency to displace the U.S. dollar. (For more on this subject, see the sidebar "The Path to Network Effects.") The situation was different for the euro, which most countries of the European Union adopted in 1999, but for reasons discussed below, the euro has also failed to become an attractive alternative to the U.S. dollar.

Second, since the collapse of Bretton Woods, developing nations have either dollarized or pegged their currencies to the U.S. dollar, creating additional demand for U.S. dollars. (Like the signatories of Bretton Woods before 1971, these foreign central banks sustain their exchange rates by buying and selling U.S. dollars on the international capital market.)[6]

Network effects alone would have likely kept the U.S. dollar dominant, but these two additional circumstances make it even harder for the dollar to lose its dominance.

The Benefits (and Risks) of Issuing a Dominant Currency

The country issuing the dominant international currency can run a large trade deficit, borrow lots of money, and run big budget deficits without having to worry too much about rising prices or interest rates. But with each of these benefits comes a risk.

The international demand for U.S. dollars is one of the factors that has allowed the U.S. economy to run a large trade deficit (that is, to import far more than it exports) for an extended period without making imports more expensive for U.S. consumers. To understand why, let's consider a hypothetical country whose currency is not widely accepted internationally. In this country, an exporter receives U.S. dollars in payment for its sale of goods and services abroad. Because the exporter also wants to purchase goods and services domestically, it needs to exchange its U.S. dollar receipts for domestic currency. An importer in this same country wants to convert its domestic currency holdings into U.S. dollars to make purchases abroad, so it needs to trade in the foreign exchange market, too. The equilibrium exchange rate in this market (that is, the price of the U.S. dollar in terms of the domestic currency) depends on two things: the quantity of U.S. dollars that exporters can offer and the importers' demand for U.S. dollars.[7]

However, if this country runs a trade deficit, its larger demand for U.S. dollars in the foreign exchange market—which is due to its imports expanding relative to its exports—will put upward pressure on its currency's nominal exchange rate. If this country runs a trade deficit for too long, the value of its currency will depreciate over time, making imports more expensive for its residents.

None of this is true for the United States. International investors and foreign central banks demand U.S. dollar-denominated assets because they can be easily sold in international markets at a predictable price, making them a key financial asset in their portfolio strategy. So long as there is this large global market for U.S. dollar-denominated assets, U.S. importers don't need to convert their domestic currency into a foreign currency to pay for these imports—they can just pay foreign exporters in U.S. dollars, and the exchange rate holds steady (all else being equal).

Indeed, U.S. consumers did not experience (much) inflation during the Bretton Woods period. And although the trade deficit has reemerged since 2000, inflation has (mostly) held steady.[8] However, running a large trade deficit for a long period creates a risk for the country that issues the dominant currency. If we ever transition to an international monetary system in which the U.S. dollar is no longer dominant, the large U.S. trade deficit may trigger a substantial decline in the demand for U.S. dollars. This would result in a persistent depreciation of the U.S. dollar and more expensive imports for U.S. consumers. This can prove difficult for U.S. households and firms that have become accustomed to cheap imports.

The second advantage of U.S. dollar dominance is that American firms can borrow more cheaply internationally and without any exchange-rate risk. In their forthcoming *Journal of Finance* article, Wharton School assistant professor of finance William Diamond and Federal Reserve Bank of New York economist Peter Van Tassel find that international demand for U.S. dollar assets reduces interest rates for U.S. firms versus a counterfactual. Because they can borrow more cheaply, these firms can invest more, boosting economic growth and incomes.

U.S. firms do not face exchange-rate risk because they can borrow by issuing debt claims denominated in U.S. dollars. This gives them a significant advantage over foreign competitors. To understand why, suppose that a foreign firm borrows U.S. dollars on the international market, but then its home country's currency depreciates before the debt obligation matures. Although the U.S. dollar value of the firm's debt obligation hasn't changed, the value of its domestic liabilities has risen. As the domestic value of the firm's liabilities increases in proportion to its revenues, it must pay more interest on its debts relative to its revenues, which reduces its profits. This problem stems from the mismatch between the denomination of the firm's liabilities (U.S. dollars) and the denomination of its revenues (domestic currency).

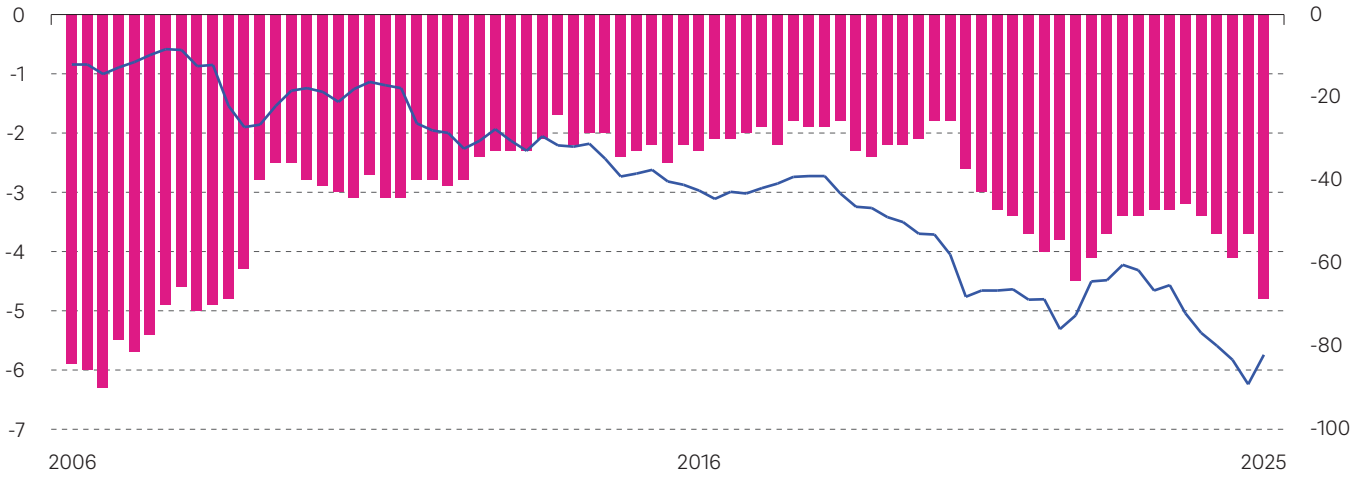
So long as U.S. firms have both their debt obligations and

FIGURE 2

Foreigners Now Own About Twice as Much U.S. Debt as Americans Own Foreign Debt

But because the U.S. dollar is the dominant international currency, this hasn't led to inflation or a shrinking economy.

The U.S. current account as a percent of GDP (red bars, left scale); the U.S. net international investment position as a percent of GDP (blue line, right scale); 2006–2024



Data Source: U.S. Bureau of Economic Analysis

their revenues denominated in U.S. dollars, they face no exchange-rate risk. However, a sudden change in the international demand for U.S. dollar assets could sharply increase the cost of borrowing for U.S. firms and eventually reduce U.S. investment. If U.S. firms can no longer issue debt denominated in U.S. dollars, they may face exchange-rate risk, which can affect their profitability.

The third advantage is that the U.S. Treasury can finance large budget deficits at lower interest rates. As noted above, international investors and foreign central banks want U.S. dollar-denominated assets such as Treasury securities because they can be easily sold in international markets at a predictable price. The higher demand for Treasury securities makes them more expensive in the secondary market, which in turn reduces the profit (or yield to maturity) an investor receives for owning a security they bought on that market.[9] This allows the United States to finance its budget deficits at a lower cost versus a counterfactual. The fact that Treasury securities have a higher price than that predicted by a counterfactual in which these securities are evaluated only by their return-risk characteristics suggests that there is a *liquidity premium*. In other words, investors are willing to pay more for U.S. Treasury securities (and thus earn a smaller yield) because they are liquid. We can even measure how much more they are willing to pay: In their 2012 *Journal of Political Economy* article, Stanford University professor of finance Arvind Krishnamurthy and University of California, Berkeley, professor of finance and management Annette Vissing-Jørgensen document that Treasury yields were reduced by 73 basis points on average from 1926 to 2008 because Treasuries were so liquid.

But here too there is a risk for the issuing country: Because borrowing is so cheap, policymakers may delay necessary budget adjustments that ensure the sustainability of debts in the long run. If there is a sudden decline in the global demand for U.S. dollars, the cost of servicing the U.S. debt can become unsustainably large, risking a sovereign debt crisis.

The risks to the U.S. economy are particularly clear when we compare the U.S. current account as a percent of GDP with the U.S. net international investment position as a percent of GDP (Figure 2). The latter figure tells us that the total foreign wealth owned by Americans is much less than the total U.S. wealth owned by foreigners. This gap is currently at 82 percent of U.S. GDP. In any other country, such a mismatch would be dangerous and would likely lead to inflation or a deep economic contraction. But the U.S. is still able to attract enough foreign investment to keep our economy steady. This is only possible because the U.S. dollar is the dominant international currency. If the dollar would ever lose its dominance, the United States would be unable to avoid a severe economic disruption. In short, the longer the U.S. dollar maintains its dominance, the more painful it may be for the U.S. economy once it loses that dominance.

Challenges to U.S. Dollar Dominance

An ongoing question in international economics is whether the U.S. dollar will maintain its dominant status. Economists propose three scenarios in which this dominance could end.

In one scenario, the U.S. dollar loses its dominant status through the emergence of a rival sovereign currency issued by an economic bloc as large as the U.S. economy. In his 2011 book *Exorbitant Privilege*, University of California, Berkeley, professor of economics and political science Barry Eichengreen argued that the 2007–2008 Global Financial Crisis (GFC), which started in the United States, damaged the United States' reputation as a financial center. This, he wrote, opened the door for the euro to emerge as a serious rival to the U.S. dollar because the same network effects that led to the rise of the U.S. dollar could emerge in a large economic bloc such as the euro zone.

Although Eichengreen built a coherent framework for modeling the rise of a new dominant sovereign currency, the euro has experienced only a limited expansion in international markets since the GFC, granting it only a distant second place in the share of international reserves and the invoicing of international trade. The strong network effects that reinforce U.S. dollar dominance remain in place despite the existence of a serious rival. As previously mentioned, it would require a sufficiently big shock to dethrone the U.S. dollar, and not even the GFC was big enough to do that. (Indeed, it took two world wars and the Great Depression to dethrone the British pound.) Also, it is not clear that the euro network has any technological or strategic advantage over the U.S. dollar network, even in the absence of a large external shock to the system.

The ascent of China to the world's second-largest economy has led some economists to argue that the Chinese yuan can rival the U.S. dollar. Although the Chinese economy plays an important role in international commerce, capital controls imposed by an autocratic regime make the Chinese currency an unappealing international currency. The Chinese government, like the Japanese and German governments before it, does not seem to attach a high priority to the internationalization of its currency, probably because it is not willing to adopt the necessary policies.[10]

In a third scenario, privately issued digital currencies replace the U.S. dollar in international commerce. Because digital currencies such as Bitcoin and Ethereum are designed to be traded on a network of computers, they are a useful means of direct payment for international exchanges.[11] In contrast, conventional international payments run through a network of correspondent banks that process cross-border payments on behalf of their customers. This market tends to be dominated by a small group of large banks, which increases their market power and results in high transactions fees.

Theoretically, a privately issued digital currency could one day displace the U.S. dollar in international payments. However, the excessive volatility of privately issued digital currencies creates serious problems for international traders.[12] In most international transactions, it takes 30 to 60 days between the invoicing of merchandise and the receipt of payment. If the transaction is invoiced in terms of a volatile digital currency, the actual real value of the exporter's sale can be very different from the expected real value at the time the merchandise was invoiced. This explains why they are not yet a popular tool for settling international transactions, even though they enable direct payments across borders.

One type of digital currency, however, could address this concern. A stablecoin is designed to provide a stable value through the implicit promise to convert one unit of the digital currency into one U.S. dollar.[13] As stablecoins have become useful for investors hoping to manage their exposure to digital assets, they have grown considerably. The current market capitalization of the two major stablecoins, Tether and USD Coin, is approximately $250 billion.

But because stablecoins are pegged to the U.S. dollar, they cannot become an alternative to the U.S. dollar in international payments. A true alternative to the U.S. dollar would be a digital currency that is not a promise to pay U.S. dollars. Although stablecoins have provided a haven for digital-currency investors, it is not clear that stablecoins can maintain their value if they sever their peg to the U.S. dollar. In this sense, stablecoins are a branch of–rather than a rival to–the broader U.S. dollar international network. Indeed, most investors buy stablecoins *because* they are pegged to the U.S. dollar.

If, however, someone were to design a stablecoin pegged to the value of a basket of sovereign currencies, then this new instrument could rival the U.S. dollar even if that basket included the U.S. dollar. But many problems would have to be solved before this instrument could develop into a sufficiently large payment network. Would the issuer of such an instrument be regulated? How would the weights in the basket of sovereign currencies be determined? Would they change over time?

More importantly, if the market value of one unit of this stablecoin deviated from the peg, stablecoin holders might want to convert their stablecoins into cash. But if the stablecoin issuer

The Path to Network Effects

Why was it the U.S. dollar—and not some other currency—that benefited from network effects in the first place? In our 2025 working paper, Philadelphia Fed senior economist Joseph Abadi, University of Pennsylvania professor of economics Jesus Fernandez-Villaverde, and I show that the initial design of a country's currency system plays a large role in the subsequent development of an international monetary system (including the rise of a dominant currency). The important elements of this initial design are the choice of a monetary standard, the creation of a central bank, the rules governing central bank policy, the ease with which residents can make foreign payments, the ease with which domestic banks can establish branches abroad, and the rules governing the way foreigners can invest in domestic assets and expatriate funds. These design choices determine the initial size of a country's currency network, which then influences a foreign agent's decision to accept that currency in payments, and thus that currency's network effects.

In our model of the world economy, if the initial size of a country's currency network is slightly larger than that of foreign competitors, foreigners will have a greater incentive to use its network to settle their international transactions, and that country's currency will become dominant. In other words, the initial, relative advantage of a country's network, even if that network is small, will drive the long-run outcome for the international monetary system. Moreover, the long-run regime is remarkably robust: Only a sufficiently large external shock can result in a dynamic process that changes the status of a dominant currency.

Based on our research, we conclude that network effects, not just the size of the U.S. economy, enabled the rise of the U.S. dollar. Because U.S. policymakers and bankers had designed a currency system between 1913 and 1944 that gave the U.S. dollar an edge in terms of network effects, the dollar could become and remain dominant for decades thereafter.

cannot quickly sell some of the assets that back its liabilities, it will need a lender of last resort to provide that liquidity. Who would be this lender? Would any of the sovereign governments or central banks that issue the fiat currencies that form the basket of currencies offer immediate assistance to the issuer? Without that expectation of immediate assistance, would the issuer be willing to overcollateralize its liabilities to insulate it from changes in the market value of its assets? Would this overcollateralization be credible? Solving these problems might not be in the interest of any one firm.[14] Therefore, it is likely that no one will issue such an instrument without governmental involvement.

Conclusion

In this article, I have discussed the history of the U.S. dollar as the dominant international currency and the main advantages and risks involved in the provision of a dominant currency. I have also considered some alternatives to the U.S. dollar. I conclude that the most feasible alternative is a stablecoin pegged to a basket of sovereign currencies. Until somebody successfully develops such a stablecoin and a sufficiently large and stable network to support it, the dollar should maintain its dominance thanks to network effects, the lack of a viable alternative, and the decision by developing nations to either dollarize or peg their currencies to the U.S. dollar. But if that dominance ends, the implicit risks of being the dominant currency may pose challenges for the entire U.S. economy.

Notes

1 See Eichengreen (2019).

2 See Flandreau and Jobst (2005).

3 In his 2011 book *Exorbitant Privilege*, Eichengreen shows how New York bankers and the Federal Reserve, which was established in 1913, developed the U.S. dollar network in the 1920s.

4 See Eichengreen et al. (2018).

5 The system built around the deutsche mark was also unstable. Member countries frequently devalued their currencies to accommodate a decline in domestic employment.

6 In the post–Bretton Woods regime, a developing country's peg to the U.S. dollar is not as rigid as it was under Bretton Woods. Central banks in developing countries frequently allow their peg to change over time in a predictable way or allow it to fluctuate within a specific band around a target value.

7 In this example, I assume that domestic households and firms do not buy foreign assets and that foreigners do not buy domestic assets.

8 In 2024, the U.S. trade deficit was about 3 percent of U.S. GDP.

9 Specifically, the yield to maturity is the difference between what you pay for a security and what you earn if you keep it until it matures.

10 See Abadi et al. (2025).

11 In my 2018 *Economic Insights* article, "Bitcoin vs. the Buck: Is Currency Competition a Good Thing," I explain the mechanics of making payments using Bitcoin.

12 So do cyberthreats, such as hackers accessing digital wallets.

13 I discuss the properties of stablecoins and other digital currencies in my 2023 *Economic Insights* article, "New Monies in the Digital Era."

14 There are additional problems: If this stablecoin is fully backed, how will the supply adjust to fluctuations in the global demand for money? Would governments always be willing to supply more debt when the stablecoin issuer needs to purchase more reserves?

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