De-Dollarization

Assessing the euro's strategic positioning

→ The United States' role as the anchor of the global financial system is being challenged by many factors, such as perception of the U.S. weaponization of the dollar, growing efforts from other countries seeking to reduce their reliance on the dollar, U.S. fiscal concerns, and concerns about the independence of the Federal Reserve, creating opportunities for other countries to play a greater role, but also creating risks.

→ As the de-dollarization trend gains momentum, the EU appears well-positioned to partially capitalize on this evolving landscape, provided it acts proactively; however, it also faces numerous constraints that will limit its growth.

Introduction

For decades, the United States has been the anchor of the global financial system, a status that has afforded the country significant economic and political advantages. However, the dollar-centric order is currently being challenged, prompting central banks and corporations to reduce their reliance on the dollar and diversify their currency holdings. From 2015 to 2024, the dollar's share of global foreign exchange reserves dropped from 66 to 57%.[1]

This de-dollarization trend is driven by many factors, including the perception that the United States has weaponized the dollar's role in international finance. The U.S. government's frequent use of economic sanctions to advance its foreign policy goals, as well as its coordinated ousting of Russian financial institutions from the SWIFT payments system in 2022, has undermined trust in the neutrality of the dollar-based financial system.

An increasing number of countries are exploring alternatives to dollar-denominated trade, including through the use of digital currencies.[2] China, which has long advocated for the internationalization of its renminbi (RMB), is at the forefront of efforts to challenge American financial supremacy and encourages countries to experiment with non-dollar transactions, leveraging emerging technologies, including China's digital RMB.[3] Russia's central bank also announced in July 2024 that importers and exporters could use cryptocurrencies in cross-border settlements under foreign trade agreements as part of an "experimental legal regime."[4] In addition, the BRICS bloc of nations, initially comprising Brazil, Russia, India, China, and South Africa, has announced plans for a digital currency cross-border payment solution to reduce its reliance on the U.S. dollar.

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Confidence in the dollar is eroding due to the ballooning U.S. national debt, concerns about the independence of the U.S. Federal Reserve and U.S. monetary policy, and weak economic growth prospects. The U.S. debt-to-GDP ratio is 121%, double the benchmark widely considered to be fiscally sustainable.[5] Yet, there is little political appetite for reducing the debt. The U.S. Congress has just approved the One Big Beautiful Bill Act, a measure expected to add trillions to the national debt.[6] Since assuming office in January, Trump has publicly criticized U.S. Federal Reserve Chairman Jerome Powell for not lowering interest rates. Trump has reportedly considered selecting and replacing Powell in the fall, even though Powell's term does not expire until May 2026.[7] Moreover, Trump's aggressive and unpredictable use of tariffs has also clouded the prospects for U.S. economic growth, creating U.S. policy uncertainty.

Investors are looking for safe haven assets and other avenues during this period of uncertainty. Refuge currencies such as the Swiss franc and the Japanese yen have performed well against the dollar recently, but also have to manage the unanticipated consequences of increased flows.[8] Swiss inflation turned negative in May as the surge in the franc has reduced the prices of imported goods and put pressure on the central bank to cut rates below 0%.[9] The Japanese yen has strengthened faster than Japanese policymakers wanted, which forced the Bank of Japan to abandon its plans to raise interest rates.[10]

This shift away from one dominant currency is not without historical precedent. The British pound sterling was the cornerstone of global trade and finance before it ceded its status to the U.S. dollar by the mid-20th century. The sterling's decline was gradual and accompanied by deep institutional change, suggesting a possible scenario for a transition away from the dollar.[11]

While the euro was not initially conceived as a currency to rival the dollar, but rather to underpin, through economic rationale, the project of EU integration more deeply, leaders have long harbored ambitions for the euro to play a more significant international role. As the de-dollarization trend gains momentum, the EU appears well-positioned to capitalize on this evolving landscape, provided it acts proactively; however, it also faces numerous constraints that will limit its growth.

Risks of de-dollarization

Global risks

Replacing the dollar with a basket of currencies would likely increase transaction costs, increase exchange rate volatility, reduce price transparency, and complicate liquidity management

A transition away from dollar hegemony poses significant risks for the global financial system. A decline in the international demand for dollars could trigger a corresponding weakening of its value. Such a development would create significant instability, particularly for emerging markets that hold large amounts of dollar-denominated debt. Replacing the dollar with a basket of currencies would likely increase transaction costs, increase exchange rate volatility, reduce price transparency, and complicate liquidity management.

On a geostrategic level, such a shift could also lead to the formation of competing financial blocs. Countries could then utilize these alliances as a diplomatic tool or a means of pressure, heightening geopolitical tensions and further fragmenting the global economic order.

U.S. risks

For the United States, de-dollarization would have far-reaching consequences. Chief among them is the potential loss of its "exorbitant privilege," which allows the United States to finance deficits at lower interest rates than it would otherwise incur.[12] The loss of this financing advantage would result in higher interest rates for the United States. In turn, this would raise borrowing costs for the U.S. government, exacerbating the nation's fiscal challenges. A depreciating dollar would also increase the cost of imports, potentially stoking inflation.

A diminished role for the dollar would also curtail U.S. geopolitical power. It would reduce its influence over global economic governance and undermine U.S. leverage in enforcing sanctions. It could also reduce foreign capital inflows into U.S. equities, bonds, and real estate, depressing asset valuations and decreasing market liquidity.

EU Risks

Despite potential gains from de-dollarization, a move away from the dollar would also present risks and challenges to the EU. Volatility in euro exchange rates could increase if the euro assumes a more prominent international role and appreciates due to heightened global demand. Such an outcome would create uncertainty for exporters. Furthermore, many EU countries hold substantial reserves denominated in U.S. dollars and maintain financial institutions with heavy dollar exposures.

The European banking sector would be more acutely impacted. Nearly a quarter of European banks have insufficient U.S. dollar funding to cover their exposures to the currency, leaving them exposed to liquidity shocks.[13] This vulnerability highlights the fragility of the EU's financial system, such as the impact of geopolitical instability or changes in U.S. monetary policy.[14]

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This structural shortfall also creates a critical dependency on the U.S. Federal Reserve, which can provide emergency dollar liquidity via a swap line arrangement. This arrangement, however, may no longer be guaranteed in the future.[15] Despite vehement pushback from some U.S. officials, President Trump and other senior members of his administration have provided ample evidence via their public comments about transatlantic relations to doubt the reliability of these swap lines and whether Trump would place additional conditions on them. To prepare for such a scenario, ECB supervisors are asking some of the region's banks to assess their need for U.S. dollars in times of stress, and as needed, reduce their exposure to dollar funding.[16]

The euro's prospects

The European Commission has emphasized the need to "strengthen the international role of the euro" to reduce vulnerabilities and enhance the EU's strategic autonomy.[17] The eurozone possesses many of the attributes necessary for reserve currency status, including a large economic area, strong legal institutions, a credible and independent central bank, and macroprudential tools to manage the risks associated with large and volatile capital flows.[18]

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However, structural impediments limit the euro's global growth, such as the EU's fragmented capital markets. Unlike the United States, which offers a single, deep, and highly liquid market for government debt, the eurozone is a collection of separate sovereign debt markets. The EU also lacks a fiscal union, which would ideally include a common safe asset and a centralized treasury. The lack of a fully implemented banking union further compounds these issues, limiting risk-sharing across the monetary union.

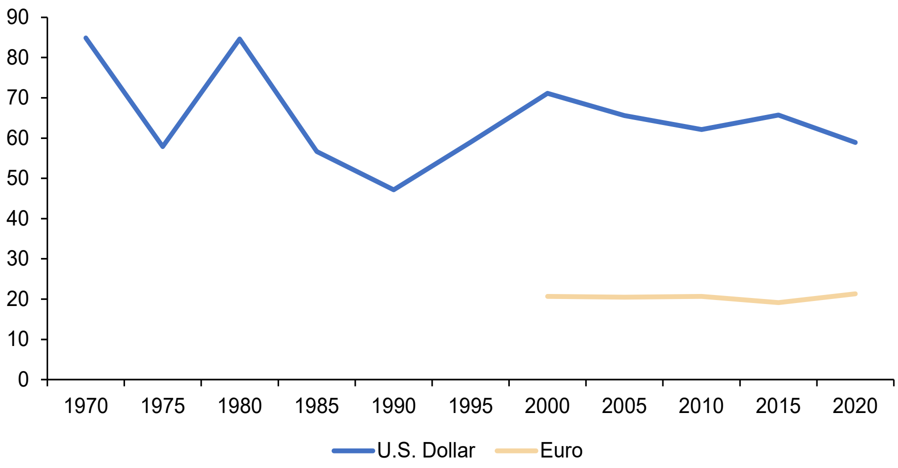
Deep liquid capital markets are critical to rival the dollar, but the size of the U.S. Treasury market ($28 trillion) dwarfs the €1.8 trillion market for German government bonds.[19] The global role of the euro also remains limited. The euro only accounts for one-fifth of global foreign exchange reserves.[20] Lastly, the EU lacks the military power necessary to prevail and maintain the value of its assets in the event of a conflict.[21]

Conclusion

Funcas believes that the current global shift away from the U.S. dollar could result in an increased international role for the European currency if the EU acts boldly to deepen its financial union

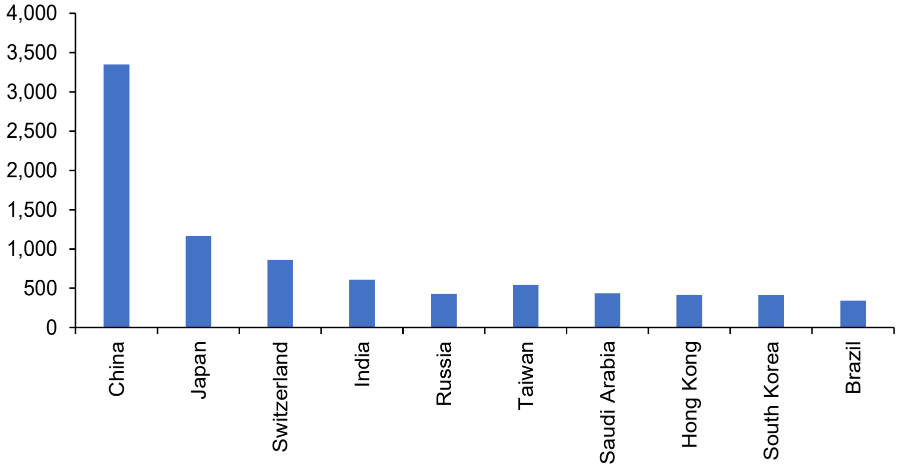
Funcas believes that the current global shift away from the U.S. dollar could result in an increased international role for the European currency if the EU acts boldly to deepen its financial union. There are a number of steps EU leaders could consider. First, they could increase the availability of safe assets. Investors require deep, liquid, and safe asset markets. The EU could accomplish this by issuing more joint debt instruments, building on the precedent set by the Next Generation EU (NGEU) recovery fund, to replace the fragmented landscape of national sovereign bonds gradually.[22] Second, they could delay the scheduled repayment of the NGEU funds to retain the large stock of highly rated securities and enhance the euro's attractiveness as a reserve currency.[23] Third, they could pre-fund future spending as part of the EU's negotiations over the next seven-year budget (2028–2035). This could be done through jointly issued euro-denominated bonds, which would offer another tranche of safe assets for global investors. Fourth, they could deepen international trade and expand trade agreements, such as passing the pending Mercosur trade deal with Argentina, Brazil, Paraguay, and Uruguay, to foster the broader use of the euro in cross-border settlements and contracts.[24] Lastly, they could offer financial tools to encourage trading in euros. Developing a digital euro, increasing the availability of euro-denominated swap lines, and fostering deeper capital market integration could support a greater international role for the euro.

EXHIBIT 1.0 – U.S. DOLLAR AND EURO SHARE OF GLOBAL FOREIGN EXCHANGE RESERVES, 1970-2020



Source: International Monetary Fund data.

EXHIBIT 2.0 – TOP 10 COUNTRIES WITH THE LARGEST FOREIGN EXCHANGE RESERVES (VALUE OF NON-GOLD RESERVES IN U.S. $ BILLIONS)



Note: Based on the last data reported, ranging from October 2024 to May 2025.
Sources: IMF data, World Bank data, and Central Bank of the Republic of China (Taiwan).

Notes

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[4] https://www.cbr.ru/eng/press/event/?id=18884

[5] https://www.worldpoliticsreview.com/us-dollar-transition-hegemony/?one-time-read-code=3754201750541483121039

[6] https://www.cbo.gov/

[7] https://www.cnbc.com/2025/06/26/dollar-hits-fresh-lows-as-trump-attacks-threaten-federal-reserve-credibility.html

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[9] https://www.reuters.com/business/retail-consumer/swiss-inflation-turns-negative-first-time-since-covid-pandemic-2025-06-03/

[10] https://asiatimes.com/2025/05/how-trump-made-japans-yen-great-again/#

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[13] https://www.ft.com/content/882e200c-8055-41ce-a52f-2620e6cbdab0

[14] https://connect.cefpro.com/article/view/europes-alarming-reliance-on-us-dollar-funding#:~:text=A%20recent%20report%20by%20the,from%20the%20US%20Federal%20Reserve.&text=The%20EBA%20reports%20that,or%20implement%20effective%20hedging%20strategies

[15] *Ibid.*

[16] https://www.reuters.com/sustainability/boards-policy-regulation/ecb-supervisors-press-banks-dollar-funding-over-trump-concerns-sources-say-2025-05-14/

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[19] https://www.ft.com/content/70565fda-ae7d-4c06-80ee-b460dc8de43e

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[21] https://business.columbia.edu/research-brief/dollars-dominance-military-financial-power

[22] https://www.ft.com/content/c02cdfac-8c46-4b67-9a3b-2aa4312852b9

[23] *Ibid.*

[24] *Ibid.*