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Dollar at the Brink? Wars, Debt, and the Future of the World's Reserve Currency

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Abstract

The US dollar's reserve currency primacy is under gradual but measurable structural stress. This paper makes two original theoretical contributions. First, we introduce the Reserve Currency Credibility Stack (RCCS): a framework proposing that reserve currency dominance rests on four interdependent layers—institutional, fiscal, energy, and geopolitical—whose erosion is non-linear. When two or more layers are simultaneously under stress, feedback loops emerge that accelerate deterioration across the stack. Second, we introduce the kinetic risk premium: a new category of sovereign asset risk that arises when financial coercion escalates into direct military force as an instrument of geoeconomic statecraft. Applied to current conditions, the RCCS predicts the pattern the data confirm: steady erosion in the share of the world's reserves held in dollars (fiscal and institutional layers under stress), alongside intact dominance in how the dollar is actually used in trade and finance (network effects layer still strong). IMF (International Monetary Fund) COFER (Currency Composition of Official Foreign Exchange Reserves) data show reserve share declining from 72% in 2001 to 57.7% in 2025. We present three forward scenarios with indicative probability weights and derive concrete implications for reserve management, corporate treasury strategy, and fixed income positioning.

Keywords: Dollar hegemony, de-dollarisation, reserve currency, petrodollar, Bretton Woods, Nixon shock, fiscal risk, sovereign risk, portfolio strategy, capital markets, BRICS

The Architecture of Dollar Dominance

The dollar's dominance as the world's reserve and trading currency is under real and accelerating pressure. IMF COFER data show the dollar's reserve share falling from 72% in 2001 to 57.7% in early 2025. For practitioners, the issue is not imminent collapse; the dollar's role in global trade and finance remains deeply entrenched, but the implications for risk pricing and capital allocation are over a 5–15-year investment horizon.

Understanding the current moment requires understanding the architecture that built dollar dominance. The dollar was not a market outcome; it was built on four institutional pillars, each now under stress. The United States faces a convergence of fiscal pressures, $38 trillion in national debt, the OBBBA (One Big Beautiful Bill Act) adding an additional $3 trillion, and geopolitical escalation that has introduced entirely new categories of risk into dollar asset pricing.

Reserve currency displacement follows structural decline, not the other way around. The dollar will not lose primacy imminently—but the direction and pace of erosion matter enormously for practitioners. This paper proposes the Reserve Currency Credibility Stack (RCCS): a framework in which dollar dominance rests on four interdependent pillars, and simultaneous stress across multiple pillars produces non-linear deterioration rather than the smooth erosion that existing models assume. We also introduce the kinetic risk premium—a new analytical category capturing a type of geopolitical risk that existing frameworks, built around financial sanctions and not military force, do not adequately price. This paper builds a theoretical framework and evaluates it against a structured reading of current institutional data, policy developments, and real-world events. All evidence is drawn from publicly available sources cited throughout.

This paper builds the RCCS as an original theoretical framework and tests it against secondary evidence: institutional data from the IMF, BIS, and Federal Reserve; recent policy and geopolitical developments; and peer-reviewed research on reserve currency dynamics and trade invoicing. It does not claim statistical generalisability. Its contribution is a structured analytical lens for practitioners and researchers, with directions for future empirical work at the close of this article. We call this framework the RCCS.

At Bretton Woods in 1944, 44 nations pegged to the dollar, fixed to gold at $35 per ounce. The IMF, lending in dollars, made dollar reserves an institutional requirement for every government—not merely a preference (Eichengreen, 2024). That architecture held for almost three decades before its first major fracture.

By 1971, US fiscal expansion had pushed dollar supply far beyond gold backing. Nixon suspended convertibility on August 15, making the dollar a pure fiat currency—its value resting entirely on US policy credibility, which is why the fiscal developments of 2025 matter so directly. The

dollar then found its next anchor not in gold but in oil.

Following the 1973 oil embargo, the United States negotiated agreements with Gulf producers: oil priced in dollars, security guarantees in return, and surplus dollars recycled into US Treasuries. Every oil-importing economy needed dollars; Gulf recycling gave the United States a captive Treasury buyer and lower borrowing costs. Over 20% of global oil now trades outside the dollar (Federal Reserve Board, 2025).

US post-war dominance created a self-reinforcing loop: reserve status lowered borrowing costs, deepened capital markets, and reinforced reserve status. The pound held reserve status for decades after US GDP overtook Britain's, losing it only after two world wars. Dollar erosion will likewise be gradual (Eichengreen, 2024). Understanding how gradual it is, and where the risks of acceleration lie, requires a systematic framework.

A Framework for Understanding Erosion: The RCCS

The RCCS holds that reserve currency dominance rests on four interdependent layers: (1) institutional credibility—rule of law, governance standards, and network effects making the currency the default medium of exchange; (2) fiscal credibility—sustainable deficits and sound sovereign credit; (3) energy credibility—anchor role in global commodity markets; and (4) geopolitical credibility—legitimacy in the use of financial and military power. The key claim is that these layers are not independent. When two or more erode simultaneously, feedback loops emerge: fiscal deterioration undermines institutional credibility; geopolitical escalation erodes energy credibility; and energy erosion accelerates reserve diversification, deepening fiscal stress. The RCCS predicts erosion that is slow and resilient when stresses are isolated but potentially abrupt when multiple pillars weaken simultaneously—tested against evidence.

Prior work has examined reserve currency dominance through several lenses that the RCCS builds on and extends. Eichengreen (2011, 2024) shows that the dollar persists not simply because it is the best option but because the cost of switching is too high for any single actor to bear alone—what he calls the incumbency advantage of network effects. Cohen (1971) introduced the idea of a currency hierarchy, arguing that reserve currencies occupy a privileged position that reflects underlying power relationships, not just market logic. Kindleberger (1973) showed that stable international monetary systems have historically required a dominant economy willing to act as a stabilising force—providing liquidity and upholding the rules of the system. The RCCS accepts these insights but departs from them in two important ways. First, it treats the four pillars of dollar dominance as interconnected: where earlier frameworks tend to examine institutional, fiscal, or geopolitical factors in isolation, the RCCS argues that stress in two or more pillars at the same time creates feedback loops that accelerate erosion beyond what any single-factor model would predict. Second, it introduces the kinetic risk premium as a genuinely new category—one

that earlier frameworks, written before the era of financial sanctions and military geoeconomics, did not have cause to address. The fiscal and geopolitical stresses on this framework did not emerge overnight.

Running persistent deficits is the price of supplying global liquidity—but those deficits erode long-term confidence in the dollar. In 2025, US interest payments exceeded defence spending for the first time. Moody's downgraded the United States in May 2025, leaving it as the highest default-risk G7 sovereign (IMF, 2025). The position now depends on continued foreign willingness to hold dollar assets—exactly the confidence that 2025-2026 events are putting under stress.

The United States has used its position in the dollar clearing system and SWIFT (Society for Worldwide Interbank Financial Telecommunication) infrastructure to exert coercive financial leverage. Bahaj & Reis (2025) show this gives the Fed, and by extension the Treasury, unmatched capacity to withdraw liquidity from any dollar-dependent counterparty. Freezing $300 billion in Russian central bank assets in February 2022 was the clearest exercise of this capability. The implication is unambiguous: dollar reserves carry political exposure, not standard risk model prices.

We introduce the kinetic risk premium: the escalation from financial coercion to direct military force as a tool of foreign economic policy, exemplified by Operations Absolute Resolve (Venezuela, January 2026) and Epic Fury (Iran, February 2026). This introduces a qualitatively new tail risk into dollar asset valuation, operating through commodity supply disruption, inflation transmission, and erosion of the rule-based order underpinning dollar legitimacy.

The RCCS generates specific, testable predictions. First, reserve portfolio erosion should precede transactional market erosion, because sovereign reserve managers are best placed to respond when pressure builds across multiple fronts. Second, erosion should be non-linear: slow when one pillar is stressed, capable of acceleration when a third weakens, and feedback loops engage. Third, the kinetic risk premium works differently from the others: unlike fiscal deterioration, which is gradual and can be partially reversed, military escalation crosses a line of credibility that is very hard to walk back. Reserve managers in non-aligned economies permanently revise their political risk premium on that currency's assets upward. This asymmetry—gradual erosion in the fiscal and institutional layers but a hard break in the geopolitical layer—is the RCCS's central theoretical claim, and the evidence below confirms it.

The stresses on the RCCS began materialising well before 2025. The 2008 crisis was the pivotal turning point for dollar credibility. Originating in the US subprime market and transmitted globally through dollar-denominated instruments, it showed that the architecture underwriting dollar centrality was also the principal channel of US-originated systemic risk (IMF, 2025).

In RCCS terms, this was the first simultaneous shock to two layers: institutional credibility (governance failures) and fiscal credibility (QE from $900 billion to $4 trillion). The trust premium in dollar assets eroded, Chinese gold accumulation accelerated, and the BRICS financial architecture took shape—activating the RCCS feedback dynamic for the first time. The 2008 shock was reinforced by a second structural force: the chronic current account deficit, which compounds the erosion.

Fiscal expansion widens the trade deficit; more Treasury issuance pushes up rates; higher yields attract short-term inflows that add to the long-run cost of repaying debt (Obstfeld, 2012). US federal debt accumulated at roughly $1 trillion every two months in the second half of 2025. The fiscal dimension of RCCS stress reached a new peak with the One Big Beautiful Bill Act.

The One Big Beautiful Bill Act (OBBBA), signed on July 4, 2025, extended the 2017 tax cuts and is projected by the Congressional Budget Office (2025) to add $3 trillion to the national debt over ten years, raising the long-run budget shortfall to 2.4% of GDP—a 45% increase since the administration took office (Center for American Progress, 2025). For fixed-income markets, wider deficits increase Treasury supply, raise long-term yields, deepen the debt service spiral, and signal an unwillingness to cut spending, on which long-term confidence in the dollar depends.

The 119th Congress also passed the Fiscal Contingency Preparedness Act (FCPA, H.R. 4642, March 2026), mandating annual fiscal stress tests. It carries a double-edged signal: marginal reassurance of fiscal accountability, or, by releasing adverse scenarios publicly, the acceleration of the very reserve diversification it aims to pre-empt.

Moody's downgrade of US sovereign credit in May 2025 completed the removal of the United States from the highest rating tier across all three major agencies, affecting how much capital banks must hold against US Treasury positions and limiting purchases by sovereign wealth funds and insurers whose mandates require top-rated assets. Reinhart & Rogoff (2010) show debt above 90% of GDP suppresses growth—a threshold the United States has exceeded. Combined with the erosion of petrodollar recycling flows, this constitutes compound stress on all four RCCS pillars. Then came the geopolitical dimension.

On January 3, 2026, US Special Operations forces captured Venezuelan President Nicolás Maduro in an operation officially framed as counter-narcoterrorism but widely interpreted as an assertion of the Donroe Doctrine—a reassertion of US resource and security interests across the Western Hemisphere. The operation established effective US control over Venezuela's 303 billion barrels of proven oil reserves, the world's largest.

For sovereign risk professionals, this confirmed the existence of a kinetic risk premium in practice. The 2022 asset freeze had shown dollar reserves carrying foreign policy exposure; Venezuela

extended that exposure to military action in pursuit of economic objectives—a category no existing pricing model captures (IMF, 2025).

Joint US-Israeli strikes against Iranian nuclear and military infrastructure commenced on February 28, 2026, targeting over 2,000 sites; the death of Supreme Leader Khamenei created a rupture in Iranian political authority without precedent since 1979. Brent crude spiked 28% to approximately $80 per barrel as the Strait of Hormuz, through which 21 million barrels transit daily, faced effective closure.

The investment implications diverge across horizons. The dollar index (DXY) rose 3% in the short run—consistent with the pattern of dollar strengthening during supply shocks. In the medium run, the operation deepened geopolitical divisions and accelerated BRICS+ settlement discussions (Catalan & Fendoglu, 2024). Near-term dollar strength should not be read as structural stability. The data confirm the RCCS prediction precisely.

What the Data Show

IMF COFER data—consistent with the RCCS prediction—show the dollar's share falling from 72% in 2001 to 57.7% in Q1 2025, roughly 0.5 percentage points per year. Arslanalp et al. (2022) call this 'stealth erosion': deliberate, distributed, and unpublicised to avoid market disruption [1]. China's US Treasury holdings fell 45% from $1.317 trillion (2013) to $730.7 billion (July 2025), while gold reserves grew to 74.06 million troy ounces (EBC Financial Group, 2025). Gold's share of total reserves rose from below 10% in 2015 to over 23% in 2025 (Federal Reserve Board, 2025)—a shift toward an asset that carries no risk of the issuer defaulting and no political exposure.

The forex market ($7.5 trillion daily) is dominated by five hard currencies. Major pairs such as EUR/USD and USD/JPY are highly liquid, enabling traders to transact in large volumes without materially moving prices—ensuring tighter spreads, lower transaction costs, and minimal slippage. The dollar accounts for 80% of all transactions, the euro for 30%, and the yen for 17% (Federal Reserve Board, 2025). The dollar has been the world's principal reserve currency since the Second World War, giving the United States the structural advantages of low-cost borrowing and the broad reach of its financial sanctions. Reserve primacy carries a cost: persistent global dollar demand keeps the currency overvalued, eroding export competitiveness and contributing to

[1] It is worth noting, however, that not all of the observed decline in dollar reserve share reflects active diversification decisions by central banks. Part of the shift is mechanical: when the dollar strengthens against other currencies, the dollar value of non-dollar reserves falls, which raises the dollar's share as a percentage of the total - and vice versa when the dollar weakens. Changes in which countries report to the IMF over time also affect the headline figure. The underlying diversification trend is real and well-documented, but the pace of de-dollarisation should be read with these technical factors in mind.

job losses as domestic industries shift production to lower-cost countries. Global forex reserves are 58% dollars and 20% euros.

The forex data confirm the RCCS prediction: de-dollarisation is happening in reserve holdings, not in transactional use. Goldman Sachs (2025) reports the dollar's SWIFT share above 50%, near all-time highs. Trade invoicing data show 40–50% of global settlement in dollars—a dominance Gopinath et al. (2020) show is self-reinforcing. Reserve portfolio erosion is outpacing transactional erosion, but further kinetic operations could narrow this gap rapidly.

The euro holds approximately 20% of global official reserves and has benefited from the NextGenerationEU programme, which created a significant pool of supranational euro-denominated bonds. However, the absence of a unified fiscal authority and the fragmentation of eurozone sovereign bond markets continue to constrain its role as a deep and liquid safe-haven asset comparable to US Treasuries; for institutional investors, the eurozone remains a collection of individual country credit risks rather than a single safe instrument (Federal Reserve Board, 2025).

The euro required decades of institutional convergence to reach 20% reserve share; a BRICS currency faces the same obstacles without shared political architecture. Against this backdrop, three forward scenarios are credible.

Given irreducible uncertainty around the political and fiscal variables that will determine outcomes, scenario analysis is the appropriate tool, with distinct implications for capital allocation, currency risk, and corporate treasury strategy.

The most evidence-consistent scenario, assigned an indicative probability of 50-55% [2] over a ten-year horizon, holds that the dollar retains dominant, though contested, primacy across global finance and trade for the coming decade. The supporting pillars are the unmatched depth and liquidity of US capital markets—which Maggiori et al. (2020) document as the world's pre-eminent 'safe asset' destination for institutional capital; the deep habit of pricing and settling trade and financial contracts in dollars; the absence of a single credible alternative; and the continued willingness of a critical mass of global institutions to price, settle, and hold reserves in dollars. The near all-time-high SWIFT share as of January 2025 is the clearest evidence for this scenario. The key triggering condition for its realisation is meaningful US fiscal consolidation: a credible plan to reduce deficits, stabilise the national debt, and restore the creditworthiness damaged by the Moody's downgrade of May 2025. For asset allocators, this scenario implies

[2]The probability weights assigned to each scenario are represent the authors' considered judgment based on the evidence reviewed, and should be read as indicative rather than precise. Their purpose is to help structure strategic thinking, not to forecast specific outcomes.

sustained demand for US Treasuries as the default global safe asset and continued dollar funding advantages for US multinationals.

The second scenario, assigned an indicative probability of 30-35%, envisions a gradual transition to a multipolar currency system in which the dollar, euro, and renminbi collectively share the reserve and settlement functions, with the dollar retaining a plurality. History offers a partial precedent in the 1920s, when sterling and the dollar coexisted as rival reserve currencies, suggesting such transitions are possible but slow. Its primary triggering conditions are partial renminbi capital account liberalisation, deepening of EU bond markets through supranational issuance, and a sustained but sub-critical level of US fiscal deterioration that motivates diversification without precipitating a disorderly exit. For institutional portfolio managers, this scenario implies a meaningful shift in how central banks allocate their reserves over a ten to fifteen-year horizon, with knock-on effects for government bond yields, currency volatility, and the baseline interest rates that underpin global asset pricing. Sustained institutional trust and cooperative governance are the necessary preconditions—both set back, though not foreclosed, by the kinetic operations of 2026.

The most adverse scenario, currently assigned an indicative probability of 15 to 20% but rising, involves a fracture of the international monetary system into geopolitically defined currency blocs: a dollar zone anchored in the Western alliance and a BRICS+ zone anchored on the renminbi, bilateral swap lines, and central bank digital currency infrastructure. The IMF (2023) and Catalan & Fendoglu (2024) estimate that severe fragmentation of this kind would result in output losses of 2% to 7% of global GDP. Its primary triggering conditions are a further escalation of US-China rivalry into a full split of their financial systems, a sharp and disorderly US fiscal adjustment that destroys foreign confidence in the depth of the Treasury market, or a second major exercise of the kinetic risk premium that prompts coordinated reserve flight among non-Western sovereigns. For multinational corporations, this scenario implies duplicated treasury operations, structurally higher transaction costs, reduced capital mobility, and the need to manage liquidity positions across competing currency systems simultaneously. For global financial institutions, it implies the potential splitting of global banking and payment networks into two separate systems. The probability of this scenario has increased materially since early 2026. The Venezuela and Iran operations are precisely the kind of geopolitical discontinuity that reserve managers in non-aligned economies are not designed to absorb passively, and the institutional response has already begun. The strategic implications for practitioners follow directly.

Implications and Outlook

The analysis generates concrete implications across three domains.

Reserve and Portfolio Management: For sovereign wealth funds and institutional reserve managers, the evidence supports accelerating diversification already underway: increased allocations to gold, non-traditional reserve currencies (Singapore dollar, Swiss franc, and Australian dollar), and bilateral settlement mechanisms that reduce exposure to the kinetic risk premium. Existing risk models do not adequately price geopolitical tail risk; a reserve manager treating US Treasuries as risk-free is underestimating real-world exposure in a post-2022 world (IMF, 2025). The kinetic risk premium is not yet a standard quantified variable, but its absence from portfolio risk models is a gap practitioners should address proactively.

In practical terms, reserve managers can begin to track the kinetic risk premium through four observable signals: the spread between gold and US Treasury yields at equivalent duration; the pace of bilateral swap line activation among BRICS+ central banks; the share of oil settlement denominated outside the dollar; and sovereign CDS spreads on dollar-reserve-heavy economies relative to their fundamental credit profiles. A reserve manager monitoring these four series in combination has a real-time dashboard for the premium—imperfect, but substantially better than ignoring them.

Corporate Treasury and Supply Chain Strategy: The 20% of oil traded outside the dollar, growth of renminbi-settled trade within BRICS+, and proliferation of bilateral swap lines signal a trading environment in which dollar-centric treasury assumptions require reconsideration. Firms with supply chain or revenue exposure to non-Western markets should develop multi-currency treasury capabilities, map operations against the three scenarios, and build contingency liquidity facilities in non-dollar currencies for Scenario Three conditions (Aiyar et al., 2023). The fragmentation scenario is not imminent, but the optionality cost of preparation is low relative to the disruption cost of unpreparedness.

For Indian firms, the UPI-based cross-border payment infrastructure—already live with Singapore, the UAE, and several Southeast Asian economies—offers a non-dollar settlement channel with real scale. The expected value of building rupee-denominated payables capability is positive under all three scenarios.

Sovereign Credit and Fixed Income: For fixed-income investors and credit analysts, the interaction of OBBBA fiscal expansion, the Moody's downgrade, and the erosion of petrodollar recycling flows into the US Treasury market constitutes a structural imbalance in Treasury supply and demand that is not yet fully reflected in term premium pricing. The ten-year US Treasury term premium, which turned positive in late 2023 after a decade near zero, is likely to widen further as fiscal supply increases and the marginal foreign buyer becomes more price-sensitive. The structural pressure from the reserve currency bind is tightening, and the risk-adjusted value proposition of US Treasuries as the global safe-haven asset is narrowing on a medium-term

investment horizon.

The portfolio positioning implications are concrete. On the rates side, long-duration US Treasuries are structurally disadvantaged: rising fiscal supply, fewer foreign buyers willing to absorb new supply, and the Moody's downgrade point to sustained widening of the term premium, making the strategy of holding longer-dated dollar bonds a risk rather than a safe haven. The more attractive positioning is short-duration dollar instruments combined with selective emerging market local currency bonds in economies with credible fiscal frameworks and non-dollar settlement infrastructure—India, Indonesia, and Gulf Cooperation Council members being the clearest candidates. On the equity side, multinationals with deep non-Western revenue bases and natural currency hedges, revenues in renminbi, rupees, or dirhams matched against local cost bases, are structurally better positioned than dollar-revenue-concentrated peers in a Scenario Two or Three environment. These are not speculative bets on dollar collapse; they are rational adjustments to a risk already materialising in the data.

For emerging market strategists, India's bilateral energy settlement model, rupees and dirhams for Russian oil, offers the clearest template for how sovereign actors can pursue practical de-dollarisation in specific trade relationships while retaining strategic flexibility at the systemic level. For the broader Global South, the structural cost of dollar hegemony, holding low-yielding Treasury reserves that effectively subsidise US consumption, has now been compounded by the kinetic risk premium. Geopolitical exposure on dollar reserve holdings is no longer a theoretical risk; it is a demonstrated one, with two precedents established in 2022 and 2026. The broader picture is one of gradual but consequential structural change.

This paper has examined the dollar's position through the lens of four institutional pillars, three analytical frameworks, and a body of current data that together make the case for structured strategic reassessment rather than either complacency or alarm. The dollar's current risk profile cannot be assessed without understanding the architecture that created its dominance.

Each of the four pillars is under measurable stress: the 2008 crisis eroded the trust premium built into dollar assets; the chronic current account deficit tightens the structural pressure inherent in reserve currency status; the OBBBA's fiscal expansion compounds an already deteriorating sovereign credit profile; and the military operations of 2026 have introduced geopolitical risk that markets do not yet know how to price.

The dollar is not on the brink of displacement. It is navigating a gradual structural erosion of the fiscal discipline, institutional credibility, and strategic legitimacy on which reserve currency status depends. The RCCS framework developed in this paper explains both the resilience and the risk: with the institutional and energy layers still partially intact, network effects sustain transactional dominance even as the fiscal and geopolitical layers deteriorate. The critical

multi-pillar threshold has not been crossed. But the 2026 kinetic operations have weakened the geopolitical layer in a manner qualitatively different from fiscal deterioration—it is harder to reverse, and it feeds back directly into institutional credibility by undermining the rule-based order on which dollar legitimacy depends. This paper's assessments are analytically derived rather than econometrically estimated and should be read as a framework for structured inquiry rather than calibrated forecasts. Three research directions follow: formal quantification of the kinetic risk premium using CDS spreads and gold allocation data; empirical testing of whether reserve portfolio erosion leads or lags transactional dollar erosion; and a survey-based study of how multinationals are restructuring treasury operations in response to IMS transitions. The events of 2025-2026 have made these questions operationally consequential. The central variable remains whether the United States restores the fiscal discipline and strategic coherence that reserve currency primacy demands. On the evidence available, that question is unresolved.

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