The Dollar, the Sort-Of Dollar, and the End of the Power of Exorbitant Privilege: What Stablecoins Mean for Reserve-Currency Status

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Before the
National Security Forum
Cosmos Club
Washington, D.C.

August 12, 2025

- Currencies rely on confidence and no currency needs confidence more than a reserve currency, but confidence in the U.S. is fading and thus so is that in the dollar.
- Threats derive from reduced faith in the U.S. rule of law, central-bank independence, foreign-policy coherence, and cross-border commitment. Treasury-market size and stability counter these risks, but also only so far and perhaps not for all that long.
- Dollar-denominated stablecoins could offset these risks, possibly even to a considerable extent. But, for that to happen, the use case for stablecoins would need to be clearer than it is today and, should stablecoin use materially grow, then new threats to Treasury-market stability would need to be countered.
- Economic statecraft has now turned into economic warfare. The dollar's status could be one of its casualties at grave cost to national security and economic stability.

Thank you, Randy. It's a pleasure to participate in the astute discussions that are a hallmark of this distinguished group. Almost two years ago in a talk here,[1] I concluded that the dollar's reserve-currency status and the awesome, if soft, power it accords the United States was secure. I will not now revisit the reasons I then provided for my expectation of continuing global faith in the U.S. rule of law and policy stability. But just mentioning these critical attributes of reserve-currency status makes clear how much has changed since Donald Trump's inauguration. As a result, the dollar's seemingly impregnable reserve status is increasingly uncertain.

Thanks in large part also to Mr. Trump, U.S. policy has taken another radical U-turn when it comes to the digital assets that are less politely called cryptocurrency. Treasury Secretary Bessent is confident that one form of cryptocurrency – "stablecoins" – will reinforce U.S. reserve-currency power.[2] I'm not so sure and thus will assess the considerable impact stablecoins will have under the new U.S. framework signed into law just last month.[3]

I conclude that the U.S. dollar is still almighty, but key Trump Administration actions threaten the pillars on which it rests, with stablecoins potentially making the dollar both a go-to option in volatile emerging and frontier markets as well as a threat to the global financial-market stability on which the dollar's prestige most importantly rests. Data to date indicates the death of the dollar is greatly exaggerated, but data do not foretell a future marked now by so much uncertainty and challenge to what once seemed unshakeable tenets of U.S. exceptionalism. As is often said, "In economics, things happen more slowly than you think they will but then happen faster than you thought they could."

Doubting the Dollar

The most recent Federal Reserve analysis of the dollar's status correctly observes that:

> For most of the last century, the preeminent role of the U.S. dollar in the global economy has been supported by the size and strength of the U.S. economy, its stability and openness to trade and capital flows, and strong property rights and the rule of law.[4]

The Fed is not allowed to opine on these somewhat subjective criteria and doubtless is even more loath to do so now given the President's relentless fusillade against Chair Powell. I am bound by no such constraint and can thus bring out the point the Fed intends by this observation: the dollar now seems unstoppable, but the premises that prop it up are unpredictable.

As I detail in my recent book,[5] all currencies are confidence games unless they are either a collateralized payment instrument such as a gold coin or a desired consumption item such as a chicken or goat. We have confidence in the dollar not because it's a thing of inherent value, but because we have confidence in the government that issues the "fiat currency" used to honor its obligations and thus make a currency both a reliable store of value and trusted medium of exchange.

As is immediately obvious in the new, "let's make a deal" world of U.S. fiscal and foreign policy, the confidence that undergirds the dollar is increasingly uncertain. Even before Mr. Trump rattled so many cages, sanctions and fears about U.S. fiscal policy gradually eroded the dollar as a percentage of foreign-government reserves from a high of 72 percent in 2001 to 58 percent as of the Fed's most recent report,[6] and the percentage of foreign ownership has dropped dramatically even after taking the Fed's huge stake into account.[7] Still, the dollar remains the world's dominant store of value via Treasury bonds and preeminent medium of exchange in international trade and non-commodities financial transactions.[8]

What Could Go Wrong

Since currencies are at bottom nothing more than a confidence game, challenges that shake confidence undermine currencies. Currencies that are reserve bastions across the globe need confidence even more than other currencies, but the U.S. is in danger of squandering this critical geopolitical and economic asset.

One imminent risk is lost confidence in the U.S. central bank. All the trillions housed in U.S. Treasury obligations are bought and sold every day based on what traders believe are rational assumptions about

U.S. monetary policy and the interest rates it transmits. This doesn't mean the markets think the Fed is always right—far from it. But the market does think the Fed does its best to be right, making its pronouncements reasonable guides for interest-rate expectations. If the central bank instead tries to make the President happy no matter its views on his correctness, then faith in the dollar will ebb – maybe fast.

Concerns over Fed independence are echoed in still broader growing worries about the U.S. rule of law. A recent study found not only that two-thirds of reserve managers around the world fear the loss of Fed independence, but nearly half also fear this for the rule of law in ways that could quickly change their asset allocations.[9] The same survey found that 35 of the forty responding central banks fear arbitrary U.S. actions adversely affecting the tenor or return on the Treasury obligations they hold either as an act of political retaliation or an effort to do something about the fiscal cost of growing U.S. debt.

Another risk to the Treasury market derives from the Trump Administration's continuing chaos when it comes to the Internal Revenue Service. As of the end of last week, the IRS has lost its fifth Commissioner since the incumbent in this usually apolitical job was forced out shortly after the inauguration.[10] Reports indicate so much basic systems chaos that the last commissioner contemplated delaying the tax-filing season. This or any other revenue-inflow delay or – far worse – interruptions threaten the Treasury market because the funds for interest payments must come from tax revenues received by Treasury for this and every other purpose of the U.S. government. Even a glitch could be systemic in terms of Treasury-market stability and the dollar's place in the world.

Treasury-market instability, let alone illiquidity, would be an immediate and potentially devastating threat to the dollar, but a slow death is also dangerous. Like all assets, Treasury obligations are subject to supply/demand dynamics. These are not looking good. U.S. fiscal deficits are expected to dramatically push up supplies of Treasury obligations, especially at the short end of the maturity spectrum, altering the yield curve and generally increasing the price the market demands to hold longer-term Treasury obligations. One bank has estimated that each one percentage point decline in foreign ownership of Treasury obligations compared to U.S. GDP raises yield by 33 basis points, an effect I think would be considerably larger if the Federal Reserve's expected portfolio reduction continues and supply thus increases still more sharply.

Also, the dollar's privileged status and resulting soft power are largely an artifact of our allies. The major competitors to the dollar in terms of reasonable volume and sound national architecture are the EU, Britain, and Japan. If these nations rethink just how close they want to get to the U.S., then new sovereign-bond options will develop followed by alternative reserve currencies.

If reserve-currency alternatives are digital, then they will challenge the U.S. even more directly and more quickly in the absence of the central bank digital currency (CBDC). Although the Trump Administration abhors a CBDC,[11] the Chinese are moving apace with so-far successful efforts to use the CBDC it and other nations have established to circumvent dollar-clearing.[12] These challenges will also take time, but once the process of undoing the dollar begins, it will be difficult to reverse.

The Stablecoin Wild Card

Let me now turn to another new phenomenon: stablecoins. These could reinforce the dollar's reserve-currency status, but then again, maybe not. Who uses stablecoins for what will determine the threat or benefit of these new financial instruments.

First, though, what are stablecoins? The name is a PR-inspired effort to differentiate one form of cryptocurrency from bitcoins and many others that depend entirely on the confidence of the beholder. Like old-fashioned gold coins, stablecoins are intended to be digital simulacra of collateral with underlying tangible value. For stablecoins, these backstops are called "reserve assets" and, under the new U.S. law, reserve assets are to match outstanding stablecoin values dollar for dollar. Eligible reserve assets are short-term Treasury obligations, liquid bank deposits, and a few other high-quality, liquid assets.

Even assuming the entirety of stablecoins is in Treasury obligations and stablecoin outstandings quickly reach the $3.7 trillion forecast by Secretary Bessent,[13] this could significantly spark demand for Treasury obligations and reinforce the dollar's reserve-currency status by reducing the damage done by growing foreign doubts and increasing alternatives to the dollar. On the other hand, simply having a reserve asset does not mean you can retrieve it instantly and at full value. The new stablecoin law is intended to prevent rehypothecation – i.e., using the same collateral more than once—but whether it does so in practice is yet to be seen. If it doesn't, then it will be difficult to ensure that stablecoin holders get their money back as seamlessly as insured-bank depositors.

A run on stablecoins could also threaten bank depositors if stablecoin issuers pull their reserve-asset deposits in a rush to honor claims. Think SVB's viral run and the crypto-fueled collapse of Signature Bank. Notably, it was only the U.S. decision in the course of the March 2023 crisis to back all deposits, not just insured funds, that prevented the sudden failure of Circle, one of the world's two largest stablecoin issuers.[14]

And, even if rehypothecation is prohibited and there is no bank run, nothing in the law or likely rules bars stablecoin issuers from maximizing the income they receive on the reserve assets they hold. This is the primary source of issuer income and thus profit maximization is for sure. Issuers could, thus, for example, engage in high-reward, high-risk "basis" trading in Treasury obligations – a way to make a lot of money in this market until you don't.

Further, Treasury obligations in the last few financial crises have been more the spark of the crisis than its cure. For example, the 2020 crash was what has come to be known as a "dash for cash" – that is, Treasury holders needed cash to honor their obligations much as stablecoin issuers will need to do in stress scenarios, but the only people willing to buy Treasury obligations paid far less than expected. This was a "fire sale" that poses systemic risk across the market and a threat to stablecoin holders, who will need to take their pace in the line of counterparties hoping for cash. A recent study found that stablecoin outflows have dramatic and asymmetric impact on Treasury-bond pricing, possibly threatening financial stability.[15]

But, for stablecoins to become a real dollar backstop or Treasury-market threat or both, someone has to want to use them. Current outstanding obligations equal about $220 billion,[16] making Mr. Bessent's $3.7 trillion expectation a significant reach, especially in a short period of time. Would anyone really use stablecoins for anything but sanctions evasion and illicit finance along with executing crypto asset transactions at the eight percent or so of U.S. households that hold them.[17]

The answer is likely yes: stablecoins do have some legitimate purposes despite the ease with which they can be used for ill and in the crypto ecosystem. One almost certain use is, as I mentioned earlier, by emerging and frontier economies. Many of these already link their currencies directly or indirectly to the dollar and all of them have banking and payment systems that can at best be described as problematic. Stablecoins may provide a way for people and even nations to access the global financial system with fewer barriers and at greater speed than is now the case. The ability to bypass law-enforcement and sanctions guardrails only makes this all the better for many of these nations, some of which are already significant stablecoin users and regulatory, tax, or illicit-finance havens.

Despite the small number of Americans who use crypto, the other use case is in the United States. This is overlooked in a recent Bank for International Settlements study of stablecoins and their dubious value proposition,[18] but it's significant. The U.S. is the only nation that regulates the fees banks may charge merchants for processing debit cards, with credit-card interchange fees also set a lot higher than merchants think reasonable. A court decision on August 6 threw the debit-card fee standard into limbo,[19] but credit-card fees remain high, and all interchange fees are a major cost of doing business for thin-margin retailers and giant tech-platform firms.

These firms face few stablecoin-implementation obstacles and have many rewards readily at hand to persuade customers to use them. Although interchange fees are a unique American consideration, the largest retailers and all the tech-platform firms are global powerhouses. Should they start issuing and accepting stablecoins, these payment instruments could well become part not only of high-risk national economies, but also of global consumer payments.

Given these varying considerations, it's simply too soon to say if stablecoins will foster dollarization and enhance U.S. Treasuries, thereby lowering their issuance cost without destabilizing this super-critical system. Similarly, it's too soon to say if stablecoins will be a niche feature of global payments, keeping smaller nations tied to the dollar and encouraging laggards to join this club. And, even if giant firms issue stablecoins, will consumers be willing to accept them? What if stablecoins turn out not to be the friction-free and easy payment instruments advocates hope or become the high-risk drivers of busted transactions that send early adapters flooding back into fiat currency? Unless or until the future of stablecoins is clear, the fate of the dollar rests on other planks, all of them showing signs of considerable wear.

Conclusion

In a recent *Foreign Affairs* article,[20] a Biden Administration senior official warns that:

> …[E]conomic warfare is no longer the exception. It is now the main arena of great-power competition. Yet economic statecraft holds both power and peril. Unbridled economic coercion can fracture global markets, entrench rivalry between blocs, and breed instability that risks triggering the very kinetic conflicts it aims to avoid. … If the United States is to maintain its unique leadership role in the global economy, it must clearly define the objectives of economic statecraft, create the institutional capacity to match that mission, and embrace a more positive vision for the use of economic tools.

This may seem partisan, but the article goes on to critique the Biden Administration's role accelerating the U.S. towards the high-stakes economic statecraft under President Trump. It was, after all, the Biden Administration that dramatically ramped up sanctions, took the unprecedented step of freezing Russian assets, and—with far less justification—blocked the Nippon takeover of US Steel. As I said, challenges to the dollar's primacy precede Donald Trump.

But, Mr. Trump's sanctions and tariff policies have turned economic statecraft into economic warfare at a time when the Administration is also undermining the certainty of U.S. law and rule, pushing the U.S.

outside the cross-border settlement system, accelerating the over-supply of U.S. Treasury obligations, and fostering cryptoassets without aligned safety-and-soundness, resolution, or customer and investor protections. This is not wholly unintentional. An influential 2024 paper from Council of Economic Advisers head Stephen Miran creates what some call the “Mar-a-Lago Accord.” Under it, foreign nations are to pay for U.S. economic and geopolitical backstops via a weakened dollar, tariffs, and sanctions.

Nations will naturally balk at so high a price for a U.S. umbrella that the Trump Administration already seems to move or close at unpredictable will. Adversaries such as China and Russia were already waging open war against the dollar while rogue nations such as North Korea continue to do all they can to destabilize dollar clearing, settlement, and payment systems. While not yet necessarily going on the offensive against the dollar, our longest and closest allies are now building strong defenses against continuing dollar dependence not only with new sovereign-bond instruments, but also with accelerating national efforts to build digital currencies that hope to combine the benefits of stablecoins with the protections of fiat currency.

The word “statecraft” connotes forward-looking policies set with discipline, care, and alignment with other national objectives. At present, U.S. economic statecraft evidences none of these attributes, meaning that the U.S. will either prosper in its ongoing economic warfare by brute strength or subside into a more uncertain, multi-polar system in which the dollar matters less and less at greater and greater cost to taxpayers, American households, global competitiveness, and financial stability. That’s hardly an ideal outcome from the U.S. perspective, but it’s one that seems surprisingly likely.

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