The Rise and Fall and Rise (and Fall) of the U.S. Financial Empire

The dollar is dead. Long live the dollar.

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January 15, 2021, 10:27 AM
Joan Wong illustration for Foreign Policy

If 2020 confirmed one thing, it was the centrality of the dollar to the global economy. U.S. hegemony may already have passed us in a political and strategic sense, but U.S. financial influence is proving more enduring. This is reassuring in the sense that the U.S. Federal Reserve has once again acted as a responsive and generous steward of the dollar-based financial system. But it is also a cause of puzzlement and frustration.

While China and Russia experiment with alternatives to the dollar-based payment system, in Europe the buzzword of the day is “strategic autonomy.” Given the increasing aggression of Washington’s financial sanctions, compounded by the capriciousness of the presidency of Donald Trump, this is hardly surprising. It is an obvious reaction to the weaponization of interdependence.

It is far from obvious to critics that dollar hegemony is an unalloyed blessing. Inequality, deindustrialization, and the loss of well-paid and secure blue-collar jobs can all be blamed on the dollar’s strength. In that sense, the dollar’s standing and Trumpian populism are not so much contradictions as functionally interconnected. One helped cause the other.

Little wonder that visionary investors such as Ray Dalio of Bridgewater, the world’s largest hedge fund, advise anyone who will listen to prepare for a future beyond the dollar. In explaining his determination to back China, Dalio points to the rise and fall of other financial empires, a recurring cycle that stretches back over half a millennium.

But are history’s lessons really that obvious? The dollar has been prominent in the world economy for just over a century, a period in which we have seen the largest explosion of population, economic activity, and state violence to date, a complete rupture on many metrics with any previous epoch in the history of our species. It’s fitting, therefore, that what we sometimes describe as a dollar system is not so much a well-defined and clearly
delineated institution than a constantly evolving assemblage tracking the staggering transformations of the real economy and the international power system. Periods of coherence in which monetary and financial policy were neatly aligned with the grand strategic posture of the American empire were brief. Contradictions are the norm, and those of the current moment are by no means the most egregious. It is a history punctuated by crises. Talk about the end of dollar hegemony started half a century ago, in the 1970s, the period during which *Foreign Policy* was founded. Yet the dollar has continued to dominate the world economy.

What allows it to do so is improvisation and action on the part of U.S. policymakers and businesses and the choices of their counterparts around the world. In gauging the future of the dollar as the world’s key currency, history should indeed be our guide. But not history in the sense of grand lawlike cycles. Our world is too complex, too protean, too radical for that. The history that we need to understand is a tangled skein of discreet actions and innovations. It is a history of power and money, in which the future is not foreordained but still very much in play.

The sudden rise during World War I of the United States as the world’s financial hegemon came as a shock. In the diplomacy of the July crisis of 1914, America was less relevant than Serbia. If you assumed that the war would be over by Christmas, as many did, then economics was irrelevant to the war, too. By 1916, with the meat grinders of Verdun and the Somme consuming men and materiel on an unimaginable scale, it was clear that everyone in the world needed dollars, the currency that offered access to the last great pool of raw materials, industrial capacity, and labor that was not already mobilized for the war. When the United States did eventually join the war, the result was that taxpayers in Britain, France, Italy, and Russia ended up owing taxpayers in the United States billions of dollars, a novel and toxic combination.

After the war, the Europeans, led by John Maynard Keynes, together with cosmopolitan bankers on Wall Street requested debt forgiveness. The less America asked for, the lighter the burden of reparations could be on Germany; a revived Europe would be good for democracy and for business.

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It was a big request—one that forced the central problem of 20th-century hegemony squarely into view. For the United States, designing the League of Nations was a responsibility with rather little burden. But now it was being asked to arbitrate real economic trade-offs between domestic and international interests. In Britain’s Victorian heyday as guarantor of the global financial order, the flow of funds from London to the
rest of the world was the equivalent of many Marshall Plans per year. But that was private money. After World War I, it was taxpayers who were on the hook at both ends. The first era of dollar preeminence was political through and through. And that didn’t sit well with U.S. democracy.

Victorious but depleted after World War I, London now challenged the Americans to join it in forgiving the debts of Russia, France, and Italy. But Britain found no willing partners. With the Republicans ruling Washington, not only did the United States refuse to make generous concessions on the war debts; it returned to protectionism, raised barriers to immigration, and savagely deflated its economy, sucking gold out of the coffers of central banks around the world. Even if its former associates in the war wanted to pay their war debts, it was virtually impossible for them to do so. Adding new private loans from Wall Street on top of the wartime debts only compounded the problem. The United States was conducting a perverse experiment in being both a global creditor and running a trade surplus at the same time.

Isolationism doesn’t describe America’s failure in the interwar period. The real problem was the incoherence of its engagement with the world, which left liberal elites in Europe and Japan who banked on the greater exercise of American power cut adrift, prey to the pressures of unmanaged financial markets and domestic political discontent. That was the backdrop of the slide into authoritarianism of Italy, Germany, and Japan. By the early 1930s, America’s financial policy was so egregiously incoherent that even France and Britain defaulted on their war debts to the United States. Lend-lease, the famous assistance program of World War II, was structured precisely to avoid the issue of war debts arising again.

In 1944, the Bretton Woods conference laid out a new vision. It was supposed to square the stability of fixed exchange rates anchored on the dollar, with limited capital mobility for the useful purposes of trade and investment. With the U.S. currency anchored on gold, and everyone else tied to the dollar, the hierarchy was more explicit than ever before. It was not so much a gold standard as one based on the dollar.

But Bretton Woods did not work and not because of American profligacy—it was the reverse: a desperate global shortage of dollars. Given the debilitated state of Europe’s economy after the war, even limited exchanges of European currencies for dollars easily resulted in a run. That became evident in the summer of 1947, when Britain, the only country to attempt to implement Bretton Woods immediately after the war, suffered a debilitating crisis and fell back into reliance on bilateral U.S. funding. A market-based remedy would have been a giant devaluation of all European currencies, but amid rising
tensions with the Soviet Union, that was too risky. Instead, on a tide of anti-communism, the U.S. Congress voted for the Marshall Plan—not so much a complement to Bretton Woods as an admission of failure.

It was not until 1958 that the basic commitment of Bretton Woods to convertibility of currencies for trade and investment purposes came into effect in the Atlantic economy. The postwar crisis of universal dollar shortage was finally over. Japan and the European economies were strong enough either to earn dollars through exports to the United States or by trading with those who did. Indeed, if the market had been allowed to set the price of the U.S. currency, it would have trended down against those of the champion exporters, Germany and Japan. But Bretton Woods was a system of fixed exchange rates. Exchange controls prevented speculative attacks on the dollar.

Source: European Central Bank and International Monetary Fund
If Japan and Germany had been willing to allow inflation at home, that would have helped maintain balance. But Germany in particular resisted that mechanism of adjustment. And to make matters worse, the system was porous. Wall Street and its allies in the U.S. Treasury never liked Bretton Woods. They would have preferred the world’s currencies simply to adjust to whatever level markets dictated, and they found allies in London, which, from the 1950s, played host to an offshore market for dollar deposits, known as the eurodollar market. On the basis of those deposits emerged a freewheeling market for cheap dollar credits. This was attractive for borrowers of all kinds. The first big eurodollar deal helped finance Italy’s new motorway system.

But the increasing flux of unregulated private funds challenged the official currency pegs. It was clear that if the market had operated freely, the dollar would have dropped hard. Tools such as central bank swap lines, which were to come back to the fore during the 2008 financial crisis, were first pioneered in the 1960s to keep the Bretton Woods system afloat. Even in its heyday, dollar hegemony was something of a Rube Goldberg contraption.

The anchor of the fixed exchange rate system was supposed to be America’s fabled gold reserve at Fort Knox. But by 1970, the year when Foreign Policy was founded, just $11 billion in gold backed $24 billion in dollar exchange reserves held outside the United States. Clearly not every one of those paper dollars could be cashed for gold. The dollar-gold peg was a convenient fiction. When, in 1965, France began exercising its right to exchange dollars for gold, it was met with accusations of extortion from America. To maintain the official price of $35 per ounce of gold, the U.S. government suppressed private gold purchases for much of the 1960s. It was better not to know what the dollar was really worth.

In August 1971, U.S. President Richard Nixon announced that the United States was ending convertibility of the dollar. When he was warned that this move might shake the confidence of Cold War allies in Europe, particularly Italy, Nixon responded, “I don’t give a shit about the lira.”

And so the modern era of fiat money was born. For the first time in history, no currency in the world was tied to gold or any other metallic standard. The value of money would rest purely on the authority of the state as judged by markets. And the verdict seemed clear. The dollar plunged in value, giving American exporters a much needed fillip. Japan and Germany faced the surge in their currencies they had long resisted. In the Winter 1971-72 issue of Foreign Policy, one article was headlined, “How the Dollar Standard Died.”

As the dollar slid against the Deutsche mark and the yen, that meme would circulate ever more widely. The modern system of summitry around the Group of 7 nations was created to help manage the resulting pressures. Fearing for his country’s exports, Helmut
Schmidt, Germany’s ferocious chancellor of the 1970s, demanded that U.S. President Jimmy Carter put America’s house in order to stop the dollar’s relentless slide. OPEC began considering whether to price its oil on a more reliable currency. The Special Drawing Right, the synthetic currency of the International Monetary Fund (IMF), was one option.

The first, and to date most serious, crisis of dollar hegemony ended in October 1979 with Paul Volcker’s decision, as Federal Reserve chairman, to allow interest rates to surge, sending a shock through the global economy. That sent the dollar soaring. But more important than the steep ascent of the dollar’s value was the mechanism by which the shock was transmitted: the ever greater flux of hot money between the financial centers of the world.

After bursting the limits of Bretton Woods, liberalized currency and financial markets boomed. And the dominant drivers of this new era of financial growth were Wall Street banks, whether in New York or London. What mattered was not the exchange rate of the dollar or formal arrangements of the Bretton Woods type but the depth and sophistication of the financial markets superintended by Wall Street. The center of foreign exchange trading may have remained in London, and the value of the U.S. currency may have fluctuated, but it was the dollar and the major American banks that were the pivot of every trade.

The promise of this new order was flexibility, an efficient reallocation of resources, and growth. In terms of GDP, the results were modest compared with the golden age of the postwar period. But the financial boom was huge. And this spilled over into a new wave of dollar-denominated international lending. The upshot was more frequent and severer crises, not just of debtors but of those who lent to them. The 1980s debt crises in Latin America were so large that they jeopardized the U.S. banking system itself.

In Eastern Europe, the stability of the Soviet bloc was threatened. By 1988, the communist bloc owed $112 billion; the Soviet share alone was $28 billion. Moscow used much of the cash to pay for grain imports to offset the failures of collectivized agriculture. But servicing the debts required a surplus, and that meant squeezing the population. This was most dramatic in Poland, the champion communist borrower, which came to owe $37.5 billion. In the early 1980s, austerity policies by the communist regime triggered the Solidarity trade union protests and the declaration of martial law.

The collapse of the Soviet bloc opened the door to a new era of unipolar dominance by the dollar. There were parts of post-Soviet Eastern Europe where Germany’s Deutsche mark was the de facto standard, notably in war-torn former Yugoslavia. But in general the greenback became king, the world’s de facto global currency—even in Russia. When Vladimir Putin took power, the Russian Treasury preferred to have taxes paid in dollars.
At the height of unipolar hubris, *Time* magazine dubbed Fed Chairman Alan Greenspan, Treasury Secretary Robert Rubin, and Deputy Treasury Secretary Lawrence Summers the committee to save the world. That was grandiose. But the world did need saving. The debt crises of the 1980s blended into those of the post-Cold War period: first Mexico in 1994-1995, then the Asian economies in 1997, then Russia in 1998—which spilled back to Wall Street by way of the hedge fund Long-Term Capital Management—and finally the traumatic crisis in Argentina in 2001.

In trying to manage these shocks through a combination of new loans, debt restructuring, and so-called structural adjustment, the U.S. Treasury and the Fed faced constant resistance both from the victim countries that railed at the infringement of their sovereignty and from a U.S. Congress that resented aid for foreign countries. The European votes on the IMF board carped that the whole regime only encouraged irresponsible financial expansion. Not for nothing, Timothy Geithner, who cut his teeth in international financial diplomacy as assistant secretary and undersecretary for international affairs in the U.S. Treasury Department under President Bill Clinton (and would become treasury secretary under President Barack Obama), would later describe the efforts of those days as “defying gravity.”

The damage done to the legitimacy of debtor regimes such as Suharto’s Indonesia and to the institutions through which the United States acted, notably the IMF, was severe. The solution as far as many emerging markets were concerned was to limit their exposure by cultivating sovereign borrowing in domestic currency rather than dollars. The IMF’s client list shrank from year to year as governments sought to avoid the odium of submitting to the Washington Consensus. Beijing drew its own conclusions.

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Undergoing a dramatic opening up and the transformation of its economy, China was determined to avoid the fate of its emerging-market peers. It pegged its currency to the dollar at an undervalued rate, used exchange controls to regulate the flow of funds to those that were essential for trade and long-term investment, and quashed inflation and any domestic discontent that arose as a result. The violent suppression of the Tiananmen protests in 1989 showed that there would be no Solidarity in China.

In economic terms, China’s was the strategy that the Europeans and Japanese had successfully used in the 1950s and 1960s. Not for nothing did economists dub the new configuration a “revived Bretton Woods.” The difference was that whereas the Germans and Japanese were aligned members of America’s Cold War power bloc, China in the new millennium was not.

For American consumers, this latest iteration of the dollar world meant cheap imports. Wall Street made fat fees on the capital flow. American workers in manufacturing faced fierce competition. Not that the United States was the only economy hit by the “China shock.” European imports from China surged, too. What the China shock exposed was the degree to which the countervailing force of organized labor that had limited inequality in
the United States in the wake of the New Deal and World War II had, since the 1970s, been disempowered. If Bretton Woods 1.0 had been the counterpart to the “Great Society,” Bretton Woods 2.0 put the cap on an era of massive social polarization. By contrast, Europe’s welfare states to a considerable extent cushioned the China shock.

This is all the more striking because it coincided in Europe with the move to the formation of a hard currency euro bloc. After a brief period of uncertainty following its inauguration in January 1999, the euro soared against the dollar from a low of less than 86 cents in September 2000 to a high seven years later of almost $1.60.

From its original conception, one of the purposes of the euro was to provide an alternative to the dollar as a key currency. And in the early 2000s, it seemed to be gaining real momentum. By 2007, the euro was beginning to rival the dollar as a currency for foreign currency-denominated debt issuance. With America bogged down in Iraq and Afghanistan and huge deficits both in government budget and trade, it seemed that we were returning to the script of the 1970s and the inevitable demise of the dollar under the burden of overstretched empire.

The meltdown arrived on cue in 2008, but it was not the one expected. It was not a crisis of U.S. public debt and the dollar but of the entire North Atlantic banking system, both American and European. Bankers in London, Paris, Frankfurt, and the Netherlands had all, it turned out, wanted a piece of the U.S. mortgage boom. Large parts of their balance sheets were denominated in dollars. Now they all needed dollar credit. Rather than overturning the dollar-based global financial system, the 2008 crisis exposed a profound dependence on America.

The Fed did its best to support the trans-Atlantic banking system by pumping dollar liquidity both to European and Asian banks in New York and to their central banks by way of liquidity swap lines. But this could not stave off Europe’s spiraling crisis. The euro area slid into a full-blown sovereign debt crisis. Whereas America’s federal government balance sheet stood strong during the crisis—U.S. sovereign debt was a safe haven, despite congressional shenanigans and a federal shutdown—Europe was menaced by so-called doom loops, in which ailing banks dragged down government credit ratings, which left the state unable to support the financial system. Global confidence in the euro collapsed.

Worldwide, the Fed’s crisis interventions under Ben Bernanke and Janet Yellen meant dollar liquidity swamped the entire world. Dollar borrowing surged. Not so much by large emerging market governments—the likes of Indonesia or Thailand—that had learned their lessons and borrowed in their own currency but by corporations and governments in so-called frontier markets. In sub-Saharan Africa, a new era of dollar borrowing began. And the new lure of the dollar extended even to China.
The story that was front and center in the new millennium was the rise of China as a new superpower. And Beijing had ambitions for the yuan, too. With the help of British Prime Minister David Cameron’s government, Beijing embarked on an ambitious push to internationalize the Chinese currency. Perhaps London could do for the yuan in the 2010s what it had done for the eurodollar in the 1960s. Yet these hopes ignored the fact that Chinese business was also internationalizing at the same time—but in the opposite direction. It was becoming enmeshed in the dollar system.

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This became apparent in 2015, when China suffered the first homegrown financial crisis of the new era. As the Shanghai stock market sold off and the yuan slipped against the dollar, Chinese corporations desperately tried to reduce their dollar debts. The U.S. Federal Reserve, under Yellen, helped by postponing an increase in interest rates. Beijing, for its part, tightened capital controls. Balance of payments liberalization and unrestricted convertibility were off the agenda. And rather than protesting at China’s financial repression, the world heaved a sigh of collective relief. In financial matters, it turned out that for Beijing to be a responsible stakeholder, it did not mean allowing trillions of dollars in Chinese funds to swash across financial exchanges. Today, Beijing pegs to a basket of currencies rather than the dollar alone, but its unilaterally declared Bretton Woods 2.0 continues to have its attractions.

Meanwhile, China’s growth continues. And with every passing year, its weight in key markets increases. For commodities such as oil, it is by far the largest growth market. In 2018, it created a yuan-based futures contract, which amid the gyrations in dollar-priced oil markets in the spring of 2020 proved its worth as a safe haven. In Shanghai, the price of oil never went negative. Meanwhile, foreign investors are ever more attracted to the interest rates on offer on Chinese bonds. Almost 10 percent of China’s sovereign bonds are now foreign-owned. That share will increase as the bonds are included in the main indices. But this is welcome diversification rather than an immediate threat to dollar hegemony.

When Trump took office, there was real fear in international financial circles that his brand of politics would be incompatible with America’s superintendence of the global financial system. Would a Trump White House and Republican-led Congress permit America to sustain the safety net for the global dollar-based financial system, ultimately underpinned by the United States? As it turned out, Trump was a president who liked a soft dollar and low interest rates. He gave not a damn for fiscal or monetary propriety. All he asked of the Fed was that it keep the taps open. When, in March 2020, the Fed embarked on quantitative easing, slashed rates, and reactivated the swap lines, Trump applauded. Soon, cronies such as Turkish President Recep Tayyip Erdogan were pleading to be included in the Fed’s programs. The Fed did not oblige, though as a gesture it opened a so-called repo facility for foreign reserve holders to swap their U.S. Treasurys for cash.
And so the ramshackle rule of the dollar has not just survived the 2020 crisis but been reaffirmed. Can it continue?

Faced with the grandiose spectacle of China’s return to global power, the conversation turns to history. Grand strategists invoke the Thucydides trap and predict war. That ought to be unthinkable. But war is, in fact, the only model we have in the modern era of a transition in hegemonic currency. It was World War I and World War II that exploded Britain’s global empire and brought about the dominance of the dollar. When advocates of monetary reform on both the left and right invoke a new Bretton Woods, it is worth remembering that the conference met in the weeks after D-Day and as the Red Army was battering its way toward Poland. If that is our future, the question of currency standards will be the least of our problems.

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If we imagine instead a more gradual transition, the key issue to watch is the ability of the United States to attract investors willing to lend to it in dollars. Foreign demand for U.S. Treasurys waxes and wanes with relative interest rates and the costs of hedging the exchange rate. In recent years, net foreign purchases of U.S. Treasurys have slowed dramatically. The vast increase in debt driven by the COVID-19 pandemic has been absorbed by U.S. investors and the Fed. There was a dangerous wobble in the U.S. Treasury market in March 2020. But that was due not to a flight out of dollars but the opposite. Too many investors needed to access their U.S. Treasury piggy bank at once. Even Wall Street’s über-sophisticated market makers could not absorb the sudden sales. Reform of the financial system’s plumbing—to ensure that the market for Treasurys can smoothly absorb the trillions of dollars of new issuance that will follow in the aftermath of the pandemic—should be an urgent priority for the incoming administration of Joe Biden.

Both Beijing and Brussels have what it takes to develop similarly deep asset markets. Europe’s fiscal pact for the first time promises the creation of a substantial pool of joint European debt. But the European Union is decades away from being able to rival the U.S. Treasury market for scale.

This does not, however, mean that the system is static. The balance in the global economy is shifting toward Asia. A green energy revolution would upend the global market for oil, gas, and coal. One can imagine digital platforms beginning to operate non-state-based currencies of one form or another, which is why central banks have been paying more and more attention to these media of exchange and stores of value. In digital currencies, the People’s Bank of China is leading the way.
In such a multipolar world, in which large parts of economic activity may well remain internal to each of the main blocs, one can imagine the dollar continuing to play a predominant role in international trade and finance.

Plausible long-range predictions out to 2050 suggest that China’s share of global GDP will likely settle at around 20 percent, compared with somewhere between 12 and 15 percent for the United States, EU, and India. In such a multipolar world, in which large parts of economic activity may well remain internal to each of the main blocs, one can imagine the dollar continuing to play a predominant role in international trade and finance. It would be a first. But then every successive stage in our monetary and financial history since the advent of the modern world economy in the 19th century has been a first, The London-centered gold standard prior to 1914, the dangerous interregnum of the interwar period, the makeshift arrangements of the post-World War II period, the brief precarious era of Bretton Woods, the breakthrough to fiat money in the 1970s, China’s peg of the early 2000s, the world of quantitative easing since 2008—each of these is without precedent.

In 1973, the economist Richard N. Cooper published an essay in *Foreign Policy* offering “an unconditional forecast about the future of the dollar for, say, the next decade.” He predicted: “At the end of a decade the position of the dollar will not be very different from what it is now. The dollar will continue to be suspect and the struggle to find acceptable ways to rein it in will continue, but generally they will fail, and the dollar will still be widely used both as a private international and as an official reserve currency. ... The basic reason for this forecast is simple: there is at present no clear, feasible alternative.”

Almost half a century later, Cooper’s forecast still seems like a good bet. The dollar is a bit like democracy: It is the worst global currency, except for all the others.