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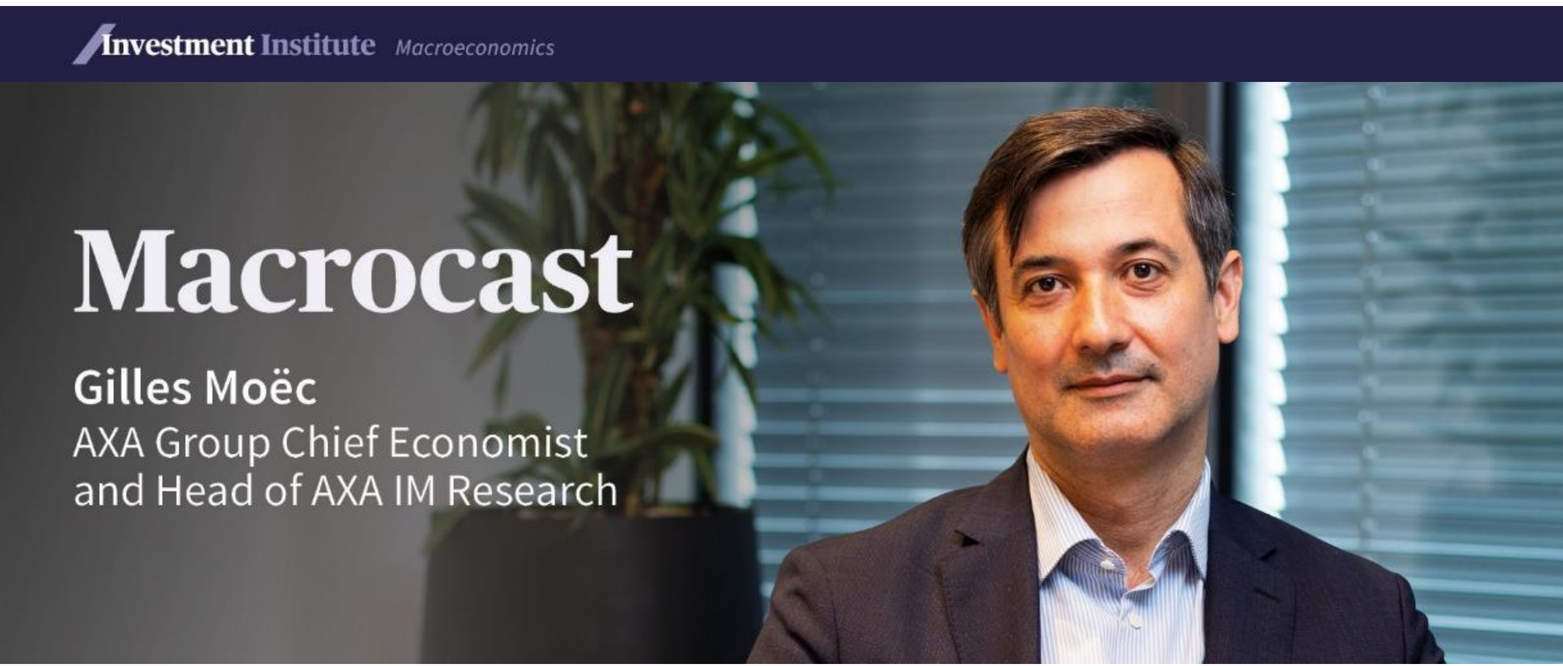


Renouncing Privileges

- In their pursuit of a weaker dollar, the Trump administration could renounce the "exorbitant privilege" which has allowed the US to run expansionary fiscal policies without meeting much financial constraint. There is no easy option to replace the US dollar should its dominant reserve currency status erode. Yet, with hard work on capital market union and political integration, the Euro could play a bigger role in the international monetary order.

Gillian Tett reported in the Financial Times on an idea circulating in Washington that financial flows into the US could be taxed to raise revenue and/or to depreciate the US dollar. A similar solution was mentioned in Stephen Miran's influential essay which we discussed three weeks ago. This would raise the funding cost of the US government and would ultimately express a renunciation of the "exorbitant privilege" which for decades has allowed the US to pursue largely unconstrained fiscal policies thanks to the dollar status as the world's dominant reserve currency.

There is a precedent in the modern history of the US when the White House voluntarily affected the US dollar status by surprise: the "Nixon shock" of August 1971, when the President suspended the convertibility to gold. While it was a political success for Richard Nixon in the short-term, it ended up exacerbating the US inflation problem. Equally, we do not think that renouncing the "exorbitant privilege" would serve the US economic interests in the long-run – the evidence that a dollar overvaluation has "hollowed out" US productive forces is scarce in our view – but these debates fuel a "mood music" in Washington which in any case is contributing to the ongoing correction of the USD.

There is no off-the-shelf solution to reshape the international monetary system should the dollar status erode. In 2010 the IMF worked on some ideas, but expanding the role of the Special Drawing Rights would not be straightforward. In any case, cooperative solutions would require a level of support for multilateralism which is – for now at least – missing in the US administration. The Euro area's preference for current account surpluses has for long impaired the Euro's capacity to play a major role in the international monetary system. The change of fiscal stance in Berlin may change this. Yet, a lot would need to be done on capital market union – including the emergence of a larger pool of jointly-issued safe assets – to bring the European currency closer to the requirements of a dominants reserve currency in terms of market depth and liquidity. Streamlining the EU's decision-making process would also probably be necessary. Raising the euro status is however no longer unthinkable.

Thinking about taxing financial inflows

In the night of the fourth of August 1789, the freshly self-instituted French National Assembly voted the abolition of the feudal privileges of the nobility and clergy. Interestingly, quite a few members of the nobility and clergy vigorously argued in favour of this motion which in effect put the *Ancien Regime* to an end. This remarkable selfless act did not necessarily play in their favour. The Duc d'Aiguillon, who was the first that day to call for the abolition, had to flee revolutionary terror in 1793. It is with this unexpected turn of events in mind that we explore **the apparent enthusiasm, in segments of the new administration in Washington, for renouncing the US "exorbitant privilege**" – to use the expression coined by French President Giscard d'Estaing in the 1960s, then in his Finance Minister capacity – which for decades has allowed the country to run policies which would have been unsustainable anywhere else, thanks to the dollar's reserve currency status.

We explored some of these issues in our Bretton Woods 3.0 piece (link here), but an angle only tangentially mentioned by Stephen Miran in his essay has come to the fore thanks to a piece by Gillian Tett in the Financial Times last Friday. She reports on the idea circulating in Washington **that the US could tax capital flows entering its financial market**, noting that a Democratic and a Republican Senators jointly introduced a bill in Congress in 2019 to this effect. The bill never moved through the legislative process, but it might be resurrected as it perfectly fits the current mood in DC.

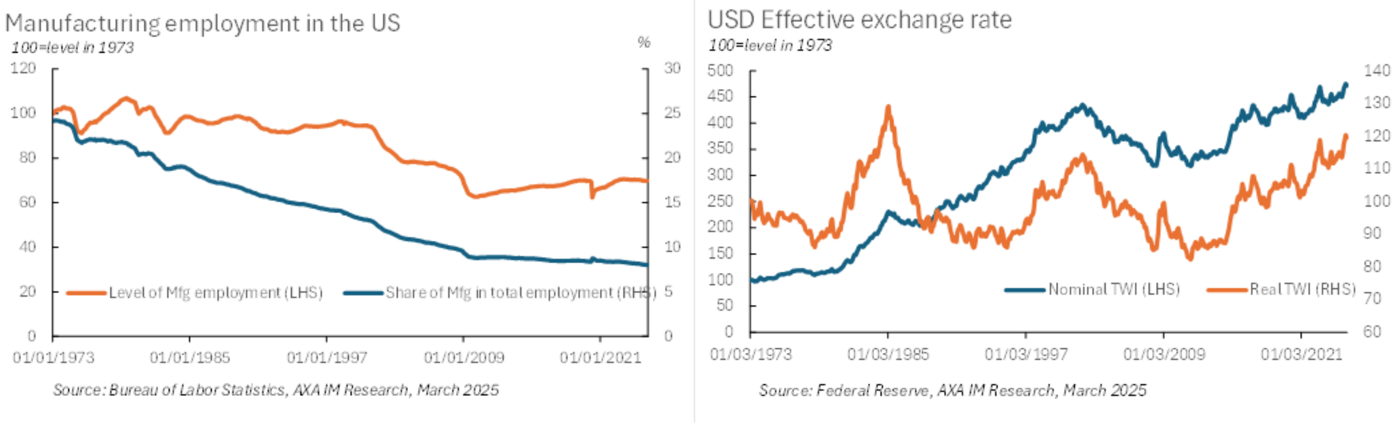
Such tax would artificially reduce the return on capital on US assets earned by non-residents. They would then have two options: either pay the tax as a "compensation" for the benefit investing in US assets brings beyond the return – stability, liquidity, market depth and protection of property rights, the attributes of a dominant reserve currency – or simply leave the US market, which would trigger a decline in the value of the US dollar. For the proponents of this new "financial mercantilism", this would serve US interests.

Economists close to the current US administration often share two convergent views. First, that it is high time for **the US to be compensated for the service they provide to their allies in the form of military protection**. Points made by Paul Kennedy in the late 1980s in his "Rise and Fall of Great Powers" book are making a comeback in the American discourse. Kennedy's central thesis is that, historically, empires decay because the financial cost of military spending ends up hollowing out resources. A logical inference is that the hegemon can try to survive by efficiently extracting a "tribute" from those whom they protect.

Second, they would welcome a **weaker dollar**. The idea is the following: as long as the US economy was dominant, it could provide the world with the reserve currency without much trouble for themselves. Yet, as the US shrinks as a percentage of world GDP, demand for dollars does not fall, which results in an overvaluation of the American currency. The nice thing for the US is however that this structural demand for dollars makes the US funding cost lower than it should be, supporting economic growth, albeit with a focus on domestic demand. Yet, **they see this "exorbitant privilege" as a "curse in disguise":** low interest rates spur unsustainable leveraging while the dollar overvaluation hollows out the US manufacturing sector. In this "New Washington thinking", the dollar must decline to re-start the US industrial base, which would be *in fine* more efficient than fiscally spendthrift industrial policies such as the Inflation Reduction Act of the Biden administration. Gillian Tett in her piece aptly links the proposal to tax financial inflows to tariffs on goods. Ultimately, this is the same logic, pursuing the same goal: reviving "industrial America".

Evidence for the "exorbitant privilege" being to blame for de-industrialisation is scarce in our view. Exhibit 1 plots the level of manufacturing employment in the US, as well as its share in total employment. The trade-weighted dollar exchange rate, both in nominal and inflation-adjusted terms, over the same period appears on Exhibit 2. The decline in manufacturing as a share of US employment had been remarkably steady in the US since the beginning of the 1970s – with little gyrations which could be easily correlated with movements in the exchange rate – before stopping in the last 15 years (the absolute number of manufacturing jobs has even increased a little bit) despite another movement of appreciation of the US dollar**. It is quite remarkable that the current focus on manufacturing jobs – and the generic lament for the loss of "industrial American" – so pervasive now in the US political discourse (on both sides of the fence) is materialising 15 years after the actual trough in industrial jobs.**

Exhibit 1 – A regular trend between 1973 to 2010… Exhibit 2 – …hard to correlate with FX gyrations



Another simple point to draw from Exhibit 2 is that, as much as the appreciation of the broad trade-weighted US dollar between 1980 and the late 1990s has been impressive in *nominal* trade-weighted terms, it was much more contained in *real* terms (i.e. adjusted for inflation), except for the "bump" of the first half of the 1980s.

The case for a continuous decline in the price-competitiveness of the US economy is not easy to argue when one looks at the US export performance of the US on goods and services. The Organisation for Economic Co-operation and Development (OECD) calculates the volume of underlying demand for US products by weighing the total import volumes of each client of the US by their share in US exports. In case of competitiveness loss, one would expect a decline in the US market share, which is reflected in the export performance metric which compares actual exports to underlying demand. It is the opposite which has been happening. **US market shares have resisted better to the emergence of new competitors from the 1990s onwards than Canadian and Japanese ones** (see Exhibit 3). This suggests that **the US structural current account deficit has less to do with a weakness of exports than with excess domestic spending**. This may be the product of interest rates being "too low" because of the dollar status but may equally be explained by a political preference for accommodative fiscal policies.

Exhibit 3 – US market shares are resilient

Export performance (goods and services)
100= level in 1975
US — Canada — Japan
Source: OECD, AXA IM Research, March 2025

Trumpnomics in the light of the "Nixon shock" of 1971

What matters however at this stage is less the evidence of a link between the currency and manufacturing jobs than the belief in US policy circles that it exists**. This is in fact not the first time that the US considers a linkage between the economic cost of its geopolitical role and the value of US dollar**. It may be worth looking at the discussions involving academics, civil servants and politicians around Richard Nixon in August 1971 – as reported in a compelling book, "Three days in Camp David", published by Jeffrey Garten in 2021. The overvaluation of the dollar was seen as a

mechanistic consequence of the Bretton Woods system under which the US currency was the "mediator" between gold and all currencies, as instituted in 1944 when the US was the uncontested hegemon in the western block. By the late 1960s, the Vietnam war had shaken US public finances. Given the habits of the time, this contributed to fuel inflation since the Federal Reserve (Fed) under Arthur Burns refused to offset fiscal profligacy with monetary rectitude. Giving up on the convertibility of the US dollar against gold was advocated by Treasury Secretary John Connally as the only way to force foreign central banks to accept a revaluation of their currencies. Allowing the Bretton Woods system to implode was seen by those in US policy circles influenced by Milton Friedman – then on the ascent – as welcome since floating exchange rates were necessary to restore monetary policy autonomy to deal with the issues inherited from the 1960s.

Yet, while it was a political success in the short-term**, the "Nixon shock" of 1971 – suspending, ultimately indefinitely, the convertibility of the US dollar to gold – did not serve US economic interests**. The sudden depreciation of the US dollar fuelled US inflation. It also contributed to the oil shock of 1973. Indeed, beyond the immediate geopolitical causes, oil producers – paid in US dollars – had seen their purchasing power over the rest of the world diminish, which they endeavoured to offset by raising the price of oil. It took until the "Volcker shock" of 1980 to bring inflation back under control.

Yet at least it is possible to present the Nixon shock as a rational response to a deeply flawed post-war arrangement and aggressive actions from the US own allies. Indeed, without repeated requests from Europeans to convert their dollar holdings into physical gold and repatriate it from the US – e.g. by sending a French warship to New York in early August 1971 – the US authorities might not have taken this course. As we discussed in our Bretton Woods 3.0 piece three weeks ago, as it works today the transatlantic macro-financial relationship is balanced. While they do not have a bilateral current account surplus with the US, Europeans are happy to spontaneously send their savings to the US financial markets (rather than keeping their dollars onshore as they did in the 1960s), and there is no evidence that the dollar reserve status has created any constraint on US policy-setting.

In the current circumstances, **we think that instituting a tax on financial inflows would result in significant capital outflows from the US**. Indeed, some of the "non-price" attributes of the US dollar as a reserve currency we listed at the beginning of this note – namely stability and protection of property rights – are now under pressure (the latter being eroded by renewed weaponisation of the US dollar, which pre-dates the Trump administration). In addition, with upside inflation risks much more obvious in the short run in the US than in the Euro area, a wider gap in policy rates can be expected, which would raise the foreign exchange hedging costs of US assets held by Europeans, who at the same time are now witnessing a growing demand for funds domestically (see next section). Finally, one could question the wisdom of European investors who would choose not to redirect at least part of their investment initially tagged to the US in response to a tax if the *explicit* goal of the measure is to take the dollar down, and the very value of their holdings with it.

What would be the consequence for the US economy? While the export sector would benefit, **the accompanying brutal re-rebalancing of the US current account needed to replace foreign investment would probably shatter domestic demand to the point that the net effect on growth would be negative**. Since the US government is unlikely to raise its own saving effort (the planned tax cuts vastly exceed spending cuts, either in D. Trump's own platform or in the House's recent project), rebalancing would take a fall in corporate investment and/or a rise in household saving which would depress consumption. This would be one of the best ways we can think about to engineer a recession.

This is why **we do not think that this option can realistically be used as leverage by the US administration to obtain cooperation from its partners in depreciating the dollar in an orderly way thanks to some "Mar-a-Lago" accord.** Indeed, while allies in Europe and Asia would probably resent the volatility that taxing inflows would trigger, as well as the subsequent appreciation of their currency, the most immediate victim would be the US itself, in terms of higher funding costs and, ultimately, lower growth. Yet, these ideas are part of a "mood music" in the US which contributes to the current weakness of the US dollar.

Who can – or want to – replace the dollar?

The last time the world financial order lost its currency anchor, in the first quarter of the 20th Century, when Sterling status eroded, the US dollar quickly established itself as the natural replacement and the process was relatively seamless. The political and cultural proximity between the two superpowers, one in decline, the other on the ascent, helped. **What is so concerning about this suspicion that the US is contemplating torpedoing the status of the US dollar is that there is no obvious replacement solution in the short run.**

For a brief moment 15 years ago, the question of the demise of the dollar as the world's dominant reserve currency was seriously explored in international policy circles. Indeed, the Great Financial Crisis originated in the US, and the seizure of the financial system over there raised the possibility that the rest of the world would lack dollar liquidity. At the time, China explicitly called for the transformation of the international monetary system into a properly multi-polar framework. Yet, decisive action by the Federal Reserve, expanding its balance sheet and establishing swap lines with key foreign central banks, put the dollar liquidity issue back to the backburner.

While the issue was still fresh, in early 2010 the International Monetary Fund (IMF) produced a thorough review of various avenues of reform for the international monetary system (see link here). **A massive upscaling of the Special Drawing Rights** (SDRs) role was explored. SDRs were created in 1969 as a partial solution to the drawbacks of the dollar-centrality of the original Bretton Woods system which drove to the 1971 crisis we sketched out in the previous section. They are additional reserves granted to IMF members which can be freely exchanged for usable currencies, which value depends on a basket of 5 currencies (USD, EUR, GBP, JPY, with the CNY joined in 2016 as a result of the Chinese push towards a less Western-dominated system). An exceptional additional allocation of SDRs was in fact implemented in 2009 to help deal with the transitory shortage of dollars. **Boosting the role of the SDR would however require the system to be transformed so that it turns into a "proper" currency** – rather than being first exchanged for one – as well as expanding access beyond governments. This would still not be a perfect substitute for the dollar, since the decision-making process at the IMF is rigid (the threshold for SDR allocation is 85% of voting rights), which makes it unsuited to handling liquidity fine-tuning. Quite logically**, the IMF paper ends up with reviving the "Bancor" idea** pushed by John Maynard Keynes during the Bretton Woods negotiations in 1944, i.e. a proper international currency managed by a proper "global" central bank.

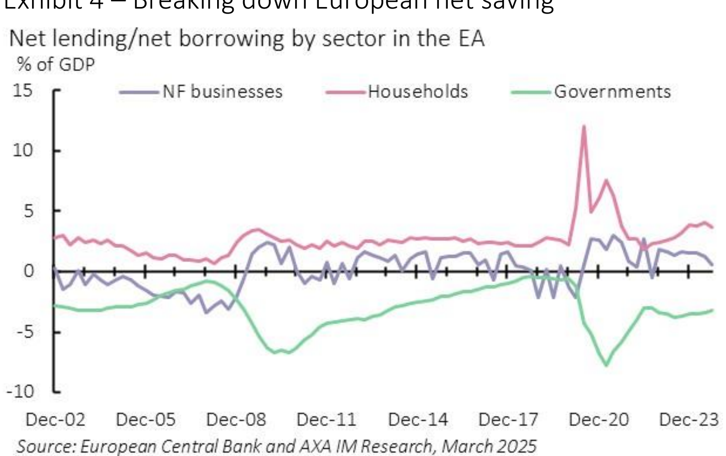
This would however require a level of multilateral cooperation which is at odds with the current mood in Washington "Project 2025" by the Heritage Foundation, which since the beginning of his mandate seems to have inspired many of Donald Trump's policies, calls on the US to withdraw from the IMF. This is one of the key differences with the "Nixon shock". Richard Nixon himself was not an isolationist. He suspended the dollar's gold convertibility to deprive the isolationists then on the ascent of one of their best arguments. After the August 1971 decision, the US engaged in a quick succession of multilateral summits to try to fix the international monetary system. Incidentally, we think that **isolationism will make it ultimately more difficult for the US to get what it wants from its partners in the financial realm. We note that the Plaza Accord in 1985 occurred *after* the Reagan administration had fully reassured US allies of the depth of his commitment to their security**, for instance during the "Euromissiles crisis" of the early 1980s. A problem in the US approach to a "Mar-a-Lago Accord" is that it may now be very difficult to rebuild the allies' trust in the solidity of the US military commitment.

Another interesting take-away **from the "Nixon shock" precedent as told by Jeffrey Garten is that it was probably what set in motion the European monetary unification project**. Indeed, the foreign exchange volatility triggered by the implosion of the Bretton Woods system was particularly detrimental to a tightly commercially integrated region such as Europe. If one could no longer rely on gold and the dollar to provide stability, than the Europeans would have to provide their own anchor, which they did with successive avatars of currency arrangements from the late 1970s until full unification in 1999. In a similar fashion, **signals that the US is ready to jettison the dominant currency reserve status of the US dollar could hasten work on raising the euro's own status**.

The Yuan is not a natural replacement for the dollar since this would entail a removal of the capital controls which – especially against the background of domestic financial stress linked to the real estate market – does not seem to be on the table. Habitual readers of Macrocast might remember that your humble servant has not been a big believer in the euro's ascent to dominant reserve status. Indeed, the economic model of Europe for decades – and particularly since the sovereign crisis of the early 2010s – has been based on exports with forms of domestic demand rationing (in a nutshell an extension to the whole Euro area of the German model). This results in a structural current account surplus, and hence a scarcity of euros made available to the rest of the world. **A reserve currency which would offer too few assets to invest in – an issue which the US does not have – would face a constant appreciation of its currency. This is the fate of Switzerland for instance,** which is often forced to intervene in the FX market to avoid a too steep overvaluation of its currency. But this may be about to change, with the new policy stance in Germany.

The Euro area's current account surplus (not vis-à-vis the US, but with the rest of the world) is the result of the saving behaviour (i.e. savings minus investments) of the government, households and the non-financial corporate sector. We approach this in Exhibit 4 by looking at the net lending/borrowing requirement in the non-financial accounts. The return to balance by the governments is going to be postponed by the defence effort – and the infrastructure catch-up in Germany. The corporate sector is close to having exhausted its savings overhang from the Covid investment strike and the profit glut which accompanied the inflation shock. The fiscal push should incentive them to lift investment. Households were still raising their net saving effort at the end of last year, but we are already above historical peaks.

Exhibit 4 – Breaking down European net saving



Still, that the Euro area is now moving towards a more "inward-driven" growth model – military spending replacing Chinese demand to support manufacturing, in a nutshell – is a necessary, but not sufficient conditions for the Euro to compete with the dollar as a reserve currency without harming itself. Protection of property rights is ensured in the European Union (EU), with a strong legal system – although decisions on the possible confiscation of frozen Russian assets could be seen as a "weaponisation" of the European financial system – and policy predictability is much higher right now than in the US. Liquidity and market depth however remain problems, given the fragmentation of the financial markets across national lines and the absence of a joint safe asset. This is precisely what the capital market union, and the prospect of joint issuance to fund defence could address. The road is still long for the euro – and decision-making in the EU institutions would probably need to change to reassure the rest of the world on its capacity to respond more quickly to crises, but **we no longer deem it "unthinkable" that it could play a more central role in the international monetary system in the future.** Yet, for the time being, between the "policy noise" in Washington and the magnitude of the efforts Europe will need to make, volatility is a given.

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Country/Region	What we focused on last week	What we will focus on in next weeks
	• S&P 500 equity index reverses further 4% to Thurs, down 10.2% from Feb peak • CPI inflation (Feb) 0.2% monthly rise, headline drops to 2.8% (3.0%), core to 4-yr low of 3.1% • PPI inflation (Feb) drops to 3.2% (from 3.7%), but components point to 0.3% PCE inflation rise • JOLTS survey (Jan) vacancies up to Nov/Dec avg • Household net worth (Q4) modest $0.2tn rise in Q4, following bumper $4.8tn in Q3	• FOMC decision (Mar) FFR expt'd unch. Fed to lower GDP and raise inflation outlook. Powell "no hurry" to persist, wary of implying/ruling out "Fed put" • Retail sales (Feb) expect rebound in sales • Empire and Philly Fed surveys (Mar) watch for any reversal of more positive trend • Industrial production (Feb) watch for mfg output to reflect improved survey tone • Existing homes sales (Feb) any impact of higher rates
	• Lagarde reiterated that uncertainties remain very high and ECB's path is dependant of tariffs decision. She also highlighted that German fiscal boost should be inflationary in the medium term • Fr and Italy endorsed needs for further defense spending but also recognised their room of manoeuvre are small with tight budget. Fr propose to leverage from private investors or savings, Italy proposes public guarantees • D.Trump threatened EU alcohol producers with 200% tax	• Final HICP (Feb) • Fr Business climate (Mar), EMU flash consumer confidence (Mar)
	• BRC Retail Sales (Feb) yoy sales eased to 0.9%, from 2.5% • RICS House Prices (Feb) fell to 11%, from 21%, a clear sign the SDLT boost is fading • Monthly GDP (Jan) fell unexpectedly by 0.1%mom, due to 0.9% drop in IP	• HMRC payrolls (Feb) look for renewed weakness. AWE ex. bonus likely unch. at 5.9% • BoE rate decision: look for no change with 6:3 cote split. Mann and Dhingra likely vote for 50bp • GfK cons conf. look for signs of weakness due to global uncertainty • Public finances (Feb) likely further overshoot in borrowing
	• Av. cash earnings (Jan) slowed to 2.8%, from 4.4%, largely due to base effects • Final GDP (Q4) showed a 2.2%qoq annualised, but private consumption was flat • HH spending (Jan) dropped by 4.5%mom	• Exports (Feb) look for further yoy pick up • BoJ rate decision: no change expected. Listen for views on trade policy in press conference • CPI inflation (Feb) headline set to rise to 4.2%; core will drop to 2.9%. Ex food and energy will ease
	• CPI (Feb) fall in deflation at -0.7%yoy, down from +0.5% in Jan, payback of the holiday boost • PPI (Feb) improved to -2.2% from -2.3% in Jan. • Modestly expanded (~2% of GDP) fiscal package from NPC, GDP target unch at "around 5%" • Total social financing flow (Feb) down to 2.2tn RMB from 7.1tn in Jan; new loan dropped to 1tn RMB from 5.1tn in Jan	• Jan-Feb combined monthly activities to pin down the momentum of the start of the year. Data release incl. retail sales, industrial production, fixed asset investment and national house prices
	• CB: Poland (5.75%, unch), Peru (4.75%, unch) • CPI (Feb): Hungary (5.6%), Romania (5.0%), Poland (4.9%), India (3.6%), Brazil (1.3%), Thailand (1.1%) • Industrial production (Jan): India (3.6%), Malaysia (2.1%), Brazil (1.4%), Turkey (1.2%), Mexico (-2.9%)	• CB: Indonesia (5.75%, unch), Taiwan (2.0% unch) Brazil 100bp hike to 14.25% • GDP (Q4): Argentina, Chile, Mexico • CPI (Feb): Malaysia, South Africa • Industrial production (Feb): Poland

Upcoming events		
	US:	Mon: Retail sales (Feb), Empire state survey (Mar), Business inventories (Jan), NAHB housing index (Mar); Tue: Housing starts (Feb), IP (Feb); Wed: FOMC announcement, Long-term investment flows (Jan); Thu: Current account (Q4), Philadelphia fed index (Mar), Initial jobless claims (w/e 15 Mar), Existing home sales (Feb)
	Euro Area:	Mon: It HICP (Feb); Tue: Ge ZEW survey (Mar); Wed: Ez HICP (Feb), Ez Labour cost index (Q4); Thu: Ge PPI (Feb); Fri: Fr Insee mfg confidence (Mar), Ez Consumer confidence (Mar, p)
	UK:	Thu: Unemp (ILO) (Jan), Avg earnings (Jan), MPC announcement; Fri: GfK consumer confidence (Mar), PSNB ex-banking groups (Feb)
	Japan:	Tue: Private 'core' machinery orders (Jan); Wed: BoJ announcement; Thu: CPI (Feb)
	China:	Mon: Fixed asset investment (Jan-Feb), Retail sales (Jan-Feb); Thu: PBoC announcement (Loan prime rate)

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** As at the end of December 2023.

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