Discussion of

"Trade War and the Dollar Anchor"

Hassan, Mertens, Wang, and Zhang

Brookings Panel on Economic Activity
Washington, DC
September 25-26, 2025

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Is the dollar’s status as the world’s global anchor in jeopardy?

- Extremely important and timely question
- Announcement of U.S. tariffs (“Liberation Day”; April 2, 2025) triggered a decline in stock and bond returns
- However, value of the dollar declined
  - Typically, tariffs increase demand for the home currency and result in an appreciation (Jeanne and John, JIMF 2024)
  - Typically, disruptions in global markets lead to a run for safety and hence, to the dollar
- Is this the beginning of the end for the dollar?

Trade and the safe-haven status of the dollar

Elegant and relatively simple model:

- Households consume traded (T) and nontraded (NT) goods
  - Productivity shocks affect the local supply of the NT good
  - Preference shocks affect the local demand for the (T, NT) composite good
- Countries trade assets and a homogeneous traded good; trade in goods helps insure households against local shocks
- Households need currency to buy traded goods from other countries; the real exchange rate differs from 1 because households have different valuations of the traded good

Two key equations: The real exchange rate and the global stress factor

$$\bar{s}^{f*} = -\frac{\gamma(1-\alpha)}{(1-\alpha)+\gamma\alpha} y_N^f + \frac{(\gamma-1)(1-\alpha)}{(1-\alpha)+\gamma\alpha} \chi^f$$

$$\lambda_T^* = -(\gamma-1)(1-\alpha)\sum_n \theta^n y_N^n + (\gamma-1)\sum_n \theta^n \chi^n$$

The real exchange rate is affected by the relative (net) demand for the traded good

Real exchange rate:
up = appreciation

$$\bar{s}^{f*} = -\frac{\gamma(1-\alpha)}{(1-\alpha)+\gamma\alpha}\boxed{y_N^f} + \frac{(\gamma-1)(1-\alpha)}{(1-\alpha)+\gamma\alpha}\boxed{\chi^f}$$

Low NT output will increase demand for T good and result in an appreciation of the exchange rate

High demand for T good will also result in an appreciation of the exchange rate

$$\lambda_T^* = -(\gamma-1)(1-\alpha)\sum_n \theta^n y_N^n + (\gamma-1)\sum_n \theta^n \chi^n$$

The global stress factor reflects the relative scarcity of the traded good

$$\bar{s}^{f*} = -\frac{\gamma(1-\alpha)}{(1-\alpha)+\gamma\alpha} y_N^f + \frac{(\gamma-1)(1-\alpha)}{(1-\alpha)+\gamma\alpha} \chi^f$$

The world's desire for the T good will be high (MU high) when supply of NT goods is low or demand for T goods is high

$$\lambda_T^* = -(\gamma-1)(1-\alpha)\sum_n \boxed{\theta^n y_N^n} + (\gamma-1)\sum_n \boxed{\theta^n \chi^n}$$

The co-movement between the real exchange and the stress factor depends on country size

$$\bar{s}^{f*} = -\frac{\gamma(1-\alpha)}{(1-\alpha)+\gamma\alpha} y_N^f + \frac{(\gamma-1)(1-\alpha)}{(1-\alpha)+\gamma\alpha} \chi^f$$

1. There is a common driver of $\bar{s}^f$ and λ_T associated with supply & demand
2. The global stress factor depends on global conditions
3. Size matters: the U.S. has a disproportionate impact on both

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A tariff effectively reduces the weight of the tariff-imposing country in the world and weakens the covariance

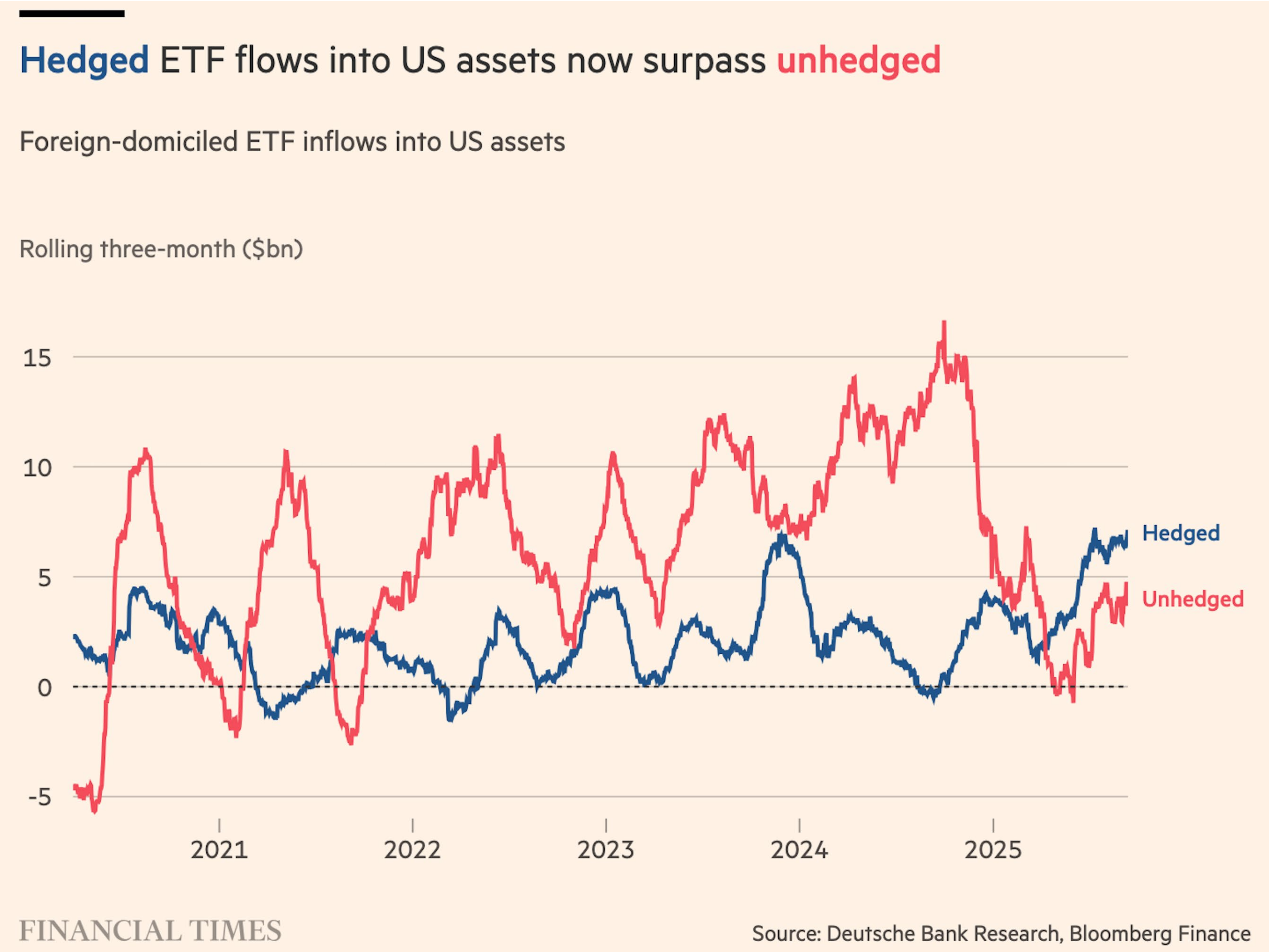
Emphasis on country size and spillovers

Mechanism: Big countries are safer in the sense that they have a larger impact on the shadow value of the T good; their currency will tend to appreciate when times are "bad" (demand > supply)

- Does this mean that China will automatically grow into a safe haven? No, see footnote 19.
- From a risk perspective, is it the volume of trade that matters?
  - Choke points; strategic inputs, etc.
- Model also implies overlap between timing of flights to safety and U.S. in trouble (i.e., shocks emanate on average from the U.S. to the ROW)
  - Counter examples: Euro crisis, COVID-19 pandemic, military conflicts

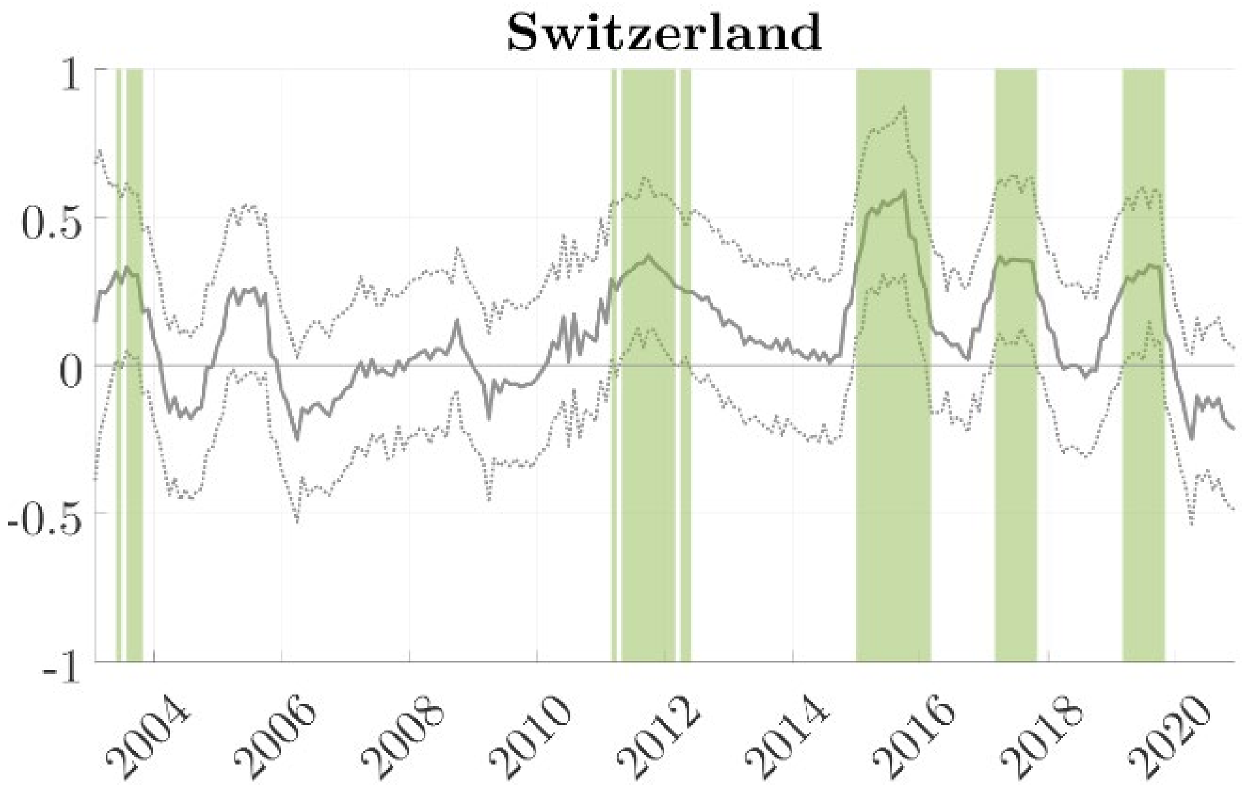
Decoupling of dollar from investment returns

- Model predicts that the trade war increases US borrowing costs and reduces the value of US firms
- What we see now is increased demand for U.S. assets, and an unwillingness to bear the risk of the dollar



What are the attributes of a safe-haven asset?

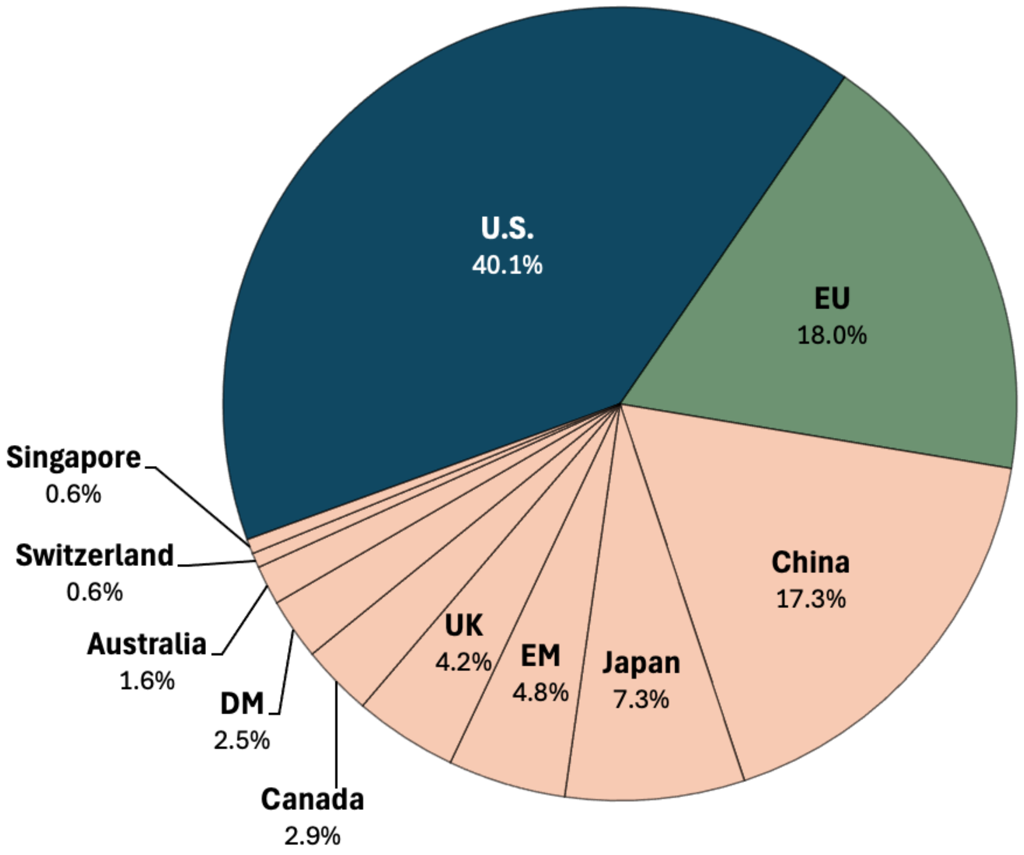
- This paper: Safe-haven asset value appreciates in times of global stress
- Foschi (2023): other assets switch in and out of safety status
- But do they become a global anchor?
  - No, other factors matter



Why isn't the euro a safe haven asset?

- Eurozone government bond market is half the size of the US markets, and fragmented
- Bonds of member states have different credit ratings, political dynamics, and liquidity profiles.

Shares of global bond market (2024),
as measured by global fixed income market outstanding



Source: Bank of Internatinal Settlements (BIS) as compiled by the Securities Industry and Financial Markets Association (SIFMA).

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April 3, 2025 at 5:40 pm ET

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The president wants companies to return production to the U.S., but it won't be easy

By Jason Douglas Follow *and Tom Fairless* Follow

April 2, 2025 9:00 pm ET

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BUSINESS

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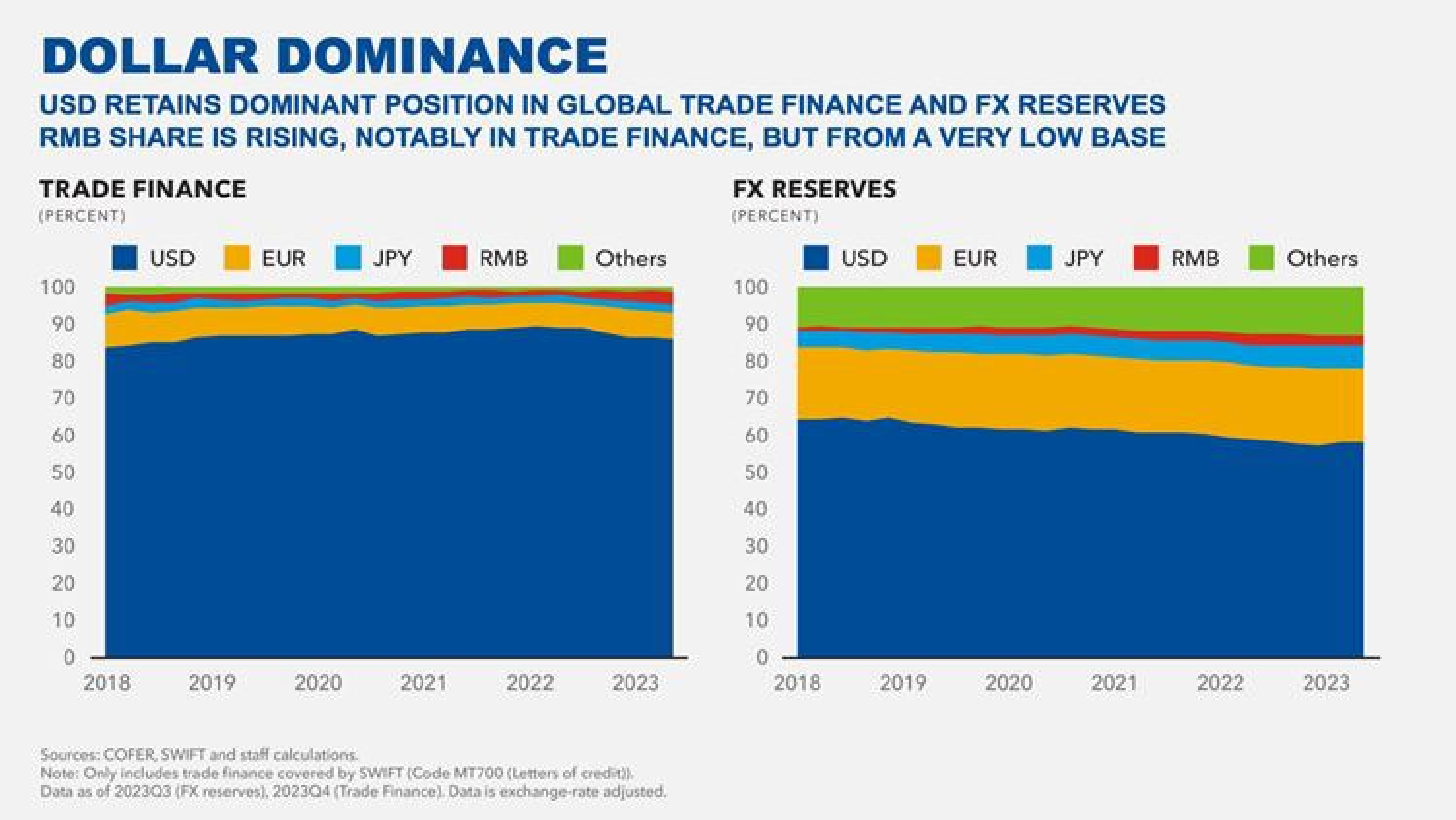
Looking ahead, threats to the dollar

- Implementation of Mar-a-Lago accords
- Fed independence
- Tax on foreign investors
- Hostile conditions for foreign firms (Hyundai) and workers
- Rising public debt
- Persistent U.S. policy uncertainty
- Rise and/or fall of other geopolitical alliances (NATO, EU, BRICS)
- Evolving (?) financial systems (+ whether regulation keeps pace)

Regardless, dollar dominance has outlasted decades of concerns regarding its longevity



Conclusion

- Taken on its own terms, this is a brilliant paper
  - Simple model that highlights key linkages between trade and risk sharing
  - Delivers stark predictions for the exchange rate, interest rate and demand for US assets
- Is this the only, or even the best, framework for thinking about the safe haven status of the dollar?
  - Not sure, but that is a tall order to fill
- Dollar remains dominant, but the foundations under the dollar may be cracking.