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The convergence of political risk, economic coercion, and de-dollarization

BY NICHOLAS MULDER

Contents

Synopsis

The first phase of global de-dollarization was fast, narrow, and transient. The current US trade and economic policy is accelerating an ongoing second phase of de-dollarization that is likely to be slower, broader, and more permanent.

Governments and investors around the world are reassessing their exposure to political risk emanating from the United States. As the second Trump administration continues its campaign to revise the global trading system, two questions have become relevant: first, to what degree can international investments, security holdings, and reserves in the US or dollar-denominated assets be subject to economic coercion? Second, will the growing threat and use of coercive measures spur a move away from dollar assets? Contrary to the idea that current US policy is without precedent, this paper examines 20th century economic history to study previous instances of US economic coercion, and shows that these did have effects on reserve holdings, currency selection, and trade. It shows that there was at least one earlier instance of global de-dollarization that was fast and narrow. The analysis here suggests that current US trade and economic policy will accelerate an ongoing second phase of de-dollarization that is likely to be slower, broader, and more permanent.

The shock of coercion

It had been widely assumed that American hegemony since the mid-20th century enhanced growth and reduced political risk. This assumption is not historically accurate. There are relevant precedents to be found in the history of geoeconomics.

In recent months, the United States has sought to reorder the international system over which it presided for decades. As a result, the global economy is undergoing an enormous transformation and its future shape is in doubt. One of the major sources of political risk is the growing use of coercion in the realm of trade, finance, and investment. Such policies have been increasing in frequency in the last decade: Chinese embargoes and export controls, Russia's severance of energy flows, and the growth of European Union and Group of Seven (G7) financial sanctions have been important factors for some time now. Yet the scale and force of recent US measures has come as a particularly strong shock. For it had been widely assumed that American hegemony since the middle of the 20th century had an overall effect on the world economy that enhanced growth, lowered interference with trade, reduced political risk, and would keep doing so.

But as this paper will show, this assumption is not historically accurate. The view that we are living through an unprecedented era of the sudden end to a regime of zero political risk is mistaken. There are relevant precedents to be found in the history of geoeconomics. A brief look at past cases in which US economic coercion changed global trade and financial and currency markets, especially in the 1970s and 1980s, helps us understand what is old and what is new about the current environment of high uncertainty. This helps us form more accurate expectations for what the consequences of the current surge in coercion might be for the future of the world economy.

As the following analysis will show, current worries about political risk emanating from the US are not novel. Fears and threats of sanctions, asset freezing, tariffs and other coercive measures have played an underappreciated role in global monetary history since the end of the Bretton Woods system in 1971. The threat of the asset freeze has in fact been a formative influence on the shape of the international trade and financial system.[1]

Economic coercion as a cause of de-dollarization

From the moment that the United States came to wield global hegemony in the 1940s, it has used geoeconomic instruments to pursue its foreign policy objectives. During the Second World War, the US Treasury froze roughly two-thirds of all foreign capital in the United States, much of which belonged to European nations occupied by the Nazis. In the Cold War, it used export controls and sanctions to contain the Soviet Union and imposed an embargo against Communist China that lasted from 1950 until the normalization of relations with Beijing in 1979.

But US administrations, like many other trading powers in history, have not been averse to using economic leverage to motivate but also occasionally outright subjugate their allies.[2] To promote decolonization and contain communism, in 1948, President Harry Truman warned the Netherlands that he would withhold Marshall Plan aid from the Netherlands unless it recognized the independence of Indonesia. During the 1956 Suez Crisis, Dwight Eisenhower made it clear he would stop all US financial and monetary support for Britain and the pound sterling if Anglo-French forces did not withdraw from Egypt. In service of a fairer balance of expenditures, both John F. Kennedy and Richard Nixon threatened to substantially reduce the US troop presence in Europe to increase burden-sharing and secure trade concessions from NATO allies.[3] In 1976, the Ford Administration raised the prospect of a US troop withdrawal from the Korean peninsula to force Park Chung-Hee to abandon a South Korean nuclear weapons program. And, in the 1980s, the Reagan administration deployed commercial restrictions and tariffs to strong-arm

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Virtually every postwar American president has imposed powerful economic sanctions, or threatened to, on adversaries and allies alike to influence strategic outcomes in the US national interest. These moves had real consequences for the development of the world economy and financial markets. Above all, they stimulated a search among asset-holding governments and firms for other safe havens.

Japan into economic and financial adjustment – setting the stage for a Japanese asset bubble that would produce decades of stagnation after it burst, even as US commentators blustered about seizing the growing pile of Japanese investments in the United States.[4] Virtually every postwar American president has imposed powerful economic sanctions, or threatened to, on adversaries and allies alike to influence strategic outcomes in the US national interest.

These moves had real consequences for the development of the world economy and financial markets. Above all, they stimulated a search among asset-holding governments and firms for new safe havens as early as the 1950s. Yet here the global monetary regime of the Bretton Woods system (1944-1971) imposed an important restriction on the emergence of competitors to the US dollar. This was the fact that the widespread adoption of capital controls limited the convertibility of most rich economies' currencies. One of the only strong currencies that was gold-backed and fully convertible, the Swiss franc, suffered from the fact that the small size of the Swiss economy limited its availability; there were simply never enough Swiss francs in the world to satiate global demand for reserves.

One of the first major effects of the Bretton Woods US gold-dollar standard was thus to stimulate the growth of offshore markets: places where dollars could be used beyond the reach of the arm of the American state. The growing use of asset freezes against Communist countries led Soviet reserve managers to move their dollar foreign exchange reserves to western European banks in the late 1940s, where they became known as Eurodollars. In the 1950s, Arab countries worried by the 1951 freeze of Iranian foreign reserves and the 1956 freeze of Egyptian funds joined the ranks of savers looking for a dollar haven domiciled outside US jurisdiction. By stashing their reserves in Paris and London, the Soviet and non-Western reserve managers minimized the risk of freezing and confiscation of their reserves, while offering cheap offshore capital to net demanders of funds, especially British, Italian, and American banks, who were evading domestic interest rate limits and capital controls.[5]

The result was a spectacular growth in intermediation, as the Eurodollar market grew from just US$7 million in 1948 to US$85 billion in 1969.[6] The immunity from potential asset freezing conferred by the market's opacity was an explicit part of its appeal. The economist Ronald McKinnon observed in the 1970s that "the layering of financial intermediaries makes the assets of any one country more difficult to expropriate and thus reduces the political risk within the Eurosystem… the United States might freeze Soviet dollar deposits in New York but would have little control over indirect dollar claims channelled through the Bahamas".[7]

But the United States also developed new tools to counter the growing power of surplus economies that were accumulating claims on dollar assets. During the 1973 and 1979 oil shocks the West grasped the leverage that Organization of the Petroleum Exporting Countries (OPEC) possessed. Tensions were alleviated as these commodity exporters began to recycle their petrodollar earnings by investing in global fixed income. At the heart of this lay a reorientation of Saudi export earnings into US Treasuries; a deal that conferred benefits to both sides but never took the possibility of asset freezing off the table. Fears of being held hostage by Arab oil exporters motivated US Congress to preserve extensive powers to freeze and seize foreign assets in the United States and under US jurisdiction under a new economic coercion bill, the International Emergency

Economic Powers Act (IEEPA), that became law in 1977 and replaced the Trading With the Enemy Act (TWEA) which dated to World War I.

IEEPA has since become the legal cornerstone of US global sanctions power, enabling the imposition of far-reaching punitive measures against American adversaries.[8] Yet global financial markets did exercise a restraining influence on the ability of the US government to freeze foreign property and deny other countries access to the dollar. In the wake of the collapse of the Bretton Woods system, it was not yet clear whether the US dollar would continue to be the world's preeminent reserve currency or whether a new national currency or international currency like the International Monetary Fund's (IMF) Special Drawing Rights (SDRs) would replace it. Excessively strong sanctions would trigger capital outflows. To preserve investor confidence at a time of rising budget deficits and inflation, US policymakers had to accept limits on their ability to interfere with foreign property and assets. As a result, between 1977 and 2025, the use of IEEPA remained confined to financial sanctions against governments adversarial to the United States, nuclear proliferators, and various non-state actors and militant groups. But its powers were not deployed to interfere directly with global trade.

The sense that the dollar's international status was brittle therefore moderated the American use of economic coercion during the 1970s and 1980s. Even relatively small reallocations of reserves by foreign official managers unsettled US policymakers. In 1978, for example, the prospect of a normalization of diplomatic relations between the United States and China prompted the Taiwanese government to consider moving its US$4 billion in reserves out of the US – though Taipei eventually didn't – to avoid their seizure and transfer to Beijing. Fearing the effects of Taiwanese reserve withdrawals on the dollar exchange rate, the Carter

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administration was quick to emphasize it would protect Taipei’s reserves in the United States despite its recognition of Beijing.[9]

The most significant geopolitical event to shape diversification out of the dollar, however, was the Carter administration’s decision in November 1979 to freeze US$12 billion in Iranian dollar reserves worldwide. Taken as an emergency measure during the Iranian embassy hostage crisis, this freeze was the largest immobilization of foreign assets ever seen at the time. Whereas all financial analysts know about the Volcker Shock of the early 1980s, an aggressive program of monetary policy tightening to quell US inflation, the near-simultaneous “Carter Shock” is much less well-known and remains little understood.

What was most shocking about the Iranian asset freeze was not the decision as such, but the global scope of the assets frozen by it. For just like the G7 asset freeze against Russian central bank reserves in February 2022, the financial world was taken by surprise when it found out that the measure extended to dollar deposits everywhere in the world. The freeze immobilized not just Iranian government funds directly under US jurisdiction, but also all funds “which are or come within the possession or control of persons subject to the jurisdiction of the United States”.[10] Since all US banks fell into this category, the asset freeze reached beyond the continental United States into the global Eurodollar market in London, Paris, Hong Kong, the Caribbean, and elsewhere. The offshore global dollar system, previously considered a citadel beyond the reach of US economic coercion, was now exposed as highly exposed to extraterritorial measures from Washington.

The Carter Shock sent shockwaves around financial circles worldwide. *The Economist* took the view that “the Iranian crisis has profoundly undermined the possible level of trust in the western banking system” and had exposed “the vulnerability of paper assets”.[11] The implication was not lost on many Gulf countries with large petrodollar deposits in US banks. “If Carter could freeze Iranian money now,” a Saudi deputy minister asked, “what is to prevent Washington from freezing Arab money in the event of another oil embargo?”[12] Kuwait called the freeze “an extremely dangerous precedent” and began a systematic campaign to diversify its holdings across asset categories and geographical locations, especially by moving into hard assets such as mines and agricultural investments.[13] Other surplus economies soon joined, and the hunt for alternative safe havens was on.

The "First De-dollarization"

It was a historical novelty for a global hegemon to be a net capital importer. One of the symptoms of the unforeseen and novel nature of this arrangement was a fear in Washington that excessive use of asset freezes would backfire against the US.

The result was a genuine move by a significant set of foreign official holders and investors out of dollar reserves, which deserves to be called the "First De-dollarization" of the 20th century. In 1976, the dollar still constituted 77% of global foreign exchange reserves. But by 1980 this share had fallen to 67%, while the Deutschmark's portion had grown from 8% to 15% and the yen had increased from 2% to 4.3% of global foreign exchange reserves. In the same period the Swiss franc also doubled its share, while the real gold price quintupled from US$200 per ounce to nearly US$1,000 per ounce.[14] By the end of 1980, just US$15 billion of the US$140 billion in oil exporters' deposits were held in New York and fully half had been diversified across Paris, Tokyo, Zurich, and dozens of other smaller financial centers such as Bahrain, Singapore, Hong Kong, and the Caribbean. Deposits held in non-dollar currencies such as sterling, Deutschmark, yen, Swiss francs, and IMF SDRs grew rapidly in these years.[15]

The geopolitical nature of the First De-dollarization is demonstrated by its persistence in the face of rising US interest rates after the Volcker Shock of 1979-1980, which strengthened the dollar exchange rate enormously and reversed the inflation of the previous decade. For foreign reserve managers, the opportunity costs of not being in the USD during this dollar appreciation were considerable. Yet many reserve holders continued to move into non-dollar currencies – a sign that investors sought insulation from US political risk rather than maximum returns on their assets. The chief drivers of de-dollarization were the Gulf states, but the growing monetary integration of the European Economic Community and borrowing in European and Asian currencies by Eastern Bloc states also contributed to reserve diversification.

The First De-dollarization left an imprint on the views that American policymakers took of economic coercion. At numerous instances they scaled back their intended use of sanctions to reassure financial markets. The Treasury Department was especially cautious. Treasury's assistant legal counsel cautioned Congress in 1980 that "domestic legislation requiring the Treasury Department to seize assets located in the United States could affect the willingness of foreign central banks to hold assets in this country. Unilateral action by the United States could adversely affect the perceptions of our major trading partners…about the safety of their holdings."[16] In 1982, Treasury advised the White House not to impose an asset freeze on Libya for fear that such a move would end petrodollar recycling through US banks. Treasury Secretary Donald Regan worried that "the use of IEEPA will invoke the memory of the Iranian sanctions and asset freeze, and send a very troubling signal to world financial markets".[17]

During the 1980s, the US pioneered the "twin deficits" posture that is today regarded as part of its enormous strength in the world economy. But in the first few years of this new macro-financial regime, it remained perilously dependent on attracting foreign capital, both from Gulf states and from the industrial export economies of Japan and West Germany. It was a historical novelty for a global hegemon to be a net capital importer. One of the symptoms of the unforeseen and novel nature of this arrangement was a persistent fear among Washington policymakers that excessive use of asset freezes would backfire against the United States.

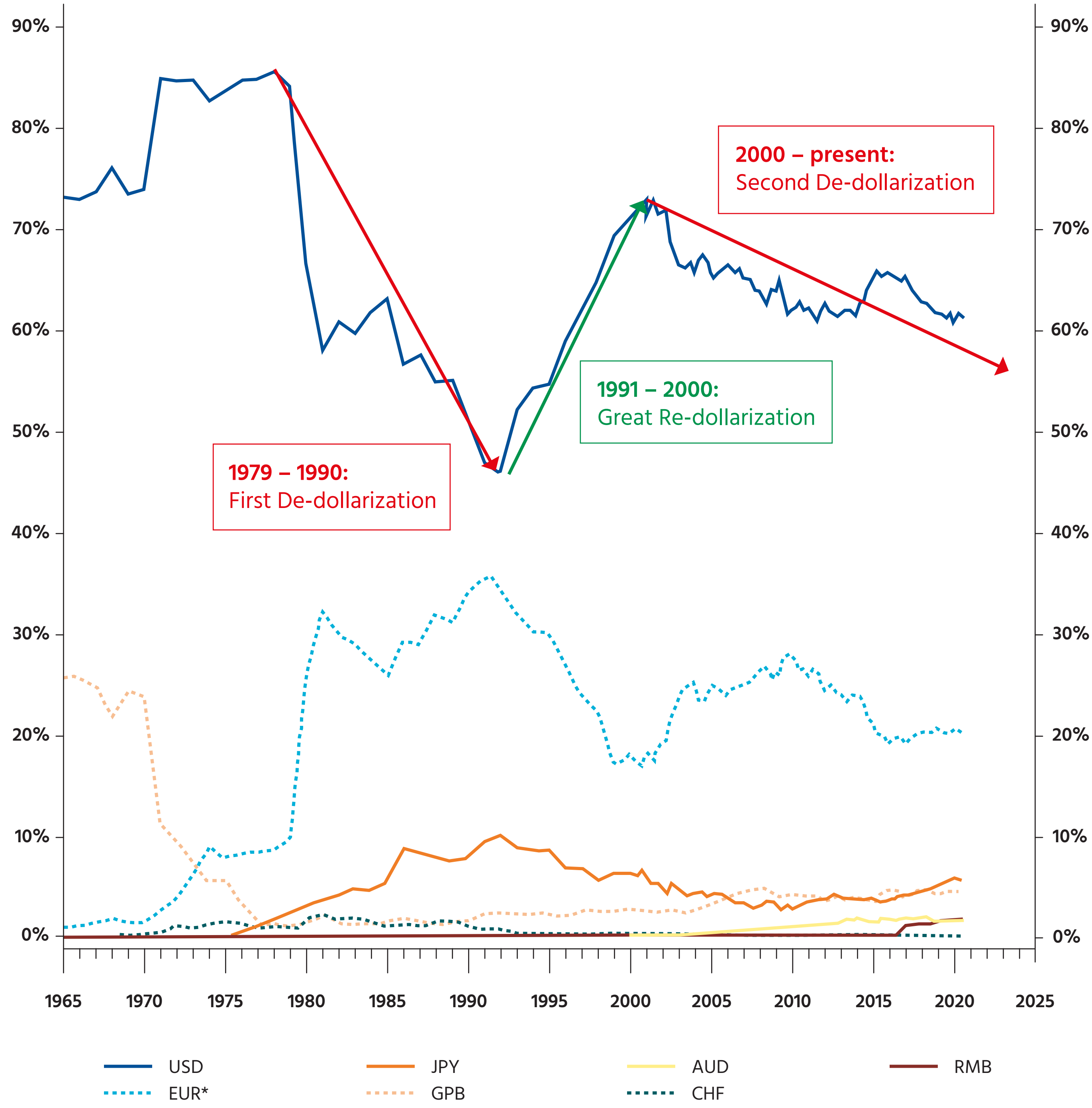
By 1986, even a US-allied country like Saudi Arabia that was deeply invested in the petrodollar recycling system held less than one-third of its reserves in dollars.[18] Four years later, at the end of the Cold War, the dollar share of global foreign exchange reserves had fallen to just 48%; still a plurality among global currencies, but no longer a majority. Some 16.5% of global reserves at this point was held in Deutschmarks, 10% in the European Currency Unit (ECU), and 8% in Japanese yen.[19] In the space of 14 years from 1976 to 1990, the dollar's share of global reserves had decreased by more than one-third. An observer of the international financial system at the end of the Cold War could thus be forgiven for expecting that the US dollar was on the way out, destined to follow the fate of the British pound sterling that had come before it.

But such early predictions of the dollar's demise proved wrong. Two factors have obscured the First De-dollarization. The first was the fact that it was more a financial than a commercial phenomenon: de-dollarization took place in reserve holding but not in trade invoicing, which continued to take place in the greenback on a large and growing scale. The second reason is the fact that the post-1979 flight from dollar reserve-holding was reversed in just as much time as it had taken to occur. Between 1990 and 2000, the dollar's share of foreign exchange reserves surged back from 48% to 71%, bringing it almost back to its level in the mid-1970s.[20] If the 1980s had seen the First De-dollarization, the 1990s were thus the period of Great Re-dollarization (see Figure 1).

Why did the “Great Re-dollarization” take place? Broadly, the resurgence of dollar hegemony from the 1990s was driven by four factors. First, the growing shares in global reserve portfolios of the Deutschmark, ECU, and yen reached a plateau and then fell as these regions experienced economic problems in the 1990s. In Japan, the bursting of the real estate boom spurred by the Plaza Accord of 1985 ended the long period of high postwar growth and led to two and a half decades of deflation in asset prices, reducing the potential and attractiveness of the yen as a dollar substitute. The 1990s revealed that Japan would never overtake the United States and hence would never supplant its reserve currency status. In Europe, the creation of the European Union and the accompanying Stability and Growth Pact (SGP) and creation of the European Central Bank imposed strict limits on the issuance of government debt and money supply growth, likewise limiting the availability of European reserve assets.

A second driver of the Great Re-dollarization was the expansion of Wall Street finance and the role of the IMF as a crisis-fighting institution in the 1990s. The Mexican, East Asian, and Russian financial crises of that decade saw the Fund intervene to bail out distressed economies, while financial market liberalization in the United States enlarged dollar-denominated balance sheets in North America. Both trends increased the availability of dollar credit and hence dollar reserve holdings. Finally, the only other emerging currency that could eventually aspire to make a dent in the dollar's dominance, the Chinese renminbi, was so tightly controlled by the Chinese state that it was effectively a Bretton Woods-era managed currency in a floating exchange-rate world. All these forces meant that the greenback was the only game in town just as a renewed round of financial and commercial globalization took off.

Figure 1 – **The First and Second De-dollarizations in historical perspective, 1970s-present (Share of global currency reserves, in percentage)**



*Includes predecessors: Deutsche Mark, ECU, French Franc, and Dutch Guilder prior to 1999.

Data source: Currency composition of official foreign exchange reserves, IMF.

Image source: BCA Research, 2022

The “Second De-dollarization”

The slow rise of non-dollar currencies in global reserve-holding and trade in the 21st century is not surprising. What is striking is how much trade continues to be invoiced in dollars despite the shrinking international footprint of US trade.

What does this history mean for the present fears about political risk driving de-dollarization? The first thing to note is that there has been a steady but slow fall in the dominance of the dollar since the beginning of the century. This “Second De-dollarization” is so gradual that it was for a long time nearly imperceptible: it has taken a quarter-century for the dollar share of global reserves to fall a mere 14 percentage points, from 71% in 2000 to 57% today – an average decline of just half a percentage point annually.

But in the last decade, especially in the wake of the growing US use of tariffs and sanctions in the late 2010s, the future of the dollar has returned to the forefront of global attention. Widespread concerns over de-dollarization date to 2022, when the G7 imposed wide-ranging sanctions against Russia over its invasion of Ukraine.[21] Ever since, the risk that the overuse of sanctions will erode dollar hegemony has been a frequent topic of public debate among policy experts and academic specialists.[22] Many analysts have dismissed this possibility, noting that the United States enjoys a unique privilege as a global safe haven and reserve currency issuer that is hard to dislodge. Eswar Prasad, for example, voiced a widespread view when he noted in 2024 that “economic and geopolitical turmoil serves only to intensify the quest for…the dollar, which remains the most trusted currency”.[23] The case for continued dollar dominance has been based largely on the conclusion that there are few feasible alternatives available, and that investment in the US comes at minimal political risk.

The slow rise of non-dollar currencies in global reserve-holding and trade in the 21st century is not surprising. What is striking is how much trade continues to be invoiced in dollars despite the shrinking international footprint of US trade, which fell by one-fifth from 2017 to 2025, from 6.5% to 5.2% of global gross domestic product. Barry Eichengreen and his co-authors of a September 2022 paper in the Journal of International Economics also noted a process of “stealth erosion” of dollar dominance due to the growth of non-dollar reserve holdings.[24] This is mainly a move into the “non-traditional” reserve currencies of small to medium-sized export economies that are highly open and competitive, such as the Australian, Canadian, and New Zealand dollars, the Norwegian and Swedish crowns, and Singaporean and Hong Kong dollars. None of this amounts to a dethroning of the dollar, but all of it taken together have slowly lowered the dollar’s share of global reserves and are likely to continue to do so.

Non-Western countries, especially large Asian economies, have been diversifying out of dollar assets for some time now. There are clear and explicit geopolitical reasons for this. The 2022 Russia sanctions and the accompanying freeze of Russian central bank reserves were a major impetus to look for new freeze-proof reserve assets. The Russian freeze opened a new risk vector for central banks with large foreign reserves, whose diversification has since helped to drive a major rally in the price of gold from US$1,800 in February 2022 to US$3,400 by May 2025.[25] On the eve of Donald Trump’s second inauguration in mid-January 2025, the economists Rashad Ahmed and Alessandro Rebucci were already observing a “sharp decline in foreign official demand for US Treasuries and a likely shift towards gold, which is less vulnerable to sanctions and asset freezes".[26] Recent US policy has considerably accelerated an already existing trend that was modest but nonetheless noticeable.

Nothing in US policy since then has reassured foreign investors who had until that point plowed massive amounts of money into Treasuries as a risk-free proposition. To the contrary, by the second week of April 2025, Trump's "Liberation Day" tariff spree caused such financial volatility and economic uncertainty that otherwise patient holders of long-dated US Treasuries began to sell their holdings. De-dollarization has now begun to spread from foreign official holders of Treasuries such as central banks and monetary authorities – who hold about 13%, or US$3.9 trillion, of the total US$28.6 trillion Treasury stockpile – to institutional investors such as pension funds across Asia and Europe.[27] US policy is now driving once-staunch allies towards de-dollarization of their reserves and trade settlement and giving investors good reason to diversify out of US assets to reduce their exposure to the political risks of asset-freezing and debt default. The risk of future coercion will drive generalized diversification even by parties that do not want to resort to coercion. Once the US Treasury market becomes a venue for a standoff between US asset freezing and foreign fire sales of US debt, portfolio managers will begin to preemptively reduce their exposure in order to avoid taking future losses.

As a result of these tensions and uncertainties, even high yields of 4% to 5% on 10- and 30-year Treasuries now appear no longer sufficient to compensate investors for the risk of holding US assets. Spooked by the continuing magnitude of US deficit spending, sources of long-term patient global capital that were hitherto easily available to the US are now much more difficult to reassure. Goldman Sachs warned that "negative trends in US governance and institutions are eroding the exorbitant privilege long enjoyed by US assets," while JPMorgan concluded that "the confidence premium in US assets has been in question".[28]

In the ongoing trade war, worries that were long purely hypothetical are now becoming much more real. In the late 1980s, US commentators were concerned that Japan's rapid economic rise could put Tokyo in a position to deploy a fire sale of US Treasuries to harm the United States. By early May 2025, the Japanese government for the first time explicitly announced its willingness to use its US$1.1 trillion Treasury stockpile as a pressure instrument in trade negotiations with the United States.[29] Although this was quickly walked back, the fact it was even raised shows how quickly the coercive mindset can take over the world economy. The twin deficits, long regarded as a source of US economic strength, may now reemerge as sources of fragility in a world of expanding economic coercion.

Conclusion

The broad nature of the Second De-dollarization suggests that it is likely to take a more diffuse and less dramatic form than the volatile shifts of the 1970s and 1980s. But this very breadth, over a longer period, also makes it less likely to be reversed.

This paper has argued that contemporary debates about de-dollarization lack specificity and historical perspective. The starting point of realistic analysis should be that episodes of currency diversification come in different shapes and sizes. For a hegemonic currency, there are two dimensions that are especially salient: the *speed and destination* of diversification. In terms of speed, diversification in response to political risk can be fast or slow. In terms of destination, it can be narrow when it is focused on a single alternative asset, or broad when it is based on the actions of many economic agents and entails a move into many different alternatives.

Most predictors and critics of the dollar demise thesis are still engaged in debating an implausible form of extreme de-dollarization. In this scenario, the move out of the dollar occurs quickly, and it is assumed that reserve holders will gravitate towards one or a few new liquid assets or currencies that will assume all the roles that the dollar currently plays. Ironically, this is not totally unlike what happened in the 1980s, when the First De-dollarization was indeed fast and narrow. But today, this specific form of de-dollarization is unlikely to come to pass. Critics of the dollar-demise view are thus right that there is no single good alternative to the dollar, and no one currency likely to take its place.

Yet the process of de-dollarization in response to political risk is nonetheless real. It is simply taking a different form than before. Today's de-dollarization is driven by a large number of countries and is flowing into many kinds of alternative assets: traditional haven currencies such as the Japanese yen, Swiss franc, and British pound; non-traditional reserve currencies like the Australian, Canadian, and New Zealand dollars, the Norwegian and Swedish crowns, and Singaporean and Hong Kong dollars; foreign fixed-income assets; gold; crypto-currencies; and even real assets such as land and real estate.

The broad nature of the Second De-dollarization suggests that it is likely to take a more diffuse and less dramatic form than the volatile shifts of the 1970s and 1980s. But this very breadth, over a longer period, also makes it less likely to be reversed. As different economies converge in terms of growth rates and asset accumulation takes less liquid forms, these holdings may be safer from political risk, but at the cost of being less fungible and stickier. If the current diversification is indeed broad and slow, then it may take quite a while longer for the dollar to truly lose its dominant role. But by the same token, we are unlikely to witness a Second Re-dollarization, presaging a monetary history of the 21st century that will be written quite differently from its predecessor.

Writer bio: Nicholas Mulder

Nicholas Mulder is Assistant Professor of Modern European History at Cornell University. His research and teaching focuses on politics, economics, international institutions, and war in the 19th and 20th centuries.

Mulder also writes about current political and economic issues for a variety of publications, including *The Economist*, *Financial Times*, *The Wall Street Journal, The Guardian*, *Foreign Affairs, Foreign Policy, The Nation, The New Statesman,* among others.

Mulder's first book, *The Economic Weapon: The Rise of Sanctions as a Tool of Modern War*, appeared in January 2022 with Yale University Press. His upcoming project, *The Age of Confiscation*, is an international history of expropriation.

Mulder studied at University College Utrecht (BA), the University of Cambridge (MPhil), and Columbia University (PhD).

Nicholas Mulder

Assistant Professor of Modern
European History, Cornell University

Endnotes

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