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MARKET VIEWS

Dollar Weakness: Cyclical Pressures or Structural Shift?

By

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Table of Contents

Rosa & Roubini Associates

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Dollar Weakness: Cyclical Pressures or Structural Shift?

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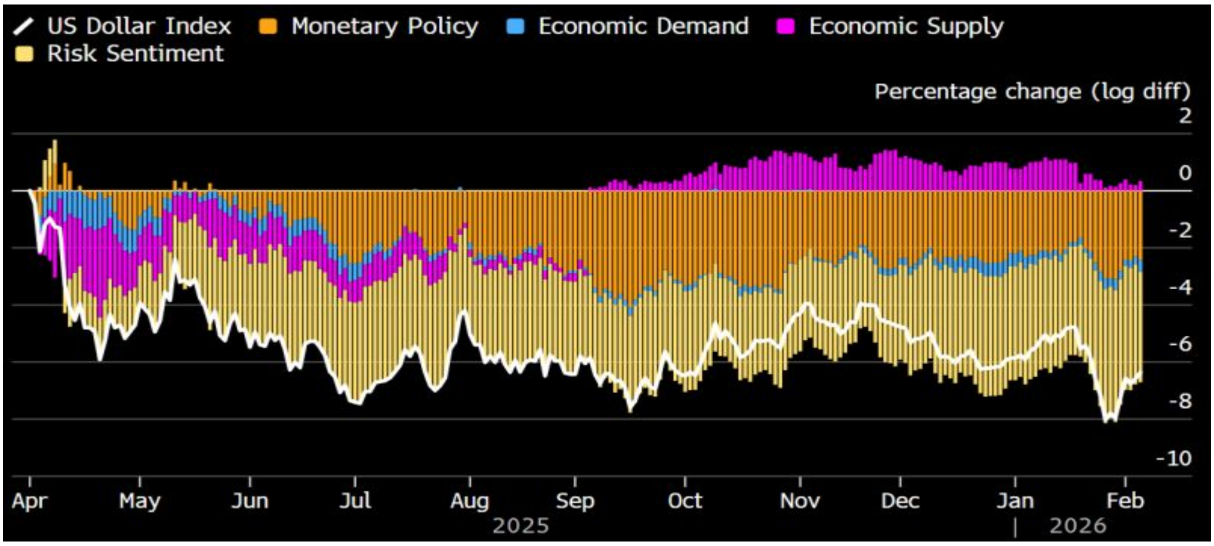
Executive Summary

- The US dollar remains the world's dominant reserve and transaction currency, retaining what has long been called America's "exorbitant privilege."
- Historically, crises strengthened the dollar, as capital flowed into US assets. Recent episodes, however, show political risk in Washington can now generate dollar weakness rather than safe-haven demand.
- Policy unpredictability, fiscal deterioration, and concerns about Federal Reserve independence have contributed to rising US risk premiums.
- While some argue the dollar's dominance remains secure due to unmatched market depth and institutional strength, others see gradual erosion. The reality lies between these extremes.
- The dollar's global role has slowly shifted from being anchored in industrial supremacy to being sustained primarily by financial dominance.
- Since 2008, US equity markets have significantly outperformed economic growth, attracting over $20 trillion in largely unhedged foreign capital.
- Much of this outperformance was supported by exceptional tailwinds — falling interest rates, tax cuts, quantitative easing, and rising profit shares — which are now fading.
- The US net international investment position (NIIP) has deteriorated to roughly -79% of GDP, reflecting decades of current account deficits financed by foreign capital.
- Foreign holdings have shifted from primarily US Treasuries to US equities, making dollar stability increasingly dependent on stock market performance.
- US Treasuries are facing renewed scrutiny amid rising debt levels and political polarization, while China is gradually reducing direct exposure, though not abandoning US assets.
- Central banks are diversifying at the margin into gold, which now exceeds Treasuries in some reserve portfolios — but this reflects risk management rather than systemic de-dollarization.
- Despite gradual diversification, no credible alternative to the dollar exists: the euro lacks political unity, a BRICS currency does not exist, and the renminbi remains constrained by capital controls. The dollar's dominance may weaken at the margin, but systemic displacement remains premature.

Key Picture: Drivers of US Dollar Index



Source: Bloomberg

Introduction

For decades, the US dollar has occupied a unique position at the center of the international monetary system. As the world's dominant reserve currency, what Valéry Giscard d'Estaing famously called America's "exorbitant privilege", the dollar and dollar-denominated assets have functioned as the ultimate safe haven during periods of global stress. In moments of turmoil, capital traditionally flows not away from the US, but toward it.

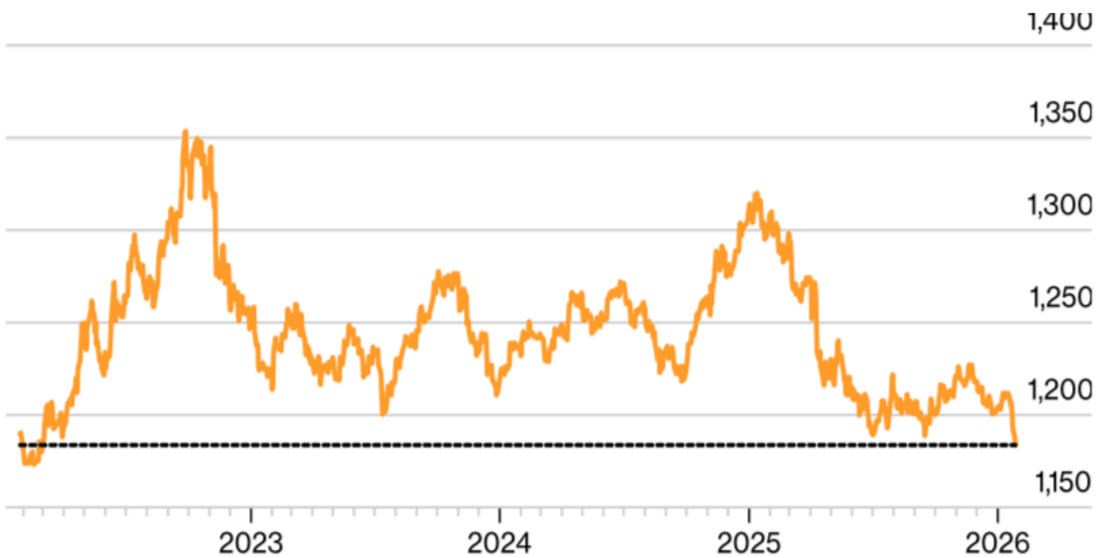
As mentioned, In past crises, investors rushed into dollar assets, strengthening the currency, as in 2008. Yet recent developments have challenged this assumption. In the days following President Trump's announcement of "Liberation Day" tariffs last April, the US dollar fell by more than 5 percent. Nearly a year later, the greenback has yet to fully recover those losses. The episode marked a rare instance in which political risk emanating from Washington translated into sustained currency weakness rather than renewed safe-haven demand.

Unpredictable policymaking, including renewed tariff threats and geopolitical rhetoric that unsettled traditional allies, has contributed to the dollar's slide (**Figure 1**). US dollar weakness has been driven primarily by a shift in global risk appetite rather than a fundamental reassessment of US eco prospects. At the same time, concerns over pressure on the Federal Reserve, a deteriorating fiscal trajectory, and rising political polarization have weighed on investor confidence. Major peer currencies have climbed to multi-year highs, prompting renewed debate about whether the dollar's dominance remains as secure as widely assumed.

Others disagree, arguing that dollar dominance remains firmly entrenched. The United States still offers the world's deepest and most liquid financial markets, strong legal protections, and unmatched network effects. No alternative currency, including the euro or the renminbi, can replicate the dollar's central role in trade invoicing, reserves, and global finance. For now, the logic of "there is no alternative" continues to hold.

Truth is somewhere in the middle. It is correct to assume that the dollar's dominance has been slowly eroding for decades. After 1945, US power rested on industrial, technological, financial and military superiority. But from the 1960s onward, the US lost manufacturing leadership, trade surpluses turned into deficits, and dollars flowed abroad through imports and outward investment. When the gold standard collapsed in the early 1970s, the US became increasingly reliant on global demand for its financial assets rather than its goods.

Figure 1: Bloomberg Dollar Spot Index



Source: Bloomberg

While several pillars of US economic dominance are under pressure (**Key Picture**), the institutional architecture underpinning the dollar remains intact. The distinction between marginal erosion and systemic rupture is crucial.

Today, while America remains financially dominant — with the dollar central to trade, reserves and global finance — its industrial edge has narrowed, particularly against China and East Asia. The dollar's "exorbitant privilege" endures, but it rests more on financial power than productive supremacy. Trump's push for tariffs and industrial revival reflects an attempt to reverse this long-term shift. Whether it strengthens the foundations of dollar dominance or accelerates uncertainty remains unclear.

Macro Context

To understand whether this represents cyclical adjustment or structural shift, one must examine the underlying drivers of US asset outperformance.

Since the global financial crisis, US equities have delivered returns far outpacing real economic growth. Foreign investors more than tripled their exposure over the past decade to above $20 trillion, largely unhedged. Rising valuations and a strengthening dollar reinforced one another, amplifying gains for international investors.

But this performance was underpinned by exceptional tailwinds that are now fading. A four-decade decline in interest rates lifted asset valuations, particularly long-duration equities. Corporate tax cuts boosted after-tax profits. Quantitative easing inflated financial assets. And the redistribution of income from labor to capital raised profit shares in GDP. Federal Reserve research suggests that lower rates and taxes alone accounted for nearly half of US profit growth over the past three decades and much of the expansion in valuation multiples.

As these supports weaken, profit growth and equity returns are likely to moderate. At the same time, concentration risk has intensified: over the past three years, just seven companies generated more than half of total S&P 500 returns, with the top 10 now accounting for roughly 40 percent of the index. This reflects narrow leadership rather than broad-based strength.

Fiscal Position

Beyond equities, the sustainability of dollar dominance depends on the structure of America's external balance sheet. And the pressing question is whether financial dominance is also weakening. One way to assess this is through the US net international investment position (NIIP), which measures the difference between US-owned foreign assets and foreign-owned US assets — including direct investment, equities, bonds and cash. The US NIIP is now deeply negative, equivalent to roughly 79 percent of GDP, and has widened steadily over time. This reflects decades of trade and current account deficits financed by foreign investors recycling surpluses into US assets.

Importantly, the composition of foreign holdings has shifted. While foreign direct investment into the US has risen, the bulk of foreign exposure is in portfolio assets — bonds and, increasingly, equities. Foreign investors now hold over $15 trillion in US bonds and roughly $21 trillion in US equities, with equity holdings surpassing bonds in recent years.

This marks a structural change. Rather than primarily financing US deficits through "safe" Treasuries, foreign investors have increasingly bought US stocks, especially during the post-pandemic market boom. As a result, the dollar's stability is now more closely tied to equity market performance. A sharp correction, for example, if the AI-driven rally were to unwind, could trigger capital outflows and renewed pressure on the currency.

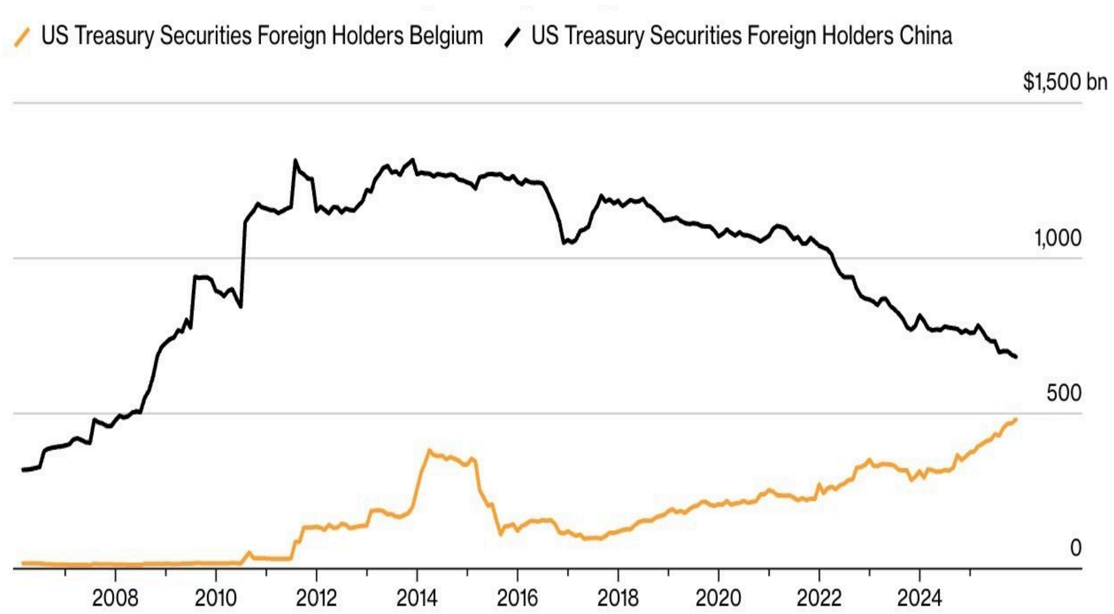
Treasuries Under Scrutiny

US Treasuries, long considered the global risk-free benchmark, are also being reassessed. Rising debt-to-GDP ratios, recurring fiscal brinkmanship, political polarization, and questions around central bank independence have unsettled investors.

Adding to the pressure, Chinese regulators have reportedly advised domestic financial institutions to reduce excessive exposure to US Treasuries. Once the largest foreign creditor to the United States, Beijing was overtaken by Japan in 2019 and by the UK last year. Its Treasury stockpile has nearly halved since peaking in 2013, falling to $683 billion in November — the lowest level since 2008. Some analysts suggest the drop may be overstated, as part of China's exposure could have been shifted to European custodial accounts. Belgium's reported Treasury holdings, which may include Chinese-managed assets, have quadrupled since 2017 to $481 billion (**Figure 2**).

The guidance, framed as a prudential effort to mitigate concentration risk and manage market volatility, encourages banks to limit additional purchases of US government bonds and gradually rebalance portfolios where holdings are deemed elevated. Notably, the directive does not apply to China's official state reserves, suggesting the move is tactical rather than a wholesale retreat from US assets. Still, Treasuries slipped on the news of guidance to Chinese banks, with yields rising modestly across maturities in Asian trading, while the dollar eased slightly against major currencies.

Figure 2: China's US Bond Holdings Fall, Belgium's Rise



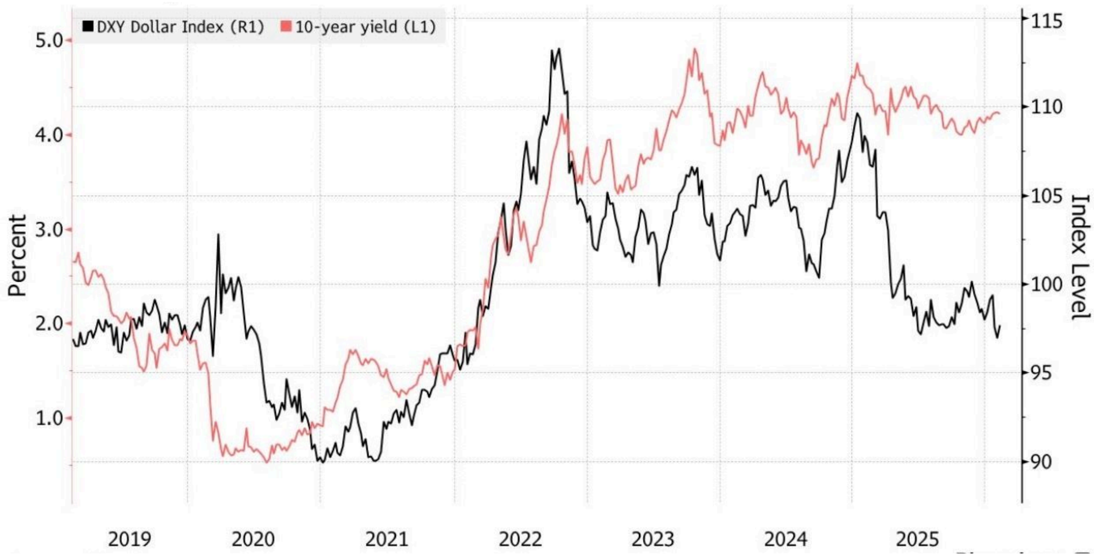
Source: US Treasury

Still, the signal is difficult to ignore. At a time when US fiscal deficits are widening and political uncertainty is intensifying, even incremental diversification by one of the world's largest holders of Treasuries reinforces the narrative of gradual portfolio reassessment (**Figure 3**). The so-called "US risk-reduction trade" appears to be gaining traction among global investors, with gold increasingly serving as an alternative store of value. The shift in bullion demand from Western financial centers toward Asia underscores a broader rebalancing of financial gravity, even if it falls short of systemic de-dollarization.

While China is actively promoting renminbi internationalization through bilateral currency swaps, the Cross-Border Interbank Payment System (CIPS), BRICS payment initiatives and the digital yuan, China is not looking to dethrone the dollar; the cost of running the world's reserve currency is far too great. What it does seek is greater use of the yuan rather than toppling the USD.

As for now, the renminbi accounts for less than 2 percent of global reserves, compared with roughly 57 percent for the dollar. China maintains capital controls, limits convertibility and operates under a state-managed financial system — features fundamentally at odds with the openness required of a true reserve currency.

Figure 3: Dollar Departs from Bond Yields



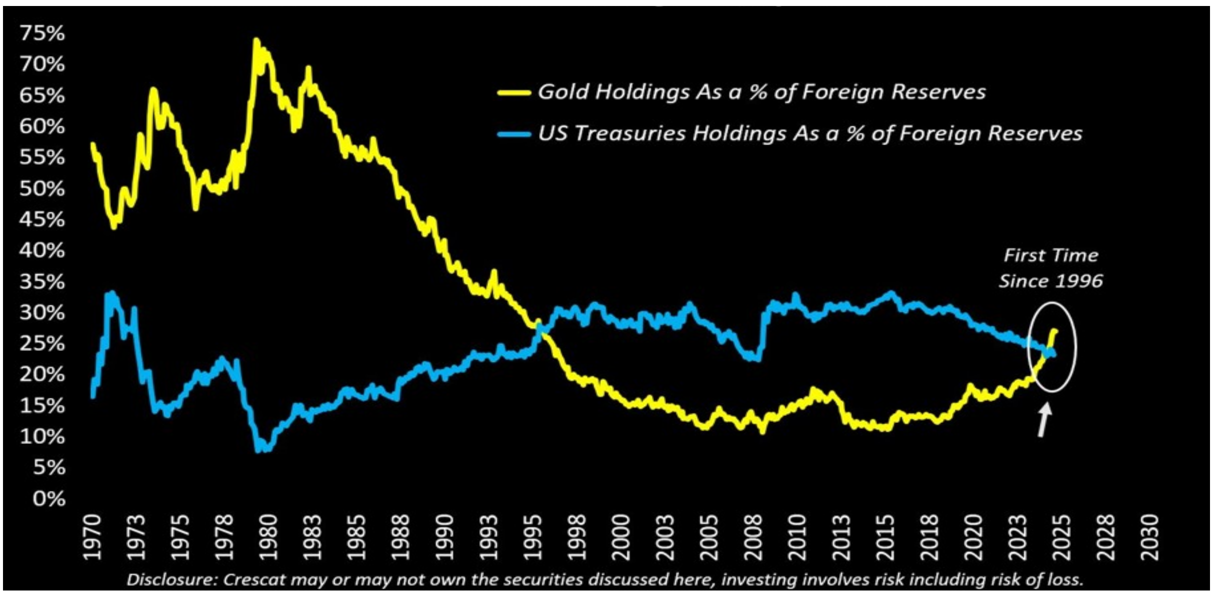
Source: US Treasury

Gold's Structural Return

For the first time since 1996, foreign central banks now hold more gold than US Treasuries in their reserves, marking a notable shift in global reserve allocation. Data released in early 2026 show that gold's share of reserves surpassed that of US government debt in 2025, driven by rising geopolitical uncertainty and efforts to diversify away from concentrated dollar exposure.

Since 2021, central banks — particularly in emerging markets such as China, India and Turkey — have steadily increased gold purchases (**Figure 4**). The move reflects concerns over expanding US debt levels, sanctions risk and broader geopolitical tensions. Viewed as a neutral, inflation-resistant asset, gold has regained prominence as a hedge against currency volatility. While this rebalancing does not displace the dollar's central role in global finance, it underscores a gradual shift in reserve management strategies amid a more fragmented and uncertain global environment.

Figure 4: Foreign Central Banks Hold More Gold Than Treasuries



Source: Bloomberg; Tavi Costa

The "Debasement Trade"

Gold's price, now back above $5,000 per ounce after a brief correction, also reflects cyclical forces. Over the past year, markets have increasingly priced what is termed the "debasement trade", a rotation out of dollar cash and Treasuries into hard assets. Investors worry that real returns on dollar assets may erode. Inflation remains above the Federal Reserve's 2 percent target, while political pressure for rate cuts has intensified. If policy easing occurs amid persistent inflation, real yields would decline further. Interest-rate expectations reinforce this dynamic. Markets anticipate US. rates falling more than those in other major economies, narrowing forward differentials and weakening the dollar's yield advantage. That shift supports gold and other non-dollar stores of value.

Yen Surge and Intervention Speculation

The Japanese yen has surged, pushing the dollar lower across markets, after reports that the New York Federal Reserve conducted rate checks — raising speculation about potential joint US-Japan currency intervention for the first time in 15 years. The yen strengthened further in Asian trading, while the euro reached multi-month highs and gold climbed above $5,000 per ounce.

Japanese officials added to the momentum by signaling readiness to intervene if necessary. The yen is now on track for its strongest multi-day rally since the unwinding of global carry trades in August 2024. Market participants interpreted the Fed's involvement as an unusually strong signal, fueling discussion of possible coordinated efforts — sometimes dubbed a "Plaza Accord 2.0" — to manage dollar strength.

Part of the move reflects a squeeze on large short yen positions. But broader dollar weakness suggests this is not merely a currency-specific adjustment. Investors are increasingly uneasy about US fiscal risks, trade policy uncertainty and potential shifts in Federal Reserve leadership. Rising policy volatility has contributed to a growing US risk premium.

Whether intervention would fundamentally change the trend remains debated. Some analysts argue coordinated action could stabilize the yen without triggering sustained appreciation. Others view the episode as a controlled policy reset aimed at preventing disorderly currency moves. The episode highlights heightened currency volatility and the increasing role of policy signaling in shaping exchange-rate expectations.

Conclusion

Although the dollar's share of global reserves has declined, it still accounts for roughly half of central bank holdings, far ahead of any rival currency or gold. In foreign exchange markets, the dollar is involved in nearly 90 percent of transactions. While direct settlements in renminbi have increased, particularly with Russia and parts of the Gulf, their scale remains small relative to dollar-based trade flows.

The same dominance holds in derivatives markets. The $100 trillion foreign exchange swap market — essential for global hedging and liquidity management — is overwhelmingly dollar-based. Institutions are not meaningfully shifting into other major currencies. Where diversification is occurring, it is largely into gold. Yet gold cannot replace the dollar's role in global finance. Even at current prices, the total value of above-ground gold is modest relative to global GDP and far smaller than global debt markets. Cryptocurrencies are even less capable of serving as systemic substitutes.

There is, for now, no credible alternative to the dollar in global markets. The euro lacks fiscal and political unity; a so-called "BRICS currency" does not exist; and the renminbi remains constrained by China's capital controls. The idea that BRICS represents a coherent financial bloc capable of replacing the dollar is overstated, and Beijing has shown little willingness to fully liberalize its capital account.

As a result, the financial pillar of US dominance remains intact. The dollar may weaken further amid slower growth, market corrections, or narrower interest-rate differentials. Does this imply the end of dollar dominance and a rapid shift to a multipolar currency system? That conclusion is premature. The structural advantages underpinning the dollar remain significant, even if the risks at the margin are rising.