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ARTICLE

DOLLAR RISK AND EURO OPPORTUNITY: A MODEL-BASED SCENARIO ANALYSIS

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Abstract
This article explores the macroeconomic consequences of a sharp US dollar depreciation against the backdrop of high US policy uncertainty, fiscal imbalances and growing geopolitical fragmentation. Using the NiGEM global macroeconomic model, we simulate three scenarios: (1) a combined shock to currency and investment risk premia; (2) a broad-based currency risk premium shock and (3) a currency risk premium shock specifically benefiting the euro. The first scenario results in a global slowdown, with pronounced effects on the US economy. In contrast, the latter two scenarios suggest potential gains for the Euro Area, conditional on the euro's enhanced international role. Realising such gains would require measures to increase the supply and liquidity of Euro Area safe assets. The analysis also highlights risks beyond the model's scope, including the potential for a financial crisis triggered by a sudden loss of confidence in the US dollar.

Keywords: macroeconomic model; exchange rate; confidence loss; risk premium; interest rate parity

1. Introduction

While the US dollar remains the dominant global currency, its status is increasingly at risk due to policy uncertainty—particularly surrounding the Mar-a-Lago Accord—, rising national debt, and mounting pressure on the Federal Reserve's independence. These risks are compounded by increasing geopolitical bloc formation and threaten to undermine the dollar's role as the primary reserve and trade currency in the medium term.

Since the new administration took office in early 2025, the US dollar has declined by 13.3% against the euro, 13.7% against the Swiss franc and 6.7% in nominal effective terms. This sharp depreciation of the US dollar reflects shifting economic expectations—namely, a modest recovery in the German economy and a slowdown in the previously booming US economy—as well as a loss of confidence in the US currency. While the dollar continues to serve as the world's primary reserve currency, its recent depreciation exceeds what would typically be considered normal exchange rate fluctuations (Figure 1).

This article proceeds as follows. Section 2 identifies the key drivers behind the dollar's recent decline. Section 3 draws on invoicing and reserve currency data to show that the dollar's global role remains intact for now. This status is at risk, however, as discussed in Section 4. Against the backdrop of recent exchange rate dynamics, we use the NiGEM global macroeconomic model in Section 5 to simulate a sharp dollar depreciation under three scenarios: (1) a combined shock to the currency and investment risk premium; (2) a broad-based currency risk premium shock and (3) a currency risk premium shock specifically favouring the euro. In the first scenario involving cross-asset shocks, global growth slows, with the US economy most severely affected. In contrast, the other two scenarios indicate that a weakening of the US dollar could substantially benefit the Euro Area, provided the euro strengthens its role as an international reserve currency. In addition to acknowledging the model's limitations, we also emphasise that a broader

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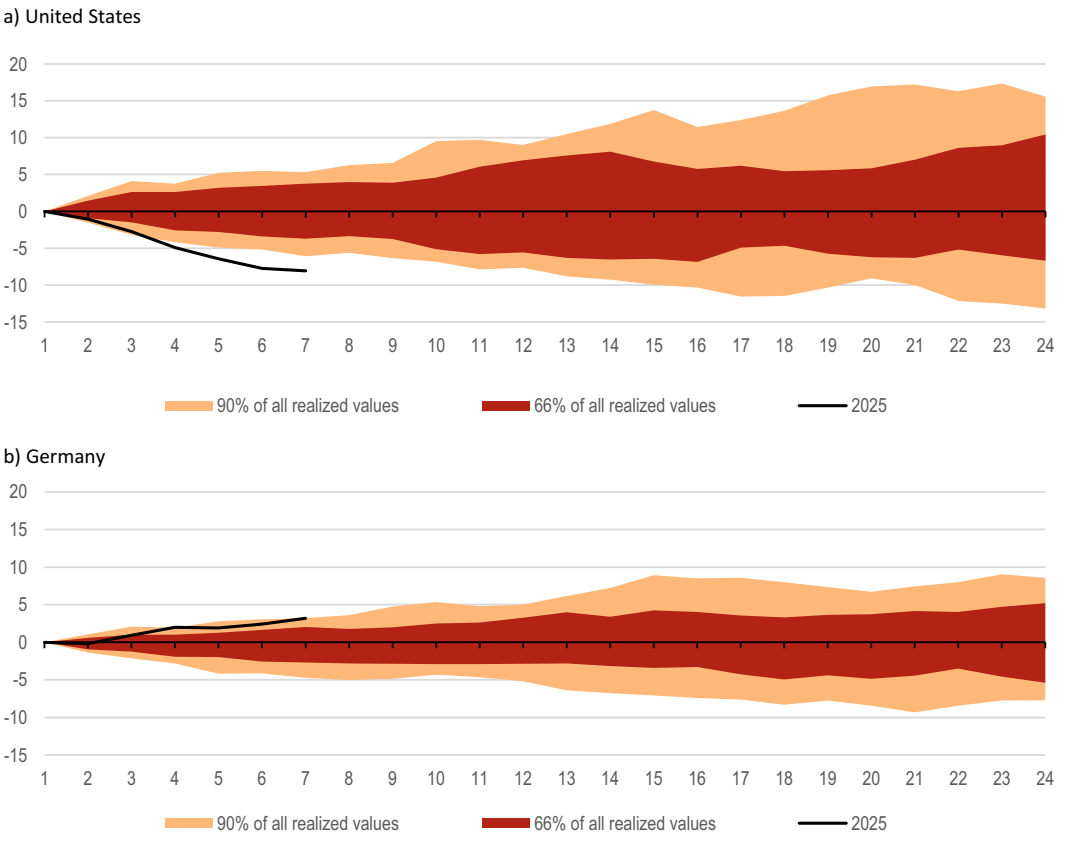


Figure 1. Real effective exchange rate since 1982. Cumulative percentage change year to date, %, monthly, narrow index. The figure shows overlapping paths of the real effective exchange rate against 51 countries over 24 months. The length of the paths was chosen based on exchange rate developments in the 1980s, also referred to in Miran (2024). Until 1985, the US dollar appreciated strongly—by 12% in real effective terms over 2 years because restrictive monetary policy and increased government borrowing led to rising US interest rates resulting in higher global investments in the US. In 1985, the Plaza Accord between representatives of the G5 countries resulted in foreign exchange interventions and a 15% real effective depreciation of the dollar by 1987
Source: Bruegel via Macrobond, authors' calculations.

international financial crisis—triggered by a sharp loss of confidence in the US dollar—cannot be ruled out beyond the scope of NiGEM. Section 6 concludes and emphasises that for the Euro Area to benefit from a weaker US dollar, long-overdue reforms are needed to expand the supply and liquidity of Euro Area government bonds that qualify as safe assets.

2. Perceived risk of US dollar assets rises in 2025

Two key factors contributed to the dollar's depreciation in the first half of 2025: revised GDP growth expectations and a reassessment of the risk associated with the dollar and US Treasuries. Against the euro, the dollar had strengthened to 1.035 USD/EUR in January 2025—a level previously recorded only in the early 2000s and the second half of 2022. This was largely driven by Germany's prolonged economic weakness since 2022 and heightened political uncertainty following the collapse of its coalition government in November 2024. However, the announcement of a planned investment initiative in early March 2025 improved Germany's economic outlook and shifted expectations for monetary policy, prompting an appreciation of the euro to 1.086 USD/EUR within days of the announcement (Figure 2). The euro's

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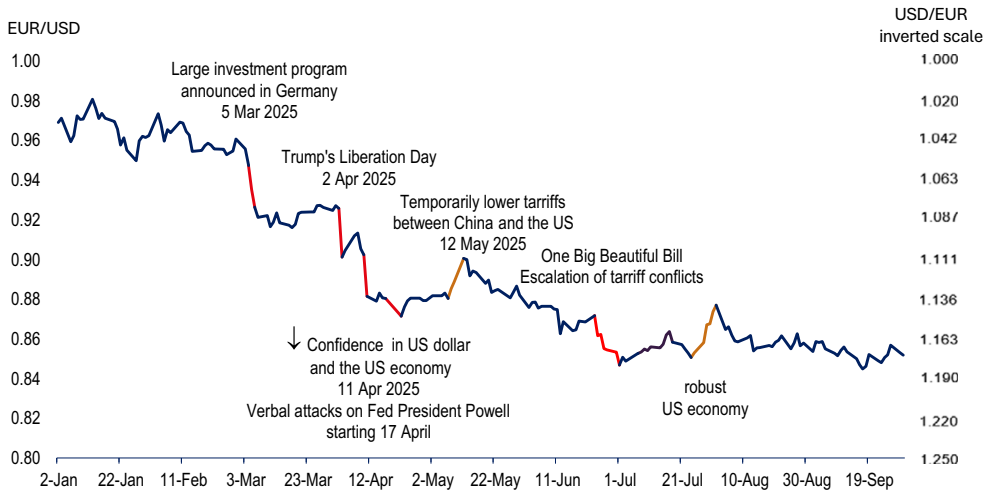


Figure 2. Daily US dollar/Euro exchange rate, January to September 2025.
Source: ECB; authors' calculations and dating.

appreciation was accompanied by an increase in Germany's long-term yields and a concurrent narrowing of the yield differential between the US and Germany.

The depreciation of the US dollar in subsequent months was primarily driven by domestic events. At times, the dollar weakened even as long-term interest rates rose—indicating a rising risk premium and a loss of investor confidence in the currency. This was most pronounced following the sweeping global tariff declaration on Trump's so-called 'Liberation Day', when the dollar fell by nearly 3% against the euro. The S&P 500 dropped by 12% over the next four trading days. Although equity markets recovered significantly within 9 days—largely due to the temporary suspension of most tariffs on April 9—the dollar had declined by a total of 5% against the euro, reaching 1.135 USD/EUR. Over the same period, the yield on the US 10-year Treasury rose by 0.3 percentage points, while its German counterpart declined by 0.1 percentage points.

The dollar reached a preliminary low of 1.15 USD/EUR on 22 April 2025, following repeated criticism by Trump of Federal Reserve Chair Powell and hints at his potential dismissal. Shifts in short-term interest rate expectations suggest that the depreciation of the dollar and the corresponding decline in the foreign-currency value of dollar-denominated assets partly reflect concerns about a weaker medium-term US economic outlook. By 22 April, the federal funds rate expected for December 2025 was 0.5 percentage points lower than on 20 February and 0.6 points lower for maturities through December 2029. However, the 10-year US-German bond yield spread stood at 1.97 percentage points—the same level observed on 1 November 2024 and 20 February 2025, when the exchange rate was significantly stronger at 1.089 USD/EUR and 1.044 USD/EUR, respectively. Meanwhile, long-dated futures (March 2030) priced the euro at 1.240 USD/EUR, up from 1.109 USD/EUR (20 February) and 1.144 USD/EUR (1 November), both for December 2027 delivery. This indicates a revaluation of US bonds that cannot be explained by interest rate expectations alone.

A confidence-driven component is also suggested by the fact that the US dollar depreciated most sharply against the euro and the Swiss franc, that are typically also regarded as safe havens (Table 1).

The marked increase in interest rates on high-risk bonds issued by US companies after 2 April 2025 also indicates a rise in the risk premium. Although these rates have since declined, a sustained upward trend is particularly evident for long-term US government bonds (Figure 3).

Since early July 2025, dollar exchange rates have moved little. In September 2025, the dollar-euro exchange rate stood at 1.173 USD/EUR, compared to 1.167 USD/EUR 2 months earlier. At the same time, the perceived risk of US dollar assets declined, as reflected in the substantial drop in the 10-year

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Table 1. Major US dollar exchange rates

	US dollar per currency unit[1]				
	Jan 2025	Jul 2025	Change (%)	Sep 2025	Change (%)
Euro	1.0354	1.1677	12.8	1.1732	13.3
Japanese yen	0.00639	0.00679	6.3	0.00676	5.9
Pound sterling	1.2354	1.3489	9.2	1.3514	9.4
Canadian dollar	0.6950	0.7304	5.1	0.7233	4.1
Renminbi yuan	0.1371	0.1394	1.7	0.1404	2.4
Swiss franc	1.0994	1.2517	13.9	1.2500	13.7

Source: Deutsche Bundesbank, FRED Database, authors' calculations.
[1]A higher value indicates a depreciation of the US dollar.

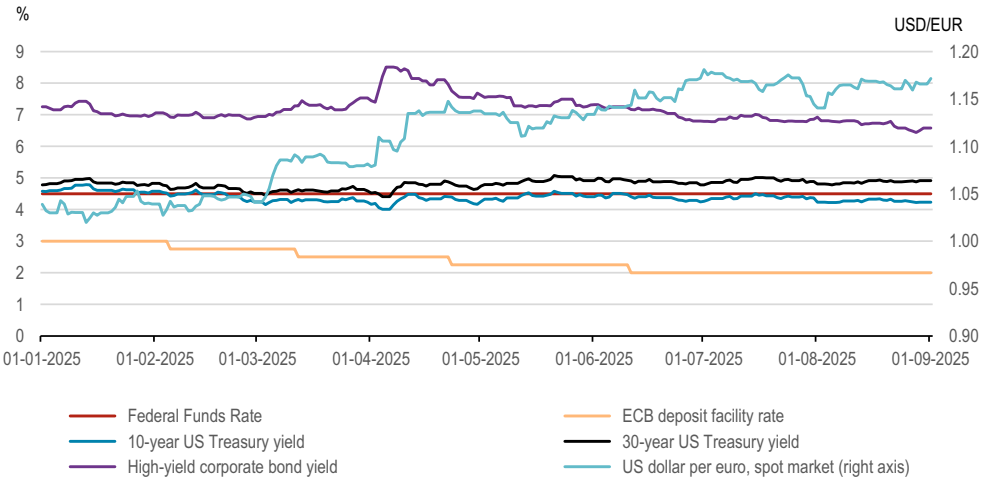


Figure 3. Diverse asset class indicators: policy, sovereign, corporate, and FX in 2025.
Source: Macrobond; Ice Data Indices; LLC via FRED; authors' calculations.

government bond yield differential between the US and Germany—from 1.72 percentage points in July to 1.41 percentage points in September. This marks a clear departure from the period between March and June 2025, when the dollar weakened from 1.081 USD/EUR to 1.152 USD/EUR and the yield differential widened from 1.50 to 1.84 percentage points, suggesting heightened risk perceptions and a revaluation of US dollar-denominated assets, given that depreciation of the US dollar and other advanced economy currencies is typically associated with a narrowing, rather than a widening, of the yield differential.

3. The US dollar's slowly waning role as global key currency

The US dollar has been the dominant international currency for over 80 years, with the US meeting all the core requirements of a key currency country: The US economy was sufficiently large to play a sizable role in global markets; its political structures were sufficiently stable and transparent, and the market for safe assets—typically sovereign bonds, such as US Treasuries—was adequately deep and liquid as well as

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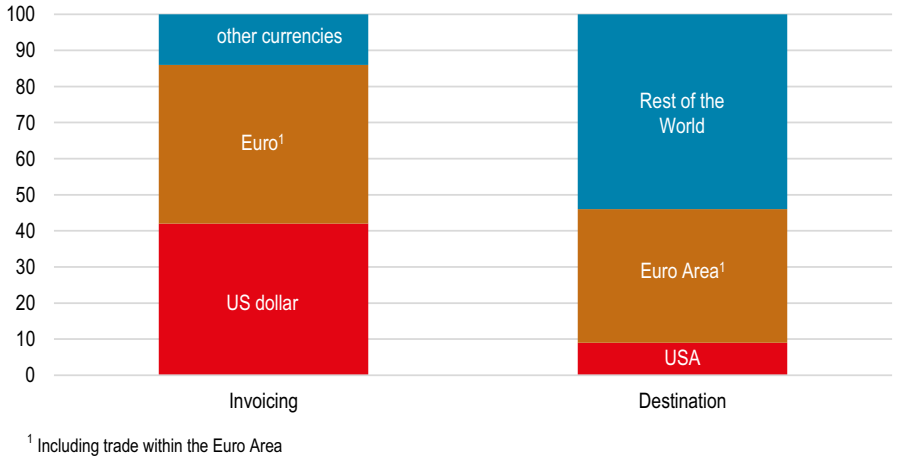


Figure 4. Global export shares by invoicing currency and destination in %. Also see Eurostat (2025).
Source: ECB, 2025, p. 52; authors' footnote.

globally accessible. In addition, the US maintained a leading position in military power, technological innovation and productivity.

As the key currency country, the United States enjoys the 'exorbitant privilege' of being able to incur debt at lower interest rates than other sovereigns while investing abroad at higher yields (Eichengreen, 2010; Gourinchas and Rey, 2022).[1] This advantage stems from the strong global demand for the key currency country's government bonds, which are widely held as currency reserves and other forms of reserves. Crucially, this demand is underpinned by the dominance of the key currency in invoicing global trade.

Not only are 94.8% and 95.8% of US imports and exports invoiced in US dollars, respectively (BIS, 2025), but the dollar also accounts for 60% of total exports worldwide (ECB, 2025). In contrast, the euro represents 25% of global export invoicing. When foreign trade within the Euro Area is included, the dollar and euro each account for approximately 40% (Boz *et al.*, 2022; ECB, 2025). However, as illustrated in Figure 4, the share of exports invoiced in euros is only marginally higher than the share of Euro Area exports in global exports, whereas the US dollar's share as an invoicing currency far exceeds the proportion of US exports in global exports.

These proportions have remained largely unchanged since 1999 (Boz *et al.*, 2022). The Chinese yuan has thus far played a minor role in global trade invoicing, accounting for less than 2% (ECB, 2025, p. 55). However, the Chinese government is eager to increase its role, and the potential for change is considerable given the size of China's GDP and its significance in Asia and the global economy.

The importance of the US dollar in international trade invoicing drives strong demand for dollars, as imports must be paid for and reserves are accumulated accordingly, typically held in short-term Treasuries.

Accordingly, the dollar continues to dominate global currency reserves. In the first decade following the introduction of the euro, there was widespread expectation that it would partially replace the US dollar as the leading reserve currency (Timmer *et al.*, 2011). However, the Euro Area crisis revealed significant institutional weaknesses within the Euro Area—most notably, the lack of breadth and depth in the market for safe government bonds. By 2009, the euro's share of international currency reserves had risen by 9.8 percentage points to 27.7%, while the US dollar's share had declined by 8.9 percentage points

[1]Another aspect of this privilege is the central bank's seigniorage gains derived from foreign cash holdings of the key currency.

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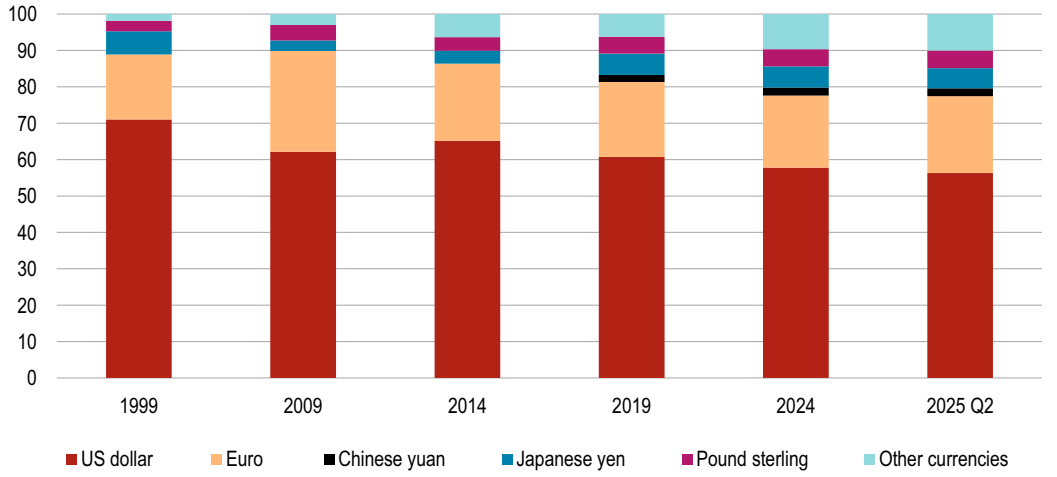


Figure 5. Currency composition of official currency reserves shares in %. In US dollars and without unallocated foreign exchange reserves.
Source: IMF, Currency Composition of Official Currency Reserves (COFER), 1 October 2025; authors' calculations

to 62.2%.[2] The euro's share then declined to 19% by 2015 and has since fluctuated between 19% and 21%, only slightly above its level at the time of introduction (Figure 5).

The share of the US dollar in international currency reserves has declined by 13 percentage points since 1999. Of this decline, approximately two percentage points each can be attributed to the euro, the pound sterling, and the Chinese yuan—the latter having been included in the IMF's official reserve currency statistics only since 2016. An additional eight percentage points have shifted to 'other currencies', most notably the Australian dollar and the Canadian dollar, while the Japanese yen has lost just under one percentage point. The likely future tripolar currency system, comprising the dollar, the euro and the yuan, is still in its early stages. The dollar continues to serve as the dominant international reserve currency, albeit in a slightly diminished capacity, while the euro and the yuan function primarily as regional reserve currencies.

4. Risks to the US dollar from economic policy and geopolitical fragmentation

The geopolitical shifts of the past 3 to 10 years, along with the economic policy agenda of the Trump administration, increase the risk that the gradual decline in the dominance of the US dollar could give way to abrupt shifts away from Treasuries and possibly US assets more broadly. Potential consequences range from a sharp depreciation of the dollar to an international financial crisis.

As a result of the sanctions against Russia and rising geopolitical tensions more broadly, trade among the BRICS+ countries has not only intensified, but a payment system independent of the US dollar has also emerged. Given that the BRICS+ countries account for 45% of the world's population and nearly 27% of global GDP (in US dollars),[3] the potential loss for the US dollar as both an invoicing and reserve currency is substantial.

Current US economic policy is likely to accelerate the decoupling of the BRICS+ countries from the US dollar and could also prompt other institutional and private investors to shift out of dollar-

[2]In part, this shift was attributable to the substantial appreciation of the euro from 1,07 USD/EUR in 1999 to 1,39 USD/EUR in 2009.

[3]Calculated using the World Bank's population data and the IMF's GDP data for BRICS+ countries Brazil, Russia, India and China (BRIC) as well as South Africa, Egypt, Ethiopia, Iran, Saudi Arabia and the United Arab Emirates in 2023.

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denominated assets. Central to this are the heightened uncertainty caused by Trump's drastic and erratic tariff policy as well as his calls for significant interest rate cuts and a weaker dollar. Specifically, the Mar-a-Lago Accord—proposed by Stephen Miran, Chairman of the Council of Economic Advisers and appointed to the Federal Reserve Board of Governors in August 2025—has increased the risk of financial losses (Miran, 2024). Miran's narrative is that providing a reserve currency is not an 'exorbitant privilege' but rather a 'burden' as the high demand for US dollars and US dollar-denominated bonds leads to an overvaluation of the dollar that undermines export competitiveness and causes deindustrialisation (Krugman, 2025). His goal is to establish an exchange rate favourable to US manufacturing while maintaining low interest rates and simultaneously preserving the dominant position of the dollar. Failing voluntary acceptance of lower yields on US Treasuries and a weaker dollar by the beneficiaries of US hegemonic power, the US would enforce a conversion of Treasuries into 100-year bonds bearing little or no interest through the threat of tariffs and the withdrawal of military support. Trump's backing of this position has created an environment in which investors must repeatedly question whether they can reallocate their US holdings ahead of a potential sell-off.

4.1. The nature of the shock matters

To assess the macroeconomic impact of large dollar depreciations, we use the NiGEM multi-country macroeconometric model, widely used by central banks. In NiGEM, exchange rates are modelled according to the risk-adjusted uncovered interest parity hypothesis, which holds that expected exchange rate changes reflect interest rate differentials and the currencies' risk premia (Gandolfo 2001; Kirby and Meaning 2014):

$$E\left[\frac{fx_{t+1}}{fx_t}\right] = \frac{1+r_t}{1+r_t^{us}}(1+\varepsilon_t) \tag{1}$$

where fx_t is the exchange rate at time, r_t and r_t^{us} are the respective policy rates and ε_t is the relative country-specific risk premium. This relationship is derived from interest rate arbitrage between domestic and foreign investments, which requires that returns on comparable investments in different currencies be equal after adjusting for the risk premium (ε_t), reflecting their differing risk profiles and underlying currencies (Engel *et al.*, 2023; Kalemli-Özcan and Varela, 2021; Obstfeld and Zhou, 2023).[4] Otherwise, arbitrageurs would exploit existing profit opportunities that subsequently vanish due to corresponding price adjustments.

The impact of exchange rate changes on macroeconomic variables like inflation and GDP growth depends on whether the shock stems from an expected change in monetary policy rates or from a change in risk premia, specifically a loss of confidence (Haincourt, 2018, Table 2).[5]

The short-term effect on inflation is similar in both cases because the exchange rate pass-through is the same. The exchange-rate elasticity of inflation depends on (i) the impact of the exchange rate (ER) on

[4]Uncovered interest parity (UIP) is a coherent, reasonable, and well-established theory in international finance. However, empirical evidence from the period between the introduction of the euro and the onset of the global financial crisis shows that currencies with relatively high interest rates tended to appreciate rather than depreciate, which contradicted UIP and became known as the forward premium puzzle (Engel, 2014). Nonetheless, empirical support exists for the periods before 1999 (Tanner, 1998) and after 2008 (Deutsche Bundesbank, 2022). In particular, incorporating a time-varying risk premium to reflect differences in risk profiles across investments and their underlying currencies strengthens the empirical validity of UIP (Engel *et al.*, 2023; Kalemli-Özcan and Varela, 2021; Obstfeld and Zhou, 2023).

[5]A change in the exchange rate driven by a shift in the risk premium is typically modeled as an endogenous shock (NIESR, 2020). This means that the values of the affected variable evolve endogenously according to the model's equations in response to an initial one-off exogenous shock. For example, a 10% exogenous depreciation would fix the exchange rate at 1.10 US dollar per euro for the entire simulation period, assuming an initial parity. In contrast, an equivalent endogenous depreciation results in a smaller change by the end of the simulation, as factors such as higher inflation, central bank rate hikes, and capital inflows into dollar-denominated assets induce a partial correction.

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Table 2. Impact of two different exchange rate shocks on GDP and Inflation 2025–2028

10%-depreciation of the nominal effective exchange rate in the fourth quarter of 2025		
	caused by	
	US rate cut	Higher risk premium
Short-term effect in the US (2026Q1)	– Deviation from baseline –	
Inflation (percentage points)	2.3	2.1
GDP (percent)	0.2	−0.5
Medium-term effect in the US (2028Q4)	– Deviation from baseline –	
Inflation (in percentage points)	1.1	0.2
GDP (percent)	1.0	−1.7

Source: Authors' calculations using NiGEM.

import prices and (ii) the pass-through (PT) of import prices to inflation. In the empirical literature, the first part is typically identified as inelastic and smaller than 1. Furthermore, the reaction of import prices is quick but varies across countries and products due to microeconomic factors such as margin behaviour and currency invoicing. The second part of the transmission channel also differs across countries, largely depending on the import intensity of GDP. In the medium term, the inflation impact differs significantly between the two scenarios: the increase in GDP following the rate cut fuels inflation, whereas the risk premium-induced decline in GDP curtails it.

In the following, we discuss the results of three depreciation scenarios related to a loss of confidence in the US dollar. The depreciation is modelled as an increase in the US dollar risk premium from the fourth quarter of 2025 until the end of Donald Trump's second term in the fourth quarter of 2028) (Figures 6 and 7).

4.2. Risk premium shock across asset classes (Simulation 1)

The most likely of the three scenarios is based on previously discussed market dynamics observed around 2 April 2025, which were characterised by heightened perceived risk not only towards the US dollar but also other dollar-denominated assets (Figure 3). We therefore shock both the investment risk premium and the exchange rate risk premium until the end of President Trump's second term.[6] The size of the first shock is chosen to reflect twice the monthly market movements around Trump's Liberation Day, i.e., the spread between March and April 2025. For high-yield bonds, the spread between April 10 and March 10 was just under 1.3 percentage points (Figure 3), resulting in a shock size of the corporate credit risk premium of 2.5 percentage points against the baseline (Figure 6). The choice of the scaling factor is subject to a certain degree of arbitrariness. However, doubling the spread does not cause market movements to fall outside a realistic range. In particular, the corresponding change in yields on high-yield bonds was far more pronounced during the 2008 financial market crisis (8 times) and at the start of the COVID-19 pandemic in 2020 (4 times). The choice of the shock size for the endogenous exchange rate risk premium shock follows a similar rationale. However, due to the combination and the nature of the shocks, the resulting magnitude in scenario 1 is not directly comparable.[7]

[6]The investment risk premium is an exogenous variable in NiGEM by default. A (endogenous) risk premium-induced depreciation of the US dollar is modelled as the appreciation of all other currencies.

[7]In fact, the shock sizes of the exchange rate risk premium for scenarios 1 and 2 are similar, i.e. -0.004 vs. -0.005. Note the endogenous character of the exchange rate shock and see formula (1) for clarification. Negative ε-values lead to a depreciation of the US dollar, as all exchange rates in NiGEM are defined per USD. In the isolated shock scenario 2, this leads to a depreciation

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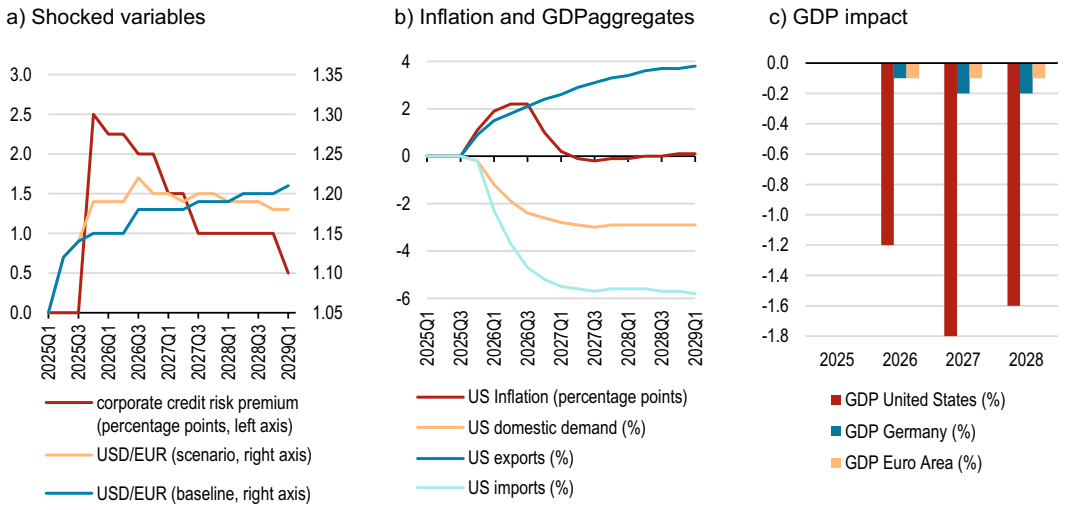


Figure 6. Loss of confidence in the US dollar across asset classes (Scenario 1). Deviation from baseline after shock to exchange rate and investment risk premium. *Source:* Authors' calculations using NiGEM.

In the simulation, the exogenous shock to the corporate loan risk premium outweighs the impact of the endogenous exchange rate risk premium shock. This is because the credit risk premium dampens corporate investment and weakens the US economy additionally, thereby mitigating the inflationary effect of the exchange rate shock. As a result, the Federal Reserve is able to lower rates again relatively quickly, which rapidly reduces the yield differential between the US and the Euro Area. Therefore, the exchange rate reverts towards its initial level and, by the end of the simulation period, even falls below it. In this scenario, by the end of Trump's second term, the US dollar appreciates by 2 cents relative to the euro, after an initial depreciation of slightly more than 4 cents against the baseline (Figure 6a).

The temporary rise in inflation and the credit risk shock reduce both private consumption and investment. As a result of diminished purchasing power and higher interest rates, US domestic demand remains around 3% below the baseline forecast in the event of a loss of confidence across asset classes (Figure 6b). In the NiGEM model, US exports increase by 4% and imports decline by 6% relative to the baseline, reflecting the exchange rate-driven drop in the cost of US exports and rise in the cost of imports. However, the current account balance (as a percentage of GDP) improves by only just over 0.5 percentage points on average over the simulation period. In addition to net exports, the model also accounts for cross-border flows of primary and secondary income. Overall, US GDP falls up to 1.8% short of the baseline forecast (Figure 6c). In an isolated shock scenario without endogenous exchange rate shock, but with an identical temporary increase in the corporate credit risk premium, the maximum GDP loss would be just under 0.4%.

Notably, in this scenario of a broad-based loss of confidence in US dollar-denominated assets, the Euro Area also experiences a decline in growth. Initially, the non-US rest of the world benefits from cheaper imports due to the dollar's depreciation, as in the other two scenarios that are limited to a loss of confidence in the currency market. Raw materials, and crude oil in particular, play a key role in this respect, as their prices are typically determined and invoiced in US dollars. As the additional credit market shock unfolds, the initially expansionary impact on the Euro Area is more than offset by the economic downturn in the US and the resulting decline in exports. Beyond the scope of the model, the impact of the shocks is likely to be more severe due to international spillover effects of the initially

of 7% or 8 cents (Figure 7a), which is double the depreciation between April 10 and March 10 (Figure 3). In the combined shock scenario 1, however, the initial depreciation is only 4 cents or around 3.5% against the baseline (Figure 6a). The reason for the weaker depreciation in the combined shock scenario is discussed in the main text.

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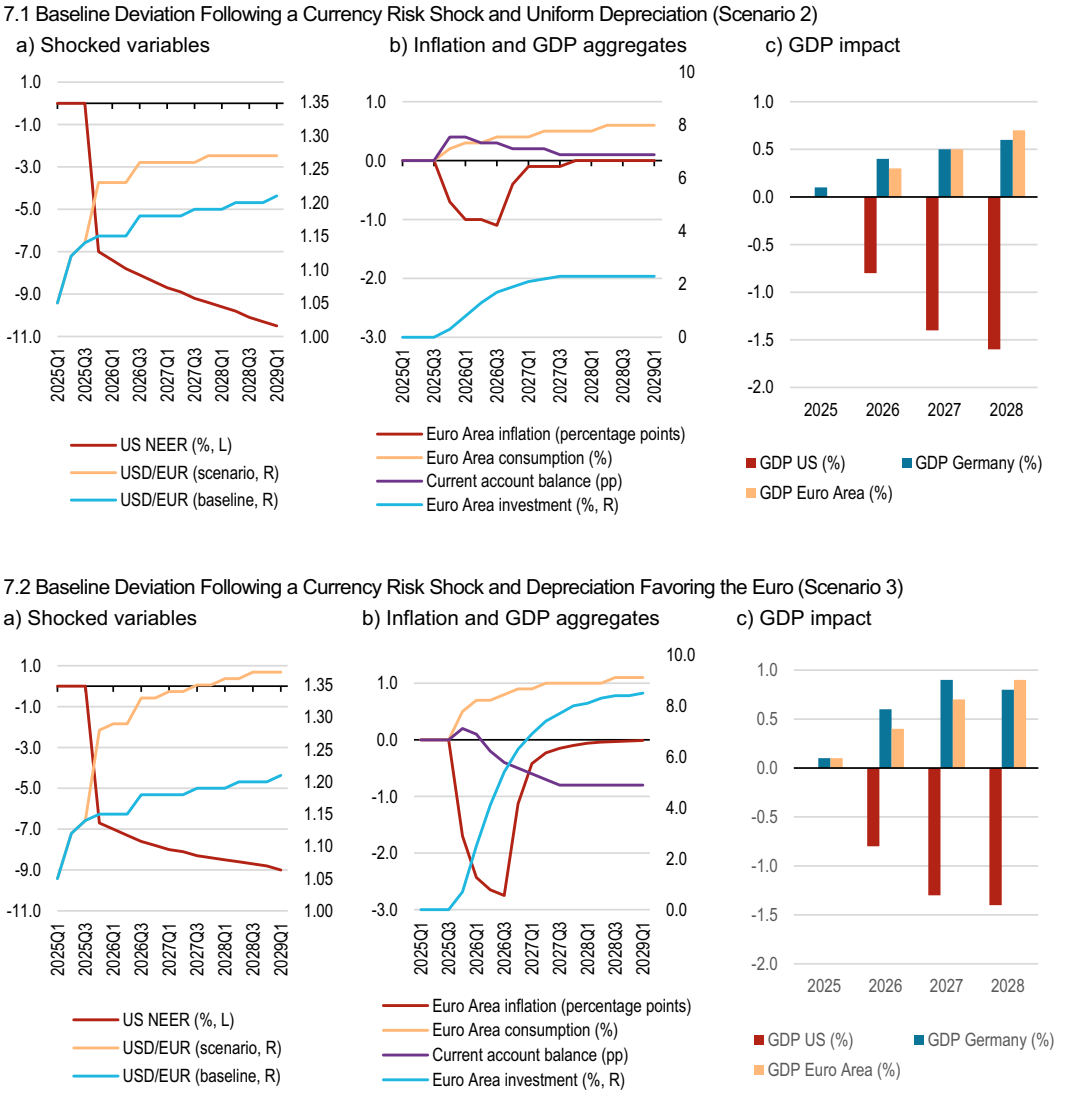


Figure 7. Scenarios with currency-only risk premium shock.
L, left axis; R, right axis; pp, percentage points; NEER, nominal effective exchange rate; current account in % of GDP.
Source: Authors' calculations using NiGEM.

domestic financial market turmoil, especially in the case of the US (Dimpfl and Jung 2012). However, the welfare-reducing spillover effects in the NiGEM simulation remain comparatively small, as the Federal Reserve's rapid monetary policy response leads to timely stabilisation without any interim turbulence. Overall, Euro Area GDP lies only 0.1% below the baseline in the years 2026 to 2028, with German GDP slightly lower at −0.2%. US GDP losses are substantially more pronounced, ranging from −1.6% to −1.8% over the period under consideration. Despite the additional credit risk shock, these losses are only slightly higher than in the scenario where the loss of confidence is limited to the foreign exchange market, as a result of the central bank's decisive response. This outcome reflects the New Keynesian structure of the NiGEM model, which is not well-suited to modelling financial market crises.[8]

[8]In particular, very large deviations from the saddle path in general equilibrium models can prevent the model from converging, making it impossible to quantify the shock response.

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A review of the literature reveals alternatives to modelling exchange rates in New Keynesian equilibrium models such as NiGEM. For example, Proaño (2011) advocates a behaviour-oriented, agent-based approach in which foreign exchange trading is driven not only by agents conducting fundamental macroeconomic analysis, but also by speculators motivated by chart analysis. As a result, periods of calm with low exchange rate fluctuations alternate with turbulent periods of high volatility. The latter have the potential to trigger a financial market crisis that destabilises the broader economy. Given the complexity of financial markets, NiGEM is therefore likely to significantly underestimate the growth losses that could arise for the Euro Area and Germany from a cross-asset loss of confidence in the US dollar.

Another caveat is that the relevant parameters in NiGEM imply a strong inflationary impact from changes in the exchange rate. This can be most easily illustrated by the long-term relationship of the error correction specification of consumer prices as a weighted average of domestic and foreign prices:

$$\ln CED = \beta \ln UTC + (1-\beta) \ln PM \tag{2}$$

where UTC describes domestic price dynamics (total unit costs) and PM describes import prices. Preliminary re-estimates for individual countries suggest that the sensitivity of consumer prices to import prices (1 – β), which are directly influenced by changes in the currency value, is lower than the NiGEM coefficient. However, re-estimating and revising the foreign trade structure of the model is beyond the scope of this article, so the results presented here rely on the original parameter values. Nonetheless, the impact of model uncertainty in this regard is clear: if the inflationary effect of exchange rate changes were smaller in our simulations, the growth losses in the US would likely be less severe. The opposite holds for the countries of the Euro Area.

4.3. Currency-only risk premium shocks (Simulations 2 and 3)

In contrast to the first scenario, which at least hints at a financial crisis, the second and third scenario reflect a less disruptive shift to a global multi-currency system.

The second scenario contemplates a significant and uniform depreciation of the US dollar against other currencies, thereby entailing an exchange rate of 1.28 US dollars per euro (Figure 7.1a). Similar to the first scenario, the US experiences higher inflation, elevated interest rates, significantly subdued domestic demand and slightly improved foreign trade. However, as the bond and credit markets are not subject to any shocks, the GDP loss relative to the baseline is slightly lower, peaking at 1.6%. Unlike the first scenario, Euro Area countries benefit from higher investment due to temporarily lower inflation, which allows the central bank to reduce key interest rates. Private consumption also increases noticeably (Figure 7.1b).

The third simulation shifts focus by assuming that a nominal effective depreciation of the US dollar—similar to that in the second scenario—results from a non-uniform depreciation of the US dollar against other currencies (Figure 7.2). The simulation now includes a depreciation of the US dollar to approximately 1.35 dollars per euro (Figure 7.2a), while all other currencies appreciate slightly less than before. The overall impact on US GDP is very similar to that in the previous scenario. However, at its peak, US GDP is now only 1.4% below the baseline level (Figure 7.2c). This simulation is more exploratory than the other two, as it is based on conditions that would require measures to increase the supply and liquidity of Euro Area safe assets. These conditions are discussed in greater detail in the conclusion.

Compared with the second scenario, Euro Area countries now fare even better. Following the ECB's rate cuts, investment is 5% above baseline and private consumption is 1% above baseline due to gains in purchasing power (Figure 7.2b). Strong domestic demand causes the current account balance to fall slightly compared with the baseline (by 0.4 percentage points). The mechanisms inherent in the model prevent deflationary risks from materialising in this scenario. All in all, under the simulated conditions, Euro Area GDP would be 0.4% to 0.9% higher than in the baseline. For Germany, GDP gains would range between 0.6% and 0.9%, depending on the year.

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5. Potential for Euro Area gains amid declining dollar dominance

Our first simulation highlights the risks to the global economy posed by an abrupt loss of confidence in the US dollar, while the exploratory third simulation highlights the euro's potential as a global currency. The Euro Area could benefit from a diminished role of the US dollar as a global currency, provided that key conditions are met to enhance the euro's attractiveness as an international currency.

However, achieving this remains challenging for a 'currency without a state' (Eichengreen, 2010), as confidence in a currency rest not only on a credible, stability-oriented central bank, but also on a sovereign with solid public finances, whose debt offers a large and reliable supply of safe assets. The euro crisis of 2011–2012 revealed a fundamental weakness in the Euro Area: the government bonds of member states cannot be regarded as broadly substitutable safe assets. In its aftermath, the potential advantages of European bonds were widely discussed, including the possibility of strengthening the fiscal space of highly indebted countries while curbing moral hazard, jointly financing growth-enhancing investments (such as in digitalisation and climate action), stabilising financial markets, and increasing the Euro Area's resilience to macroeconomic shocks. The latter is particularly important, as the dearth of safe government bonds leaves the Euro Area vulnerable to sudden shifts in expectations, which can trigger a vicious circle of rising risk premiums, higher private borrowing costs, falling output and capital flight (Theobald and Tober, 2020).

The Euro Area has evolved in recent years, notably through joint borrowing initiatives such as the NextGenerationEU program, the Eurosystem's securities purchase programs, and the ECB's new Transmission Protection Instrument. However, for the euro to play a stronger international role, additional steps are needed to develop a sufficiently broad and deep market for safe euro-denominated bonds. Currently, only the government bonds of Germany, the Netherlands, and Luxembourg hold top credit ratings. Politically, joint and several eurobonds, which could supplement the existing stock of safe bonds in the Euro Area, are not feasible at this time. Nonetheless, it has become clear that EU bonds issued by the European Commission may represent a viable alternative (Blanchard and Ubide, 2025).

The yield on EU bonds issued to finance NextGenerationEU at a remaining maturity of 10 years is only 0.4 percentage points above the yield on 10-year German government bonds and could be further reduced if these bonds gained the same status as sovereign bonds. Following Blanchard and Ubide (2025), Euro Area countries could transfer a certain share of their existing sovereign debt to the EU and, in return, commit a corresponding share of their tax revenues for servicing this debt. Crucial for building trust is that no new debt is issued for this purpose; rather, existing debt should be converted into a new pool of safe euro-denominated EU bonds. This would also make the Euro Area more resilient to the risk of a financial crisis triggered by a major loss of confidence in the US dollar, a risk not to be underestimated even though we do not explicitly simulate such an event in this article.

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