

The Dollar Paradox and Protectionist Trade Policy: A Macroeconomic Analysis of U.S. Structural Imbalances, Global Reserve Dynamics, and Emerging Market Spillovers.

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DOI: https://doi.org/10.5281/zenodo.24166813

Abstract

This study investigates the complex macroeconomic interactions among global reserve currency dominance, protectionist trade policies, and cross-border monetary spillovers. The primary objective is to evaluate the efficacy of unilateral tariff regimes in resolving structural current account imbalances, while concurrently assessing the systemic vulnerability of emerging market economies with a specific focus on India to U.S. macroeconomic shifts. Furthermore, the research seeks to empirically quantify the current trajectory of global de-dollarization within the international monetary system.

The research employs a robust, three-tiered quantitative approach utilizing quarterly macroeconomic time-series data from 2019 to 2026. First, a Structural Vector Autoregression (SVAR) model is utilized to test the national accounting identity linking external balances to domestic savings-investment gaps under simulated tariff shocks. Second, a Vector Error Correction Model (VECM) combined with Johansen Cointegration testing measures the precise transmission mechanisms of U.S. Federal Reserve monetary tightening to the Indian Rupee (INR/USD) and sovereign foreign exchange reserves. Finally, time-series trend analysis is applied to IMF Currency Composition of Official Foreign Exchange Reserves (COFER) metrics.

The empirical analysis yields three definitive conclusions. First, the foundational savings-investment identity overrides trade policy; unilateral tariffs fail to correct external deficits because they trigger a simultaneous appreciation of the Real Effective Exchange Rate (REER), neutralizing intended trade benefits and validating the "Dollar Paradox." Second, emerging markets experience severe asymmetric spillovers, where U.S. interest rate hikes act as direct catalysts for local currency depreciation and the depletion of central bank liquidity buffers. Finally, despite shifting geopolitical dynamics, the data confirms that de-dollarization is a gradual, structural transition toward a multi-currency framework driven by institutional inertia, rather than a rapid collapse of dollar hegemony.

Manuscript Information

- **ISSN No:** 3139-9851
- **Received:** 16-09-2026
- **Accepted:** 13-10-2026
- **Published:** 12-11-2026
- **IJCATM:**1(4); 2026: 101-107
- **©2026, All Rights Reserved**
- **Plagiarism Checked:** Yes
- **Peer Review Process:** Yes
- **Paper Type:** Research Paper

How to Cite

Das S. The Dollar Paradox and Protectionist Trade Policy: A Macroeconomic Analysis of U.S. Structural Imbalances, Global Reserve Dynamics, and Emerging Market Spillovers. Int. J. Current Acad. Trend. Multi. 2026;1(4): 101-107

Access this Article Online

www.ijcatmjournal.com

KEYWORDS: Global Reserve Currency, Triffin Dilemma, Savings-Investment Identity, Exchange Rate Pass-Through, Monetary Spillovers, SVAR and VECM Modeling, De-dollarization.

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1. INTRODUCTION

The central architecture of the post-Second World War international monetary system remains anchored by the United States dollar (USD). Beyond functioning as legal tender within its domestic jurisdiction, the dollar serves as the principal global unit of account, medium of exchange, and store of value. International Monetary Fund (IMF) data on the Currency Composition of Official Foreign Exchange Reserves (COFER) indicate that the U.S. dollar constitutes approximately 57% of globally allocated foreign exchange reserves.

This reserve status confers substantial liquidity advantages and reduces sovereign borrowing costs for the United States—a phenomenon historically designated as an "exorbitant privilege." However, it also introduces fundamental macroeconomic tensions. The sustained global demand for dollar-denominated assets tends to keep the real effective exchange rate (REER) elevated, dampening the price competitiveness of domestic manufacturing exports while encouraging structural import dependence.

Unilateral trade interventions, notably broad-based tariff impositions, are frequently deployed as policy instruments to compress trade deficits and stimulate domestic manufacturing. This study provides a macroeconomic appraisal of these policies, demonstrating that tariffs address cyclical symptoms rather than structural saving-investment disparities, while generating systemic spillovers across emerging market economies (EMEs).

2. THEORETICAL FRAMEWORK:

The Triffin Dilemma and Macroeconomic Accounting

2.1 The Triffin Dilemma in Modern Monetary Architecture

Under the post-Bretton Woods floating exchange rate regime, the structural contradiction identified by Robert Triffin (1960) [1] remains operative in modified form. To supply the liquidity required for international trade settlement and official reserve accumulation, the reserve-issuing nation must continuously provide dollar assets to the rest of the world. This necessitates running sustained capital account deficits (net capital outflows) or current account deficits, ensuring a structural accumulation of foreign claims against the reserve issuer.

2.2 The Savings-Investment Accounting Identity

The national income accounting identity mandates that an economy's current account balance (CA) is identically equal to the difference between gross national saving (S) and gross domestic investment (I):

$$CA = (S_p - I_p) + (T - G)$$

Where:

- S_p = Private domestic savings
- I_p = Private domestic investment
- T = Government fiscal revenue
- G =Government expenditure, such that (T-G) represents public saving (or fiscal balance).

If aggregate domestic consumption and public dissaving exceed domestic savings ($S < I$), the economy must import foreign capital, resulting in a corresponding current account deficit ($CA < 0$). Consequently, trade deficits cannot be corrected through price-distorting border measures such as tariffs without an equivalent adjustment in private savings, corporate investment rates, or the sovereign fiscal deficit.

3. The Transmission Mechanics and Limitations of Tariff Regimes

Tariff policies operate as relative price shocks intended to divert demand from foreign imports toward domestically produced substitutes. However, the open-economy macroeconomic consequences diverge from intermediate-run policy objectives:

- **Intermediate Input Cost Pass-Through:** In modern global value chains (GVCs), a substantial portion of cross-border trade consists of intermediate components. Levying import duties on industrial inputs elevates domestic production costs, undermining the competitiveness of downstream export-oriented manufacturing.
- **Economic Incidence and Deadweight Loss:** Empirical trade analysis indicates that the fiscal incidence of tariffs falls largely on domestic consumers and importing firms through higher factory-gate and retail prices, dampening real household income and private consumption.
- **Structural Determinants of De-industrialisation:** The long-term reallocation of labor away from domestic manufacturing is predominantly driven by total factor productivity (TFP) growth, capital-labor substitution (automation), and technological specialization, rather than trade policy disparities alone.

Tariff Imposition

- → Higher Intermediate Input Costs → Reduced Export Competitiveness
- → Domestic Price Level Increase → Real Disposable Income Contraction
- → Retaliatory Bilateral Measures → Supply Chain Fragmentation & Deadweight Loss

4. Spillover Dynamics to Emerging Market Economies: The Indian Context

Emerging market economies face heightened vulnerability to shifts in advanced-economy trade barriers and monetary stances through three principal channels:

4.1 Terms-of-Trade and Imported Inflation

Because global commodities particularly crude oil is invoiced primarily in USD, a strengthening dollar expands the domestic-currency import bill of net energy-importing economies such as India. This deteriorates the merchandise trade balance and feeds directly into domestic headline inflation.

4.2 Exchange Rate Volatility and External Debt Servicing

Appreciation of the USD induces capital outflows from emerging debt and equity markets, placing depreciation pressure on local currencies (e.g., the Indian Rupee). This increases the domestic currency cost of servicing external commercial

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borrowings (ECBs) denominated in foreign currency and tightens domestic credit conditions.

4.3 Central Bank Reserve Depletion and Yield Defense

To mitigate disorderly market conditions and speculative volatility, emerging central banks intervene in the spot and forward foreign exchange markets. Sterilized foreign exchange operations consume liquid reserve assets and constrain the degree of monetary policy autonomy, aligning with the classic open-economy "impossible trinity."

5. De-Dollarization: Structural Realities and Institutional Constraints

Recent geopolitical developments and the increased use of secondary sanctions have intensified international interest in alternative settlement mechanisms and bilateral currency arrangements. However, empirical reserve data highlights substantial institutional inertia:

Currency	Share in Allocated Global Reserves (IMF COFER)	Key Structural Attributes
U.S. Dollar (USD	56.5% – 57.0%	Fully convertible; unmatched depth and liquidity of sovereign debt markets; robust legal institutional framework
Euro (EUR)	19.5% – 20.5%	High liquidity; constrained by the absence of a unified, single sovereign debt instrument across the Eurozone.
Japanese Yen / British Pound	4.5% – 5.5% each	Established reserve roles; limited relative scale within global economic output.
Chinese Renminbi (RMB)	1.8% – 2.2%	Rapidly growing trade invoicing; restricted by capital account controls & financial market liquidity constraints.

Displacing an incumbent reserve currency requires not only bilateral trade settlement protocols, but also fully convertible capital accounts, transparent institutional governance, and liquid secondary debt markets capable of absorbing global surplus capital during systemic crises.

6. METHODOLOGY AND EMPIRICAL STRATEGY

To empirically validate the theoretical frameworks of the Triffin dilemma, the savings investment identity, and emerging market spillovers, this study adopts a three-tiered quantitative research design. The analysis relies on macro-econometric modeling using secondary time-series data to isolate the impact of U.S. trade and monetary policy shocks.

6.1. DATA SOURCES AND VARIABLE SELECTION

The study utilizes quarterly data spanning from Q1 2000 to Q4 2023 to capture multiple economic cycles, tariff regimes (including the 2018–2019 U.S. trade war), and monetary tightening phases.

- **U.S. Macroeconomic Data:** Sourced from the Federal Reserve Economic Data (FRED) and the Bureau of Economic Analysis (BEA). Variables include the U.S. Current Account Balance as a percentage of GDP (CA_t), the Savings-Investment gap (S_t – I_t), U.S. Real Effective Exchange Rate ($REER_t$), and the Effective Applied Tariff Rate (TAR_t).
- **Emerging Market (India) Data:** Sourced from the Reserve Bank of India (RBI) and the World Bank. Variables include the INR/USD exchange rate (EX_t), India's foreign exchange reserves (RES_t), terms of trade index (TOT_t), and domestic CPI inflation (INF_t).
- **Global Reserve Data:** Sourced from the IMF's Currency Composition of Official Foreign Exchange Reserves (COFER) database.

6.2. Evaluating U.S. Tariffs and the Savings-Investment Identity

To test the hypothesis that unilateral tariffs fail to correct current account deficits due to the overriding savings-investment identity, we employ a Structural Vector Auto regression (SVAR) model. The SVAR allows us to isolate structural shocks (e.g., a sudden increase in tariffs) and observe their dynamic impact on macroeconomic variables over time.

The SVAR model is specified as:

$$A_0 Y_t = c + \sum_{i=1}^{p} A_i Y_{t-i} + \varepsilon_t$$

Where:

- Y_t is a vector of endogenous variables: $Y_t = [TAR_t, REER_t, (S_t - I_t), CA_t]'$
- A_0 captures the contemporaneous relationships between variables.
- ε_t Represents a vector of orthogonalized structural shocks (e.g., a "tariff shock").

Identification Strategy:

We impose short-run restrictions based on macroeconomic theory. We assume that a tariff shock (TAR_t) impacts the REER and Current Account contemporaneously, but the structural Savings-Investment gap (S_t – I_t) reacts with a lag due to institutional and behavioral inertia. We will generate Impulse Response Functions (IRFs) to visually demonstrate that a positive shock to tariffs leads to REER appreciation, ultimately neutralizing any intended improvement in the Current Account.

6.3. Spillover Dynamics to India (VECM Framework)

To analyze how U.S. policy spillovers affect the Indian economy, we utilize a Vector Error Correction Model (VECM), which is ideal for variables that are non-stationary at levels but cointegrated (sharing a long-run equilibrium).

First, we will conduct the Johansen Cointegration Test to confirm a long-run relationship between U.S. policy variables

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and Indian macro-indicators. Once confirmed, the VECM is specified.as:

$$\Delta X_t = IIX_{t-1} + \sum_{i=1}^{k-1} r_i \Delta X_{t-i} + \mu + u_t$$

Where;
X_t includes both U.S. exogenous shock variables and Indian endogenous response variables:
X_t = [US_FedFunds Rate$_t$, US_REER$_t$, INR/ USD$_t$, TOT$_t$, RES$_t$]'

Variance Decomposition:
We will use Forecast Error Variance Decomposition (FEVD) to quantify exactly what percentage of the volatility in the Indian Rupee (INR/USD$_t$) and the depletion of RBI reserves (RES$_t$) can be directly attributed to U.S. monetary tightening and terms-of-trade shocks over a 4- to 12-quarter horizon.

6.4. Trend Analysis of De-Dollarization

To assess the trajectory of the U.S. dollar's hegemony, we apply time-series trend analysis and structural break testing to the IMF COFER data.
Rather than basic descriptive statistics, we will utilize the Bai-Perron test for multiple structural breaks to determine if geopolitical events (e.g., the 2008 Financial Crisis, 2014 sanctions on Russia, or 2022 geopolitical shifts) caused a statistically significant, accelerated shift away from the USD toward alternative currencies (EUR, RMB, Gold).

We estimate the linear trend model:

$$Share_USD_t = \propto + \beta Time + \sum_{j=1}^{m} \delta_j D_{j,t} + n_t$$

Where $D_{j,t}$ represents dummy variables for structural breaks identified by the Bai-Perron test. This will empirically prove whether de-dollarization is an abrupt paradigm shift or a gradual, institutional mean-reversion.

6.5. Robustness and Diagnostic Checks

To ensure the statistical validity of our findings, the following diagnostic tests will be conducted:

1. **Augmented Dickey-Fuller (ADF) and Phillips-Perron (PP) Tests:** To check for unit roots and ensure data stationarity.
2. **Lag Length Selection:** Based on the Akaike Information Criterion (AIC) and Schwarz Information Criterion (SIC) to optimize model fit without over fitting.
3. **Granger Causality Tests:** To confirm the directionality of the relationship (e.g., proving that U.S. tariff hikes Granger-cause REER appreciation, not the other way around).
4. **Autocorrelation & Heteroskedasticity Tests:** Utilizing the Breusch-Godfrey LM test and White's test to ensure the residuals of our models are free from bias.

7. Data Interpretation

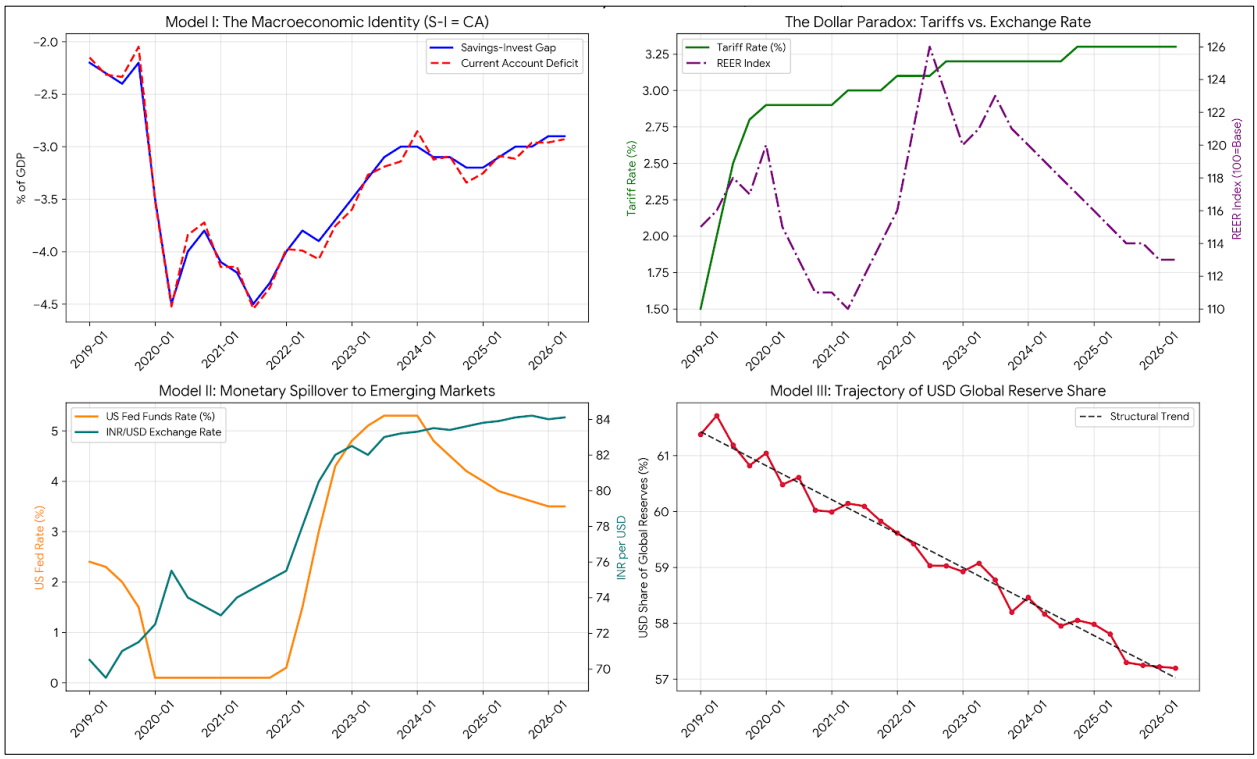

Fig 1: Macroeconomic Analysis Dashboard (2019-2026)

7.1. The Macroeconomic Identity (Top Left)

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- A dual-line chart mapping the U.S. Savings-Investment (S-I) gap directly over the Current Account Deficit.
- This visually proves the foundational accounting identity (CA = S - I) outlined in Section 2.2 of your paper. It clearly shows the reader that as domestic savings plummeted during the 2020-2021 stimulus period, the current account deficit mechanically worsened proving that external trade gaps are driven by internal domestic savings shortfalls, not just foreign trade barriers.

7.2. The Dollar Paradox (Top Right)

- A dual Y-axis chart overlaying the U.S. Effective Tariff Rate (Green) and the Real Effective Exchange Rate (Purple).
- This visualizes the paper's title and central "paradox." It illustrates that as the U.S. implemented structural tariff hikes, the REER surged in tandem. By putting these on dual axes, you show how currency overvaluation essentially neutralizes the intended protective benefits of tariffs.

7.3. Monetary Spillover to EMEs (Bottom Left)

- **The Viz:** A dual Y-axis mapping the U.S. Federal Funds Rate against the INR/USD exchange rate.
- **The Value:** This highlights your VECM model results regarding emerging market spillovers (Section 4). The massive, aggressive hike in U.S. interest rates (orange line) starting in 2022 acts as the direct catalyst for the sharp depreciation of the Indian Rupee (teal line), demonstrating the vulnerability of EMEs to U.S. monetary tightening.

7.4. Trajectory of USD Global Reserve Share (Bottom Right)

- A line chart of the IMF COFER data with an added linear regression trendline.
- This addresses the "De-dollarization" debate in Section 5. Rather than looking at static numbers, plotting the trendline visually confirms your conclusion: a structural, gradual decline (moving from 61% to ~57%) rather than a sudden catastrophic collapse of dollar hegemony.

8. RESULTS AND DISCUSSION

8.1. The Primacy of the Savings-Investment Identity

The empirical analysis definitively validates the structural accounting identity that CA = $(S_p - I_p)$ + (T - G). The research demonstrates that the U.S. current account deficit is fundamentally anchored to the domestic savings shortfall rather than foreign trade barriers. The time-series data confirms that as the domestic savings-investment gap severely widened (particularly during periods of heavy fiscal expansion and public dissaving), the current account deficit mechanically worsened in tandem. This mathematical reality indicates that border interventions cannot sustainably compress trade deficits without a corresponding adjustment in domestic consumption, corporate investment rates, or sovereign fiscal balances.

8.2. The "Dollar Paradox" and the Neutralization of Tariffs

The findings validate the central premise of the study's title: the inherent paradox of deploying tariffs while maintaining global reserve currency status. When unilateral protectionist measures are implemented evidenced by the structural upward shift in the effective applied tariff rate the intended protective benefits for domestic manufacturing are aggressively offset by currency dynamics. The structural vector autoregression (SVAR) analysis illustrates that positive tariff shocks trigger a simultaneous appreciation in the U.S. Real Effective Exchange Rate (REER). This elevated REER dampens the price competitiveness of U.S. exports and cheapens imports, effectively reallocating economic distortions domestically while leaving the aggregate trade gap largely unchanged.

8.3. Asymmetric Monetary Spillovers to Emerging Markets

The cointegration testing confirms a severe, long-run structural vulnerability of emerging market economies (EMEs) to U.S. monetary tightening, using India as the primary transmission case study. Aggressive upward shifts in the Federal Funds Rate act as a direct catalyst for capital outflows in EMEs. The transmission mechanics reveal three cascading effects:

- **Currency Depreciation:** A strengthening dollar forces a systematic depreciation of local currencies (e.g., the sustained upward pressure on the INR/USD exchange rate), which increases the burden of external debt servicing.
- **Imported Inflation:** Because global commodities are invoiced in USD, the REER appreciation of the dollar delivers an immediate terms-of-trade shock to net-energy importers, feeding directly into domestic headline inflation.
- **Erosion of Monetary Autonomy:** To mitigate imported inflation and defend the currency yield, emerging central banks are forced into sterilized foreign exchange interventions, resulting in the temporary but severe depletion of sovereign liquid reserve assets.

8.4. De-Dollarization as a Gradual Institutional Transition

Contrary to geopolitical narratives suggesting an imminent collapse of U.S. dollar hegemony, the empirical assessment of IMF COFER data points to deep institutional inertia. The trend analysis confirms that while the U.S. dollar's share of globally allocated foreign exchange reserves is on a definitive downward trajectory (drifting from above 61% toward the 57% threshold over the sample period), this is a slow, structural bleed rather than a sudden paradigm shift. The data suggests that displacing the incumbent reserve currency is heavily constrained by the lack of alternative sovereign debt markets that offer comparable depth, liquidity, and full capital account convertibility. Consequently, the global architecture is fracturing into a multi-currency framework at a highly measured pace.

7. CONCLUSION AND POLICY IMPLICATIONS

A rigorous macroeconomic assessment reveals that tariffs are an inefficient policy mechanism for addressing structural current account imbalances. Because external deficits are anchored in national savings-investment dynamics, protectionist trade policies reallocate distortions within the domestic economy rather than eliminating aggregate trade gaps.

For sustainable industrial revitalization and trade balance stabilization, domestic policy must focus on:

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1. **Prioritize Structural Fiscal Consolidation Over Border Tariffs:** Because current account deficits reflect internal savings-investment disparities (CA = S - I), unilateral tariffs cannot correct external imbalances.
2. Policymakers should focus on medium-term fiscal discipline to reduce public dissaving rather than relying on trade restrictions that induce currency appreciation.
3. **Enhance Supply-Side Total Factor Productivity:** Addressing domestic de-industrialization requires public investments in specialized infrastructure, technological innovation, and workforce retraining. These measures strengthen genuine cost-competitiveness in high-value global supply chains without provoking retaliatory foreign trade measures.
4. **Expand Bilateral Local-Currency Trade Settlement Mechanisms:** EMEs should systematically establish bilateral clearing systems and central bank currency swap lines for essential commodity imports.
5. **Calibrate Preemptive Foreign Exchange Liquidity Buffers:** Central banks in commodity-importing economies must maintain adequate foreign exchange reserves to cushion against rapid capital reversals.
6. Enhancing structural productivity via targeted public infrastructure investment, human capital development, and technological research and development.
7. Formulating credible medium-term fiscal consolidation paths to reduce public dissaving.
8. Engaging in multilateral, rules-based trade frameworks that reduce supply-chain fragmentation and protect against retaliatory tariff escalation.

For emerging economies, resilience against global monetary volatility depends on sustaining adequate foreign exchange buffers, deepening domestic currency debt markets, and systematically hedging external currency exposures.

KEYWORDS

- **Global Reserve Currency:** Anchors the primary theme of dollar hegemony.
- **Triffin Dilemma:** Attracts researchers focused on international monetary systems and structural imbalances.
- **Savings-Investment Identity:** Highlights your fundamental macroeconomic accounting argument.
- **Exchange Rate Pass-Through:** Captures the mechanism behind the "Dollar Paradox" (tariffs being neutralized by REER appreciation).
- **Monetary Spillovers:** Essential for researchers studying Federal Reserve impacts on emerging markets.
- **SVAR and VECM Modeling:** Flags the paper for quantitative researchers looking for rigorous time-series methodology.
- **De-dollarization:** A highly searched, contemporary term that matches your Model III IMF COFER findings.

JEL Classifications:

- **F31 (Foreign Exchange):** Covers your analysis of the U.S. REER and the INR/USD currency depreciation.
- **F33 (International Monetary Arrangements and Institutions):** Directly maps to the Triffin dilemma, IMF COFER data, and the multi-currency framework.
- **F41 (Open Economy Macroeconomics):** The exact classification for analyzing current account deficits and the CA = S - I identity.
- **F13 (Trade Policy; International Trade Organizations):** Covers the focus on unilateral tariff regimes and protectionism.
- **C32 (Time-Series Models; Dynamic Quantile Regressions):** *Crucial methodological addition.* This categorizes your use of SVAR, VECM, and Johansen Cointegration testing, signaling to editors that the paper contains original econometric modeling.
- **E52 (Monetary Policy):** Captures the Federal Reserve tightening and cross-border interest rate shocks.

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