The Dollar Hegemon?

Evidence and Implications for Policymakers

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A Dollar World

We live in a dollar world

- Global trade is invoiced in dollars
- Cross-border financial flows and security issuances are in dollars
- Monetary authorities anchor to the dollar
- International reserves are held in dollars

Even more so now than at any time in the past!

A Dollar World

The dollar plays an essential role in three areas:

1. The expansion of global trade and capital markets
2. The coordination of macroeconomic policies
3. The provision of international liquidity

This largely shapes the policy choices of the rest of the world, especially in Asia

Outline of the Talk

1. The Emergence of the Dollar Hegemon

2. Implications for Policymakers

3. Directions for the Future

The Dollar Hegemon

Kindleberger (1981)

'I argue(d) that for the world economy to be stable, it needs a stabilizer, some country that would undertake to provide a market for distress goods, a steady if not counter-cyclical flow of capital, and a rediscount mechanism for providing liquidity when the monetary system is frozen in panic. [...]

Britain, with frequent assistance from France, furnished coherence to the world economy along these lines during the nineteenth century and through the "belle époque." The United States did so from 1945 (or perhaps 1936) to 1968 (or 1963 or 1971).'

Viewed the collapse of BW as the end of the era of uncontested US dominance...

The Emergence of the Dollar Hegemon

The opposite happened:

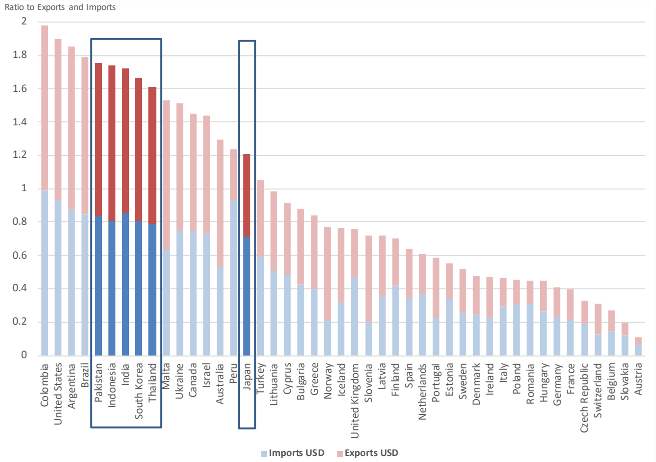
> *"[After BW], the dollar assumed greater monetary importance than gold." Mundell (1973).*

Increased dollar dominance:

- For trade invoicing and settlement
- For securities issuance and holdings
- As an anchor and intervention currency
- For foreign exchange reserves

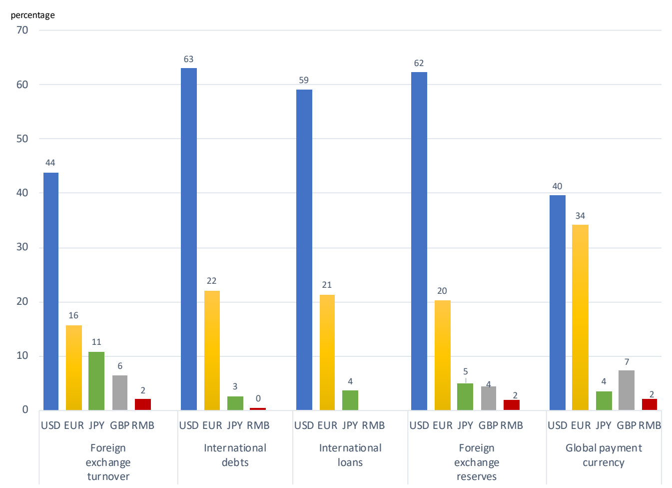
Trade Invoicing

1. dollar's invoicing share ≈ 3.5 share in trade. Gopinath (2015), Goldberg & Tille (2009).



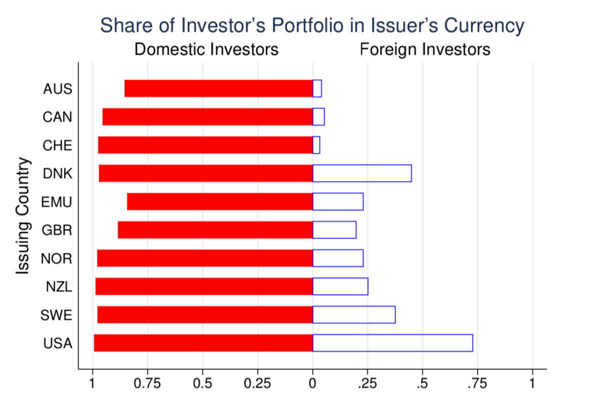
Average across Asian countries in sample: 1.61

2. The use of the dollar in global markets. Eichengreen and Xia (2019).



Financial Transactions: Currency Home Bias

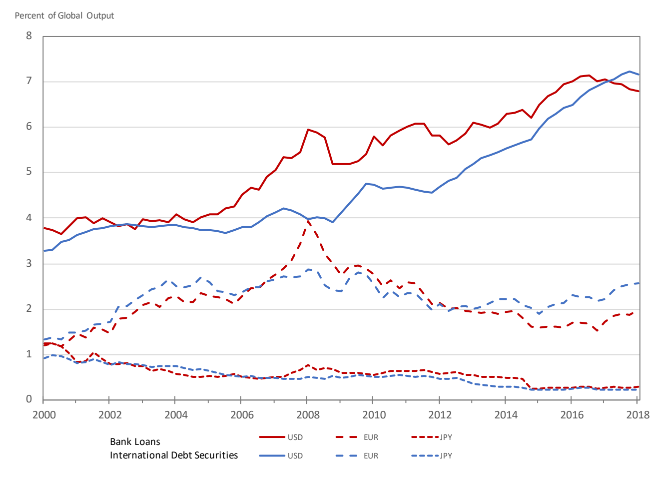
3. Share of Corporate Bonds in Issuer's Local Currency. Maggiori et al (2019).



The red bar reports for each issuing country, the share of bonds denominated in the issuer's local currency out of all domestic investment in its corporate bonds. The hollow blue bars show, for each issuing country, the share of bonds denominated in the issuer's local currency out of all foreign investment in its corporate bonds.

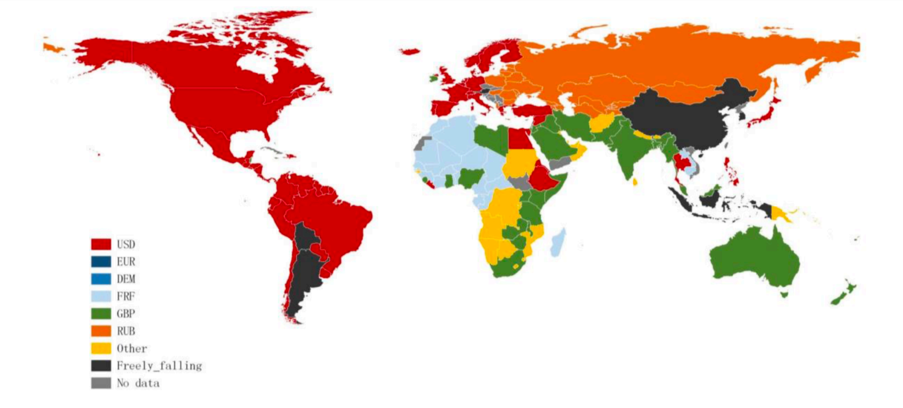
Financial Transactions: Dollar Funding

4. International Credit to Non-Residents by Currency. BIS global liquidity indicators.



The Geography of Anchor Currencies, 1950

5. The spread of the dollar as an anchor currency. Ilzetski, Reinhart and Rogoff (2019).



The Geography of Anchor Currencies, 2015

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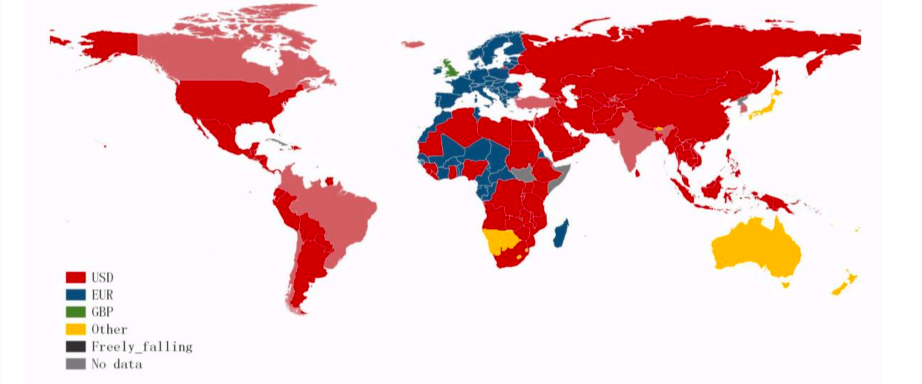

Important Complementarities

- [invoicing $\rightarrow$ anchor] Dollar invoicing generates asymmetric spillovers and makes dollar anchoring more desirable (Egorov & Mnuchin, 2019)
- [anchor $\rightarrow$ invoicing] Dollar anchoring makes dollar pricing more desirable compared to producer or local pricing (Mnuchin, 2019).
- [funding $\rightarrow$ anchor] Dollar funding increases spillovers from US monetary policy and makes dollar anchoring more desirable (global financial cycle, Rey 2013).
- [anchor $\rightarrow$ funding] Lower dollar volatility makes dollar funding more desirable.
- [anchor $\rightarrow$ reserves] Dollar anchoring requires larger dollar FX reserve holdings
- [invoicing $\leftrightarrow$ funding $\leftrightarrow$ holdings] Dollar invoicing makes dollar funding and dollar holdings more desirable and vice versa (Gopinath & Stein 2018)

Lock-in effect, in favor of the dollar

The Collapse of Bretton Woods Revisited

Yet, the current era of dollar hegemony started with a run on the dollar. Why?

Three separate dynamics at play:

1. The collapse of the dollar-gold parity in 1968. Original Triffin dilemma.
2. A short term adjustment: depreciation of the dollar due to excess dollar liquidity in 1971-73. dollar glut
3. Deeper low frequency dynamics: with increased capital mobility and volatile exchange rates, demand for safe assets relocated from local assets ('shadow' dollar safe assets) to dollar assets. Potential modern Triffin dilemma.

Key insight: center country is a net provider of the global safe asset (Caballero et al, 2017)

Asian Countries and the Dollar Anchor

Country	Start of the dollar anchor	Previous Anchor
Philippines	1945	none
Japan	July 1947	none
Korea	February 1953	none
Indonesia	April 1969	none
Pakistan	September 1971	UK pound
Singapore	June 1972	UK pound
Hong Kong	July 1972	UK pound
China (Mainland)	January 1974	none
Malaysia	September 1975	UK pound
India	August 1979	UK pound
Vietnam	January 1992	none
Cambodia	January 1994	none

Source: Ilzetzki et al (2019). The table reports the date at which latest dollar anchoring begins.

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Was the UK pound anchor a *shadow US dollar anchor*?

Implications for Policymakers

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Four key implications:

1. Exchange rate passthrough and the effectiveness of flexible exchange rates
2. Dollar factor and global trade
3. The Trilemma vs Dilemma debate
4. Global real rates, safety traps and currency wars

1. Dollar price passthrough and trade elasticity

	import prices		import quantities	
	(1)	(2)	(3)	(4)
	$\Delta p_{ij,t}$	$\Delta p_{ij,t}$	$\Delta y_{ij,t}$	$\Delta y_{ij,t}$
$\Delta e_{ij,t}$	0.757***	0.164***	-0.119***	-0.0310*
	(0.0132)	(0.0126)	(0.0139)	(0.0160)
$\Delta e_{\$j,t}$		0.781***		-0.186***
		(0.0143)		(0.0250)
R-squared	0.356	0.398	0.069	0.071
Observations	46,820	46,820	52,272	52,272
Dyads	2,647	2,647	2,807	2,807

Source: Gopinath et al (2019).

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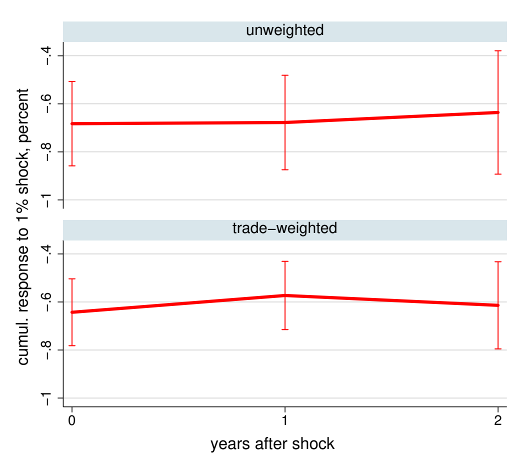
"Dominant Currency Paradigm":

Weak expenditure switching (via imports only), flat terms of trade, less effective depreciation

2. Global Trade and the Dollar



Source: Gopinath et al (2019). Error bars: 95% confidence intervals, clustering by dyad.

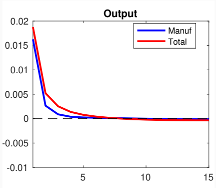
- Bilateral trade not driven by bilateral exchange rate, but by the dollar exchange rate.
- 1% appreciation of the dollar associated with 0.6-0.8% decline in the volume of trade between countries in the ROW within a year.

3. Trilemma/Dilemma Debate

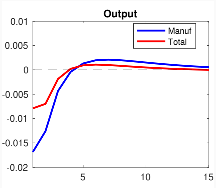
- The importance of dollar funding makes balance sheets worldwide sensitive to the dollar and indirectly to US monetary policy (Rey 2013)
- Question: Does this make flexible exchange rates less desirable (Dilemma)?
- Answer: it depends on the strength of balance sheet effects. (Gourinchas 2018)
  - **Weak balance sheet effects**. Standard Mundell/Friedman world.
    Flexible exchange rate is desirable.
  - **Intermediate balance sheet effects**: US tightening is contractionary, but domestic easing is expansionary.
    Flexible exchange rate is more desirable.
  - **Strong balance sheet effects**: US tightening is contractionary, and so is domestic easing.
    Flexible exchange rate may become less desirable.

The last case is theoretically possible, but requires perverse transmission of monetary policy

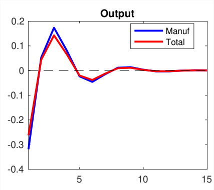
3. Trilemma/Dilemma Debate



(a) Weak

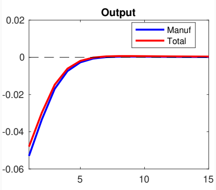


(b) Intermediate

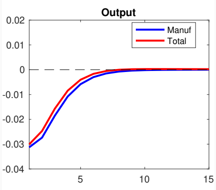


(c) High Spillovers

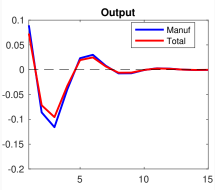
Impulse Response of EME output to a US Monetary Policy Tightening.



(d) Weak



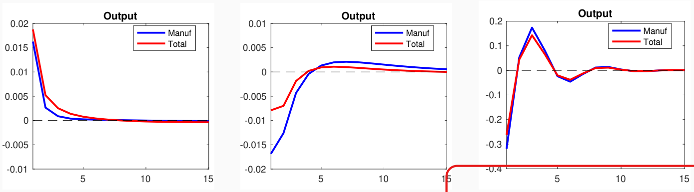
(e) Intermediate



(f) High Spillovers

Impulse Response of EME output to a local Monetary Policy Tightening.

3. Trilemma/Dilemma Debate



(a) Weak (b) Intermediate (c) High Spillovers

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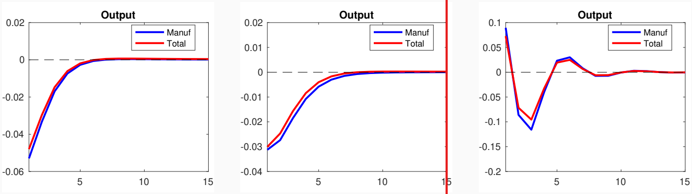


(d) Weak (e) Intermediate (f) High Spillovers

Impulse Response of EME output to a local Monetary Policy Tightening.

Perverse Transmission of Monetary Policy

4. Global Real Rates, Safety Traps, Currency Wars

- Global safe assets are scarce. How do we know this? Because global real rates are low and declining, while various risk premia remain elevated.
- Low levels of the safe global real rate brings the global economy up against the effective lower bound
- Three major implications:
  - This maintains the global economy on the edge of a regime of permanently depressed demand: secular stagnation, liquidity or safety traps....
  - This creates strong incentives for countries to attempt to reflate their economy at the expense of their neighbors: Trade and currency wars.
  - Policies that are optimal locally can be destabilizing globally: accumulating reserves, fiscal austerity, excessively strict liquidity requirements on the financial sector.

Caballero, Farhi & Gourinchas (2016), Eggertsson et al (2017), Fornero & Romei (2019).

Implications for the Future

Implications for the Future

I see three main implications

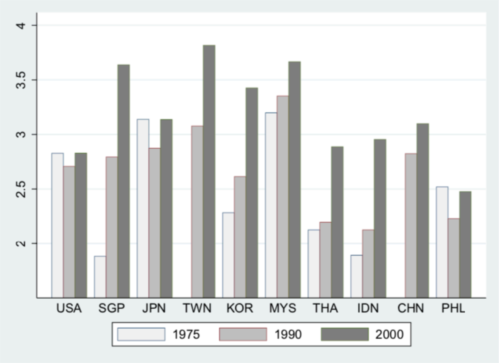
1. In the short to medium run, the dollar standard is here to stay, however dysfunctional:
   Safe asset scarcity, low real rates, depressed global demand, monetary policy spillovers and the potential for FX or trade disruption.
   Important potential implications for Global Value Chains, especially for small open economies (Singapore?)

2. In the (very) long run, the dollar dominance is bound to disappear.
   Modern Triffin dilemma: eventually, the US will become too small and unable to expand the supply of safe dollar assets without exhausting its fiscal capacity.

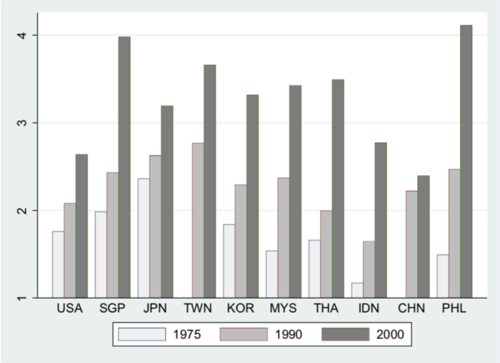
3. The transition, when it happens, could be quite sudden.
   As long as the RMB-USD rate remains stable, a dollar anchor could be a shadow RMB anchor. US dollar anchors could go the way of the UK pound anchors...

Currency and Trade Wars and Global Value Chains

Figure 1: Average upstreamness index by country for 1975, 1990 and 2000



(a) Manufacturing



(b) Electronics

Source: Fally and Hillberry (2018). Upstreamness measures the average distance to the final consumer, constructed from global IO tables.

Thank You!