The Dollar and the International Monetary System

Arvind Krishnamurthy
Stanford University GSB, NBER, and SIEPR
Outline

1. The features of the dollar-centric IMS
   • Trade
   • Finance

2. How does the role of the dollar affect economies?
   • Implications for US
   • Implications for global financial cycle

3. What underlies the dollar equilibrium and will the dollar’s centrality be challenged?
   • Theory and some history
   • Digital currency
Dollar dominance in invoicing of world trade (5)*

Example: Mexican manufacturer imports a heavy machine from a Japanese firm. What denomination is the contract?

*References are at the end of this slide deck.
Dollar dominance in banking (16,19)

For banks residing outside the country of the currency

As of Q42020

Dollar financing dominance also carries over to the corporate bond market
Dollar funding advantage for safe assets \(^{(4,11,15)}\)

\[ \text{Basis} = \text{Yield on \$ bond} - [\text{Yield on Foreign bond} + \text{cost of FX swap hedge}] \]
Safe asset demand ⇒ dollar dominance \(^{(12)}\)

- Investors around the world demand safe dollar bonds ("world money")
  - Driving down the yields on safe dollar-denominated bonds
- Banks, firms, governments tap into this demand
  - Tilt borrowing decisions towards dollars … less so towards Euro, Yen
- Exporters and importers rely on trade finance from global banks
  - Ample supply of dollar finance from banks
  - An exporter invoices in dollars to reduce currency mismatch
    - Revenue stream in dollars to match the currency denomination of borrowing
Implications

1. Safe asset demand induces high leverage within the U.S.\(^{(1)}\)
   - Global imbalances/savings glut arguments

2. In addition … safe asset demand induces high dollar leverage outside the U.S\(^{(6,11)}\)
   - Where non-U.S. borrowers are currency mismatched

3. Global financial cycle\(^{(7,17,18,19)}\)
   - Tightening terms on dollar credit spills over to the rest of the world
   - Dollar appreciation hits currency mismatched borrowers

4. Global crises\(^{(11,17)}\)
   - Non-U.S. issuers of dollar debt face difficulties rolling over debt
   - Flight to U.S. govt: increasing U.S. fiscal space; some of this space recycled as LLR to US financial system, and via dollar swap lines to rest-of-world
Past trends and future…

- These patterns have strengthened over the last two decades
  - World “money demand” grows in proportion to world GDP
  - And US GDP as share of world GDP is falling

- What about the next decades?
Money and the Reserve Currency Phenomenon

- Coordination/complementarity/externality have to be central
  - The adoption of the dollar as the international currency is a natural phenomenon (*de-facto* not *de-jure*)
  - Always one (or maybe two) … $, GBP
  - Finance portfolio theory pushes towards a basket for diversification purposes

- Roles of money
  - Medium of exchange
  - Store of value
  - Unit of account
Economic factors and policy decisions

- “Fundamental” factor: Absolute size of the U.S. economy supports large quantity of private and public safe assets\(^{(8)}\)
  - Drawing in buyers and sellers and enhancing the liquidity of safe dollar claims

- Then equilibrium outcomes re-enforce the dollar equilibrium
  - Financial market development enhances liquidity (repo, securitization, etc.)
  - $ is a hedge: appreciates in times of a global crisis
  - Firms invoice in dollars because financing in dollars is cheap…input/output chains\(^{(3,6)}\)

- Deliberate policy choices that enhance the dollar equilibrium
  - Openness to capital flows
  - Fed swap lines
    - Private dollar bonds are easier to roll-over given Fed’s LLR capacity and swap lines
Dethroning the U.S. dollar needs a challenger\(^{(2,8,9)}\)

- Requires an income (GDP) base to back a substantial quantity of safe bonds
  - e.g. Canada is too small
  - As is any current crypto model
- Needs to be relatively safer than the challengers
  - Two World Wars left UK finances in shambles
  - But US budgetary forecasts …
- Needs to be investable
  - U.S. financial system and open capital market
  - In comparison, China is not (much) investable
Policy choice: digital currency

- Policy intent for non-US is often defensive
  - Emerging market creates local digital currency to keep the dollar at bay\(^{(14)}\)
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• Policy intent for non-US is often defensive
  • Emerging market creates local digital currency to keep the dollar at bay\(^{(14)}\)

• But can also enhance the hegemony
  • If the U.S. were to introduce a digital currency
References with links

3. Doepke and Schneider, “Money as a Unit of Account,” Econometrica
5. Gopinath, "The International Price System", Proceedings of the Federal Reserve Bank of Kansas City Jackson Hole Symposium
7. Gourinchas and Rey, “From World Banker to World Venture Capitalist,” NBER Volume