The Dollar Hegemon?
Evidence and Implications for Policy Makers

(by Pierre-Olivier Gourinchas)

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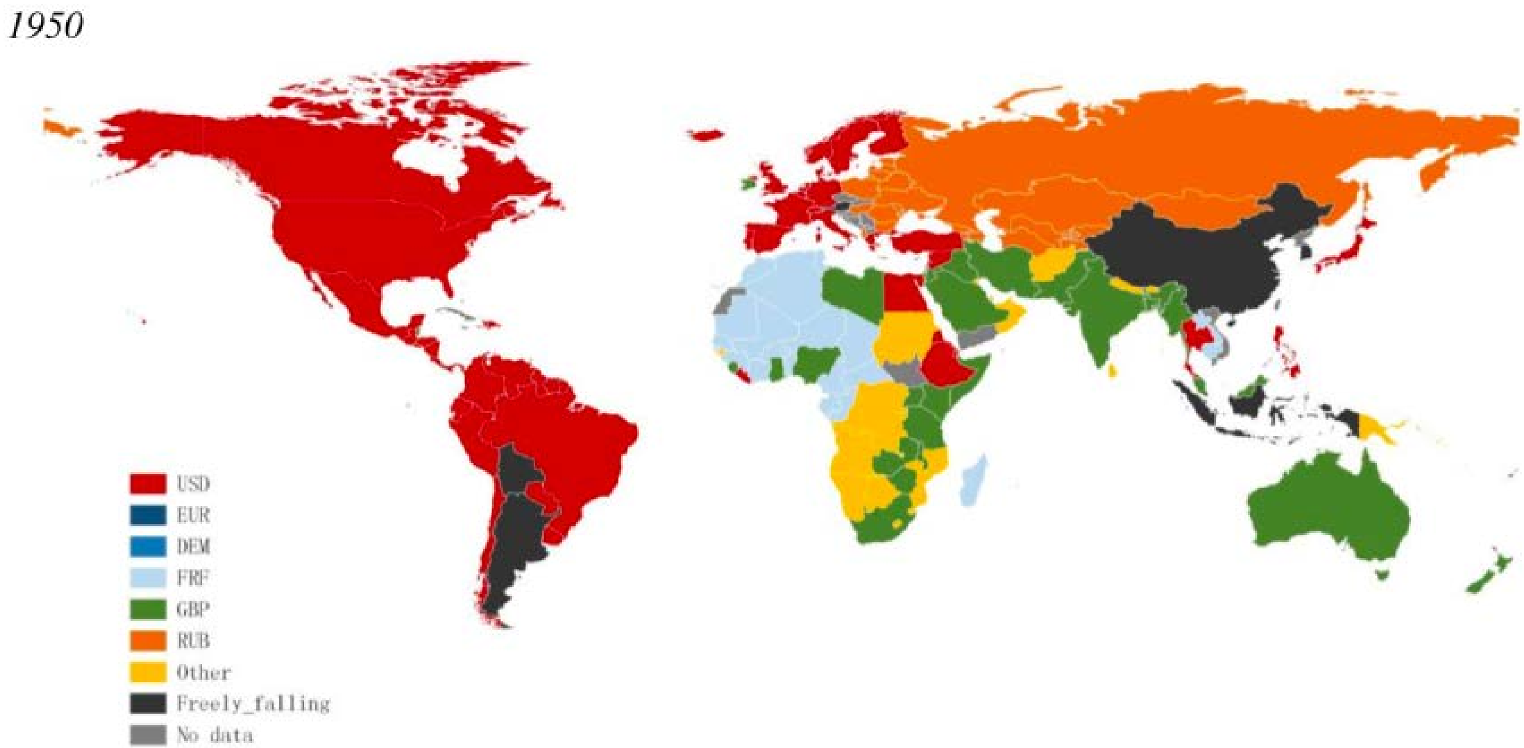
Summary: It’s a dollar world!

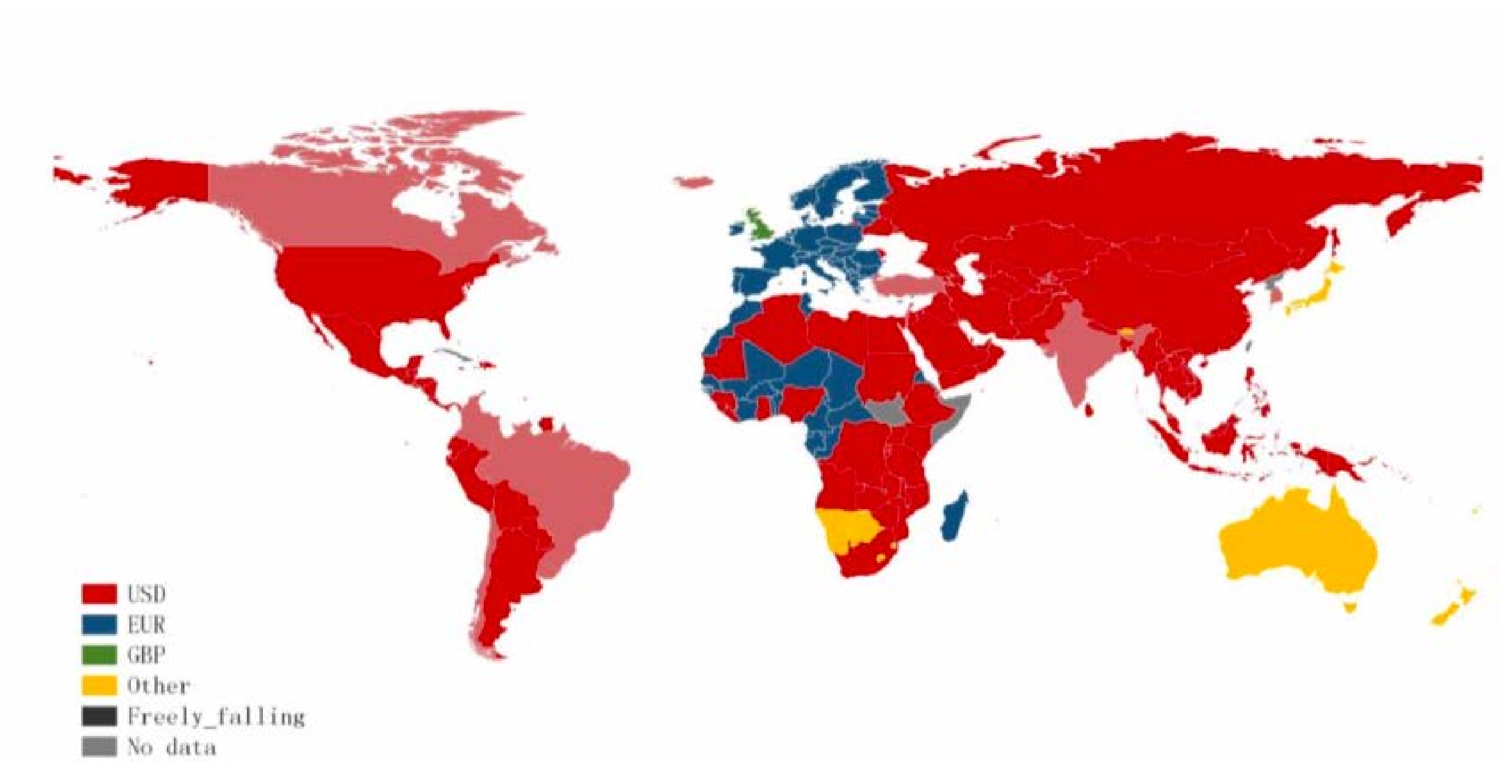
- Sections 2 (historical) and 3 (the present) document the dollar’s dominance in trade and financial transactions, and its role as a monetary anchor
  - Breakdown of BW led to USD depreciation but did NOT interrupt USD dominance
  - In fact, the USD has grown more dominant since then… (cool Figure 5)

Summary: It's a dollar world!



Summary: It's a dollar world!

2015



Summary: It's a dollar world!

- Section 4: Discusses implications for policymakers.
  - Lots of discussion of NK models with DCP… but concludes that flex exchange rate is probably good, nonetheless
- Section 5: Conjectures about the future
  - USD equilibrium is locally stable but unsustainable since g(US)<g(W)
  - Don't worry too much, RMB = Shadow USD…

Small Comment (NK/Pricing)

- USD is clearly special in international trade (DCP)
- But I'm not sure the standard NK workhorse is very useful to address the type of questions POG is addressing (not his fault… it's the literature):
  - Calvo parameter is very ad-hoc. Do you really expect it to be immune to exchange rate regime and pricing currency? (Ss lit)
  - What about financial frictions? Path of earnings is very different under different regimes.
  - What about incentives? Dollar liabilities will depend on expected CB's response to shocks (SS lit)

Bigger Comment/Question

- Financial markets: Safe store of value view… I like it!
- Is it the UST or the USD?
  - This paper seems to claim it is the USD, and most of us have a hunch that this is at least partially right…but paper doesn't really show it…
  - P30:

To begin with, in the near future, the US is bound to remain the primary issuer of global safe assets. All other candidate international currencies lag far behind the dollar along almost all dimensions (see Fig. 3). The immediate implication is that, unless the

Some evidence for the UST view

- Idea: It is the increase in the UST convenience yield that leads to violation of UIP (and possibly CIP) and *causes* an appreciation of USD (Jiang et al 2018)

$$0 = \lambda_t^* + (i_t^{\$} - i_t^*) + E_t[\Delta s_{t+1}] + \frac{1}{2} var[\Delta s_{t+1}]$$

$$s_t = ct + E_t\left[\sum \lambda_{t+\tau}^*\right] + E_t\left[\sum (i_{t+\tau}^{\$} - i_{t+\tau}^*)\right]$$

- Treasury basis variation accounts for 25% of the quarterly variation in the USD between 1988 and 2017

Some evidence for the UST view

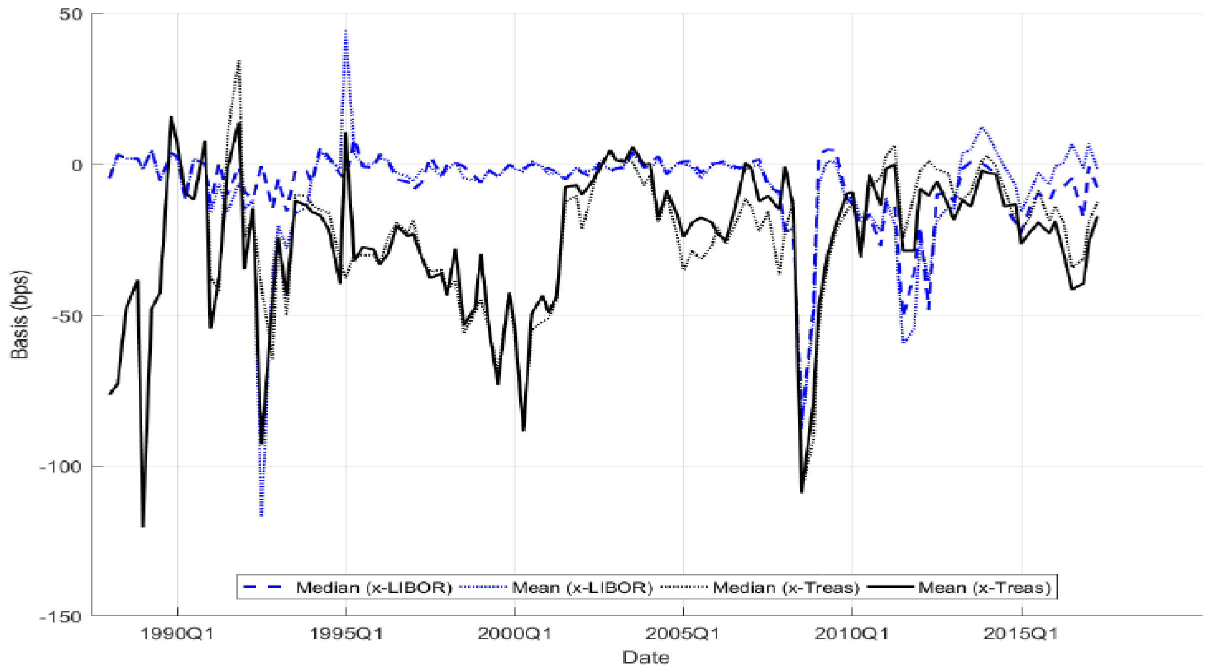


Figure 2: LIBOR and Treasury basis in basis points from 1988Q1 to 2017Q2. The maturity is one year.

Source: Jiang, Krishnamurthy, Lustig 2018

Some evidence for the UST view

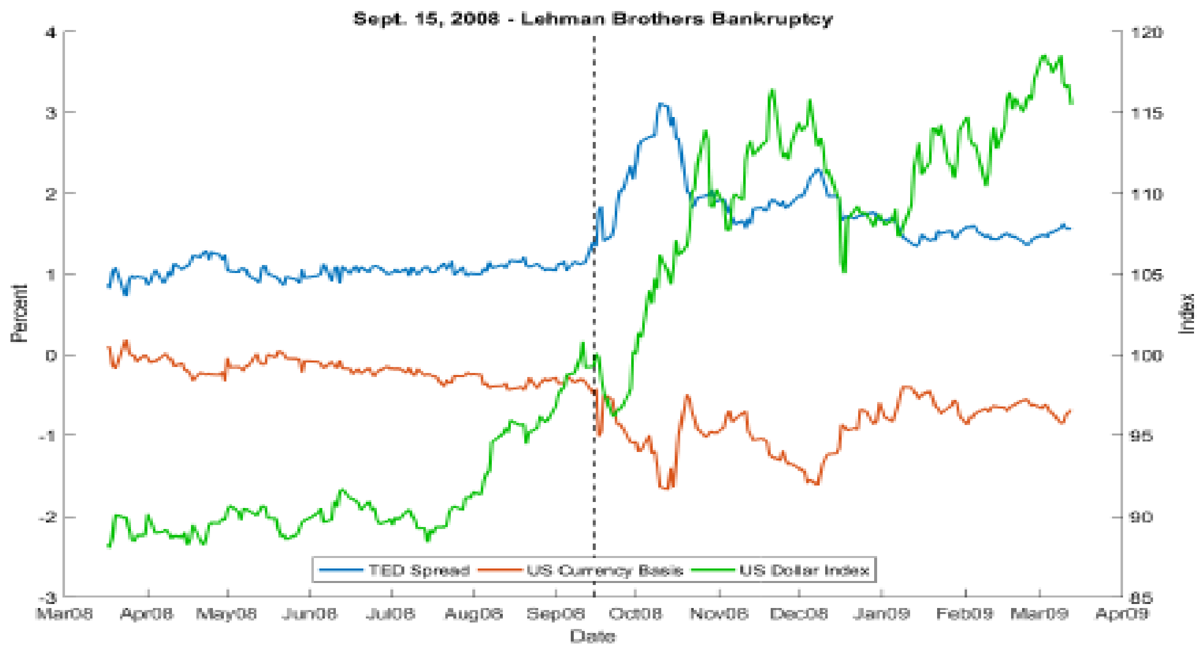


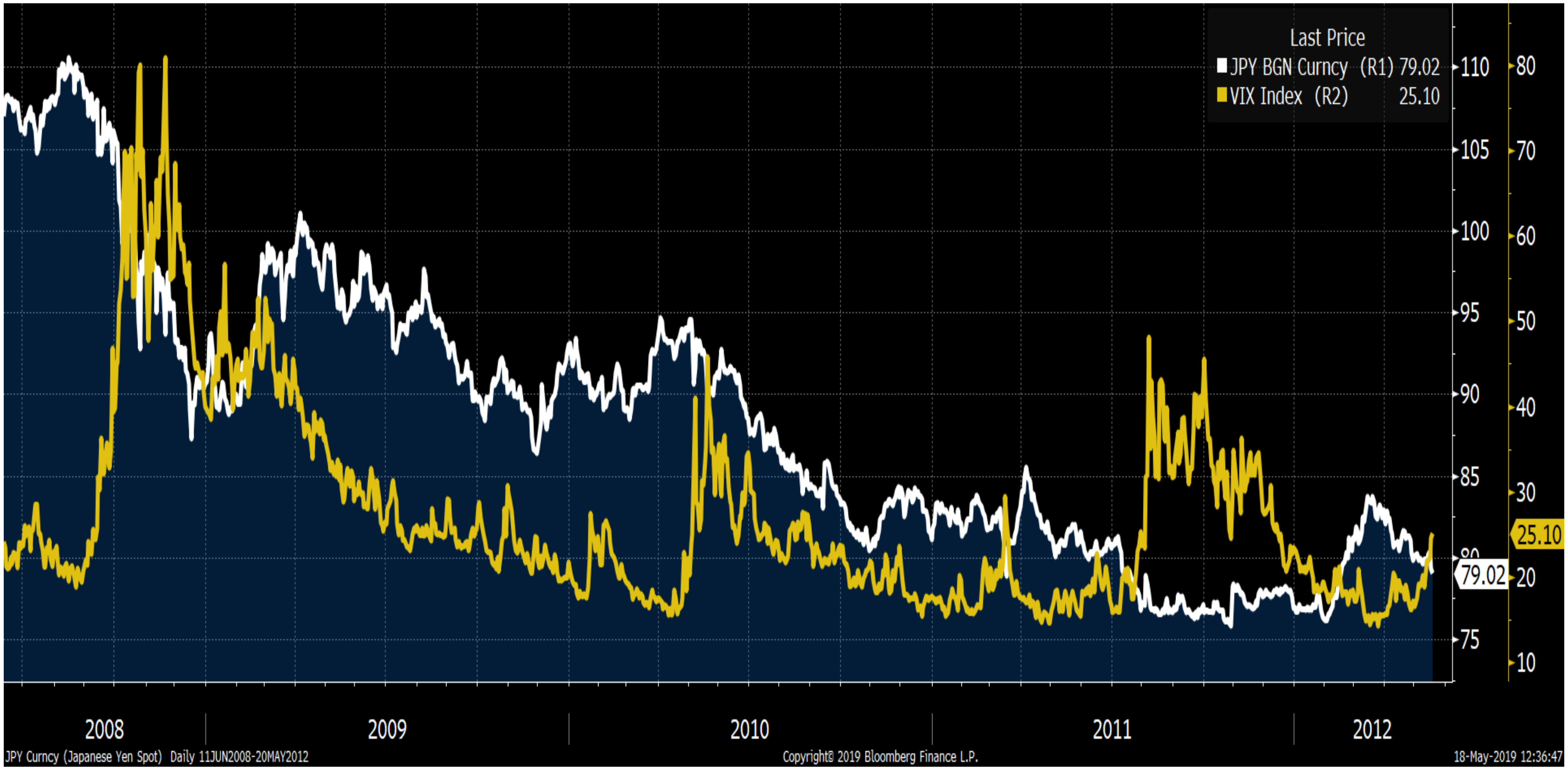
Figure 1: TED Spread, Average Treasury Basis and Dollar.

Source: Jiang, Krishnamurthy, Lustig 2018

Is the USD really the safest?

- The Japanese don’t seem to think so…
  - Typical pattern:
    - Risk on: Buy US fixed income, unhedged
    - Risk off: Keep the bonds but hedge the fx

Is the USD really the safest?



A Caricature/Extreme View

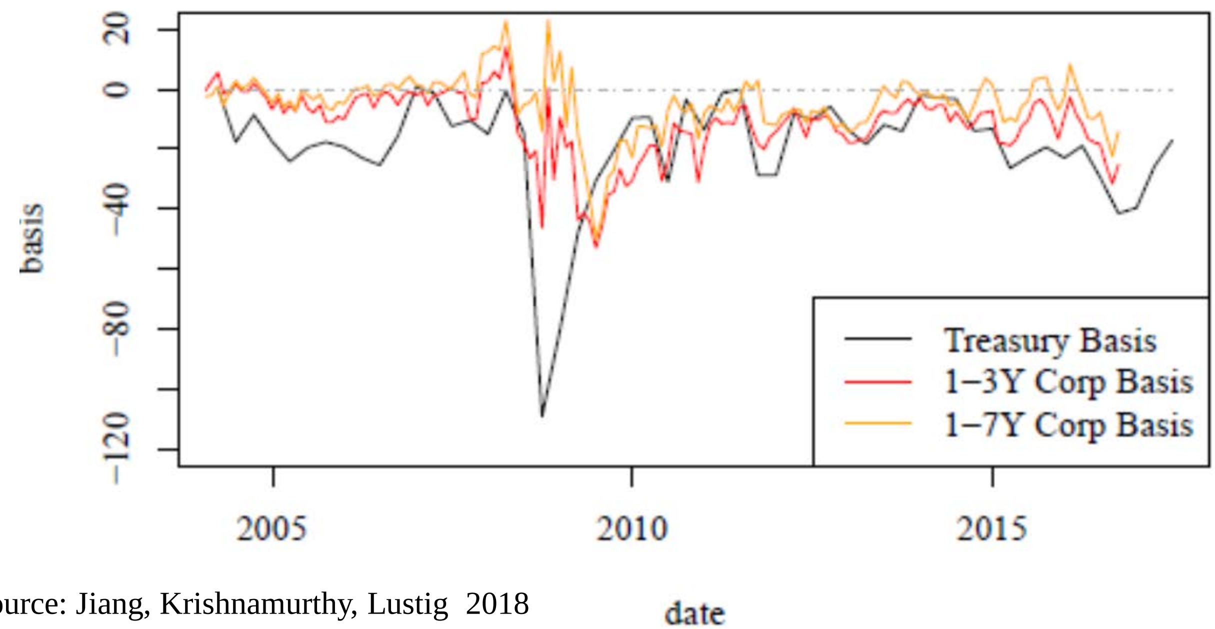
- For financial markets side of the story:
  - UST clearly special
  - USD, not so clear…
    - It is a convenient unit of account for fixed income globally…
    - Deepening of FX markets means one can separate the unit of account from the FX exposure (different specialists)… which may explain part of USD deepening

A Caricature/Extreme View

- For an (extreme) example of this separation: In Brazil most financial transactions are in BRL… but that doesn't make the BRL a "safe currency" for Brazilians…
- The point is: Just looking at the denomination of bonds tells us very little about whether people find the currency a safe store of value or not…

A Caricature/Extreme View

- UST is special
- USD not so much….

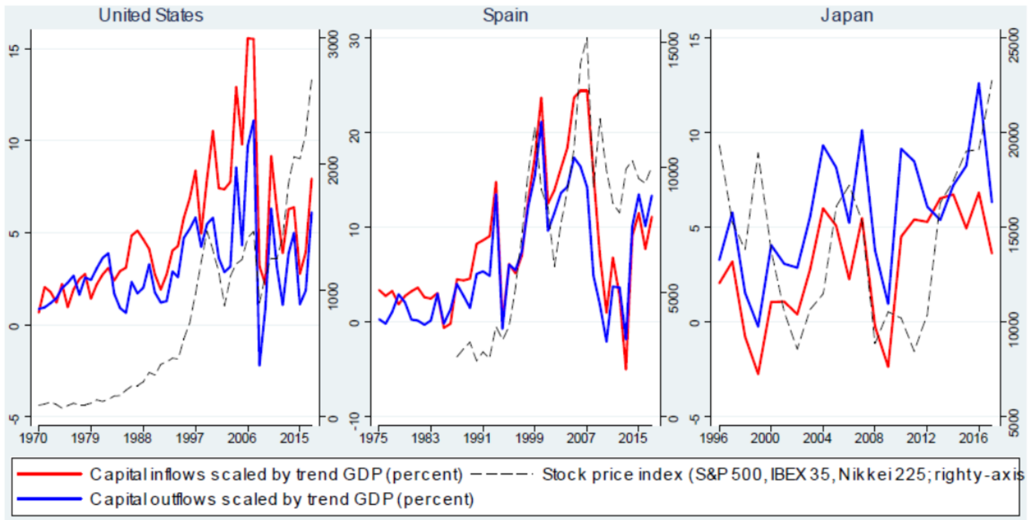


Source: Jiang, Krishnamurthy, Lustig 2018

A Caricature/Extreme View

- What explains USD risk-off behavior? … carry trade dynamics due to retrenchment

  - If long USD during risk on (Japan…), then local ccy appreciates during risk-off
  - IF short USD (EM…), ccy depreciates
  - On average, more of the latter among active investors… perhaps because of UST convenience yield…



Source: Caballero and Simsek 2018

Conclusion

- The paper summarizes an important literature with great elegance. A must read
- My main concern with the literature is that it is often vague with respect to the exact location(s) of the safety-convenience yield
- We need to be more precise on this issue, in order to identify the main bottlenecks in safe asset creation and the available scape valves for the secular scarcity of these assets

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