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Floating Exchange Rates at Fifty

US and dollar dominance in the International Monetary System

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Self-reinforcing mechanisms and dollar dominance

- Finance:
  - Positive feedback cycle : liquidity and safety of \$ assets ⇒ issue more \$ ⇒ liquidity

- Trade
  - Increased trade invoicing in \$ ⇒ incentives to invoice more to reduce currency risks
  - Global value chains have strengthened \$ dominant position

- Very stable equilibrium

- Interrelated: need for financial collateral in international trade

What is next ?

- No obvious substitute and two competitors (Renminbi + euro)

- Chinese Renminbi and geopolitical tensions
  - Will eventually abandon fixed exchange rate: diversification gains higher to invest/denominate in Renminbi
  - Financial sanctions: $ less of a safe asset but Chinese rule of law
  - China shock on trade behind us
  - Unprecedented geopolitical tensions with clear US objective to decouple: political pressure to align trade and financial flows with political affinities ⇒ regionalization of global supply chains and friendshoring ⇒ friendcurrencing
  - Economic mechanisms behind $ dominance based on positive sum game view of international economic relations
  - Military conflicts reduce trade flows persistently which also make military conflicts more likely

What is next ?

- Euro
  - Size factor
  - Euro crisis has put doubt on euro safe assets
  - Weaponization of international economic relations: Europe will align with US (no strategic autonomy vis a vis US) ; no space for a third partner

Economic and politics (de-globalization, fragmentation…) will reduce the mechanisms behind dollar dominance in trade and finance

But: also reduce the possibility of an abrupt change in equilibrium and limit gains for other currencies

Does this matter ?

- Economic efficiency losses : Positive externality in one actor deciding to denominate debt in dollar (improves market thickness and liquidity for all other borrowers and lenders) ⇒ may accelerate de-globalization trends

- Exorbitant privilege literature points to potentially sizable gains for the US

- Difference in returns between assets and liabilities + large gross flows

- De-globalization will reduce gains from dollar dominance for the US