

Discussion of “Banking, Trade, and the Making of a Dominant Currency” by Gita Gopinath and Jeremy Stein

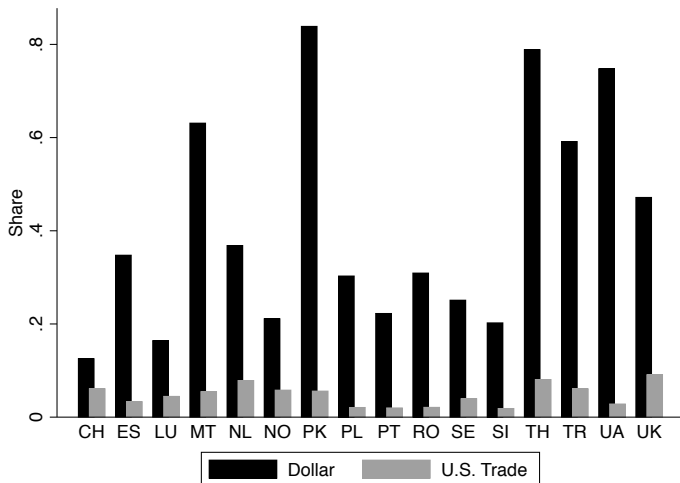
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Gopinath (2015) 'The International Price system'

- ▶ Dollar's invoicing share in imports vs share of imports from U.S.



This paper

- ▶ U.S. dollar widely seen as a *dominant currency*
- ▶ Plays outsized role in denomination of
 1. Trade invoicing, including non-U.S. country pairs
 2. Deposits of non-U.S. banks
 3. Borrowing of non-U.S. firms
- ▶ Moreover
 4. U.S. dollar borrowing typically cheaper
 - ▶ systematic uncovered interest rate parity (UIP) violations
 5. Corporate balance sheets are often currency mismatched
- ▶ **This paper**
 - ▶ Connects facts 1–5 using a unified, elegant theory
 - ▶ Derives potential implications for EUR and RMB going forward

Two key ingredients

- ▶ Two key model ingredients:
- 1. U.S. dollar as **unit of account** for assets and liabilities, including
 - ▶ Trade payables = liability for importers
 - ▶ Trade receivables = asset for exporters
 - ▶ Sticky prices in invoicing currency \Leftrightarrow lack of FX indexation
 - ▶ Currency risk in balance sheet, just like any other asset or liability
 - ▶ Generates hedging incentives, connecting facts 1 – 3

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 - ▶ Currency risk in balance sheet, just like any other asset or liability
 - ▶ Generates hedging incentives, connecting facts 1 – 3
 2. U.S. dollar as safe **store of value**
 - ▶ Generates cheap dollar funding... (fact 4)
 - ▶ ... and incentive for currency mismatch in balance sheets (fact 5)

The model in a picture

- Importers have trade payables invoiced in \$...

Exporters

Assets	Liabilities

Banks

Assets	Liabilities

Importers

Assets	Liabilities
	\$

The model in a picture

- ▶ generating a demand for \$ deposits...

Exporters

Assets	Liabilities

Banks

Assets	Liabilities

Importers

Assets	Liabilities
\$	\$

The model in a picture

- ▶ pushing down on \$ rates and encouraging exporters to borrow \$...

Exporters

Assets	Liabilities
	\$

Banks

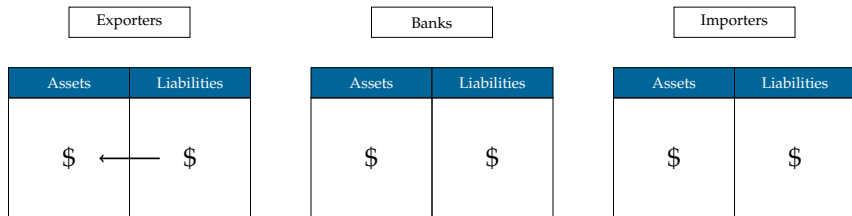
Assets	Liabilities
\$	\$

Importers

Assets	Liabilities
\$	\$

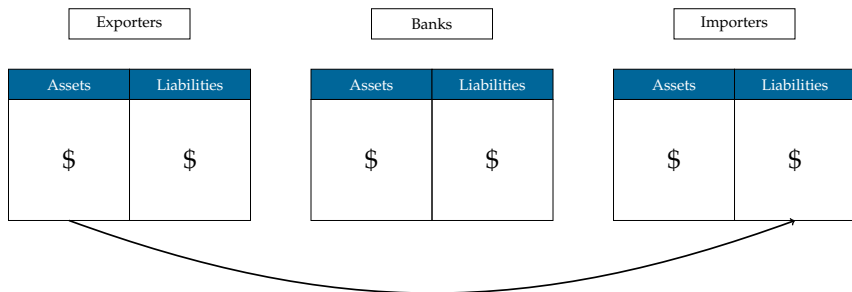
The model in a picture

- ▶ in turn encouraging exporters to invoice in \$... (not fully: mismatch)



The model in a picture

- ▶ which finally affects *other* countries' importers



Key questions

- ▶ Why doesn't the whole world dollarize?
 - ▶ Benefits of flexible exchange rates are unmodeled in the paper
 - ▶ Optimal currency area literature mostly modeled the costs of union
 - ▶ This paper fleshes out the benefits side. Could integrate both?

Key questions

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- ▶ Multiple equilibria?
 - ▶ USD replaced GBP after WWI
 - ▶ EUR or RMB might in principle become dominant currencies instead
 - ▶ But existing assets and liabilities have long maturities.
 - ▶ Anchor of history probably very strong

UIP violations

- ▶ Risk-neutral savers (importers) value dollars in utility

$$\begin{aligned}\max \quad & C_0 + \beta \mathbb{E}[W_1] + \theta \alpha_{\$} \log D_{\$} \\ & C_0 + D + \mathcal{E}_0 D_{\$} \leq W_0 \\ & W_1 = D(1+i) + \mathcal{E}_1(1+i_{\$})D_{\$}\end{aligned}$$

- ▶ Generates UIP violation (exorbitant privilege) at equilibrium:

$$1+i = \mathbb{E} \left[(1+i_{\$}) \frac{\mathcal{E}_1}{\mathcal{E}_0} \right] + \frac{\theta}{\beta} \frac{1}{\mathcal{E}_0} \frac{\alpha_{\$}}{D_{\$}}$$

- ▶ Complementary to typical risk-based explanation
- ▶ But does not generate CIP violations?
 - ▶ This relies on assuming that swapped \$ do not yield utility
 - ▶ Could make opposite assumption and explain cross-currency basis

Testing the theory

- ▶ Paper tests in data one cross-country prediction
 - ▶ Countries with larger $\alpha_{\$}$ also have larger $D_{\$}$
- ▶ Theory provides many micro-level predictions:
 - ▶ Importers with larger $\alpha_{\$,i}$ have larger $D_{\$,i}$ within a country
 - ▶ Banks whose clients are importers with larger $\alpha_{\$,i}$ issue more \$ loans
 - ▶ Exporters who choose to invoice in \$ also tend to borrow in \$
- ▶ Would be nice to test these in firm/bank level data

Concluding thoughts

- ▶ Novel, coherent framework linking prominent role of dollar in trade invoicing and banking:
 - ▶ \$ invoicing creates asset-liability management motive for firms
 - ▶ Creates causal chain from import invoicing to export invoicing, via cheap funding
- ▶ My view: role of dollar as unit of account more important than safe store of value, and most essential part of the story
- ▶ Expect many more papers on the topic
 - ▶ Flesh out testable implications