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

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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 outsize 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 ⇔ 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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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 $...
The model in a picture

- generating a demand for $ deposits...

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The model in a picture

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

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The model in a picture

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

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Banks

Adrien Auclert (Stanford)
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?
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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

\[
\max \quad C_0 + \beta \mathbb{E} [W_1] + \theta \alpha_s \log D_s \\
C_0 + D + \mathcal{E}_0 D_s \leq W_0 \\
W_1 = D (1 + i) + \mathcal{E}_1 (1 + i_s) D_s
\]

- Generates UIP violation (exhorbitant privilege) at equilibrium:

\[
1 + i = \mathbb{E} \left[ (1 + i_s) \frac{\mathcal{E}_1}{\mathcal{E}_0} \right] + \frac{\theta}{\beta \mathcal{E}_0} \frac{1}{D_s} \alpha_s
\]

- 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 $ \text{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