

The domain of the dollar: 8 questions

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The \$'s domain: markets, myths, macropolicy

8 questions

- How many \$s do non-US residents owe? \$12 trillion
- Is more \$ debt hidden in foreign exchange forwards? Yes, >\$10 trillion
- How big is the “dollar zone”? Big: 50-60% of global GDP
- Is the ROW short the dollar? No, but it acts that way
- Does \$'s role make US current account or gov't debt unsustainable? No
- Does the \$'s role confer an exorbitant privilege on the US economy? No
- Is \$ domain too big for the Fed to backstop? No, did so in 2008 & 2020
- Do politics threaten the Fed's backstop of the \$ domain? Perhaps

1. How many \$s does the rest of the world owe?

- Firms and governments outside the United States owe \$12 trillion, or about 18% of the rest of the world's GDP in 2019, mostly to offshore banks and investors.
- Fed monetary policy immediately affects firms with dollar debts linked to Libor.
- And the Fed's US bond-buying spurred massive offshore dollar bond issuance: outstanding bonds rose from \$2.5 trillion in 2008 to \$6.3 trillion in 2019.

2. Is there more hidden dollar debt offshore?

- Yes, over \$10 trillion off balance sheets.
- Firms with \$-denominated exports and investors with \$ securities hedge by promising to pay \$s against other currencies in FX forwards.
- In strained markets, arbitrage dries up and \$ yields in FX markets autonomously rise above US \$ money market rates (“CIP violated”).
- In 2008 and 2020, Fed swapped \$s to force global \$ yields into line.

3. How big is the dollar zone?

- Half or more of global GDP. Defined as economies whose currencies vary less against the \$ than against the euro or other key currency, the \$ zone has remained at 50-60% of world GDP.
- While the \$ zone has shrunk in Europe, faster growth in more \$-linked Asia has maintained the \$ share.
- \$ zone features high
 - \$ share of trade invoicing,
 - \$ share of international debts and
 - \$ share of official foreign exchange reserves.
- A big question: how the RMB will relate to the \$ and euro?

4. Is the rest of the world short the dollar?

- No, but it acts that way.
- The rest of the world is in aggregate long the \$, with net \$ claims on the US of over 100% of US GDP; *in aggregate*, \$ appreciation must raise wealth in the ROW.
- But what is true of the whole is not true of the (behaviourally salient) parts: the fallacy of division.
- The corporate sector in many countries has substantial \$ debt, much of which does not hedge \$ cash flows or assets.
- As a result, \$ appreciation acts like a global tightening of credit terms.

5. Does global \$ demand impose dilemmas?

- No, evidence is weak for neo-Triffin arguments that demand for \$ reserves imposes unsustainable US current account or fiscal deficits.
- Re current account, US still not recording net investment payments, despite big foreign debt.
- Re safe assets shortage, US Treasury does not have a monopoly in supplying safe \$ assets.
- And official \$ foreign exchange reserves did not grow in 2014-2019, contradicting premise of growing demand for safe assets. Gradual, now rapid, rise in US Treasury debt to GDP ratio cannot be blamed on demand from official reserves.

6. Does \$ confer an exorbitant privilege?

- No, pecuniary benefits are small or so widely shared as to not qualify as a privilege:
 - Offshore holdings of \$ bills benefit as an interest-free loan, but it is macroeconomically tiny, especially at near zero yields.
 - The US borrows in its own currency, but other advanced debtor countries do too.
 - The US Treasury may borrow more cheaply owing to official holdings, but the rest of the world shares in this advantage.
 - US external assets yield more than US external liabilities, but this advantage arises from foreign firms' losses in acquiring US companies, not from the \$'s global role.
 - US banks may play on a home court, but they have in fact won a modest share of offshore \$ banking.
- Without even counting costs, non-pecuniary benefits ("weaponisation", eg to enforce sanctions) would have to be large for \$ to confer big benefit.

7. Is the \$ domain too big for the Fed to backstop?

- No, with precedents in the 1960s, the Fed proved in 2008 and 2020 that it can extend credit to backstop \$-indebted non-US banks.
 - In particular, it swapped dollars for the currencies of major central banks to allow them in turn to provide \$s to banks HQed outside the US.
 - Almost \$600 billion in 2008, almost \$450 billion in 2020.
 - In 2008, swaps succeeded in bringing down \$ Libor, a critical offshore link in the transmission of Fed policy rates to US firms and households.
 - It also brought down \$ yield premia in forward FX markets.
- In 2020, the Fed's buying of US corporate bonds lifted \$ bonds issued offshore: the Fed's backstop of the \$ domain extended to longer maturities, following market developments.

8. Do politics threaten the Fed's backstop of the \$?

- Possibly.
- The Fed extended swaps to just 4 emerging market central banks in 2008 and 2020.
- Borrowers from other emerging markets account for a substantial and growing share of the dollar's global domain.
- Not all of these countries are friends with the United States.

Punch lines

- Markets have extended the dollar's domain well beyond US borders.
- The dollar's domain gives Fed policy powerful global effects and makes the dollar's FX rate a surprising global risk factor: appreciation = global credit tightening; depreciation = global loosening.
- In myth, the global domain of the dollar is unstable and lucrative; in reality, stable and little privilege.
- In 2008 and 2020 the Fed swaps reconciled national objectives and the dollar's global role.
- But politics may put at risk the Fed's future ability to backstop the dollar's global domain.