I would like to thank the organisers for the kind invitation to speak at this prestigious conference. I am delighted and honoured to be in such distinguished company.

The question I would like to address today is whether a more pluralistic international monetary system – one with more international currencies on a more equal footing – would enhance global monetary, financial and macroeconomic stability.

This is a perennial question. It was, for instance, just as prominent under the Bretton Woods system as under the arrangements that have followed – which some regard as a “non-system” (e.g., Padoa-Schioppa and Saccomanni (1994)). And it presupposes the answer to another, more fundamental, question: what is the Achilles heel of the international monetary and financial system (IMFS)?

Note that I am choosing my words carefully. For, the “financial” dimension is just as important as the “monetary” one, although the shorthand “international monetary system” is much more common. This tendency perhaps harks back to post-war arrangements in which, for quite some time, finance played a subordinated role owing to constraints on capital flows and foreign exchange transactions. As we all know, that world is long gone.

There are three takeaways from my presentation.

First, there is no doubt that the dominance of one currency creates challenges for the IMFS. Fundamentally, the domestic interests of the country of issue need not coincide with those of the system as a whole.

Second, it is less clear, though, whether a more pluralist system, even if it was achieved, could help address the IMFS’s main weakness. To my mind, that weakness is its inability to prevent the build-up and unwinding of hugely damaging financial imbalances, or outsize financial cycles, thereby amplifying weaknesses in national arrangements (Borio (2014a)). This is what, with a colleague, Piti Disyatat, we have termed its “excess (financial) elasticity” (Borio and Disyatat (2011)). Think of an elastic band that you can stretch out further and further but that, as a result, snaps back more violently.

Third, addressing this weakness would require stronger anchors at national and international level. Some progress has been made, especially at national level. But much more needs to be done.

In what follows, I will first recall some basic facts to illustrate the US dollar’s dominance in the IMFS. Here I will consider the dollar’s three familiar roles, as a means of payment, a store of value and a unit of account. I will then explore the possible problems that this can create and put forward three propositions. I will finally turn to possible solutions and make three observations.

1 I would like to thank Bob McCauley, in particular, for help in the preparation of these remarks.
Outline

- CIP deviation
  - what
  - why

- Relation with other asset pricing
  - FX hedging
  - local currency credit spreads
  - shadow cost of balance sheet
CIP deviation

Covered interest rate parity

\[ e^{ny_{t,t+n}} = e^{ny_{t,t+n}} \frac{S_t}{F_{t,t+n}} \]

- \( y_{t,t+n}/y_{t,t+n} \): n-period risk-free rate in US/foreign country
- \( S_t \): spot exchange rate in unit of foreign currency per dollar
- \( F_{t,t+n} \): n-period forward rate in unit of foreign currency per dollar

Cross-currency basis

\[ x_{t,n} = y_{t,t+n} - (y_{t,t+n} - \log \frac{F_{t,t+n}}{S_t}) \]

forward premium \( \rho_{t,t+n} \)
Figure: 5y cross-currency basis
Possible factors underlying the deviation

- Du et. al. (2017), Borio et. al. (2018), Avdjiev et. al. (2018), etc.

- increase in FX hedging demand
  - banks and institutional investors: swap out of home currencies to fund long-term US dollar assets
  - corporates: swap out of cheap foreign currency funding

- limits to arbitrage
  - regulation: cost of balance sheet
  - dollar: risk-taking capacity
FX hedging

\[
E_t(R_{i,t+1}) = \frac{E_t(S_{i,t+1}) - F_{i,t}}{S_{i,t}}
\]

\[
= \left( \frac{E_t(S_{i,t+1})}{S_{t-1}} - \frac{1 + r_{\$,t}}{1 + r_{i,t}} \right) - \left( \frac{F_{i,t}}{S_{t-1}} - \frac{1 + r_{\$,t}}{1 + r_{i,t}} \right)
\]

\[
= \beta_{i,t} \left[ \text{carry}_t \right] = g_{i,t}(X_t)
\]

- focus on the first term?
Related question: why does Out-performance seem to manifest after GFC?
Local currency credit spread

\[ \text{LCCS}_{i,n,t} \equiv y^{LC}_{t,t+n} - y^{*LC}_{t,t+n} \]
\[ = y^{LC}_{t,t+n} - (y^{\$}_{t,t+n} + \rho i,t,t+n) \]
\[ = -x_{i,t,n} \]

- \( y^{LC}_{t,t+n} \): local currency n-period sovereign yield
- \( y^{*LC}_{t,t+n} \): synthetic risk-free local currency n-period yield
Changes since 2013

Basis points

Jan 2013 = 100

Average bilateral exchange rate against USD (rhs)

JP Morgan GBI-EM Diversified spread (lhs)
EMEs: Appreciation of dollar ⇒ larger spread
G10: Appreciation of dollar ⇒ more negative cross-currency basis
EMEs vs G10: similarity and difference?
”original sin redux” or ”new dollar sin”?
Anomalies in swap markets (and other markets) may also relate to balance sheet constrain.

Joint analysis may better pin down shadow price of balance sheet?
a. Start

A

\[ X \text{ (EUR)} \]

↑

X\cdot S \text{ (USD)}

B

S: FX spot rate

b. Maturity

A

\[ X \text{ (EUR)} \]

↓

X\cdot F \text{ (USD)}

B

F: FX forward rate
a. Start

A

X (EUR)  X·S (USD)

B

S: FX spot rate

b. During the term

A

EUR 3M Libor + α

B

USD 3M Libor

c. Maturity

A

EUR 3M Libor + α

B

USD 3M Libor

X (EUR)  X·S (USD)