BRANDEIS INTERNATIONAL
BUSINESS SCHOOL

The Second Dollar-Based Financial System

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A few facts

- Gross international investment positions:
  ~150% global GDP, >$100 trillion
- US dollar accounts for
  - 80% of trade finance
  - 87% of currency transactions
  - 42% of transactions on SWIFT
- Off-shore short-term or maturing long-term US dollar liabilities:
  $10 to $15 trillion
- US banking system total assets $11 trillion

There are two dollar-based financial systems!

Global role of US dollar

- Central to global economic & financial activity
- Major financing & investment currency outside US
- Facilitates economic activity & risk transfer globally
- Important element of balance sheet of intermediaries without direct access to the Fed

Banks as liquidity insurers

- Demandable deposits & callable lines of credit
- Balance sheet structure $\Rightarrow$ runs, fire sales, failure
- Externalities

Need a liquidity reinsurer

Domestic currency?

Foreign currency?

The world without liquidity reinsurance

- 1870 to 1910
  - 4 major banking panics
  - 8 minor banking panics
- Capital of 20% was insufficient
- 21^{st} century
  - Government will provide liquidity reinsurance ex post
  - Recognize this and create scheme ex ante

The 2007-09 Financial Crisis

- European banks short dollar positions > $1 trillion
- Solutions
  - Domestic central banks supply US$ from FX reserves
    - FX swaps, repo, loans
    - Argentina, Brazil, Korea, Philippines
  - Fed US$ Liquidity Swaps
    - Dec 12, 2007: ECB and SNB
    - Eventually 14 agreements covering 28 central banks
    - Some uncapped
    - Volume peaked at $553 billion in Dec 2008
    - Structured to ensure monitoring by those best informed

Options for foreign currency reinsurance

- Prudential ban or restriction
- Responsibility of authorities where activity occurs
- Regional pooling of FX reserves
- Supranational institution
- Responsibility of issuing central bank

These are <u>not</u> mutually exclusive.

Options for foreign currency reinsurance

- Prudential ban or restriction
  - Risks losing benefits of global finance
  - Will not stop activity

Options for foreign currency reinsurance

- Prudential ban or restriction
- Responsibility of authorities where activity occurs
  - US dollar FX reserves ~$15 trillion
  - Cost is enormous

(0.2% of global GDP per pp that US$ return is < global marginal prod cap)

Options for foreign currency reinsurance

- Prudential ban or restriction
- Responsibility of authorities where activity occurs
- Regional pooling of FX reserves
  - Like Chiang Mai: currently $240 billion
  - Can the fund really be large enough?

Options for foreign currency reinsurance

- Prudential ban or restriction
- Responsibility of authorities where activity occurs
- Regional pooling of FX reserves
- Supranational institution
  - IMF FCL: qualified countries guaranteed access
  - Shifts decision to politicians
  - Stigma: would country really draw in a crisis?
  - Does the IMF have the sufficient resources?

Options for foreign currency reinsurance

- Responsibility of issuing central bank: Fed
  - US benefits
    - Funding advantage of 0.5% US GDP per year
    - Current account deficit of >2% per year

      (see www.moneyandbanking.com commentary on July 24, 2014)
  - US costs
    - Value of dollar elevated
    - Encourages borrowing
    - Creates sectoral imbalances
  - Swaps were offered to countries systemic to the US

Reinsuring the second US$ system

- How should we think about this?
  - Should CBs pay fee ex ante for swap line?
  - When will US provide dollars? And how much?
  - Can countries
    - ensure that dollar mismatches remain small?
    - have dollar reserves to cover what's left?
- Benefits accrue to US & costs to everyone else
- Does the US have an obligation?

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