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# Dollar Dominance in Global Finance and Exchange Rate Policies

ŞEBNEM KALEMLI-ÖZCAN

Fifty years after many predicted it would lose its primacy with the end of the Bretton Woods system, the US dollar remains the dominant currency in the international system. The dollar's unique role gained special salience recently because of its weaponization amid the financial sanctions Russia faced after invading Ukraine. The current consensus is that there is no alternative hegemonic currency—but this need not remain the case forever. To inform the debate over the dollar's present and prospective role, we need to understand how the dollar retains its dominant place, why other currencies cannot (for now) replace it, and what the dollar's dominance implies for the world economy and exchange rate policies.

A dominant currency plays a central role in world trade, world finance, and central banks' reserves. It serves as a medium of exchange, a unit of account, and a store of value throughout the global economy. The dollar satisfies all these three requirements for a dominant currency. The euro and the renminbi do not.

Although the role of the dollar in world trade is singular, I focus here on its dominant role in world finance and central bank reserves. The reason for this focus is the theme of this conference: how well the floating exchange rate system is doing 50 years after its birth. Nurkse (1944) describes the potentially destabilizing effects of floating exchange rates; Friedman (1953)

Şebnem Kalemli-Özcan is a Neil Moskowitz Endowed Professor of Economics at University of Maryland-College Park, coeditor of *American Economic Journal: Macro*, and an NBER and CEPR research associate. She serves at the editorial board of *American Economic Review*.

focuses on the shock-absorbing properties of flexible rates. Floating rates absorb a large fraction of risk premia shocks (Kalemli-Özcan 2019), which are frequent in the global financial system (Rey 2013). Floating exchange rate countries enjoy higher output and lower output volatility than fixed exchange rate countries in the face of these risk premia (or "sentiment" shocks.) The dominant role of the dollar in world finance makes the case for countries to have flexible exchange rates vis-à-vis the dollar, protecting them from risk sentiment shocks that are global in nature and also linked to fluctuations in US monetary policy.

One striking development of the past 50 years has been the growth of emerging economies, their progressive integration into global markets for goods and assets, and in many cases their embrace of greater exchange rate flexibility. Since the 1990s, emerging-market economies have suffered when the dollar strengthened. Obstfeld and Zhou (2022) show that, even if the dollar initially appreciates only against advanced country currencies, emerging markets suffer negative effects, including depreciations of their own currencies. Bruno and Shin (2015) show that the dollar is unique among advanced currencies in this way and that its impacts work largely through the bilateral dollar exchange rates of the emerging markets. As a result, emerging markets are very reluctant to let their exchange rates float vis-à-vis the dollar—"fear of floating" (Calvo and Reinhart 2002)—and therefore usually operate managed floats. They accumulate dollar reserves, which help them put their savings in a safe asset and gives them the power to manage their currencies with foreign exchange interventions in response to financial shocks.

A large body of literature on the global financial cycle that began with the work of Rey (2013) and was extended by Miranda-Agrippino and Rey (2020) shows the important role of risk sentiment shocks for financial and real outcomes across the world. This line of work argues that the expenditure-switching property of a flexible exchange rate may not be enough to insulate countries from global financial shocks: Countries may face a dilemma between financial openness and monetary autonomy rather than a trilemma in which exchange rate flexibility allows monetary policy freedom despite openness to international capital flows. That is, even with flexible exchange rates, countries are exposed to financial risk/sentiment shocks. This is because even a favorable shift in net exports will not entirely protect a country's financial markets if global investors take a risk-off position and run for the safety of the dollar. However, in such a scenario, flexible exchange rates can still help via asset markets instead of its limited help via goods market, as Kalemli-Özcan (2019) shows. In this risk-off environment, flexible exchange rates help because of their risk premia-

absorbing properties, as argued by Friedman (1953), leading to a smaller rise in risk premia and lower capital outflows, resulting in a soft landing for their domestic economies.

This risk shock–absorbing property of flexible rates is important for emerging markets, because the main reason they suffer more than advanced economies from a US dollar appreciation is the greater risk sensitivity of their capital flows (Kalemli-Özcan 2019, Di Giovanni et al. 2022). Any risk-off episode will be priced in as higher borrowing costs for emerging markets, for their firms and sovereigns, captured by higher sovereign spreads on dollar borrowing (Longstaff et al. 2011) and higher uncovered interest parity (UIP) risk premia on local currency borrowing of private agents (Kalemli-Özcan 2019). Thus, UIP, a key international wedge, passes thorough domestic lending rates for households and firms (Di Giovanni et al. 2022). These effects do not occur in advanced economies as capital flows to those countries are less sensitive to risk.

## How is US monetary policy transmitted to the rest of the world?

The literature on the global financial cycle also connects risk sentiment shocks to US monetary policy, as US policy transmits strongly through US financial markets, a critical component of global financial markets. As a result, it is hard to separate the impact on emerging markets of US dollar shocks, risk-off shocks, per se from that of US monetary policy, as US monetary policy affects both the dollar and the relative pricing of risky and risk-free assets in financial markets, where emerging markets account for a large share of risky assets.

To see how transmission occurs, consider the effect of US monetary policy on Mexico. A tighter US policy will lead to dollar appreciation and peso depreciation, which, if trade elasticities are high enough, leads to higher export values and lower import values for Mexico via expenditure switching. In theory, this trade channel should have an expansionary effect in Mexico. But the data show that depreciations in emerging markets are generally contractionary.

Some models were developed to explain why, focusing on balance sheets (Krugman 1999; Cespedes, Chang, and Velasco 2004). A higher domestic value of dollar-denominated debts, as a result of dollar appreciation, weakens Mexican balance sheets, thereby hampering borrowing and investment, counteracting the expansionary force of higher net exports. The need to import intermediate inputs can amplify the contraction (Mendoza and Yue 2001), leading to recessions.

Another explanation is that higher US interest rates raise borrowing costs. And because emerging markets are a risky asset class, tighter monetary policy in the United States also means higher risk premia in such countries.

Mexico's own monetary policy response is also endogenous and has an impact. Tight monetary policy in Mexico could be attractive if exchange rate pass thorough leads to high inflation, however if the financial channel is very strong leading to higher risk premia and capital outflows, resulting in a contraction in Mexico and a tighter monetary policy will make everything worse. During sudden stop events, related to tight US monetary policy, emerging markets cannot borrow to smooth shocks; even if they tighten monetary policy, due to higher risk premia, capital will flow in only one direction (out of Mexico, into the United States). Higher policy rates combined with higher risk premia slow the economy, limiting the availability of external finance even more. Any policy that aims for a bigger external deficit after a sudden stop would thus just force risk premia up until the desired current account deficit falls to a level consistent with the limited amount foreign lenders are willing to provide. If balance sheet effects are of no concern—that is, the volume of dollar debt in Mexico is low—a more accommodative monetary policy by Mexico's central bank is preferable, as peso depreciation would absorb the higher risk premia, lowering the cost of external finance for Mexico and stabilizing output.

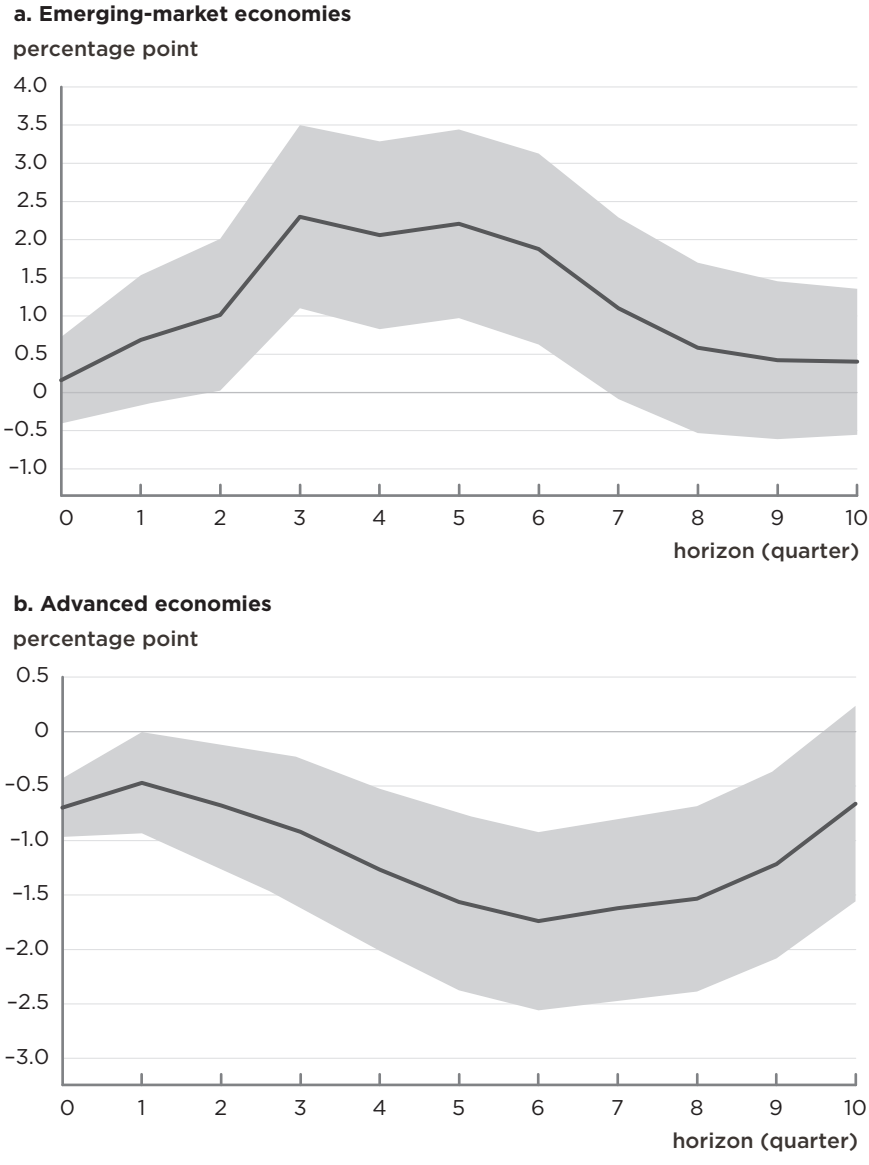
Figure 23.1 (from Kalemli-Özcan 2019) shows how risk premia act differently in emerging markets and advanced economies in response to an exogenous tightening of US monetary policy. When US monetary policy tightens, the difference between the yield on 12-month domestic government bond and 12-month US Treasuries rises more in countries like Mexico than in countries like Canada. In fact, the spread falls in advanced countries, which let their exchange rates depreciate vis-à-vis the dollar and do not tighten their monetary policies in response to the US tightening. In emerging markets, spreads rise even if they do not tighten their monetary policy in response to US tightening, because of higher risk premia, as global investors switch to a risk-off mindset (De Leo, Gopinath, and Kalemli-Özcan 2023).

De Leo, Gopinath, and Kalemli-Özcan (2023) also show the contractionary effects of US tightening on emerging markets if they loosen their monetary policy. Output falls; capital flows out; and inflation rises initially, as a result of the peso depreciation, before then falling, as a result of a slowing economy.

A looser monetary policy may not be the optimal policy. Kalemli-Özcan (2019) shows that looser policy and depreciated exchange rates serve

Figure 23.1

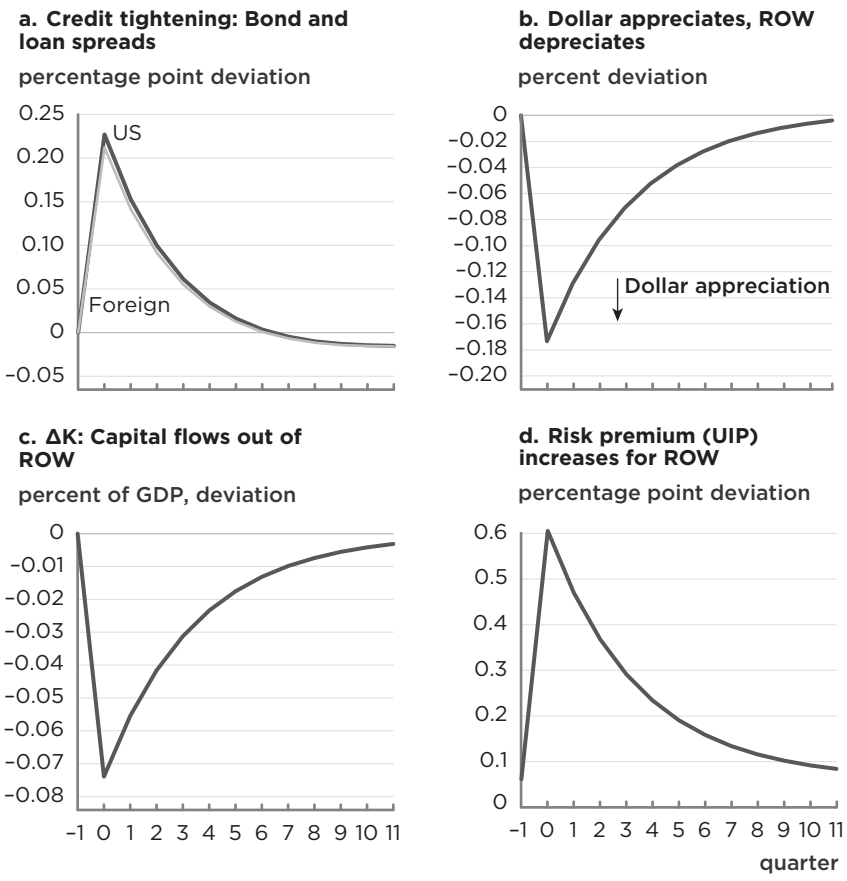
**Responses of sovereign spreads to US monetary policy tightening (US 3-month Treasury rate shock)**




*Source:* Kalemli-Ozcan (2019).

Figure 23.2

**Responses in emerging markets to a risk-off (VIX) shock in the United States**




ROW = rest of world
*Source:* Akinci, Kalemli-Ozcan, and Queralto (2022).

emerging markets much better in the face of tighter US policy that induces a risk-off sentiment. Gourinchas (2018) shows that an easier policy would be optimal to stimulate the domestic economy; the fact that the peso is depreciating is irrelevant and should not be counteracted with tighter policy to fight the depreciation and attract capital. Kalemli-Özcan (2019) shows that this is the case because a tighter policy increases risk premia and makes the contraction even deeper but does not solve the depreciation problem.

Figure 23.2 digs deeper into the reasons for the contractionary effects of a US tightening in emerging-market economies. Such tightening creates

a risk-off environment globally. Using the calibrated open-economy model, Akinci, Kalemli-Özcan, and Queralto (2022) plot the simulated results of a positive uncertainty/risk-off shock, measured by the VIX (the Volatility Index of the Chicago Board Options Exchange [CBOE]). Although it is a US market variable, the VIX captures global uncertainty shocks, because volatility in US financial markets is a prime driver of volatility in global financial markets. Higher uncertainty in the United States leads to higher borrowing costs, wider credit spreads, an appreciation of the dollar, and capital outflows from emerging markets. Risk premia—measured as excess returns on emerging-market currencies compared with an uncovered interest parity benchmark—also rise.

## Benefits of Floating Exchange Rates

The evidence strongly shows the benefits of floating exchange rates, especially given the central role of the dollar in world finance and the global financial cycle. Floating rates absorb risk premia shocks rooted mainly in US financial markets, which can result from changes in US monetary policy that spread to the world given the dominant role of the dollar in global financial transactions.

One original intention of the move to floating exchange rates 50 years ago was to reduce systemic asymmetry associated with the dollar's special status. That goal was not achieved; dollar dominance is a byproduct of the current system.

Another was for flexible exchange rates to absorb macroeconomic shocks. Given the interconnected nature of the global financial system, today's macroeconomic shocks are increasingly macro-financial shocks rather than more conventional productivity or demand shocks. Despite concerns that floating exchange rates provide little insulation from the global financial cycle (because switching demand for goods via net exports cannot fully offset financial shocks), the evidence shows that floating exchange rates have indeed been absorbing global risk shocks. Policymakers in emerging-market countries should take note and reevaluate exchange rate management policies that may lead to greater exposure to global financial shocks.

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