

International Roles of the US Dollar and Financial Stability

Linda S. Goldberg*

Federal Reserve Bank of New York, NBER, and CEPR

"Recent Developments and Future Prospects for the International
Monetary System"

Joint conference of HKIMR-AMRO-ECB-BOFIT

August 24 2023

*The views expressed herein are those of the author and not necessarily those of the Federal Reserve Bank of New York or the Federal Reserve System.

International roles of USD and Financial Stability

Panelist role: Longer-term trends in the use of reserve currencies, geopolitics, and the financial stability risk of the global financial system.

Organization of my remarks

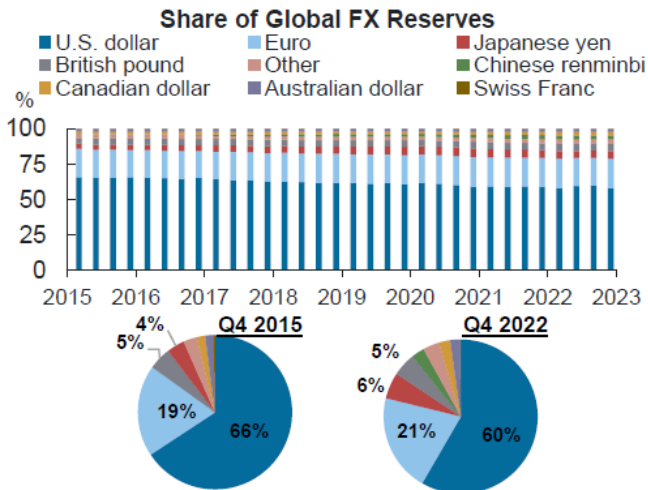
- International roles of USD are diverse, dollar remains dominant.
- Questioning "trends" with perspective from analytics on:
 - ▶ USD share of official FX reserve portfolios, with focus on tranches, interest rate environment, geopolitics.
 - ▶ Official gold holdings, with focus on concentrated accumulation and data questions.
- Financial stability, Federal Reserve policy and operational considerations.

Big picture on international currency roles

Comprehensive: ECB *International Role of the Euro* report (June 2023)

- International roles of the euro and dollar resilient in 2022.
 - ▶ All key roles in international monetary system: composition of official FX reserves, exchange rate regime anchor, safe-haven sovereign assets (USD, CHF, Yen), banknotes held by foreigners.
 - ▶ All key trade and financial transaction roles (invoicing and settlement, contracts, payments infrastructure).
- ECB Special Features address high profile questions. Despite developments in macro environment and Russia's war in Ukraine.
 - ▶ Geopolitical fragmentation risks. Evidence to date is more about announcements, without broader diversification from USD trends.
 - ▶ Some developments around official gold accumulation are cited.
 - ▶ European economic integration supports euro use, especially in trade invoicing, but also in cross-border lending.

Trend decline in the Dollar share of Official FX Reserve Holdings



Source: IMF, Haver

Research into Drivers of Foreign Official Sector Portfolio Allocation

Using annual data for 80 countries, Aslanalp, Eichengreen, Simpson-Bell *JIE* (2022) provide empirical support for key continuing roles as drivers of

- Macroeconomic stability / store of value of key currency issuers
- Foreign currency debt shares (traditional debt coverage ratio)
- International trade exposures to US, euro area, Japan
- Volatility hedges

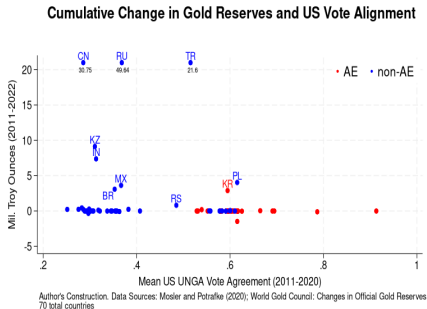
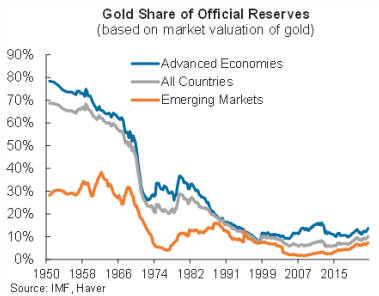
AES (2022) posit that recent periods have a shift toward smaller and less liquid currencies for higher portfolio returns, and because liquidity of trading has improved. Also emphasize possible geopolitics drivers.

My own research extends that study with formal tests for these conjectures, adding investment versus liquidity tranche considerations, and using Ito and McCauley (2020) updates of portfolio compositions through 2021/2022.

Drivers of the Dollar Share in Official Foreign Exchange Reserves Goldberg and Hannaoui (Preliminary)

- ① Purely based on unweighted composition, across countries declining USD share not broad-based.
- ② Among drivers, trade-orientation by country and exchange rate regime dominant (euro area proximity raises euro share).
- ③ USD shares in portfolios are lower, and roles of nontraditional currencies higher, when the investment tranche share of a portfolio is larger.
- ④ Marginal shift toward nontraditional currencies when returns are higher and for investment tranche. Diversification is not statistically stronger during low (ZLB) USD rate periods.
- ⑤ Low geopolitical alignment based on UN voting does not imply lower USD share. Lower alignment countries are more likely to have a higher - not lower - USD share in official reserve portfolios.

How much of a trend increase in official gold holdings?



Generally, strong inertia in holdings. Value of gold holdings overall remain a small fraction of the value of financial assets in official reserve holdings.

At least through end of 2022, the rise in gold held by the official sector in emerging and developing economies - mainly Russia, China, India, Turkey.

Strongest growth in WGC estimates, less in country reporting to IMF.

Financial Stability, Federal Reserve Policy and Operational Considerations

- Federal Reserve reinforces the dollar's status through well-executed policy and operations.
- Well-communicated monetary policy; Low and stable inflation.
- Dollar liquidity to US and foreign financial institutions.
 - ▶ Normal times: Institutional frameworks and transactions costs.
 - ▶ Stress periods: lender of last resort dollar liquidity (includes swap lines, FIMA repo).
- Effective supervision framework.
- Effective and efficient payment systems (Fedwire, FedNow).
- Central Banks International Account Services.

Concluding Remarks

- Dollar, and then the euro, have extensive international roles.
- Lots of focus on declining dollar roles: not readily apparent, except perhaps the trend declines in dollar shares of official reserves and uptick in official gold holdings. These are driven by a few countries.
- Financial stability considerations. Dollar roles can decline, with potentially different implications if due to strengthening of frameworks around other currencies, or geopolitical and geoeconomic fragmentation.

Linda.Goldberg@ny.frb.org

Supplemental

A couple of references

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