Competing Currencies

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Perspectives on global currency

• **International Trade:**
  – Dominant Currency Pricing
  – The Chinese Paradox.

• **International Finance:**
  • International Capital Flows
    – Debt Pricing (Currency Mismatch)
  • International Reserves
Old Paradigms in International Trade

Currency Pricing

• Producer Currency Pricing: Law of one price
  – a nominal depreciation raises the price of imports relative to exports (the terms-of-trade) thus improving competitiveness.

• Local Currency Pricing: Law of one price fails.
  – a nominal depreciation lowers the price of imports relative to exports, a decline in the terms-of-trade, thus worsening competitiveness.

• Instead, the vast majority of trade is invoiced in a small number of ‘dominant currencies,’
Dominant Currency Paradigm (Gopinath, Gourinchas et al., 2019)

• Under DCP, firms set export prices in a dominant currency and change them infrequently.

• The stability of the terms-of-trade under DCP follows from the pricing of imports and exports in a common currency and the low sensitivity of these prices to ER fluctuations.

• DCP stabilizes terms-of-trade
  – Monetary Policy stabilizes financial shocks, target domestic sources of inflation.
Dominant Currency Paradigm

• For non-dominant countries: high exchange rate pass-through
• For the dominant, low pass-through into import prices
• When the dominant ER appreciates uniformly against all other currencies, it should lead to a decline in trade between countries in the rest of the world (i.e. excluding the dominant).
• Contractionary Monetary Policy Shocks in the dominant country have strong spillovers to MP in the rest-of-the world and reduce Rest of the World and global trade
• MP shocks in non-dominant currency countries generate only weak spillovers and have little impact on world trade.
Implication for the Euro

• Dominant Currency Pricing with more than one dominant currency is not very well understood.
  – Currency Choice
  – Coordination of Monetary policy among dominant.

• Asymmetry Dollar vs. Euro

• Import-Price Channel of Monetary Policy and Pass Through
  – As of today, more than 90% of US imports are invoiced in US dollars.
  – By comparison, less than 50% of extra-euro area imports are invoiced in euro.
  – If this share were to increase to, say, 70%, the sensitivity of import prices to exchange rate movements would decline by around one-third.
The Chinese Paradox

• China in order to manipulate the value of its currency cannot not be fully integrated in international capital market.
• With global dominant currency pricing, the exports gains from currency manipulation are more limited.
• China does not want to be on the wrong side of the dominant currency divide.
• Trade War substituting Currency War
Collateral Damages of Global Currencies

• Effect on non-global currency players

• Trade
  – Large fluctuations in trade for non-global currency player
  – Implications for global trade and global demand.

• Crisis Risk
  – Currency mismatch
  – Boom-bust cycles and crises
Currency Mismatch Paradigm
Tornell-Ranciere (2008, 2016)

• Emerging Markets Perspective
• Currency Mismatch: Revenues in Domestic Currency; Debt Issuances in Foreign Currencies.

• Less True for Sovereigns
  – Local Currency

• Still True for Corporates
  – Discipline on government.
Currency Mismatch Paradigm

• Currency Mismatch and the Real Exchange Rate
• Non-Tradable Sector borrow in foreign currency
• Self-reinforcing mechanisms in good times (cheaper cost of funds) and in bad times (default risk)
• Boom-bust Cycles.
• Bad: not necessarily: crisis risk is a way to go around financial bottleneck and can boost investment and growth (Tornell-Ranciere)
International Reserves
(Jeanne-Ranciere, 2011)

• Reserves as insurance against sudden stop in capital flows:
  – More reserves lower the probability of sudden stops
  – Reserves are used to mitigate the sudden stop.
  – Central Bank liquidity as a buffer.

• Composition of reserves
  – Liquidity needs in different currencies
  – Exchange Rate depreciation (hedging)