Privilege Lost?
The Rise and Fall of a Dominant Global Currency

Discussion of Arvai and Coimbra (2023)

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The views expressed here do not necessarily reflect the position of the Bank of England.

This Paper

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Size matters! If dominant-currency country grows less than the rest of the world, its status as a safe haven erodes and return differentials decline

My Comments

#1 Do I believe that ‘size matters’ for global currency dominance?

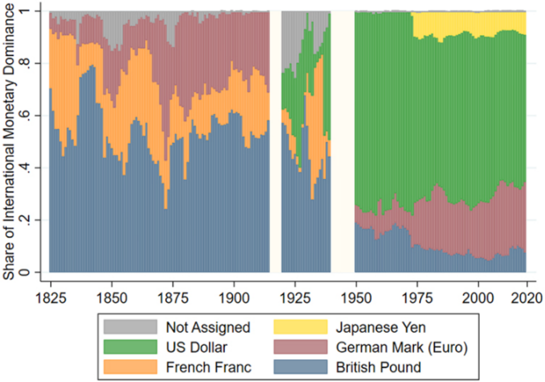
#2 How should I interpret ‘size’ in the model?

#3 Do larger countries necessarily face more diversified shocks? *(Assumption #1)*

#4 Do larger countries provide more ‘convenience’ in govt. bond markets? *(Result #2)*

#1. Does Size *Really* Matter?

What I remember from my British Economic History lectures? GBP had dominant role in intnl. fin. transactions until post-WWII, despite US growing larger than UK pre-WWI



Source: Vicquéry (2022), ‘The Rise and Fall of Global Currencies over Two Centuries’

#1. Does Size *Really* Matter?

Quantities vs. Prices: focus here, in empirics and model, is on relative 'returns'

Spread rate	1870-1914	1915-2008	2009-2020
Real long rate	-1.81%	0.13%	-0.24%
Real total bond return	-1.59%	0.17%	0.16%
USD long rate	-1.34%	1.29%	-0.11%
USD total bond returns	-1.13%	1.33%	0.07%
Real USD long rate	-1.36%	1.27%	-0.10%
Real USD total bond returns	-1.13%	1.32%	0.11%

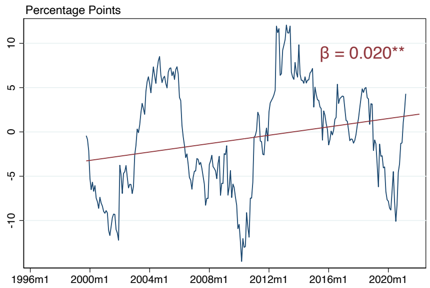
Source: Arvai and Coimbra (2023), Table 1

Suggestion: Clarify focus is really about 'privilege' (i.e., relative returns), and less about actual 'dominance' (i.e., relative quantities)

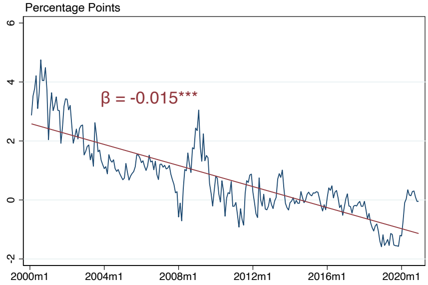
#1. Does Size *Really* Matter?

Is it 'size' per se that matters, or is it really 'risk' (for which size is one driving factor)?

U.S. Relative Permanent Risk



U.S. 10Y Cross-Country Conv. Yield



Source: Corsetti, Lloyd, Ostry and Marin (2023), 'U.S. Risk and Treasury Convenience'

Suggestion: Do more to acknowledge that size is just one factor driving risk

#2. How Should I Interpret ‘Size’?

Matters for how we interpret results and how seriously one should interrogate assumptions

Two key building blocks in the paper:

- *Assumption #1*: larger countries face more diversified shocks
- Size modelled via CES aggregator for govt. consumption

$$G_t = \left(\sum_j^{N} \omega_j^{\frac{1}{\theta}} g_{t,j}^{\frac{\theta-1}{\theta}} \right)^{\frac{\theta}{\theta-1}}$$

#2. How Should I Interpret 'Size'?

Different ways to think of size N, for example:

- Regions $\Rightarrow$ acquire privilege by gaining territory
- Population $\Rightarrow$ acquire privilege by making babies
- Economic size $\Rightarrow$ acquire privilege by growing, but does growth not come with specialisation?
- Sectors $\Rightarrow$ acquire privilege by expanding sectors, but could lose gains from specialisation?

Suggestion: Provide discussion to lead reader towards preferred interpretation of size

#3. Do Larger Countries Necessarily Face More Diversified Shocks?

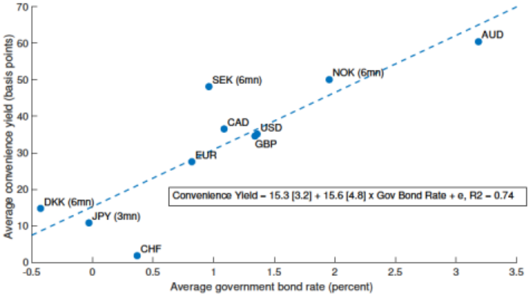
Not *a priori* obvious. In context of intnl. openness, potentially competing effects:

- *Specialisation*: growth/openness resulting from specialisation can result in *greater volatility* by limiting flexibility in the face of shocks [Newbery and Stiglitz, 1984]
- *Diversification*: growth/openness can allow diversification of supply and demand, so reduce volatility [Caselli et al., 2020]
  ...but at what cost to productivity?

<u>(Cheap) Suggestion</u>: Discuss role of shock correlation more in model results (I'd expect ρ to be more interesting than θ in experiments)
<u>(Fancy) Suggestion</u>: Consider building out a trade-off between diversification and specialisation in model

#4. Do Larger Countries Provide More Convenience?

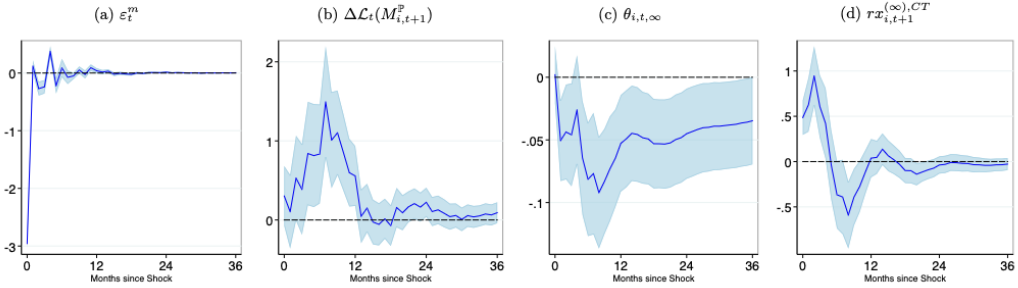
For various reasons, model-based measure of convenience isn't easily mapped to the data...but not all measures imply that convenience is linked to size (or indeed inversely linked to interest rates)



Source: Diamond and Van Tassel (2023), 'Risk-Free Rates and Convenience Yields around the World'

#4. Do Larger Countries Provide More Convenience?

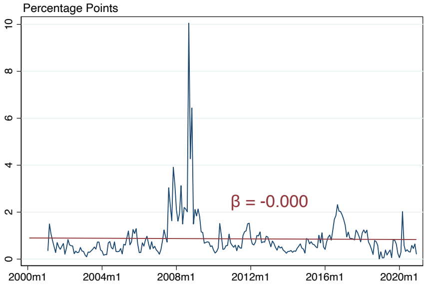
Indeed, higher bond supply $\uparrow B/Y$ need not be associated with higher convenience...
Here a monetary policy easing on relative US risk (panel b), long-run US convenience (panel c) and long-run carry-trade returns (panel d)



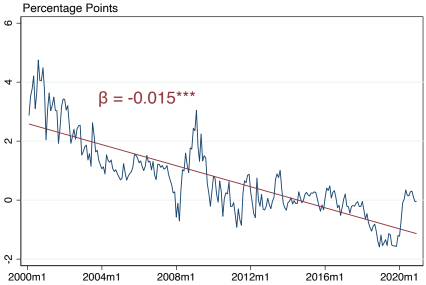
Source: Corsetti, Lloyd, Ostry and Marin (2023), 'U.S. Risk and Treasury Convenience'

#4. Do Larger Countries Provide More Convenience?

U.S. 6M Cross-Country Conv. Yield



U.S. 10Y Cross-Country Conv. Yield



Source: Corsetti, Lloyd, Ostry and Marin (2023), 'U.S. Risk and Treasury Convenience'

(Cheap) Suggestion: Include model-implied convenience yields in model results

(Fancy) Suggestion: Consider which measure of convenience is most related to model

My Answers

#1 Do I believe that ‘size matters’ for global currency dominance?
I’m convinced size plays a role in ‘privilege’ and returns

#2 How should I interpret ‘size’ in the model?
I think I want to interpret ‘size’ as a measure of ‘diversified’ regions/sectors in economy, an admittedly challenging concept to conceptualise

#3 Do larger countries necessarily face more diversified shocks? *(Assumption #1)*
I’d love to see more sensitivity to different assumptions around diversification

#4 Do larger countries provide more ‘convenience’ in govt. bond markets? *(Result #2)*
Hard to tell at this stage, but this paper does provide a valuable new model of a specific source convenience, grounded in network externality-type story...its for future papers to disentangle competing explanations!