Discussion of

Collateral Advantage: Exchange Rates, Capital Flows, and Global Cycles

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Motivation: US external position is unique

In normal times

- $NFA = A - L < 0$
  ("World's Venture Capitalist")
- $r_A \gg r_L$
  ("Exorbitant privilege")

In bad times

- $\uparrow$ \$ appreciation
  ("Safe haven")
- $NFA \downarrow$, transf. US to RoW
  ("Exorbitant duty")
- Capital flows reversal
  ("Retrenchment")

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Puzzles

- Reserve Currency Paradox (Maggiori '17): $\downarrow NFA \Rightarrow \downarrow$ \$, but we observe $\uparrow$ \$
- Retrenchment Puzzle: $\uparrow$ demand US assets $\Rightarrow \uparrow$ inflows $\Rightarrow \downarrow TB$, but observe $\uparrow TB$

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This Paper: NK model w/ Financial Frictions (Gertler-Kiyotaki'10, Gertler-Karadi'11)

1. **US gov. bonds as superior collateral** $\Rightarrow$ endog. convenience yield
2. **Sticky LCP pricing** $\Rightarrow$ disconnect RER from ToT

Mechanism

- Banks invest in H/F bonds/capital (local deposits only). **Leverage constraint**:

$$V_{i,t} > \kappa_h D_{h,t} + \kappa_f S_t D_{f,t} + \kappa_{Kh} Q_t K_{h,t+1} + \kappa_{Kf} S_t Q_t^* K_{f,t+1}$$

where $\kappa_h < \kappa_f, \kappa_{Kh}, \kappa_{Kf}$ **Home bond is superior collateral**

$$E_t \Lambda_{i,t+1} \left(R_{h,t+1} - R_{f,t+1} \frac{S_{t+1}}{S_t} \right) = \lambda_{i,t} (\kappa_h - \kappa_f) < 0$$

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- **In bad times:** $\uparrow \lambda_{i,t} \Rightarrow$ UIP premium $\uparrow \Rightarrow S_t \downarrow$ (\$ appreciation)
  - $\downarrow S_t \Rightarrow \downarrow NFA$ (transf. US to RoW)
  - leveraged US banks + higher equity portfolio $\Rightarrow \downarrow Y/Y^*, C/C^*$

Comments

1. **Pricing assumption**
2. **What about dollar funding?**
3. **Regime transition**

Comment # 1: Pricing assumption

Reserve Currency Paradox

- **Financial channel**: $\downarrow S_t \Rightarrow NFA \downarrow$ (Foreign wealth $\uparrow$)
- **Real channel**: $\downarrow NFA +$ home bias $\Rightarrow ToT_t \uparrow \Rightarrow \uparrow RER_t, S_t$

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$$ToT_t = P_{f,t}/P_{h,t} \qquad \mathcal{D}_t = S_t P^*_{h,t}/P_{h,t}$$

$$RER_t \propto ToT^{2\omega-1} \times \mathcal{D}_t$$

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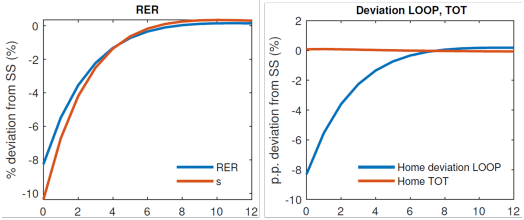
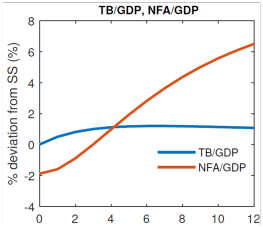
Global quality shock under LCP





↓ *NFA*

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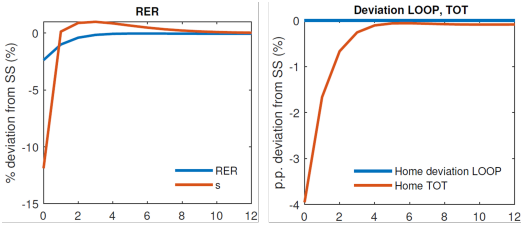

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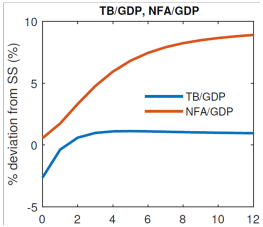

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- What about **Dominant Currency Pricing (DCP)**?
  - Trade mostly invoiced and sticky in US dollars
    (Gopinath et al.'10, Gopinath et al.'18, Gopinath et al.'20, Gopinath-Itskhoki'22)
  - Specific for the US: X $\sim$ 96% and M $\sim$ 95% are priced in US dollars.
- With DCP: P_h, P_f and P_f^* set, thus $\Delta ToT \approx 0$, $\downarrow S_t \Rightarrow RER_t \downarrow$

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- **Dollar funding** is key for the int'l financial system and dollar dominance
  (Bruno-Shin'15, Avdjiev et al.'19, Bahaj-Reis'22, Bianchi-Bigio-Engel'25 WP, etc.)

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2. Could $\kappa_h < \kappa_f$ also replicate $\underbrace{\frac{S_t B_{f,t}}{B_{h,t}}}_{\text{Foreign funding in Home banks}} < \underbrace{\frac{B^*_{h,t}/S_t}{B^*_{f,t}}}_{\text{Home funding in Foreign banks}}$?

Intuition during good times:

regulation?

* $\kappa_h < \kappa_f \longrightarrow$ high demand for US assets $\longrightarrow$ RoW min FX exposure $\longrightarrow B^*_{h,t} \uparrow$
* NFA changes, but calibrate $\kappa_f, \kappa_{Kh}, \kappa_{Kf}$ to get $NFA < 0$
* What could happen in **bad times?**

Comment # 3: Regime transition

What if the US loses its collateral advantage?

- **Current steady state:** ($\kappa_h < \kappa_f$) US bonds as superior collateral
- **SS with no hegemon:** ($\kappa_h \approx \kappa_f$) due to geop. shocks, erosion of trust, debt issues...
- Can the model shed light on the potential **transition paths** between SS?
  - Perhaps as a shock to κ_h w/ high persistence
  - Timely analysis

In sum

- Rich and ambitious paper!
- Scope to understand how broader dollar dominance aligns w/ the quant. results

  (e.g., dominant currency pricing, global dollar funding)
- Very useful for policy discussions in int'l macro