Discussion of "Dollar Dominance in FX Trading" by F Somogyi

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This Paper – Dollar dominance & FX trading

- **Dollar dominance – four main views:**
  - Vehicle currency view: due to its international use as a vehicle currency (eg McKinnon (1979), Goldberg and Tille (2008)).
  - Trade view: due to its use in international trade. (eg Gopinath and Stein (2020)).
  - Safe asset view: due to its safe haven properties (eg He et al (2019)).
  - Debt view: due to monetary policy support from the Federal Reserve (eg Eren and Malamud (2021).
- Vehicle currency view is the most obvious. Strong network effects. But hard to contribute to!
- Somogyi (2021) makes a well-executed contribution to this view.
  - Starts with a very simple point, brings more predictions, brings data, provides an identification strategy.
  - Connection to the big picture needs work.

Main idea: example - McKinnon (1979, 2012)

- Suppose there are N national currencies. Say N=150 (higher if we include crypto…)
- Without a vehicle currency: N*(N-1)/2 bilateral markets. N=150 that is 11,175 markets!
- With a vehicle currency, we only need 149! Quite a reduction…

- McKinnon: “Once the N-1 FX rates are established against the central currency, triangular arbitrage with the central money becomes sufficient to establish all the relevant cross rates between any pair of non-dollar currencies.”

- Somogyi: “Markets of nondollar currencies are not liquid. Use a vehicle currency to reduce the price impact of your trades.”
  - Conditions under which dollar becomes the vehicle currency.
  - The time series of the dollar’s dominance.
  - Predictions about which non-dollar currencies could trade directly (without going through USD).

Summary of the paper

- In a model of FX trading with strategic avoidance of price impact, dominant dollar as vehicle currency depends on dollar pairs (within a triplet of currencies) having:
  - Larger average initial trading demands: no effect on price impact but linearly increasing in equilibrium trading volume.
  - More volatile initial trading demands: lower price impact
  - Less volatile exchange rate returns than non-dollar currency pairs: due to mean-variance setting.
- A key empirical challenge:
  - What is initial trading demand?
    - Dealers internalize as much as they can and bring remaining directional positions to market.
    - Key assumption: because dealers don't do prop trading, customer flow determines their initial demand.
- Empirically:
  - Variance decomposition of trading volumes: 22% initial trading demand, 12% variance, 4% currency returns.
  - IV setup with scheduled FOMC announcements to show dollar dominance increases by 25% after spikes in the liquidity of dollar pairs occurring on these days.

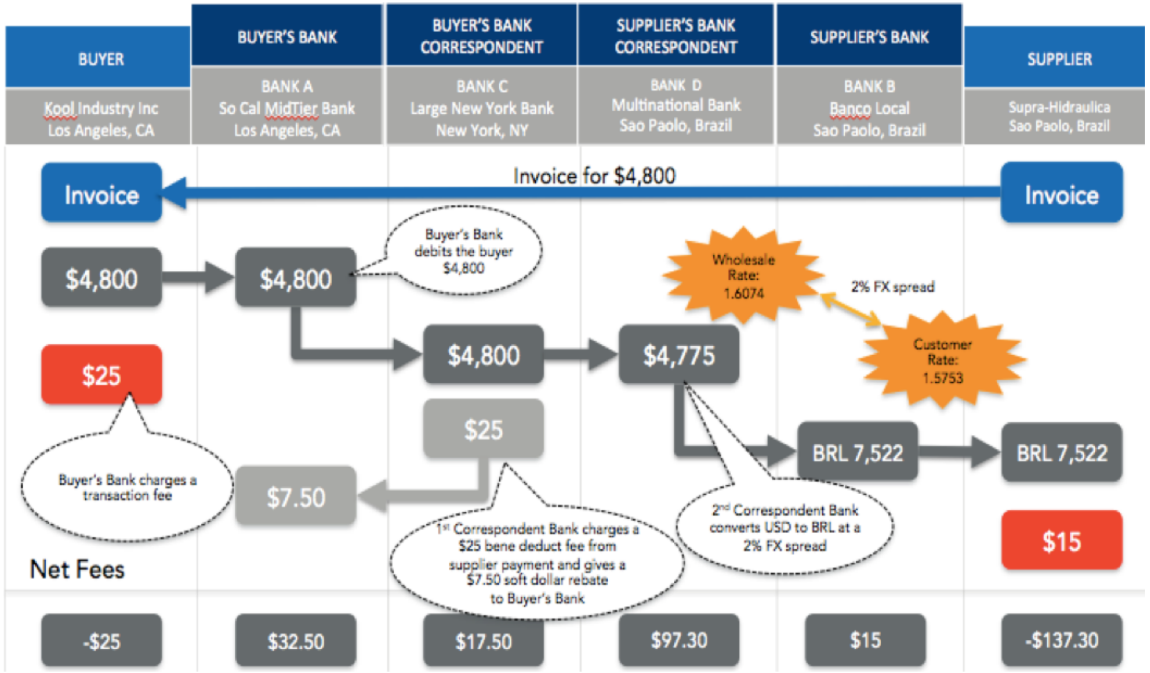
What are the real effects? How significant is the dollar dominance here for the global economy?

- In the trade view, dollar dominance changes terms of trade, X-M decisions.
- In the debt view, dollar dominance means fewer defaults. Fed monetary policy has global real impacts.
- In the safe asset view, there is a convenience yield on dollar assets with real effects.

- Use information about the sectors in the data. How does the dollar dominance compare between inter-dealer trades, NBFI-dealer trades, NFC-dealer trades etc.
- Consider adding a simple stylized model of X-M decisions where not using the dollar would alter X-M decisions.
- Nice to show how dollar dominance varies over time. But how did we get there at the first place? What would it take for other currencies to overthrow the dollar?
- What are the benefits of having the vehicle currency to the US? To others?
- Does it have any monetary policy implications?

What is the role of correspondent banking in the use of the dollar as a vehicle currency?

- Many transactions go through correspondent banks. Because most banks have offices in New York.
- Location is the reason why we use the dollar as a vehicle currency, not price impact.
- Can you disentangle FX trading demand from correspondent banking?
- International trade generates correspondent banking relationships. Any heterogeneity to aid identification? Using sectoral information could help, maybe also bilateral trade relationships.

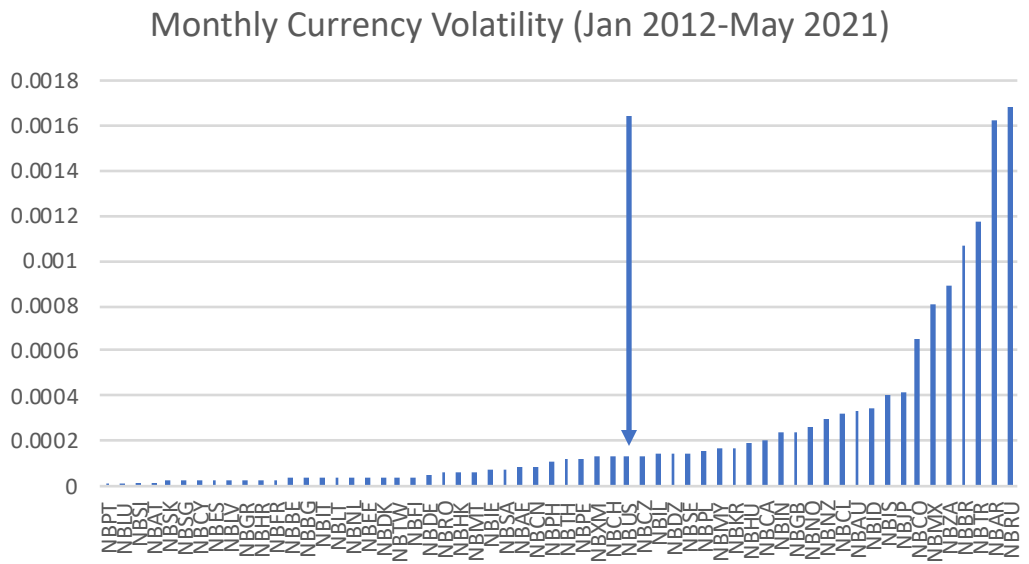


FOMC meetings as an instrument…

- Regressors are all determined in equilibrium. Potential endogeneity concerns…
- Need an instrument that impact the regressors, but do not directly affect how non-dollar trading demands are executed (ie directly or indirectly via the USD).
- Bruno and Shin (2015) and many other papers: Dollar is a global risk factor.
- FOMC announcements do potentially affect other currencies, the demand for trading those and their relations both vis-à-vis the dollar or potentially other carry trade currencies.

Variance of initial demands?

- Initial demand is rather obvious.
- Currency volatility: No clear indication why the dollar should be a vehicle currency. It is right in the middle.
- Variance of initial demands seems to be the interesting contribution. Can you get more mileage out of it?



Speaking of initial demands…

- Measuring it is tricky: clever idea nevertheless.

- It is not very convincing to say these dealers don't do prop trading so they don't have any FX trading demand on their own.

- All these are global banks with operations everywhere. That does lead to FX trading demand.
  - Can you use the office locations as a measure to get at this/at least as a control variable? Some currencies are more likely to have more dealer presence, leading to differences in initial demand.