Exorbitant Privilege and Exorbitant Duty

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15th Annual Paul Woolley Centre Conference

Motivation

Already a very influential paper

- Has inspired me and many others working in international economics and finance
- Deals with very important questions

Motivation

Important to understand the structure of the International Monetary System:

- What is the role of the reserve currency issuer?
- What are the dynamics of international flows and positions?

Motivation

The US has an "exorbitant privilege" (Gourinchas and Rey (2007)):

- There is a higher return on external assets than liabilities $\rightarrow$ relaxes external constraints (can run larger trade and current account deficits)

Does this privilege come for free?

This paper

How can the US earn a high return on their net foreign assets (NFA)?

- Finance theory: Because they take more (priced) risk

This paper

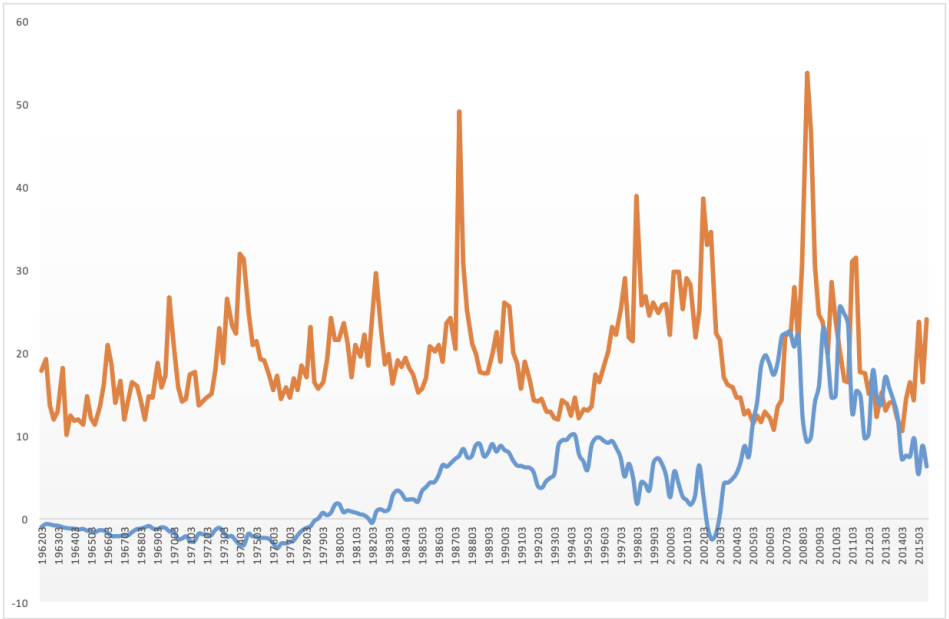


Figure 6: VIX and Net Foreign Asset Position (percent of US GDP)

Let's look at NFA and VIX (risk)

This paper

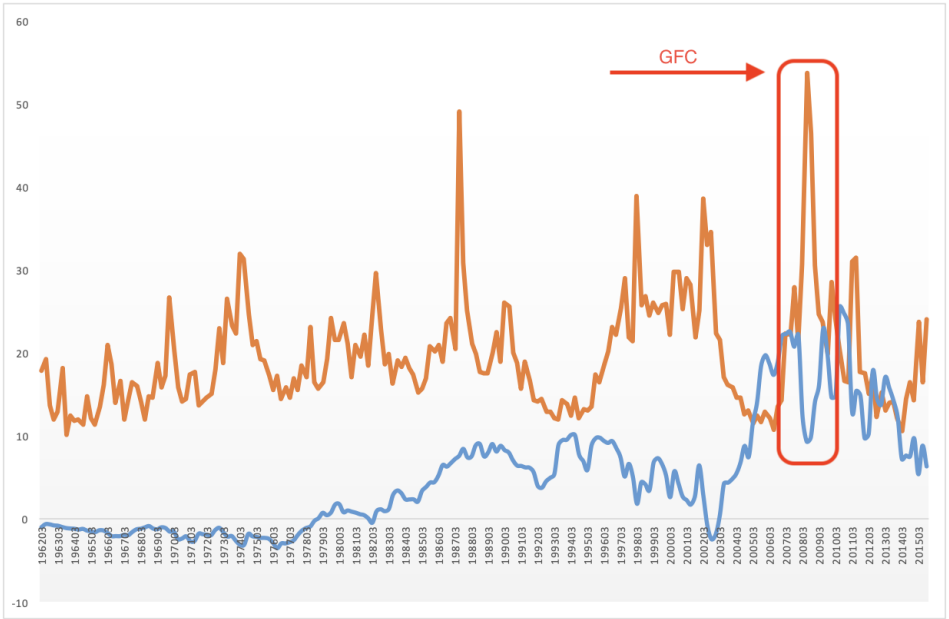


Figure 6: VIX and Net Foreign Asset Position (percent of US GDP)

This paper

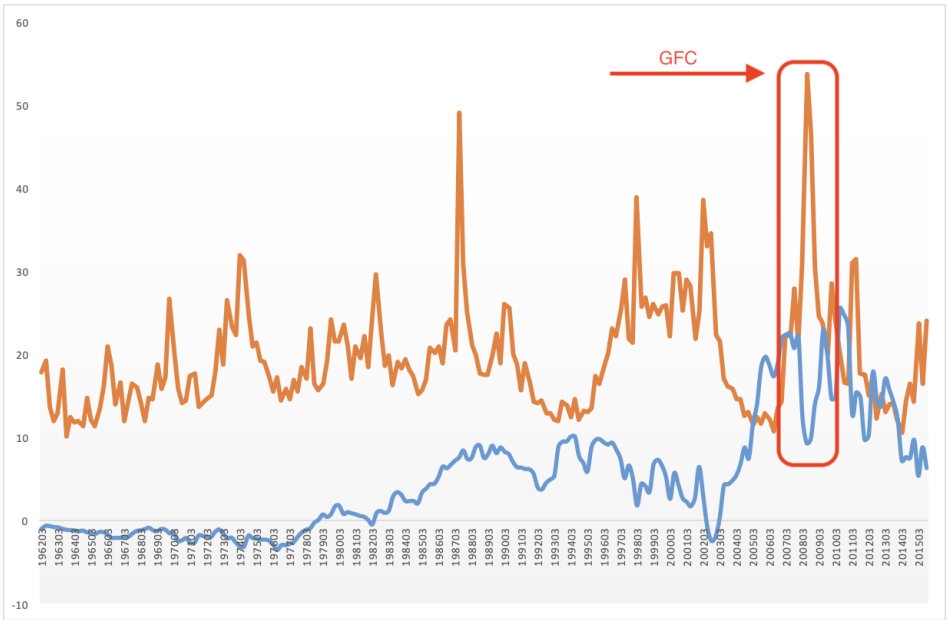


Figure 6: VIX and Net Foreign Asset Position (percent of US GDP)

This paper establishes this fact and coin it "exorbitant duty"

This paper

Empirically:

- Document an excess return of about 2.5% in the US net external position
- Show the the US NFA falls during times of global stress (world insurer)
- Show that dollar appreciate during times of global stress

Model:

- Basic idea: US more risk tolerant
- Can rationalize a high excess return on the US NFA (exorbitant privilege)
- Can rationalize a countercyclical NFA (exorbitant duty)

Comments

- Very important paper
- Nice combinations of empirics and theory
- The model can match many challenging moments

My comments mostly evolve around interpretations

Comments - Empirics

How should we measure insurance?

- In this paper: NFA
- External (NFA) and *internal* balance sheet (total wealth)
- Transfer of resources (net exports)
- Origination of the shock (US, ROW, global, traded, non-traded)

Comments - Model

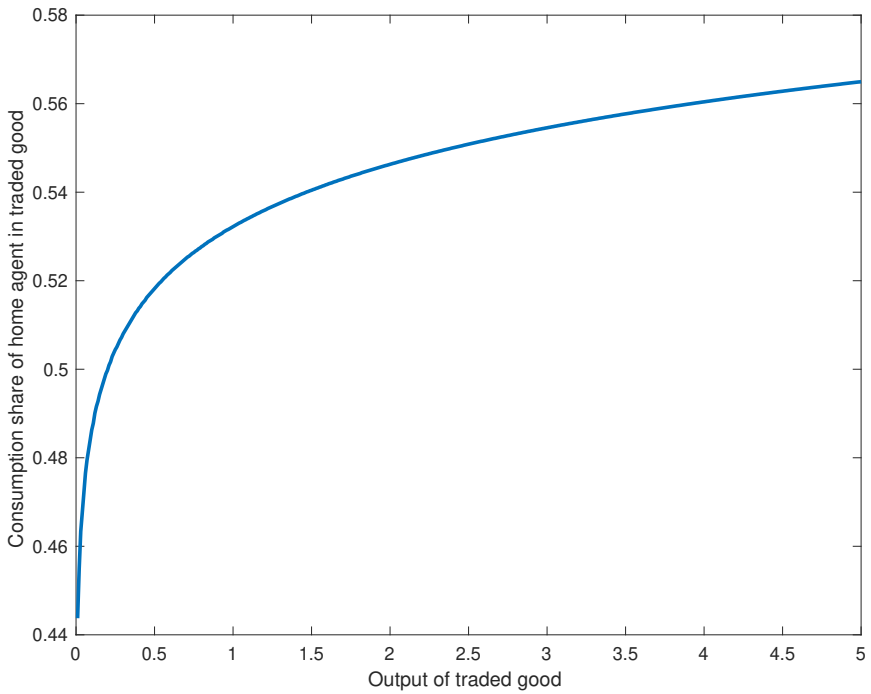
A lot is going on at the same time:

- Three states: Normal, Fragile, Disaster
- Risk aversion of foreign investor changes from Normal to Fragile/Disaster
- Partial default of government bonds during the disaster state

Comment: I would like to better understand the role of each component better

Comments - Model

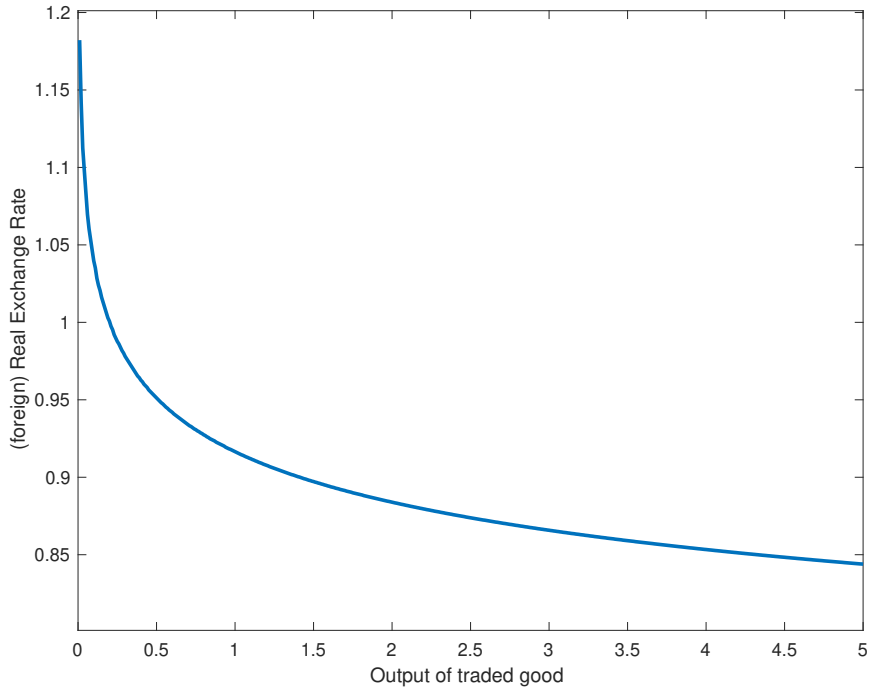
Classic risk sharing:



Risk tolerant investor (US) take large losses in bad times

Comments - Model

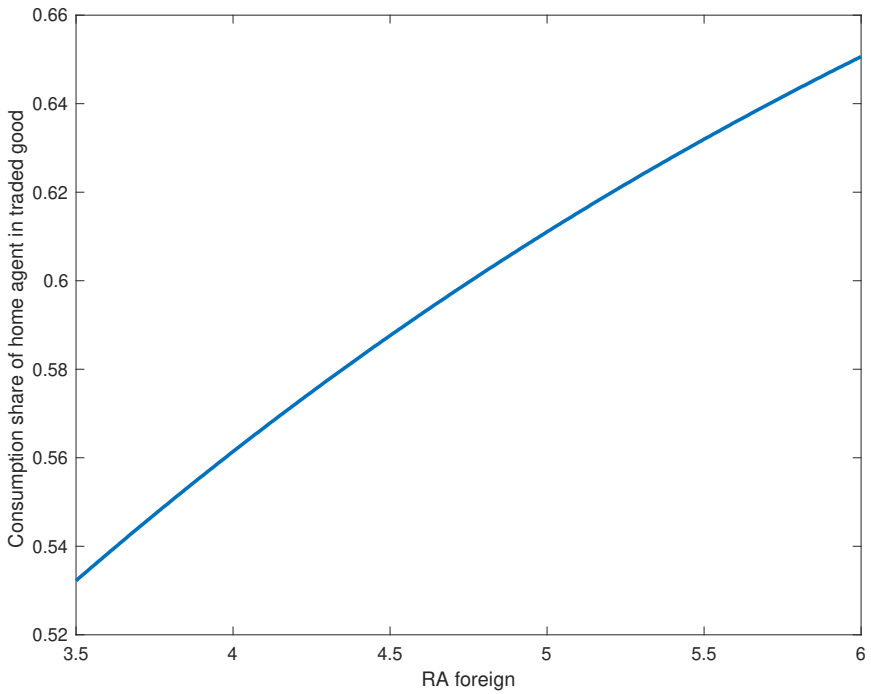
Classic risk sharing (FX):



Traded good consumption drops more in US in bad times $\rightarrow$ Price of US non-traded falls more than foreign non-traded $\rightarrow$ USD depreciation

Comments - Model

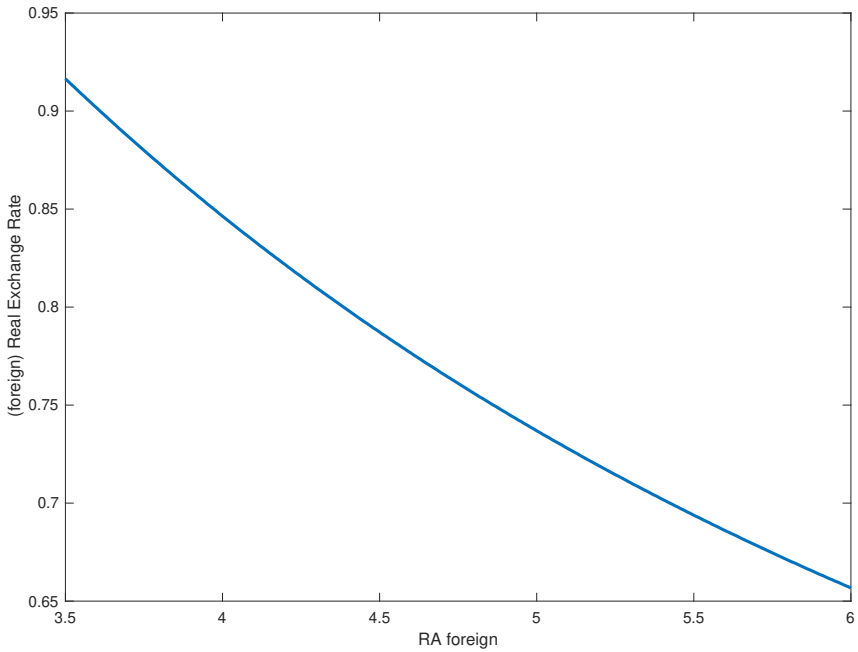
Risk aversion changes:



Risk tolerant investor (US) provide more insurance

Comments - Model

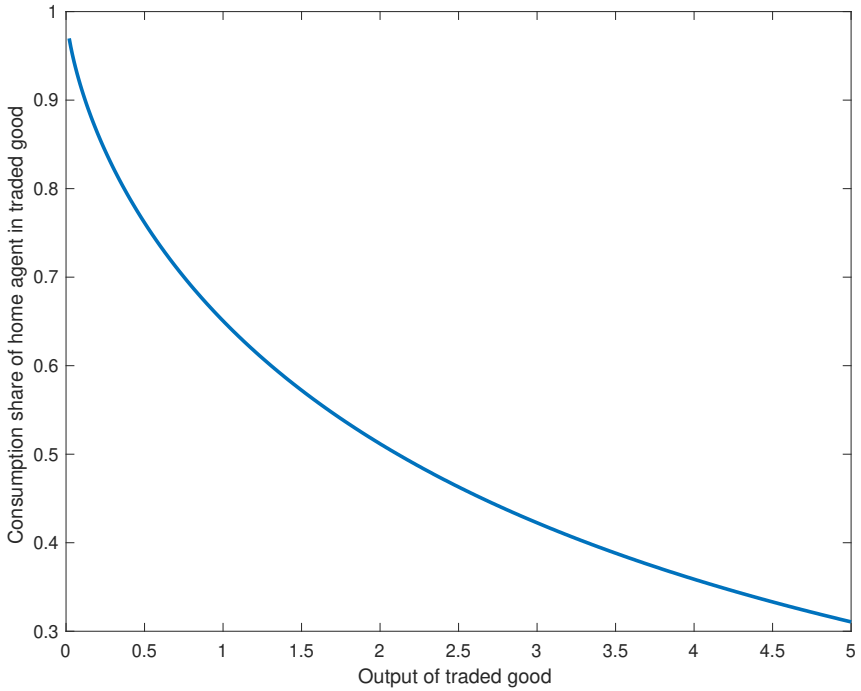
Risk aversion changes (FX):



Traded good consumption increases more in US in when RA of foreign goes up $\rightarrow$ Price of US non-traded increase $\rightarrow$ USD appreciation

Comments - Model

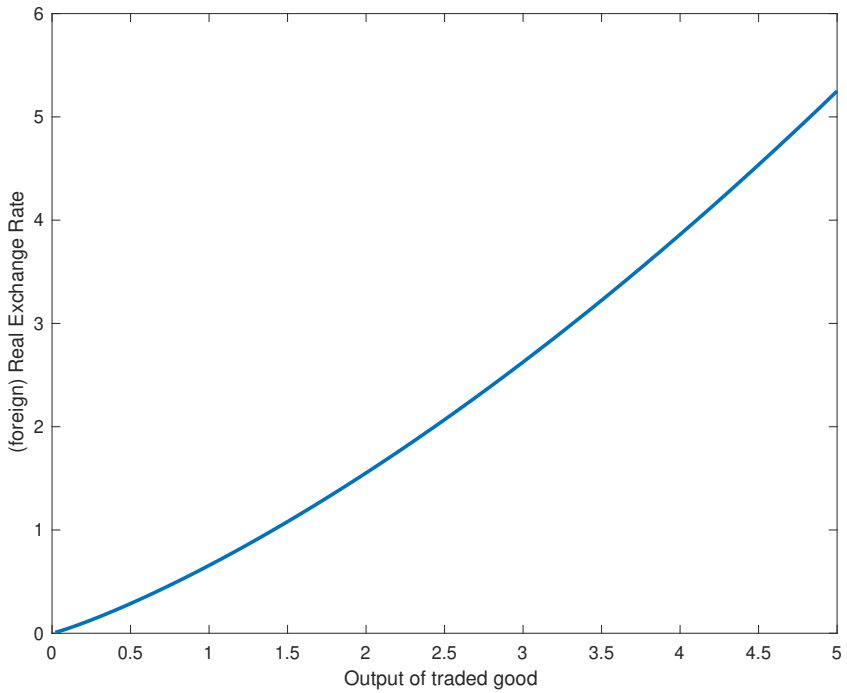
US non-traded changes:



Low US non-traded output $\rightarrow$ high consumption share of traded good to equate marginal utilities

Comments - Model

US non-traded shock (FX):



Low US non-traded output $\rightarrow$ high price US non-traded good $\rightarrow$ USD appreciation

Comments - Model

Two possible ways to help the reader understand better the mechanism:

- Dig deeper into the current quantities you already discuss
- Show implications for some other moments

Comments - Dig deeper

Would be nice to decompose the effects to understand the mechanism even better:

- Disaster is a proportional shock to all outputs
- Risk sharing is pulled in different directions (non-traded, traded, risk aversion)
- The fragile state is a shock to risk aversion and increased probability of the disaster state $\rightarrow$ large impacts on valuations?
- I have a feeling that the fragile state implies large effects on valuations that can resolve some of the tensions in other models (nice)

Comments - Other moments

Already does a great job in matching "difficult moments"

- Risk premia
- NFA dynamics
- Large FX movements in recessions

To better understand the mechanism could look at:

- Total wealth
- Aggregate consumption
- FX risk premia
- Yield curves

Conclusion

A great paper that has inspired me a lot!