Introduction to
The Dollar and the Global Price of Risk
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Virtual Finance Workshop

FX and Trade in Assets

1. Changes in exchange rates seem to be driven as much by the demand for financial assets as the demand for goods
   - Backus and Smith (1993) puzzle

2. US is the "world's banker"
   - US dollar's importance in international finance is much bigger than US's share of GDP or trade
   - foreign governments and households are large savers in US bonds
   - foreign financial and non-financial firms borrow in US dollars in the US and abroad

3. Movements in the value of the US dollar largely drive the carry drive
   - flight to safety in dollars during crises
   - US monetary policy appears to impact international markets much more than other central banks

Question: How to explain/model all of this?

Finance, Risk Premia, and What's So Special about the Dollar?

1. Observations seem to put financial intermediation at the heart of exchange rate determination

2. Idea: dollar assets have a special "safety premium" or "convenience yield" that fluctuates over time

$\Rightarrow$ Risk takers buy risky assets by borrowing in the highly-demand dollar bonds

$\Rightarrow$ Shocks to dollar bond demand affect risk takers and change risk premia, causing equity prices and FX to change

- I like the focus on risk premia, which is often absent from macro
- "A Model of Monetary Policy and Risk Premia," (2017): model how monetary policy impacts risk taking and risk premia
- "Deposits Channel of Monetary Policy," (2017): explain monetary policy impacts production of safe assets by financial sector

Important to Understand

1. Why does demand for US bonds need to move the exchange rate?
    - why not just the relative price of US bonds?

2. Why do risk tolerant investors necessarily finance themselves in bonds?

More Questions

1. Risk premium impact is due to shifts in wealth distribution, but these shifts are small. Normal fluctuations in the stock/asset markets should then produce bigger effects than the monetary policy shocks here, but don't appear to.
    - this is a regular challenge for models based on the "balance sheet effects"

2. If the convenience yield is for all safe assets, even those produced by firms (not just governments), then why don't they satiate the demand for this convenience/safety and reduce the premium down to 0?

3. Is the central bank accommodating changes in deflation/inflation that occur as a result of shocks to demand for US bonds? Why is the real rate changing?