RATIONALITY OF HOLDING US DOLLAR ASSETS BASED ON GLOBAL US DOLLAR LIQUIDITY STRUCTURAL TRANSFORMATION: A NEW PERSPECTIVE ON ASSET ALLOCATION

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ABSTRACT

As a crucial share of global liquidity, USD liquidity heightens a prominent negative spillover effect within the international monetary system. Especially, against the turbulent world background after the 2020 pandemic and the Russo-Ukrainian War, it is more observable to intensify the negative spillovers of USD liquidity during bad times. US Treasury securities, which greatly contribute to the USD liquidity externality because of their safety and reliability, have long been preferred by the world's main economies. Moreover, the yield of US Treasury securities can be an important factor determining the USD liquidity spillover and is a key consideration in evaluations of the international monetary system. Considering the dilemma USD assets holders are faced with, we dig into the spillover effect at the macro-economic level and extend this mechanism into asset allocation effectiveness at the micro-economic level. Our investigation results point to a significantly negative relationship between the effect and risk level of USD assets on the one hand and the scale of USD foreign exchange reserves on the other. This implies that the world's main economies face more challenges regards to international liquidity management, lacking a feasible plan for replacing USD assets. We contend that reform and diversification are needed in the current USD standard monetary system to strengthen the effect of global liquidity.

Keywords: *negative externality of USD liquidity, US Treasury securities, asset allocation, monetary system reform, turbulence*

1. INTRODUCTION

When making international investment decisions, an investor's asset allocation decision is influenced by various factors, especially her risk appetite. Today's international currency system is characterized by the dominance of the US dollar (USD). Under the "flight to quality", the US typically sees sustained and stabilizing net capital inflows toward its safest assets. Olivier (2012), based on a study on consumption return, finds that the main economies, especially emerging ones, tend to exchange most of their account surplus into US assets to avoid reductions in the return on US dollar foreign exchange reserves caused by domestic currency appreciation. Researchers describe the safety attributes of US assets, namely, their low risk and high liquidity, as the source of the dollar's "safe haven" status. Kaul and Sapp (2006) assume the USD to be the principal safe haven in the context of the Y2K problem and provide evidence that safe haven trading has an appreciable influence on global financial markets. From another perspective, Ranaldo and Söderlind (2010) suggest that the value of a safe haven currency increases with the risk or market participants' risk aversion and that USD asset purchases are related to the risk appetite pervading financial markets. Gorton (2017) discusses safe assets from the perspective of liquidity and argues that safe assets are valued at face value, without expensive and prolonged analysis. US government assets are especially liquid. On the one hand, there is very little likelihood that the US government will default on its debt due to the independence of the Federal Reserve leading to low inflation. On the other hand, Uribe (1997) argues that the network externalities of dollarization decrease transaction costs and thus that USD assets are widely held for their liquidity. Overall, the USD is not only the most important pricing and