Dollar Dominance and Monetary Policy[1]

Silvana Tenreyro

London School of Economics, CfM and CEPR

Banco de España Latin American Economic Forum

Tarragona, May 2026

[1] Material based on: "Dollar dominance and the transmission of monetary policy" by McLeay and Tenreyro (2026). The views in the paper do not represent those of the Bank of England or any of its committees.

The Question

- Is monetary policy effective in a world of **dollar dominance**?
  - State of play: **No**. (Gopinath et al, 2020, “Dominant Currency Paradigm”)
  - Our take: **Yes**. (McLeay and Tenreyro, 2026, “Dollar Dominance and the Transmission of Monetary Policy”)

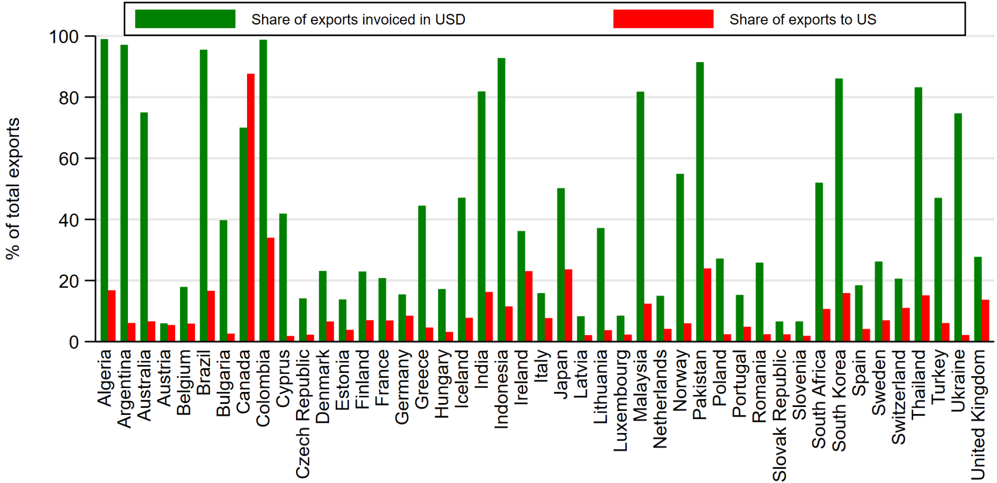
Background

1. A large share of international trade transactions is invoiced in dollars (Goldberg and Tille, 2008; Gopinath, 2016)

2. New dominant currency pricing (DCP) paradigm shifted policy views. DCP:
   - Makes exports unresponsive to exchange rate changes
   - Reduces the value of flexible exchange rates as shock absorbers
   - Limits effectiveness of monetary policy

3. DCP premises: 1) exporters have monopoly power; 2) prices are sticky in dollars. But (McLeay and Tenreyro, 2026):
   - Dollar dominance is prevalent in homogeneous-good markets in which prices are flexible
     - Many developing and EM producers are price takers. They export commodities or fairly homogeneous products with limited market power. Even if there is market power, prices tend to be flexible; e.g., commodities
     - Advanced-economy producers face elastic demands and flex prices in competitive markets. Where goods are differentiated, PCP prevails (as in Obstfeld-Rogoff 1995)

Dollar invoicing dominates trade. 1990-2019 Averages



Background

1. A large share of international trade transactions is invoiced in dollars (Goldberg and Tille, 2008; Gopinath, 2016)

2. New dominant currency pricing (DCP) paradigm shifted policy views. DCP:
    - Makes exports unresponsive to exchange rate changes
    - Reduces the value of flexible exchange rates as shock absorbers
    - Limits effectiveness of monetary policy

3. DCP premises: 1) exporters have monopoly power; 2) prices are sticky in dollars. But (McLeay and Tenreyro, 2026):
    - Dollar dominance is prevalent in homogeneous-good markets in which prices are flexible
        - Many developing and EM producers are price takers. They export commodities or fairly homogeneous products with limited market power. Even if there is market power, prices tend to be flexible; e.g., commodities
        - Advanced-economy producers face elastic demands and flex prices in competitive markets. Where goods are differentiated, PCP prevails (as in Obstfeld-Rogoff 1995)

Background

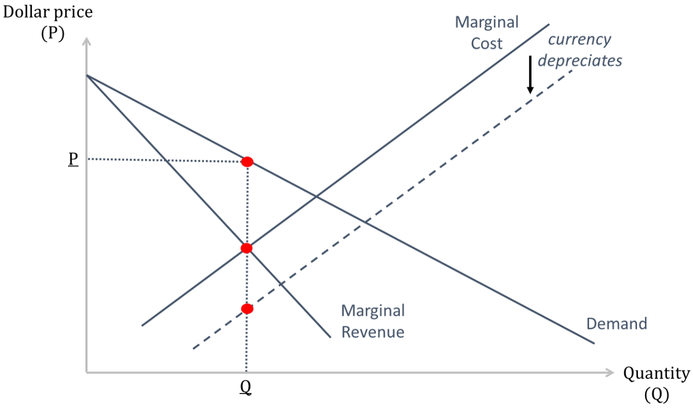
1. A large share of international trade transactions is invoiced in dollars (Goldberg and Tille, 2008; Gopinath, 2016)

2. New dominant currency pricing (DCP) paradigm shifted policy views. DCP:
   - Makes exports unresponsive to exchange rate changes
   - Reduces the value of flexible exchange rates as shock absorbers
   - Limits effectiveness of monetary policy

3. DCP premises: 1) exporters have monopoly power; 2) prices are sticky in dollars. But (McLeay and Tenreyro, 2026):
   - Dollar dominance is prevalent in homogeneous-good markets in which prices are flexible
     - Many developing and EM producers are price takers. They export commodities or fairly homogeneous products with limited market power. Even if there is market power, prices tend to be flexible; e.g., commodities
     - Advanced-economy producers face elastic demands and flex prices in competitive markets. Where goods are differentiated, PCP prevails (as in Obstfeld-Rogoff 1995)

DCP: monopolist with sticky price

Depreciation with sticky dollar prices: monopolist

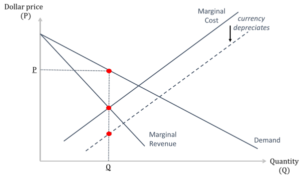


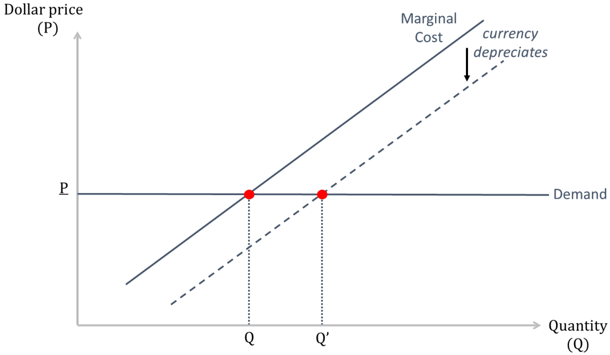
- With sticky dollar prices, export quantities do not change

MCP: commodity producer (flexible export prices)

Depreciation for a commodity exporter: price taker

MONOPOLIST



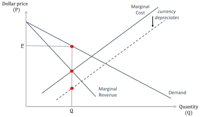


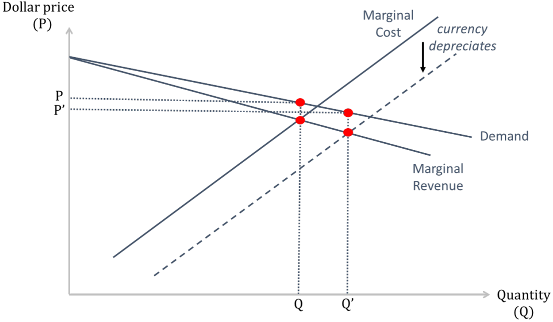
- Dollar commodity prices do not change, but export quantities increase
- Lack of price passthrough not evidence of stickiness
- MCP (mixed currency pricing): flexible export prices and sticky domestic prices

MCP: producer in competitive markets

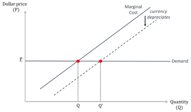
Depreciation with elastic demand

Monopolist





Price taker



- For a producer facing an elastic demand, flexible prices may appear sticky in equilibrium
- Export quantities increase a lot, as for the commodity exporter

Three Remarks

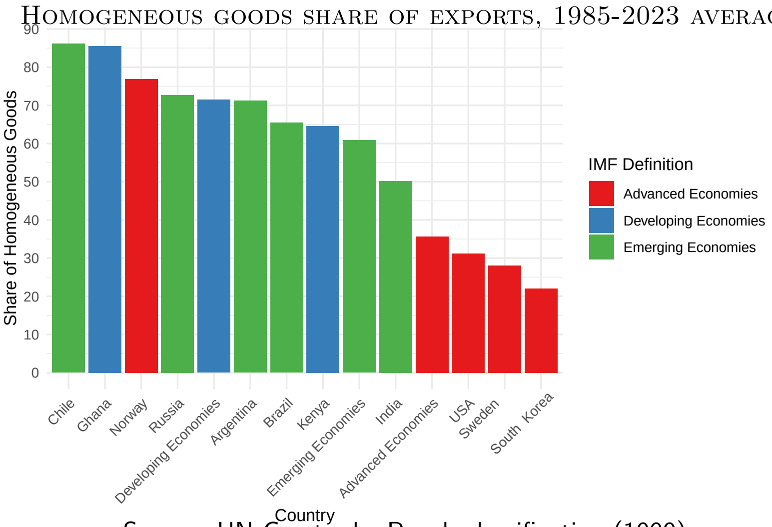
1. Using a vehicle currency for pricing/invoicing does not need to entail sticky prices or monopoly power
   - Empirical evidence suggests the opposite: use of dollar is more likely in competitive homogeneous good markets with flexible prices (e.g., commodities)
   - In markets for which prices are flexible, invoicing currency is not relevant

2. Lack of pass-through to prices from ER depreciations does not imply nominal rigidity

3. MCP model: With elastic demands and flexible USD prices, an ER depreciation does not affect export prices but increases export quantities. ER acts as shock absorber. Monetary policy is effective
   - Effect depends on supply capacity

Empirical Observations

Fact 1 - Homogeneous products have a large export share



Source: UN Comtrade, Rauch classification (1999)

- Homogeneous goods (sold in competitive markets, categorised by Rauch (1999).

Fact 2 - Homogeneous goods tend to have flexible prices

- Bils and Klenow (2004); Nakamura and Steinsson (2008)...
- Examples: median monthly price durations
  - Homogeneous goods (organised): <1 month
  - Homogeneous goods (reference): 3 months
  - Differentiated goods: 9 - 14 months

Fact 3 - Invoicing in vehicle currency is more prevalent in homogeneous-good sectors

- McKinnon (1979) and many others: producers with lower market power in homogeneous good markets will tend to price in foreign currencies, as they would stick very closely to the competitive prices in those markets. Bachetta-and-van Wincoop (2005) formalise the idea

- Goldberg and Tille (2008) using microdata on Canadian imports, show dollar pricing more likely for exporters that
  - sell homogeneous goods
  - have low market shares

Fact 3 - Invoicing in vehicle currency is more prevalent in homogeneous-good sectors

Share of exports invoiced in USD

	(1)	(2)	(3)	Averages
Export share of	0.717***	0.752***	0.766***	0.830***
homogeneous goods	(0.0325)	(0.0333)	(0.0497)	(0.239)
Constant	16.11***	14.50***	22.04***	15.57
	(1.671)	(1.697)	(2.372)	(13.34)
Year FE	No	Yes	Yes	NA
Weighted by GDP	No	No	Yes	Yes
Observations	1,170	1,170	1,170	100
R-squared	0.294	0.331	0.340	0.363

Robust Standard errors in parentheses.

**** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$

Model summary

- NK model nesting different configurations of nominal frictions (DCP, PCP, MCP)
  - Focus on small open economy version
  - Financial markets are incomplete
- Production and competition:
  - Imported intermediates used in production
  - Allows for a flexible market structure that permits intra-sector international competition, and heterogeneity in the degree of price stickiness
  - **Low (standard)** substitution across different goods/sectors.
  - But international competition $\rightarrow$ **higher** substitution across different varieties of the same good/sector
- Wage and price-setting
  - Across all specifications: rigid wages and nontradables' prices (sticky in home currency)
  - Export prices sticky in PCP or DCP and flexible in MCP

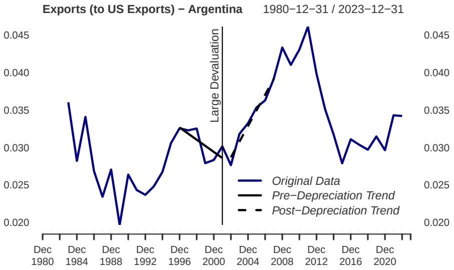
Is monetary policy effective with dollar dominance?

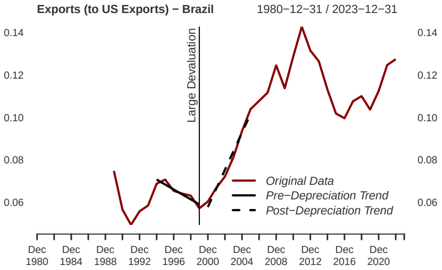
(McLeay and Tenreyro, 2026)

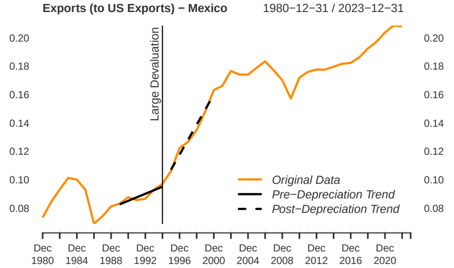
1. MCP model: quantitative model with mixed currency pricing. Answer: yes
   - Flexible homogeneous-good prices (USD invoicing); price rigidities in differentiated goods (producer-currency invoicing).

2. Three empirical approaches. Answer: yes
   - VAR analysis of Canada and Chile. When policy tightens:
     - Export volumes fall across all sectors
     - Commodity exports react immediately; non commodity sectors take longer
     - Broader activity also falls; unemployment increases; inflation falls
   - LP analysis of 38 EME and developing economies (monetary policy shocks from Brandao-Marques, Gelos, Harjes, Sahay, and Xue, 2021). When policy tightens:
     - exports, activity, inflation fall Local Projections
   - Case studies of large exchange-rate devaluations

Exports and large devaluations







Answer to Question: Key takeaways

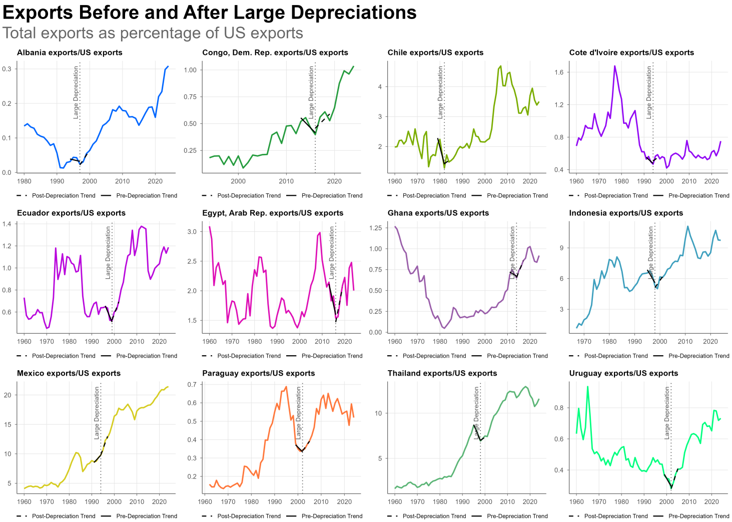
- Yes, monetary policy is effective when the dollar (or any other vehicle currency) is used in export markets
  - Exchange rates can act as shock absorbers
  - Consistent with evidence from large devaluations and identified MP shocks

OUTSIDE OF THE MODEL

- Other policies suitable to tackle climate and geopolitical shocks
- Need for a "real-side" policy strategy to prevent, mitigate and cope with geopolitical or climate related shocks
    1. Investment on technological diversification, focused on low substitutability inputs or technologies (Koren and Tenreyro, 2010)
    2. Trade diversification, especially with low geopolitical-risk countries to lower exposure to domestic shocks to specific suppliers/buyers, reducing volatility (Caselli, Koren, Lisicky and Tenreyro, 2020)
    3. Supply buffers to prepare for shortages in critical inputs (energy, water, etc.)

Exports and large devaluations

Back



EMERGING/DEVELOPING ECONOMY MONETARY POLICY SHOCKS

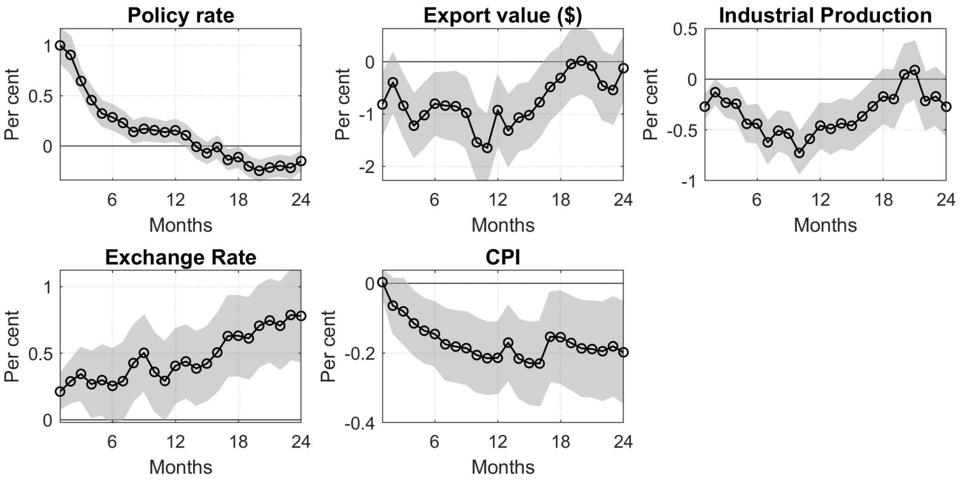
- Panel of 38 emerging and developing economies from Brandao-Marques et al. (2020)

- They identify monetary policy shocks as residuals ($\hat{\epsilon}_{i,t}$) to estimated Taylor Rule:
  - $\Delta i_{i,t} = \phi_{\pi^f} E_t \pi_i^f + \phi_{y^f} E_t y_i^f + \sum_{j=1}^{2} \phi_\pi \pi_{i,t-j} + \sum_{j=1}^{2} \phi_y \Delta y_{i,t-j} + \sum_{j=1}^{2} \phi_e \Delta NEER_{i,t-j} + \sum_{j=1}^{2} \phi_i i_{i,t-j} + \epsilon_{i,t}$

- We estimate effects on macro variable ($y_{i,t+h}$) at each time horizon (h) using local projections with country fixed-effects (μ_i^h):
  - $y_{i,t+h} = \mu_i^h + \sum_{j=0}^{2} \gamma_j^h \hat{\epsilon}_{i,t-j} + \delta_0^h \Delta NEER_{i,t} * \hat{\epsilon}_{i,t} + \sum_{j=0}^{2} \beta_j^h * controls_{i,t-j} + \omega_{i,t}^h$
  - Effect assuming simultaneous 1s.d. exchange-rate change is $\gamma_0^h + sd(NEER) * \delta_0^h$.
  - Also interact responses with other country characteristics

Back

Effect of a monetary tightening shock in EME/DE



- Dollar export values fall in response to tightening that induces appreciation.
- If prices also adjust, Δ values might be a lower bound to quantity response.
- Responses comparable to Canada and Chile Back