Bank of England

Financial innovation, dollar dominance and their UK monetary policy implications

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"Financial Innovation and the International Monetary System"
by Gordon Liao, Eswar Prasad and Tony Zhang

- Model of liquidity demand and debt denomination considers the implications of financial innovation in the international payment system for capital flows and choice of reserve currencies.

- Thorough discussion on how to measure dollar dominance and the fragmentation of the 'second tier' of global currencies.

- Model weighs network effects that support the dominant currency against the reduction in financial frictions from financial innovation, considering 5 cases.

- Through the lens of the model and calibration to current data, financial innovation proxied via a stablecoin is unlikely to weaken dollar dominance.

"Financial Innovation and the International Monetary System"
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- The focus is on financial innovation (in the payments system as proxied by a stablecoin) as an enabler of the dominant currency is an important contribution to understanding domestic welfare calculations and international implications, especially financial stability.

- Other important determinants of a dominant currency, such as the role of institutions, political and macroeconomic stability, openness, and trust are not modelled.

- The paper has less to say about monetary policy implications, which I will emphasize today.

With a UK lens, core topics relevant for monetary policymaking

- Sterling as a store of value, a unit of account, and a medium of exchange.
- The US dollar as reserve currency and its implications for spillovers to the UK domestic environment.
- Financial innovation and implications for monetary policy transmission.

The role of the US dollar

What makes a global reserve currency?

What makes a global reserve currency?

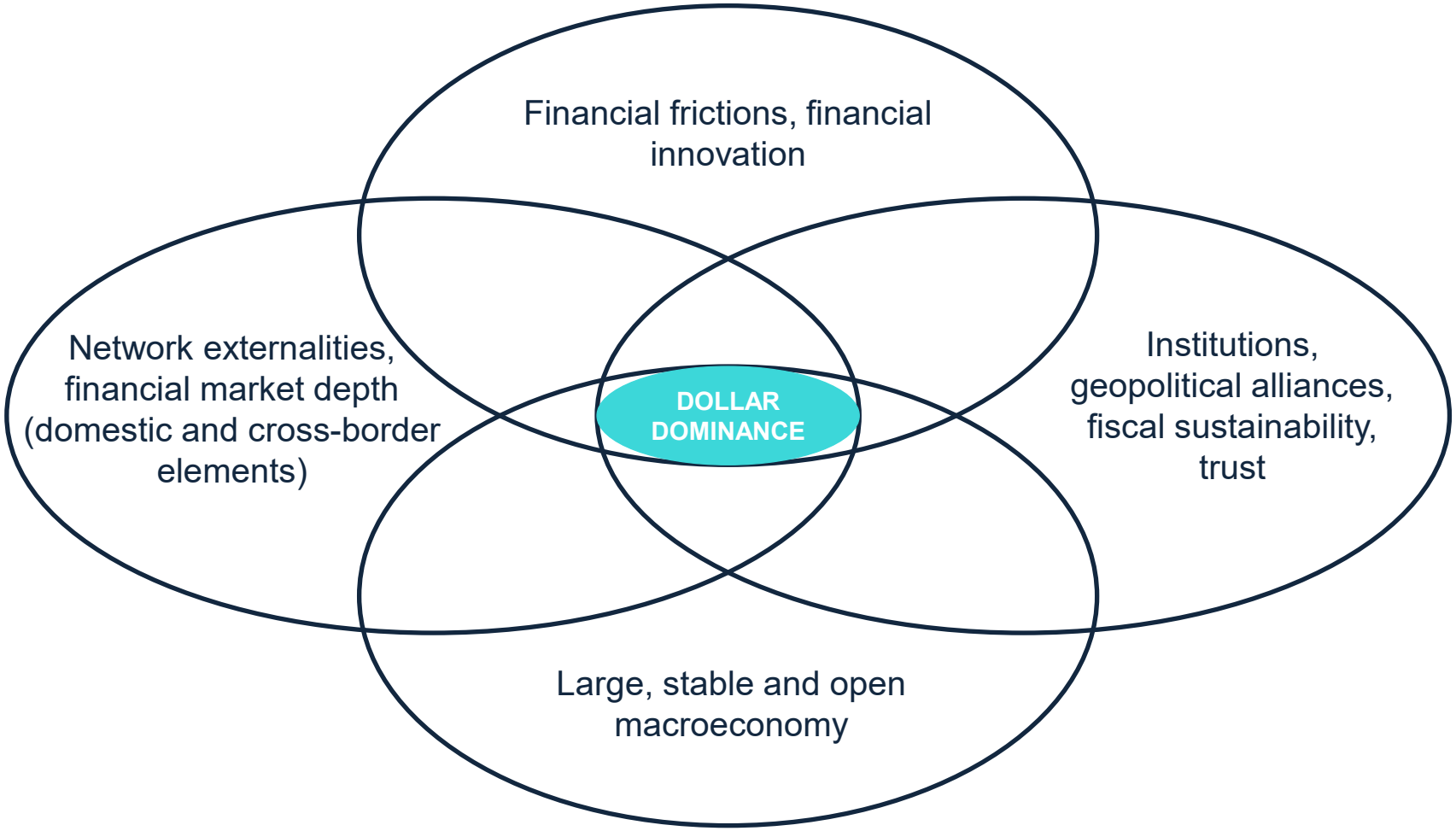
Uses

FX RESERVES	CAPITAL FLOWS	TRADE
Official foreign exchange reserve holdings	Denomination of corporate and government bonds, bank loans and other financial instruments	Import and export invoicing

Conditions for success

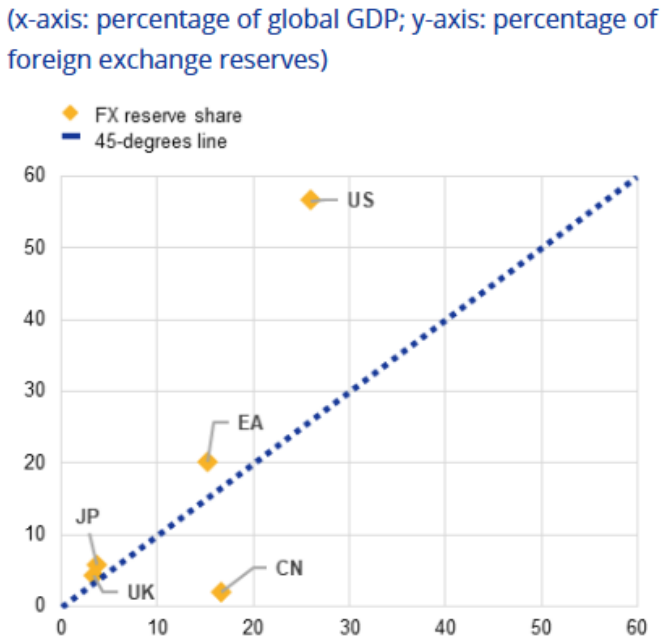
ECONOMIC & FINANCIAL SIZE	POLICY & INSTITUTIONS	INNOVATION
A large, interconnected economy; financial markets with size, depth, liquidity, stability and openness; network effects	Credible policy frameworks; strong, effective institutions; (geo)political stability; fiscal sustainability; trust	Financial innovation; financial frictions

Dollar dominance is reinforced by interlocking factors

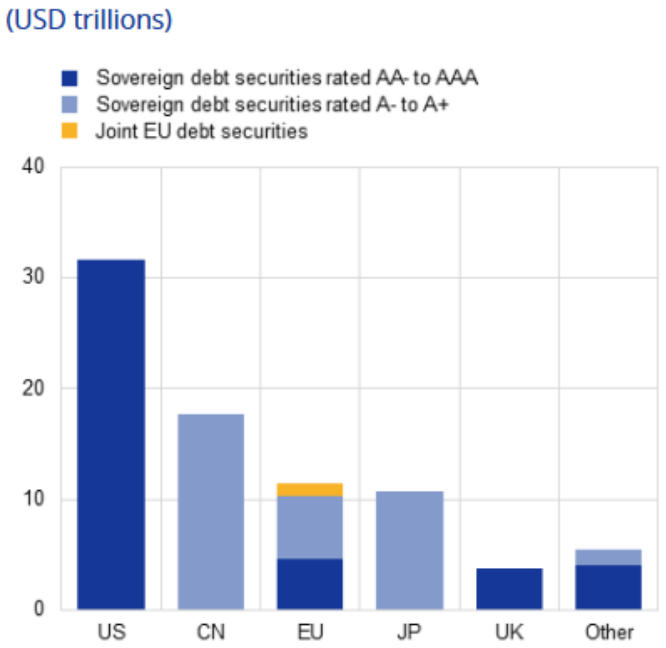


Store of value: size and depth of public and private markets, an international comparison

Share of foreign exchange reserves and global GDP in 2025

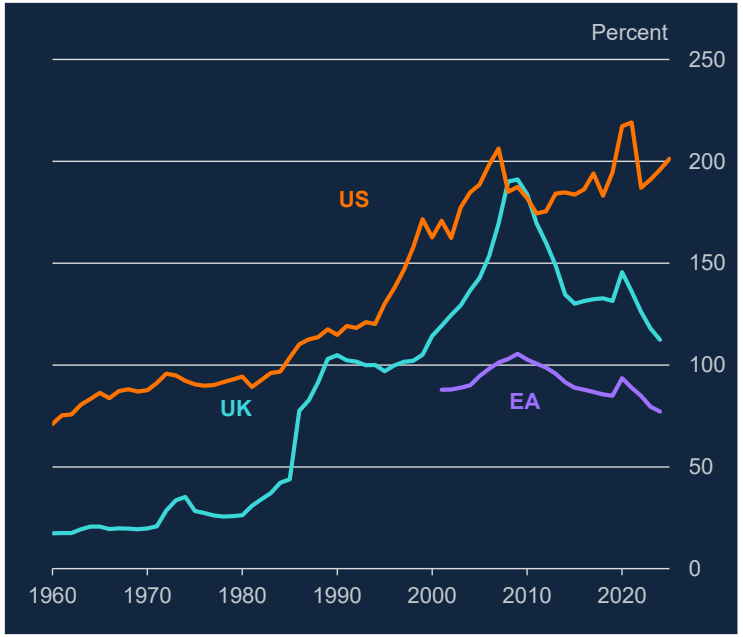


Outstanding amount of highly rated sovereign debt securities by issuer (April 2026)



Source: Domenech Palacios, M., Gandolfi, R., Georgiadis, G. and Rousová, L. (2026). "**Global safe assets and their convenience yields**", in **The international role of the euro, June 2026**. ECB.

Domestic credit to the private sector by banks as a % of GDP

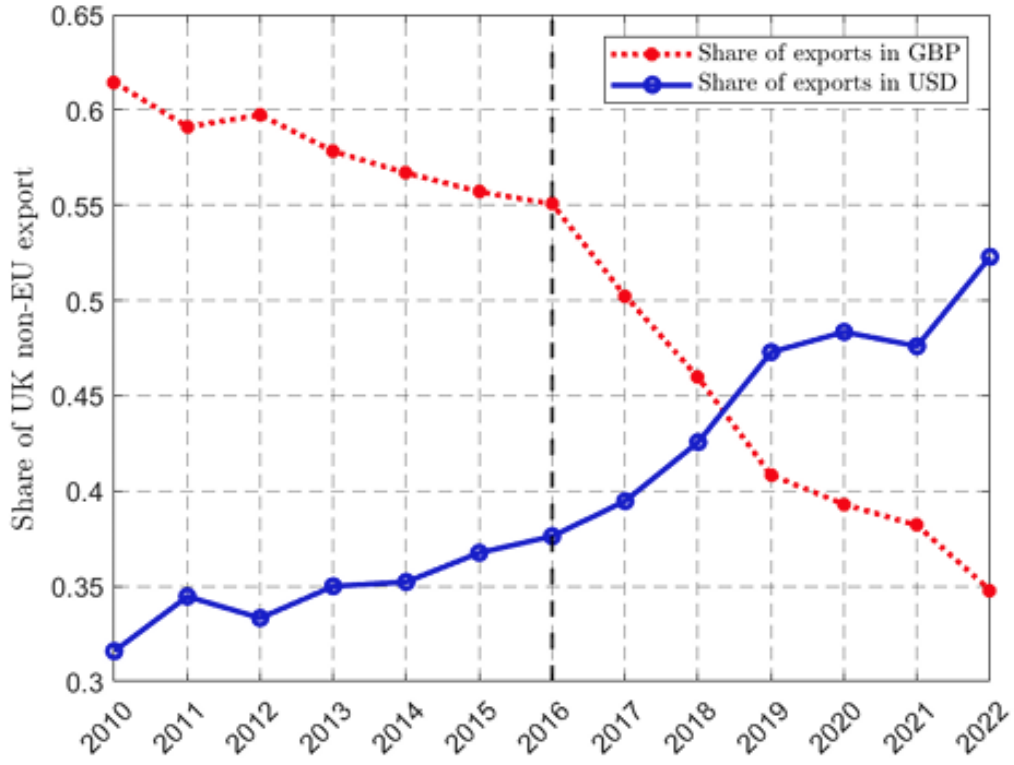


Source: World Bank

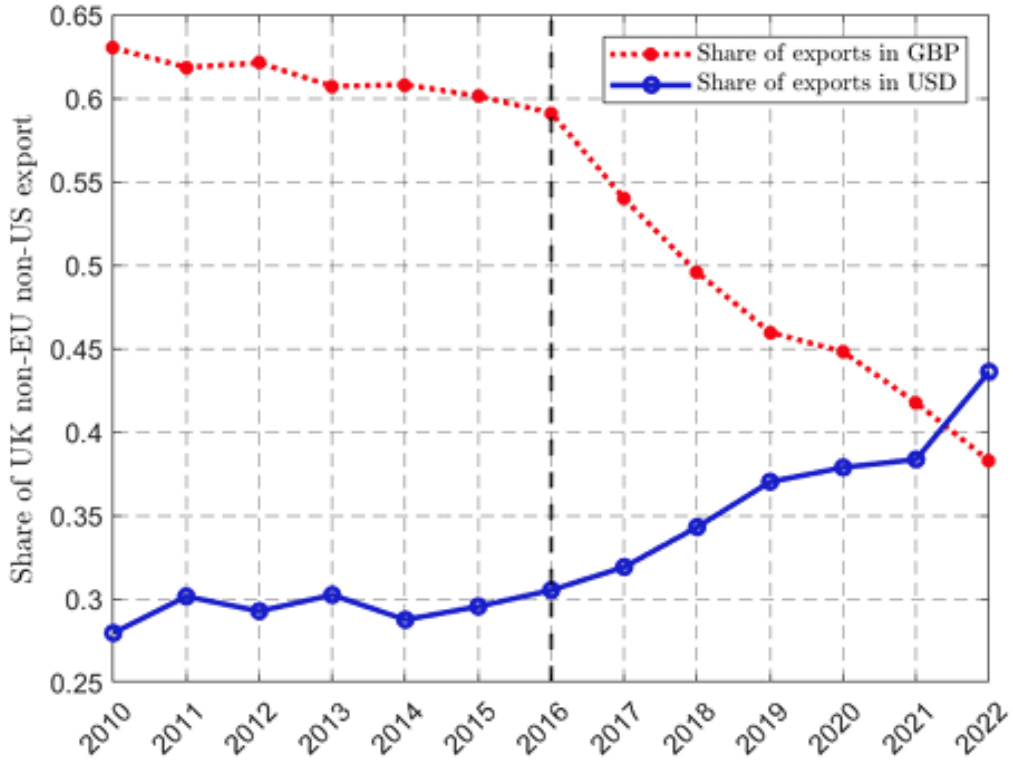
Unit of account: trade import and export invoicing

Brexit case study (shock to trade openness & political stability)

Share of UK non-EU exports invoiced in GBP and USD



Share of UK non-EU, non-US exports invoiced in GBP and USD



Source: Garofalo, M., Rosso, G. and Vicquéry, R. (2024). '**Dominant currency pricing transition**', Bank of England Staff Working Paper No. 1,074.

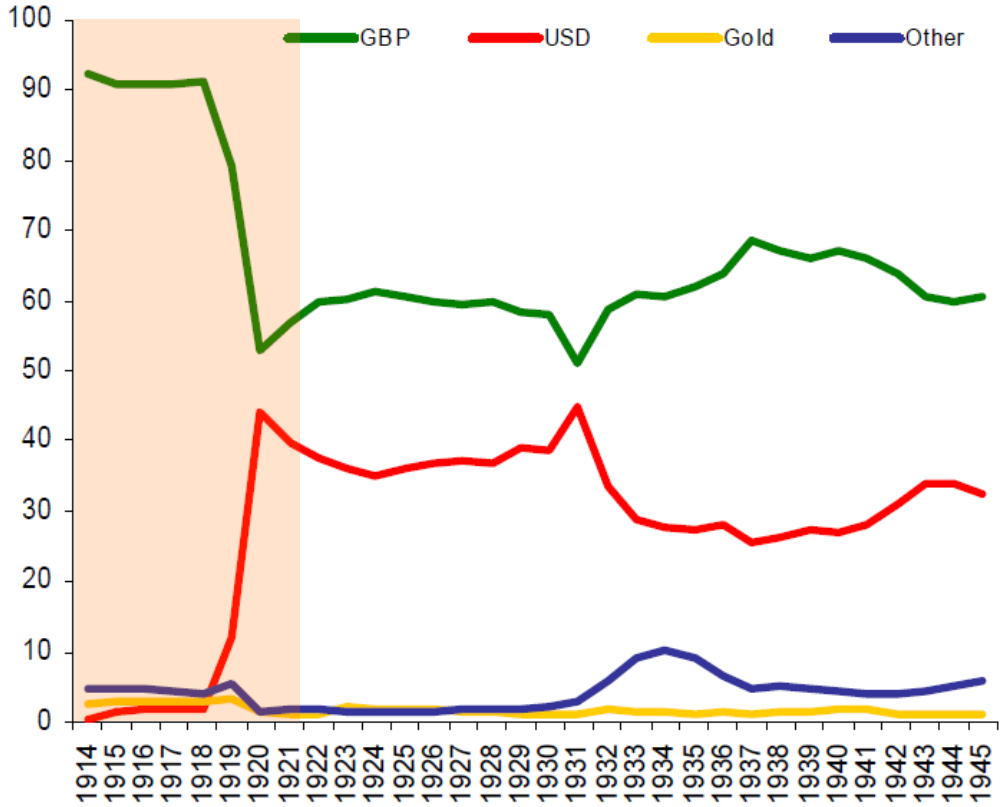
The rise of dollar dominance

1. Increase in US share in global trade and lending post-WWI (large, open economy)
2. Establishment of the Federal Reserve (institutional infrastructure)
3. New York financial markets outperform London (deep and liquid financial markets)
4. High UK inflation, repeated devaluations against the US dollar (macro instability)
5. Restricted international use of currencies following WWII (Germany, Japan, France)
6. Bretton Woods (institutional cementing of dollar's central role)

Sources: Eichengreen (2005 and many others!), Subacchi and Vines (2023), Federal Reserve Bank of St. Louis (2013)

Other factors: Commonwealth countries' political and economic ties to the UK initially helped maintain sterling's dominant role

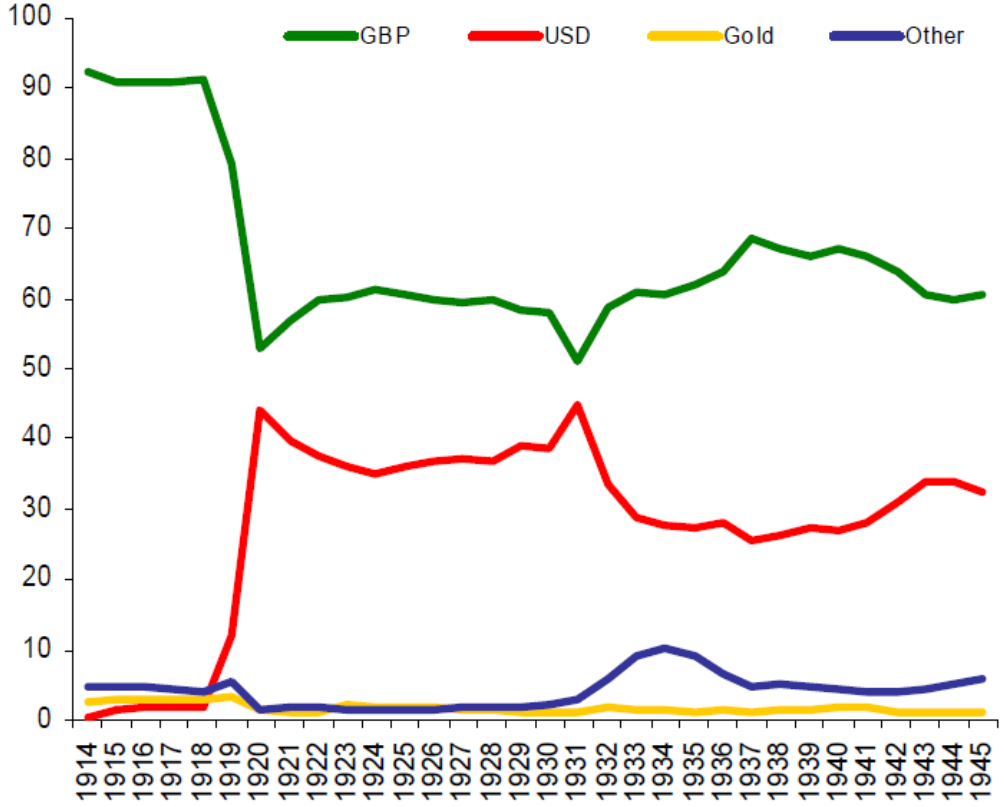
Selected currency shares of global foreign public debt (**incl. Commonwealth** countries, % of total)



Source: Chiţu, L., Eichengreen, B. and Mehl, A. (2014), "**When did the dollar overtake sterling as the leading international currency? Evidence from the bond markets**", Journal of Development Economics, 111 (C), pp. 225-245.

Without Commonwealth countries, sterling's role erodes

Selected currency shares of global foreign public debt (**incl. Commonwealth** countries, % of total)



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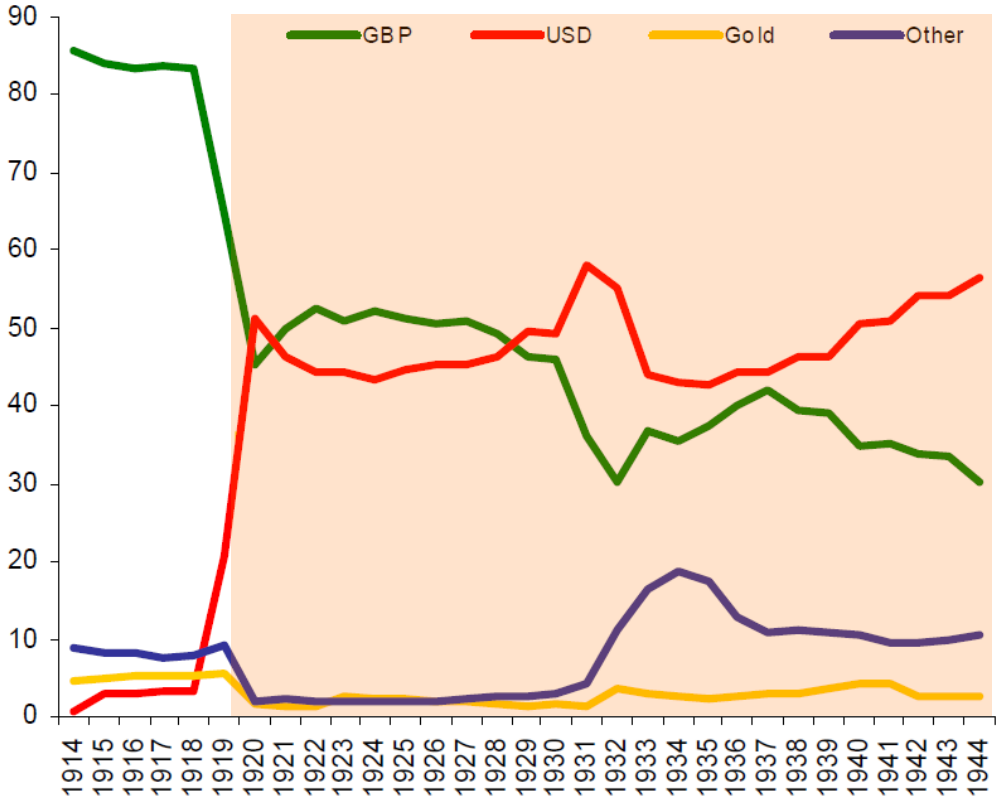
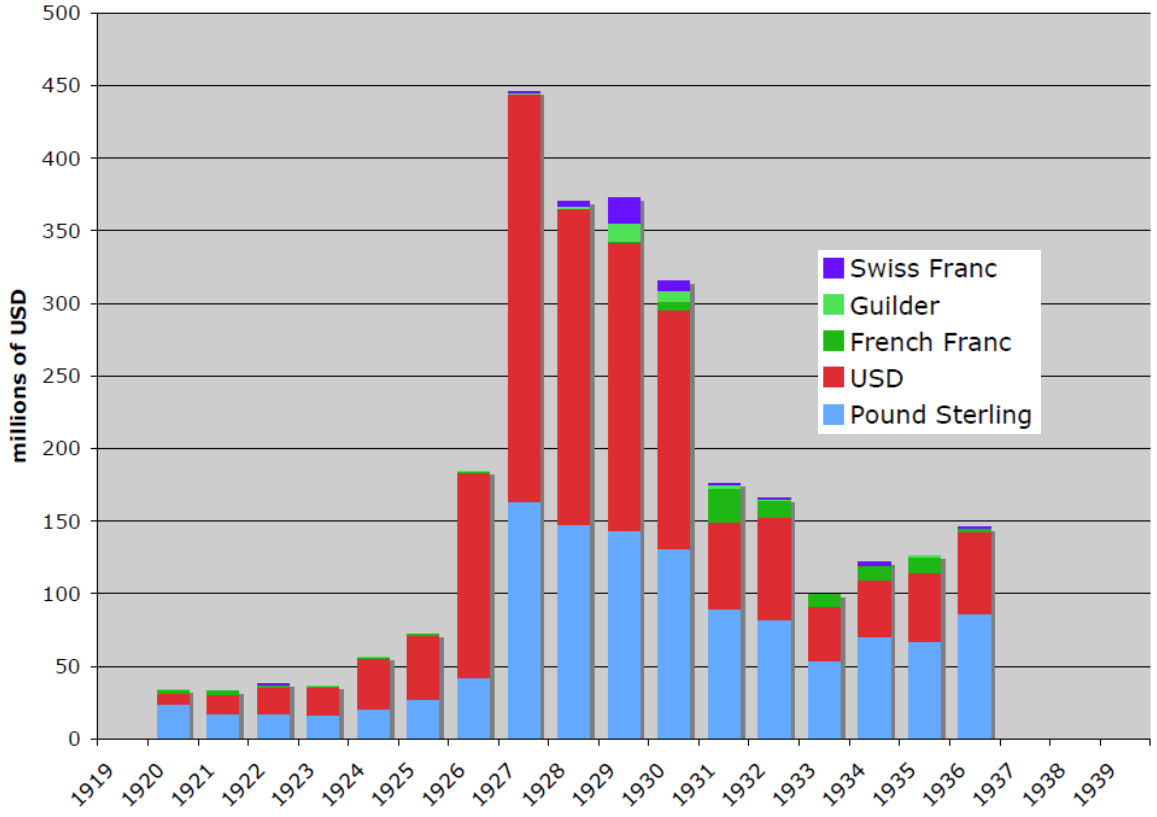


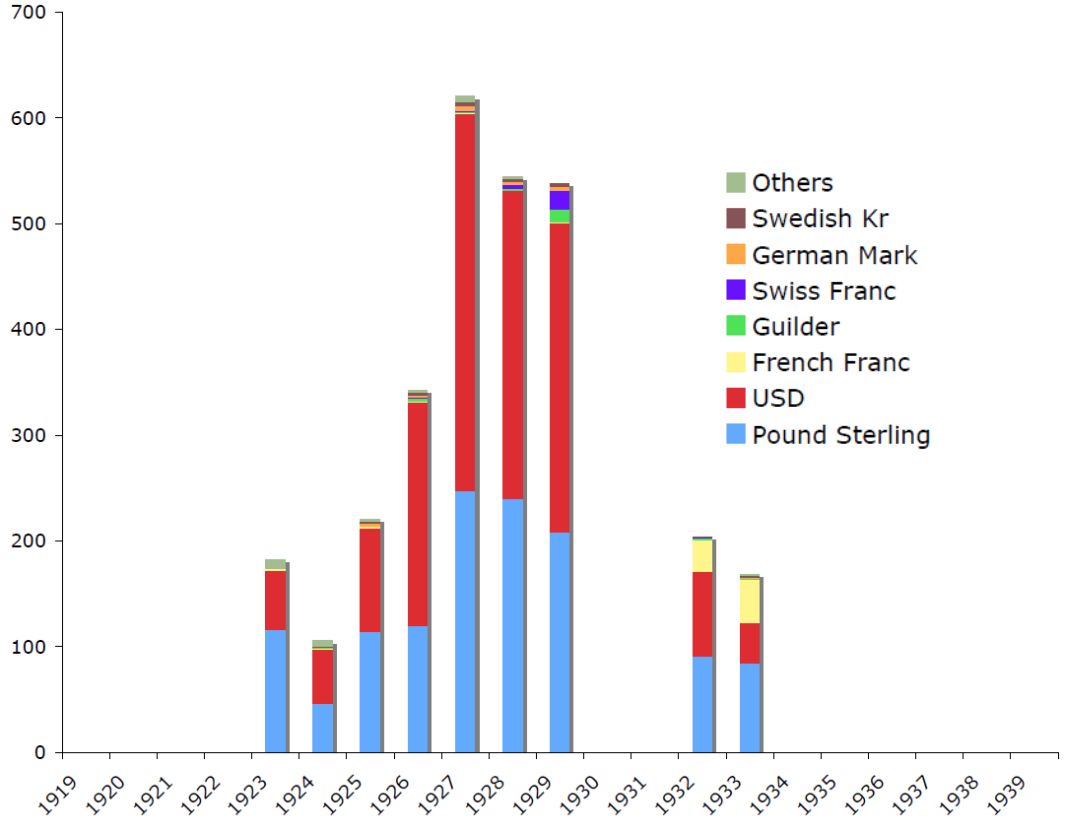
Source: Chiţu, L., Eichengreen, B. and Mehl, A. (2014), "**When did the dollar overtake sterling as the leading international currency? Evidence from the bond markets**", Journal of Development Economics, 111 (C), pp. 225-245.

Decomposition of foreign exchange reserves suggests USD had already overtaken GBP prior to WWII

Decomposition of reserves across Italy, Norway, Spain and Switzerland



Decomposition of reserves across G10 (million USD)



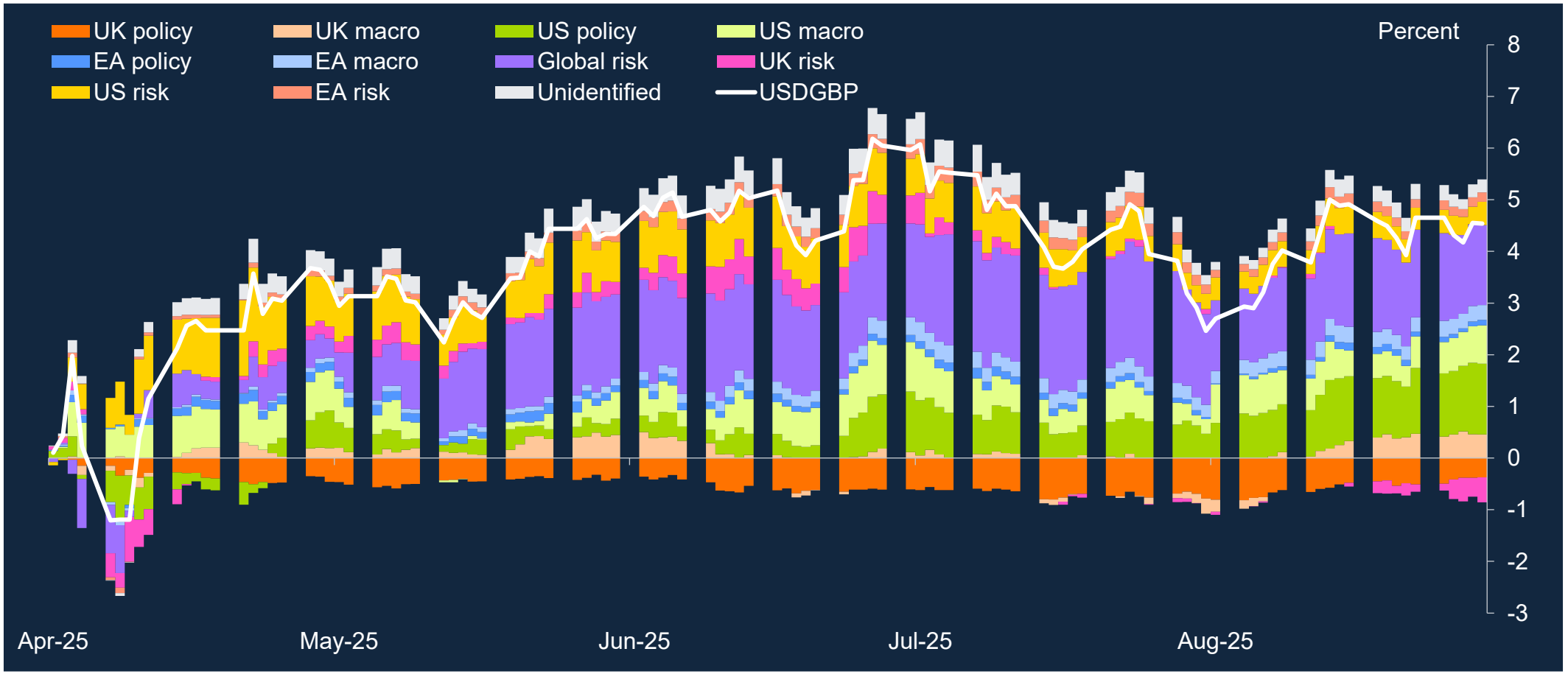
Source: Eichengreen, B. and Flandreau, M. (2009), "**The rise and fall of the dollar (or when did the dollar replace sterling as the leading reserve currency?)**", European Review of Economic History, 13 (3), pp. 377-411.

US dollar as a reserve currency

Spillovers to the UK

Geopolitical shocks can drive moves in reserve currencies

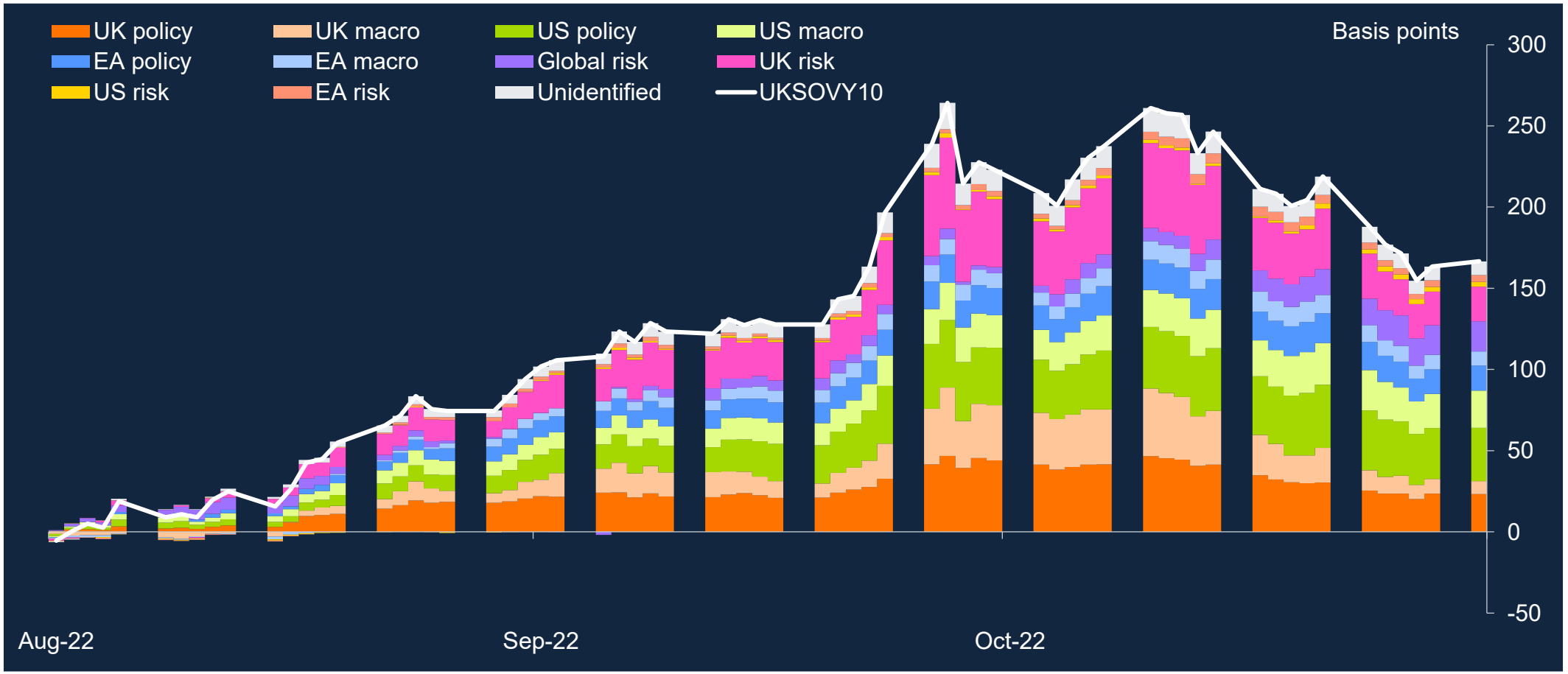
Decomposition of USDGBP following the 'liberation day' announcement



Source: Brandt and Burr (mimeo).
Notes: Chart shows historical decomposition from a Bayesian daily asset price SVAR identifying UK, US, EA policy, macro and risk shocks and a global risk shock using a combination of sign and magnitude restrictions. Sample estimation: Sep 1999 – Dec 2025.

Shocks to political stability can come from within

Decomposition of the UK 10-year gilt yield following the 'mini-budget' turmoil



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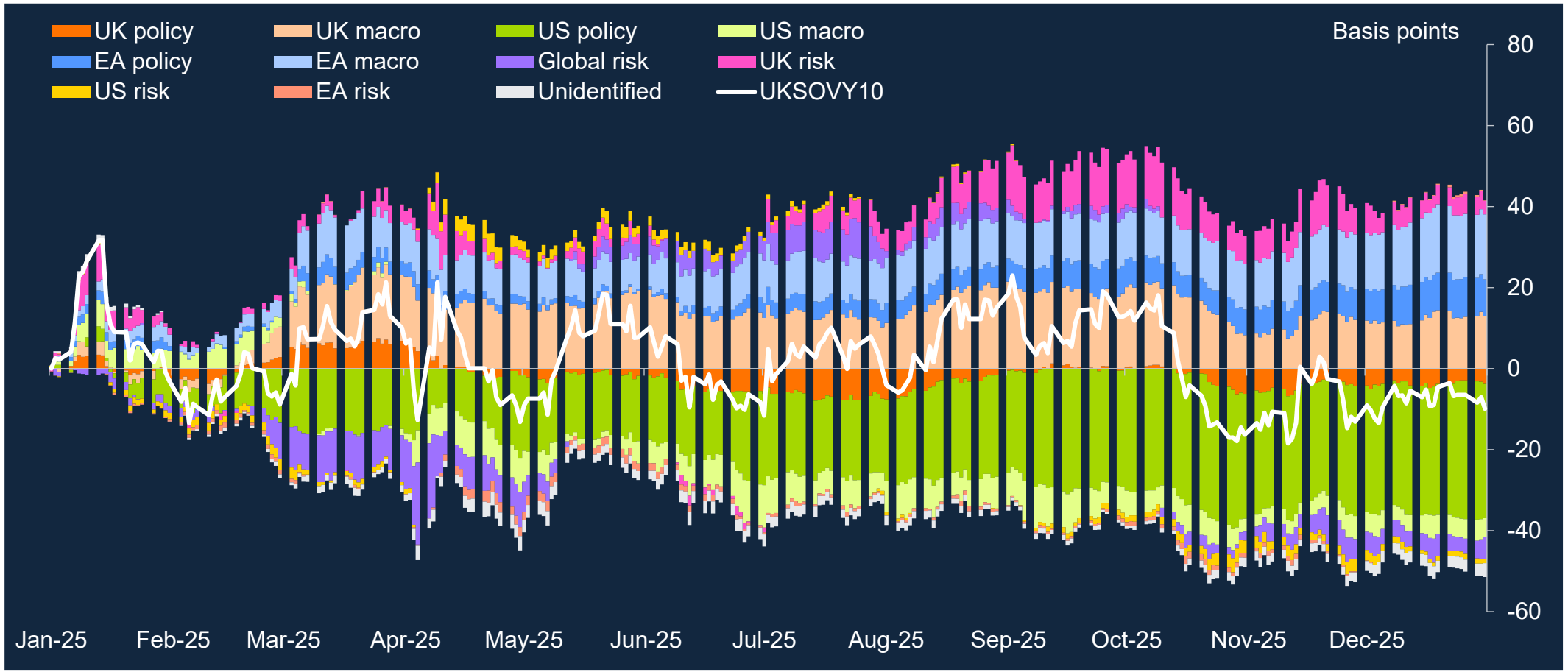
Spillovers from large neighbors, reserve currency or not, can dominate domestic UK financial drivers

Decomposition of the UK 10-year gilt yield over 2025



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Financial innovation

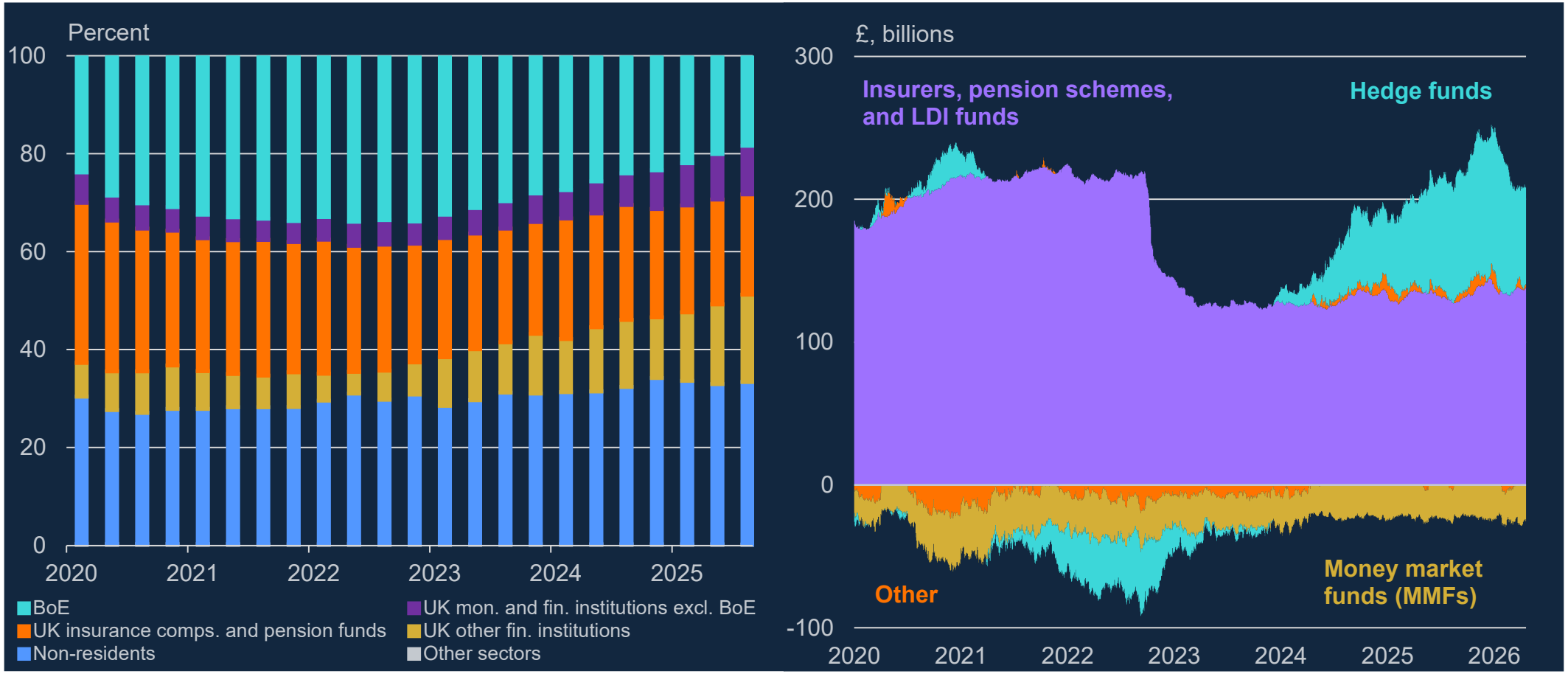
Monetary policy implications

Bank of England principles of financial innovation and regulation

- **Financial stability is the primary concern**, but there are monetary policy implications too.
- **Central bank money must remain the anchor** for the most systemic transactions in the financial system (Breeden, 2025; Lagarde, 2026).
- **More research is required to understand the economic and financial implications of stablecoins** and other financial innovations. The LPZ paper contributes to that understanding.
- **Financial market participants already have changed.** Do UK data offer insights for how, for example, stablecoins might affect monetary policy?

While £ is not a dominant currency, the UK financial sector is large, globally exposed, and with a changing set of investors

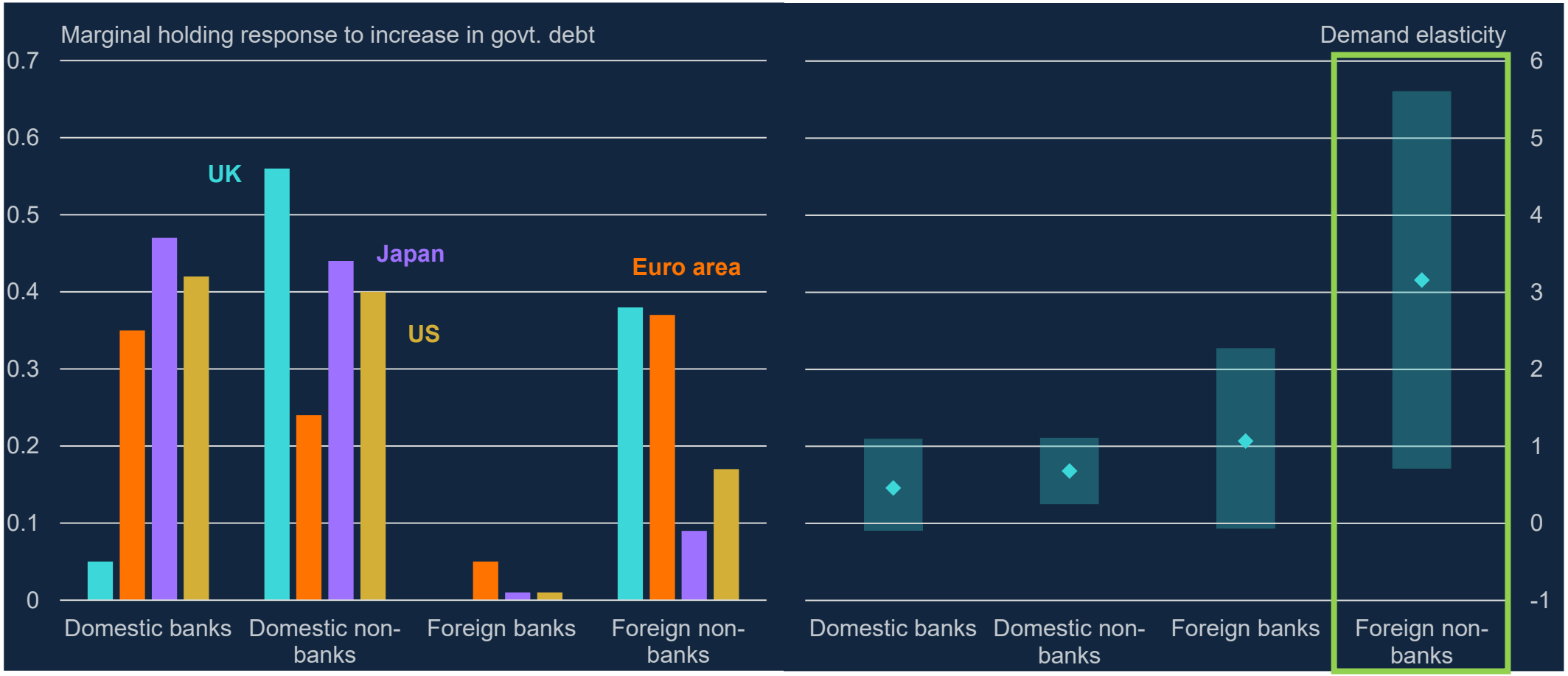
Share of total stock of gilts outstanding held by different sectors (LHS) and net repo positioning across non-bank sectors in billion pounds (RHS)



Source: **Mann (2026)** using ONS and Bank calculations.
Notes: ONS data on sectoral holdings in the UK financial accounts are subject to limitations related to data granularity, coverage gaps, and the constraints of traditional survey-based methodologies and should be interpreted with caution.

Non-banks have absorbed higher gilt issuance in the UK. Foreign non-banks are most price-elastic across advanced economies

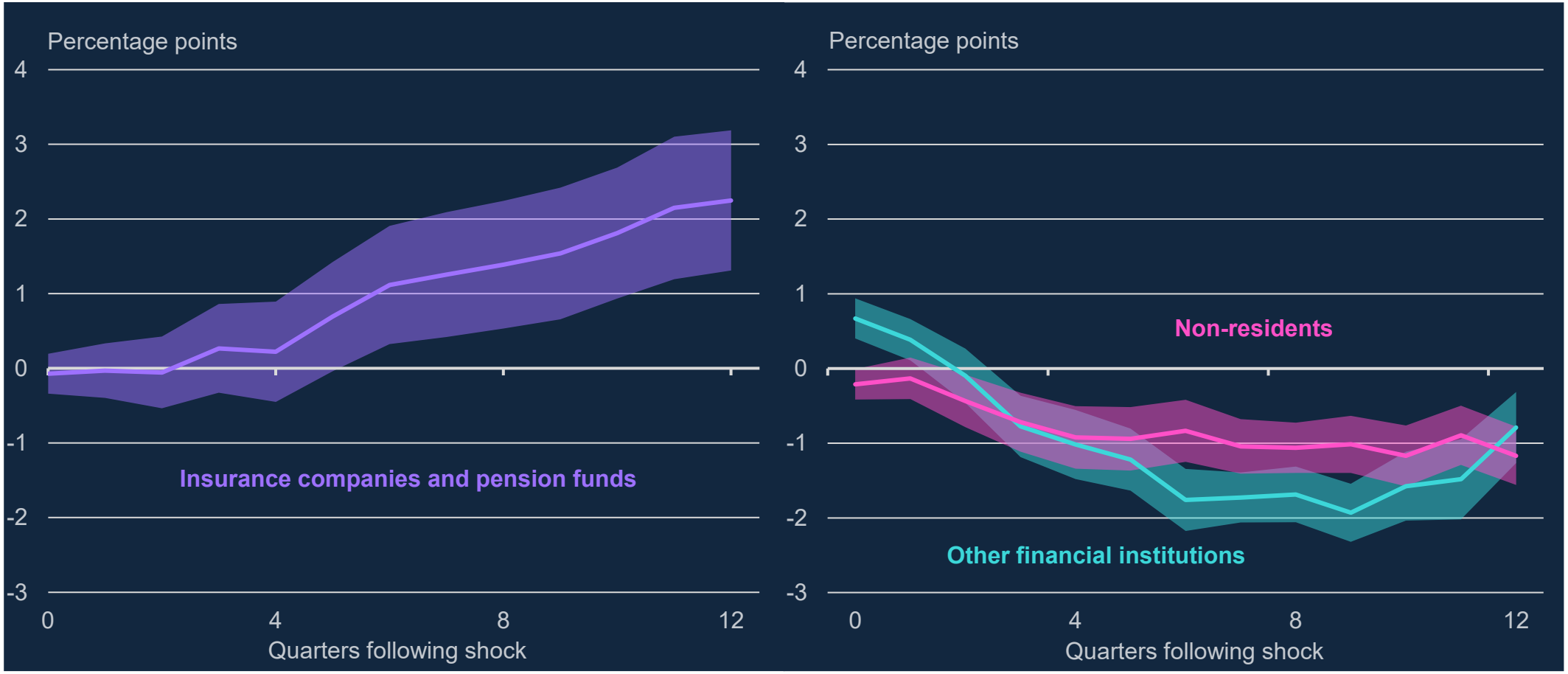
Marginal investor response to additional debt (LHS) and price elasticity of demand (RHS)



Source: **Mann (2026)** using **Norges Bank Investment Management (2024)** and Bank calculations.
Notes: Marginal responses to increases in government debt (left chart) capture country-specific absorption of new debt by different investor types. Price elasticities of demand (right chart) capture investor-specific price sensitivity and are assumed to be common across countries. Aqua diamonds in the right chart denote demand elasticities by investor type. Shaded bars denote 95% confidence intervals.

Following a global risk shock, non-residents and OFIs reduced gilt holdings, while ICPFs (now less important) had increased theirs

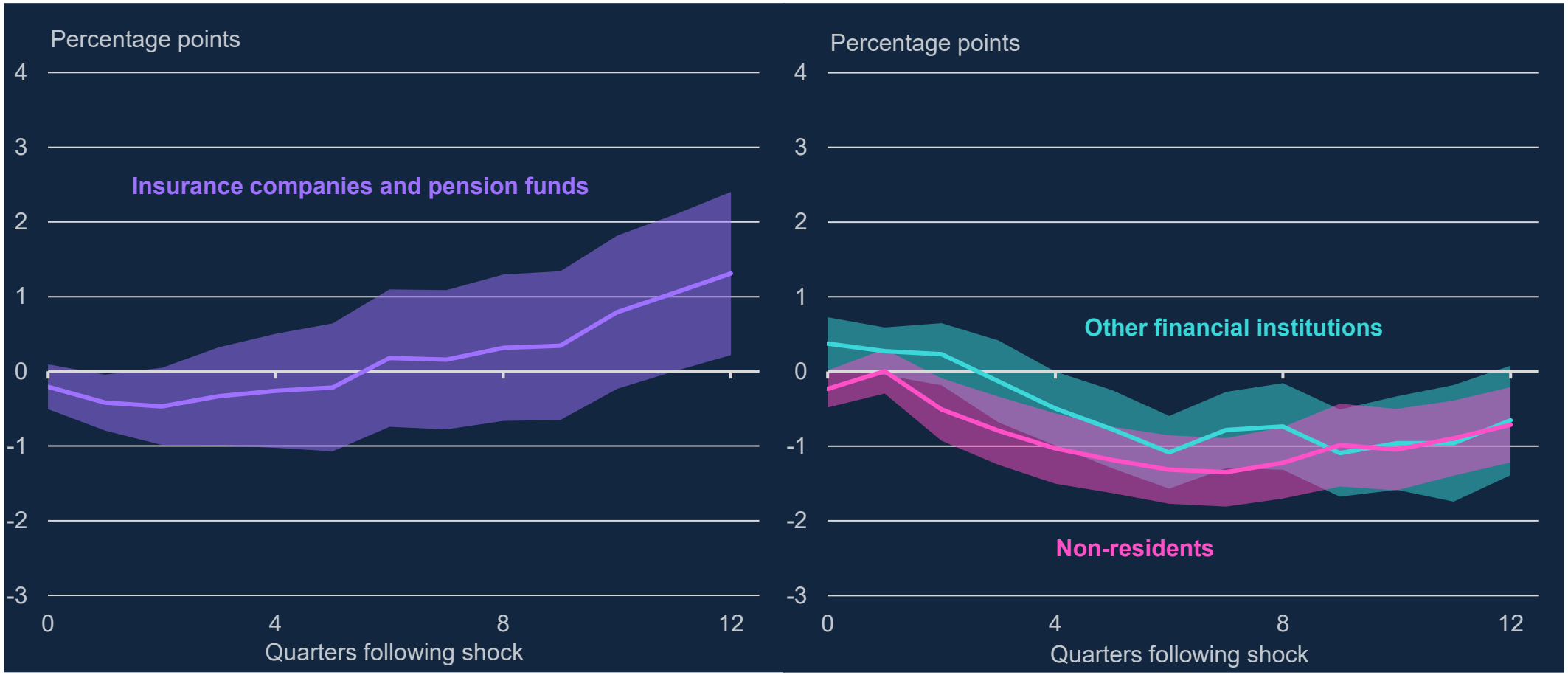
Responses of share of gilts held by less (LHS) and more elastic (RHS) investors to a global risk shock



Source: **Mann (2026)** using ONS and Bank calculations.
Notes: Impulse response functions are derived from a local projection model estimated over the period 1997-2025. Shaded areas denote 68% confidence intervals using Newey-West standard errors. The impulse response functions are scaled to reflect a 5% depreciation in pound sterling relative to the US dollar on impact. The global and UK risk shocks are identified using a structural decomposition as in **Mann (2023)**.

Following a UK-specific risk shock, OFIs and non-residents reduced gilt holdings, with no significant change for ICPFs

Responses of share of gilts held by less (LHS) and more elastic (RHS) investors to a UK risk shock



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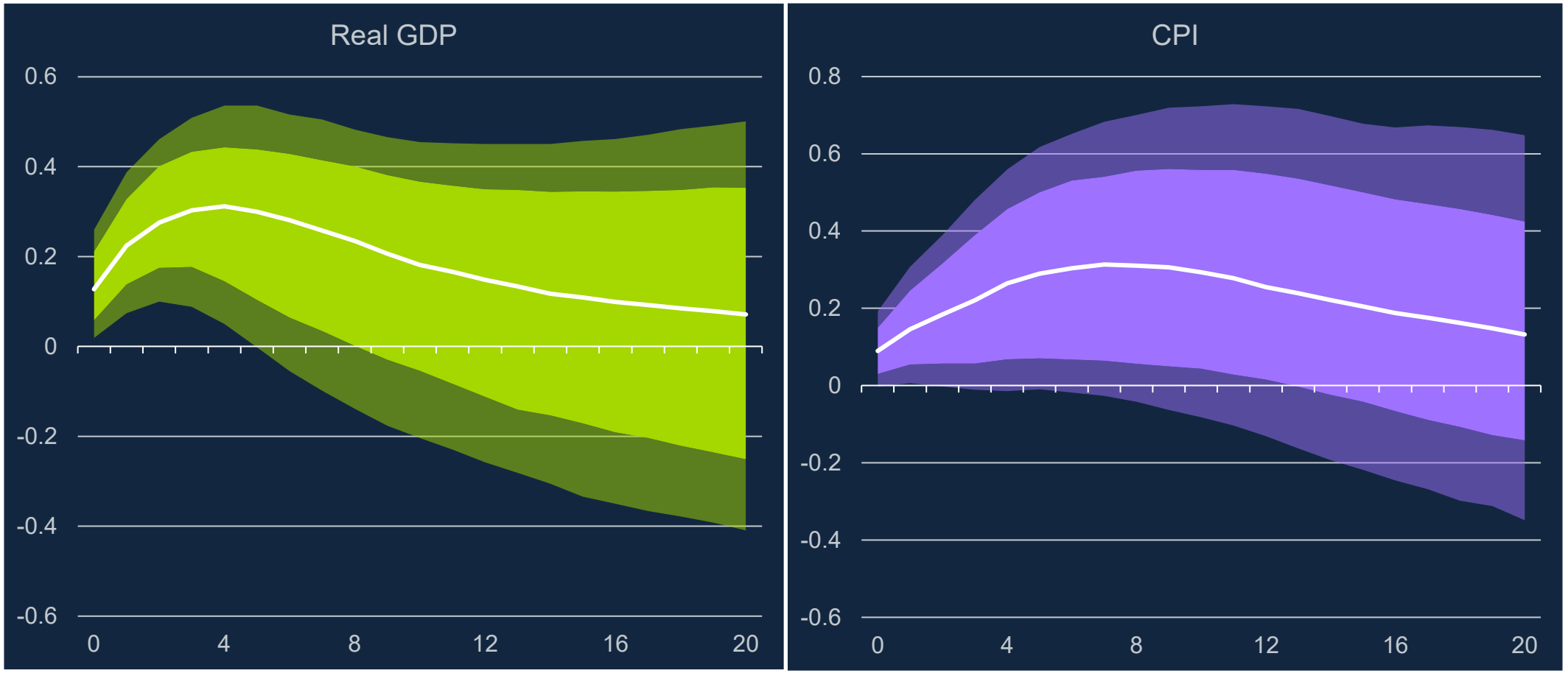
Global financial intermediation shocks are important external drivers of UK macroeconomic conditions

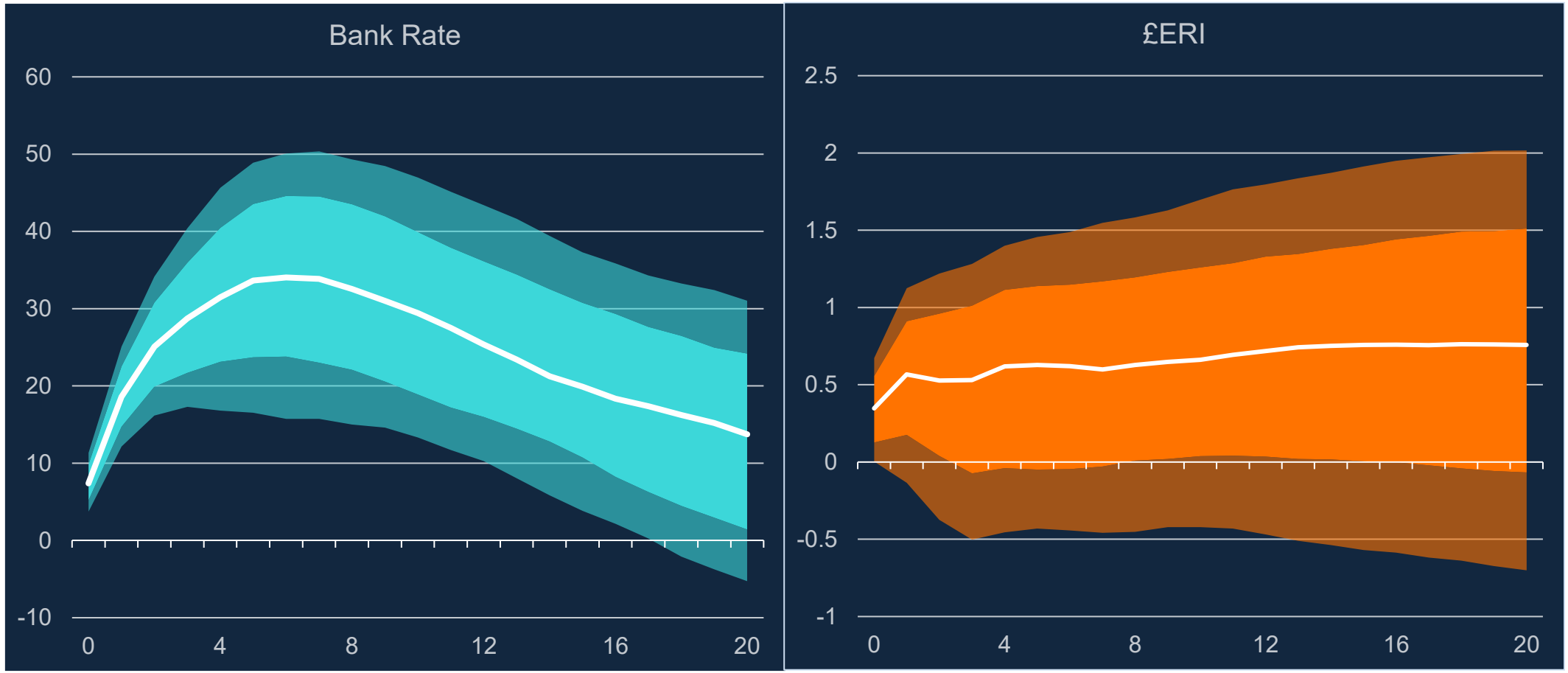
Responses of **real GDP** and **CPI** to a positive global financial shock



Source: Anesti, N., Cesa-Bianchi, A., Esady, V., Hjortsoe, I. and Hong, S. (Forthcoming). 'Global-to-UK SVAR', Bank of England Macro Technical Paper.

Therefore, global financial intermediation shocks are important external drivers of UK policy and financial conditions

Responses of **Bank Rate** and **£ERI** to a positive global financial shock



Source: Anesti, N., Cesa-Bianchi, A., Esady, V., Hjortsoe, I. and Hong, S. (Forthcoming). 'Global-to-UK SVAR', Bank of England Macro Technical Paper.

Possible monetary policy implications from current research – more needed!

- **Weakening transmission of monetary policy**: should economic agents move money from bank deposits into (unremunerated) stablecoins.

- **Increased exposure to USD**: higher exposure to dominant currency ($) through stablecoins makes economies more exposed to spillovers from global financial conditions, US monetary policy, and shifts in investor confidence, all with implications for currency mismatch and external balance.

- **Potential for higher volatility:** stablecoins could transmit volatility to UK financial conditions via wholesale bank funding and to gilt markets via responsiveness to regulatory news, and high trading volumes associated with short-term arbitrage strategies across platforms, collateral backing, and investor types.