Everybody Hates *The Dollar*

But there's no alternative. The solution is to stabilize the dollar-renminbi relationship.

By Ronald McKinnon

The United States emerged from World War II as the only major industrial country with an intact and highly developed domestic financial system without exchange controls. Foreigners were free (if they could escape their own currency restrictions) to take positions in dollars: to hold dollar bank accounts or buy and sell U.S. Treasury bonds, and so on. The dollar then quickly became generally accepted as "international money." With the advantage of economies of scale from having just one key currency, the dollar remains so in 2014—even though other industrial economies have now opened their financial systems.

Since 1945, the dollar standard has played a dual role in the world economy—for facilitating private international commerce, and for domestic macroeconomic control by governments. These two roles are natural complements in such a key currency regime.

First, the dollar facilitates international trade by providing a common invoice currency for exports of primary commodities worldwide, and even for the manufactured exports of developing countries such as China. Outside Europe, the dollar both spot and forward is the vehicle currency used by banks to greatly reduce the private costs of making foreign exchange payments multilaterally.

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The dollar standard has played a dual role in the world economy.

Second, insofar as foreign governments have pegged their exchange rates to the dollar as has China, the dollar acts as a nominal anchor for their price levels—sometimes in the context of major domestic financial stabilizations.

For more than twenty-five years after World War II, U.S. government policy ensured that both the first and second roles held. The stable U.S. price level anchored price levels in the Western European and Japanese economies whose dollar exchange rates were more or less fixed. In recovering from the war, these industrial economies enjoyed very high trade-led growth in their real GDPs—reminiscent of China's growth in recent years. As the world's *de facto* central banker, the U.S. Federal Reserve behaved appropriately. In the 1950s and 1960s, the United States did not run with fiscal or trade deficits: it made substantial net direct investments abroad.

THE WEAK DOLLAR SYNDROME

But starting in the 1970s and continuing to the present day, an unfortunate confluence of economic circumstances began to undermine the second role—the dollar's anchoring role in the world economy. U.S. saving rates, both private and government, began to fall somewhat endogenously. Private saving edged downward, but public saving, in the form of federal fiscal deficits, fell quite sharply on occasion. In the 1980s, President Reagan presided over a large military build-up that was not tax-financed—and which led to the famous "twin" deficits of fiscal and trade. Although there were the usual dire warnings that such fiscal deficits would harm the economy, U.S. interest rates actually fell in the course of the Reagan "boom" in the late 1980s.

While generally unrecognized by politicians and most economists, it was (and is) the United States' central position within the world dollar standard that allowed it to borrow very cheaply by selling U.S. Treasury bonds and other financial assets to foreigners—mainly central banks in West Germany and Japan in the 1980s. Having learned a false lesson that deficits did not matter, this has emboldened American politicians—Keynesians to be more Keynesian in targeting unemployment with massive fiscal deficits during the 2008 downturn and disappointingly slow recovery, and supply-siders (sometimes called the Club for Growth) to become ever more reckless in their demands to cut taxes, or to refuse tax reforms to raise more revenue, or to provide tax revenues for needed public goods such as highways.

Since 2000, emerging markets have been the big buyers of U.S. Treasuries and other dollar assets—with China alone having official foreign exchange reserves of more than US$4 trillion, which is about half the emerging market total. But so what? What harm comes from America's soft international borrowing constraint that reduces domestic saving and creates more or less permanent fiscal and trade deficits?

First, the trade deficit itself. America's main international creditors—mainly West Germany and Japan in the 1980s, but now more China and other industrialized Asian emerging markets—are major exporters of manufactures. Thus, the real counterpart of their purchases of U.S. financial assets is to run trade surpluses in manufactures with the United States. Indeed, in recent decades, virtually the whole of the U.S. current account deficit (equal to America's saving deficiency) is equal to the U.S. trade deficit in manufactures.

If Democrats or Republicans wanted to ameliorate industrial decline, they should take steps to increase America's saving rate by reducing or eliminating the fiscal deficit—and thus curtail the trade deficit. Instead, they labor under the false doctrine: the exchange-rate *cum* trade-balance fallacy. They accuse foreigners of

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Ronald McKinnon, 1935–2014

We will greatly miss the wisdom of Stanford University economist and *TIE* contributor Ronald McKinnon. In his many articles for *TIE,* McKinnon addressed topics of tremendous importance to the financial system, especially the dollar's role in the global currency system. The manuscript published here was sent to *TIE*'s inbox by McKinnon shortly before his death. An intellectual giant in his field, both he and his contributions will not be forgotten.

—*TIE*

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unfairly manipulating their exchange rates to keep them undervalued, and one result is the excessive use of anti-dumping duties against many different kinds of manufactured imports. But the major cost of this false doctrine is to distract political attention away from the fiscal deficit. And in his most recent budget, President Obama projects large federal fiscal deficits as far as the eye can see, through 2015 and beyond.

Second, this exchange-rate *cum* trade-balance fallacy undermines the dollar standard's natural stabilizing role in world economy: providing a nominal anchor for other countries, most of which for good reasons would prefer to operate with stable dollar exchange rates. Without an exchange rate policy of its own, since 1970 the U.S. government has continually tried to weaken the value of the dollar against other major currencies.

This weak dollar syndrome was first manifest in the Nixon "shock" of August 1971 where he forced the other industrial countries to appreciate their currencies. It was followed by further "bashing" of Japan in the late 1970s to mid-1990s to appreciate the yen, and followed by China bashing in the new millennium to appreciate the renminbi. Since 2002, the dollar has also been weakened by the Fed setting interest rates too low (now near zero) which induces volatile hot money outflows that force at least some emerging markets to appreciate—and induces other more mature industrial countries to keep their interest rates similarly too low to avoid appreciating.

REFORMING THE UNLOVED DOLLAR STANDARD

Despite this rather sorry tale of the loss of worldwide macro stability because of the erosion of the dollar's anchoring role as described above, its remarkably resilient facilitating role for money changing under the first role remains in place. As of 2014, the dollar still remains the most commonly used currency for invoicing exports, as a vehicle currency for interbank foreign exchange transacting, and as a reserve currency for governments.

Even so, nobody loves the international dollar standard. Foreigners are distressed by macroeconomic shocks emanating from the United States, and the "exorbitant privilege" of America having an indefinitely long line of cheap dollar credit from the rest of the world. Americans, laboring under the exchange-rate *cum* trade-balance fallacy and their large trade deficit, complain that foreign governments manipulate their dollar exchange rates unfairly to secure a mercantile advantage—while the rules of the dollar standard game leave the United States with no direct exchange rate policy of its own.

If Democrats or Republicans wanted to ameliorate industrial decline, they should take steps to increase America's saving rate by reducing or eliminating the fiscal deficit—and thus curtail the trade deficit.

So we have a great paradox. Although nobody professes to love the dollar standard, the revealed preference of both governments and private participants in the foreign exchange markets since 1945 has been to continue to use it. As the principal monetary mechanism ensuring that international trade remains robustly multilateral rather than narrowly bilateral, it is a remarkable survivor that is too valuable to lose and too difficult to replace.

There are great economies of scale of having just one international money. But many, many suggestions have been made for replacing the dollar with something else—a commodity reserve currency in the 1950s, the IMF's Special Drawing Rights in the early 1970s, an internationalized yen in the Japanese bubble phase of the 1980s, the euro in its good phase in the early 2000s, and

False Lesson

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—R. McKinnon

now an internationalized renminbi from China's trade ascendancy. I won't rehearse the pros and cons of each one here, nor propose a new one.

Realistically, the remarkable resilience of the dollar standard leads me to conclude that "international" monetary reform really should be directed to improving the monetary and exchange rate policies of the United States—with China becoming a more equal partner, and the IMF continuing to provide important legal cover.

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The most important aspects of any such reform are conceptual:

- To rid Americans of their weak-dollar syndrome by exposing the exchange-rate *cum* trade-balance fallacy in textbooks and in the financial press, and
- To get U.S. politicians to see the link between ongoing fiscal deficits leading to trade deficits and the excess imports of manufactures that so upset their constituents.

If American politicians could be persuaded to eliminate the current U.S. fiscal and thus trade deficit, or even move them into surplus, a reshuffling of the capital account of the U.S. balance of payments would ensure the sufficient provision of international liquidity. As the current account deficit was phased out, U.S. longer-term capital outflows such as foreign direct investment would increase, possibly quite sharply, while foreigners could continue to build up their liquid dollar claims unimpeded. As the United States moved away from being a net borrower in world financial markets, more international capital could flow into poorer countries—albeit only those that are credit-worthy. And U.S. protectionists would have a tougher time making arguments for tariff or quota restrictions on the reduced flow of imports.

CHINA TO THE RESCUE?

But this hypothetical reshuffling of U.S. international payments is best done in the context of mutual adjustment with America's largest creditor, China. Just as the 1944 Bretton Woods Agreement was negotiated between just two countries, the key to successful rehabilitation of today's dollar standard is a *modus vivendi* between China and the United States.

China's enormous trade-led growth since 1980, secured by its membership in the World Trade Organization in 2001, and macroeconomic stability since 1994 when its dollar exchange rate was fixed, has thrived under the dollar standard. The vast expansion of China's dollar-based trade has made it, albeit inadvertently, a pillar of the dollar standard. China would have a lot to lose if the dollar standard were to collapse or become seriously damaged. So what is a short laundry list of issues over which the two countries might negotiate?

The first issue is the end of American China bashing to appreciate the renminbi, which has been a consequence of the influence on Americans of the exchange-rate *cum* trade-balance fallacy.

For the second, the United States would agree to phase out its fiscal deficits in return for China phasing in higher domestic consumption. Each country can decide on its own mix of tax and expenditure measures for achieving these ends. If both governments move simultaneously, this will maintain aggregate demand in the world economy, and make is easier to keep the yuan/dollar rate stable.

For the third, the Fed should agree to begin raising U.S. interest rates to more normal levels to relieve the pressure of hot money inflows into China and other emerging markets. China would then agree to start phasing out its capital controls as a step toward "internationalizing" the renminbi and opening up its capital markets.

And last, mutual goodwill coming out of these negotiations then could spread to other areas such as flawed U.S. antidumping laws and Chinese regulatory pursuit of highly competitive foreign firms for "antitrust" and other questionable violations of Chinese laws.

Nobody loves the international dollar standard.

Although cloaked in the garb of an international agreement, these measures could well increase domestic economic efficiency in each country. A relevant historical example is China joining the WTO in 2001. At the time, one motivation of Premier Zhu Rongji was that the bylaws of the WTO would help prevent protectionism from hampering China's own interprovincial trade.

INTERNATIONALIZING THE RMB

Paradoxically, having China and the United States agree on reforms to strengthen the dollar standard could remove an important constraint on the greater use of the renminbi in China's own huge international trade and capital flows.

The present U.S. policy of keeping interest rates on short-term dollar assets near zero, and undue downward pressure on long-term interest rates through quantitative easing, makes it next to impossible for China (and other emerging markets) to properly liberalize its own internal financial system. With ultra low U.S. interest rates, there is undue pressure for "hot" money to flow into China, necessitating exchange controls on inflows of financial capital. (Otherwise, Chinese interest rates would be driven toward zero.) Chinese exporters are inhibited from invoicing in renminbi because potential foreign importers could not hedge their exchange risk by buying renminbi forward.

In addition, the exchange controls on hot money inflows are inevitably somewhat porous. To stabilize the yuan/dollar rate, the People's Bank of China is continually forced to enter the foreign exchange markets to buy dollars with renminbi. The excess renminbi liquidity must then be sterilized by keeping high reserve requirements on Chinese commercial banks—thus decreasing their efficiency as international financial intermediaries.

This hot money inflow is further aggravated by continual American China-bashing to appreciate the renminbi—and China has on average appreciated the renminbi by 3 percent or so per year since July 2005. So this expectation (including the possibility of a large appreciation of renminbi) inhibits foreigners from borrowing in renminbi to cover China's large trade surplus. Potential foreign borrowers won't take out renminbi-denominated bank loans, nor issue longer-term renminbi-denominated bonds in Shanghai, because they worry that the renminbi will appreciate in the future.

Thus, despite China being a huge international creditor country with a large saving surplus, its currency is surprisingly little used in financing the resulting current account surplus or in invoicing its exports. It remains an "immature" international creditor. Because of the need for exchange controls and limits on deposit rates of interest in its domestic banking system, the Chinese government cannot "internationalize" the renminbi by liberalizing its domestic financial markets and opening them up to foreign transactors.

Instead, the People's Bank of China is trapped financially into acting as the country's principal international financial intermediary by building up dollar claims on foreigners; currently the State Administration for Foreign Exchange holds more than $4 trillion. But within the trap, life has been satisfactory with high rates of growth in China's real GDP. With the current distortions in international financial markets, full financial liberalization in China would be a mistake.

However fanciful, suppose the two countries negotiate an "ideal" Sino-American pact as suggested above. No more China-bashing on the exchange rate, U.S. interest rates rise to more normal levels, and U.S. fiscal deficits are curbed as consumption in China increases. Then China could open its financial markets so as to become a "mature" international creditor with private (nonstate) agents building up renminbi claims on foreigners—and with exporters naturally invoicing more sophisticated manufactures in renminbi without the government giving them any special inducements to do so.

But even here, the nature of the reformed dollar standard pretty well confines the natural ambit of renminbi internationalization to China's own enormous foreign trade. Because of the convenience of having just one truly international money, the dollar would continue to be the intermediary currency for money changing in the Americas, Africa, and most other Asian countries.

What are the implications for the rest of the world? Much of the spirit of the 1944 Bretton Woods agreement was to try to curb the beggar-thy-neighbor exchange rate changes and hot money flows that so disrupted the world economy in the 1930s. A return to worldwide exchange stability anchored by a credibly stable yuan/dollar rate, to which other countries—particularly in Asia—attach themselves voluntarily, would reflect that spirit. ◆

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