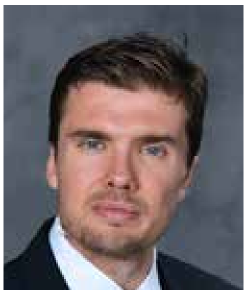
The Political Economy of International Money: Common Currencies, Currency Wars and Exorbitant Privilege

By J. Scott Davis



and Mark A. Wynne

2014 Conference Summary

When: April 3–4

Where: Southern Methodist University Dallas, Texas

Sponsors: Owens Foundation and the Federal Reserve Bank of Dallas' Globalization and Monetary Policy Institute

The Political Economy of International Money: Common Currencies, Currency Wars and Exorbitant Privilege" conference was held at the John Goodwin Tower Center at Southern Methodist University on April 3–4. It was sponsored by the Owens Foundation and the Federal Reserve Bank of Dallas' Globalization and Monetary Policy Institute.

Kathleen Cooper of the Tower Center, SMU economics professor Thomas Osang, and Mark A. Wynne and Jian Wang of the Dallas Fed organized the conference, the third such gathering in which the Dallas Fed participated along with the Tower Center and the Owens Foundation. The first two, in 2010 and 2012, were immigration related.[1]

The importance of international economic forces has increased significantly over the past three decades with the opening of China, the collapse of the Soviet bloc and liberalization of the Indian economy. The net effect of these developments has been to add about 3 billion consumers and producers to the global economy.

The extraordinary growth rates that some emerging-market economies have realized over the period meant that in 2007, for the first time, more economic activity occurred in emerging-market and developing economies than in the advanced economies, according to International Monetary Fund (IMF) estimates (*Chart 1*).[2]

The center of gravity of global economic activity is shifting inexorably from the North Atlantic to East Asia. By some estimates, China's economy is already as big as that of the United States.

The term "globalization" has been used to describe these changes. While some have tended to dismiss the expression as faddish, it remains useful shorthand. Of course globalization is not new. Students of history are familiar with the first era of globalization, prior to World War I. Then, international monetary relations were governed by the widespread adherence to a commodity standard, and central banks played a role very different from what they do today. But goods, capital and people flowed across national borders as easily as now.

This year's conference examined a very different aspect of globalization. When planning for it began, the euro crisis was headline news. Financial globalization has remade the world in ways that few could have anticipated when the first steps were taken toward liberalizing capital flows four decades ago. It is fair to say that in the absence of international capital flows, the housing boom in the United States would have ended sooner and probably with less dire consequences than those the nation has confronted since 2008.

Likewise, it seems reasonable that housing booms in Ireland and Spain would have been less dramatic absent the cross-border lending facilitated by a common currency. The policy response to the financial crisis had an important international dimension that was unprecedented—from coordinated interest rate cuts in October 2008 to the creation of international currency swap lines that have since become semipermanent.

Advanced economies' highly accommodative actions led to claims that the Fed and other central banks were engaging in a currency war against emerging markets. When talk began in 2013 of tapering Fed asset purchases under quantitative easing, the central bank was again criticized for pursuing policies perceived as adversely affecting other countries. Thus, an examination of the economic and political economy dimensions of financial globalization seemed timely, and the conference brought together top scholars.

Improving Policy Coordination

Jeffry Frieden, a professor of government at

Harvard University, addressed international cooperation in economic policy in his keynote remarks, characterizing proposals to improve the exchange of ideas as ranging from cynical to utopian. The recent financial crisis elicited an unprecedented degree of cooperation between the world's leading central banks, though even more frequent cooperation was probably needed. Frieden said he believes that from a political economy standpoint, greater policy coordination is likely in the future.

The challenges posed by international capital flows, especially the procyclical nature of such flows, are particularly relevant, he said. Previously, only emerging-market economies confronted this problem, but over the past 15 years advanced economies have also faced it. Such flows create an externality warranting a policy response, he said, with the case for action resembling macroprudential regulation of the banking system. Just as individual banks don't have an incentive to take into account how their lending activities impact the national financial system, national regulators don't have an incentive to gauge the impact of their actions on the international financial system. For this reason there is benefit to policy coordination to monitor and possibly restrict international capital flows. While nations are reluctant to surrender sovereignty, delegation of responsibility over some matters, if managed correctly, may be possible. The European Union provides an example in this regard.

Ronald McKinnon, an international economics professor at Stanford University, gave the second keynote address. McKinnon, now deceased, was one of the fathers of the theory of optimum currency areas, an idea that when it was proposed seemed far-fetched and of theoretical interest at best.[3] From the 1960s through the 1990s, few envisioned sovereign nations agreeing to share a common currency. In 1999, the euro became a reality.

Some of the currency's recent problems were anticipated by the contributors to the theory of optimum currency areas; others, such as the need for a banking union, were not. McKinnon wrote on many other issues as well, perhaps most prolifically in recent years on the global dollar standard, which he characterized in a 2013 book as "unloved."[4] Three decades ago, he called for harmonizing monetary policies among the world's leading central banks. He suggested fixing the trend rate of growth of each country's monetary base to provide greater international monetary system stability.[5] And he was an early proponent of taking a global rather than a domestic perspective on monetary developments to better ensure price stability.[6] Many of the issues with which McKinnon wrestled during his career remain.

In his remarks, titled "The Unloved World Dollar Standard: Greenspan-Bernanke Bubbles in the Global Economy," McKinnon noted that the world has long operated on a dollar standard, with Federal Reserve monetary policy creating a first-order impact on global financial stability. Reiterating an observation he first made decades ago, McKinnon said that except at times of international financial crises, the Fed tends to be inward looking, focusing on domestic economic developments and ignoring potential international collateral damage from its monetary policies. In McKinnon's view, this makes the U.S. economy less stable. Since fall 2008, ultra-low interest rates on dollar assets have propelled waves of money into emerging markets by investors engaging in carry trades, which exploit differences in borrowing costs between nations. These investments have generated bubbles in international primary commodity prices and other assets. Quite apart from the detrimental effects that ultra-low interest rates in the

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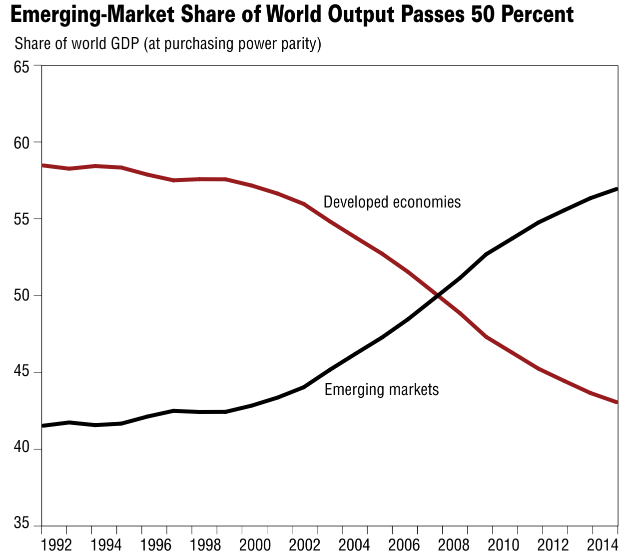
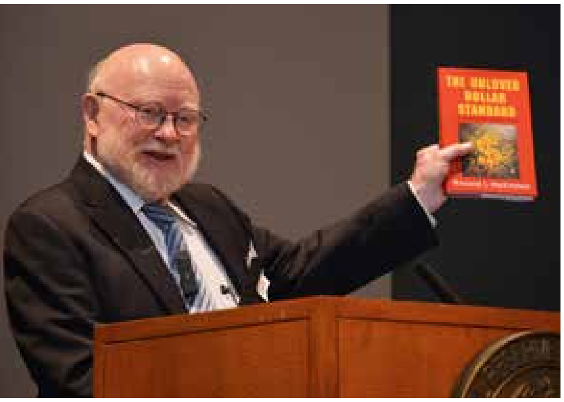
Chart 1

Emerging-Market Share of World Output Passes 50 Percent



SOURCE: International Monetary Fund.



Professor Ronald McKinnon of Stanford University

U.S. have on the rest of the world, near-zero interest rates also hold back investment in the American economy.[7]

Many of the issues that McKinnon raised in his opening remarks are addressed at greater length in his book, *The Unloved Dollar Standard: From Bretton Woods to the Rise of China*. Following his presentation, audience members questioned some elements of his thesis, such as how low interest rates might simultaneously boost commodity prices and not stimulate demand in advanced economies, or how a policy of low short-term interest rates detracted from the ability of banks to lend profitably.

Volatility of Flows

Globalization is about international capital flows first and foremost, and the first panel addressed this issue from several different angles. The scale of U.S. capital outflows has exploded in the past few decades. The volatility of these capital flows during the recent financial crisis was unprecedented (*Chart 2*).

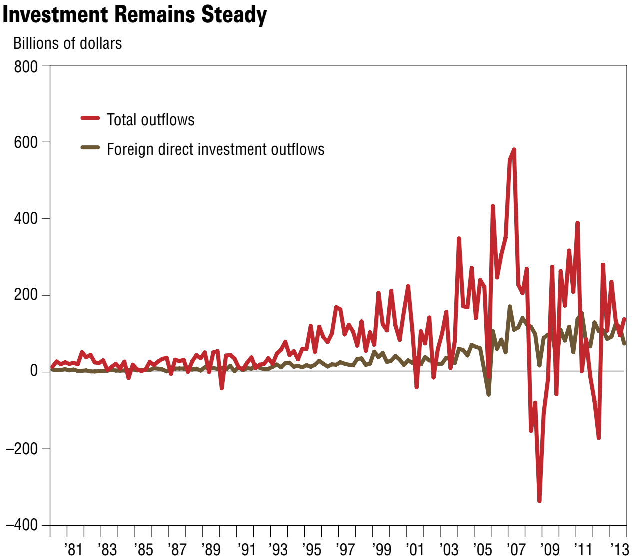
The first panelist, Carol Bertaut, the chief of the Global Financial Flows Section of the Federal Reserve System Board of Governors, built on issues McKinnon raised in his address, specifically the character and determinants of "hot money" flows into emerging markets. As indicated in Chart 2, while U.S. long-term foreign direct investment outflows are fairly steady, the volatility in capital outflows in the past few years has been due to fluctuations in short-term, hot money flows. Bertaut sought to determine whether a "reach for yield" or possibly some other motivation drove these flows. She found that most U.S. investment in foreign bonds is in high-quality assets. While the share of U.S. investment into riskier emerging-market bonds rose in recent years, its 15 percent share of the total U.S. foreign bond portfolio remains small. A "search for safety," not the "reach for yield," remains the main driving factor behind U.S. investment in foreign bonds, Bertaut said, citing evidence that the trend is mainly driven by investment into high-grade financial corporate bonds. There is limited evidence that the reach for yield has driven U.S. investment in foreign government bonds since the global financial crisis in 2008.

Michael Klein, a professor of international economic affairs at Tufts University, opened his presentation with two quotes from John Maynard Keynes. The first was an oft-repeated excerpt from *The Economic Consequences of the Peace*, highlighting just how easy it was for an investor in pre-WWI London to "adventure his wealth in the natural resources and new enterprises of any quarter of the world, and share, without exertion or even trouble, in their prospective fruits and advantages." The second was a less-well-known quote from Keynes' inaugural Finlay Lecture at University College Dublin in 1933: "I sympathize … with those who would minimize rather than those who would maximize economic entanglements among nations. … Let goods be home-spun whenever it is reasonable and conveniently possible and, above all, let finance be national."[8]

Klein used the quotes to open a discussion of how conventional wisdom regarding the desirability of controls on international capital flows has shifted, especially following the global financial crisis. Klein drew a distinction between controls that he characterized as "gates" (designed to regulate flows) and those he viewed as "walls" (designed to prevent flows). Too often, discussion of the desirability of gate-like controls was confused by likening them to wall-like controls, Klein said.

Gates have their problems (they may not shut

Chart 2
U.S. Capital Outflows Exhibit Volatility, U.S. Foreign Direct Investment Remains Steady



SOURCE: International Monetary Fund.

tightly, they may shut too late and they may have rusty hinges), but they may sometimes be employed usefully to support monetary autonomy and for macroprudential purposes. However, data on the experiences of Brazil and Korea, with gate-like controls in recent years, seem to suggest that they were of limited effectiveness unless broad based, he said.[9]

The third panelist, Frank Warnock, professor of business administration at the University of Virginia's Darden School (and also a senior fellow at the Globalization and Monetary Policy Institute), argued for more careful language when discussing capital flows, noting that they come in many forms and can be due to portfolio reallocation and portfolio growth.

Even after controlling for portfolio growth, it is important to distinguish between active and passive reallocation due to exchange rate changes, for example. These distinctions are important when assessing whether U.S. investors are underweight in foreign securities. U.S. investors appear to be becoming more underweight in emerging markets, investing less in these markets than simple benchmark models would suggest, Warnock said.

Discussions of global capital flows, especially over the past decade and a half, are often conditioned by what former Fed Chairman Ben Bernanke characterized as a global saving glut.[10] In the discussion that followed the session, audience members asked whether the real problem associated with international capital flows prior to the crisis was a global banking glut as opposed to a global saving glut, as South Korean financial economist Hyun Shin has argued.[11]

Shared Monetary Challenges

In the euro area, the sharing of the common currency amplifies the challenges international capital flows cause. Rutgers University economics professor Michael Bordo, a senior fellow of the Globalization and Monetary Policy Institute, opened the second panel on common currencies, asking whether the euro will survive.

He cited work with Lars Jonung that showed national monetary unions tend to work better than international unions. The euro crisis exposed flaws in the design of the single currency, he said. Moreover, the crisis response has been troubled. Bordo argued that the IMF and other members of the so-called troika—the IMF, the European Central Bank (ECB) and the European Commission—would have done better by allowing Greece to default rather than restructuring its sovereign debt. In its crisis response, the ECB engaged in fiscal policy and exposed itself to credit risk. The euro's prospects for a crisis-free future are limited, though it will likely survive as long as there is political will, Bordo said.

The architects of European Economic and Monetary Union were aware of the difficulties that arise when a diverse group of countries share a common currency. To that end, they installed an institutional framework, the Maastricht Treaty. What few seemed to appreciate prior to the launch of the single currency in 1999 was the need for a banking regulatory union to accompany monetary union. The absence of such oversight was key to crises in Ireland and Spain. (The crisis in Greece was due to a failure to follow Maastricht Treaty guidelines.)

Hubert Kempf, an economics professor at ENS Cachan in Paris, examined the progress toward building a banking union in the euro area. Only a partial banking union, covering the single market and the TARGET2 payments system, exists, he said. Other aspects of a full union—a single set of regulations, bank supervisor, resolution mechanism and deposit insurance protection—are missing. While there has been progress, problems remain related to risk sharing and ceding of national sovereignty.

David Malpass, president of Encima Global, a New York economic research and consulting firm, examined changes in balance sheets of the Federal Reserve and the ECB as a result of their responses to the financial crises. Despite Fed balance sheet growth, the U.S. central bank faces less risk than the ECB. At the time of the conference, the ECB had not engaged in a quantitative easing (QE) program comparable to what the Fed began in 2008. A challenge to ECB efforts could be European asset-backed (mortgage) securities, which differ greatly from such debt in the U.S. In Europe, almost all mortgages are floating rate rather than fixed rate. Further, if a QE type program is to succeed in the euro area, it must work through the banking system rather than through portfolio rebalancing, as in the U.S.

In the subsequent question-and-answer session, audience members asked about renationalization of the euro-area banking system postcrisis.

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Banks that were active in cross-border lending before the crisis seem to have retreated to their home markets. This might weaken the case for a robust euro-area banking union. Others inquired about the new fiscal compact designed to provide a more rigorous framework for responsible management of public finances in the euro area, and whether it can be viewed as a meaningful step toward fiscal union.

Still others questioned whether the fiscal compact will prove any more binding than the Stability and Growth Pact that it replaces. One presenter noted that real progress toward the creation of a fiscal union will necessitate the creation of a transfer union and the issuance of a euro bond, neither of which seem likely imminently.

Jeffrey Frankel, professor of capital formation and growth at Harvard University's Kennedy School, presented the third and final keynote speech. Frankel's presentation ranged over a variety of issues that arose during conference discussions. Frankel, responding to McKinnon's argument that U.S. monetary policy lies at the heart of the global dollar standard, said that targeting nominal gross domestic product would be superior to the current practice of a formal inflation target (or numerical price objective) and informal employment target. In the international arena, he argued that providing emerging market economies a greater say in the management of the global economy is long overdue.

The creation of the Group of 20 (as an alternative to the G7) is an important step, but others are needed, for example, altering the distribution of votes in international institutions such as the IMF, Frankel said. He also proposed an unorthodox solution to problems facing the Fed and the ECB. The Fed is holding large quantities of U.S. Treasuries that it will need to dispose of at some point, while the ECB needs to boost activity in the euro area, or at a minimum prevent an entrenched Japan-style deflation. An ECB purchase of the Treasuries could remedy both problems, Frankel said. This would allow the Fed to dispose of its holdings of Treasuries while allowing the ECB to add liquidity without violating the Maastricht Treaty prohibition of monetary financing.

Assessing Currency Wars

The final session of the conference was devoted to a discussion of currency wars. Brad Setser, deputy assistant secretary for international economic analysis at the U.S. Treasury Department, opened by suggesting that martial language (such as references to currency wars) doesn't aid resolution of these issues. Such talk is probably better suited to the 19th century than to contemporary international relations, Setser said. He noted that significant progress has been made in eliminating international imbalances, though more needs to be done.

China's surplus with the rest of the world and the U.S. has declined by a substantial amount in recent years, due in no small part to appreciation of the renminbi, he said. Additionally, the IMF entered the financial crisis with fewer resources than some emerging-market economies hold in foreign exchange reserves. Even after a recent increase in the resources available to the IMF, it still falls short of what the best-resourced emerging-market economies have at their disposal, Setser said. Finally, Setser addressed the issue of adverse spillovers from U.S. monetary policy to the rest of the world, noting that the world generally benefits from U.S. demand expansion.

Benjamin Cohen, professor of international political economy at the University of California at Santa Barbara, discussed attempts to manage exchange rates between the world's currencies. He argued that the notion of currency wars had its origins in the experiences of countries with floating exchange rates during the 1930s. This shared experience prompted the post-World War II consensus in favor of managed exchange rates. However, such attempts have not proven effective because national governments have been reluctant to cede authority to supranational institutions such as the IMF. Dirty floats are prevalent, and talk of currency wars is not exaggerated, he said.

Conflicts about currency values are ultimately conflicts about trade, and specifically about countries seeking to gain an unfair advantage for their exporters internationally. Lawrence Broz, a political science professor at the University of California at San Diego, examined the interaction between real exchange rate appreciation (that is, exchange rate appreciation correcting for differences in price levels) and calls for trade protection in the United States. Such demands in the U.S. increased significantly in the first half of the 1980s as the real value of the dollar soared (especially against Japan) and again in the 2000s as the value of the renminbi was prevented from gaining against the dollar.

Yet movements in real exchange rates have very different effects at the level of individual industries and sectors. The extent to which exchange rate movements pass through to final goods prices will influence how strongly an industry or sector will lobby for trade protection. Commodity producers with limited pricing power will tend to be more sensitive to exchange rate movement, while companies with extensive global supply chains that import a lot of their inputs will be less sensitive.

Benn Steil, a senior fellow at the Council on Foreign Relations, offered the conference's last formal presentation. He focused on how Fed policy impacts emerging markets, opening with a hypothesis about the impact of tapering on political developments in Ukraine: The Fed's reduction of bond purchases pushed up interest rates and reduced financing available to many emerging-market economies; in Ukraine this lack of foreign funds drove then-President Viktor Yanukovych to seek support from Moscow, igniting protests in late 2013 that sparked the crisis.

Transcripts of Federal Open Market Committee (FOMC) meetings held during 2008 were released in early 2013, and Steil called attention to the discussion of extending U.S. dollar swap lines to emerging-market economies. Not all countries requesting such swap lines received them. Rather, priority was given to those countries perceived as posing systemic risk to the U.S. financial system if forced to liquidate their holdings of dollar-denominated securities to meet liquidity needs. Thus, Fed policy in deciding which countries would receive swap lines directly impacted financial conditions in emerging markets by determining availability of dollar-denominated liquidity.

'Exorbitant Privilege'

The conference ended with a question posed by an audience member echoing the title of the conference: "Is exorbitant privilege intact?" This question effectively summarizes much of what was discussed. Among the conclusions, the dollar's position as the international reserve currency is safe, largely because there are no obvious candidates to take its place, and the euro is beset by serious structural flaws requiring resolution before it can be anything more than a regional currency. The renminbi is not freely traded, and capital control "walls" in China will continue preventing any internationalization of the currency. Increasing financial integration will mean that the U.S. economy becomes ever more entangled with the economies in the rest of the world, and the dollar's position as the world's reserve currency means that U.S. monetary policy and the actions of the Fed will continue affecting economic conditions far beyond U.S. borders.

Conference presenters

Notes

[1] The Owens Foundation was established by the widow of John E. Owens in memory of her husband, a prominent Texas banker. During his lifetime, Mr. Owens was intensely interested in international relations and he sought to establish a foundation that would memorialize this interest. The broad objective of the conferences sponsored by the Owens Foundation is to deepen public understanding of international economic forces in the philosophical context of free trade.

[2] Developed economies refers to the IMF classification of advanced economies and includes the Group of 7 countries: the U.S., the U.K., Japan, France, Italy, Germany and Canada. Emerging markets refers to the IMF classification of emerging markets and developing countries and includes BRICS countries: Brazil, Russia, India, China and South Africa.

[3] See "Optimum Currency Areas," by Ronald I. McKinnon, *American Economic Review*, vol. 53, no. 4, 1963, pp. 717–25.

[4] See *The Unloved Dollar Standard: From Bretton Woods to the Rise of China*, by Ronald I. McKinnon, Oxford, U.K.: Oxford University Press, 2013.

[5] See "Why U.S. Monetary Policy Should Be Internationalized," by Ronald I. McKinnon, in *To Promote Peace: U.S. Foreign Policy in the Mid-1980s*, Dennis Bark, ed., Palo Alto, Calif.: Hoover Press, 1984, pp. 57–68.

[6] See "Currency Substitution and Instability in the World Dollar Standard," by Ronald I. McKinnon, *American Economic Review*, vol. 72, no. 3, 1982, pp. 320–33.

[7] McKinnon argued that ultra-low interest rates in the U.S. encourage large U.S. corporations to turn to financial markets instead of banks for financing. The loss of some of their larger and safer customers makes the balance sheets of many smaller banks riskier, so they may be forced to cut their overall loan portfolio, including reducing lending to many small and medium-sized corporations that cannot turn to financial markets for financing.

[8] See "National Self-Sufficiency," by John Maynard Keynes, *Studies: An Irish Quarterly Review*, vol. 22, no. 86, 1933, pp. 177–93.

[9] See also Klein's VoxEU article "Capital Controls: Gates versus Walls," Jan. 17, 2013, www.voxeu.org/article/capital-controls-gates-versus-walls.

[10] See "The Global Saving Glut and the U.S. Current Account Deficit," speech by Ben Bernanke at the Sandridge Lecture, Virginia Association of Economists, Richmond, Va., March 10, 2005.

[11] See "Global Banking Glut and Loan Risk Premium," by Hyun Song Shin, paper presented at the 12th Jacques Polak Annual Research Conference, International Monetary Fund, Washington, D.C., Nov. 10–11, 2011.