NINETY-FIRST INTERNATIONAL ATLANTIC ECONOMIC EUROPEAN CONFERENCE

Managing the Dollar Over its Cycles

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Punch lines

- The United States has ceded to the rest of the world managing the $ over its cycles.
  - The US has all but withdrawn from the FX market for 20 years.
  - The rest of the world's "systematic managed floating" (Frankel, 2019) features more $-buying over the $'s downswings than in its upswings.
- US policy seeks to name and shame countries that accumulate FX reserves while running sizeable current account surpluses.
- The policy does not succeed, even in its own limited terms.
- Alternative policies:
  - The US could reinstate its withholding tax on interest income received by non-residents and negotiate tax treaties that embody policy criteria.
  - The US could intervene to counter intervention by jurisdictions running chronic surpluses.

$-centric intern'l monetary and financial system as intern'l public good with free riding: status quo

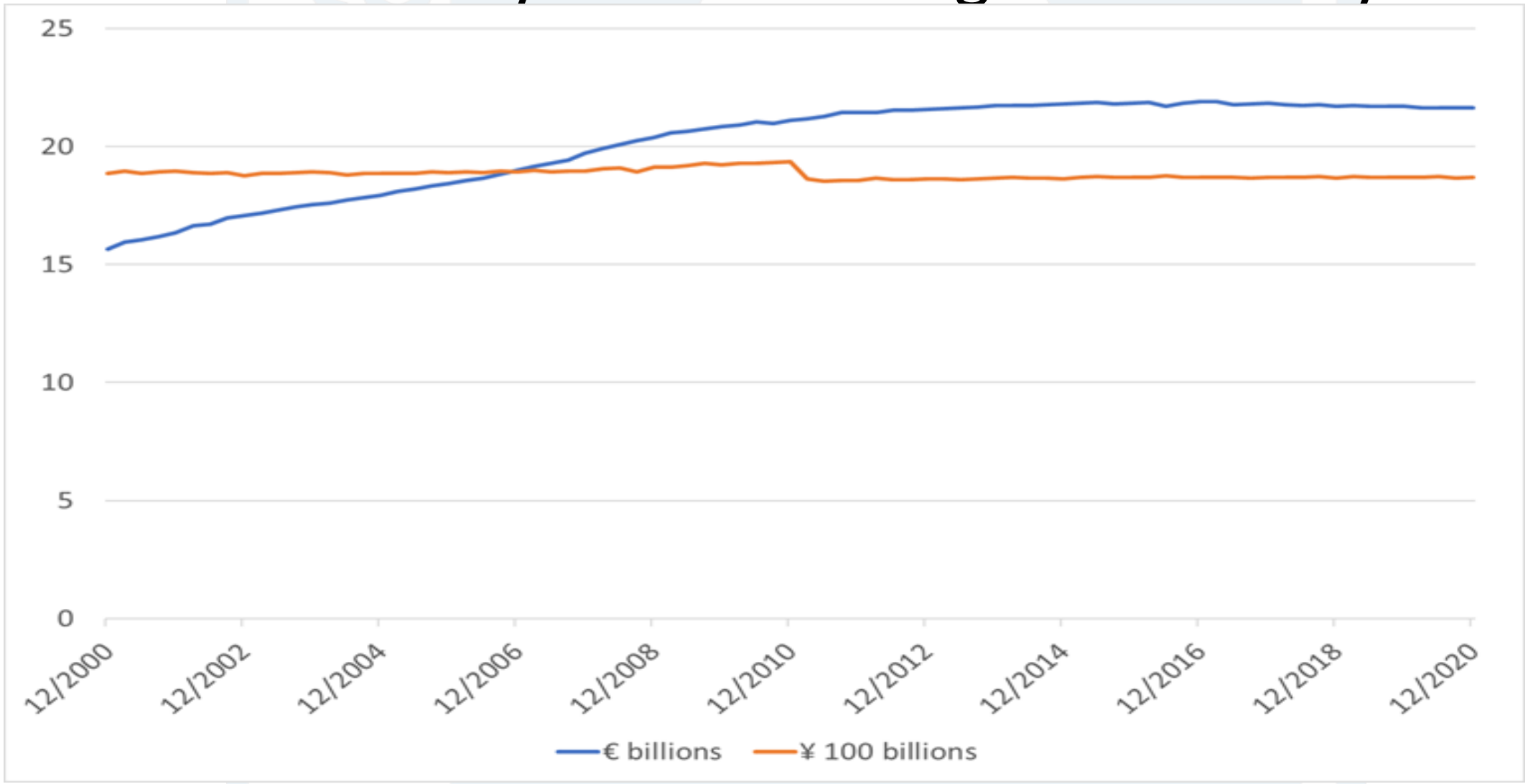
		US intervention	
		No	Yes
Rest of world intervention	No	US notion of optimum	
	Yes	Large intervention + current account surplus => "currency manipulator" **Threaten to punish ...but meanwhile let US traded goods sector shrink to avoid yes-yes equilibrium (Olson & Zeckhauser 1966)**	

$-centric intern'l monetary and financial system as intern'l public good with free riding: **alternatives**

		US intervention	
		No	Yes
Rest of world intervention	No	US notion of optimum	
	Yes	**Re-impose withholding tax on interest paid to non-residents, conditioned on large intervention & current account => lower returns on $ reserves**	**Meet yes with yes (Bergsten & Gagnon 2017)**

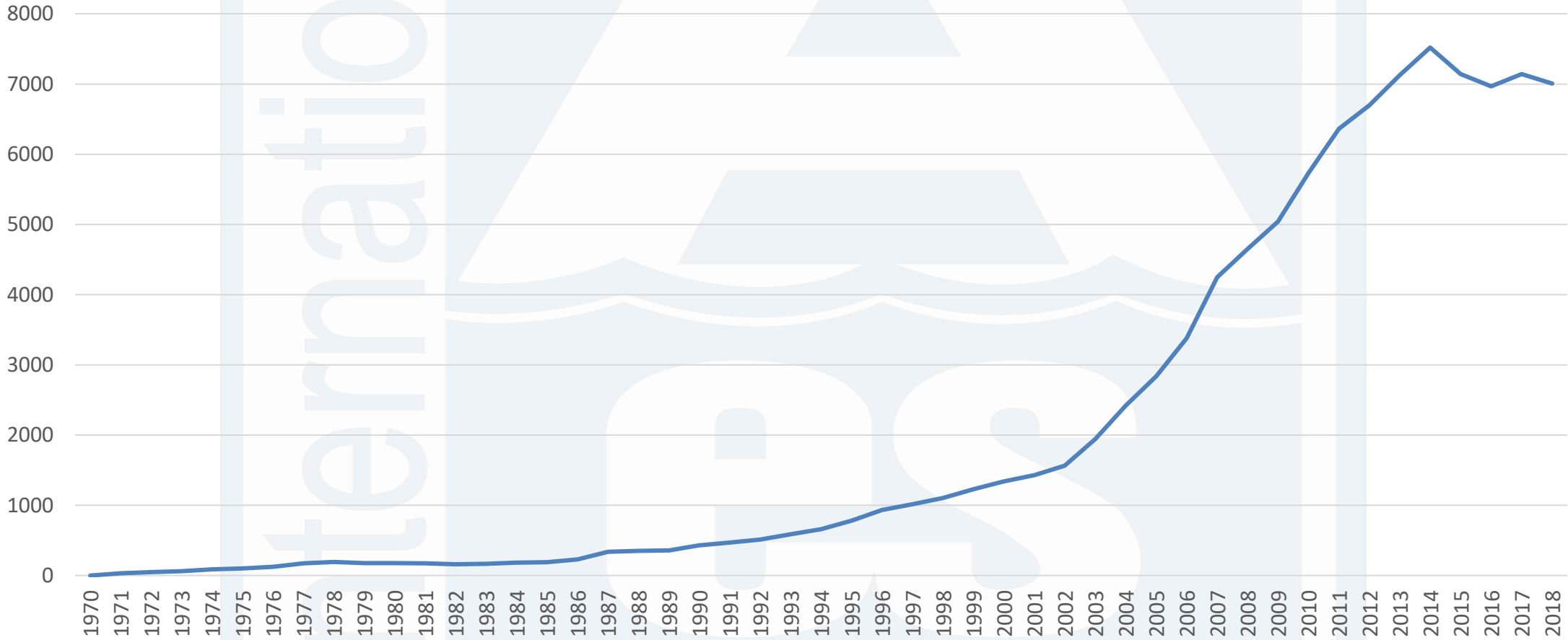
US POLICY HAS CEDED TO THE REST OF THE WORLD MANAGING THE $ OVER ITS CYCLES.

US Treasury & Fed holdings of euro & yen

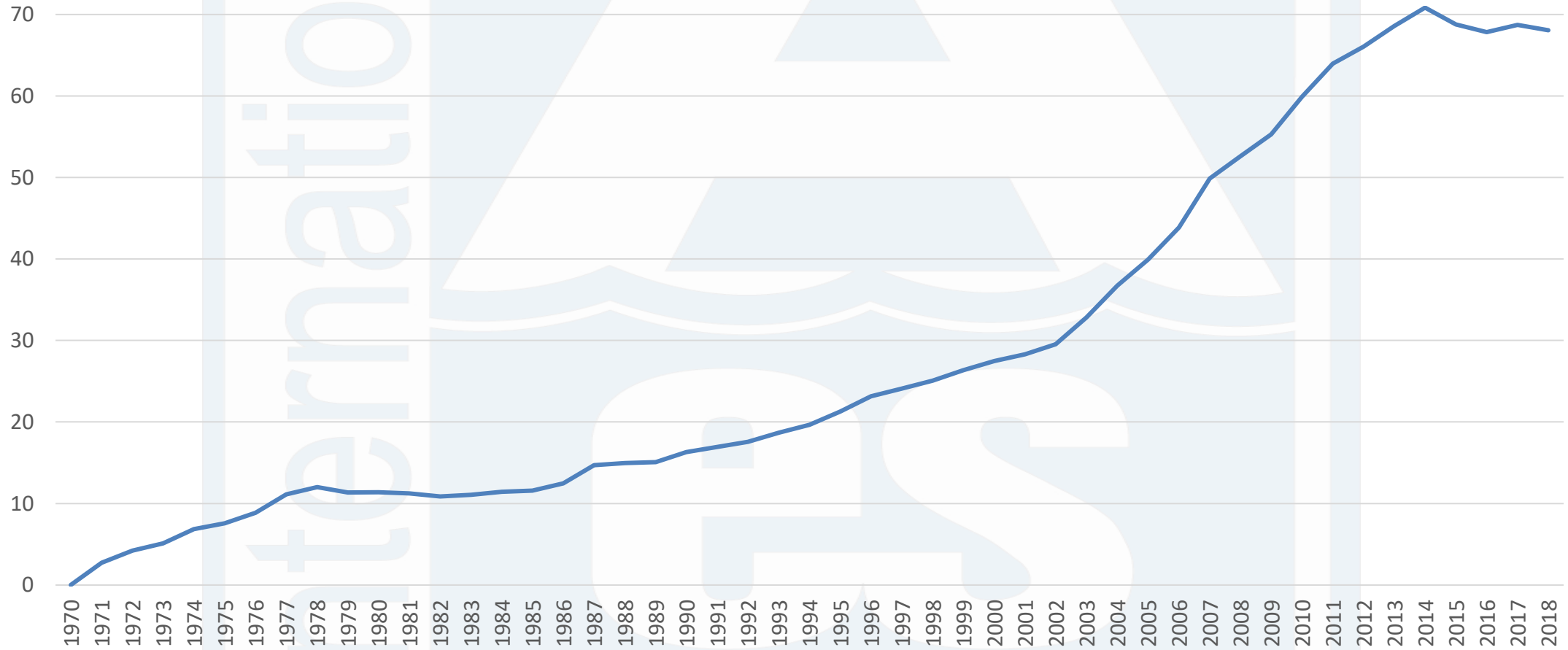


Source: Chinn et al (2021).

Global dollar foreign exchange reserves, cumulative change since end-1970, in billions of US dollars



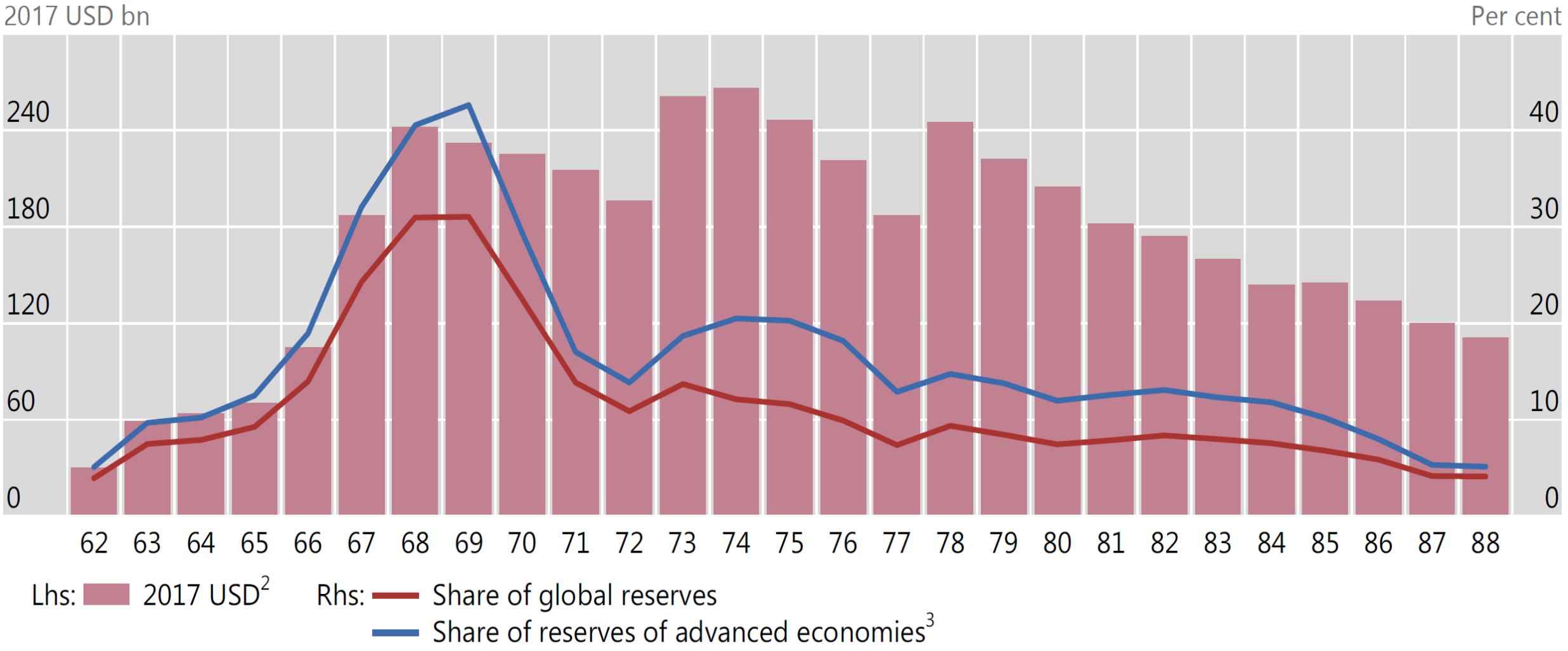
Global dollar foreign exchange reserves, cumulative change since end-1970, in % of US GDP



When did US $ policy unilaterally disarm?

- **Not** in 1933, when FDR & Morganthau set FRBNY $ gold prices in FDR's bedroom.
- **Not** in 1971, when the "Nixon shock" imposed a 10% tariff to force DM, ¥ appreciation (Irwin 2013).
- **Not** after 1973, when swap lines continued to grow (McCauley & Schenk 2019)– see Graph.
- **Not** in November 1978, when the Treas Sec Blumenthal arranged a $30 billion $ support package ($150 b in terms of current GDP), including the ultimately profitable Carter bonds in DM and CHF [check].
- When Treasury Undersecretary of Monetary Affairs Beryl Sprinkel announced in April 1981 that the FX intervention would only counter disorderly markets.
  - Eg when President Reagan was shot in March 1981 (Destler & Henning 1989).
  - Sprinkel had drunk the Chicago Kool-Aid of Friedman (1953) and Johnson (1969).
- The resultant violent upswing of the $, ascribed in textbooks to the combination of loose fiscal policy and tight monetary policy, got a further fillip in 1984 from the repeal of the withholding tax on non-resident receipts of portfolio interest (see below).

Fed swap lines peak after 1973



Source: McCauley and Schenk (2020).

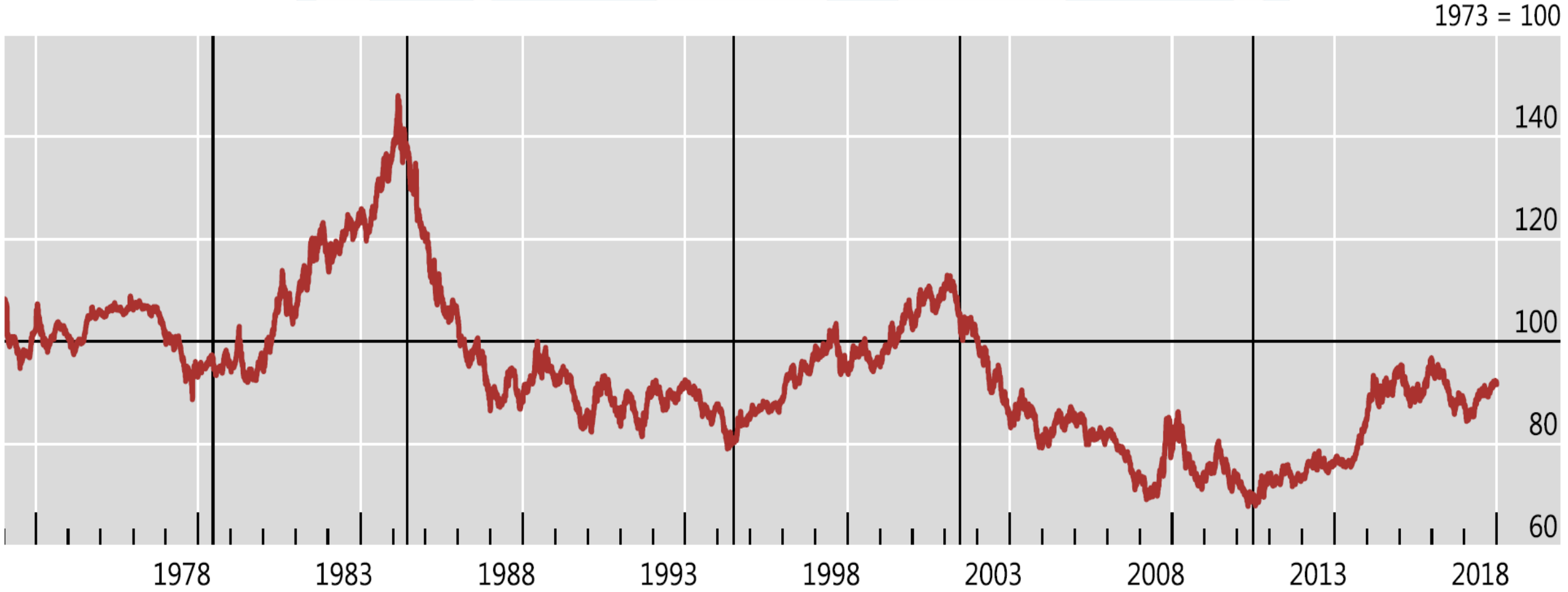
When did US $ policy unilat'ly disarm? (con'd)

- ...only to be reversed by Treasury Sec Baker, who, to avoid Congressional tariffs, led G5 September 1985 Plaza Accord to depreciate overvalued $ (Funabashi 1989; Volcker & Gyohten 1992).
- **Not** when US led G6 in February 1987 Louvre Accord to brake $ fall.
- **Not** when US joined G10 to buy $s in August 1995, shortly *after* the $ had bottomed vs DM and ¥, "pushing on an open door" (BIS 1996).
- **Not** in 2000, when the Fed joined with the new ECB to support the flagging €, although the lack of centralisation of FX reserves in Eurosystem may have limited the scale of the operation (Fatum & Hutchison 2002).
- Since then, US only spent $1 b equivalent ¥ to hold down the ¥ after the Tohoku Earthquake in March 2011, alongside the Ministry of Finance, Bank of England and Bank of Canada (Neely 2011).
- **Thus 20+ years, covering more than a $ cycle, have elapsed since the US checked $ strength.**

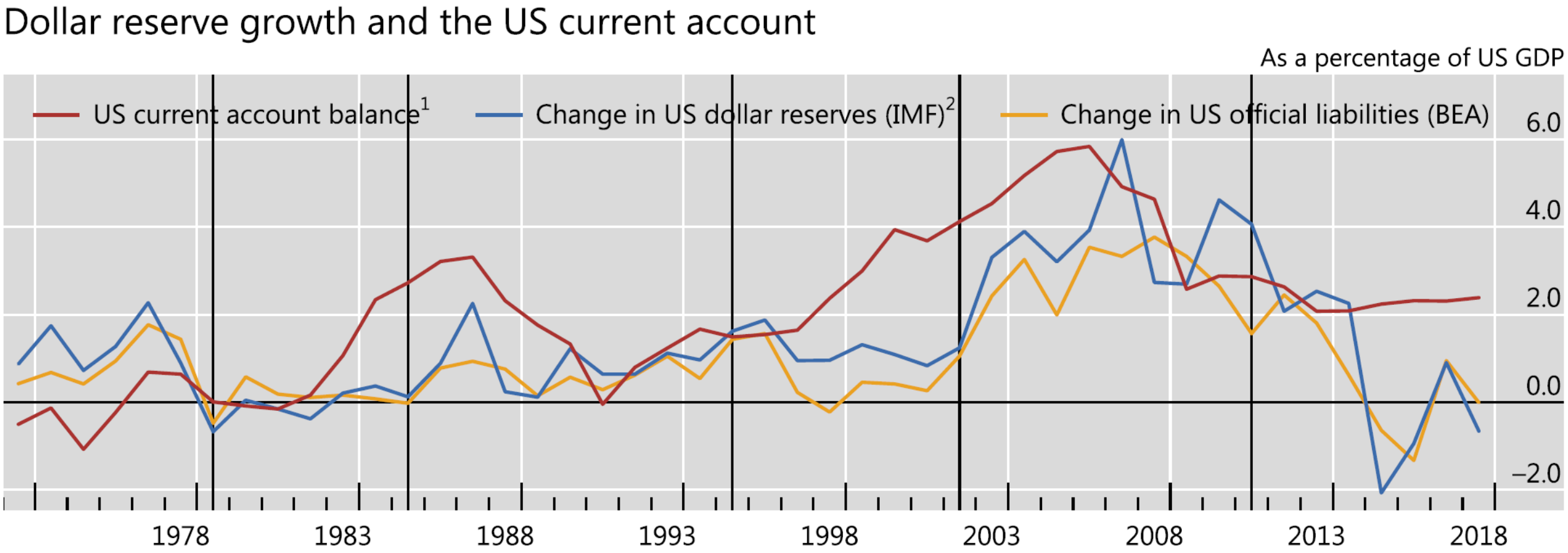
$ reserve growth differs X $ up-/down-swings

- The rest of the world's officials accumulate more dollars
  - in dollar downswings than
  - in dollar upswings (Bordo & McCauley 2019).
- This finding points to reserve accumulation as more
  - by-product of currency management (Machlup 1966; Cheung & Qian 2009; Bird & Mandilaras 2010) than
  - optimising precautionary behaviour (Aizenman & Lee 2007).
- Such an asymmetry stabilises the $'s value, like currency rebalancing in reserves (Chinn et al 2021).
- But the more limited downswing is seen as contributing to US deficits.

$ long swings since ’73: 3 down & 3 up



ROW buy $ reserves faster in $ downswings



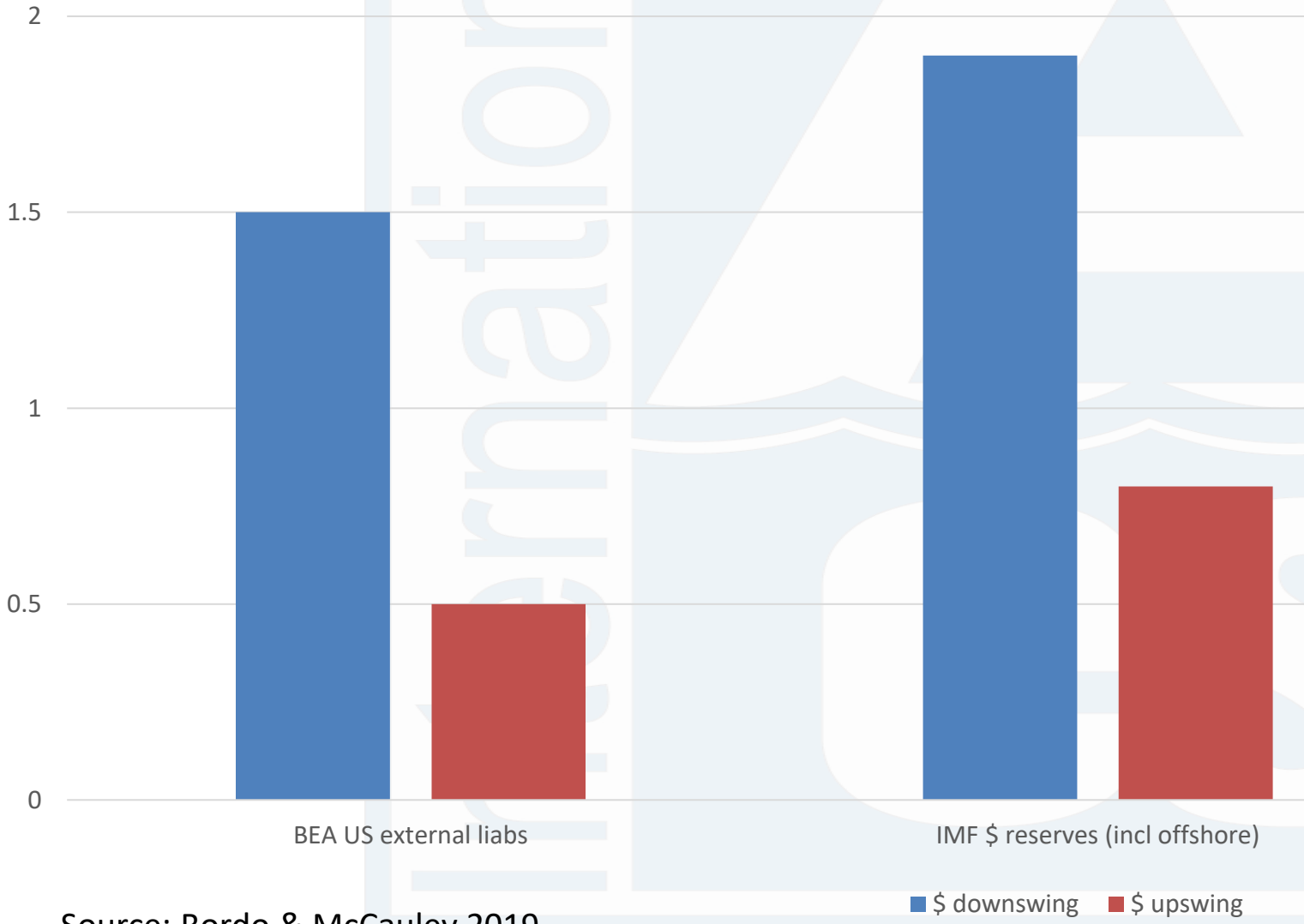
ROW buys $ reserves faster in $ downswings

Annual averages in percent of US GDP

	(1) US current account deficit	(2) Change in US official liabilities (BEA)	(3) Change in US dollar reserves (COFER)[a]	Memo: "reserve financing share"[b] (%)	
				(2)/(1)	(3)/(1)
1973–1978 (USD down)	– 0.1	0.9	1.3		
1979–1984 (USD up)	0.6	0.1	– 0.1	19	– 17
1985–1994 (USD down)	1.8	0.6	0.8	31	45
1995–2001 (USD up)	2.5	0.6	1.2	23	49
2002–2010 (USD down)	4.5	2.8	3.5	63	78
2011–2018 (USD up)	2.4	0.7	1.0	29	43
1973–2018 (1979–2018)	2.1 (2.5)	1.0 (1.0)	1.4 (1.4)	48 (42)	65 (57)
Memo: Average—USD down (1985–2010)	2.3 (3.1)	1.5 (1.6)	1.9 (2.1)	63 (53)	82 (68)
Average—USD up	1.9	0.5	0.8	26	41

ROW adds $ reserves 2-3X faster in $ downswings

Annual average, in percent of US GDP



If reserve accumulation is for precautionary purposes (Aizenman & Lee 2007), why does it not occur evenly across the $'s long swings?

If reserve accumulation is a by-product of resisting appreciation, then Machlup (1966) applies

Source: Bordo & McCauley 2019.

US POLICY STATUS QUO:
NAME & SHAME & THREATEN.

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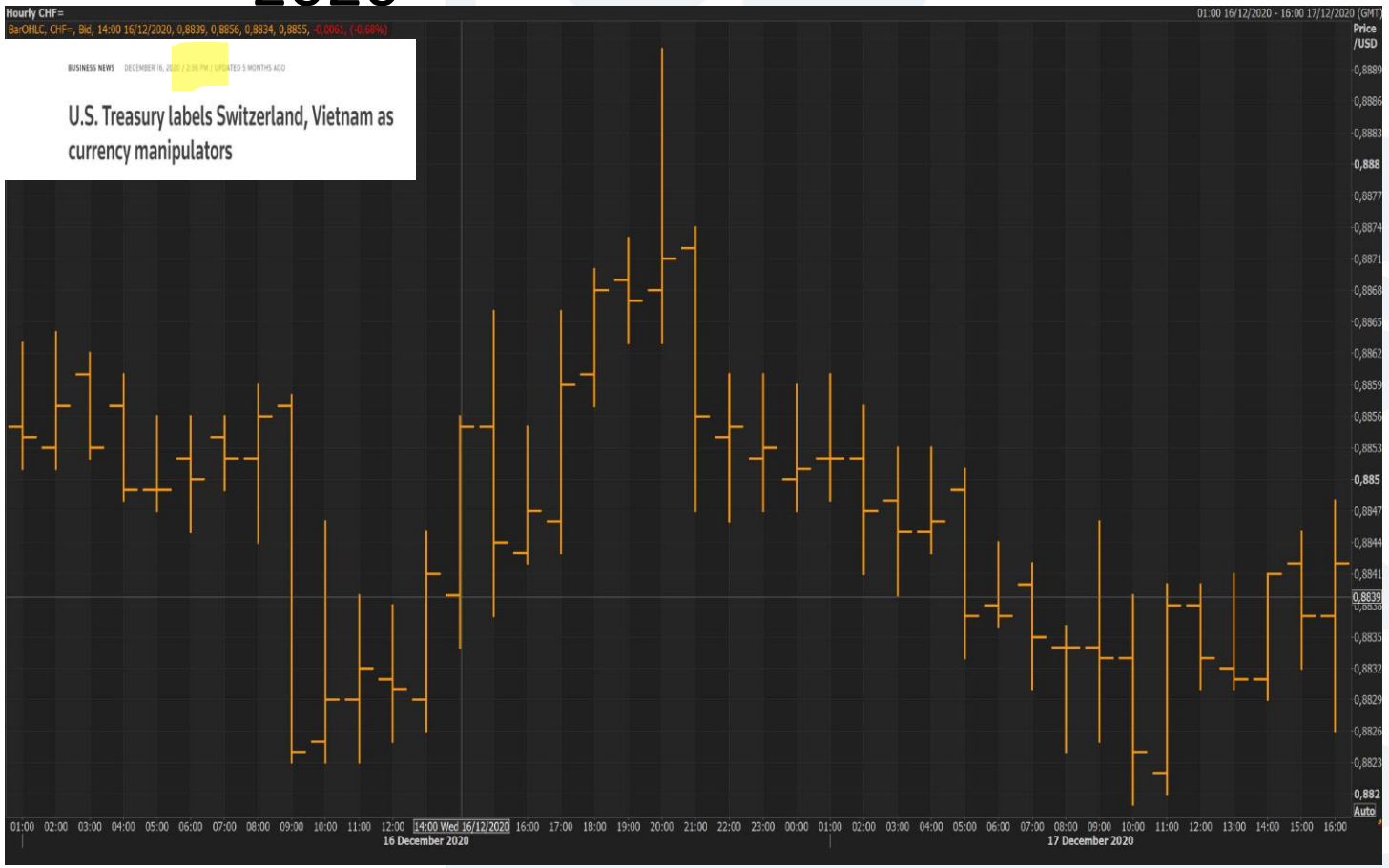
Is name and shame working? CHF after "currency manipulator", 16 December 2020

- Lame duck US Treasury (2020) Sec Mnuchin surprises, fingering CH & VN.
- 3 criteria met (italics and bold added):
  - "conducted ***large-scale, one-sided intervention***, significantly larger than in previous periods, to resist appreciation and reduce risks of deflation": estimated net FX purchases of $103 b in Q32019-Q22020, 14% of Swiss GDP
  - ***Current account surplus*** of 10.9% of GDP in 2019 and 8.8% Q32019-Q22020.
  - "***United State's goods trade deficit*** with Switzerland widened notably over the last year, reaching $49 billion over the four quarters through June 2020, due partially to an increase in Swiss gold exports in the first half of 2020".
- Absurdity of US law's focus on bilateral balance demonstrated big time:
  - CH refines but does not mine gold.
  - Thus CH value added in gold exports is *de minimus.*
  - Switzerland reports an overall deficit in nonmonetary gold.

Event study: CHF/USD, 16 Dec 2020 when US Treasury labels Switzerland a “currency manipulator”

- CHF vs USD, 16-17 December 2020



- CHF *depreciates* vs $ immediately after Treasury announcement at 14:30 GMT
- Reuters reports that designation anticipated.
- CHF does appreciate vs €, which depreciates vs $.

POLICY ALTERNATIVES:

- Impose withholding tax on interest
- Counter intervention with intervention

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Re-impose withholding tax on US interest earnings of non-residents?

- The Deficit Reduction Act of 1984 removed the 30% US withholding tax on most interest payments to foreigners.
  - No one called this withholding tax a capital control or capital management measure!
  - See Franson 1984-1985; Pront & Zaitzef 1985; Lewis 1987.
- Could re-impose such a withholding tax (Goulder 1990), and bilateral treaties could make a lower rate contingent on recipient jurisdiction's not running a current account surplus and accumulating reserves.
  - Could in principle lower returns to surplus jurisdictions' $ reserve holdings.
  - Would fall short of Keynes' proposal to charge interest (5-10%!) on cumulated surpluses above a certain level (Steil 2013 p 144).
- The practical difficulty of such a measure is illustrated but not exhausted by the practice of US-based firms selling euro$ bonds through Netherlands Antilles financing subsidiaries (Papke 1989).
- And central banks' investing $s offshore could induce more $ bond issuance offshore by highly rated non-US obligors—already McCauley (2020) estimates $ reserves held offshore at $1 trillion.

Counter $ intervention with intervention?

- Threaten to counter ROW Yes with US Yes: “countervailing currency intervention”, as dubbed by Bergsten and Gagnon 2017 and Bergsten 2019.
  - If threat is credible, move from (US No, ROW Yes) to (US No, ROW No).
  - If threat not credible, move to (US Yes, ROW Yes), a real currency war, with unforeseeable FX market effects.
- But unlike tariffs, which can be so popular as to make their removal politically difficult (Irwin 2013), if ROW chooses No, then US follows suit.
- “Countervailing currency intervention” would exactly offset ***large $ reserve accumulation***, given large current account surpluses and ample reserves.
  - Central banks could evade this bilateral approach by investing in $ instruments offshore, which already account for $1 trillion of $7 trillion in $ reserves in 2017 (McCauley 2020).
  - They could also evade by buying dollars vs euros and other key currencies forward in the unobservable over-the-counter market.
  - They could also evade by buying Hong Kong $, Canadian $, Mexican pesos or other currencies that co-move with the $ against the euro (Ito & McCauley 2019, Iltzetzski et al 2019).

Better, counter *all* intervention by large surplus countries with intervention?

- Ideally, the IMF membership could decide to police large chronic surpluses recycled through the government balance sheet.
  - IMF could then perform the countervailing intervention.
  - The record of the IMF's surveillance of global imbalances suggests that its members could not reach such an agreement.
- In the absence of such a fully multilateral approach, a coalition could employ the Bank for International Settlements to perform countervailing intervention against the recycling through government balance sheets of chronic large surpluses.
- Absent such a club approach, the US authorities could carry out the countervailing currency intervention on a fully multilateral basis.
  - Countervailing intervention would be blind to the investment of FX reserves in the $, the euro or other key currencies (Ito & McCauley 2020; Iancu et al 2020).
  - Issues: recycling surpluses through state-owned banks, pension funds, etc

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