NINETY-FIRST INTERNATIONAL ATLANTIC ECONOMIC EUROPEAN CONFERENCE

INTRODUCTION

KATHERINE S. VIRGO

EXECUTIVE VICE PRESIDENT

INTERNATIONAL ATLANTIC ECONOMIC SOCIETY

19-22 May 2021

NINETY-FIRST INTERNATIONAL ATLANTIC ECONOMIC EUROPEAN CONFERENCE

PLENARY PANEL:
Managing the U.S. Dollar

Robert Aliber, Brendan Brown, Robert McCauley, Gylfi Zoega

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Chair

Robert Aliber

University of Chicago

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FOREIGN DEFENSES AGAINST THE INFLATIONARY DOLLAR HEGEMONY: WHY SO WEAK IN THE PAST QUARTER CENTURY?

Brendan Brown

Hudson Institute: Senior Fellow, Mises Institute; Partner, Macro Hedge Advisors

19-22 May 2021

Four main themes:

1. How does US spread inflation globally, distinguishing goods inflation and asset inflation?
2. What are the possible forms of foreign resistance and their effectiveness?
3. History of foreign resistance since 1919 – failures and successes
4. A counterfactual history of defensive strategies - 1996 to present; three case studies

How the US hegemon spreads inflation around the world

1. Distinguish spread within dollar zone and outside
2. Illustrative case of country X with freely floating currency and firm independent monetary anchor
3. How US can spread asset inflation to X, but within limits (to be described)
4. A successful defence still leaves X exposed to downsides from US inflationary policy

Costs of foreign defence against US inflationary hegemon

1. Exchange rate volatility
2. Export industries in general suffer
3. Domestic currency might become attacked by speculative mania (upwards)
4. Problems related to establishing anchor to independent monetary regime

Benefits of defence strategies against US inflationary hegemon

1. Less exposure to goods inflation
2. Domestic investors less likely to suffer impairment of rationality in midst of global asset inflation
3. Opportunities for domestic investors to buy global assets (outside bubble epicentre) cheaply
4. Less damage eventually to domestic investors from bubble-and-bust globally
5. Less malinvestment in the country with effective defence
6. Local currency could assume an international role
7. Less likelihood of asset inflation in domestic residential real estate market, less social tensions

History of defence strategies against US inflationary hegemon

1. Weimar Republic 1927
2. West Germany, 1969—79; 85-9
3. Switzerland 1972-8
4. Japan 1976-9; 2008-12

Counterfactual defence strategies against US inflationary hegemon 1996-21

Three case studies: two large countries, one small

Germany

Japan

Israel

Counterfactual defence strategies against US inflationary hegemon 1996-21

Conclusions:

Defence failures against US inflationary hegemon have increased geo-political dangers

US monetary inflation has hurt both US and its foreign allies, strengthened its enemies

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Managing the Dollar Over its Cycles

Lawrence L Kreicher* and Robert McCauley**

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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

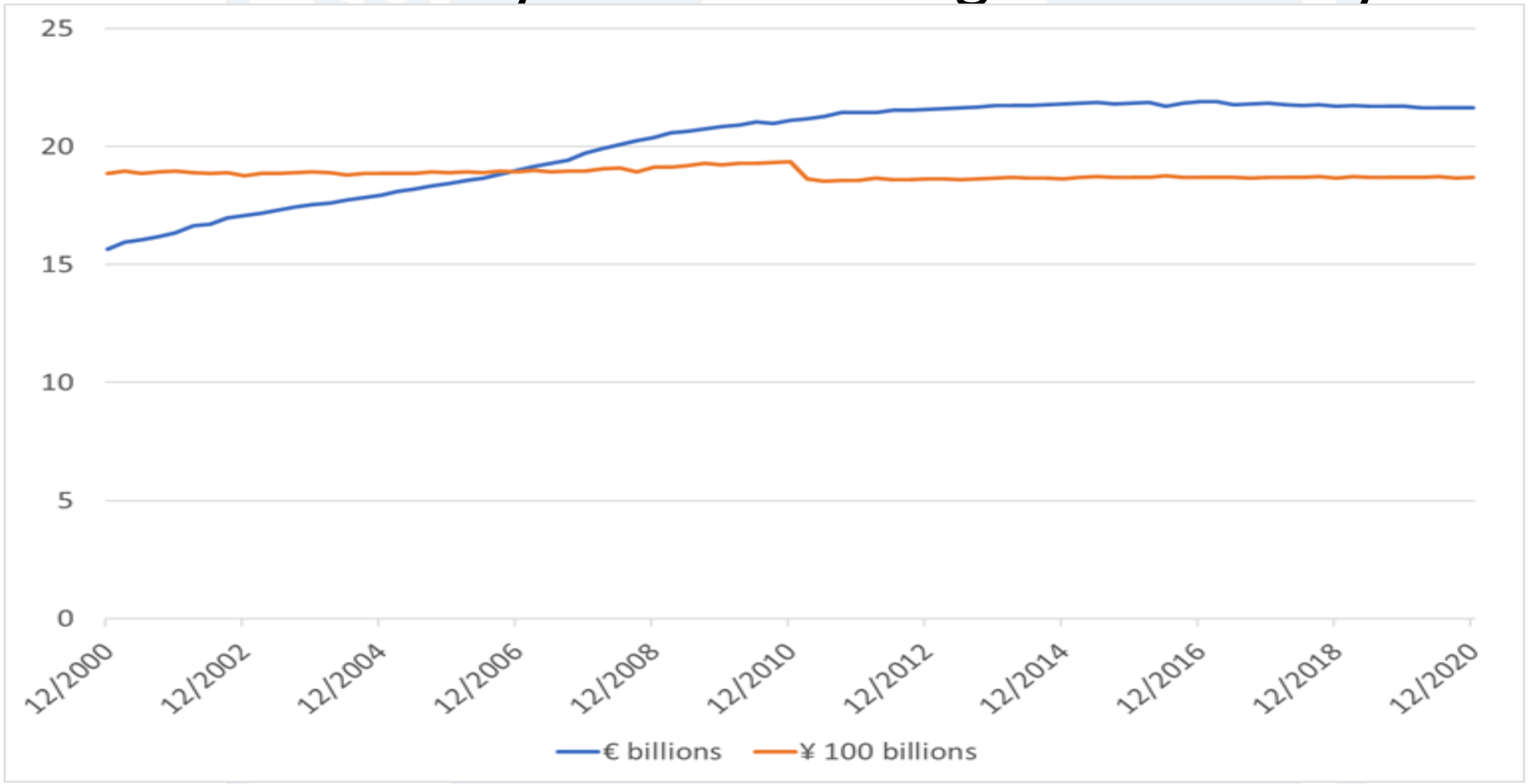
		US intervention	
		No	Yes
Rest of world intervention	No	US notion of optimum	
	Yes	Large intervention + current account surplus => "currency manipulator" **Threaten to punish ...but meanwhile let US traded goods sector shrink to avoid yes-yes equilibrium (Olson & Zeckhauser 1966)**	

$-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)**

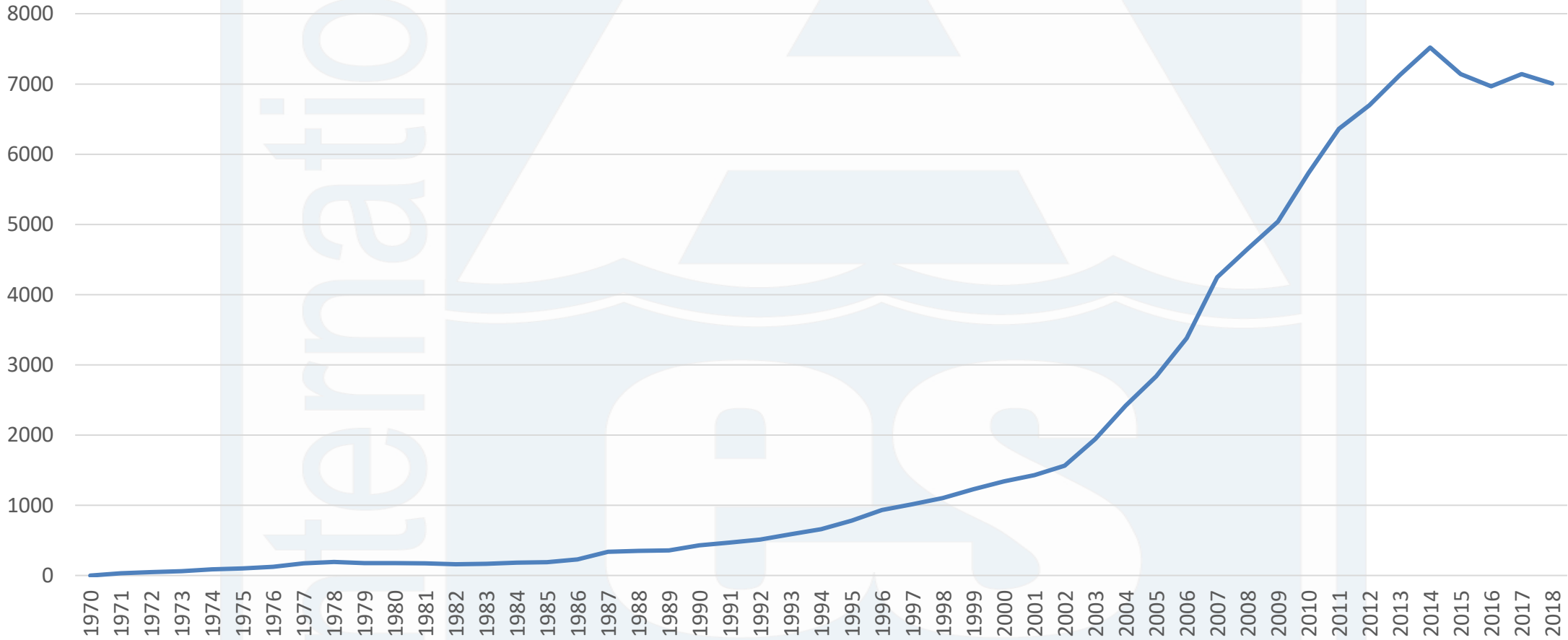
US POLICY HAS CEDED TO THE REST OF THE WORLD MANAGING THE $ OVER ITS CYCLES.

US Treasury & Fed holdings of euro & yen

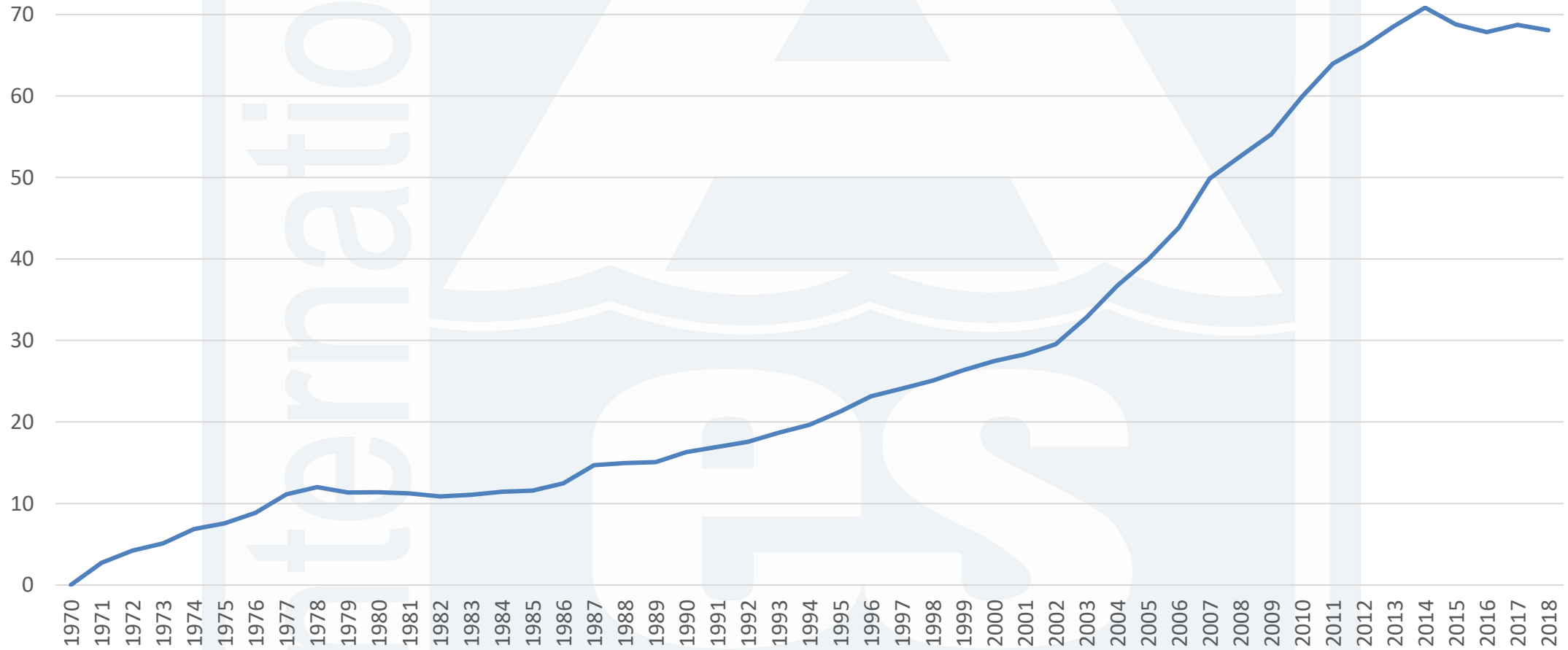


Source: Chinn et al (2021).

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



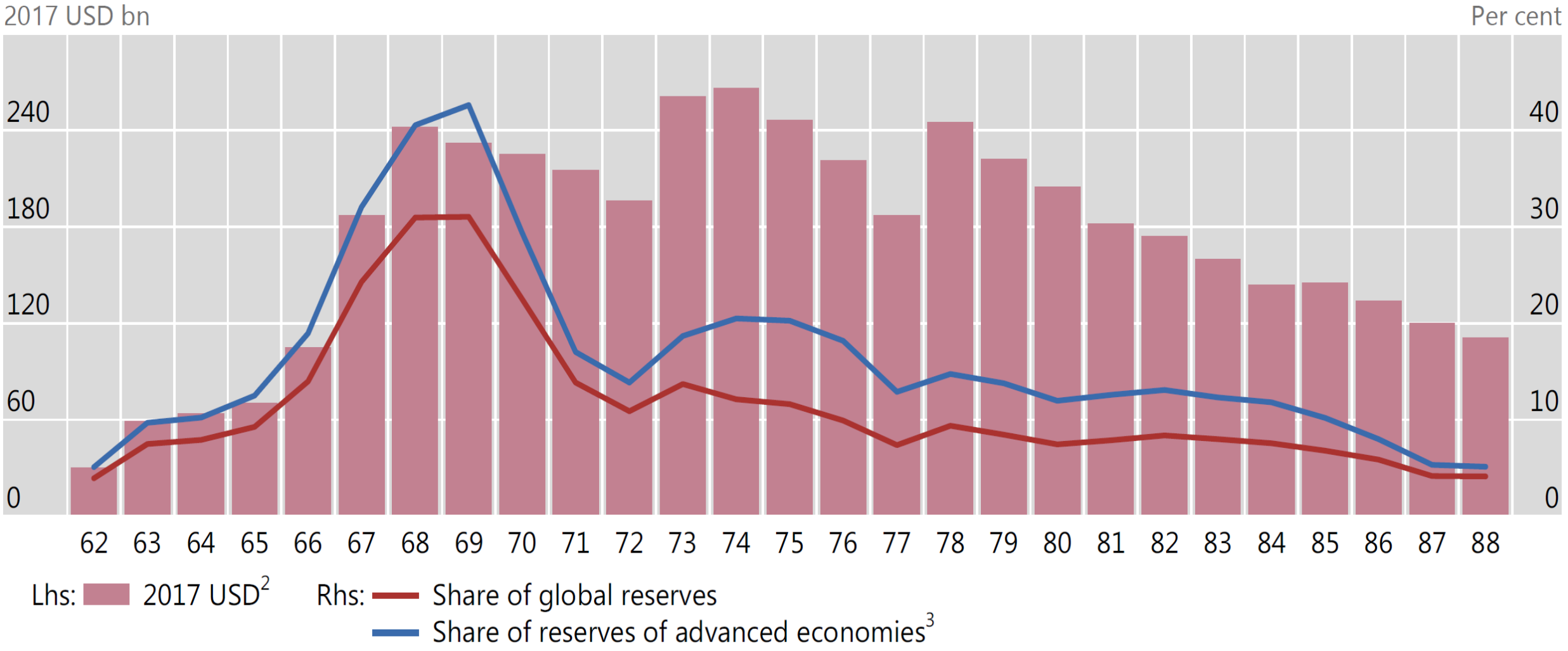
Global dollar foreign exchange reserves, cumulative change since end-1970, in % of US GDP



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).

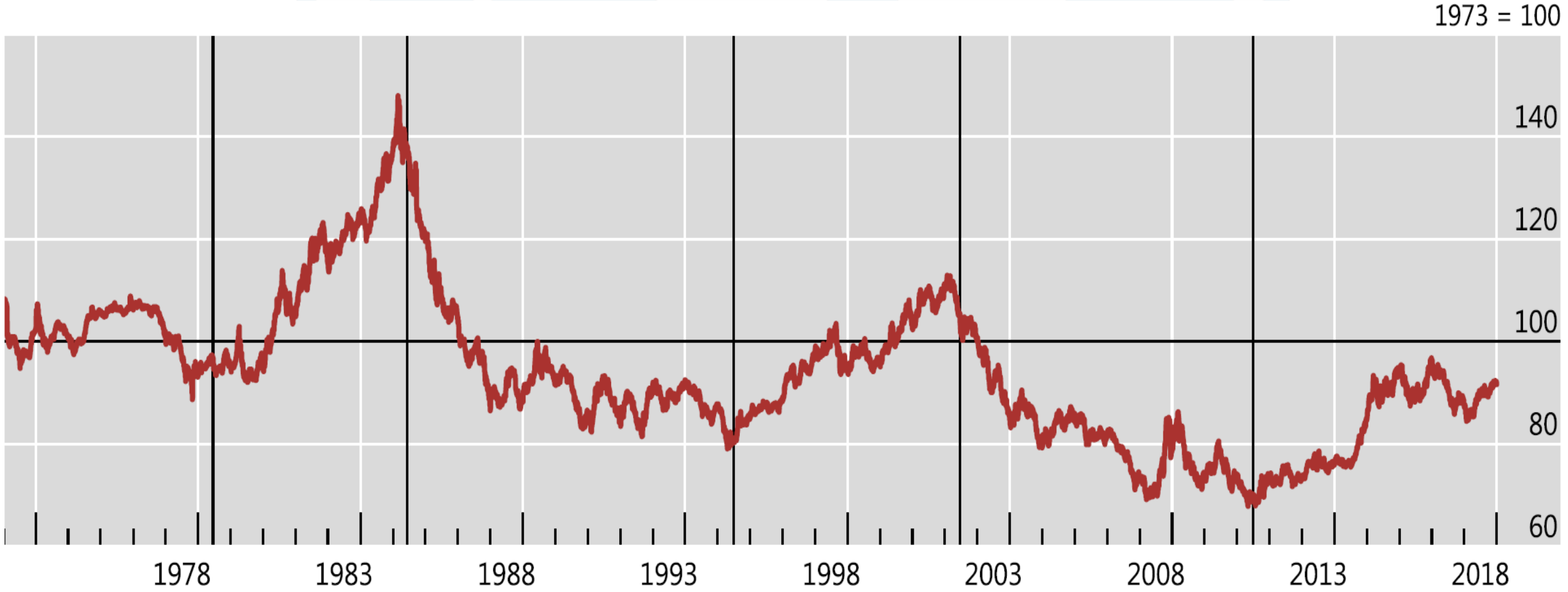
When did US $ policy unilat'ly disarm? (con'd)

- ...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.**

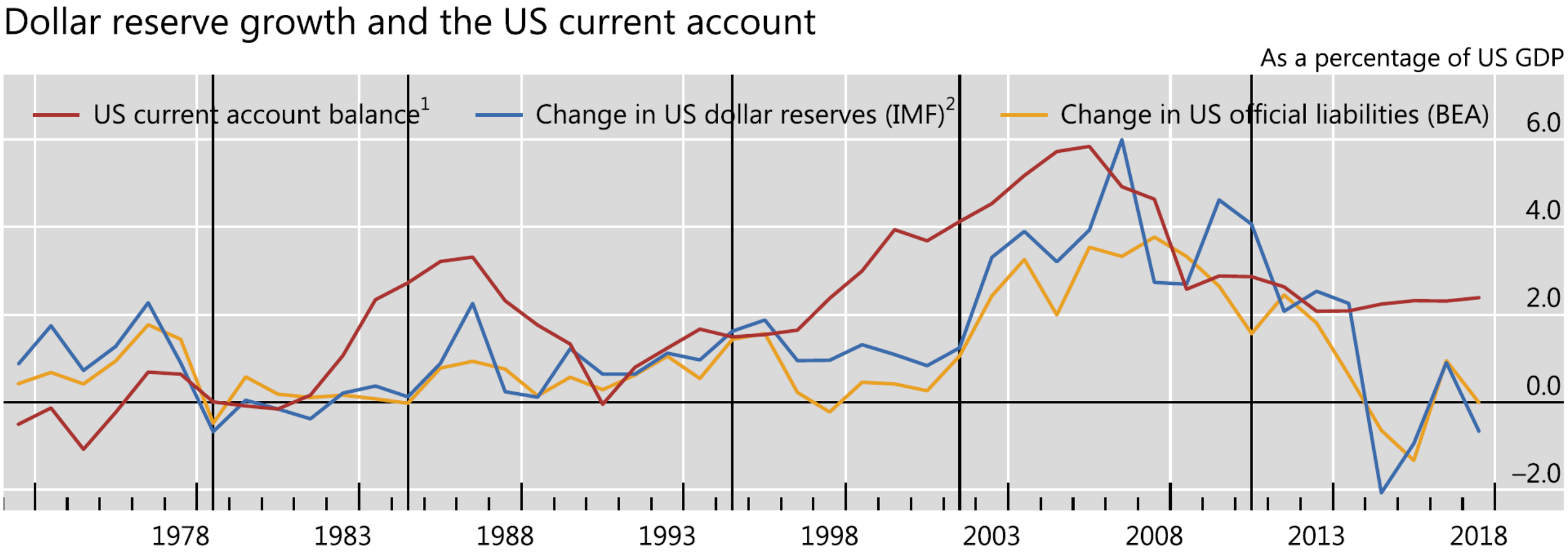
$ reserve growth differs X $ up-/down-swings

- 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



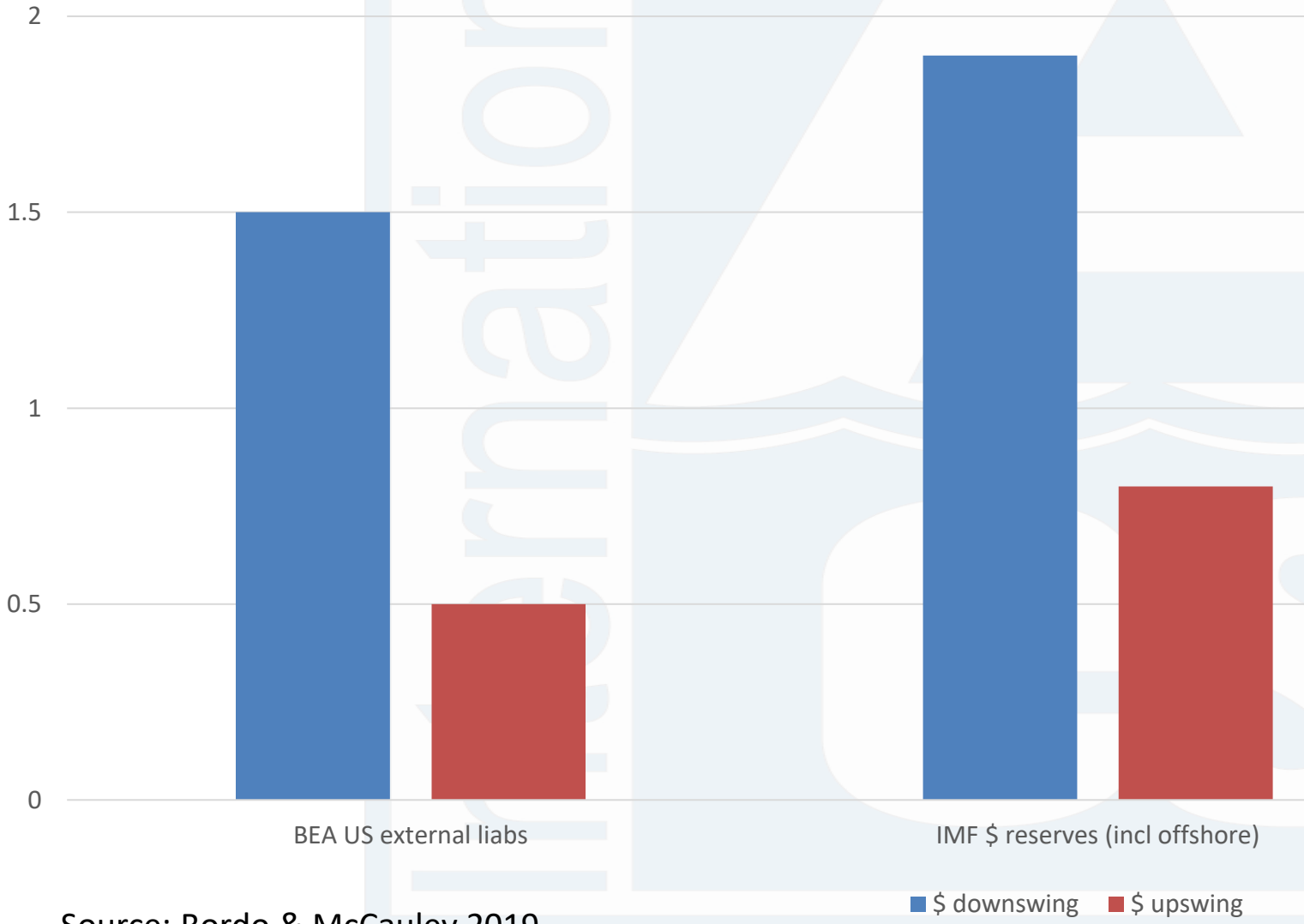
ROW buys $ reserves faster in $ downswings

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.

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

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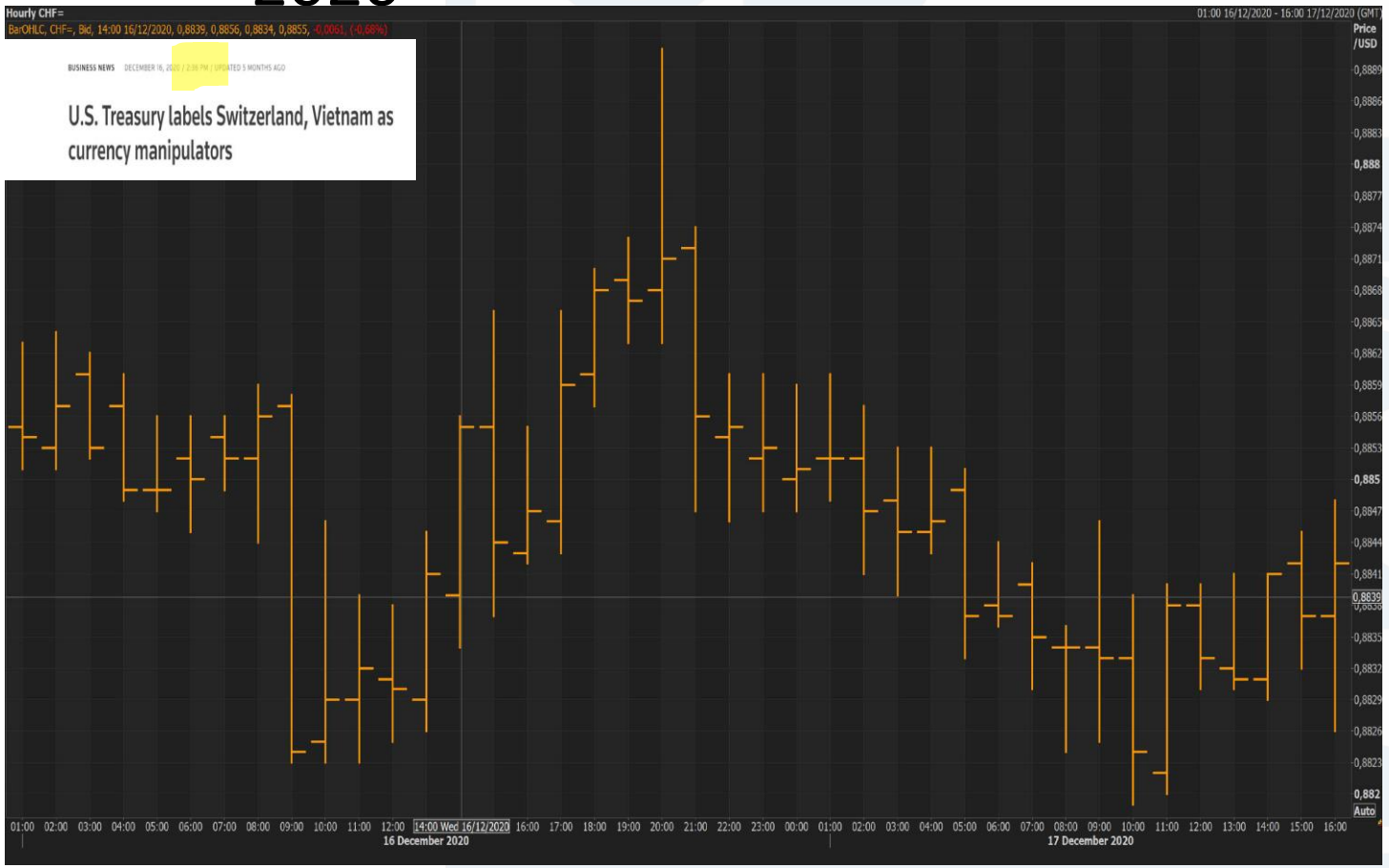
	Yes	Large intervention + current account surplus => "currency manipulator" **Threaten to punish ...but meanwhile let US traded goods sector shrink to avoid yes-yes equilibrium (Olson & Zeckhauser 1966)**	

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

$-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)**

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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Goldfinger, Morgenthau, and the Changes in the U.S. Dollar Price of Gold

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19-22 May 2021

OVERVIEW OF PRESENTATION

- THE BOOK/MOVIE PLOTS OF IAN FLEMING'S GOLDFINGER –
- 1914--THE UNITED STATES BECOMES THE "MARKET MAKER" IN GOLD
- CHANGES IN U.S. GOLD POLICY IN 1933-1934
- CHANGES IN U.S. GOLD POLICY AT CAMP DAVID AUGUST 1971

THE BOOK/MOVIE PLOTS OF GOLDFINGER

- THE PLOT IN THE BOOK
- THE PLOT IN THE FILM
- GOLDFINGER’S INSIGHT

THE U.S. ROLE AS THE MARKET MAKER IN THE WORLD GOLD MARKET

- WHAT DOES IT MEAN TO BE A “MARKET MAKER”-
- HOW DID THE UNITED STATES BECOME THE MARKET MAKER
- IMPLICATIONS OF U.S ROLE AS MARKET MAKER
  - RESIDUAL BUYER
  - RESIDUAL SELLER
- THE UNITED STATES AS THE MANAGER OF THE MARKET PRICE

CHANGES IN U.S. GOLD POLICY 1933-34

- PRE-1933 POLICY
- 1933--NATIONALIZATION OF PRIVATELY- OWNED GOLD
- 1934--INCREASE IN THE U.S. DOLLAR PARITY TO $35.00
- THE *GOLDEN AVALANCHE*

CHANGES IN U.S. GOLD POLICY--1971

- THE MENU OF POSSIBLE CHOICES
- INCREASE THE U.S. DOLLAR PRICE OF GOLD
- WITH PEGGED RATES
- WITH FLOATING RATES
- CLOSE THE U.S. TREASURY'S GOLD WINDOW
- REPUTATIONAL COSTS OF EACH CHOICE

IF MORGENTHAU HAD BEEN AT CAMP DAVID

- A NEW U.S. GOLD PARITY OF $100 AN OUNCE
- MARKET VALUE OF EXISTING GOLD RESERVES TRIPLES
- MARKET VALUE OF ANNUAL GOLD PRODUCTION TRIPLES
- PRRIVATE PURCHASES OF GOLD DECLINE
- FOREIGN CENTRAL BANKS SELL DOLLAR SECURITIES, BUY GOLD
- U.S. PAYMENTS DEFICIT DECLINES AS FOREIGN CENTRAL BANKS BUY
- MORE GOLD

IMPACT OF CLOSING THE GOLD WINDOW

- WHAT WOULD HAVE HAPPENED TO THE FOREIGN OFFICIAL DEMAND FOR U.S. DOLLAR SECURITIES OF THE U.S. DOLLAR PRICE OF GOLD
- HAD BEEN INCREASED TO $100/OUNCE?
- HAD BEEN REDUCED TO $10/OUNCE?

EXPERIENCE WITH FLEXIBLE EXCHANGE RATES

- THE NORMATIVE OBJECTIVES
- THE POSITIVE CLAIMS
- THE EXPERIENCE

CONCLUSION

- THE U.S. ROLE AS THE MARKET MAKER IN GOLD
- WHEN THERE IS A GOLD GLUT
- WHEN THERE IS A GOLD SHORTAGE

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Current Account Surpluses and Financial Crises in the Nordic Countries

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19-22 May 2021

How did the Nordic countries develop persistent current account surpluses?

Why do they run beggar-thy-neighbour policies?

Hypothesis: Financial crises bring about higher national saving and a positive current account, both in the short run and the medium run

Aliber (2010): Seven waves of financial crises since collapse of Bretton Woods

Common pattern:

Financial crises preceded by capital inflows,
the inflows generate higher stock prices and exchange rates,
consumption is increased due to a wealth effect,
current account deficits develop.

Reversal of capital flows causes stock market collapse and exchange rate depreciation.

Current account surpluses

Table 1. The current account as a share of GDP in 2007 and 2019

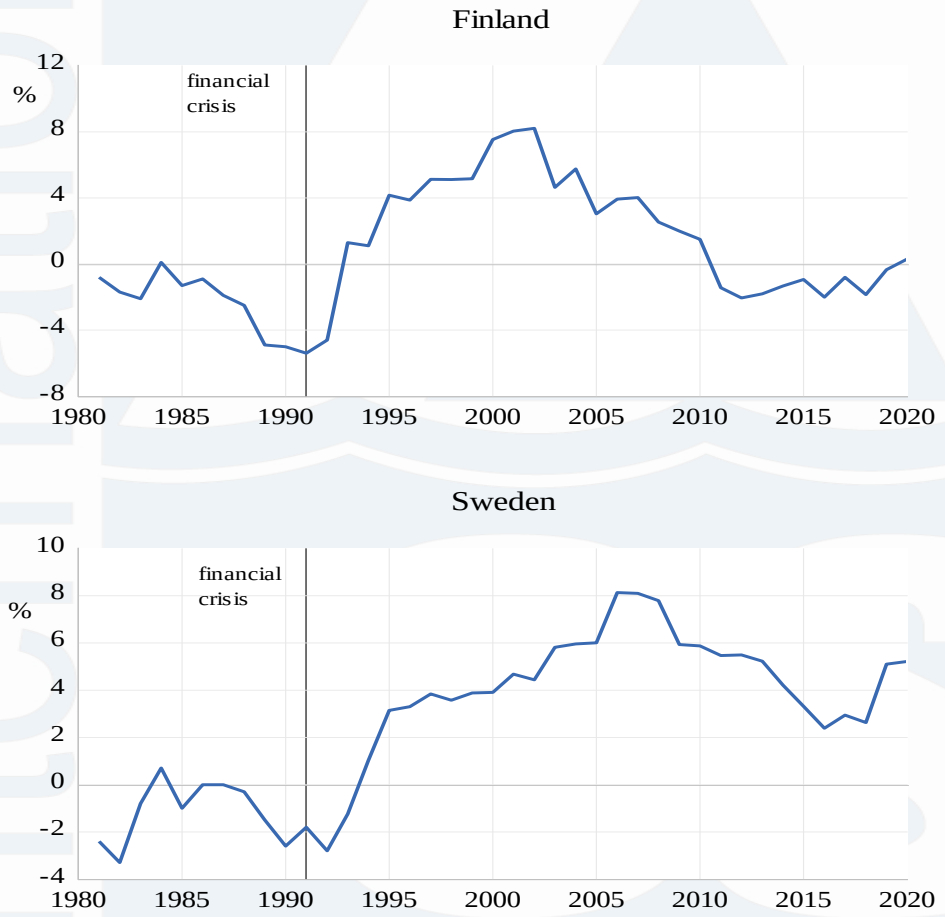
Current account surplus/deficit (% of GDP), 2007				Current account balance (% of GDP), 2019			
Surplus countries		Deficit countries		Surplus countries		Deficit countries	
Saudi Arabia	24.3	Latvia	-22.3	Netherlands	9.9	Ireland	-11.6
Norway	15.6	Iceland	-20.2	Denmark	8.8	Chile	-3.9
China	11	Estonia	-17.7	Germany	7.1	New Zealand	-3.3
Luxembourg	10	Lithuania	-14.6	Switzerland	7.0	United King.	-3.1
Switzerland	9.5	Greece	-14.3	Iceland	6.5	South Africa	-3.0
Netherlands	8.7	Spain	-10.1	Saudi Arabia	4.8	Brazil	-2.8
Sweden	8.6	Portugal	-9.5	Sweden	4.6	Indonesia	-2.7
Germany	7.9	New Zealand	-7.8	Luxembourg	4.4	Slovak Rep.	-2.7
Russian Fed.	5.9	South Africa	-7.3	Russian Fed.	3.8	United States	-2.2
Japan	4.8	Australia	-7.1	Japan	3.7	Canada	-2.1
Chile	4.4	Hungary	-6.8	Korea, Rep.	3.6	Greece	-1.5
Finland	4.3	Turkey	-5.8	Lithuania	3.3	India	-1.0
Austria	3.6	Ireland	-5.3	Italy	3.0	Argentina	-0.9
Argentina	2.8	United States	-5.3	Austria	2.8	France	-0.7
Indonesia	2.4	Slovak Rep.	-4.9	Norway	2.6	Latvia	-0.7
Canada	2.1	Poland	-4.8	Spain	2.1	Mexico	-0.3
Belgium	2.1	Czech Republic	-3.3	Estonia	2.0	Czech Rep.	-0.3
Denmark	1.5	United King.	-2.7	China	1.0	Hungary	-0.2
Korea, Rep.	0.6	Italy	-2.4	Turkey	0.9	Finland	-0.2
Brazil	0.1	France	-1	Australia	0.6	Portugal	-0.1
		India	-1	Poland	0.5		
		Mexico	-0.8	Belgium	0.3		

Source: The World Bank (https://data.worldbank.org/indicator/BN.CAB.XOKA.GD.ZS).

Financial crises in the Nordic countries in the 1990s: Finland 1991, Sweden 1991

- Financial deregulation set the stage for excessive credit expansion, asset price inflation and a rapid growth in consumption and investment.
- There followed a capital inflow and a loss of foreign competitiveness.
- The downturn started with speculation against the pegged exchange rates in both countries. This was met by interest rate increases, which caused asset prices to fall, which then made the banks fragile.
- The governments raised taxes and cut expenditures to reign in the budget deficits.
- The central banks were forced to abandon the pegged exchange rate regime and allow the markka and krona to float in the fall of 1992.
- The move to a floating exchange rate system then helped with the economic recovery.
- The economic recovery in Finland and Sweden was led by the rise of net exports.

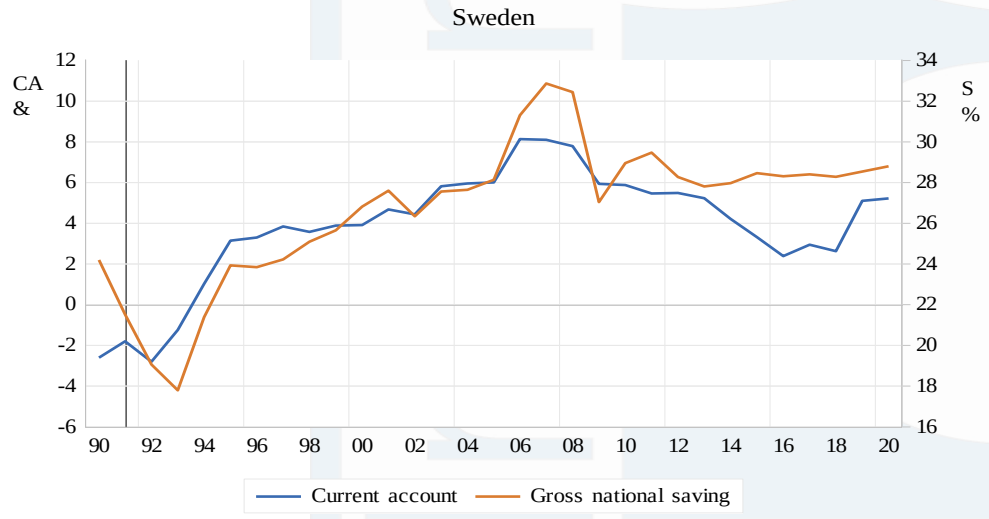
Figure 1. The current account in Finland and Sweden



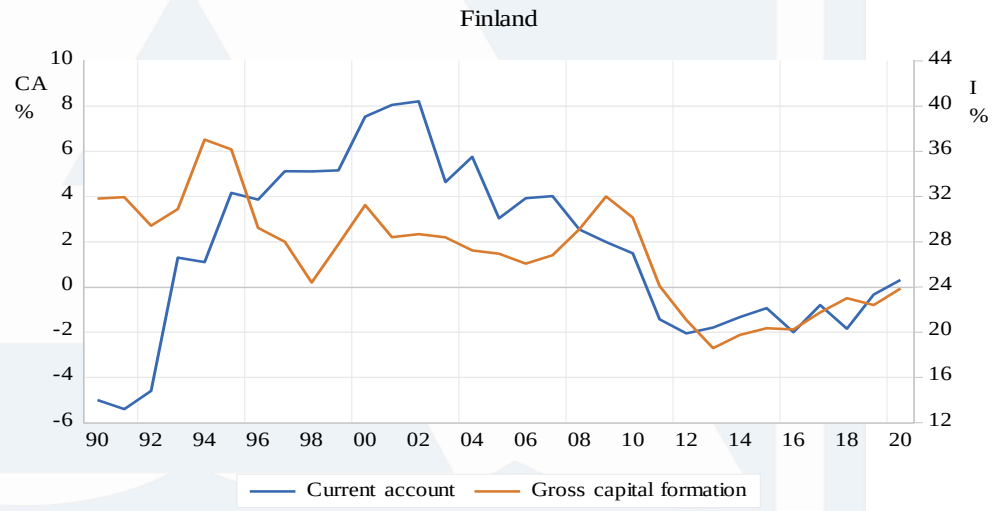
Persistent surpluses not explained by the initial depreciation.

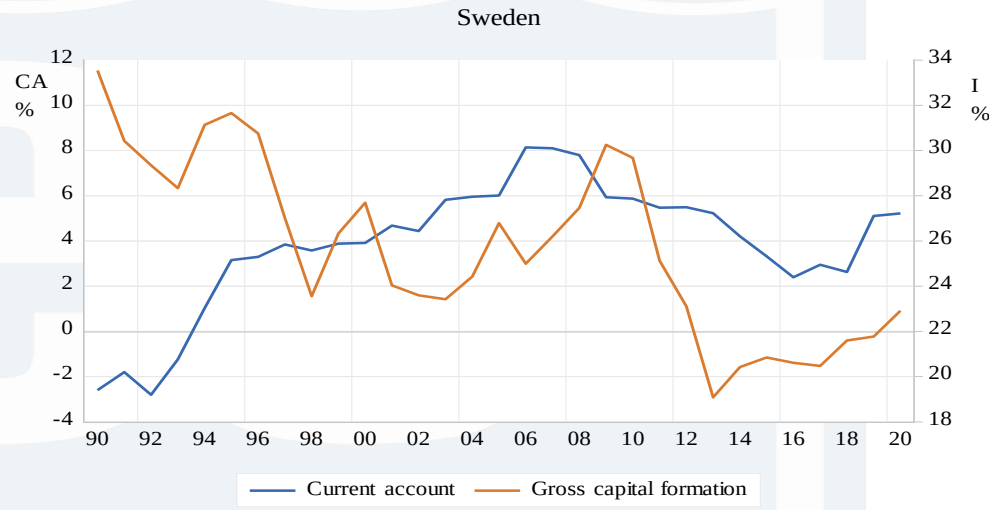
Finland and Sweden

Gross national saving and current account



Gross capital formation and current account



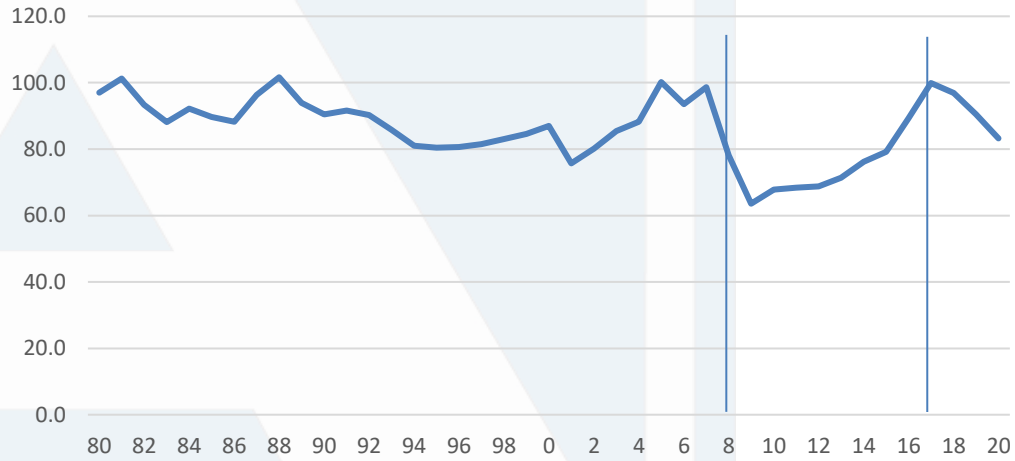


Crisis in Iceland in 2008

- Current account deficits every year until 2008.
- Bank privatisation in 2003 followed by a rapid expansion of the banking system.
  - Total assets amounted to one year's GDP in 2000, one and a half year's GDP in 2003, then rose to 193% of GDP in 2004, 303% in 2005, 390% in 2006 and 744% at the end of 2007.
  - Banks' direct ownership of shares when share prices were rising rapidly (because of the banks' credit expansion) increased capital but also the banks artificially inflating their capital by lending to buy own shares..
- Increase in country's balance sheet.
  - Foreign liabilities went from being 75% of GDP in 2003 to becoming 476% of GDP at the end of 2007.
- Domestic credit expansion
  - Domestic liabilities rose from 60% to 268% of GDP.
- Stock market went up by a factor of ten.
- The sudden stop of the inflow of capitals in 2007-2008 caused the krona collapsed, the current account deficit to disappear and become a large surplus, output to fall and unemployment to go up.

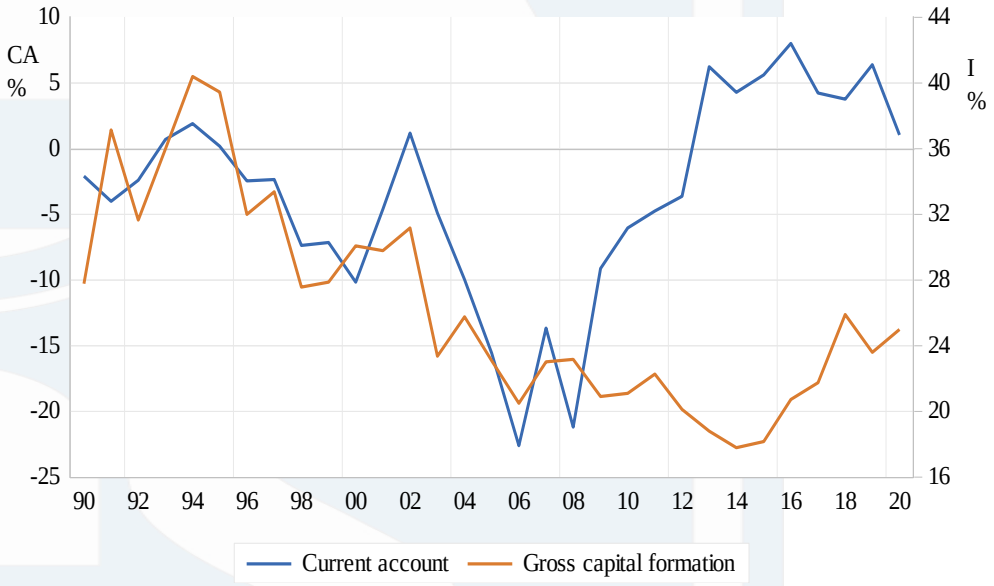
The price of foreign currency

Real exchange rate



Current account and national saving in Iceland

Current account and gross capital formation in Iceland



Possible reasons for persistent current account surpluses in the wake of crises

In the short run

- Depreciation of currency,
- wealth effect of falling asset prices on consumption

Housing bubble in Sweden and Denmark and rising house prices in Iceland in recent years.

Finland and Sweden never lost access

- limited access to international credit markets
- Increased risk aversion raising saving
- Changed government policies aimed at limiting c.a. deficits and debt accumulation