The Dollar and the International Dimension of Monetary Policy

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• I will focus on the question of whether central banks should tailor their policies to their impact on economic conditions abroad.
• And, if so, how.
• These are large and complex issues. In order to render them practical I will:
  – Focus on the case of the Fed.
  – And utilize historical evidence (look at a particular historical episode).
The international role of the Federal Reserve is of course a much-discussed topic

- The Fed has long been reluctant to acknowledge its international responsibilities.
- But then there was the global financial crisis, the Fed’s dollar swaps with the ECB, BoE and SNB, and its four $30 billion emerging-market currency swap arrangements.
  - At the height of the crisis, the Fed had $583 b. of swaps outstanding, by my count.
- There was the “taper tantrum” in May/June 2013.
- Now there is considerable criticism of the Fed for ignoring the impact on emerging markets of its impending increases in interest rates.
There is the impact of international factors on the domestic economy.
And there is the impact of domestic policy on the international economy

• In particular, the global monetary and financial system runs on dollar credit.

• Making foreign borrowing by EM banks and nonbank (nonbanks this time) very sensitive to its price.

• Growth in emerging markets (ex China) has now slowed to 0.1%. EM central banks would like to loosen. But their currencies have already weakened significantly, increasing the weight of dollar debts. So they are constrained.

• Shouldn’t the Fed be worrying more about this? Shouldn’t it be taking the plight of EMs into account?
As the Fed is evidently aware

- To quote: “Because the economy and financial system are becoming increasingly globalized, fulfilling [the Fed’s] objectives requires us to achieve a deep understanding of how evolving developments and financial markets and economies around the world affect the U.S. economy, and also how U.S. policy actions affect economic and financial development overseas...”
• Seems uncontroversial. The question being how this realization should affect central bank policy in general, and Federal Reserve policy in particular.
A historical perspective suggests that this question is not new

- My own work on the two first decades of the U.S. central bank, that is, from 1914 to 1934 (displayed here), points to a number of instances when international considerations featured prominently in the Fed’s decision-making.
  - Let me talk a little more about this rich historical period.
Doing so requires making the following distinction

• It requires distinguishing several different senses in which international considerations could have influenced U.S. monetary policy.
  – Four different senses, in point of fact.
First, the Fed could have organized policy around an international target or external economic indicator. It could have adopted an exchange rate target (as it did by pegging the dollar price of gold and maintaining a minimum statutory ratio of gold reserves to monetary liabilities) and adapted policy accordingly (something that will have to be established).

Second, it could have adjusted its policies so as to influence economic and financial conditions in other countries, because developments abroad had a significant impact on the American economy.

Third, the Fed could have adjusted its policies with problems in other countries in mind because it cared about the problems of those other economies, independently of any immediate impact on the U.S. economy.

Finally, the Fed could have adjusted its policies with international considerations in mind because it was concerned with stability of the international monetary and financial system as a whole.
• You will note that these four senses in which international factors could matter also figure in current discussions of US policy:
  – Some say that the Fed should pay more attention to how events in the rest of the world are affecting the prospects for the US economy.
    • Janet Yellen flagged this concern in the speech I cited earlier.
  – Others say that the Fed should worry about the impact of its decisions on other countries insofar as those foreign impacts feed back on the US.
    • Again, this concern was flagged in the Yellen speech.
  – Still others say that the Fed should worry about the welfare of other countries for its own sake.
    • A view that is, understandably, more controversial.
  – And still others point to the Fed’s responsibility for the stability of the global monetary and financial system.
    • Again, controversial.
    • So what can history (the colorful history of the Fed’s first two decades) tell us about these questions?
In my historical period, international considerations mattered importantly on 6 occasions that I will now briefly discuss:

- 1919-20 recession
- 1924-5 interest rate cuts.
- 1927 decision to reduce interest rates.
- May-July 1931 emergency loans to European central banks.
- October 1931 interest rate hike.
- August 1932 abandonment of expansionary open market operations.

  - This, you can see, was a period when the Fed paid extensive attention to international considerations.
  - And the results, ultimately, were unhappy. (Fed policy in the 1920s and 1930s is not widely praised.)
  - Therein lies a cautionary tale, as I will emphasize at the end.
Post-WWI Recession

• This was the first Fed-induced recession.
• The decision to tighten in 1919 and early 1920 was motivated by international considerations.
  – US gold ratio were falling, as flight capital was repatriated to Europe, dictating tightening on Gold-Standard Doctrine grounds. Reserve ratios in late 1919 and early 1920 were dangerously close to the 40 per cent statutory minimum.
    • So the Fed tightened starting in November 1919.
  – Preserving the US gold standard also set the stage for restoration of the international gold standard.
    • Which certain influential figures within the System, like Benjamin Strong, viewed as a priority.
• The gold reserve ratio bottomed at 42% in May 1920 and then began to rise.
  – Thus, the sharp but short post-WWI recession was mainly a byproduct of the Fed’s pursuit of international targets.
Post-WWI Recession

• As you can see here, this was a deep recession, one of the three most severe recessions of the 20th century.

• Which, in my view, should have served as a cautionary tale.

Fig. 1. Percentage change in real GNP, 1910–1929. (Source: Table 6.)
Easing in 1924-5 and 1927

• First initiative designed to help Bank of England back onto the gold standard.

• Second initiative designed to help keep it there.
  – Second episode in particular is criticized for fueling domestic financial excesses.
  – You can guess to what I am referring.
Summer 1931 Emergency Loans

- Response to the spreading Central European banking crisis.
- Included $1 million for Austria on May 30, $2 million for Hungary on June 19 (later increased to $5 million), $25 million for Germany on June 26, and $125 million for Bank of England on August 1st.
  - US nominal GDP is 200 times larger now. By this metric this was a $200 m. loan for Austria, a $5 b. loan for Germany, and a $25 b. “swap line” for England. Total of $30 b. or so at 2015 prices. Small by recent standards.
  - Treasury Secretary Mellon (an ex officio member of the Board) and several other board members opposed more extensive support. Half-hearted support was too little, too late. And the consequences spilled over to the United States.
October 1931 Tightening

- No question in this case that international considerations dominated.
  - Occurred after Britain’s departure from gold.
  - Tightening was a clear response to gold outflows.
  - Greatly aggravated the severity of the Great Depression.
Open Market Operations of April-August 1932

- Gold losses accompanied the expansionary open market operations, and Gold Standard Doctrine dictated tightening in August.
  - So I argued (in this book) long, long ago...
- The skeptics (Hsieh and Romer) argue that new (post-Glass-Steagall) gold cover ratios were never threatened.
- I of course am an impartial arbitrator. But my view, for what it’s worth, is that Gold Standard Doctrine was not just a statute but also a mentalité, and worries about the gold cover ratio remained influential.
- My view is that the central bank’s prioritizing international over domestic considerations in October 1931 and August 1932, greatly aggravated the Great Depression.
- It was, in large part, what precipitated FDR’s transferring control of monetary policy from the Fed to the RFC (and ultimately to his own hands) in 1933.
So how do we evaluate the role of international considerations overall?

- This short review suggests that the Fed was right not to ignore conditions in the rest of the world. What happened in the UK or Germany didn’t stay in the UK or Germany, as highlighted by the events of 1931.
- That said, Federal Reserve officials could have dealt more wisely with the international aspects of policy.
- Attempting to reconstruct an international gold standard along prewar lines in social, political and economic circumstances that were now radically changed was not wise, perhaps. (It is tempting to draw a parallel with the euro...)
- Once that decision was taken, however, the Fed either should have either supported that system wholeheartedly or else acknowledged that the experiment was a failure and abandoned it. The half-measures taken in 1931 to support Austria, Germany and the United Kingdom solved nothing. (It is tempting to draw a parallel with the euro...)
• At the same time, if you believe (as I do) that the Fed has to worry about global financial stability as well as domestic price and financial stability, then it needs to develop multiple instruments to target multiple objectives.
  – The Tinbergen Principle applies here, as elsewhere.

• You can only hit two birds with one bullet by dint of (very) good luck.
  – Extending larger loans (swap lines) to the Bank of England and British government would have been a better approach than interest rate cuts in 1924 and 1927, for example.
Finally, 1930s experience sheds light on the controversy over “currency wars”

• This argument, in its current incarnation, has a long history.

• Ragnar Nurkse, in his 1944 classic, *International Currency Experience*, argued that reflationary policies following the collapse of the 1920s-era gold standard operated by depreciating the exchange rate. Countries that pushed down their exchange rates had the greatest success at preventing further falls in prices and output, insofar as they substituted external demand, in the form of additional net exports, for deficient demand at home.
But the policy was “beggar thy neighbor”

- One country’s additional external demand was another country’s loss. Insofar as all countries eventually followed suit, no country was able to depress its exchange rate on a sustained basis.
- The net effect of their uncoordinated policies was just additional currency volatility and uncertainty that depressed international trade and compounded the fall in spending.
- Competitive devaluation was therefore a negative-sum game.
• These are exactly the arguments made by today’s Cassandras of currency wars.

• In the current environment, they warn, the only way for central banks to stave off deflation is by using conventional and unconventional monetary policies to depreciate the exchange rate.
  – With interest rates already having been pushed to zero and in a growing number of cases below, there is no scope for monetary policies, conventional or unconventional, to push up the prices of risk assets and otherwise operate through portfolio-balance channels.
And as for the expectations channel...

• ...the main way for central banks to transform expectations and credibly signal that the future will be different from the past is by actively depreciating the exchange rate, something that under normal circumstance they hesitate to do.
  – This is precisely what a growing number of central banks, seeking to shape expectations, are now doing.

• The problem being that not every central bank can push its currency down on the foreign exchange market at the same time.
  – The net result is that they only neutralize one another’s signals. Their uncoordinated actions only heighten exchange rate volatility, further depressing international transactions.
A view based on what theory? What evidence?

• Neither Nurkse, nor the many other economists and textbook writers who channeled his arguments, had a model of monetary policy in the 1930s.
  – They simply observed that the main way it operated was by pushing down the exchange rate.
  – Other channels of transmission, it seemed, were weak or inoperative. Had those other channels been effective, output, employment and trade would have recovered robustly once the gold standard was abandoned and central banks regained their policy autonomy.

• Instead, the recovery of output and employment was lethargic, presumably because the positive effects of policy were neutralised by competitive devaluations.
  – World trade was still more than 10 per cent below 1929 levels at the end of the 1930s, presumably reflecting the negative-sum effect of the resulting foreign exchange market volatility and uncertainty.
Subsequent scholarship shows (I like to think), that the main reason monetary policy didn’t work more powerfully in the 1930s was that it wasn’t tried (apologies to E. Cary Brown). As I have argued here, central banks in the 1930s were reluctant to utilize their newfound monetary freedom. They were uncomfortable about making policy without an exchange rate anchor. They feared an outbreak of uncontrollable inflation even in what was a deeply deflationary environment.

• Because, in this deflationary environment, they failed to make open-ended commitments to raise prices, they failed to effectively transform expectations.

• Because they failed to supplement the new monetary regime with supportive fiscal action, they failed to convince investors that they were committed to a fundamentally new policy regime.

• Because they hesitated to expand domestic credit more aggressively, they ended up relying on net exports as a way of supporting domestic demand, as argued here.

• And because they failed to coordinate their monetary and exchange rate policies internationally, haphazard exchange rate changes only created volatility and uncertainty.

Today, in contrast, central banks like the Bank of Japan and European Central Bank are making open-ended commitments to do what it takes – to stick with their security-purchase programs until they produce the desired result of inflation expectations anchored at 2 per cent.

- The Japanese government has deferred its second VAT increase and embarked on a modest balanced-budget fiscal expansion.
- The Eurozone shows signs of moving, at least modestly, from fiscal consolidation to greater fiscal ease.
• With sufficiently aggressive monetary action and supportive fiscal steps, policy can still produce results even in this environment.
• But without that action and those steps, the Cassandras of currency wars will be right.
Implications for Today

• Even a central bank with good reason to worry about economic and financial conditions in the rest of the world will achieve nothing if it fails to attend first to the health and stability of its own economy.
  – This was true of the Fed in the 1920s and 1930s.
  – The same is true today when we hear calls for the Federal Reserve to abandon policies tailored to the needs of domestic stability in order to address problems in the rest of the world.
  – Better is to develop a second set of instruments expressly tailored to this second set of objectives.
    • By analogy with the argument for macroprudential policy as a second set of instruments for pursuing financial stability goals.
• The problem here is the failure of the Fed to make its 2008 currency swaps to emerging markets permanent.
• It is the partial and capricious manner in which they were extended (to only four emerging markets).
• It is whether the “audit the Fed movement” will allow such policies to be repeated.
• And it is whether the US will authorize the governance reform that is a necessary if not sufficient step toward the IMF taking on such a role.
• Thank you very much.