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## **U.S. Current Account Deficits and the Dollar Standard's Sustainability: A Monetary Approach**

by

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1. Introduction and Overview: Current Account Deficits Forever?
2. Statistical Dimensions of Today's Dollar Standard and the Euro "Threat"
3. The Exchange Rate and the Trade Balance: The Phillips Curve Déjà Vu?
4. Bretton Woods I and II: The Undervaluation Myth versus the Monetary Approach
5. Taylor's Rule, U.S. Monetary Policy, and Excessive Inflation in the New Millennium
6. The Transfer Problem in Reducing the U.S. Current Account Deficit
7. The Subprime Lending Crisis, the Trade Balance, and the U.S. Treasury

*Notice the non-standard format of this paper. The section headings read together are the equivalent of an abstract. The paper itself is simply an overview of these seven sections, which could become seven chapters in a future book. When I refer to supporting data and analysis in a particular section, it exists but has not yet been incorporated into the paper.*

*References in this overview refer mainly to my articles and books that are available on demand. These contain the supporting data and more formal underlying analyses. My apologies for not being more completely scholarly at this stage in the manuscript's development. Yet, I believe this overview by itself hangs together sufficiently to explain my idiosyncratic monetary approach to understanding the international dollar standard.*

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## **Introduction and Overview: Current Account Deficits Forever?**

Economists have failed rather dismally to construct convincing theoretical models of why the seemingly endless U.S. current account deficits are sustained by a seemingly endless willingness of the rest of the world to acquire dollar assets. Reflecting this conceptual inadequacy, many see the continuation such of global “imbalances” to be unsustainable because foreigners—both governments and their private sectors—will eventually cease buying dollar assets, which will trigger a collapse in the dollar’s value in the foreign exchanges. Beginning with the infamous twin deficits of the Reagan presidency in the 1980s, such failed predictions have been commonplace for more than 20 years.

Throughout Asia, the Americas, and much of Africa, the dollar remains the dominant money as a vehicle for clearing international payments between banks, as a unit of account for international trade in goods and services, and as a reserve cum intervention currency for governments. True, the euro has become by far the most important regional currency spanning the smaller economies immediately east of the euro zone. There is a “euro standard” in Eastern Europe. But the euro is not yet important for transacting among non-European countries, whereas the dollar dominates transactions *not* involving the United States, e.g., when China trades with Malaysia or Brazil or Angola.

This resilience of the world dollar standard makes the dollar definitive international money. Alone among nations, the United States has a virtually unlimited line of credit with the rest of the world to sustain its current account deficits because, in extremis, it could create the necessary international means of payment to repay debts to foreigners. This confounds the prognosticators of the dollar’s imminent collapse because they have seen less highly indebted countries in Asia and Latin America ultimately being forced to repay—often in crisis circumstances. What makes the position of the U.S. dollar, and the borrowing capacity of the American economy, so different?

### **The Monetary Approach**

Rather than appealing to America’s military or commercial or political hegemony—past or present—to explain the dollar’s continued international predominance, I shall take a more purely monetary approach. It has two main facets.

First is the need for one common international money, really a natural monopoly, to facilitate complex multilateral exchanges in goods and capital flows. It is directly analogous to having a single money—as a medium of exchange, unit of account, and store of value—to facilitate purely domestic transacting within a purely national domain. In Section 2 and in McKinnon (2005a), I touch lightly on this literature emphasizing the importance of inertia in preserving the dollar’s domain in international exchange—and mainly content myself with updating the empirical dimensions of the dollar’s continuing role in facilitating transacting on an international scale. Once a national money becomes

predominant internationally, economies of scale and network effects make it hard to displace.

Second, going beyond the purely domestic monetary analogy, the dollar acts as a *monetary anchor* for the macro economic policies and price levels of other countries. This anchoring role takes a strong form when countries opt to fix their exchange rates (typically within a narrow band) indefinitely against the dollar—as with many Western European economies (including Japan) in the 1950s and 1960s under the old Bretton Woods regime, or China from 1995-2005, or many small island economies which have dollar-based currency boards such as Hong Kong's. If the fixed nominal exchange rate is maintained long enough, and impediments to trade are absent, inflation rates in the prices of tradable goods in such countries converge to those prevailing in the United States.

More widespread at the present time, however, is a somewhat “weaker” form of the dollar's international role as a monetary anchor. Because prices of tradable goods and services, virtually all primary products and most manufactures (except for exports from industrial Europe) are set in dollars in international markets, central banks in emerging markets and less developed countries unofficially peg “softly” to the dollar—sometimes called Bretton Woods II. Although they no longer have official dollar parities, they intervene continually to smooth high frequency, i.e., day-to-day or week-to-week, fluctuations in their dollar exchange rates—and stand ready (with high dollar reserves) to prevent major fluctuations (Reinhart 2000, McKinnon 2005b ch.2). Occasionally, even more developed economies, which nominally are floaters, will intervene. In 2003 into early 2004, the Bank of Japan intervened massively to buy dollars in order to prevent a sharp appreciation of the yen.

Instead of borrowing in its own currency, a debtor country on the dollar's (or euro's) periphery can only borrow on reasonable terms in foreign exchange—largely dollars (or euros) and so bears the exchange risk. Thus it must worry about fluctuations in the value of its currency against the dollar. A devaluation will increase the servicing cost of its dollar-denominated debts forcing internal bankruptcies in the short run, and inflation in the longer run—as per Argentina's deep devaluation in 2002, or those of the five East Asian crisis economies 10 years ago. Once a peripheral debtor country builds up significant foreign currency debts, it becomes vulnerable to an attack with capital flight that leaves it with insufficient dollars with which to repay its (dollar) debts. The resulting debt defaults, loss of access to foreign capital, and deep devaluation can then and force a painful cutback in domestic expenditures and fall in the government. The markets know this, so they limit how much any peripheral country can borrow in the first place—although perhaps not stringently enough.

However, in the new millennium, after more than 20 years of U.S. current account deficits, most U.S. trading partners have become dollar creditors—but creditors which also bear the foreign exchange risk because they cannot lend to the United States in their own currencies. Instead, they pile up dollar claims. Those with substantial holdings of dollar assets worry that a sharp appreciation of their currencies would lead to capital losses for the domestic holders of the dollar assets—as well as a decline in the mercantile

competitiveness of their exporters. If prolonged, an appreciation would impose domestic deflation—as per the earlier experience of Japan in the 1980s into the mid 90s.

Consequently, in order to avoid currency appreciation and deflation, surplus-saving countries, in Asia, the Persian Gulf, and elsewhere, are now trapped into acquiring dollar assets from the saving-deficient United States. If purchases of dollar assets by their private sectors are insufficient to cover their current account surpluses, their central banks step in as residual buyers to prevent their currencies from appreciating. The upshot is the huge build up of official exchange reserves, typically in U.S. Treasury bonds, by central banks in Asia and oil producing countries more generally. These *stocks* of official exchange reserves now far exceed any estimate of what is prudent or optimal. Instead, these “reserves” are largely the unwanted residue from their efforts at exchange rate stabilization in the face of ongoing *flow* imbalances—their current account surpluses.

The U.S. current account (trade) deficit is the mechanism by which real resources are transferred from the rest of the world: the counterpart of foreign net purchases of U.S. financial and other assets. From its central position in the world’s financial system, the United States alone can borrow in its own currency, i.e., issue dollar denominated debt. Because the United States is never going to run out of dollars, it can always avoid outright defaults on its government’s debts—if only because the U.S. Federal Reserve System can always step in to buy back U.S. Treasury bonds held by foreigners.

Although foreigners creditors see no default risk in holding U.S. Treasury bonds, they would balk at a substantial loss in the dollar’s real purchasing power—as with general inflation in the United States, or substantial devaluations of the dollar against several other currencies that reduce the dollar’s purchasing power elsewhere. Then, foreign central banks would no longer be so anxious to stop their currencies from appreciating against the dollar, and would withdraw from being dominant buyers of U.S. Treasuries. Consequently, the key to maintaining the dollar standard in its present form—and with it America’s indefinitely long line of credit from the rest of the world—lies mainly with the U.S. Federal Reserve Board’s control over monetary policy, and not directly with the U.S. Treasury’s control over fiscal policy or the American saving rate more generally. *As long as the American price level remains stable, there is no well-defined ex ante restraint on the amount the U.S. can borrow internationally.*

Is the Fed up to the job? In principle, the Fed is committed to a policy of low inflation—although it has yet to name a definite low inflation target in the mode of the European Central Bank or the Bank of England. Nevertheless, the U.S. is the country where Taylor’s Rule was born (Taylor 1993)—where my colleague John Taylor estimated the rule econometrically as if the Fed was targeting the rate of inflation of about 2 percent in the American CPI. In Section 5, I reproduce Taylor’s Rule, and try to assess how well the Fed has done by this criterion in recent years.

## **Rising Protectionism in the United States and Conflicted Virtue in Asia**

Be that as it may, currently the main threat to the Fed's ability to commit to stable money is not monetary *per se*. Rising protectionism in the United States is the major threat to the dollar's pre-dominance as international money. By threatening trade sanctions against imports from trade-surplus countries unless they appreciate their currencies, many politicians and economists in the United States hope to force widespread devaluations of the dollar against the yen, renminbi, and the currencies of other surplus saving surplus counties—much like the Nixon Shock of August 1971.

These threatened American trade sanctions thrust the surplus Asian countries onto the horns of a dilemma, which I call *conflicted virtue* (McKinnon 2005b). Trade surplus countries are “virtuous” in the sense of being high savers, but this naturally generates a collective current account surplus in trade with the saving-deficient United States. American politicians and many economists then see these foreign trade surpluses, often accompanied by large buildups of official exchange reserves, as *per se* evidence of unfair currency manipulation to keep Asian currencies undervalued. So American politicians apply pressure to have the Asian currencies appreciated.

But any individual Asian government knows that a substantial appreciation of its currency against the dollar would create domestic macroeconomic turmoil: exports, domestic investment, and spending more generally, would fall with slower economic growth. A sustained appreciation of its nominal exchange rate would eventually lead to deflation—as in Japan in the 1980s and 1990s. But if it fails to appreciate, it could be subject to American trade sanctions. So under this outside political pressure to appreciate, the foreign creditor country becomes “conflicted”—whence *conflicted virtue*.

Suppose, however American political pressure takes a more general form. Beyond any individual foreign country, suppose most American trading partners were coerced into agreeing to appreciate. Most have trade surpluses of greater or lesser degrees because as the counterpart of the huge U.S. trade deficit. William Cline (2005) is a leading advocate of a more general devaluation of the dollar against 30 or more leading U.S. trading partners. From the monetary approach to exchange rate determination, however, *a general nominal depreciation of the dollar could only be sustained if U.S. monetary policy becoming more expansionary relative to its trading partners, i.e., inflation at home and relative deflation abroad.*

In sustaining such a general dollar devaluation, how the necessary monetary adjustment would be partitioned between inflation in the United States and deflation elsewhere is quite arbitrary. It depends on the particular historical circumstances associated with such an economically cataclysmic event. For several years after the Nixon shock of August 1971 requiring the sharp appreciation of European currencies, the Japanese yen, and the Canadian and Australian dollars, high inflation in the United States (initially suppressed by wage-price controls) and more subdued inflation elsewhere was the mode of adjustment. For 10 years after the Plaza Hotel Accord of 1985 when the

major industrial countries agreed to have their currencies appreciate against the dollar, there was outright deflation in Japan whose currency appreciated the most, and suppressed deflation in Europe (then called “eurosclerosis”), and relatively modest inflation in the United States.

## **Two Conundrums**

Behind today’s rising protectionism in the United States and conflicted virtue in Asia are two related conundrums.

The first conundrum is the painful “real” transfer problem. The transfer of Asian saving to the U.S. in real terms shrinks the size of the U.S. manufacturing sector, a shrinkage that is at the root of the protectionist upwelling in the American mid west and east coast—even though full employment in the country overall has been well maintained by the offsetting expansion of service industries.

Why is U.S. manufacturing particularly impacted? The principal Asian creditors—Japan, China, Korea, Taiwan—and principal European creditor Germany, only export manufactures and are themselves major importers of services and raw materials including oil. Thus, their trade (saving) surpluses with the rest of the world, and bilaterally with the United States, are embodied in a surplus of manufactured goods exported to the United States—forcing a contraction in U.S. manufacturing employment (McKinnon 2005c). Notice that because of more rapid technical change in manufacturing compared to other sectors of the economy, employment in manufacturing has been falling in all of the mature industrial countries. But it is falling relatively faster in the United States because the American saving deficiency necessitates net imports of manufactures from foreign industrial, or industrializing, countries.

So American protectionism for manufacturing is not purely gratuitous politically. But unfortunately, the protectionists see it as an exchange rate problem rather than as an international saving imbalance. Although this perception is false, it is no less of a threat to de-stabilizing the purchasing power of the dollar and igniting inflation in the U.S.

The large trade and saving surpluses of the oil producing countries, such as the Emirates in the Persian Gulf don’t generate a similar protectionist response in the United States. Although Americans don’t like the high price of oil, they need it. Moreover, oil is homogenous and relatively anonymous in its impact on American industries—and there is no “obvious” exchange rate or tariff measures that the U.S. could take to change the behavior of, say, Saudi Arabia.

The second conundrum is doctrinal: the widespread belief in the economics profession, and among fellow travelers, that countries with trade surpluses should appreciate their currencies to (help) reduce the surpluses. Although plausible (like the belief in the Phillips Curve trade off between inflation and unemployment in the 1950s and 1960s), this belief in the desirability of exchange rate appreciation for trade surplus

countries (or devaluations for deficit countries) is not generally valid for the highly open economies characteristic of today's era of "globalization".

In particular, if creditor countries with dollar assets, such as China or Japan, are pressured into appreciating their currencies, the effect on their net trade surpluses would be indeterminate. This all-important conceptual issue is taken up in Section 3 below, but the basic indeterminacy had been established earlier in McKinnon and Ohno (1997, Chs. 6 and 7) and Qiao (2007). However, the mainstream of the economics profession continues to believe that the exchange rate should be assigned to adjusting trade imbalances—a belief that could yet undermine the dollar standard.

## **Bretton Woods I and II: Mercantilism Unbound**

Michael Dooley, David Folkerts-Landau, and Peter Garber (2003) present a mercantilist argument (discussed in Section 4 below) which presumes that emerging markets in general, but Asian countries in particular, are deliberately undervaluing their currencies to generate export surpluses—particularly to the United States. They see emerging market trade surpluses to be sustainable because of compatible mutual interests. The United States needs external financial support to offset its low domestic saving and the emerging markets (including Japan apparently) want higher real growth through exports to promote development.

DFG are to be commended for coming up with a model that at least tries to come to grips with long-term global "imbalances" i.e., why U.S. current account deficits have run on for such an unexpectedly long time. They are right to ridicule proponents of dollar devaluation as throwing red meat to the protectionists, and scathing of those who use faulty inter-temporal modeling of international capital flows to continually predict an imminent collapse of the dollar. However my alternative monetary approach to explaining the willingness of Asian governments, and those in other emerging markets, to stabilize their dollar exchange rates differs from DFG's mercantilist approach in several dimensions.

In this overview, however, I focus just on the most essential difference: DFG's frequent and incorrect use of the word *undervaluation* to reflect the exchange rate policies of countries on the dollar's periphery. In effect, DFG still see the exchange rate as a control variable for the net trade balance in line with the elasticities model of the balance of trade. Whereas I see the exchange rate itself to have little or no predictive power for the net trade balance, which is dominated by saving-investment imbalances in the U.S. compared to its periphery—as per Section 6 below. But the dollar exchange rate is significant for price-level determination on the periphery .

In their original paper, DFG (2003) drew an intriguing parallel between Bretton Woods I from 1950 to 1971—where the principal high-growth peripheral countries were those of Western Europe and Japan—and what we now call Bretton Woods II, where the high-growth peripheral countries are now in Asia with a scattering of emerging markets

elsewhere. In DFG's view of the 1950s and 1960s, the Western European countries and Japan— under cover of the Bretton Woods parity arrangements—kept the dollar values of their currencies “undervalued” in order to promote more rapid export growth into the American market. The Americans tolerated this mercantilist behavior because, in the Cold War, they were anxious to promote recovery in Western Europe and Japan.

Under Bretton Woods II in 1990s to the present, a large fringe of emerging markets—particularly in East Asia—intervene heavily to keep their dollar exchange rates “undervalued”, in order, according to DFG, to generate export surpluses to better promote their economic development. They are willing to treat the resulting huge build up of official exchange reserves, largely invested in low-yield U.S Treasuries, as an opportunity cost of the more rapid export growth. On the other hand, the U.S has tolerated this mercantilist behavior of the Asian group because it needs cheap finance to cover its very low rate of saving. Because both sides benefit, DFG see the Bretton Woods II regime of high Asian trade surpluses and high U.S. trade deficits to be sustainable. Whence the appeal of their model to explain ongoing global trade “imbalances”.

While commendable in seeing much greater sustainability of the current regime than most other commentators, their model's essential building block, where the peripheral countries in both Bretton Woods I and II, deliberately keep their currencies undervalued to promote exports, or export surpluses, is seriously misleading. Apart from exchange rate policies, export surpluses simply reflect relative saving surpluses.

What then motivates so many emerging markets to peg their exchange rates to the dollar? Under the monetary approach, the peripheral countries peg to the dollar in order to credibly stabilize their domestic price levels. When domestic capital markets are underdeveloped or in disarray for some other reason, then the central bank in a country on the periphery of a more stable valued central currency finds it much easier to peg to it as a external monetary anchor in its quest for domestic price-level stability.

Consider some historical examples. After World War II, the capital markets in both Western Europe and Japan were in great disarray with open and repressed inflation, multiple exchange rates, and government controls over both interest rates and bank lending. In 1948 with advent of the Marshall Plan, individual European countries were encouraged to consolidate their finances, eliminate multiple exchange rates and balance of payments restrictions for current account transactions, curb inflation, and then each peg to the dollar at a unified exchange rate. The culmination of this process was the setting up of the European Payments Union (EPU) in 1950, backed by a U.S. line of credit, to begin clearing international payments multilaterally by central banks at fixed dollar exchange rates—not even with the one percent margins of variation in the Bretton Woods agreement itself. With some modifications, these central dollar parities for Western European currencies held for the better part of 20 years—although the one percent margins of variation around these central rates became common after 1958.

Japan was similar. From 1945 through 1948, there was open and repressed inflation, multiple exchange rates, and all kinds of interest rate and balance-of- payments

controls for allocating foreign exchange. Then in 1949, the Detroit banker Joseph Dodge was sent to Japan with an American line of credit and instructions to encourage the Japanese to consolidate fiscally and curb inflation, unify the exchange rate, and begin phasing out exchange controls on current account transactions. Because of the financial chaos before 1949, the Japanese had no idea (nor did the Americans) what an equilibrium number for the unified exchange rate should be that would end the inflation but keep the economy viable for exporting. So they just guessed. They picked 360 yen to the dollar to be the anchor, and then geared the Bank of Japan's monetary policy to maintaining this rate so that the economy would grow into it.

But they didn't guess quite right. Inflation continued for a year or two before being phased out—and this left the yen somewhat overvalued in the sense that, in the early 1950s, Japanese companies were having difficulty exporting. But rather than give up their hard-won nominal anchor of 360 yen per dollar and devaluing, they chose to disinflate further to help tradable goods producers. It worked. By the mid-1950s, Japan settled on a high export-led growth path (much like China's today) with the domestic rate of WPI inflation in tradable goods converging to being virtually the same as that in the United States, the anchor country, until the Nixon shock of 1971 (McKinnon and Ohno 1997, and McKinnon 2007b).

Although probably more than enough historical background for most readers, the main point is that, in both Japan and Western Europe in the 1950s and 1960s, dollar exchange rates were set to anchor national price levels and stabilize domestic financial markets—as our monetary approach would have it. Unlike what DFG suggest, these rates were *not* cunningly “undervalued” to promote export surpluses and secure a mercantile advantage over the United States. Indeed, the U.S. itself had an overall current account surplus during “Bretton Woods I”.

Since the early 1990s, under the looser dollar pegging called Bretton Woods II, the search for a monetary anchor also describes the behavior of Asian countries and emerging markets elsewhere better than DFG's alleged mercantilist plot to deliberately “undervalue” their currencies to generate export surpluses. There are too many of these countries to do a historical analysis of each one in this overview.

However, consider just China. Before 1990, China's currency was inconvertible with exchange controls and mandatory state trading companies for importing and exporting that (with the exception of special economic zones) insulated the domestic structure of relative prices from the international one: the so-called airlock system. In this early phase of China's liberalization of its domestic markets, it would not have been possible to use the nominal exchange rate as a monetary anchor. Indeed, wherever the official exchange rate was set (beginning at one yuan per dollar in 1978) was quite arbitrary and made little difference to actual economic decision making within the country. And China did experience something of a roller coaster ride in domestic rates of inflation and real growth rates (McKinnon 2007a) into the early 1990s.

From 1993 to 1995, China suffered a major bout of inflation, peaking out at over 20 percent per year. In 1994, in a major move toward current account convertibility to satisfy the International Monetary Fund, China decided to unify its multiple “swap” exchange rates with the official exchange rate—including a net depreciation in the unified rate of about the same order of magnitude as the internal inflation. Of course, nobody knew precisely what the new unified rate should be in “equilibrium”, but by 1995 the rate was pegged at 8.28 yuan per dollar and held there for 10 years. The economy grew into this new monetary anchor and inflation converged down to the American level. Indeed, in 1997-98, there was net deflationary pressure in China from the Asian crisis when the surrounding smaller countries (and export competitors)—Korea, Indonesia, Malaysia, Philippines and Thailand—were forced into depreciating. Fortunately, China ignored foreign advice to depreciate with them (which would have made the regional calamity much worse), held on to its nominal anchor of 8.28 yuan/dollar, and engaged in a large internal fiscal expansion to overcome the deflationary pressure.

So the China story in Bretton Woods II is similar to that of Japan’s and Western Europe’s in Bretton Woods I. Before securely pegging to the dollar, all of these countries had inflation, financial disorganization, and inconvertible currencies. The most efficient way out was to peg to the more stable central money, and then move toward greater currency convertibility so that the dollar peg became a more effective monetary anchor. What is clear, however, is that the nominal exchange rate cum future monetary policy in each case was chosen in a crisis situation to secure domestic financial stability. The dollar exchange rate was not deliberately, or even accidentally, undervalued so as to secure a mercantile advantage for exporting into the American market.

Using our monetary approach, the Bretton Woods II model where peripheral countries continue to peg—albeit loosely—to the dollar as an anchor, is potentially more robust than DFG’s mercantilist model. The monetary model could survive a major re-balancing of trade flows associated with a rise in net saving in the United States accompanied by an equivalent fall in Asia—all with nominal exchange rates remaining unchanged—as we shall see.

### **The Transfer Problem in Reducing the U.S. Current Account Deficit**

Correcting global trade imbalances is a form of the transfer problem: spending must be transferred from trade-deficit countries (mainly the United States) to trade-surplus countries. Reducing the U.S. current account deficit requires that net saving be increased in the United States and reduced abroad—particularly in Asia. But contrary to most literature on the subject, exchange rates need not, and probably best not, be changed as part of the transfer process for improving the U.S. trade balance (McKinnon 2007c.)

To show why this is so, I draw on the older literature on the transfer problem associated with paying war reparations—see Section 6 for a more detailed analytical model. Adjustment in absorption, i.e., aggregate spending, is two-sided because the loser (the transferor) must raise taxes to pay an indemnity to the winner (the transferee), which

then spends it. But there is no presumption that the terms of trade must turn against the transferor. That is, the losing country, which is forced into running a trade surplus (or smaller deficit), need not depreciate its real exchange rate to effect the transfer.

The definition of the “real” exchange rate is important here. If foreign and domestic prices are rather sticky in response to a change in the nominal exchange rate—as in the elasticities model of the balance of trade or in large scale macroeconomic models which typically presume that each country produces just one good (as with the U.S. Federal Reserve’s Sigma Model)—then the terms of trade turn against the devaluing country. So most authors associate a depreciation of the nominal exchange rate with a decline in the terms of trade, i.e., export prices fall relative to import prices. But such a devaluation is not necessary, and possibly even counter productive. Beyond having the United States tighten its belt by reducing expenditures relative to income in the process of reducing the American trade deficit, a devaluation that turns the terms of trade against the U.S. would impose an unnecessary secondary burden.

Over the extended period when the expenditure reduction would (must) take place in the United States, as paired with a rise in expenditures in Asia and elsewhere, the relative price of tradables versus non tradables must increase in the U.S. and fall abroad. How much is anybody’s guess. However, with the necessary expenditure adjustments being spread out over some months or years, and modern technology continually eroding the distinction between tradables and nontradables, this necessary relative price change could be surprisingly modest.

With no change in the dollar’s nominal exchange rate so that the dollar prices of tradable goods worldwide remain unchanged on average, the dollar’s anchoring role for price-levels in peripheral emerging markets (as per the monetary approach) would be undisturbed even though the U.S. trade balance improved.

### **The Subprime Lending Crisis, the Trade Balance, and the U.S. Treasury**

The necessary decline in overall spending in the United States must fall mainly on the household sector. The huge net spending deficit of American households, including residential construction, of the order of 4 percent of GDP (see Section 7) is indeed without historical parallel. However, with the subprime crisis and new restraints on mortgage lending, coupled with a fall in home prices, the American household’s sector spending deficit could turn around fairly quickly and become a normal surplus.

Should we worry about a deficiency in global aggregate demand when American households reduce their spending? In the longer run, the overdue righting of the financial imbalance in American households is both opportune and necessary to reduce the huge American current account deficit. But, in the near term when American households are no longer “consumers of last resort”, how can this be accomplished without falling into a pit of deficient aggregate demand at the global level?

Instead of nattering about the dollar's exchange rate, which is the wrong variable to adjust, the U.S. Secretary of the Treasury should now approach his counterpart finance ministers in East Asian countries and possibly Germany to expand aggregate demand jointly. In China, for example, household consumption has been lagging behind the very rapid growth in GDP; and China's recent success—not fully anticipated—in collecting taxes could be generating an as yet unrecognized fiscal surplus. Similarly, Japan has actually been running public sector surpluses over the past four years. So these governments, and Germany's, can afford to be fiscally expansive over the next two years or so as part of a world wide countercyclical policy. Apart from international altruism, each of these countries has an individual incentive to expand fiscally because their exports will decline as the American consumer is forced to retrench.

If foreign governments jointly become more expansionary, the U.S. can better avoid another unwise round of unduly easy monetary policy—like that following the collapse of the high-tech bubble in 2001. And further American fiscal expansion is not desirable if the current account deficit is to be reduced. (This does not rule out a balanced-budget expansion such as a substantial increase in the federal gasoline tax to support a much needed rebuilding of roads and bridges.)

But how can U.S. Treasury Secretary Henry Paulson orchestrate with incentives a collective fiscal expansion in Asia and Europe? In April 1995, his illustrious predecessor, Robert Rubin, announced a strong dollar policy and the end of two and a half unhappy decades of Japan bashing to get the yen up and the dollar down, which severely damaged the Japanese economy. Circumstances are not quite the same in 2007. But today's China bashing to get the renminbi up has been going on for more than four years, with legislation in Congress threatening high tariffs on Chinese goods unless the renminbi is sharply appreciated. Somewhat surprisingly, Japan bashing also returned earlier this when the incoming Democratic committee chairmen—Levin, Rangel, Frank, and Dingel—wrote to Secretary Paulson to criticize the weak yen and unduly low interest rates in Japan (McKinnon 2007b).

At this critical juncture, with the fall in American consumer spending, the way forward is clear. Secretary Paulson should call a summit of Asian and European finance ministers to work out a joint program of fiscal expansion outside the United States. In return, he would reinstate Rubin's strong dollar policy by ending the bashing of China and Japan to appreciate their currencies. Ideally, he could even promise to reform the notoriously arbitrary U.S anti-dumping laws and other protectionist legislation.

At the beginning of his term as Secretary of the Treasury, Henry Paulson announced his intention of getting the U.S to engage China "constructively". He judged that a smooth economic and political relationship between the two economic giants was key to their mutual prosperity in the new millennium. He was right.

But suppose, instead of this constructive engagement, the doctrinal battle on the exchange rate is lost. At the behest of American protectionists, suppose the U.S. government moves toward a policy of forcing continual dollar devaluation on its trading

partners until there is a substantial reduction in the U.S. trade deficit. But because the supposed link between the relative price effects of exchange rate changes and the trade deficit is not there, the U.S. trade deficit need not fall. In denial, the U.S. government keeps pushing for further devaluation—as it did with continued forced appreciations of the yen in the 1970s through mid 1995.

Once foreigners see this happening on a worldwide scale, they will stop buying dollar assets—leaving the dollar in potential free fall and losing their monetary anchor. But the major damage would be in the United States itself. The cessation of foreign purchases of dollar assets and capital flight from the U.S. will shock the saving-deficient American economy with a sharp credit crunch and high interest rates. Domestic spending in general, and that for investment in particular, would fall sharply so as to compress imports and reduce the trade deficit. But such a reduction in the trade deficit would come primarily from the catastrophic fall in domestic absorption and not from the relative price effects of the dollar devaluation, unlike how the elasticities model would have it.

Thus, in depreciating the dollar and ending the dollar standard, be careful for what you wish for!

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