Reflections on Currency Regimes

BY RICHARD H. CLARIDA

The uncertainty of the dollar's future role.

Ten years ago, in the aftermath of the Asian-Russian-LTCM crisis, I was invited by Paul Volcker to prepare a report for the Group of Thirty on "G3 Exchange Rate Relationships: A Review of the Record and of Proposals for Change." Readers of *TIE* will recall, during that turbulent time, there was widespread (but certainly not unanimous) dissatisfaction with the prevailing regime of managed floating exchange rates among the G3—comprised of the United States, Germany (now the eurozone), and Japan. It was said by many that G3 exchange rates were not well-anchored by fundamentals and were excessively volatile.

As a consequence, the critics believed, the post-Bretton Woods status quo for G3 exchange rates contributed to, rather than stabilized, the turbulence of the global financial system of the late 1990s. Defenders of the status quo did not, in general, suggest that G3 exchange rate relationships were ideal but rather that the leading alternative proposals—essentially variants of a target zones with hard or soft commitment to narrow or wide bands—were likely either to be inferior or, if superior in the abstract, not feasible (time inconsistent) in practice.

In this article, I reflect on what has been learned about G3 exchange rate relationships that was not clearly foreseen or fully appreciated (including by myself) ten years ago.

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CAPITAL ACCOUNTS NOW DRIVE CURRENT ACCOUNTS—G3 EXCHANGE RATES AND THE SAVING GLUT

Some things never seem to change, but our interpretation of them can and should as the underlying circumstances do change. The United States ran large current account deficits in the 1980s, in the 1990s, and will for the entire first decade of the twenty-first century. In the 1980s and 1990s, large U.S. current account deficits were correlated with high real interest rates in the United States. Low U.S. saving relative to average or better U.S. investment generated a current account deficit which required a capital inflow attracted by these high real interest rates. The U.S. current account deficits of the present decade widened (from an already elevated reading of 4 percent of GDP in 2000) in large part because of the global saving glut—more precisely the excess of desired saving relative to desired investment at unchanged global interest rates.[1] The global saving glut brought down global real interest rates, both spot and forward, and this encouraged consumption and residential investment not only in the United States, but in other countries as well (such as the United Kingdom and Spain).

Initially the driving source of the global saving glut was Asia. China and other emerging Asian countries joined Japan which has had its own structural saving glut (and the current account surpluses to show for it) since the Carter administration. Notwithstanding all the focus on China, and its undervaluation- and export-based development strategy, it is important to remember that as recently as 2003, China's overall current account surplus was just 2 percent of GDP. Since 2003, strong global growth in the emerging world has triggered a commodity boom which has become a second source of excess global saving though the channel of petrodollar recycling.

The global saving glut, and the explosion of gross cross-border capital flows that accompanied it, has had a significant impact on G3 exchange rate relationships. The widening of the U.S. current account deficit that resulted, the fact that much of it has been financed through central bank reserve accumulation and not private capital flows, and the bursting of the U.S. housing bubble that was, in part, caused by it, have for some time and will continue to put downward pressure on the dollar. To date most of this adjustment has been borne by the euro, as well as the pound, the Canadian, and Aussie dollars. Until April 2004, Japan fiercely resisted allowing its exchange rate to appreciate rapidly, intervening massively (and in largely unsterilized fashion) in the foreign exchange markets to halt deflation. Since then, the yen has fluctuated with the whim and whimsy of the pool of global capital chasing exchange rate carry trades, ten years after the original crash of the yen carry trade the source of much fluctuation in the dollar-yen exchange rate. *Plus ça change, plus c'est la même chose.*

GLOBAL RESERVE CURRENCY STATUS OF THE DOLLAR AND ROLE OF THE EURO

A decade ago, there was much anticipation but also a great deal of uncertainty over the prospects for the euro as viable competitor to the dollar. There were those (and I was among them) who were skeptical that European monetary union would even be launched. The skeptics (and they were mostly on this side of the Atlantic) for the most part supported the creation of the European Central Bank and the euro in the abstract, but made the judgment that, in the end, the Bundesbank, among other powerful institutions, would delay the launch or at minimum, limit it to a small, core group of countries. Of course, the skeptics were wrong and the euro and ECB have, without question, more than assumed the role in the first decade of the twenty-first century that the mark and the Bundesbank played in the last decades of the twentieth century.

Given the euro's recent reputation as a strong currency (it hit a record $1.56 as I write this) and a very viable alternative to the dollar, it is easy to forget that the euro spent most of its first three years depreciating against the dollar, all the way from $1.18 at its launch in 1999 to $0.82 in the summer of 2001. I did not at the time judge this to reflect a market verdict against the brand-new ECB, but rather a global market infatuation with U.S. internet and tech stocks. As I often remind my students, everything worth studying in international finance depends on relative not absolute valuations, and the launch of the euro coincided by chance with the peak of the internet bubble (and it should be pointed out, the peak of market preoccupation with the U.S. "strong dollar" rhetoric). Since then, the journey for the euro against dollar has been mostly up, reflecting the forces discussed

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above as well as the accumulating credibility of the European Central Bank in anchoring inflation expectations.

As we look ahead to the next ten years, is it likely that the euro will supplant the dollar as the global vehicle currency? I, for one, do not think so. By vehicle currency, of course, I mean the role that the dollar plays not just in the reserve holdings of global central banks, but also in the daily trading in the foreign exchange market, the interest rate derivatives markets, and as the currency of invoice for global commodity trade and also much trade in goods and services. To date there is no compelling evidence that the dollar's market share as a vehicle currency has materially declined, not withstanding a substantial depreciation since 2001 and somewhat higher U.S. inflation as compared with euro-area inflation.

There is some evidence (for example the International Monetary Fund COFER data on the currency composition of official foreign exchange reserves) that the dollar's share as a global reserve currency has peaked and is on a path of gradual decline. While I expect this trend in reserve diversification to continue, I also expect that it will evolve slowly and not involve a crash landing. There is a crucial difference between dollar's share of reserve portfolio holdings—in which it makes good sense to hold a diversified portfolio—as contrasted with the dollar's role as a vehicle currency in the currency, derivatives, and commodity markets where, owing to economies of scale and scope, there is likely to be only one dominant currency.

Over the longer term, the euro could conceivably supplant the dollar at least as a global reserve currency. The best recent research on this is by Menzie Chinn and Jeffrey Frankel who argue that, absent the United Kingdom—and thus a global financial hub in London—joining the euro, it is unlikely that the euro—lacking such a hub—would be expected to overtake the dollar. However, with the United Kingdom (and London) in the euro, the authors describe plausible scenarios in which a persistently weak dollar (and presumably higher relative U.S. inflation) could trigger a gradual but material shift in global currency reserves to the euro. I would say not implausible, but not likely.

THE EXORBITANT PRIVILEGE—$500 BILLION A YEAR AND A SOURCE OF A WEAKER DOLLAR

Fact one: Between 2001 and 2006, the United States ran cumulative current account deficits in excess of $3.1 trillion. Fact two: Between 2001 and 2006, the U.S. net international investment position improved, and its net foreign liability position fell, by more than $200 billion.

How could the United States run large current account deficits without running up a commensurate increase in its net foreign liability position? The answer reflects the twenty-first century "exorbitant privilege" that accrues to the United States as the provider of the global reserve and vehicle currency. As is by now much better understood than it was a decade ago, there are two sources of the privilege.

While virtually all of the U.S. gross external liability (which at year-end 2006 was in excess of $18 trillion) is U.S. dollar-denominated, most of gross U.S. holdings of foreign assets (which at year end 2006 was in excess of $16 trillion) is denominated in foreign currency. As a consequence of their country's ability to borrow massive amounts in its own currency, U.S. investors benefit from a capital gain (and European, Japanese, and other investors suffer from a capital loss) when the dollar depreciates against the euro, yen, and other currencies. Because of the immense gross holding of foreign assets by U.S. investors, even an orderly decline in the dollar generates a large and growing net capital gain to U.S. investors. In 2002, 2003, 2003, 2004, and 2006, the net capital gain from a weaker dollar accruing to U.S. investors totaled more than $1.3 trillion.

The second and larger source of the exorbitant privilege results from the fact that U.S. investors in the aggregate own a riskier, higher-average-return portfolio than do foreign investors in the United States. U.S. portfolios abroad are weighted toward equity investment and foreign direct invest-

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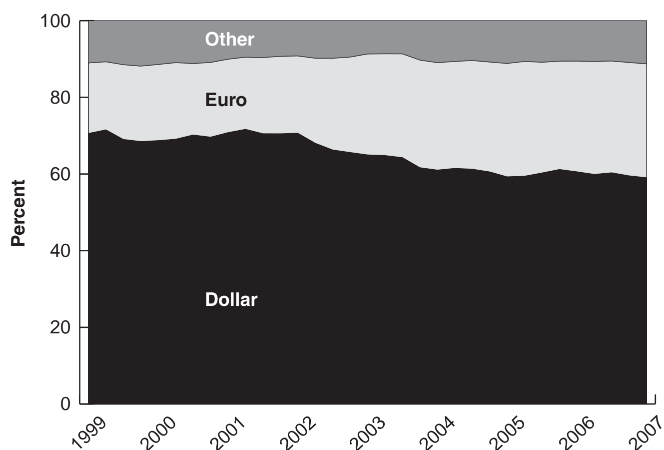
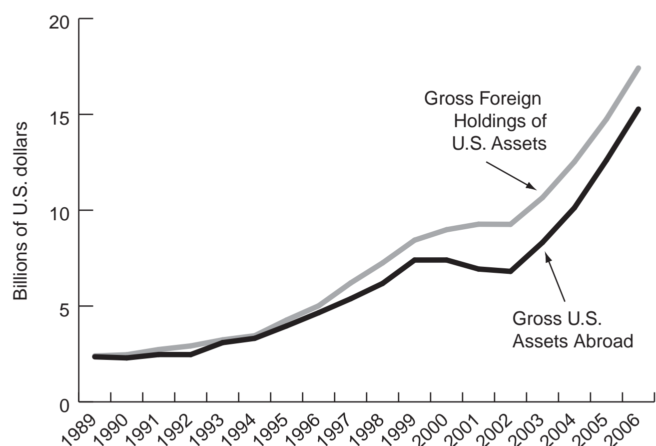
Currency Composition of EM Reserves



Financial Globalization



ment, while foreign claims against the United States are more concentrated in government and agency securities and bank deposits. As a consequence, in recent years capital gains (in local currency) on U.S. investments abroad have far exceeded the capital gains enjoyed by foreign investors in the United States.

Thus, notwithstanding the run of record U.S. current account deficits, the U.S. net international investment position has remained roughly stable in dollar terms and has actually declined as a share of U.S. and world GDP. This does not imply that it will remain stable forever if current account deficits persist. But it does confirm that the United States has benefited from the exorbitant privilege, and that the revaluation of the U.S. net liability position caused by a weaker dollar is an important part of the international adjustment process of the twenty-first century.

This has been costless until recently, because little of recent years' dollar depreciation has been passed through to higher import prices—instead it has been absorbed by the profit margins of foreign producers. If, however, the weaker dollar does start to raise import prices on a more sustained basis, it will translate into a terms of trade deterioration and lower the real incomes of U.S. households. So a depreciation of the dollar produces a one-time capital gain to U.S. investors abroad, but also a potentially permanent reduction in U.S. real income from current production. Thus in open as in closed economies, there is no "free lunch" from dollar depreciation.

CONCLUSION

So much has happened in global finance in the past ten years, it would be foolish to forecast with any precision what will happen in the next ten. It would seem, however, that the financial clout of the saving glut countries—China and the commodity exporters—is likely to grow and to shape in important ways the global capital market and G3 exchange rate relationships. While the most likely scenario is for the dollar to remain the global reserve currency, the fate of the dollar will rest in part on the geo-financial calculations and policies of these sources of global capital outflows. In recent weeks, we have seen a flight-to-quality scenario in which Treasury yields fall in tandem with the dollar. In a true dollar crisis, bond yields would have risen to attract the capital inflow in tandem with a sinking dollar. We are not there yet, in part because European officials are uncomfortable with the euro surge that would accompany a dollar collapse. Perhaps the main uncertainty looking ahead is how much collateral damage to the dollar's role as a global reserve currency will be done by the U.S. policy responses—both fiscal and monetary—to the current crisis. ◆

NOTE

1. I made this point internally at Treasury in 2003 and publicly in a February 2004 speech at the Peterson Institute when I said, "The U.S. current account deficit is a global general equilibrium phenomenon that reflects … a post-bubble excess supply of global saving relative to profitable investment opportunities." The term "saving glut" would be introduced fourteen months later in a speech by then-Fed Governor Ben Bernanke.