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The Credit Crunch and the Flight From the Dollar

By Ronald McKinnon

Beyond the problem of mortgage credit associated with the slump in home prices, the great unresolved puzzle in the current U.S. financial crisis is why other private credit markets are seizing up. The financial press is full of stories of a shortage of U.S. Treasury bonds that are necessary in the multi-trillion dollar interbank market as collateral for borrowing (usually through repo agreements) by illiquid banks. This shortage seems even stranger in the face of a still large federal fiscal deficit – $237.5 billion in 2007 – that continually increases the supply of new Treasurys. However, this shortage of Treasurys, and the unexpected severity of the credit crunch, can be linked to the flight from the dollar in the foreign exchanges.

Since July 2007, the U.S. Federal Reserve Bank has hastily cut short-term interest rates from 5.25 percent to just 2.25 percent in March 2008. Unsurprisingly, private capital inflows for financing the huge U.S. trade deficit have dried up. In addition, hot money has flowed out of the United States into those countries, of which China is the most prominent, with currencies that are most likely to appreciate. Foreign central banks (apart from those in Europe) are then induced to intervene, sometimes massively, to buy dollars in order to slow their currencies' appreciations. In 2007 for example, China

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About The Author

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His fields of interest are international economics and development finance. McKinnon has written over 100 articles and several books, which include: *Money and Capital in Economic Development* (1973); *Money in International Exchange: The Convertible-Currency System* (1979); *The Order of Economic Liberalization: Financial Control in the Transition to a Market Economy,* 1993; *The Rules of the Game: International Money and Exchange Rates,* 1996; *Dollar and Yen: Resolving Economic Conflict Between the United States and Japan (with Kenichi Ohno),* 1997; and *Exchange Rates under the East Asian Dollar Standard: Living with Conflicted Virtue*, in 2005.

His books have been translated into many European and Asian languages, and he has been a consultant to central banks and finance ministries the world over-including international agencies such as the World Bank and International Monetary Fund.

had the biggest overall reserve buildup of $460 billion. Other central banks, from the Persian Gulf oil-producing states to Russia, Brazil, and some smaller Latin American and Asian countries, have also intervened to accumulate dollar reserves.

A substantial proportion of these official reserves is invested in U.S. Treasurys. The Federal Reserve's Flow of Funds data (March 2008) show that in 2007 foreign central banks accumulated about $209 billion of U.S. Treasurys. Somewhat inconsistently, the Treasury's own data show an accumulation of $250 billion.

These purchases of Treasurys by foreign central banks are of the same order of magnitude as the U.S. fiscal deficit. Although acute in 2007 and more so going into 2008, this drain of Treasurys was also very large from 2003 to 2005. By early 2004, the federal funds rate had been cut to just 1 percent, which also triggered a flight from the dollar – at that time more into yen than renminbi. This previous episode of easy money and unduly low interest rates greatly aggravated both the U.S. housing bubble and the more general over leveraging of the U.S. financial system from 2003 to 2006.

In 2007-08, the crash in housing and the implosion of over-leveraged hedge funds, special investment vehicles (SIVs), and so on have increased counterparty risk in most financial transacting. Illiquid financial institutions cannot effectively bid for funds by putting up suspect private bonds or loans as collateral. Unsurprisingly, there is a "flight to quality" that increases the private domestic demand for Treasurys. But this is happening at a time when the flight from the dollar in the foreign exchanges has greatly reduced their supply.

This increased demand coupled with a fall in supply helps explain why, in the midst of a U.S. credit squeeze with higher interest rates on private financial instruments, nominal interest rates on U.S. Treasury bonds have fallen to surprisingly low levels. Despite substantial ongoing U.S. price inflation of 4.3 percent in the CPI and 6.4 percent in the PPI, Treasury yields are less than 1 percent on a three-month bill, 1.32 percent on a two-year note, and 3.5 percent on benchmark 10-year bonds. There are even reports of effectively negative *nominal yields* on very short-term Treasurys used in some repo-type trading. The real yield on TIPS (Treasury Inflation Protected Securities) has turned negative – see chart.

So we have a paradox. Despite the financial turmoil in the United States and its government's not-so-strong fiscal position, with huge contingent liabilities for guaranteeing private and public pensions as well as bailing out failing banks, its credit standing has strengthened! Because the U.S. government can market Treasury bonds at derisory low interest rates, this provides at least a second-best argument for using fiscal stimuli – such as the $160 billion tax rebate passed in February 2008 – to prop up the sagging U.S. economy.

Similarly, one can also justify the action of March 11 when "the Fed unveiled a broadened securities-lending program for banks and bond dealers, offering to lend them as much as $200 billion of much-sought Treasurys from its own portfolio for as many as 28 days in return for a

variety of collateral, including bonds backed by mortgages that aren't guaranteed by government-sponsored Fannie Mae and Freddie Mac." (*WSJ,* March 12, 2008) The Fed was responding to complaints from dealers of a shortage of Treasurys in the interbank markets, but without recognizing that the root cause was the flight from the dollar in the foreign exchanges.

Returning to a Strong Dollar Policy

The first-best solution to the current crisis is to stop the flight from the dollar. This would be beneficial beyond relieving the drain of Treasurys and relaxing the crunch in American credit markets. Letting the dollar depreciate without any convincing action to secure its long-term value against other major currencies undermines any confidence that people in general might have in its long-term purchasing power. It lets the inflation genie out of the bottle. A return to the kind of stagflation characteristic of the 1970's would then seem imminent.

Because of the way the world dollar standard works, this inflation threat to the United States itself could be aggravated if foreign central banks intervene against the dollar to prevent their currencies

Figure 1: Negative TIPS Yields (5-Year Treasury Inflation-Indexed Note, Due 4/15/2011)

Source: FRB

from appreciating too fast, as in China today, and so overly expand their money supplies. In the 1970s under the dollar standard, episodes of a weak and depreciating dollar led to monetary explosions in foreign trading partners, with worldwide inflationary consequences.

Stabilizing the dollar in the foreign exchanges and encouraging the return of flight capital to the United States has two major facets. The first is to convince the U.S. Federal Reserve that continually cutting interest rates and expanding the U.S. monetary base is not the appropriate response to today's credit crunch. There is a potentially vicious circle. The Fed responds to the credit crunch by cutting interest rates – the seemingly correct textbook strategy if the economy were closed and the foreign exchanges could be ignored; but the economy is open and capital flies out of the country. Because of the unique position of the United States at the center of the world dollar standard, the drain of Treasurys – the prime collateral in impacted credit markets-exacerbates the credit crunch and monetary expansion abroad possibly worsens worldwide inflation. The Fed then further expands in response to the tightening of U.S. credit markets.

After retrenching U.S. monetary policy, the second facet of a strong dollar policy could be more direct action on exchange rates. The U.S. government should cooperate with central banks in Europe, Japan, Canada, China, and elsewhere, to stabilize the sinking dollar. If the government truly believes that a strong stable dollar is sustainable in the long run, it should intervene in the near term to strengthen the dollar.

But there's a catch. Under the normal operation of the world dollar standard that has prevailed since 1945, the U.S. government maintains open capital markets and generally remains passive in foreign-exchange markets, while other governments intervene more or less often to influence their exchange rates.

Today, outside of a few countries in Eastern Europe linked to the euro, countries in Asia, Latin America, and much of Africa and the Middle East use the dollar as their common intervention or "key" currency. Thus they avoid targeting their exchange rates at cross purposes and minimize political acrimony. For example, if the Korean central bank dampened its currency's appreciation by buying yen and selling won, the higher yen would greatly upset the Japanese who are already on the cusp of deflation – and they would be even more upset if China also intervened in yen.

Instead, the dollar should be kept as the common intervention currency by other countries, and it would be unwise and perhaps futile for the United States to intervene unilaterally against one or more foreign currencies to support the dollar. This would run counter to the accepted modus operandi of the post-World War II dollar standard, a standard that has been a great boon to the U.S. and world economies.

If the ECB, the Bank of Japan, the Bank of Canada, the Bank of England, and so on were to take the initiative, the United States would be wise to cooperate. Joint intervention on this scale would avoid intervening at cross-purposes.

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Also, official interventions are much more effective when all the relevant central banks are involved because markets receive a much stronger signal that national governments have made a credible commitment. The relevant signal from the United States is that its monetary policy will be tightened in the near future, with the Fed also agreeing to joint intervention with other central banks to support the dollar.

The timing for joint intervention couldn't be better. The U.S.'s most important trading partners have expressed angst over the dollar's decline. The president of the European Central Bank (ECB), Jean-Claude Trichet, has expressed concern about the "brutal" movements in the dollar-euro exchange rate. Japan's Prime Minister, Yasuo Fukuda, has worried in public about the rising yen pushing Japan back into deflation. The surge in the Canadian "petro dollar" is upsetting manufacturers in Ontario and Quebec. OPEC is studying the possibility of invoicing oil in something other than the dollar. And China's premier, Wen Jiabao, recently complained that the falling dollar was inflicting big losses on the massive credits China has extended to the United States.

This brings us to China – and all the misplaced concern over its exchange rate. Given the need to make a strong-dollar policy credible, it is perverse to bash the one country that has done the most to prevent a dollar free fall. China's massive interventions to buy dollars have curbed a sharp dollar depreciation against the renminbi; they have also filled the U.S.'s savings deficiency and financed its trade deficit.

As the renminbi's exchange rate is the linchpin for a raft of other Asian currencies, a sharp appreciation of the renminbi would put tremendous upward pressure on all the others – including Korea, Japan, Thailand, and even India. Forcing China into a major renminbi appreciation would usher in another bout of dollar weakness and further unhinge inflation expectations in the United States.

China, with its huge foreign-exchange reserves (more than $1.6 trillion), has another important role to play. Once the major industrial countries with convertible currencies (led by the ECB) agree to put a floor under the dollar, emerging markets with the largest dollar holdings, China and Saudi Arabia must agree not to "diversify" into other convertible currencies such as the euro. Absent this agreement, the required interventions by, say, the ECB would be massive, throwing the strategy into question.

Cooperation is a win-win situation: The gross overvaluations of European currencies would be mitigated, overseas holders of dollar assets would be spared capital losses, and the United States would escape an inflationary conflagration associated with general dollar devaluation while mitigating its credit crunch. For China to agree to all of this, however, the United States (and the EU) must support a true strong-dollar policy by ending counterproductive China bashing to appreciate the renminbi.

References

This Policy Brief combines two very recent Wall Street Journal op-eds:

McKinnon, Ronald "The Dollar and the Credit Crunch", *Wall Street Journal*, March 31, 2008

McKinnon, Ronald and Steve Hanke "A Rescue Plan for the Dollar", *Wall Street Journal*, December 27, 2007."

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