Notes on Dooley and Garber's "Three Notes"[1]

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The first rule of forecasting is give them a forecast or give them a date but never give them both.[2] Mssrs. Dooley and Garber have given us a forecast, namely that the dollar will fall and U.S. Treasury yields will rise. Bravely, they have also given us a date. Unfortunately for those of us interested in the future, that date is 1971.

Like Dooley and Garber, I agree that what cannot go on forever generally will not. But in contrast to Dooley and Garber, I do not believe that recent events in financial markets can help us pin down the timing. Mid-March, just prior to the Panel meeting, saw an increase in noise about the possibility that foreign central banks might diversify out of dollars. The governor of the Bank of Korea made some widely reported comments about the need for more active reserve management. Prime Minister Koizumi of Japan told a parliamentary committee that reserve diversification was "necessary."[3] Indian Reserve Bank Governor Reddy said that the diversification of reserves was under active discussion.[4] Ukrainian economy minister Teriokhin argued publicly that the country should diversify its reserves out of dollars and into euros.[5] This upsurge in noise was associated with an eight-month high in U.S. Treasury yields. This correlation supports the belief that reserve diversification by central banks could eventually force the dollar down and U.S. Treasury yields up.

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[1] Comment on Michael Dooley and Peter Garber, "Three Notes on the Revived Bretton Woods System," presented to the Brookings Panel, 31 March 2005, and forthcoming in *Brookings Papers on Economic Activity.*
[2] Attributed to Edgar R. Fiedler by Dickson (1978).
[3] Steve Johnson, "Dollar Wobbles on Japan Diversification Talk," *Financial Times* (10 March 2005).
[4] Reuters (11 March 2005, 11:36AM).
[5] Reuters (16 March 2005, 12:50PM).

At the same time, the eight-month high in U.S. Treasury yields is not all that high. I would acknowledge that this is a troubling point. I am not alone, of course: Chairman Greenspan has commented on this issue extensively, to the point where it is now known as the Greenspan conundrum. Factors invoked to help explain it include the relatively short supply of new long-term Treasury debt coming onto the market as U.S. debt managers shorten maturities, and the inelastic demands of various institutional investors for government securities. In Dooley and Garber's view, the proper interpretation is that financial market participants are attaching a positive probability to Asian central banks continuing to support the dollar by making massive purchases of U.S. Treasury bonds. This is the substance of the first of their three notes.

Who am I to second guess the markets, much less to second guess our esteemed authors? Well, I'm an economic historian who can recall a substantial number of previous episodes where major imbalances leading to sharp changes in exchange rates were not obviously factored into financial markets until immediately prior to the event. For example, the January-March 1933 run on the dollar, a suggestive precedent, had virtually no discernible impact on interest differentials or forward exchange rates until almost immediately before it occurred, despite the fact that the possibility had been actively discussed for the better part of a year.[6] The 1992 attacks on the pound sterling, a currency that commentators regularly cited as ready for a fall, was similarly not preceded by the emergence of noticeable interest differentials or a forward discount in the foreign exchange market until a couple of weeks before the denouement.[7] Particularly interesting, given the context, is that in 1968-71, in the run-up to the collapse of the

[6] See Hsieh and Romer (2001).
[7] See Eichengreen and Wyplosz (1993).

Bretton Woods System, the forward discount on the dollar was very modest, as was the interest differential vis-à-vis Germany.[8] Then in the summer of 1971 the forward discount jumped up. While one can always attempt to ascribe this behavior to the arrival of new information, it is not as if people failed to see the collapse of the Bretton Woods System and a substantial devaluation of the dollar coming. To the contrary, there was an immense contemporary literature warning that the system would dissolve and the dollar would have to fall substantially. Yet there seemed to be a striking reluctance to take a position on this basis until one minute before the clock struck midnight. This behavior may be hard to reconcile with perfect foresight, but if it exists asset prices will not be telling us when it is 11:58.[9]

Dooley and Garber's second note is an analysis of the end of several large current account surplus/reserve accumulation episodes. Since this analysis was not presented at the panel meeting, my comments on it are brief. The authors' intriguing finding is that many such episodes come to an unhappy end, with a sharp real and nominal *depreciation,* which is not how most observers of China expect the current situation to play out. I would simply observe that how ancillary variables like the real exchange rate will react when China's accumulation of reserves ends will depend on why it ends. If it ends because the People's Bank of China and the government, observing robust economic

[8] See Obsfeld (1993). Imperfect capital mobility complicates the process of drawing inferences from these data, although as Obstfeld notes capital mobility was rising strongly toward the end of the Bretton Woods period. Imperfect capital mobility also complicates drawing inferences from interest rates today, as Dooley and Garber themselves note.

[9] Parenthetically, it is worth recalling that interest rates remain perfectly stable in the original Krugman-Flood-Garber model until the moment the exchange rate collapses, despite the fact that everyone has perfect foresight and can see the end coming. I understand, of course, that this is the instantaneous interest rate and not the long-term rate, and that the result depends on some restrictive assumptions. But add this to the well-known fact that the markets appear to attach a heavier weight to short rates than the term-structure hypothesis would lead one to predict, and people like me are able to reconcile our conviction that the end is near with the observed low level of long term rates.

growth and mounting inflationary pressure, choose to tighten monetary policy in order to cool fears of overheating, then the currency will appreciate. But if they wait until domestic financial excesses further infect the banking system, creating a crisis of confidence, there may instead be a scramble to get out, causing the currency to crash. The wisdom of moving away from the peg while confidence is strong, capital is still flowing in, and reserve are still being accumulated is the central lesson of the literature on exit strategies.[10] It provides the strongest argument for why China should abandon its peg to the dollar now.

Dooley and Garber's third note extends an earlier paper that characterizes the role of the United State in the current international system as providing financial intermediation services to the rest of the world.[11] The U.S. borrows short, increasingly short given the shorter and shorter tenor of U.S. Treasury debt, and lends long in the form of foreign direct investment. It thus provides the liquidity transformation services of a bank. It enhances the efficiency of resource allocation, also like a bank. Again, there is a suggestive analogy with Bretton Woods, there having been an argument in that period that the U.S. was acting as banker to the world, borrowing short and lending long. It was similarly argued at that time that the U.S. deficit on liquidity account was not a problem because foreigners were simply the happy recipients of these intermediation services.[12]

But there is a difference between Bretton Woods and today, namely that the present situation occurs against the backdrop of large, ongoing current account deficits

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[10] See for example Eichengreen and Masson et al. (1998) and, for an application to China, Eichengreen (2005).

[11] Dooley, Folkerts-Landau and Garber (2004).

[12] See Despres, Kindleberger and Salant (1966). Others objected to this view on the grounds that the capital inflow was really the temporary balancing item that offset a U.S. current account surplus that was too small to fully finance U.S. foreign direct investment abroad.

for the country that is banker to the world. In principle, there is no reason why the country with the most efficient financial system that is providing intermediation serves to the rest of the world cannot run a balanced current account or, for that matter, a surplus. There is no reason why importing short-term capital and exporting long-term capital should also require it to run a current account deficit, as the United States is doing. The U.S. ran current account surpluses following World War II, even after contemporaries stopped referring to the dollar gap. Britain ran persistent current account surpluses before World War I when it was similarly acting as banker to the world. Being an international financial center and providing maturity transformation services to the rest of the world does not doom a country to current account deficits.

So China must be buying something else through its bilateral surpluses and heavy investment in U.S. Treasury bonds. According to Dooley and Garber, it is buying custodial services. The United States is now custodian to the world (this is not a comment on the post-industrial economy). In other words, the United States holds the collateral against which countries like China are then able to borrow. The idea is that China can attract foreign direct investment from abroad because if it ever decided to nationalize U.S. or other private assets, the U.S. would then default on U.S. official liabilities held by the Chinese government.

This is a provocative hypothesis whose validity is highly questionable. The story is China specific, whereas the accumulation of reserves and chronic surpluses vis-à-vis the United States is pan-Asian. No one worries that Japan, South Korea or Taiwan will expropriate U.S. investments, and yet they hold massive claims on the United States. I am not aware of U.S. corporate executives who have pointed to China's large dollar reserves as a form of collateral justifying their decision to invest there. Nor am I aware of statements by Chinese officials in which they explain that they are accumulating U.S. Treasuries as a way of posting collateral for FDI inflows. Dooley and Garber rightly emphasize the importance of looking at the current international financial system through the eyes and statements of Asian officials. Here is an instance where their point works against them.

Moreover, the timing is wrong: U.S. FDI in China rises starting around 1992, where the massive reserve accumulation comes only a decade later. Then there is the fact that the U.S. accounts for only a small fraction – perhaps 4 per cent – of FDI in China, as emphasized by Morris Goldstein and Nicholas Lardy (2005). Thus, one must assume that the United States would be willing to go to bat on behalf not just of U.S. private foreign investors but also of those from other countries. Historically, the way foreign investments in China have been expropriated is through the surreptitious stripping of assets by Chinese managers and joint-venture partners. It is hard to imagine that the U.S. government would risk tarnishing its public credit in response to more such instances. Rather, one has to assume a major geopolitical blow-up between the U.S. and China, a decision by Beijing to freeze all U.S. investments there, and retaliation by the U.S. government in the form of freezing all Chinese Treasury bonds held in custody in the United States. Such events are not beyond the realm of possibility, but they do not exactly strike me as an obvious way of explaining the current pattern of global imbalances.

This suggests testing the hypothesis with a systematic analysis of the impact of inward FDI and property rights protection on the demand for reserves. Specifically, I am imagining a regression of the level of reserves on FDI, where the coefficient on the latter is larger in economies where property rights are less secure, the government is communist, and the country is not in a political alliance with the United States. One of course would have to control for the other standard determinants of the demand for reserves and correct for the endogeneity of FDI. But this would be a much more direct way of marshalling evidence for Dooley and Garber's hypothesis.

If you join me in dismissing the collateral story as implausible or at best as unsubstantiated, then to explain the Chinese authorities' insistence on keeping their currency down against the dollar we are forced to fall back on the traditional rationale for export-led growth. The export sector, this rationale goes, is the locus of knowledge spillovers and productivity growth. Distortions affecting the economy justify the imposition by the government of another distortion in the form of an undervalued exchange rate, which pushes more resources into this sector than would the unfettered operation of market forces. The distortion in question might be the fact that the productivity effects associated with producing for export are external to the firm, providing inadequate incentive to shift resources into the sector absent other interventions. It might be an inefficient financial system that prevents Chinese savings from underwriting adequate investment in the export sector. It might be a shortage of organizational knowledge that is strongly complementary with exports and can only be augmented by export-linked FDI that imports organizational knowledge from abroad.

The authors don't tell us which of these distortions they have in mind. I suspect that they will be tempted to answer "all of them." But which of these distortions provides the primary motivation for pursuing the export-led growth strategy matters importantly for how quickly we should expect the government to move away from current arrangements. I have the sense that Chinese managers and entrepreneurs are rather quickly gaining the organizational knowledge necessary to run a modern, export-oriented manufacturing firm. I have the sense that the productivity effects from learning by exporting are internal as well as external to the firm, much as in other countries. In other words, the time may not be very long in coming when these justifications for keeping the exchange rate artificially low are no stronger in China than in a variety of other middle-income countries.

The strongest argument in favor of the indefinite maintenance of the status quo is that the export sector, where productivity is higher than in the rest of the economy, is being starved of funds by an inefficient Chinese banking system and that an undervalued exchange rate is needed to offset this distortion. Maybe an undervalued exchange rate could offset this distortion by artificially boosting the prices of traded goods relative to nontraded goods and enhancing the profitability of investing in the traded goods sector enough to neutralize the aforementioned distortion. But this would boost the prices of traded goods across the board, whether manufactures or agricultural products and whether produced by SOEs or private firms. This hardly looks like a sensible strategy for enhancing efficiency.[13] Alternatively, an undervalued exchange rate could lead to China's accumulation of U.S. Treasuries and thus encourage efficiently allocated FDI in China. This is the reasoning that forces Dooley and Garber into the logical corner in

[13] There is also the question of whether undervaluing relative to the dollar is an appropriate strategy for boosting exports in general. The U.S. takes about a third of China's exports (including exports that go via Hong Kong). Even if we aggregate other dollar peggers, the share of the "dollar area" is still only 40 per cent. Europe takes 25 per cent of Chinese exports. Over the last ten years, the dollar has risen as well as fallen against the euro. Between 1994 and 2002 it rose very substantially. Was Chinese policy makers' preference then for increasing overvaluation on an effective basis?

which they now (comfortably) find themselves. It also brings us back to my earlier objections to the collateral-and-selective-default story.

So if you join me in rejecting their collateral argument, we must hang our hats on the first two distortions: learning spillovers external to the firm and shortages of organizational knowledge. It is then hard to resist the conclusion that these justifications for an undervalued exchange rate will grow less compelling rather quickly, for the reasons I have just enumerated. As the authors say, capital losses on dollar-denominated reserves should be counterbalanced against the returns, and these returns are likely to be strongly declining. In addition, the liability side of the equation should include also the other costs of an undervalued exchange rate, such as the very limited extent of monetary control, the incentive under current conditions for large amounts of credit to flow into the property market, heightening financial fragility, and the additional difficult that this poses for efforts to raise lending standards and otherwise strengthen the banking system. These feature not at all in Dooley and Garber's analysis.

These are all reasons, then, why Asian governments are likely to move away from the strategy of export-led growth through undervaluation before long.[14] Once countries they see their neighbors doing so, and thereby lending less support to the dollar, there will be an obvious incentive not to be late.[15] At that point familiar models of speculative attacks, which the authors helped to pioneer, will not just be "dancing in our heads."

[14] Notice the first rule of forecasting.
[15] The point emphasized in Eichengreen (2004).

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