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Trapped by the International Dollar Standard

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In 2004, the world economy showed robust economic growth. Among the industrial countries, the United States led the way with annual growth of about 3.7 percent. Among developing countries, China enormous growth of 9.5 percent stimulated economic activity throughout East Asia. India grew about 6.6 percent—well above population growth and its own past history. More astonishingly, after languishing for more than two decades, Latin America's growth averaged 5 to 6 percent. True, the euro area and Japan are lagging, with annual growth averaging less than 2 percent, but elsewhere the world economy is quite buoyant.

So it might seem strange, even churlish, to talk about a distortion in the international dollar standard. Nevertheless, America's saving deficiency—large fiscal deficits by the federal government, and meager household saving coupled with a virtually unlimited line of credit on which to borrow *in dollars* from the rest of the world—is distorting the world's economy in two important ways.

First, heavy U.S. international borrowing, as manifested in its current-account deficit, pulls real resources from developing countries that are much poorer, as well as from other industrial countries. Asia, Europe, Canada, and now even countries in Latin America are trapped into running current account surpluses. The East Asian countries collectively have become America's biggest foreign creditor.

Second and more paradoxically, the distortion in the dollar standard has trapped even the United States itself. American current account deficits have been mainly embodied in large trade deficits in manufactures that accelerate domestic deindustrialization. Employment in U.S. manufacturing, with its very high rate of technical change, is falling faster and further than in other mature industrial countries. And the soft international borrowing constraint has conditioned Americans, both households and the U.S. federal government, to consume rather than to save. The U.S. now has the lowest national saving rate in the industrial world.

Let us first discuss the trap for countries on the periphery of the dollar standard, particularly in East Asia, and then consider its implications for the United States.

The Dollar Exchange Rate Trap in East Asia

Outside of Europe, the dollar is the prime invoice currency (unit of account) in international trade in goods and services. All primary products—industrial materials, oil,

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food grains, and so forth—are invoiced in dollars. A few mature industrial countries invoice some of their exports of manufactured goods and services in their own currencies. But even here, the international reference price of similar manufactures is seen in dollar terms. So manufacturers throughout the world “price-to-market” in dollars if they can. Because most East Asian countries invoice their trade in dollars, these countries collectively are a natural dollar area. Japan is the only Asian country that uses its own currency to invoice some of its own trade. Even here, almost half of Japan’s exports and three-quarters of its imports are in dollars. But when China trades with Korea, or Thailand with Malaysia, all the transactions are in dollars.

For two closely related reasons, each East Asian country has a strong incentive to peg to the dollar, either formally or informally. First, as long as the U.S. price level remains stable, i.e. the purchasing power of the dollar over a broad basket of tradable goods and services is stable as it has been from the mid 1990s to the present, then pegging to the dollar anchors the domestic price level. The ambit of dollar invoiced trade with neighbors in East Asia is now much greater than that with the United States itself (McKinnon and Schnabl 2004, McKinnon 2005). Thus the anchoring effect for any one country pegging to the dollar is stronger because East Asian trading partners are also pegging to the dollar.

Second, East Asian countries are strong competitors, particularly in manufactures, in each other’s markets as well as in the Americas and Europe. No one East Asian country wants its currency to suddenly appreciate against the world’s dominant money. This would lead to a sharp loss in mercantile competitiveness in export markets, followed by a general slowdown in its economic growth, followed by outright deflation if appreciation continued.

Indeed, the macroeconomic repercussions of a sharp appreciation against the world’s dominant money are so strong that the effect on the appreciating country’s trade balance is ambiguous. True, as its exports become more expensive in dollar terms, they would decline. But as the economy slows, it would import less. The impact on the net trade balance is unpredictable (McKinnon and Ohno, 1997 chs. 6 and 7). Indeed, when Japan was cajoled (forced) into appreciating the yen several times from the mid-1980s into the mid-1990s, it was thrown into a decade-long deflationary slump with no obvious decline in its large trade surplus.

Conflicted Virtue

When East Asian countries run balance-of-payments surpluses (as they do now because of the American saving deficiency), the dominance of the dollar implies that these countries don’t lend to foreigners in their own currencies. Even Japan, which is much richer and more highly developed than the others, lends relatively little to foreigners in yen. Japan has had large current account surpluses since the early 1980s. Apart from direct investment abroad, almost all of Japan’s current account surpluses have been financed by building up dollar claims on foreigners—both privately held (as in some Japanese insurance companies) and by the accumulation of huge official exchange

reserves. As international creditors, China lends nothing in renminbi, Korea hardly anything in won, and so on.

Besides their private holdings of dollar assets, Japan, China, Korea, and several smaller Asian economies have accumulated far more official dollar exchange reserves than they need for precautionary reasons—Japan more than \$800 billion, China more than \$600 billion, South Korea more than \$200 billion, and so on. In the absence of enough private financial intermediation for their current account surpluses, their central banks are trapped into continually intervening to buy dollars so as to prevent unwanted currency appreciation. Much of these dollar reserves are switched into U.S. Treasury bonds or similar dollar-denominated instruments.

Unfortunately, this enormous buildup of dollar claims by East Asian countries leads to pressure, often by foreigners, for currency appreciation: what I call the syndrome of “conflicted virtue” (McKinnon 2005). East Asian countries are “virtuous” because they are high savers relative to the low-saving United States. Yet they are “conflicted” because any sharp appreciation of their currencies against the world’s dominant money would lead to a loss of mercantile competitiveness, a slowdown in economic growth and deflation. In the absence of capital controls, the resulting negative risk premium associated with holding dollar assets drives domestic interest rates down toward zero. For a discussion of the foreign exchange origins of Japan’s zero-interest liquidity trap, see Goyal and McKinnon (2003).

Because of the continual threat of (forced) appreciation of the renminbi, China could also fall into such a zero-interest liquidity trap if capital and interest-rate controls are removed. Apart from the quasi-independent euro area, creditor countries on the periphery of the dollar standard can only overcome conflicted virtue to achieve portfolio balance in domestic asset markets—with private agents being willing to hold some of the dollar assets—when the nominal exchange rate is credibly fixed so as to eliminate the fear of currency appreciation.

China has done its best to establish such credibility by keeping the renminbi pegged at 8.28 yuan/dollar since 1994 while adjusting domestic monetary policy to support it. Consequently, domestic price inflation within China has converged to that prevailing in the United States—as shown in Chart 1. In this sense of *relative purchasing power parity*, 8.28 yuan/dollar has become an “equilibrium” exchange rate. China’s inflation in 2005 is about the same as or slightly lower than in the United States.

<Chart 1 about here>

In 1994, chart 1 shows the sharp depreciation of the renminbi when the currency was unified into a single exchange rate regime. This depreciation was accompanied by high inflation in China relative to the U.S. so that, by 1997, any “real” undervaluation of the renminbi had been eliminated. Since then, chart 1 shows that China’s inflation (as measured by the CPI growth) has closely tracked that of the U.S.—being slightly less from 1998 to 2003, slightly greater in 2004, and about equal currently. This convergence

to a sustainable relative purchasing power parity, with the alignment of the American and Chinese inflation rates, is remarkable. In effect, the fixed exchange rate now provides an effective nominal anchor for China's price level against the world's dominant international money.

Of course China's and the other East Asian countries' trade surpluses will continue as long as the U.S. has a saving deficiency. But exchange rate changes are not the answer to American trade deficits and Asian trade surpluses. Indeed, potential private holders of dollar assets in China have been sufficiently spooked by foreign pressure for renminbi appreciation that simply letting the yuan/dollar rate "float" would simply lead to an indefinite upward spiral of the foreign exchange value of the renminbi—as with the Japanese yen earlier. There would be no determinant upper bound until the People's Bank of China was forced back in to the foreign exchange market to provide one—but now with diminished credibility regarding its ability to prevent future appreciations and the associated deflation.

Is the United States also Trapped?

Foreign central banks now hold almost half the outstanding stock of U.S. Treasury bonds. The incidental effect has been to provide a cheap and very long line of dollar credit to the U.S. Treasury and U.S. economy more generally. Because the United States is the only country that can go deep into debt in its *own* currency, it is invulnerable to the usual risk faced by other debtor countries whose debts are denominated in foreign currencies. Because the Federal Reserve Bank could potentially "print" enough dollars to repay the U.S. Treasury's foreign dollar debts, outright default is not a possibility. Indeed, in international portfolios, U.S. Treasury bonds are generally treated as the world's "risk-free" financial assets against which risk premia in bonds denominated in other currencies are measured. And, with the big proviso that the U.S. price level remains stable, foreign central banks are loathe to see their currencies appreciate against the dollar. Today's very low nominal interest rates on dollar assets, from 2 to 5 percent, suggest that the markets don't take U.S. default or depreciation risk very seriously. Is this then nirvana for America's willing borrowers?

Despite being at the center of the international dollar standard, the United States itself is also trapped by it—although not so obviously as its creditor countries on the dollar's periphery. The entrapment of the United States has longer and shorter run dimensions. First, since the 1960s, ever-softer international borrowing constraints on American households and the federal government eventually induced U.S. national saving to fall to the very low levels we see today. Second, following the bursting of the high-tech bubble in 2001, the immediate need for a "Keynesian" countercyclical fiscal policy of government deficits to prevent an economic downturn—not only in the United States itself but in countries but in countries on the dollar standard's periphery—rationalizes the worldwide need for American fiscal deficits into the new millennium.

Consider the long-run problem first. In 2005, the American economy is now more fragile because of low U.S. domestic saving: meager personal saving has fallen to less than 1 percent of GNP, and large government fiscal deficits are now more than 4 percent of GNP—although the economy has pretty well recovered from its cyclical trough in 2001–2002. The resulting current account deficit of almost 6 percent of GNP reflects this long-term saving deficiency. America needs to borrow heavily in world markets in general, and from East Asia in particular, to prevent a domestic credit crunch that would sharply reduce U.S. investment—normally about 16 percent of U.S. GNP. So the U.S. is trapped in the sense that it needs the foreign finance to prevent a credit crunch.

U.S. domestic politics have taken a strange turn that reflects this soft borrowing constraint. The reckless political pressure from so-called “supply siders” to cut taxes, no matter what are the budgetary consequences, could only be sustained for so long in the United States because it alone has virtually unlimited access to international credit denominated in its own currency to cover the resulting fiscal deficits. Other debtor economies face the specter of having debts build up in foreign currencies (largely dollars) that, if continued indefinitely, would provoke an attack on their currencies—as with the forced depreciations of the Indonesian, Korean, Malaysian, Philippines’, and Thai currencies in 1997-98. Such an attack, or the threat thereof, then forces a retrenchment in the debtor country’s government finances.

In the shorter run, because of the insufficiency of aggregate demand in the world economy, the U.S. government is inhibited from arresting this long-run decline by increasing taxes or cutting expenditures in order to raise the national saving rate. The rest of the world has come to depend on high net U.S. aggregate demand for their export products. Japan, China, Korea, and now the euro area face a growth slowdown with deflationary pressure unless exports to the United States can be sustained—whence the willingness of East Asian economies to accumulate huge volumes of dollar exchange reserves to prevent their currencies from appreciating. In 2005, the European Central Bank (ECB) may well be coerced into following this pattern by selling euros to buy dollars to dampen the euro’s sharp appreciation so evident in 2004. This uncomfortable dependence of the United States on its foreign creditors is mutually symbiotic.

The upshot is that the world is in a financial trap from the operation of the international dollar standard. U.S. current account deficits, reflecting the American saving deficiency, are the proximate cause of “excess” accumulation of official exchange reserves and threatened currency appreciation on the dollar’s Asian periphery and elsewhere. Yet, on a deeper level, the U.S. saving deficiency is endogenous: the result of having an unduly soft line of credit in dollars from the rest of the world over the past several decades. The international dollar standard relaxes the borrowing constraints on agents in the American economy, particularly households and the federal government, and lures them into feeling that they need not save much.

The Deindustrialization of the United States

There is an additional cost to the “trapped” center country: an untoward contraction in the size of its manufacturing sector. Heavy reliance on foreign borrowing speeds the pace of deindustrialization in the United States.

Ignoring business-cycle fluctuations, employment and output in American manufacturing has been shrinking for a long time. In the mid-1960s, manufacturing output was 27 percent of GNP and its share employment was 24 percent. By 2004, these numbers had fallen to about 13.8 percent and 10.1 percent, respectively. Although not so dramatic as in the United States, the other advanced industrial countries also show marked shrinkage in the size of their manufacturing sectors. The consensus explanation is twofold: since the 1960s rapid technical progress has been greater in manufacturing than in services, and, as households become richer, demand naturally shifts away from goods toward services. Even with far fewer resources being allocated to manufacturing, modern economies are still in consumption equilibrium.

But how does foreign trade enter this consensus view? Stalwart free traders—such as Gregory Mankiw, then chairman of the Council of Economic Advisors in the *Economic Report of the President* (February 2004)—argued that America’s remarkable productivity growth, particularly in manufacturing, is the proximate reason for the shrinkage in the size of the manufacturing sector. Mankiw also argued that foreign competitive pressure, including outsourcing, increases technical progress in manufacturing. Weaker American manufacturing industries are being continually displaced, and manufacturing output becomes concentrated in more profitable and technically dynamic activities.

So, in the United States and other industrial economies, foreign trade shrinks the size of manufacturing sectors indirectly by benignly increasing the pace of technical progress—rather than (malignly) by direct displacement of workers without increasing the economy’s overall productivity and ability to reabsorb them. And the outsourcing of jobs in manufacturing and services, however ominous it might seem, is simply the modern manifestation of healthy ongoing international competition.

This standard defense of free trade is well and good as far as it goes. However, it fails to link the unusual shrinkage in manufacturing employment to America’s saving deficiency. Heavy foreign borrowing aggravates the natural decline in the size of the U.S. manufacturing sector well beyond that experienced by other mature industrial countries, which generally are not net borrowers internationally.

The transfer of foreign saving to the United States is embodied more in goods than in services. Outsourcing to India aside, most services are not so easily traded internationally. Thus when American spending rises above output (income), the net absorption of foreign goods—largely raw materials and manufactures—increases. True, in 2003 and 2004 the unusually high price of oil significantly increased the U.S. current account deficit. However, chart 2 also shows that since the early 1980s the trade deficit

in manufactures alone has been about as big as the current account deficit, i.e., as big as America's saving shortfall.

<Chart 2 about here >

Assume that spending by American households and firms for manufactures is more or less independent of whether the goods are produced at home or abroad. Then domestic production of manufactures shrinks by the amount of the trade deficit in manufactures. The consequent loss in jobs depends inversely on labor productivity in manufacturing, which rises strongly through time. The actual path of manufacturing employment from 1965 to 2003 is the unbroken dark line in chart 3.

<Chart 3 about here>

If we take the trade deficit in manufactures and add it back to get "adjusted manufactured output", and assume that labor productivity (output per person) is the same in adjusted output as in actual output, we get projected employment in manufacturing—the dashed line in chart 2. For example, in 2004, actual employment in manufacturing was just 10.1 percent of the American labor force, but it would have been 14 percent without a trade deficit in manufactures: the difference is 4 to 5 million lost jobs in manufacturing.

As early as the 1980s, employment in manufacturing began to shrink substantially because of the then large current account deficit (chart 2) attributed to the then large fiscal deficit: the famous twin deficits of Ronald Reagan's presidency. With fiscal consolidation in the 1990s under President Clinton, the saving gap narrowed but wasn't closed because American personal saving weakened. Now under President George W. Bush, the fiscal deficit has exploded while private saving remains weak. The result is heavy borrowing from foreigners leading to all-time highs in the U.S. current account deficit in 2003 and 2004. The main component remains the trade deficit in manufactures, leading to intensified shrinkage in American manufacturing employment.

Should we be concerned? Note that I am not suggesting that the trend in overall U.S. unemployment has increased, but only that its composition has been tilted away from tradable goods—largely manufactures. In the long run, the U.S. economy remains a very efficient job-creating machine, with growth in service-sector employment largely offsetting the decline in manufacturing. However, the rate of technical change in manufacturing is much higher than in other sectors. And it is hard to imagine the U.S. sustaining its technical leadership with no manufacturing sector at all.

More uncomfortably, more Congressmen, pundits, and voters feel justified in claiming that foreigners use unfair trade practices to steal American jobs, particularly in manufacturing. Protectionists can use the concern with outsourcing, the claim that East Asian countries (particularly China) undervalue their exchange rates, the existence of poor working conditions in countries that are naturally poor, and so on, as pretexts for imposing tariffs or other restraints on manufactured imports into the United States.

Ironically, if imports from foreigners were somehow greatly reduced, this would prevent the transfer of foreign saving to the United States and lead to a credit crunch with a possibly even greater loss of American jobs.

The Long Way Out

There is no easy way out of the worldwide dollar standard trap. A deep devaluation of the dollar from its historical norms will only worsen macroeconomic conditions, deflation on the periphery or inflation in the U.S., within the trap *without* springing it. So what can be done?

Since the 1970s, the low-saving syndrome of the United States is increasingly evident. I have argued here that the soft credit line from the rest of the world, due to the operation of the international dollar standard, is largely responsible—albeit inadvertently. That is, it is not deliberately exploited by the U.S. federal government or low-saving households, but rather conditions their behavior below their level of consciousness. At the center of the world's monetary system, Americans, including most professional economists, are blissfully unaware of how the dollar standard works, whereas in peripheral countries outside of semiautonomous Europe, people are much more aware—and sometimes terrified—of it.

However, the dollar standard is both very useful in facilitating trade and is deeply ingrained in the world's financial system. Having a single world money for clearing international payments, setting exchange rates, and invoicing trade and capital flows is a very natural outcome of market processes. If the dollar standard did not exist, a similar institution would have to be developed to take its place. But transition would be difficult and expensive, if only because the network effects supporting the common use of the dollar as international money are so strongly reinforcing. Only some cataclysmic event, itself probably highly undesirable, could upset it.

So the most promising, although still difficult, way out is to change the saving behavior of the United States over the next decade or two. Immediate large increases in taxes or cuts in government expenditure are not desirable from today's counter-cyclical point of view. Instead a slow and deliberate improvement in the U.S. public finances from deficit to surplus with a strong improvement in the propensity to save of American households—perhaps through tax incentives—is devoutly to be wished.

However, the first step is for Americans to recognize how the current impasse in the world economy, i.e., the dollar exchange rate trap, arises in the context of the international dollar standard. Education and understanding are essential if the United States is to take deliberate measures to make the dollar standard work better—both in the world's and its own best long-term interests.

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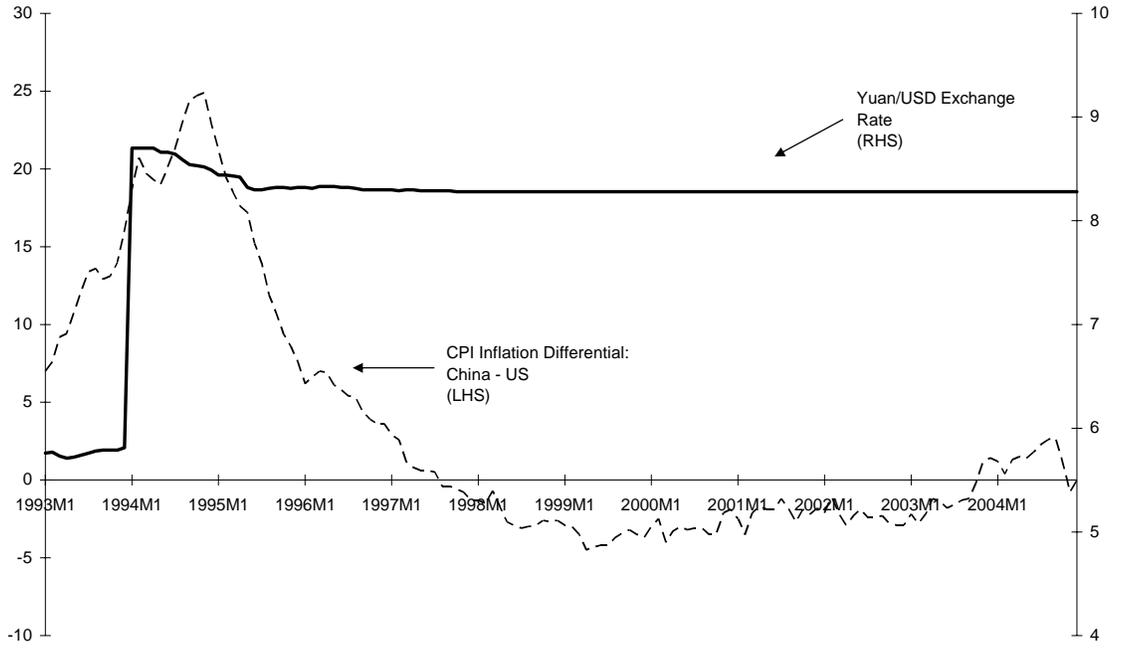
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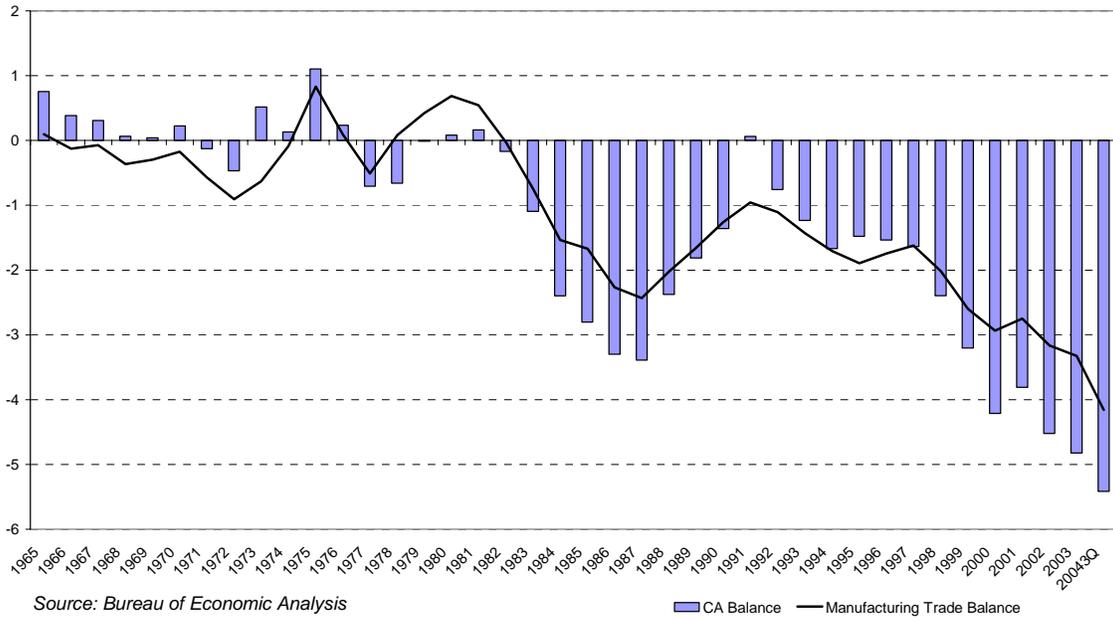
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Chart 1: China - U.S. Inflation Differential and Exchange Rate, 1993-2005
(Source: EIU)



**Chart 2: U.S. Current Account Balance and Trade Balance in Manufacturing, 1965-2004
(% of GDP)**



**Chart 3: Projection of Labor Growth in U.S. Manufacturing under
Balanced Manufacturing Trade, 1965-2004**

