

# Beggar-Thy-Neighbor Interest Rate Policies

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## *Abstract*

*The United States is a sovereign country that has the right to follow its own monetary policy. By an accident of history, since 1945 it is also the center of the world dollar standard—which remains surprisingly robust to the present day. So the choice of monetary policy by the U.S. Federal Reserve can strongly affect its neighbors for better or for worse. Beginning with the Nixon shock in 1971, American policy makers have frequently ignored foreign complaints. But by ignoring feedback effects from the rest of the world, the Fed has made both the world and American economies less stable.*

*The most recent example is the Fed's policy of setting short-term interest rates close zero to since mid 2008, and then compounding this effect in late 2010 by "quantitative easing" designed to drive down long rates as well. At the November G-20 meeting in Seoul, foreign officials complained vociferously of hot money inflows from the United States creating inflationary pressure. Ironically, the Fed's zero interest rate policy also impedes bank lending within the United States itself while seriously weakening other American financial institutions—such as insurance companies and pension funds.*

**Key Words:** dollar standard, exchange rates, interest rates, asset bubbles

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## **Beggar-thy-Neighbor Exchange Rates**

In the international currency chaos that so worsened the Great Depression of the 1930s, much was made of “beggar-thy-neighbor” exchange rate policies. These arose out of the collapse of confidence in the international gold standard, which Britain had tried to restore in 1925. But restoration proved to be impractical and ultimately disastrous. After World War I, the industrial world’s inflated price levels were too high for its limited gold stock. The resulting deflationary pressure, and the attempt of European countries to conserve their gold stocks by preventing hot money outflows, led to successive rounds of government “austerity” measures—higher interest rates and cuts in wages and spending. These only made the collective downturn worse.

Finally, in September 1931, Britain gave up its fixed gold parity, and the pound fell 25 percent from \$4.86 to \$3.40 carrying Scandinavian and British Commonwealth currencies with it. This depreciation made the U.S. dollar less competitive with exports turning down, and in 1933, President Franklin Roosevelt virtually demonetized gold for domestic transacting while forcing the dollar to depreciate sharply in terms of gold even though the U.S. had a trade surplus. This left the remaining gold bloc countries in Europe—France, Germany and a raft of smaller ones—hopelessly overvalued and facing capital flight. In 1936, the remaining gold bloc countries gave up and depreciated, but not before they suffered a precipitate drop in exports and industrial production. Whence the odium associated with “beggar-thy-neighbor” devaluations.

## **The Bretton Woods Reaction**

From this appalling interwar experience with exchange rate fluctuations, and anticipatory hot money flows, sprang the postwar Bretton Woods (BW) Agreement of 1944. The victorious allies—led by the United States and Britain—resolved never again to allow uncontrolled exchange rate fluctuations and the ebb and flow of hot money across currency boundaries. In this new international monetary order, gold was dethroned as the common monetary anchor and the U.S. dollar was enthroned. Outside the United States, participating countries declared fixed dollar exchange parities that could be changed only moderately and with the permission of the newly created International Monetary Fund. Outside the private foreign exchange markets, other *governments* could sell U.S. Treasury bonds for gold to the U.S. *government* at \$35 per ounce.

Because by 1945 the U.S. had accumulated almost all the world’s gold, and the immediate postwar was the era of the great dollar “shortage”, people at the time did not project that the U.S. gold obligation to be anything more than pro forma. Alone among countries, the U.S. at the center of the new BW regime was free to determine its own monetary policy and price level objective. In contrast, other countries had to subordinate, at least in part, their domestic monetary policies to maintain their dollar exchange rates parities. This asymmetrical system worked well as long as (1) the U.S. Federal Reserve bank successfully stabilized its own (and hence world’s) price level in dollars, and (2) did not object to how other countries set their exchange rates against the dollar.

In the 1950s and 60s, dollar exchange rates and prices were remarkably stable so as to ease the industrial countries’ return to current-account convertibility (under the IMF’s Article VIII) by the mid 1960s. The resulting rapid growth in multilateral international trade led to high

GDP growth in the industrial countries and many developing ones. Unlike the failure of postwar recovery after World War I, the buoyant recoveries of war-torn Western Europe and Japan after World War II were particularly striking.

In this halcyon (“high” Bretton Woods) period, however, financial capital could not move freely. Indeed, one of the principal architects of BW was John Maynard Keynes. He was obsessed with the damage that “hot” money flows in anticipation of exchange rate changes, and what we now call “carry trades”, responding to interest differentials—had done in the interwar period. The Keynes Plan of 1944 for an International Clearing Union envisioned that all cross-currency payments for imports and exports would be cleared multilaterally through central banks. Open foreign exchange markets made by commercial banks, which inevitably must bet on which way exchange rates and interest rates might move, would no longer exist. With hot money flows suppressed, Keynes wanted each national government to have national macroeconomic autonomy in monetary and fiscal policy without being constrained by the foreign exchanges.

In 1945, however, it was the White Plan, named after the American Harry Dexter White, that mainly prevailed. Private foreign exchange markets were re-opened with the dollar used as the clearing currency in interbank trading between any two countries outside the communist bloc. However, Keynes’s influence was still strongly felt in the IMF articles of Agreement. All member countries remained, and remain today, free to impose capital controls on international payments. Their currency convertibility obligation under Article VIII only covers payments for current account transactions: importing and exporting as well as payments of interest and dividends must be kept free of exchange controls. In 1945, almost all IMF members opted to retain, or impose, capital controls in some form. Only the United States chose not to do so. Foreigners were left free to transact in the New York financial markets, for example, by buying or selling U.S. Treasury bonds. Indeed for the dollar based system of international payments to work, the U.S. itself could not impose capital controls.

Amazingly, despite many dire predictions of the dollar standard’s demise, today the dollar still prevails as “international money” for clearing foreign payments and invoicing most international trade—now including members of the former communist bloc! In 2010, China’s imports and exports are largely invoiced in dollars, and Chinese banks use the dollar as the intermediary currency in clearing spot and forward transactions in foreign exchange. (The Chinese government would like to change this, but so far without much success.) Newly emerging markets such as Turkey, Korea, Brazil, Russia, and India have accumulated large dollar exchange reserves—with China’s State Administration for Foreign Exchange (SAFE) holding over \$2.6 trillion.

The Nixon Shock of forced dollar devaluation in 1971 ended the BW regime of fixed dollar parities with its vestigial link to gold. As the world shifted on to an unrestrained “pure” dollar standard with more flexible exchange rates, American monetary policy became more erratic. Over the next four decades, the consequences of American financial volatility for the world economy were dire with bouts of inflation, asset bubbles, and deflation. Apart from its disliked political asymmetry, the international dollar standard became increasingly unloved outside of the United States because of erratic monetary policy at the center.

More surprisingly, the dollar standard is also unloved by many Americans. Because of the dollar's continued central role in clearing international payments, most foreign governments still opt to peg, or smooth, their exchange rates against the dollar. To prevent conflict, since 1945 the U.S. itself has (correctly) not intervened directly to influence the dollar's exchange rate against other currencies. Nevertheless, many Americans still complain—sometimes vociferously—that foreigners often “cheat” to keep their currencies undervalued to run trade surpluses with the U.S. Whence the paradox that the international dollar standard is unloved by *both* foreigners and Americans.

But in today's world where capital flows freely, these complaints lack analytical validity. The connection between exchange rate changes and trade imbalances has become ambiguous. Trade imbalances across countries simply reflect net saving surpluses (China) or net saving deficits (United States) and exchange rate changes themselves will not “correct” either. But if economists and politicians believe that exchange rate changes would be effective, this false belief can still influence U.S. government policies. American China bashing today to appreciate the renminbi, or Japan bashing back in the 1970s through the mid 1990s to appreciate the yen, were aimed at reducing their trade surpluses—but neither succeeded in doing so.

Although nobody loves the dollar standard, it remains an amazingly robust institution that is too valuable to lose and too difficult to replace. This uncomfortable fact remains even more true in today's world of threatened international currency “wars”. Thus, my longer paper argues that rehabilitating the dollar standard by making U.S. monetary and fiscal policies less insular and more outward looking is the only viable option for restoring international monetary stability. And, in the long run, the biggest beneficiary would be the United States itself.

### **Rehabilitating the Unloved Dollar Standard (Hypothetical Insert)**

This sad postwar history is contained in my paper “Rehabilitating the Unloved Dollar Standard” (2010). This paper is an integral part of my story from 1945 to 2009, but is too long to reproduce here.

### **Beggar-thy-Neighbor Interest Rates**

Now fast forward to 2010. As if no lessons had been learned from the past, insular U.S. monetary and fiscal policies are again playing havoc with the financial systems of many countries on the dollar standard's periphery. In responding to the weak American recovery from the global downturn of 2008, the U.S. Federal Reserve has kept short-term interest rates near zero in 2009 and 2010 and projects that it will keep them low into the indefinite future. In addition, the Fed is also engaging in more quantitative easing—the so-called QE2—by buying longer term U.S. Treasury bonds to drive long-term interest rates down further. But the yield on 10-year treasuries is already less than 3 percent.

Unsurprisingly, this has unleashed a flood of hot money into most “peripheral” countries in Asia and Latin America as well as Australia, Canada, and New Zealand. Figures 1A, 1B, and 1C, shows these currencies appreciations against the dollar in the latter part of 2010.

China is a significant exception with its recent (October 19) small increase in interest rates to counter domestic inflationary pressure and its greater ability to keep the RMB from appreciating against the dollar. But that is a losing game. Insofar as China's domestic interest rates go up, more hot money pours in despite China's attempts to impose controls on capital inflows. To prevent the RMB from ratcheting up, the People's Bank of China must buy the excess dollars in the foreign exchange markets—thus inadvertently expanding the domestic monetary base and stoking the inflationary pressure.

To prevent a precipitate decline in the competitiveness of their exports, central banks in Korea, Thailand, Japan, Brazil, Malaysia, Singapore, and other emerging markets—have intervened to dampen their currencies potential appreciations by buying dollars. Figures 2A and 2B show the sharp ballooning in their official (dollar) exchange reserves in 2010. To make these interventions effective and dampen further inflows of hot money, most have allowed their money supplies to expand faster and reduce interest rates. Complete sterilization is either infeasible or too expensive.

From this worldwide monetary expansion mainly in emerging markets, the resulting the inflationary pressure has driven up the **dollar** prices of primary commodities sharply. As of Nov 9, 2010, Figure 3 shows *The Economist's* newly weighted commodity price index rising 38.8% year over year—with food rising 31.5% and industrial raw materials rising 47.9%. With yields on financial assets becoming increasingly unattractive, the system becomes more prone to bubbles in commodity markets provoked by investors searching for higher yields<sup>2</sup>.

### **The Two-Speed World Economy:**

Figure 4 shows the sharp fall in “world” GDP (52 countries as compiled by the IMF) in 2008 into 2009, and then the sharp recovery in 2009-2010 so as to reach pre-crisis levels. But the recovery is quite unbalanced. Taking 2002 as the base, Figure 5 shows that the mature industrial economies have only grown only 1 percent net going into 2011. Whereas emerging markets and developing countries (in which China is represented) grew almost 6 percent over the same decade—although some of this growth is normal “catch-up”. In effect, the emerging markets fell less in the 2008-09 crash and have recovered more strongly.

This divergent growth pattern helps explain why we have ultra low interest rates in the mature industrial economies—zero short rates in the U.S. and Japan, and close to 1 percent in the Euro area and the U.K. Reducing interest rates is a standard textbook response to sluggish growth, but, textbooks notwithstanding, going to zero could be a serious mistake. (See the following section on the zero interest rate trap.)

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<sup>2</sup> In 2010, real estate bubbles would have also re-appeared if recently there had been no recent calamitous collapses in real estate markets with unresolved mortgage defaults in Europe and North America in 2007-08. Without the immediate precedent of a collapse in real estate prices, however, now, China is now threatened with a real estate bubble made worse by hot money inflows from the United States. The PBC is being forcing it to curtail the domestic credit expansion that had pulled it and much of the rest of Asia out of the global downturn of 2008-09.

In contrast, countries on the periphery in Asia and Latin America face inflation and higher growth from the boom in primary commodities' prices and from hot money inflows. Most of these would like to raise interest rates to fight inflation, as Australia, India, and China have. But they are constrained from raising them very much because of low interest rates in the mature industrial economies from which hot money is flowing.

Ultra low interest rates at the center—particularly in the United States with its new QE2 program—is creating unwanted financial turmoil on the periphery. But, by again ignoring these signals of foreign financial distress, is the United States acting in its own best interest?

Clearly, with high and possibly rising unemployment, the U.S. wants to stimulate real output in its economy. But there are two negative aspects of near zero interest rates that are impairing this goal.

- The broken American system of financial intermediation where some large banks are piling up huge excess reserves as overall commercial bank credit continues to decline,
- The bubbles in primary commodity prices on the periphery which are the wrong kind “inflation” for reducing real interest rate below nominal ones.

Let us consider each in turn.

### **The Zero Interest Rate Trap and Decline in Bank Credit**

To counter the global downturn in 2008, the Keynesian response of stimulating aggregate demand through easy money and loose fiscal policy was correct to a point. But flooding the system with excess liquidity that drives short-term interest rates to near zero has been a serious mistake. By the end of 2008, U.S. interest rates on federal funds and short-term Treasury Bills were virtually zero—where they remain today (figure 6). In this liquidity trap, the interbank market remains almost paralyzed so that further Fed injections of liquidity simply led to a buildup of excess reserves in U.S. commercial banks without stimulating new lending to households and nonbank firms.

After the financial panic began in July 2008, figure 7 shows that the Fed responded by more than doubling the stock of base money, which reflects the huge increase in commercial bank reserves from the Fed's extraordinary purchases of financial assets from the private sector. However, M2—a broad measure of deposits held by the nonbank public— only increased a modest 5 percent, reflecting an offsetting large fall in the base money multiplier. Most disappointing of all, figure 7 also shows the post-crash continued decline in retail bank lending through 2010. Insofar as U.S. commercial banks did slightly increase their net assets as the counterpart of the modest increase in M2, it was to buy securities such as government bonds or mortgages fully insured by the government. But increased working capital for businesses,

especially small and medium sized, languished despite the gargantuan efforts of the Fed to expand the size of the banking system.

Why was it a mistake for the Fed to flood the system with so much liquidity that short-term interest rates were driven toward zero? In line with textbook economic theory, the Fed focused mainly on the shortfall in aggregate demand rather than on the underlying supply constraint on credit availability. However, starting from a position where interest rates are already very low, say 2 percent as in early 2008, reducing them to zero has only a second-order effect on expanding aggregate demand. But going from 2 percent to zero has a first-order effect of tightening the credit constraint on the supply side. Although in 2010 the economy may show a “dead cat bounce” from supercharging aggregate demand through fiscal policy, leaving the fed funds rate at zero makes it impossible for the resumption of normal bank credit to support investment growth in future years.

Because credit is an input into working capital, a credit constraint acts very much like a supply constraint on physical capital. In either case, dumping more liquidity into the system does not increase output. But why should congestion in the wholesale interbank market constrain banks who see good retail lending opportunities? Why don't such banks just raise their interest rates to final (retail) borrowers enough to maintain their profit margins and willingness to lend?

This is an important and not generally understood point. Retail bank lending involves making risky *forward* commitments, much like transacting in forward markets in foreign exchange. For example, a bank might open a line of credit to a corporate customer that could be drawn upon over the next year. But below some well-defined maximum, the customer chooses when to draw it down, and by how much.

The willingness of banks to make such forward commitments to lend to nonbank firms and households depends very much on the wholesale interbank market. If the wholesale interbank market works smoothly without counter party risk at positive interest rates, then even currently illiquid banks can make forward loan commitments to their retail customers. If such a bank happens to be still illiquid when a corporate customer suddenly draws down its credit line, the bank can cover its retail commitment by bidding for funds in the wholesale market at close to the "risk-free" interest rate. Because the riskiness of making forward retail loan commitments is thereby reduced, the bank's willingness to do more retail lending increases. (Otherwise, without participating in the interbank market, each commercial bank would have to hold much higher liquid reserves against its potential retail lending opportunities.)

Now suppose some upsetting event, such as a crash in home prices makes all mortgage related assets on bank balance sheets suspect. Then counter party risk becomes acute, and banks become less willing to lend to each other unsecured. Because LIBOR interbank loans in London

are unsecured, one very rough measure of counterparty risk from the U.S. housing crash is the difference between the federal funds rate, which is fully secured by repo agreements based mainly on Treasury bonds as the collateral, and the unsecured LIBOR. Figure 6 shows that before mid 2007 (when the crisis began), the one-month LIBOR rate closely tracked the fed funds rate. Then after mid 2007, LIBOR began to edge above the federal funds rate before spiking sharply in late summer and fall of 2008 to more than 200 basis points above the fed funds rate. With the benefit of hindsight, we know that this was the most acute phase of last year's financial panic when interbank trading dried up. Thus, in 2008, the main constraint on interbank trading was counterparty risk.

Governments everywhere responded to the panic by pumping more equity into banks, greatly expanding the ambit of their deposit insurance, and opening up various central bank discount windows for distress borrowers. Among large banks trading with each other, this gigantic effort seems to have reduced counterparty party risk and the fear of bank failure. Figure 6 shows the one-month LIBOR rate coming down close to the Fed funds rate, now near zero, by mid 2009 and staying there through 2010.

In 2009 -10, however, with counterparty risk in abeyance but not completely vanquished, the zero interest rate policy became an important supply-side constraint on the resumption of normal interbank trading. Positive rates of interest at all terms to maturity are necessary for normal borrowing and lending in the wholesale interbank market. Only then will banks that are liquid, i.e., have excess reserves but no good future lending opportunities at retail, lend to those that are illiquid—i.e., those with good retail lending opportunities in domestic or foreign trade but no excess reserves. But if the risk-free federal funds rate is close to zero, banks with excess reserves will not bother parting with them for a derisory yield.

Figure 8 shows the astonishing shrinkage in interbank loans from \$0.45 trillion in May 2008 (before the crisis) to just \$0.20 trillion on October 2010. I hypothesize that this “led” the milder percentage shrinkage in from \$1.54 in May 2008 to just \$1.22 trillion October 2010 in Commercial and Industrial loans. The counterpart to this shrinkage in retail bank credit was the buildup of Treasury and Agency Securities, as well as cash assets (mainly excess reserves), on the banks' balance sheets as also shown in figure 8.

Interest rates don't have to be very high to unblock private interbank markets— just 1 to 2 percent. However, banks with surplus reserves but without good retail lending opportunities need some profit margin for them to play their vital intermediary role of lending to illiquid banks with better retail opportunities rather than engage in hot money flows abroad. Otherwise the Federal Reserve itself has to be the intermediary by using the (excess) reserves of the commercial banks lodged with it to lend directly to the private sector—for example, by buying commercial bills directly from large corporations. Apart from the potential undesirable political biases in government direct lending, small- and medium- sized firms—which that cannot issue marketable commercial bills— are still left starved for even normal bank credit.



I have made a distinction between “illiquid” and “liquid” banks without specifying much in the way of an institutional frame work for distinguishing between the two classes. Indeed, banks that are illiquid in any one period need not be in the next. Being illiquid seems pejorative, but it is not if, at any point in time, it includes banks with the better (forward) retail lending opportunities. Also, with the government’s massive injections of new equity into large banks, their counterparty risk may have been substantially eliminated. LIBOR has converged to the federal funds rate in 2009 and 2010 at near zero interest rates (figure 6).

However, residual counterparty risk could still be lodged in smaller U.S. banks among which there have been numerous failures so far in 2009 and 2010. Indeed, LIBOR only reflects average interest rates for trading among the world’s 20 or so largest banks in London. It need not reflect the plight of smaller banks, which have not been beneficiaries of government largess. But smaller banks are the natural lenders to small- and medium-sized enterprises, which seem the most stressed in the current downturn. Thus, figure 7 could reflect a huge build up of excess reserves concentrated in large banks while, simultaneously, many small and medium sized banks—without easy access to the interbank market— reduce their (retail) lending thus making a robust U.S. economic recovery impossible.

### **Commodity Price Bubbles and Real Interest Rates**

In formal macroeconomic models of a closed economy, aggregate productive investment is inversely and monotonically related to the real rate of interest. At any term to maturity, the real interest rate is defined as the nominal rate less the expected rate of price inflation—which is measured by the expected rate of increase in some broad price index such as the CPI or PPI. If investment is slack, these models suggest that the central banks should reduce nominal interest rates in order to reduce real rates. But if nominal interest rates are bounded from below by zero as in the current U.S. or Japanese liquidity traps, the theory suggests that the authorities should target a higher inflation rate—both actual and expected—so that “the” real” interest rate becomes negative—thus allegedly providing the needed investment stimulus.

Although superficially attractive—at least to some economists, such as Chairman Bernanke of the U.S. Federal Reserve Bank—this theory is particularly problematic for open economies. Hot money outflows and large exchange rate depreciations may result. Open economies come in different sizes with differing economic characteristics. But let us consider the United States, which is now highly open, still bulks large in the world economy, and most importantly is at the center of the world’s money machine—the world dollar standard.

Since the global downturn in 2008, the more immediate effect of America’s current ultra easy monetary policy is to induce hot money outflows that weaken the dollar in the foreign exchanges, generate inflationary pressure most easily visible in emerging markets, and create

bubbles in primary commodity markets such as food and energy--although this turmoil is not yet visible in the more broadly based U.S. CPI or PPI.

However, bubble-like increases in primary products prices are not, on net balance, conducive to increased productive investment in the U.S. True, farming, petroleum, and other extractive industries appear to be more profitable in the short run. But if such increases are seen to be bubbles that could explode, longer term investment in these sectors is inhibited. More importantly, because the U.S. is a mature industrial economy with a huge service sector, industrial commodities—iron ore, copper, oil, and so on—are best viewed as inputs (many of which are imported) into the American industrial machine. From this perspective, QE2 could well reduce the effective or “real” rate of return to onshore U.S. investment in the medium term.

Everyone agrees that introducing more macro economic uncertainty inhibits productive investment—as distinct from speculative investments in bubble-prone “commodities” or real estate. And given the huge expansion in the Fed’s monetary base (Figures 7 and 8)—almost all of which is in excess commercial bank reserves—creates great uncertainty as to what the future rate of American and world inflation will actually turn out to be.

The current flight from the dollar in the form of hot money flows into foreign countries—not only emerging markets, some of are re-imposing capital controls on inflows—leads to a weakening dollar and further massive increases in America’s liquid liabilities to foreigners. The willingness of foreign creditors to support the saving-deficient United States then becomes more doubtful. The possibility of a sudden stop, where foreigners cease lending to cover the U.S. trade (saving) deficit thus causing a “credit crunch”, seems remote—but it has happened before<sup>3</sup>. All this adds to the future uncertainty inhibiting current investment in the United States itself.

Beyond the banks, near zero interest rates will—and already are—seriously weakening other important U.S. financial intermediaries. Insurance companies with longer-term annuity or death-benefit liabilities, or defined benefit pension funds—particularly at the state and local level—will find it increasingly difficult to fund these benefits as interest earnings on the asset sides of their balance sheets plunge. Major bankruptcies here are not out of the question.

### **Springing the Liquidity Trap: An Active “Market Maker” Window for the Fed?**

So how should the Fed spring today's low-interest liquidity trap? Any plans to directly drive down longer-term interest rates on Treasuries, such as QE2, should be abandoned. Bank intermediation is already curtailed because interest rates are already too low to compensate for the risk of taking on new liabilities. Flooding the system with yet more dollar liquidity would

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<sup>3</sup>The credit crunch of 1991-92 caused a temporary, but sharp, downturn in the U.S. economy sufficient to prevent the 1992 re-election of George H. Bush—despite his decisive victory in the Gulf War in 1991. The collapse of the Japanese asset bubbles in 1990-91 coincided with German reunification in the same year. So America’s two biggest creditors of that era suddenly stopped lending for the next two years (McKinnon and Ohno, 1997, chapter 5).

only accelerate hot money flows abroad while large commercial banks at home would pile up ever greater excess reserves.

But something more positive can be done to get interest rates up to modest levels in order to promote the recovery of interbank, and then retail bank, lending in the United States— while halting the flow of hot money abroad. The broken system of U.S. domestic financial intermediation must be mended directly. The Fed has the legal authority to be an active "neutral" financial intermediary to replicate a properly functioning interbank market. So I suggest a new *market maker* (MM) window for the Fed

By accepting deposits and making loans at all terms to maturity in the interbank market through its MM, the Fed could nudge rates up to, say, 2% on short-term deposits with a modest upslope in the yield curve to, say, 4% at long term. By acting as broker-dealer in the interbank markets, the Fed can suppress counterparty risk between any two private banks—while behaving as a neutral auctioneer to set interest rates to just balance the flow of funds at each term to maturity. The fear banks have of dealing directly with each other would be eliminated, and money would start moving again—particularly to smaller banks with better retail lending opportunities<sup>4</sup>. At moderately positive interest rates, the biggest source of funding would come from excess reserves now held by the larger commercial banks.

Counterparty risk naturally rises with term to maturity of the interbank loan. Even if Bank A was fairly sure that Bank B could repay a short-term interbank loan, a three-month-or six-month loan would carry a higher probability the Bank B would default. Thus interbank transacting as seized up more at longer terms to maturity. However, it is active interbank transacting at these longer terms that facilitates commercial bank lending of three to six months or more for working capital to large and small businesses.

In springing the zero-interest liquidity trap, the Fed's interventions through its new MM window would only involve banks. Then, with assured access to the wholesale interbank market as a backstop, a commercial bank could more safely make forward retail commitments to extend credit to nonbank firms and households—albeit all properly collateralized—at moderately positive rates of interest. The Fed can then avoid the political moral hazard of direct retail bank lending—unlike many of the Fed's extraordinary interventions in the crisis of 2008-09 where the Fed bought mortgages and mortgage backed securities, as well as private commercial bills.

### **A New Exchange Rate or New Interest Rate Regime?**

In reforming the international monetary system, exchange rates usually get primary attention front and center—such as in the recent November Meetings of the Group of 20 in Seoul. And nobody wants a replay of the destructive beggar-thy-neighbor exchange rate depreciations of the 1930s.

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<sup>4</sup> An additional advantage of transacting through the MM window is that the Federal Reserve authorities would be in a better position to spot rogue banks that are overextending themselves by borrowing from too many sources.

But at the G-20 meeting, President Obama attacked China for not *appreciating*. In the dollar-based world of East Asia, China's monetary policy has been oriented toward keeping the yuan/dollar rate fairly stable since 1994, when it unified its exchange rate system and went to current-account convertibility under the IMF's article VIII. This policy of exchange rate stability has served China well as an anchor for its domestic price level, and to balance exchange relationships with its smaller neighbors (McKinnon and Schnabl 2009). In addition, the left hand panel of Figure 9 shows no clear evidence that China's exchange rate is undervalued vis-à-vis Europe or the United States relative to their "real" multilateral exchange rates average over of the past 20 years.

Not finding any agreement on exchange rate practices, the G-20 Meetings then shifted to trade imbalances. The United States suggested that countries with trade surpluses cap them at, say 4, percent of GDP. But trade surpluses simply reflect net saving surpluses: the difference between national saving and investment. And in market economies, governments don't directly control either—nor, contrary to popular opinion, can exchange appreciation be used as an instrument to reduce any creditor country's saving (trade) surplus (Qiao 2007, McKinnon 2010). Moreover, the U.S. weakened its position by not following through: it did not pledge to eliminate its saving deficiency, i.e., to reduce its fiscal deficit and to raise the woefully deficient saving of American households. But, *eventually*, for global imbalances to be corrected, surplus countries must consume more while the saving-deficient United States consumes much less. However, in view of the dramatic November impasse at the G-20, better to let sleeping dogs lie.

With exchange rates and trade balances off the table for now, what remains for constructive international monetary reform? Almost all countries at the G-20 meeting complained about ultra-low interest rates at the "center" inducing hot money flows to the "periphery". With today's two-speed world recovery (Figure 5), the slowly growing mature industrial countries—the United States, Europe, and Japan—have cut short-term interest rates very low. The result in 2010 is a "carry trade" with a flood of hot money into higher growth emerging markets causing exchange appreciation and an inflationary loss of monetary control—while setting off worldwide bubbles in commodity prices.

Carry trades result from wide interest differentials, and are aggravated by associated exchange rate movements—as per the exchange appreciations in the peripheral countries for the latter part of 2010 shown in figures 1A, 1B, and 1C. Compared to the 1950s and 1960s, the carry trade problem has become more acute in the last two decades in part because of the general relaxation of controls on international movements of financial capital. (However, illiquid longer-term direct foreign investments are not a problem.)

The Asian crisis of 1997-98 was worsened by an earlier carry trade with Japan. By 1995, Japan had fallen into a near zero interest rate liquidity trap with a weakening yen. Hot money poured out of Japan and into the Asian Crisis Five: Indonesia, Korea, Malaysia, Philippines, and Thailand. Although Japan was not the only source only for over borrowing by the Five, they

became badly over extended in their foreign-currency indebtedness. Thus when Thailand was attacked in June 1997, the contagion spread to the other four by the end of the year—with widespread financial bankruptcies, sharp exchange rate depreciations, and sharp downturns in output and employment. Japan was hurt as its exports to East Asia slumped. Fortunately, China ignored foreign advice to depreciate the renminbi in tandem. Instead, the yuan/dollar rate was kept stable—which made it easier for its five smaller East Asian trading partners (and competitors) and Japan to recover.

Another example of a disruptive carry trade resulted from the U.S. decision in 2003—04 to reduce the Federal Funds rate to just 1 percent, and raise it only slowly subsequently. The outflow of hot money caused a steadily weakening dollar and stoked various commodity and real estate bubbles around the world—with the price of oil reaching an all-time high in June 2008. The fact that Japan remained mired in its zero interest liquidity trap, with hot money outflows and a weakening yen, aggravated the commodity bubbles. More importantly for the United States, the unduly easy U.S. monetary policy precipitated the great U.S. real estate bubble (Taylor 2010)—with echo effects in Britain, Spain, Ireland, and so on. When the bubbles collapsed in 2008, so did the both the American and European banking systems.

How best can carry trades, including the one we see today in 2010, be limited? Central bankers from the G-20 could meet continually in order to monitor each other. Clearly, the first item on the agenda would be abandon monetary policies by the mature economies that set interest rates near zero, which puts pressure on emerging markets to keep interest rates low despite the inflationary pressure they now face. The Fed has to be the leader because, under the asymmetrical world dollar standard, it has the greatest autonomy in monetary policy. To better preserve financial and exchange rate stability in the transition, the big four central banks—Fed, ECB, Bank of England, and Bank of Japan—should move jointly and smoothly to phase in a common target minimum target—say 2 percent—for their basic short-term interbank rates. By escaping from liquidity traps which so impair the efficiency of domestic bank intermediation, the mature center would benefit along with the periphery.

Reducing the spread in interest rates between the center and periphery would dampen carry trades and hot money flows in an important way. But it may not be sufficient to end them altogether. So acknowledging the legitimacy of emerging markets using capital controls and other devices to dampen hot money inflows should be an important part of the new G-20 discussion. Indeed central banks in the mature center could monitor their own commercial banks to help central banks on the periphery enforce their controls.

But there is an important asymmetry here. Capital controls are not for everybody. In particular, the United States at the center of the world dollar standard cannot itself impose capital controls without destroying the world's system for clearing international payments multilaterally. Thus everybody has a vested interest rehabilitating the unloved dollar standard, and the first of

many necessary steps in the rehabilitation process is to coax the Fed to phase out its policy of keeping short rates at zero and abandoning QE2.

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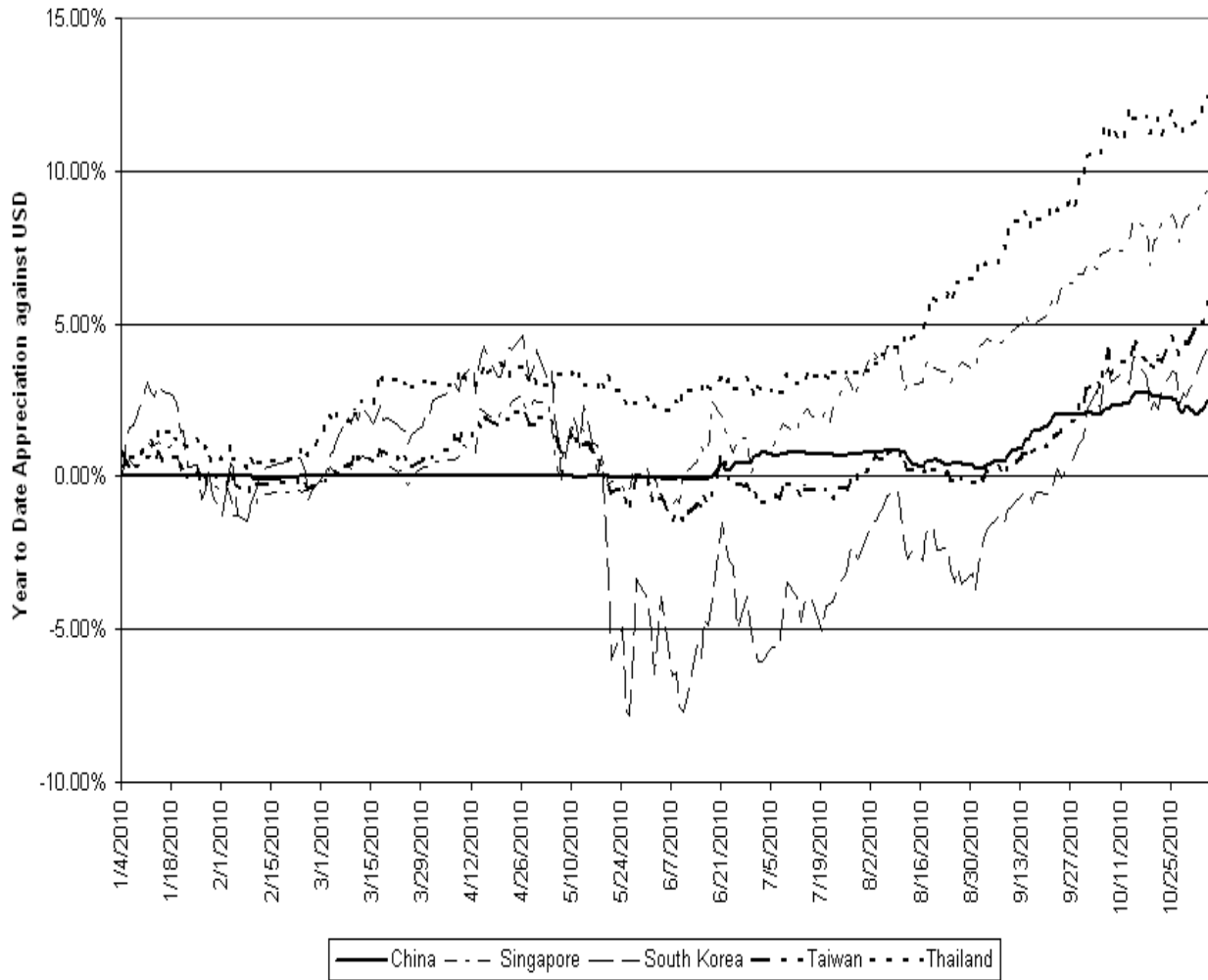
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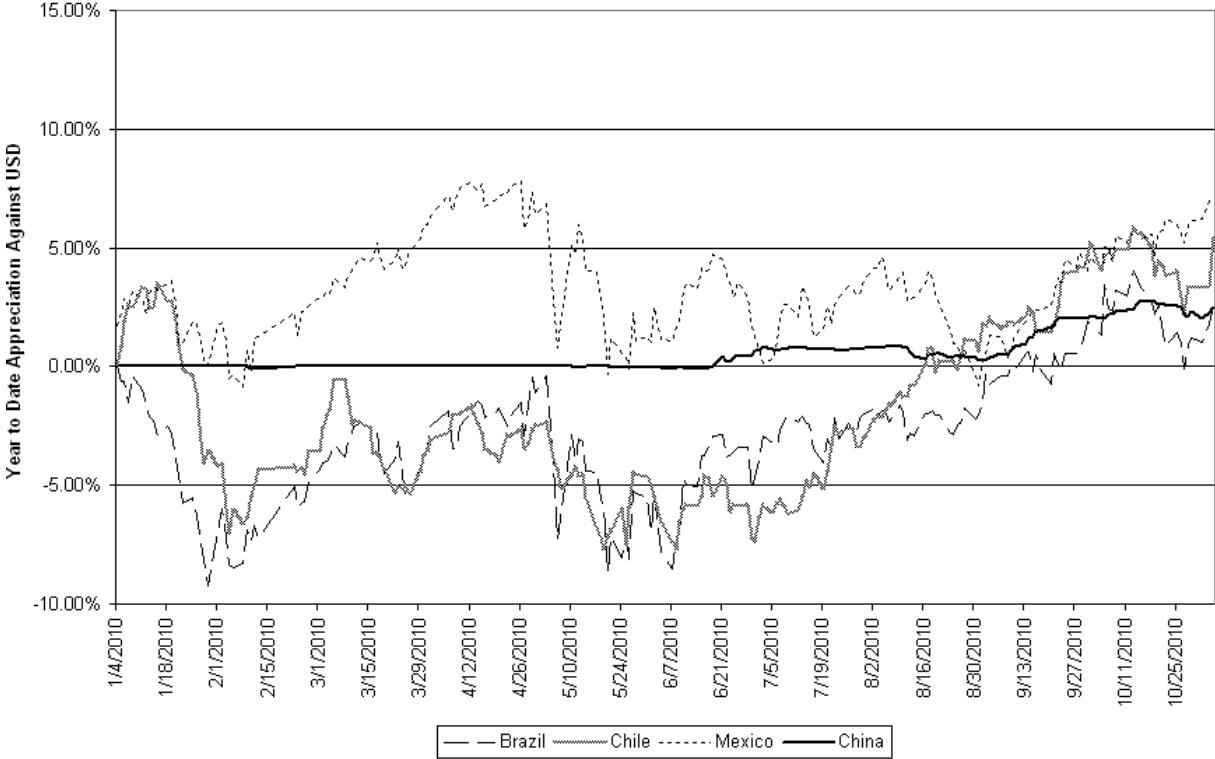
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Figure 1A: Currency Appreciation against USD of Selected Asian Countries (%)



Source: Bloomberg

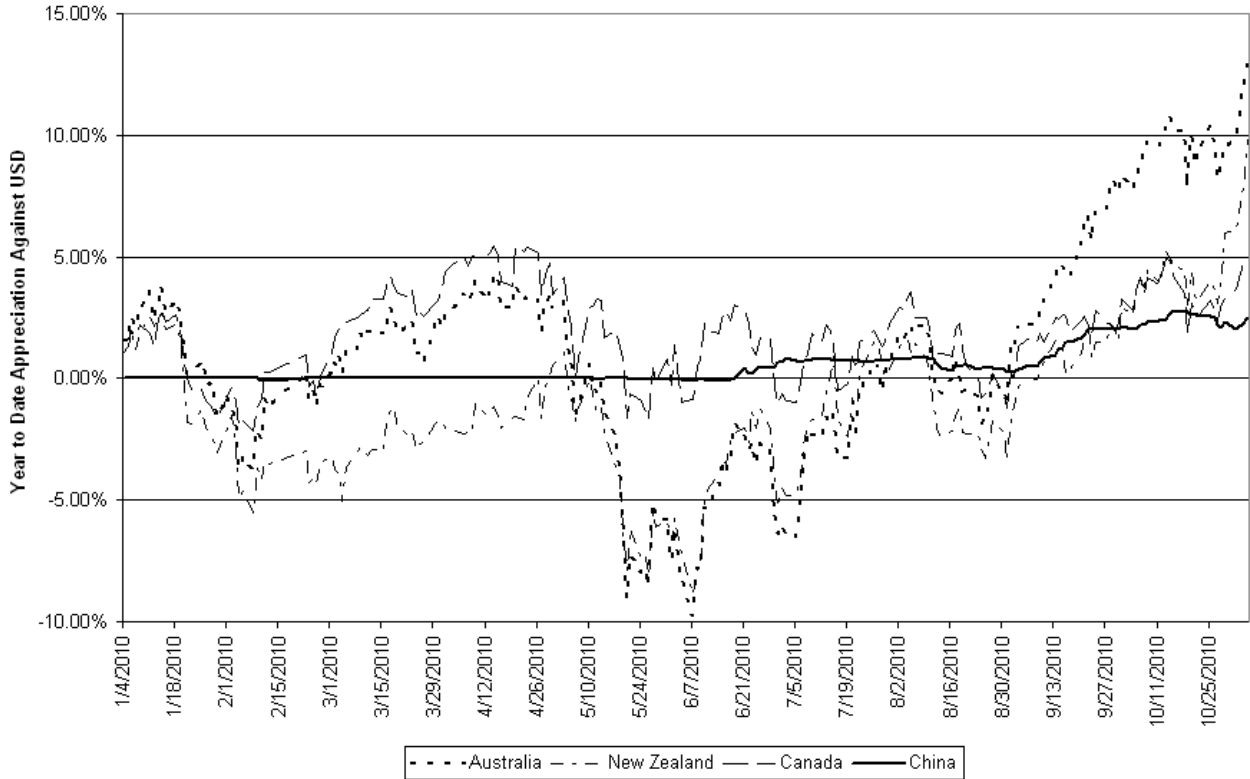
Figure 1B: Currency Appreciation against USD of Selected Latin Countries (%)



Source: Bloomberg

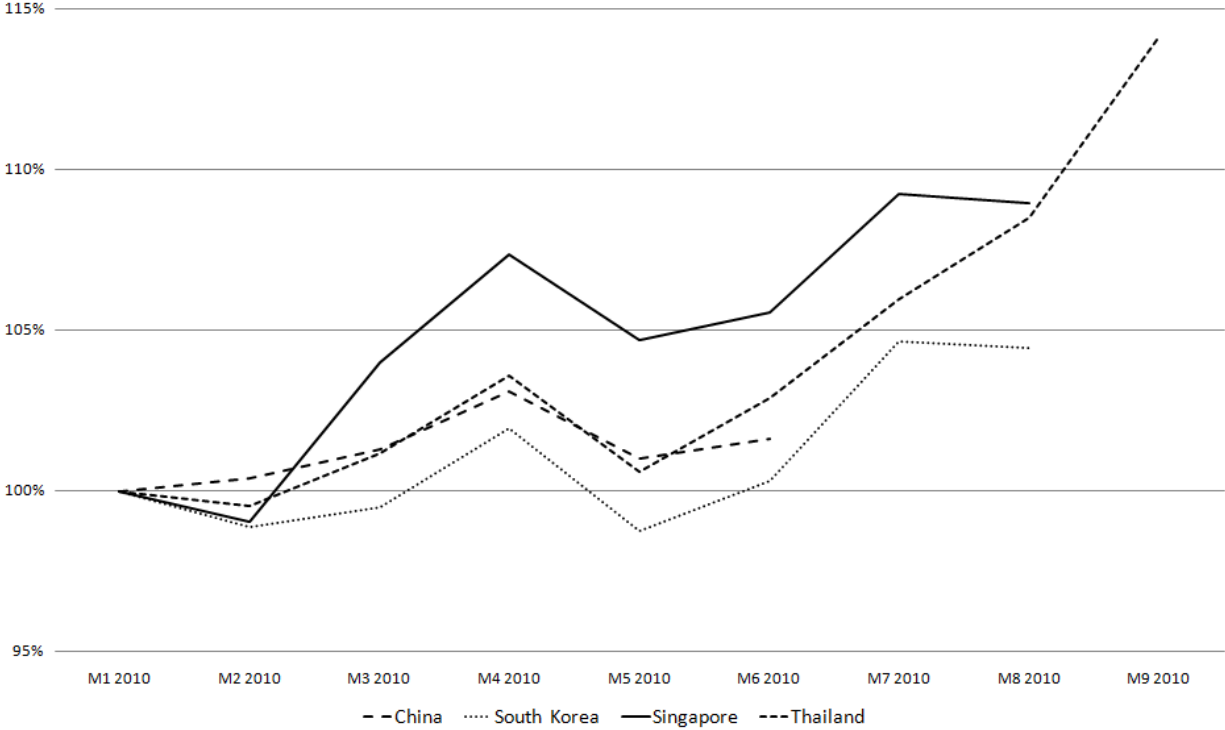


Figure 1C: Currency Appreciation against USD of Selected Western Countries (%)



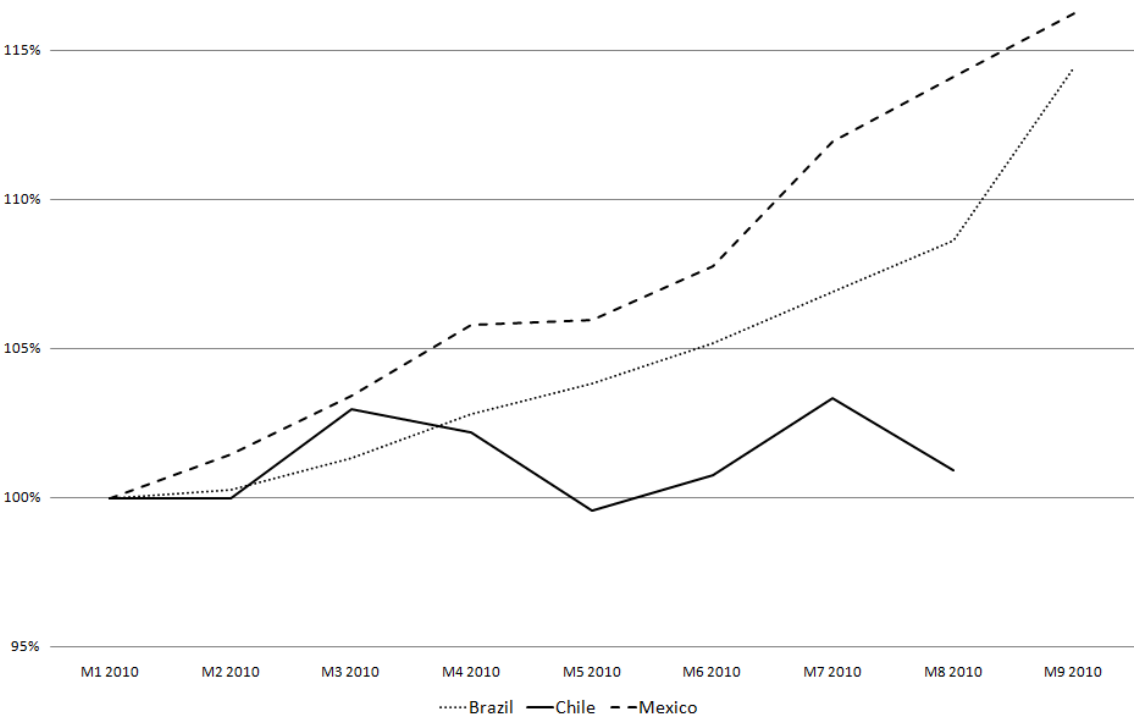
Source: Bloomberg

**Figure 2A: Foreign Exchange Reserves of Selected Asian Countries (% Change since Jan 2010)**



Source: IFS

**Figure 2B: Foreign Exchange Reserves of Selected Latin Countries (% Change since Jan 2010)**



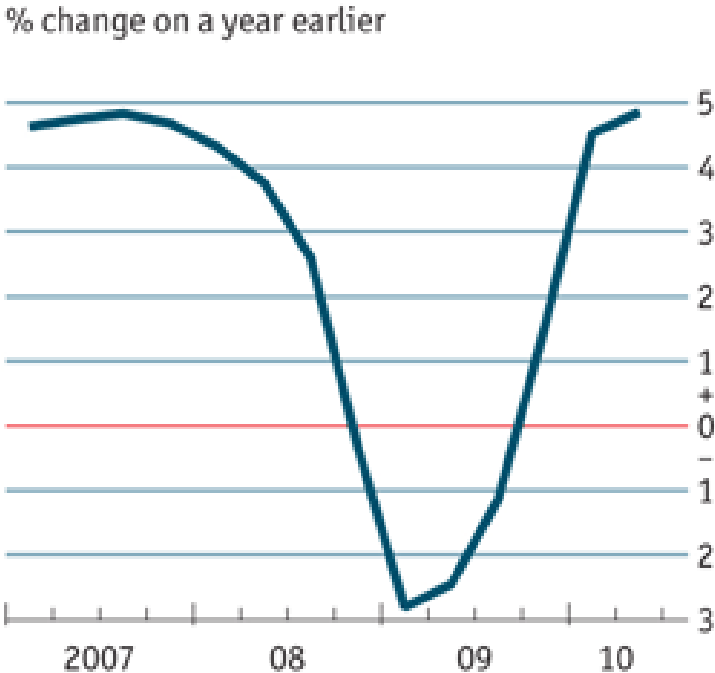
Source: IFS

Figure 3: Commodities Index



Source: The Economist (Oct 30-Nov 5 2010)

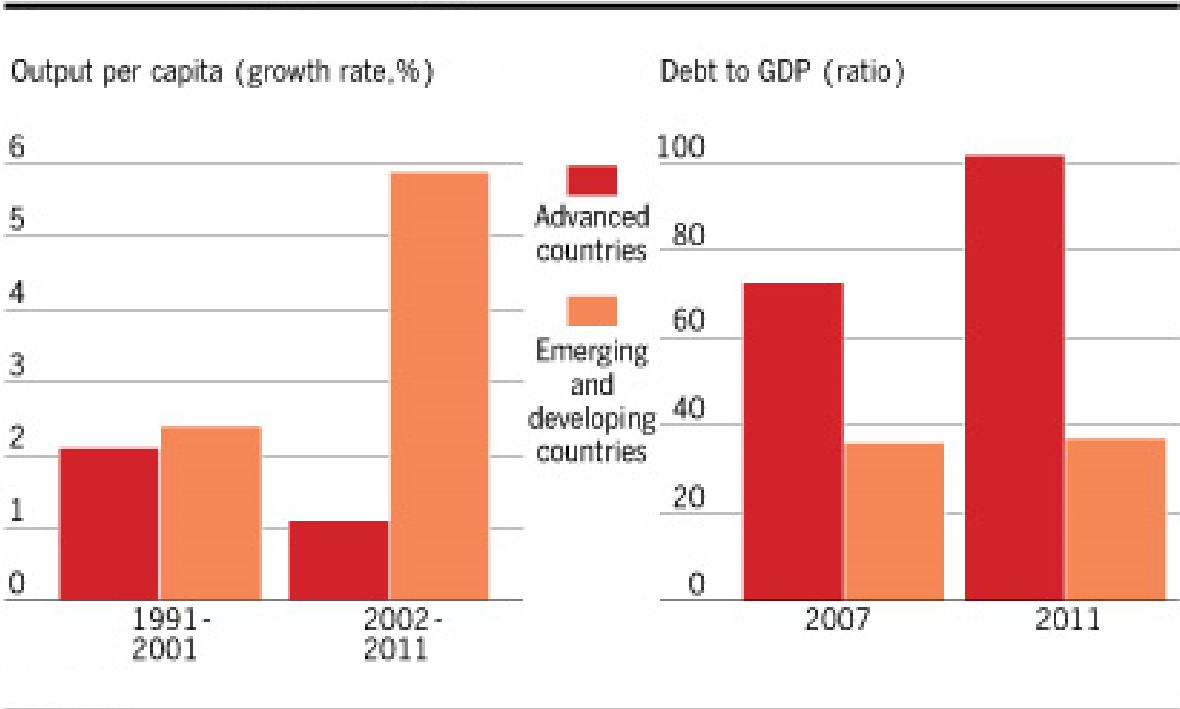
Figure 4: World GDP\*



Source: The Economist (Oct 30-Nov 5 2010)

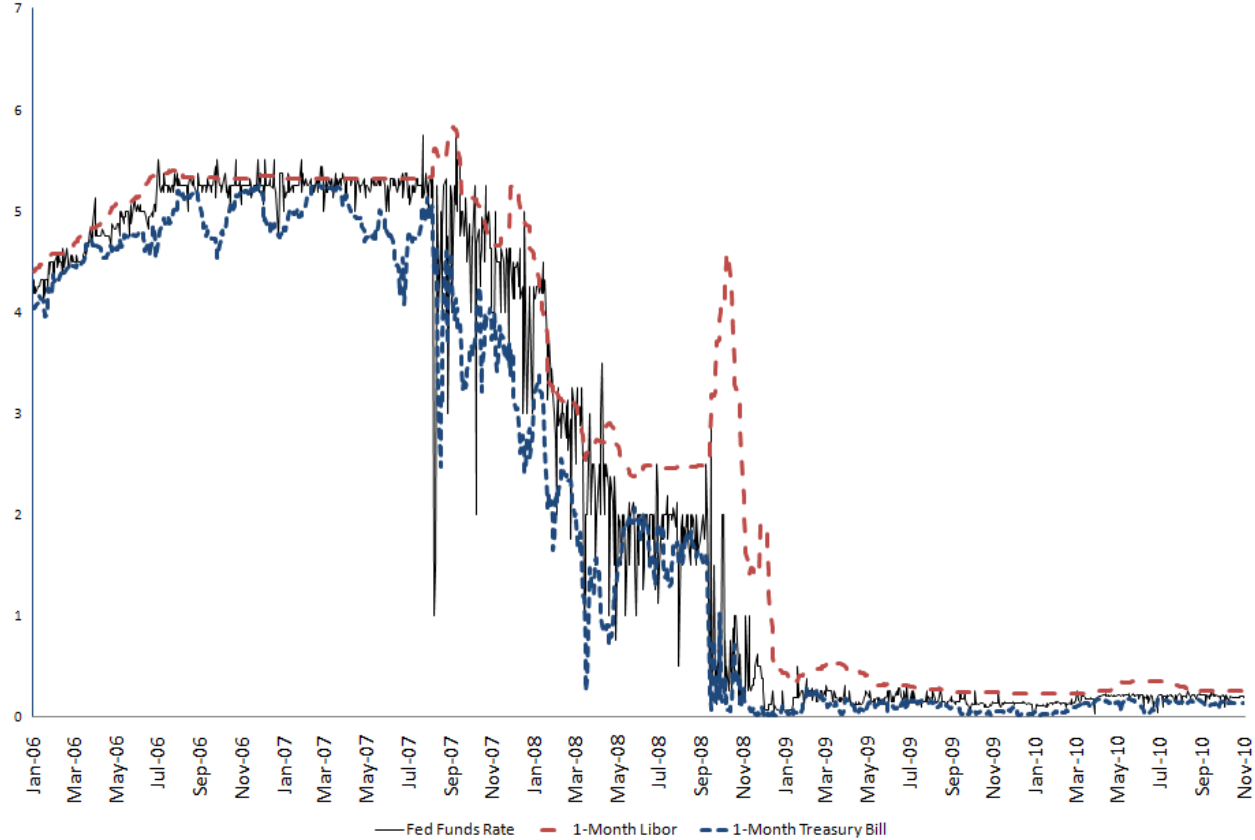
\*Estimates based on 52 countries representing 90% of world GDP. Weighted by GDP at purchasing power parity

Figure 5: Two Speed Recovery



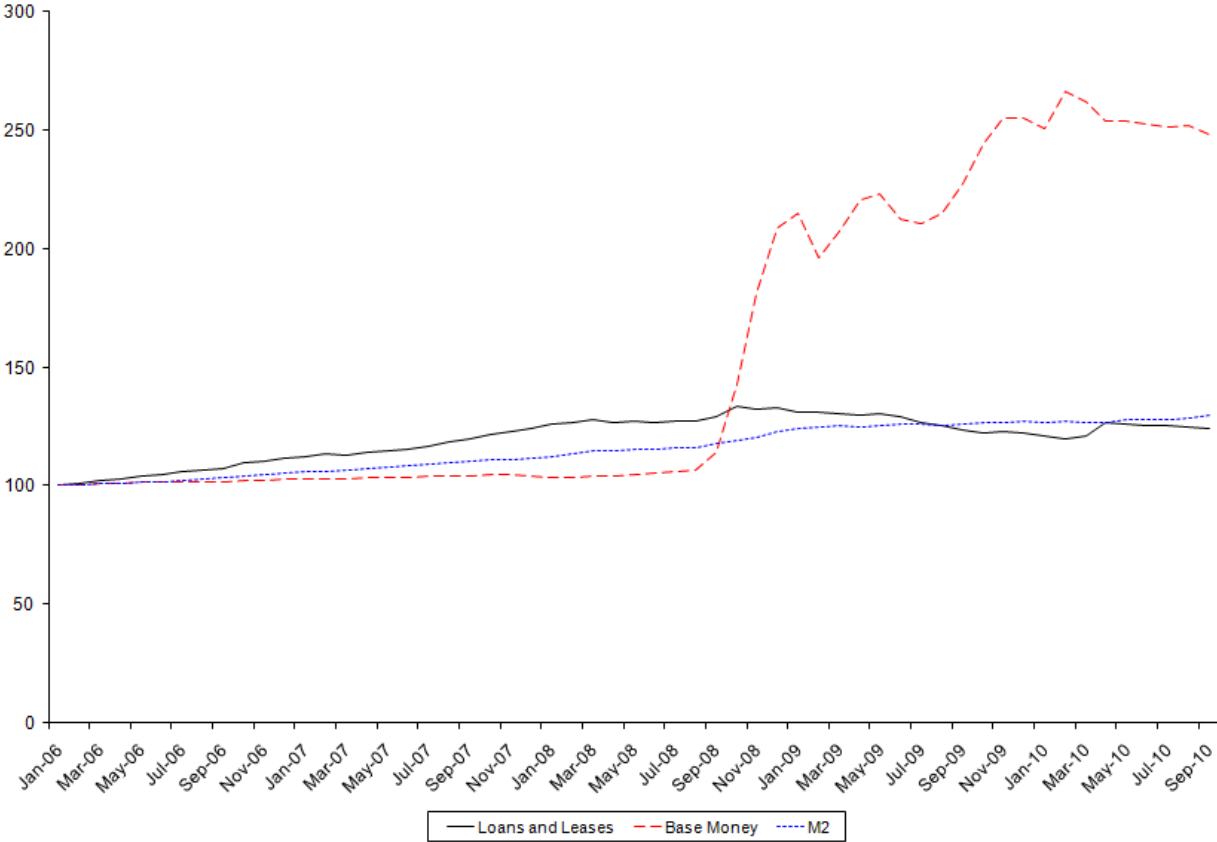
Source: Financial Times (November 12, 2010)

Figure 6: U.S. Short-term Interest Rates (%)



Source: Federal Reserve Economic Data and bloomberg

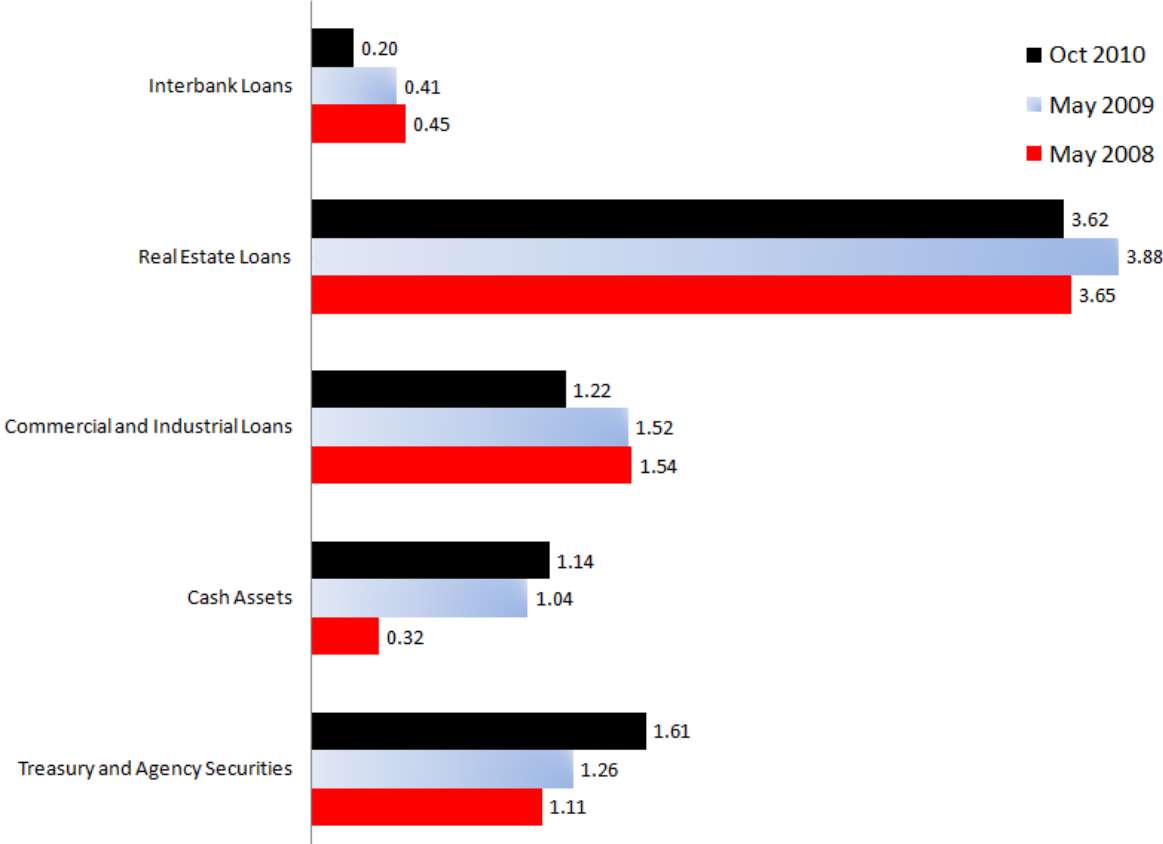
Figure 7: Loans and leases of U.S. commercial banks, base money and M2 (2006 Jan = 100)



Source: Federal Reserve Economic Data



Figure 8: Holdings of bank assets at commercial banks in the U.S. (\$ Trillion)

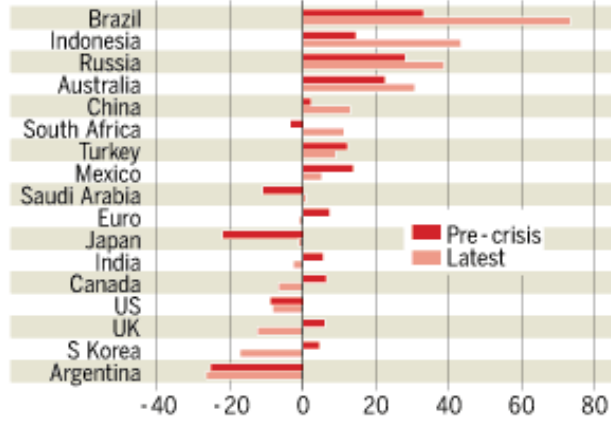


Source: Wall Street Journal, replicated with data from Federal Reserves

**Figure 9: Exchange Rate Valuations**

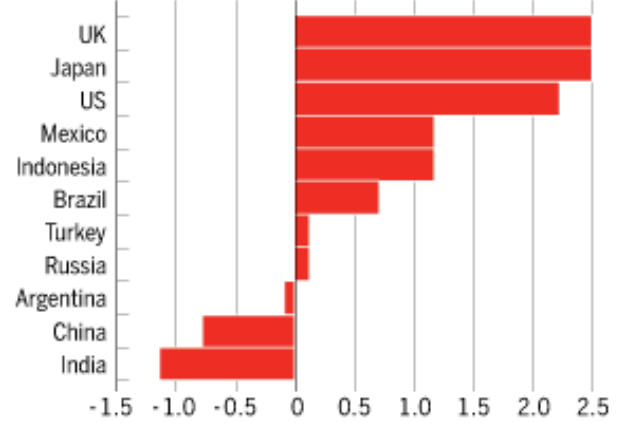
**Over/under valuation of G20 currencies**

JP Morgan real broad exchange rate indices, valuation against long-term (1990-2010) average (%)



**Measurement of degree of capital account openness**

2008, index\*



Source: Financial Times, November 11, 2010