EconoFact Chats: The Strong Dollar and the World Economy

Maurice Obstfeld, University of California, Berkeley

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Michael Klein:

I'm Michael Klein, executive editor of EconoFact, a non-partisan, web-based publication of the Fletcher School at Tufts University. At EconoFact, we bring key facts and incisive analysis to the national debate on economic and social policies, publishing work from leading economists across the country. You can learn more about us and see our at www.econofact.org.

Michael Klein:

Martin Wolf of the Financial Times, one of the world's preeminent economic columnists, began a recent article with the sentence, "in times of trouble, the dollar is the world's refuge and strength." These are certainly times of trouble. But as Mr. Wolf points out, having the dollar as the world's financial refuge presents its own problems as a strong dollar can hurt other countries, especially lower income and so-called emerging market countries. The arguments in Martin Wolf's column are largely based on a recent research paper co-authored by my guest today on EconoFact Chats, Professor Maurice Obstfeld of UC Berkeley. Maury is widely recognized as one of the world's leading experts in international economics. He served as a member of President Obama's Council of Economic Advisors. And from 2015 to 2018, he served as Chief Economist at the International Monetary Fund. Maury, welcome back to EconoFact Chats.

Maurice Obstfeld:

Thanks, Michael. It's a pleasure to be here,

Michael Klein:

Maury, the Financial Times column by Martin Wolf that I cited draws heavily on the paper you presented in September at the Brookings Panel on Economic Activity. The paper is called 'The Global Dollar Cycle.' The organizers of the conference elicit papers from leading experts on timely topics. When and why did they ask you to write a paper on the dollar?

Maurice Obstfeld:

Well, a couple of years ago I joined the Brookings Advisory Council, and from the get-go I had been advocating for a more internationally focused macro paper. Brookings has always been pretty domestically focused. Clearly, there is a lot going on in the international economy. Brookings, in fact, has this great tradition of very broad ranging papers on the international macro-economy. In fact, you may remember that I did one in 1985 in another period of exceptional dollar strength. You were actually the research assistant on that paper.

Michael Klein:

That was one of the highlights of my graduate school career, Maury.

Maurice Obstfeld:

So after suggesting this and the editors actually trying to recruit writers unsuccessfully, I decided I would probably have to do this myself. I persuaded Hoanan Zhou, a very talented grad student at Princeton to join me. He had been my research assistant at the IMF, so I knew him well. The September paper was the result.

Michael Klein:

So if you can't get somebody to do it, do it on your own.

Maurice Obstfeld:

Absolutely.

Michael Klein:

I guess, they must have been thrilled that you were actually willing to do that. When you first thought about doing this paper, what was the situation with the dollar? Was it strong then, and has it strengthened since that time?

Maurice Obstfeld:

Well, with COVID reopening, the international macro picture has of course been very dynamic, let's say. At at the time I first proposed something, we were actually in a expansive stage of what I call the Global Dollar Cycle. The dollar spiked up in March 2020 when the pandemic emerged and caused a crisis in financial markets. With all of the Fed stimulus that followed, the dollar depreciated. It was only in the middle of 2021 that the dollar began its upward ascent, well before the Fed did its first rate hike in March of this year, as people began to realize that given the strength of the US economy relative to other countries, the Fed would be tightening before other central banks.

Michael Klein:

We have some work on EconoFact already about the strength of the dollar. I have a memo on how the dollar as a safe haven...was stronger after the Russian invasion of Ukraine, and we have a recent podcast with Kathryn Dominguez about that, as well.

Maury, the dollar was at the center of the world financial system during the post-World War-II Bretton Woods System. That broke down almost 50 years ago, but the dollar is still at a central place in the world economy, a point you emphasize in your paper

Maurice Obstfeld:

At some level, it's an ironic history. The dollar, of course, had pride of place in Bretton Woods, the postwar fixed exchange rate system. All countries in the world effectively pegged their currencies to the dollar, and so the US more or less called the tune in terms of global monetary conditions. One of the motivations for moving to flexible rates. Of course, to some extent there was an ex-post motivation because the system collapsed. But one perceived advantage was that it would be more symmetric. Other countries would regain monetary control. The dollar would no longer be so special, because countries wouldn't have to intervene in foreign exchange markets to keep their exchange rates fixed to the dollar. They wouldn't have to hold so many dollars as far in exchange reserves.

Remarkably, if you fast forward to now, the dollar remains very central, and it remains a critical determinant of global monetary and financial conditions, which is what our paper is largely about. It's the predominant component of countries' international reserves. Why that is, is something that is really beyond the scope of the paper we wrote, but it is nonetheless a remarkable and durable fact.

Michael Klein:

I guess, one important point is that the dollar is what's called the vehicle currency of the world, that trade even between countries other than the United States, say between Germany and Great Britain is priced in dollars. And also, lots of commodities are priced in dollars as well. Oil, wheat, copper and so on. So that's one way in which the dollar has this preeminent role, right?

Maurice Obstfeld:

Yes. And the other is that while it's the main invoice currency for trade, it is also the main currency in financial markets for funding, for debt issuance, globally -- far outpacing the Euro, which is the nearest competitor. Moreover, you could argue that the dollar is a money among monies, in the sense that most trades in the foreign exchange market pass through the dollar. I mean, if you wanted to trade the Indian rupee for the Brazilian real, that's a pretty thin trade. That's a pretty thin market. And so in practice, what people do is they trade rupees for dollars, and dollars for real, because those two trades are much more liquid.

Michael Klein:

Well, I'm glad you brought that up because another important theme of your paper is the vast expansion of world financial markets since the end of the Bretton Woods fixed exchange rate system in 1973, and the way in which the dollar has played a central role in that expansion.

Maurice Obstfeld:

Yeah, and that's a fascinating story. I've written on it in a number of places. Alan Taylor at UC Davis and I have a book on global capital markets where we chronicle that development in terms of the organizing principle of what we call the monetary trilemma for open economies -- the idea that a government can choose a fixed exchange rate, open capital markets, or a domestically oriented monetary policy. Of that list, they can pick two out of three, but not all three. What the demise of the Breton wood Woods's fixed exchange rate system did and the advent of floating exchange rates was is it freed countries to open their capital markets while still preserving domestic monetary autonomy to some degree.

Now, that doesn't explain why they did so. That's something I tried to address in a more recent paper in Oxford Review of Economic Policy. And there, the story is very much mixed up with politics, with geopolitics, with ideology, with lobbying capability and financial interests of banking and finance industries. So it's a complex tableau, but there was remarkable growth in international financial transactions starting in the mid-'90s roughly, and culminating in the global financial crisis in 2008, 2009. Since then, markets have not really retracted, but the torrid pace of growth that we saw in the late '90s and the early 2000s has moderated to some degree.

Michael Klein:

So let's talk about that expansion of financial markets. There's a view that expanding financial markets enable economic growth. And there's evidence to support that, but this expansion also makes countries more vulnerable to financial disturbances, either originating in those countries themselves or from abroad.

Maurice Obstfeld:

Well, both things are true, Michael. We sort of know from a long history, and this was actually recognized in this year's Nobel Awards to Ben Bernanke and Diamond and Dybvig, that financial markets have the potential to play a very constructive role in enhancing efficiency, enhancing growth, but can also be fragile and subject to the fickle expectations of market participants. So the challenge for policymakers is to harness these markets for good while trying to discipline their vulnerabilities; the vulnerabilities to panic, to frenzies, to the other sorts of phenomena we've seen indeed over the centuries in these markets going back to Dutch tulip craze and other 17th century events.

If we look at international markets, just coming back to the point you raised about their expansion, it's clear that leading up to the great financial crisis in 2008, the Lehman collapse, these markets expanded way beyond the scope of anything that could be justified by economic efficiency. And in fact, if we look at these markets, there are lots of distortions. A lot of financial flows across borders are motivated by considerations of tax avoidance. Those don't raise efficiency at all. There are also transactions which may be fueling bubbles in the economy. One of the big factors in the first decade of this millennium was lending from US non-bank actors to European banks who would then recycle this money into the US, into securities linked to subprime markets, thereby deriving their motivation from the housing bubble in the US but also feeding the housing bubble in the US. So we indeed need to be very careful about these flows, and then when you think about emerging markets where the financial institutions may be even more brittle than those in the advanced economies, you need to be extra especially careful.

Michael Klein:

So going back to your Brookings paper and the fact of this expansion and the deepening of financial markets, what are the ways in which the swings in the value of the dollar can cause problems for emerging market countries?

Maurice Obstfeld:

Well, there are a number of factors at work. One factor, which is not really a causal factor but is simply the reality that ... and this is sort of where you started out. A strong dollar is often a reflection of lower risk appetite or tighter financial conditions. In extreme cases, outright panic in global markets. And this of course is going to be negative for emerging market countries and lower income countries. It's also the case that in most of these middle and lower income countries, and this gets back to the dollar's critical role in financial markets -- many resident liabilities are denominated in dollars so that when the dollar strengthens, the real value of these liabilities goes up. That harms balance sheets. It leads to a restriction in the availability of credit. This is not as true as it used to be for sovereign debts, that is for government borrowing, but it certainly remains a dominant factor for corporate borrowing in these economies.

Michael Klein:

So Maury, what should the Federal Reserve do about this? Its mandate is to pursue high employment and stable prices, but there's nothing in the mandate about the exchange rate, nor about concerns for other countries. And in fact, you and I have an EconoFact memo that we posted more than three years ago, arguing that if the Fed tried to weaken the dollar, it was akin to the tail wagging the dog.

Maurice Obstfeld:

Well, in the US, as in most countries, the authority with responsibility for the exchange rate for the external sector is the Treasury, not the Central Bank. Although, the Central Bank may have the job of intervening when directed to do so by the Treasury. The exchange rate is always inherently viewed as a much more political issue. And for the Fed, effectively the exchange rate is a residual of the monetary policy condition, which, as you say, is driven by the domestic mandate.

Now, on the other hand, the exchange rate will have domestic effects. They may be distributional effects, but they may be distributional effects that have a real impact on growth. For example, a very strong currency leads to pressures for protection, which in turn could limit growth. We've seen episodes like that in the past. Shortly after that '85 Brookings paper that you and I worked on, trade tensions helped to lead to the Plaza Accord in which governments of the biggest industrial nations agreed to intervene to drive the dollar down.

But coming back to what should the Fed do, I think that the Fed, even consistent with its domestic mandate should realize, as I think they do, that if a strong dollar leads to tighter financial conditions, to much slower growth in the rest of the world, that will spill back onto the US. That will affect demand in the US. It'll affect the inflationary outlook in the US. So I think it's critically important, particularly in the setting that we are in, for the Fed and in fact for all central banks around the world to be especially attentive to the actions of other central banks, and to the reactions of other central banks to what they do, because those are going to affect everyone's outlook going forward.

Michael Klein:

We have a recent EconoFact podcast with Jeff Frieden, a friend of ours, both yours and mine, who's a political scientist who focuses on the distributional and political impact of exchange rates along the lines of what you're suggesting.

So Maury, as I mentioned at the outset, you served as Chief Economist at the IMF. If you were in that role today, what advice would you give to governments, emerging markets, and developing countries with respect to their concerns about a strong dollar? For example, there's some recent reports that countries like Chile have been raising their interest rates for a while, but nonetheless the Chilean peso is still weakening against the dollar. So if you had to put back on that fancy suit you wore when you were the Chief Economist of the IMF, what would you say to the people coming from the emerging market countries who are asking you what should we be doing?

Maurice Obstfeld:

Well, since the pandemic, my suits are definitely collecting dust in the closet. Let me try to unpack your question. First, in general terms, emerging markets are sort of getting hit by a double whammy right now. The Fed's tightening actions, especially the Fed, but also we could add in the European Central Bank, the Bank of Canada, all of the major central banks. Those are tightening financial conditions. Primary among those effects is a stronger dollar, and that's affecting emerging markets. But on the other hand, when the dollar appreciates and the currencies of these countries depreciate as they have been, that intensifies the inflationary pressures that they feel. Now, everyone in the world is facing inflationary pressures from oil prices, from natural gas prices, from food prices. Often these commodities are denominated in dollars, so there's direct pass-through, when the dollar strengthens, to higher domestic inflation. So if you're a typical emerging market, you've got the financial tightening effects of higher global interest rates, and a strong dollar, but you've also got this direct effect on inflation, which you're trying to control. So it's a very devastating set of shocks that they are facing.

What can they do? They can try to intervene in foreign exchange markets to slow the depreciation of their currencies. That has a number of problems, including limited effectiveness in the current conditions, and possibly also running down your stock of reserves rather rapidly. Reserves are important because they are the war chest that the government maintains against possible negative shocks, and we may have more of those coming down the road. So countries are going to be reluctant to, or should be reluctant to run down their reserves.

If the Federal Reserve and other major central banks were to reactivate and extend the swap lines that they've extended to some emerging markets in the past, that could effectively augment their available foreign exchange reserves. They may be able to do something similar by signing up for some of the precautionary facilities that the IMF has been offering for years, but that were expanded during the pandemic, and where there's been very limited appetite from emerging and developing economies to sign up to make these lines of credit available. They should also be redoubling their efforts in terms of what we call macroprudential policy; thinking about the hazards that might lurk within their own financial systems, the sort of financial vulnerabilities that this year's Nobel Prize focused on, and try to guard against those as best they can because the shocks are likely to just keep coming.

And Chile, as you mentioned, a number of emerging market central banks, many in fact began to raise their interest rates in the middle of 2021. This is long before the Fed and certainly the European Central Bank took that action. And not withstanding that, many of them, not all of them, but I would say most have still suffered substantial depreciations of their currencies, which would probably have been even greater had they not moved quickly to raise interest rates. Every country has its own story. As Tolstoy said, "every unhappy family is unhappy in its own way."

The Chilean case illustrates a couple of problems that unfortunately are not likely to be confined to Chile. One, Chile is a major copper exporter. China is a major market for that copper. China is suffering severe economic difficulties at the moment due to a domestic financial crisis in the housing sector, and the zero COVID policy. Other factors as well. But with Chinese demand lower and with the world economy likely heading into recession, reducing the demand for commodities such as copper, Chile is getting hammered, and prospectively getting hammered worst in terms of its main commodity export.

The other issue in Chile, which again unfortunately may be shared by other countries is a political issue. The country last year elected a left-wing president. Markets are somewhat wary of that. The country also rejected a draft constitution that was put up for a referendum. It was also a rather left-leaning constitution, and now they're in a bit of a limbo where it's unclear exactly where the constitutional process will go. So you add that uncertainty onto the negative picture for their main commodity exports, you can understand why despite having raised interest rates a lot, the Chilean peso remains weak.

Michael Klein:

Well, Maury, our conversation today reminds me why way back in 1985 I really liked talking to you about exchange rates, and how multifaceted the issue is, and how important as well. So thank you for joining me once again on EconoFact Chats and sharing your insights on this very important topic.

Maurice Obstfeld:

It's always a pleasure, Michael. Thank you for having me.

Michael Klein:

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