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The debate about key currencies: an Austrian perspective

Abstract

Since the 2008 financial crisis scholarly attention has been increasingly directed towards the current account imbalances between the United States and a host of other countries as one of the main sources of the crisis. The United States is said to enjoy an exorbitant privilege due to the fact that it supplies the de facto key currency of the international monetary system. This exorbitant privilege allows it to postpone balance of payments adjustment thus exacerbating potential problems. This essay takes issue with the importance that is given to the current account in explaining the financial crisis. Instead it adopts a capital account perspective in which the domestic monetary policy of the United States has international spillovers due to the widespread use of the United States dollar. In a fiat money standard this can give rise to a global liquidity glut rather than a global saving glut as is often assumed under the current account imbalances theory. In the international monetary system of the early 2000's, metaphorically named Bretton Woods II, this expansive domestic monetary policy was largely recycled back to the United States where it contributed to the asset price boom in the housing sector, laying the foundation for the financial crisis.

Introduction

In the wake of the financial crisis that started in 2007-08 many theories have been put forward to try and explain what exactly happened. Arguably the most famous one is the 'global saving glut' hypothesis, first put forward by then Governor (and later Chairman) of the Federal Reserve Ben Bernanke. In a speech in 2005 Bernanke first outlined the main tenet of this hypothesis: the transformation of developing countries from net borrowers to net lenders combined with high saving rates in some industrial countries, in particular Germany and Japan, were the main cause of the saving glut that put downward pressure on US interest rates. With a strangely predictive twist he then summarizes the consequence of these evolutions: "This increased supply of saving boosted U.S. equity values during the period of the stock market boom and helped to increase U.S. home values during the more recent period, as a consequence lowering U.S. national saving and contributing to the nation's rising current account deficit." (Bernanke, 2005).

The global saving glut hypothesis was the catalyst for an ever increasing focus on the current account deficit of the United States. This spawned an entire literature that saw the contrast between the current account deficit of the United States and the current account surplus of many East-Asian countries (notably China) and industrialized countries, colloquially known as 'Global Imbalances', as the main source of the financial crisis and the subsequent Great Recession. The biggest disagreement in this literature is whether the origin of these imbalances is to be found within the United States or internationally. Ben Bernanke for instance subscribes to the latter explanation. During the past few years this literature about global imbalances has, regardless of differences in locating the origin of the problem, achieved such prominence that the term global imbalances is commonly used as a synonym for current account imbalances.

Within this literature a very interesting sub-theme has developed that focuses on the prominent role of the United States dollar as the undisputed international reserve currency. It is argued that the key currency status of the dollar has conferred upon the United States a so called 'exorbitant privilege'[1] that allows it to avoid balance of payments adjustments. Consequently, the dollar is seen as the main cause for the persistence of the global imbalances (Vermeiren, 2010).

This essay will take issue with the prominence that is given to the current account in general as the most important variable in explaining the financial crisis. Instead we adopt another perspective that has only recently been put forward as an alternative to the current account imbalances theory. Our approach will focus on the capital account rather than the current account. We agree with Borio that to some extent the two will offer overlapping analyses because both are part of the balance of payments yet there is considerable potential in distinguishing between the two (2014a). Moreover, as Borio argues, it is not just the mere act of focusing on the capital account instead of the current account that could prove to be useful, it's the embeddedness in the international monetary and financial system (IMFS) that allows us to see why the capital account outweighs the current account in analyzing the origins of the Great Recession.

By placing the spotlight on the link between the capital account and the IMFS the debate about the United States dollar as key currency in the global economy becomes much more interesting, not in the least when looked at from an Austrian perspective. Moreover, this focus on the capital account fits within a broader increasing literature on the so-called global financial cycle (Rey, 2013): a global co-movement of credit, asset prices and capital flows that heavily coincides with financial crises.

The argument runs as follows (Borio, 2014a; Borio, 2014b). In order to get a better grasp of what exactly happened in the run-up to the financial crisis a two-tiered approach is necessary:

[1] A term usually attributed to French president Valéry Giscard d'Estaing but which actually originated with president Charles de Gaulle.

1. On the national level domestic monetary and financial regimes exhibit a tendency for 'excess financial elasticity'. Excess financial elasticity of domestic monetary and financial regimes means "their inability to prevent the build-up of *financial* imbalances, in the form of unsustainable credit and asset price booms that overstretch balance sheets, thereby leading to serious (systemic) banking crises and macroeconomic dislocations." (Borio, 2014b, p.1). In other words by highlighting financial imbalances the excess financial elasticity view stresses the role of the capital, rather than the current, account.

2. On the international level the IMFS plays a key role in amplifying and transmitting this central weakness of domestic regimes. By doing so it shows that, contrary to popular opinion, "The Achilles heel of the IMFS is not so much a contractionary bias that reflects an asymmetric current account adjustment problem, what might be termed a propensity to generate "excess saving"; rather, it is its propensity to amplify the financial booms and busts – financial cycles – that generate crises" (Borio, 2014a, p.2).

A core question that follows from this is whether the domestic economies have anchors in place that can prevent the overall expansion of credit, and external funding more generally, from fuelling the unsustainable build-up of financial imbalances? By asking this question we focus our attention on the monetary regimes that set monetary conditions in the various national currencies and their international interaction. When talking about a monetary regime we adopt Peter Bernholz his definition, namely the set of rules that govern institutions and organisations that ultimately determine the amount of money supplied. We also adopt his analytical distinction between three possible kinds of regimes (2003):

1. A metallic standard using either gold, silver, copper or a combination of these metals. Arguably the most well-known example is a gold standard.
2. A weakened metallic standard.
3. A discretionary paper money (fiat) standard.

The monetary standard that prevails under different regimes and the influence it exerts on the supply of money is a variable that has been left largely unexplored in mainstream economics yet holds considerable merit in helping to understand the underlying causes of the Great Recession. We shall argue that the excess financial elasticity of domestic monetary regimes is a mere consequence of the monetary standard that has prevailed since the end of Bretton Woods and that the amplification of financial elasticity on the international level is intrinsically linked to the dominant position of the United States dollar in the contemporary IMFS (Cohen & Benney, 2014). As such the system is first and foremost prone to a so called 'liquidity glut' rather than a saving glut. Research has shown that different monetary standards are predisposed towards different levels of liquidity creation and that the end of Bretton Woods signaled a major increase in liquidity (Rolnick & Weber, 1995; Rolnick & Weber, 1997; Bernholz, 2001).

The essay will start off with a quick recap of the Bretton Woods monetary system and the reasons why it ended in 1971[2]. The short Bretton Woods recap is essential for some of the arguments that will be made in the main discussion about the contemporary post-Bretton Woods period. The ultimate goal being to demonstrate that the build-up to the Great Recession is more comprehensible when viewed from a monetary standard perspective in which the United States dollar is the key currency in the contemporary IMFS than from the currently dominating current account perspective.

[2] The actual year Bretton Woods ended is disputed: some say 1971 (severance of the link between the dollar and gold) while others say 1973 (discontinuation of the fixed exchange rates between European currencies and the dollar).

Bretton Woods

The monetary system that was formalized at the Bretton Woods conference in 1944[3] reflected a peculiar set of preferences that the participants at the conference had about international monetary relations and has subsequently been labelled as 'embedded liberalism' (Ruggie, 1982). The design was meant to combine the best of both worlds:

> "The architects of the Bretton Woods system wanted a set of monetary arrangements that would combine the advantage of the classical gold standard (i.e., exchange rate stability) with the advantage of floating rates (i.e., independence to pursue national full employment policies). They sought to avoid the defects of floating rates (destabilizing speculation and competitive beggar-thy-neighbor devaluations) and the defects of the fixed exchange rate gold standard (subordination of national monetary policies to the dictates of external balance and subjection of the economy to the international transmission of the business cycle). As a consequence, they set up an adjustable peg system of fixed parities that could be changed only in the event of a fundamental disequilibrium." (Bordo, 1993, p. 5)[4].

To achieve these goals the following was put in place: only the United States dollar maintained a formal link to gold[5] while the currencies of the European countries would have a fixed exchange rate with the dollar[6]. The seeming contradiction between having fixed exchange rates and the desire to conduct an independent national monetary policy was resolved firstly by creating the International Monetary Fund to provide emergency liquidity to countries to sit out transitory shocks and secondly

[3] Formally known as the United Nations Monetary and Financial Conference.
[4] The opaque term 'fundamental disequilibrium' was purposefully never elaborated.
[5] Gold was valued at 35 dollar per ounce.
[6] For this reason the Bretton Woods system is often called a 'gold dollar standard'.

by allowing the implementation of capital controls to prevent capital outflows in response to large exchange rate deviations. Each member of the IMF was required to establish a par value for its currency in terms of either gold or the US dollar and to maintain the market exchange rate of its currency within 1% of the declared par value through intervention in the foreign-exchange market by buying and selling the currencies of other countries.

Reality didn't exactly play out the way the founders of the system had hoped. Starting in the late 1950s three developments changed the way the system operated:

1. Adjustment: throughout the years the use of capital controls became less stringent and thus the potential for destabilizing capital flows increased, thwarting attempts by monetary authorities to maintain a parity far removed from the fundamentals. To avoid large adjustments of the exchange rate that were so dreaded governments would have to show a credible commitment to maintaining it instead of relying on capital controls as was originally envisioned. In effect "virtually fixed exchange rates and a common price level for tradable goods were reimposed; and the macroeconomic autonomy of each participating country was again constrained by an international monetary standard." (McKinnon, 1993, p. 15)[7]. In other words the metaphorical straightjacket of the classical gold standard had resurfaced despite attempts to thwart it.

2. Liquidity: the IMF never played the important role in providing liquidity to countries that it was meant to do. As the world economy grew ever larger in the post-World War II era its reserves became inadequate and consequently the main source of liquidity had become the United States[8].

[7] Aptly referred to as a fixed-rate dollar standard.
[8] Despite heightening their official reserves three times they still remained small compared to the size of international transactions.

3. Confidence: The inherent contradiction between the progressive decline in official US gold holdings since the end of World War II and the ever expanding use of the dollar in international reserves gave rise to the infamous Triffin dilemma. As more and more dollars were circulating there would inevitably come a time when convertibility was called into question: "Such a movement obviously could not continue indefinitely without ultimately undermining foreigners' confidence in the dollar as a safe medium for reserve accumulation. The time will certainly come, sooner or later, when further accumulation of short-term foreign liabilities will either have to be slowed down or substantially matched by corresponding increases in our already bloated gold assets." (Triffin, 1960, p. 63).

Some attempts were made to try and stave off the threat of a convertibility crisis, most notably by installing what is called the London Gold Pool in 1961: the Federal reserve and the central banks of seven European countries pooled (part of) their gold reserves in order to strategically buy and sell gold when the price of gold was declining or increasing. The United States contributed 50% of the total amount of gold in the Pool. For the next six years the Pool did succeed in stabilizing the price of gold at $35 per ounce but it did not prevent a further steady decline in the monetary gold stock of the United States.

After the eventual collapse of the Gold Pool in 1968 a crucial chain of events unfolded that would lead to the fall of Bretton Woods only a few years later. After the fall of the Gold Pool monetary authorities that participated in it agreed amongst themselves neither to sell nor to buy gold from the market. The $35 per ounce price would only be maintained in transactions amongst themselves. Private transactors would buy and sell at the market determined price[9]. On top of that the United States removed the 25% gold backing requirement for Federal Reserve notes. As Bordo argues this was a fundamental change: "The key consequence of these new arrangements was that gold was demonetized at the margin. The

[9] In order to prevent arbitrage between the private and official markets for gold, central banks agreed not to sell in the private gold market.

link between gold production and other market sources of gold and official reserves was cut…. In effect, the world switched to a de facto dollar standard." (1993, pp. 70-72). Eventually in 1971 the de jure link between gold and the dollar was ended.

The question that still remains is why the United States decided to loosen and eventually cut the proverbial anchor of gold in the monetary system? In contrast to for instance the situation under the classical gold standard of the end of the nineteenth century and beginning of the twentieth century where the international monetary system was diffuse (Flandreau & Jobst, 2005), under Bretton Woods the national currency of the United States was at the same time the de facto international money. The most important consequence of this was that, again in contrast to the original Bretton Woods agreement, the international monetary system became asymmetrical.

This asymmetry meant there had to be one set of rules for every country in the system and another set of rules specifically for the United States. Seeing as how the United States provided the international currency it had to forgo explicit balance of payments or exchange rate-targets and had to conduct a monetary policy that would make sure the dollar was a stable nominal anchor for the world economy. Being the only country with the possibility of an independent monetary policy under the so called fixed-rate dollar standard didn't square well with the need to keep the dollar stable:

> "By far the major flaw in U.S. policy, and the most damaging feature of the Bretton Woods system, was the failure to prevent U.S. inflation. As the system developed, the United States was able to choose domestic over international goals whenever a choice had to be made…. U.S. policymakers typically chose expansion to deflation and used controls of various kinds to get temporary reductions in the capital outflow. And, after 1966, policymakers adopted more inflationary policies than before. Given the priority placed on employment and other domestic goods, such as housing, price stability was ruled out." (Meltzer, 1991, p. 82).

Combined with this expansive monetary policy during the 1960s the current account surplus also steadily deteriorated until it went into deficit for the first time in 1971[10] and the public debt increased severely because of expenses for the Vietnam war and the Great Society programs of Lyndon B. Johnson. All of this combined to make the US dollar increasingly overvalued as time went by. A devaluation of the US dollar was not a popular political option in the United States who insisted that European countries should revalue their undervalued currencies in order to lower the pressure on the United States. Yet as we have seen previously, economic developments during the post-World War II period such as increased capital mobility made exchange-rate changes an uncommon occurrence because of fear of destabilizing capital flows if this would happen[11].

As a conclusion we can say that the gold backing of the dollar was the main element making the fixed-rate dollar standard unstable. In the face of declining US gold reserves an expansionary domestic US policy gave birth to the Triffin dilemma which eventually played out in reality when in 1971 France and Great-Britain had intentions to convert dollars into gold. In response to this Nixon decided to close the gold window and impose several other economic measures to stabilize the US dollar. The choice of the Nixon administration to completely sever the link between gold and the dollar in 1971 can be seen as a choice of adjustment over gold convertibility: "This principle that the U.S. not have an independent exchange rate policy was respected until, in 1971, President Nixon insisted that the dollar be devalued. Although Nixon acted according to the spirit of Bretton Woods Articles that permitted exchange-rate flexibility, dollar devaluation violated the unwritten rules of the game of the Fixed-Rate Dollar Standard." (McKinnon, 1993, p. 17).

[10] Although the United States had a current account surplus until 1971 it had a general balance of payments deficit due to net capital outflow.

[11] France adjusted its exchange rate in 1957 and 1958, Germany in 1961, Great-Britain in 1967 and again Germany and France in 1969.

Post-Bretton Woods

Starting in 2003[12] a series of influential essays by Dooley, Folkerts-Landau and Garber (DFG) stated that although Bretton Woods came to an official end in 1971, it's unofficial structure was reincarnated in the early 2000's and shows a remarkable degree of similarity to the original system[13]:

1. In both cases the regime is composed of a center country (twice the United States) and a group of countries constituting a periphery. In the original Bretton Woods system European countries were the periphery while in the 'Bretton Woods II' system a group of East-Asian countries took over this role.
2. Under both regimes the periphery adopt an export-led growth strategy based on undervalued currencies that have a fixed exchange rate with the dollar[14].
3. In both regimes the undervalued currency of the periphery gives rise to accumulation of foreign-exchange reserves mainly in the form of US-dollar-denominated financial instruments.
4. The United States is the main export market for the periphery's export-led strategy in both regimes.
5. As mentioned previously there is asymmetry between core and periphery in setting interest rates. The United States, being the center country, ignores external factors in setting interest rates while the periphery pays close attention to external factors.

[12] The paper that first drew the comparison is Dooley, M., Folkerts-Landau, D. & Garber, P. (2003).
[13] The term 'Bretton Woods II' is often used in this context.
[14] Not all of these currencies have an actual fixed exchange rate but considerable effort is done in the case of floating currencies to avoid any (large) movements against the US dollar. Calvo and Reinhart conclude that there is a considerable 'fear of floating' amongst these countries (2002).

The DFG thesis that the international monetary system of the early 2000's constitutes a revived Bretton Woods system is of particular interest for the argument that this essay will make although not for the reasons usually associated with it. Originally the DFG thesis is part of the saving-glut explanation for the financial crisis as discussed in the introduction. The relevance of the DFG thesis in our approach rests in the similarity between the latter years of the original Bretton Woods (starting in 1968) and the revived version, as discussed by Hall and Tavlas:

> "Our thesis is that to the extent that the Bretton-Woods metaphor is valid, the Bretton-Woods II regime is marked by an underlying bias in favour of excessive global liquidity creation that can lead to asset-price bubbles as measured by changes in commodity prices. In particular, the specific combination of (1) a large (in terms of economic size) periphery that maintains pegged and undervalued exchange rates, (2) a large hegemon, the currency of which is used by the periphery as the anchor for the peg and (3) the absence of a convertibility requirement on the hegemon leads to a bias conducive to "excessive" global liquidity creation…. As a result, under the latter stages of the Bretton-Woods I regime, the absence of a convertibility requirement on the hegemon left it free to issue its fiat liabilities without a convertibility constraint. With the sharp increase in the US balance-of-payments deficits, the issuance of US fiat liabilities swelled, contributing to a huge increase in global liquidity as non-US central banks acquired dollar reserves in an effort to maintain their exchange-rate pegs against the dollar." (2013, p. 348).

The de facto transition in 1968 and the de jure transition in 1971 from a weakened metallic standard to a fiat standard removed the formal convertibility constraint on liquidity creation by the United States, the country whose national currency served (and still serves) as the key currency in the international economy. As such it has been able to conduct a monetary policy focused exclusively on domestic priorities. However, in a world of highly open capital markets a supposedly domestic policy

can easily spill over internationally, especially with the international use of the US dollar. This will be the focus of the next paragraphs.

Starting in the early 2000's the Federal Reserve embarked on an unprecedented monetary expansion[15]. As is well known, an expansive monetary policy causes a gap between the *natural rate of interest* and the *market rate of interest*[16]. In this way a national credit boom can arise when a central bank lowers policy rates below the natural rate. In response to this the banking sector finances additional investment through their lowering of the capital market interest rate for credit provided to private enterprises. Monetary policy has this consequence because it is monetary policy that underpins the term structure of market interest rates. And it is the relationship between market interest rates and the unobservable natural rate that underpins credit creation and the availability of external financing in general.

This results in malinvestment and an artificial economic boom because the lower interest rate gives entrepreneurs misguided economic signals: "They make some projects appear profitable and realizable which a correct calculation, based on an interest rate not manipulated by credit expansion, would have shown as unrealizable. Entrepreneurs embark upon the execution of such projects. Business activities are stimulated. A boom begins." (Von Mises, 2008, p. 550). In this sense money can be said to be non-neutral: injections of credit influence entrepreneurial experiments that require scarce resources and heighten economic activity at the point of injection, thereby affecting relative prices. The importance of credit in shaping economic outcomes rightly makes it a 'commanding height' of contemporary economies (Bilo & Wagner, 2015)[17].

In a world of highly open capital markets and the predominant use of the US dollar an expansive national monetary policy doesn't just have domestic effects[18]. While domestically the expansive

[15] The specific reason(s) why the Fed started the expansionary policy will not be discussed here, for an explanation, see Selgin, Beckworth & Bahadir (2015).
[16] For the seminal statement see Von Mises (2009).
[17] The non-neutrality of money makes sure that an expansive monetary policy finds it way not into the general price level but into specific sectors. In the case of the 2008 financial crisis this was mainly the housing sector.
[18] For a fully worked out two-country model see Hoffmann & Schnabl (2013).

monetary policy lowers interest rates investors can easily look elsewhere in search of a higher yield. In the early 2000's these higher yielding opportunities were mainly found in the fast growing East-Asian countries. What followed was a large influx of foreign capital, putting upward pressure on their currencies. Appreciating currencies was not something these countries wanted considering they owed their large growth percentages to an export-led strategy based on an undervalued currency against the dollar, as was/is part of the Bretton Woods II configuration. In order to maintain this artificially undervalued peg these countries had to stabilize the exchange rate which led to an enormous accumulation of foreign reserves (mostly dollars) on the balance sheets of periphery central banks, most notably China. Apart from the export motive the accumulation of foreign reserves was also seen as a broader defense strategy that would (largely) help prevent events such as the 1997 East-Asian financial crisis from occurring again[19]:

> "This could limit the risks of an Indonesian-style implosion via three channels. First, reserves accumulated through sterilized foreign exchange market intervention would help prevent real exchange rate appreciation and thus the gradual erosion of competitiveness that had helped to trigger the Asian crisis. Second, if the currency did come under pressure, the accumulated reserves could be used to counter any speculative attack or at least ease the adjustment to a new equilibrium exchange rate. Third, the hard currency could be used to recapitalize any domestic financial institutions caught up in such a crisis, without resorting to fire-sales to foreign banks or excessively weakening the central bank or government balance sheets." (Beckworth & Crowe, p. 101, 2012).

This strategy was not without risk as Steiner (2014) points out. On an individual level it makes sense for countries to amass large amounts of international reserves to protect themselves from economic

[19] For an informative account of the East-Asian crisis that also incorporates some of the elements discussed in this paper, see Wade (2000).

shocks like sudden stops of capital flows and contagious financial crises. Yet on a systemic level this might lead to setting the stage for two types of financial crises: first, overborrowing and overinvestment in the reserve currency country that ends badly when expectations worsen, reserve accumulation ends or economic growth slows down. Second, by steadily worsening the net foreign asset position of the reserve currency country, possibly ending in a currency crisis.

The first kind of crisis, overborrowing and overinvestment in the reserve currency country, is exactly what happened in the run-up to the financial crisis. By buying large amounts of international reserves the East-Asian countries were sending large amounts of capital back towards the United States[20]. This contributed further to a lowering of US interest rates (Warnock & Warnock, 2009), adding to the domestic credit boom.

The question remains why the Fed ultimately let this unsustainable build-up continue? During his time as chairman of the Fed Alan Greenspan was well aware of the possibility of asset price bubbles yet considered it of secondary importance to maintaining general price stability[21]. Moreover, even if bubbles could be spotted in time and held in check the question remains if this would have been the right course of action? Greenspan himself concludes that "… the degree of monetary tightening that would be required to contain or offset a bubble of any substantial dimension appears to be so great as to risk an unacceptable amount of collateral damage to the wider economy." (2002). Preemptive action by the Federal Reserve was ruled out. Instead both Greenspan and Bernanke pursued a policy that focused more on ex-post interventions that would mitigate the fallout from financial panics after they happened. The Fed would mop up after the bubble burst and ensure a smooth transition.

This kind of monetary policy that is quite narrowly focused on general price stability is quite paradoxical as Schularick and Taylor point out: "The important structural changes that have taken

[20] Although the United States was running a record current account deficit in the early 2000's they had a general balance of payments surplus due to enormous capital inflows.
[21] This focus on general price stability is a hallmark of the so called inflation targeting approach to monetary policy.

place in the financial system over the past decades have led to a greater role of credit in the macroeconomy. It is a mishap of history that just at the time when credit mattered more than ever before, the reigning doctrine had sentenced it to playing no constructive role in monetary policy." (2012, p. 1058).

Conclusion

The elements of the previous section conform to the structure that was outlined in the introduction, namely that national monetary regimes based on fiat money with no convertibility constraint are prone to 'excess financial elasticity' and that the defining feature of the International Monetary and Financial System (IMFS), labeled 'Bretton Woods II' in the essay, is the amplification of nationally induced financial cycles based on large credit creation that eventually leads to boom and busts[22].

The Fed's 'monetary nationalism' leads to expansive central bank policy that lowers domestic US interest rates but, in a world of freely moving capital flows, also spills over in to the IMFS where the dollar is still the undisputed key currency. The de facto fixed exchange rates of the Bretton Woods II system can lead to a strengthening of the nationally expansive monetary policy by providing an international flow of capital into the reserve-currency-issuing country, putting additional downward pressure on US interest rates.

The argument presented in this essay goes against conventional wisdom in that it views the behavior of the Fed as being the primary source influencing the occurrence of boom and busts. The occurrence of credit and asset price booms are not the consequence of complex and innovative financial

[22] For a historical perspective of the growing prominence of credit see Schularick & Taylor (2012).

innovations in the financial sector but rather of the Fed's loose monetary policy that affects credit creation and has global repercussions.

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