American-Made Financial Repression

HONG KONG – A generation of development economists owe Ronald McKinnon, who died earlier this month, a huge intellectual debt for his insight – introduced in his 1973 book *Money and Capital in Economic Development* – that governments that engage in financial repression (channeling funds toward themselves to reduce their debt) hamper financial development. Indeed, McKinnon provided the key to understanding why emerging economies’ financial sectors were underdeveloped.

At the end of his life, McKinnon was working on a related – also potentially groundbreaking – concept: a dollar-renminbi standard. In his view, such a system would alleviate the financial repression and fragmentation that is undermining global financial stability and growth. The question is whether the powers that be – particularly in the United States, which has long benefited from the dollar’s global domination – would ever agree to such a cooperative system.
The notion that the dollar’s global dominance is contributing to financial repression represents a significant historical shift. As McKinnon pointed out, the dollar became a dominant international currency after World War II because it helped to reduce financial repression and fragmentation in Europe and Asia, where high inflation, negative real interest rates, and excessive regulation prevailed. By using the dollar to anchor prices and the Federal Reserve’s interest rate as the benchmark for the cost of capital, invoicing, payments, clearing, liquidity, and central-bank reserves all became more stable and reliable.

As long as the US remained competitive and productive, currencies that were pegged to the dollar benefited considerably. For economies in transition – such as Western Europe in the 1950s-1960s, Asia during the growth miracle of the 1970s-1990s, and China in 1996-2005 – the dollar provided an anchor for the macroeconomic stabilization efforts and fiscal and monetary discipline that structural transformation demanded.

But two disruptions undermined these benefits. First, in 1971, the US terminated the dollar’s convertibility to gold, opening the way for the emergence of a new exchange-rate regime, based on freely floating fiat currencies.

Then came the period of “Japan-bashing” in the 1980s-1990s, which culminated in threats from the US to impose trade sanctions if Japan’s competitive pressure on American industries did not ease. With the subsequent sharp appreciation in the yen/dollar exchange rate, from ¥360:$1 to ¥80:1, the world’s second-largest economy has suffered through two decades of deflation and stagnation.

Throughout this period, McKinnon argued that, by forcing America’s trade partners to bear the burden of adjustment, the dollar’s predominance leads to “conflicted virtue”: surplus countries like Japan, Germany, and China faced pressure to strengthen their currencies, at the risk of triggering deflation. If they failed to do so, their “undervalued” exchange rates were criticized as unfair.

But McKinnon disagreed with the conventional wisdom that the best way to resolve this conflict would be to shift to flexible exchange rates. Instead, he recommended that Asian countries develop a regional currency that would provide macroeconomic stability in the face of dollar volatility. Long before the Bretton Wood institutions conceded that capital controls could be useful, McKinnon was asserting that, under certain circumstances, such controls might be necessary to supplement prudential banking regulation.

McKinnon has a particularly strong following among Chinese economists. China achieved
its strongest growth when the renminbi was pegged to the dollar – a system that required steadfast reforms and strict fiscal discipline.

The renminbi’s steady appreciation against the dollar – at an annual rate of about 3%, on average, since 2005 – shrank China’s current-account surplus. In a weak global economic environment, China’s progress in addressing macroeconomic imbalances, while maintaining an annual growth rate of about 7%, was no small feat.

But the renminbi’s appreciation also attracted carry-trade speculators, who purchased renminbi assets in order to benefit from high interest rates (particularly after 2008) and exchange-rate gains. This is partly why China’s foreign-exchange reserves have swelled so rapidly, from $250 billion in 2000 to $4 trillion this year.

The problem, as McKinnon recognized, is that these speculative inflows of “hot” money have weakened China’s macroeconomic tools and fueled ever more financial repression. For starters, China’s leaders, recognizing that higher interest rates would draw even greater inflows, are increasingly wary of interest-rate – and even capital-account – liberalization.

Making matters worse, the Chinese authorities are tightening credit and regulating the money supply through sterilization and high reserve requirements for bank deposits – an approach that undermines real economic growth considerably. In order to stem this decline without raising interest rates too much, they have resorted to administratively targeted credit loosening.

More “China-bashing,” with the US demanding that the renminbi be allowed to appreciate further, is clearly not the answer. Instead, the US should focus on reducing its own fiscal deficit, thereby facilitating Chinese efforts to boost domestic consumption. If the Fed’s benchmark interest rate can be restored to historical trend levels, China would have more policy space to adjust interest rates in alignment with its growth pattern and pursue an orderly opening of its capital account.

Simply put, the world needs its two largest economies to work together to bolster global monetary stability. Together, China and the US can alleviate financial repression, avert protectionist tendencies, and help maintain a strong foundation for global stability. Unfortunately, McKinnon’s policy advice has not been popular among mainstream American economists and policymakers, who prefer the short-term political advantages afforded to them by free-market rhetoric.
It is time for US leaders to recognize that what former French Finance Minister Valéry Giscard d’Estaing called the “exorbitant privilege” that the dollar’s global dominance affords America also entails considerable responsibility. Global monetary stability is, after all, a public good.