Abstract (summary)

On May 22, 2013, the US Federal Reserve's then chair, Ben Bernanke, suggested that the Fed might, if the US economy continued improving, soon begin to pare back, or "taper," its monthly purchases of US Treasury and mortgage-backed securities. The Fed had begun the purchases the previous September in order to push down long-term interest rates and encourage private lending; their end would mean higher yields on longer-maturity US bonds, making developing markets decidedly less attractive. Investors in Ukrainian bonds therefore reacted savagely to the taper talk, dumping them and sending their yields soaring to near 11%. Had the Fed stayed dovish, Ukraine could have at least delayed its financial crisis, and a crisis delayed can be a crisis averted. Pres Viktor Yanukovych ultimately turned for help to Moscow, which successfully demanded that he abandon an association agreement with the European Union in return. Ukrainians took to the streets -- and the rest is history.

Full Text

In April 2013, Ukraine was sporting a massive current account deficit of eight percent, and it badly needed dollars to pay for vital imports. Yet on April 10, President Viktor Yanukovych's government rejected terms set by the International Monetary Fund (imf) for a $15 billion financial assistance package, choosing instead to continue financing the gap between its domestic production and its much higher consumption by borrowing dollars privately from abroad. So a week later, Kiev issued a ten-year, $1.25 billion eurobond, which cash- flush foreign investors gobbled up at a 7.5 percent yield.

Everything seemed to be going swimmingly, until May 22, when the U.S. Federal Reserve's then chair, Ben Bernanke, suggested that the Fed might, if the U.S. economy continued improving, soon begin to pare back, or "taper," its monthly purchases of U.S. Treasury and mortgage-backed securities. The Fed had
begun the purchases the previous September in order to push down long-term interest rates and encourage private lending; their end would mean higher yields on longer-maturity U.S. bonds, making developing markets decidedly less attractive. Investors in Ukrainian bonds therefore reacted savagely to the taper talk, dumping them and sending their yields soaring to near 11 percent, a level at which they would remain for most of the rest of the year.

Ukraine's financial problems had been mounting over many years, but it was the mere prospect of the Fed pumping fewer new dollars into the market each month that pushed the cost of rolling over its debt—that is, paying off old obligations with new bonds—beyond Kiev's capacity to pay. Had the Fed stayed dovish, Ukraine could have at least delayed its financial crisis, and a crisis delayed can be a crisis averted. Yanukovych ultimately turned for help to Moscow, which successfully demanded that he abandon an association agreement with the European Union in return. Ukrainians took to the streets—and the rest is history.

But that history has, until now, overlooked the role that the Fed’s taper talk played in the toppling of Yanukovych and the chaos that followed. And this insight becomes even more worrisome when you consider that Ukraine is but one of a great many fragile, dollar-dependent countries with markets that can be sent spinning wildly at the mere suggestion of a change in Fed policy.

DOLLAR FOR DOLLAR

The U.S. dollar plays a unique role in the global economy. Although the United States accounts for only 23 percent of global economic output, most of the world’s trade outside the eurozone and 60 percent of foreign exchange reserves are denominated in U.S. dollars. Particularly for developing countries, economic interaction with the rest of the world takes place overwhelmingly in U.S. dollars. Changes in U.S. monetary policy can therefore have immediate and significant global effects, expanding or constricting the flow of capital into and out of developing nations and whipsawing the value of their currencies against the dollar, which can in turn dramatically alter local inflation rates and export volumes. As a result, for many such countries monetary sovereignty is nothing more than an unattainable ideal. Recognizing this, a few of them, such as Ecuador and El Salvador, have in recent decades gone so far as to eliminate their national currencies entirely, adopting the U.S. dollar for use at home as well as abroad.

Ukraine was, following Bernanke's taper talk last May, only one of many developing nations suffering massive selloffs in their bond and currency markets, as investors sought to repatriate funds for safer investments in the United States. The selling was not indiscriminate, however. The countries hit hardest—Brazil, India, Indonesia, South Africa, and Turkey—had all been running large current account deficits, which needed to be financed with imported capital. Their markets recovered modestly following the Fed's unexpected decision in September to delay the taper but faltered again in December when the Fed announced that it would move forward with its plans.

As these markets tanked, many leaders of the worst-hit countries criticized Washington for its selfishness and tunnel vision. "International monetary cooperation has broken down," said an angry Raghuram Rajan, the governor of India's central bank, following another selloff in his country's currency and bond markets in January. The Fed and others in the rich world, he said, can't just "wash their hands off and say, we'll do what we need to and you do the adjustment."

In trying to understand what Rajan had expected from the Fed and why he was so angry, the recently released transcripts of the October 2008 Federal Open Market Committee meeting are illuminating. They show that the committee's members were acutely aware of the global nature of the growing crisis, yet they were focused not on stopping its spread through emerging markets gen- erally but on limiting blowback into the United States. The members agreed that the Fed's swap lines with emerging-market central
banks, whereby the Fed would lend them dollars against their own currencies as collateral, should be
temporary and limited to those countries that they considered large and important to the U.S. financial
system: Brazil, Mexico, Singapore, and South Korea, all of whose problems could potentially spread
directly to U.S. markets. For example, Donald Kohn, then a member of the Fed's Board of Governors,
expressed concern about the potential for large-scale foreign selling of Fannie Mae and Freddie Mac
Certain countries might go down that route, he argued, if they lacked less disruptive means of accessing
dollars, such as Fed swap lines. And "it would not be in our interest" for them to do so, Kohn observed.

That year, the Fed privately rebuffed swap-line requests from Chile, the Dominican Republic, Indonesia,
and Peru. And two years later, when the U.S. economy had become much less vulnerable to foreign
financial instability, the Fed allowed its swap lines with Brazil, Mexico, Singapore, and South Korea to
expire. Two years after that, in 2012, the Fed denied a swap-line request from India—thus explaining
Rajan's anger.

Just as the Fed was criticized for causing foreign currencies to plunge with its taper talk in 2013, so had it
been condemned for doing the opposite, causing foreign currencies to spike by initiating quantitative
easing, in 2010. Many countries' export competitiveness was hurt as a result. As Zhu Guangyao, China's
vice finance minister, complained at the time, the Fed had "not fully taken into consideration the shock of
excessive capital flows to the financial stability of emerging markets." Brazil's finance minister, Guido
Mantega, was more colorful, accusing the Fed of starting a "currency war."

Yet expecting the Fed to act otherwise, however desirable it might have been for other countries, was
unrealistic: the Fed's primary objectives—ensuring domestic price stability and maximum employment—are
set by law, and the Fed is not authorized to subordinate them to foreign concerns. Unsurprisingly, it has
not shown any inclination to do so since the financial crisis erupted six years ago.

FROM BRETTON WOODS TO BITCOIN

It is easy to see why other governments have begun looking for an alternative to the current dollar-
dominated global financial architecture—one in which U.S. monetary policy would be less disruptive abroad.
In 2009, China's central bank governor, Zhou Xiaochuan, echoed John Maynard Keynes' call in the 1940s
for the creation of a genuine supra-national currency, under the management of the IMF, which would take
over the outsized international role of the U.S. dollar. In fact, the fund's Special Drawing Rights, which
represent potential claims on the currencies of IMF members, could already play that role. Yet currently, no
private-sector invoicing, borrowing, or lending takes place in SDRs. And until that changes, there is little
incentive for central banks to hold much more of them than they currently do—a total of around three
percent of global currency reserves.

Back when SDRs were created, in the late 1960s, Jacques Rueff, then the primary economic adviser to
French President Charles de Gaulle, famously dismissed them as "nothingness dressed up as currency."
Keynes had detailed how the supply of an IMF currency could be expanded, but never how it could be
contracted. Rueff believed that SDRs therefore had a built-in inflationary bias that no bureaucracy would be
able to control. He called instead for a return to the gold standard of the late nineteenth century, which
had allowed a multilateral trading system to flourish without generating the global imbalances that cause
crises. The system had done this, he explained, by automatically raising interest rates in deficit countries
and lowering them in surplus countries.

The idea of returning to some form of gold standard still has some well-known backers today, such as Ron
Paul, the former Republican congressman from Texas, and the businessman and writer Lewis Lehrman. Yet
particularly given the extreme hardship endured by southern member states of the eurozone since 2008, it
is not surprising that proposals for governments to reduce their active management of national monetary affairs—whether through the creation of new international currencies, such as the euro, or through a return to some form of commodity backing for money—are more widely seen by policymakers as dangerous steps backward. Of course, the digital currency Bitcoin has shown that something with the properties of transnational money doesn’t necessarily have to be created by policy-makers. Yet in the wake of the chaotic collapse of Mt. Gox, once the largest Bitcoin exchange, the Bitcoin market is also the last place anyone would look to minimize volatility and avoid a crisis.

Many still point to the Bretton Woods era of fixed exchange rates, from 1946 to 1971, in which global trade and output grew robustly, as an example of the type of international monetary cooperation to emulate. But other initiatives in the immediate aftermath of World War II, such as the 1948 Marshall Plan and the 1950 European Payments Union, deserve much more of the credit for kick-starting trade and growth. Furthermore, the monetary system that the imf was set up to oversee could not actually be said to have started until 1961, 15 years after the fund was inaugurated, when the first nine European countries made their currencies convertible into U.S. dollars. And by this time, the system was already coming under stress, as France and others began demanding that the United States redeem their excess dollars for gold.

Today, a road map for cooperative monetary reform appears out of reach politically. Bretton Woods was, in essence, a deal between two nations whose policies were critical to global financial stability: the United States, the world’s dominant creditor, and the United Kingdom, its largest debtor. The former agreed to assist countries struggling with current account deficits, and the latter to forswear competitive currency devaluation. Today, China is the world’s largest creditor, and the United States its largest debtor. Yet both seem unwilling to cede any measure of control-Beijing over its currency exchange rate and Washington over dollar interest rates—even if doing so might theoretically serve the global good.

All of this suggests that the world economy is condemned to remain reliant for some time on what the Stanford economist Ronald McKinnon has called “the unloved dollar standard.” But McKinnon and his colleague John Taylor think there are steps that the Fed could take to regain some love abroad. Taylor has argued that the United States should unilaterally return to a more rules-based, less discretionary approach to monetary policy, since that would lead to less volatile capital flows and economic conditions abroad.

Taylor is surely right in arguing that predictability in U.S. monetary policy has historically been a factor in helping stabilize global markets. Yet the relative unpredictability of such policy today is a direct result of the damage done to the U.S. economy by the financial crisis, which drove short-term interest rates down to zero and obliged the Fed to improvise. It should hardly be surprising that views on what such improvisation should com- prise, not least within the Fed, are many, varied, and shifting. Never before have economists and policymakers disagreed so much about what the right rules for monetary policy are and under what conditions a given rule should be followed, modified, or abandoned. And unless these rules are codified, central bank officials will each devise their own pre- ferred ones and, periodically, simply change their minds about them. Indeed, they have been doing so ever since 2010, when the Fed made its first forays into unconventional monetary policy, such as large-scale asset purchases.

Last June, for example, Bernanke tried to steer market expectations by suggesting that the Fed’s asset purchases would end once unemploy- ment got down to around seven percent; yet the Fed only began a modest monthly tapering of such purchases in January, by which time unemployment had already dropped well below that level, to 6.6 per- cent. In some cases, the Fed has tried to convince the public that it will not do certain things, such as raising interest rates, until a certain distant date (mid-2015). Meanwhile, it has said that it will calibrate other interventions, such as asset purchases, to monthly data on employment and the like, which are typically volatile and therefore suggest frequent changes in the Fed’s behavior. No wonder markets have at times been on edge.
PROTECTION POLITICS

But can’t developing countries take actions on their own to protect themselves, without cooperation from the United States? Indeed, they can. A recent study published by the IMF concluded that countries whose economies have been more resilient in the face of unconventional U.S. monetary policy since 2010 have three characteristics: low foreign ownership of domestic assets, a trade surplus, and large foreign exchange reserves. This has clear policy implications: in good times, emerging-market governments should keep their countries’ imports and currencies down and their exports and dollar reserves up.

Unfortunately, many in the United States see such policies as unfair currency manipulation, harming U.S. exporters. To prevent foreign governments from taking such steps, some influential American economists, such as C. Fred Bergsten, supported by major U.S. corporations, have called on the White House to insert provisions against currency manipulation into future trade agreements. Others, including the economists Jared Bernstein and Dean Baker, have gone so far as to call for Washington to impose taxes on foreign holdings of U.S. Treasuries and slap tariffs on imports from alleged manipulators.

Such suggestions are misguided; they would only raise global trade tensions and political conflict. But the very fact that prominent commentators are calling for these actions illustrates how the functioning, or malfunctioning, of the global financial and monetary system can encourage a spiral of damaging policy actions. China’s recent agreements with Brazil, Japan, Russia, and Turkey to move away from dollar-based trade, for example, could undermine the multilateral trading system. The U.S. dollar plays a critical role in this system, as countries are willing to export more than they are compensated for in imports only because they believe that the money they accumulate in the process—U.S. dollars—will retain its global purchasing power over time. Take the dollar out of the picture and countries will erect trade barriers to prevent bilateral imbalances from emerging, since they won’t want to stockpile one another’s less credible currencies (a fair bet for Brazil, Russia, and Turkey). And if everyone followed suit, the result would be the kind of trade wars that spread the Depression globally in the 1930s.

FED FUTURE

The U.S. Federal Reserve was created a century ago to end domestic banking panics. The devastation wreaked on British finances by two world wars elevated the Fed above the Bank of England to its current, privileged role at the center of the global monetary system. But even as the power of the Fed increased, it never adopted the same sense of global stewardship as its British counterpart had in the nineteenth century. The U.S. Congress has never shown any desire to change this, and it is hard to imagine it changing its mind anytime soon.

Given the clear trajectory of U.S. policy, the turmoil in emerging-market currency and bond markets over the past year should spur more effective collective action to defend the global financial system against future Fed-induced whiplash. Most emerging-market countries lack the resources to protect themselves individually. But they could build sufficient currency reserves if they acted in concert. In Asia, for example, the Chiang Mai Initiative Multilateralization of 2010 allows the 13 nations involved to tap their $240 billion of combined reserves in the event of a balance-of-payments crisis.

Unfortunately, however, there is much less here than meets the eye. The Chiang Mai countries have not actually pooled the money they have pledged, and members can call on significant funds only if they are under an IMF program and therefore subject to the fund’s surveillance and conditionality—a status that carries a heavy stigma. In reality, governments in the region remain hesitant to extend credit to one another during crises, which is the only time it is actually needed. Meanwhile, the 2013 announcement by the BRICS countries (Brazil, Russia, India, China, and South Africa) that they would create their own
development bank is equally long on promise and short on prospects for meaningful action. Neither initiative has yet provided a penny of mutual assistance, nor do they appear likely to do so in the future.

All of this goes to show that it is as easy to bemoan a lack of U.S. financial leadership as it is difficult to substitute for it, even when the resources required to do so are readily available. Given its mandate, the Fed has little choice but to continue pursuing domestic objectives, irrespective of the consequences for those countries that cannot credibly threaten to export economic instability to the United States. But if Washington can’t lead, it should at least get out of the way by abjuring calls to apply anti-currency-manipulation measures against countries taking legitimate steps to bolster their defenses against future Fed-induced shocks. For as the ongoing crisis in Ukraine suggests, nasty financial crises tend to become even worse political ones—and the world is likely to see plenty of both in the years ahead.

Sidebar
Observers have overlooked the role that the Fed’s policy played in the toppling of Yanukovych.

For many countries, monetary sovereignty is nothing more than an unattainable ideal.

AuthorAffiliation
BENN STEIL is a Senior Fellow and Director of International Economics at the Council on Foreign Relations. He is the author, most recently, of The Battle of Bretton Woods: John Maynard Keynes, Harry Dexter White, and the Making of a New World Order.

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