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Federal Reserve Bank of Cleveland

Global Risks to U.S. Monetary Policy

by Owen F. Humpage

We recently invited four international economists to the Federal Reserve Bank of Cleveland to discuss global developments and to help us identify and understand the risks that these developments present for U.S. monetary policy. This *Commentary* develops a key macroeconomic concern that emerged from our conversations.

Congress has given the Federal Reserve System a dual policy mandate: maintain price stability and promote maximum sustainable economic growth. The Federal Open Market Committee interprets its charge solely in terms of inflation and economic growth within the United States, but its members understand that global events can easily interfere with the System's ability to achieve its domestic objectives. Consequently, they continuously watch international developments and assess the risks that these changes pose to the attainment of their dual mandate.

As part of this assessment process, the Federal Reserve Bank of Cleveland recently invited four experts to discuss global developments and to help us identify and understand the risks that these developments present for U.S. monetary policy. Our experts were Kathryn Dominguez from the University of Michigan, Charles Engel from the University of Wisconsin, Kenneth Kuttner from Oberlin College, and Brad Setser from Roubini Global Economics. Our discussions were broad in scope, ranging from trade issues to financial market regulations. This *Economic Commentary* develops a key macroeconomic concern that emerged from our conversations. Instead of attempting to attribute specific points to individuals, this article reflects the collection of viewpoints that they expressed. Arguably, their perspectives encompass the opinions of most economists on the issues discussed here.

The Biggest Risk

According to our panel, the biggest international risk to U.S. monetary policy is the prospect of a "hard-landing" adjustment to global imbalances, one consisting of a rapid, broad-based depreciation of the dollar and a rise in domestic real interest rates. The adjustment process—depending on how rapidly it might unfold—could easily complicate monetary policy. This would be especially true if it occurred when the System needed to ease monetary policy in the face of softening domestic demand and if the central banks of other major developed countries were simultaneously tightening their monetary policies; under these two circumstances, domestic policy might actually accelerate the adjustment process and harden the landing.

The key characteristic of global imbalance is persistent U.S. current account deficits. Since 1982, the United States has experienced a deficit every year but one, primarily because we import more goods and services than we export (see figure 1). Last year, the U.S. current account deficit reached a record $811.5 billion, or 6.1 percent of GDP, and most observers anticipate little if any sustained improvement in the foreseeable future.

The United States pays for its deficits by issuing financial claims, such as corporate stocks and bonds, government securities, and bank accounts, to the rest of the world. As a consequence of our persistent deficits, the world now holds approximately $3.5 trillion in net financial claims on this country (see figure 2). Because they essentially are entitlements to future U.S. output, we often gage our ability to service these financial claims by expressing them as a percentage of GDP. Last year, the world's net financial claims against the United States equaled a record 26.5 percent of GDP.

Most economists insist that these financial claims cannot rise indefinitely relative to our ability to pay. At some point, the world's savers will become increasingly reluctant to add dollar-denominated assets to their portfolios without receiving a premium for the growing risks associated with doing so. Some may even begin to diversify out of dollar-denominated assets. When this happens, the dollar will depreciate in the foreign exchange market and U.S. real interest rates will rise.

Economists disagree about how this scenario might play out. They line up on a continuum between the hard-landing and soft-landing contingents, often according to what they consider the underlying source of global imbalances. Those who attach a high probability to a hard-landing scenario—that is, a rapid, disruptive adjustment in dollar exchange rates and in U.S. real interest rates—often see the current situation as largely inexplicable in terms of normal market behaviors. They attribute it to such things as myopic U.S. consumers, unsustainable rates of foreign savings, excessive U.S. fiscal expansion, or out-and-out currency manipulation abroad. Economists of the hard-landing

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stripe see the current situation as precariously balanced and therefore subject to rapid adjustment. They claim that foreigners' willingness to finance the deficit is already starting to wane as the current account shifts deeper into deficit and as U.S. economic growth prospects slow relative to the rest of the world.

In contrast, economists of the soft-landing persuasion view the U.S. current account deficit as a natural market outcome and for that reason believe that the adjustment process will be orderly. The savings and investment patterns that underlie the U.S. current account deficit have generally followed market incentives. In a world that is not hamstrung by restrictions on cross-border financial flows, funds will naturally move from countries with high savings rates relative to their own investment opportunities to countries with low savings rates relative to their investment opportunities. Until recently, for example, U.S. growth had typically outpaced that of other developed countries, and despite the recent slowing, foreigners' confidence in U.S. growth prospects generally remains firm. We should, therefore, naturally see wider current account deficits and surpluses across the globe today than we saw 20 or 30 years ago. As U.S. growth slows relative to that of the euro zone, foreigners may start to rethink their decisions, but we are unlikely to see a massive shift out of dollars.

■ The China Syndrome

Those participants who lean in the hard-landing direction pointed out that foreign central banks and other official agents have recently been financing the lion's share of U.S. current account deficits. They contend that many of the countries that have acquired large dollar reserves are effectively engaged in a policy of supporting the dollar relative to their domestic currencies. While their interventions have helped the Federal Reserve maintain a reasonably modest inflation rate and have kept interest rates relatively low, they pose a risk of reversal. To be sure, the chances of an abrupt change in this tacit policy may be small, but the potential impact could be quite large.

China, for example, closely manages its exchange rate and has accumulated massive holdings of official dollar reserves. At over $1.3 trillion, most of which appears to be held in liquid dollar-denominated assets, China's official reserves now exceed those of any other nation. China issues sterilization bonds to its banking sector in an attempt to soak up the excess renminbi liquidity that its reserve acquisition creates. This mechanism channels domestic savings into financing China's external position.

But should the type of financing—official or private—matter? Are official financial sources less reliable (that is, more prone to rapid flight) than private sources?

Many financial analysts have recently suggested that emerging-market economies are diversifying their reserve holdings away from dollars, or are planning to do so. The relevant data have many technical and measurement problems, but IMF evidence does indeed suggest that the composition of official reserves is shifting away from dollar-denominated assets toward euro-denominated assets. Official foreign agencies, however, do not seem to be selling off their dollars. Instead, they are adding euro-denominated assets to their portfolios faster than dollar-denominated assets, thereby changing the composition.

Some participants questioned whether such diversification would have much impact on the dollar. They point out that dollar- and euro-denominated assets are close substitutes; that is, they have very similar risk profiles. Consequently, an official shift from dollars to euros, while ultimately altering the currency composition of both official and private portfolios, would have minimal—if any—effect on exchange or interest rates. The overall official-sector portfolio would shift to hold relatively fewer dollars and more euros, while the aggregate private-sector portfolio would do just the opposite.

Others point out that even if official and private holders of dollar assets began to view them as increasingly risky, a wholesale shift from dollars is not in the interest of foreign monetary authorities. A rapid shift would prompt a steep (hard-landing-style) dollar depreciation and force them to realize valuation losses on the unsold portion of their portfolios. Official holders of dollars are no more likely to diversify quickly than are private holders of dollar-denominated assets. In short, the prospects of an officially induced hard landing seem very slight.

■ What's a Policymaker to Do?

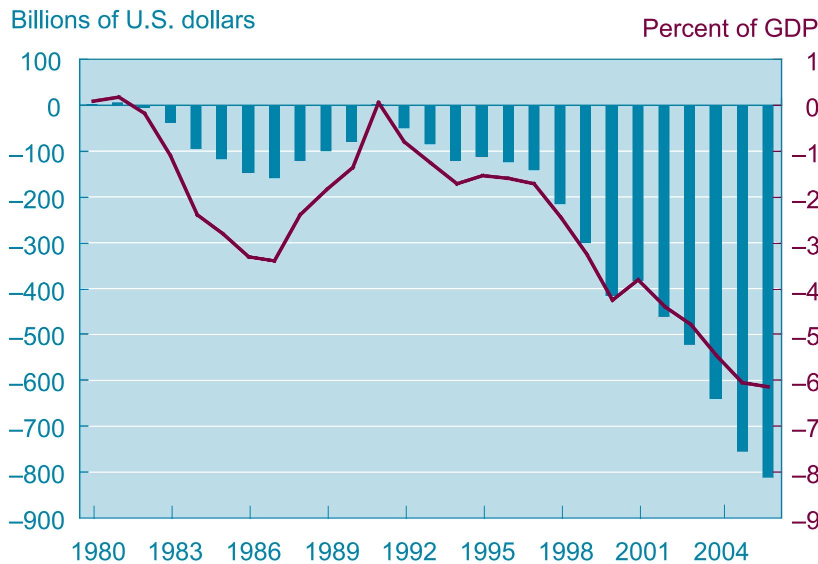
In a world of significant international risks, how should a central bank behave? Should the Federal Reserve respond directly to international shocks, such as sharp increases in imported commodity prices or rapid dollar depreciation, or should it only respond to international developments insofar as they conflict with its domestic objectives?

Many participants argue that the Federal Reserve should focus policy solely on maintaining inflation within a stated target range over some reasonable time horizon. Even though the System has had a fairly good track record in recent years, a clearly defined inflation objective would anchor long-term inflation expectations against unforeseeable developments. The gains might be small, but there are gains to be had nonetheless.

Within this framework, exchange rate fluctuations or commodity-price shocks might occasionally push the measured inflation rate beyond the target range. The Federal Reserve would respond only as necessary to pull the inflation rate back within the target range and to maintain the target over the long term. Under a credible inflation target, short-term misses emanating from international surprises would not affect long-term inflation expectations and, through that route, economic behavior.

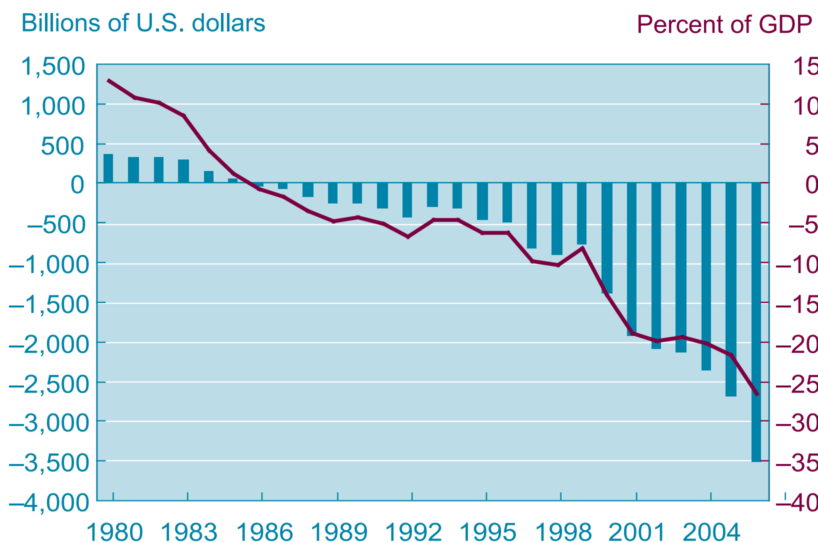
Others, however, believe that the United States has little to gain from a formal inflation target. In recent years, the Federal Reserve—like many other central banks—has achieved a fair degree of price stability and credibility with respect to maintaining a low inflation rate even without formal inflation targets, and they question whether such targets could enhance the System's credibility any further. When a central bank, which maintains a reasonably low rate of inflation, adopts a formal inflation target, it must convincingly explain small deviations from that target. A series of short-term misses, if not convincingly explained, might even reduce credibility. A central bank with

FIGURE 1 CURRENT ACCOUNT BALANCE



Sources: Bureau of Economic Analysis; Haver Analytics.

FIGURE 2 NET INTERNATIONAL INVESTMENT POSITION



Sources: Bureau of Economic Analysis; Haver Analytics.

a formal inflation target might find oil or other international commodity price shocks especially problematic, because such price jolts might also weaken economic activity and require a long period before the inflation rate returned to its target range.

A few participants, however, would even broaden the scope of Federal Reserve policy beyond its traditional goals. Inflation is a problem, they note, largely because it temporarily distorts the prices of some goods relative to others. But exchange rate changes that reflect new information about future fundamentals can have similar effects. Because goods prices do not respond as quickly as exchange rates to new information, market developments that affect exchange rates will—much like inflation—distort the price of domestically produced goods relative to imported goods. Ideally, if the Federal Reserve's monetary policy responded to very large exchange rate movements, it might be able to offset the distortionary impacts of such exchange rate changes and improve the economy's allocative efficiency.

What Have We Learned?

Monetary policymakers have always had to contend with risk, and the growing globalization of goods and financial markets over the past few decades has not appreciably changed that fact. If anything, the past 20 years have witnessed a vast improvement in the results of monetary policy. Inflation has slowed, and real economic fluctuations have diminished. The gains have been so significant that many economists now refer to the period as the "Great Moderation."

If the risks have not changed, what accounts for the Great Moderation? Central bankers have learned that in a naturally uncertain world, lessening the uncertainty associated with monetary policy is helpful. Whether they have adopted formal inflation targets or not, most have focused policy more directly on maintaining reasonable price stability. In addition, central banks are becoming increasingly transparent about their monetary policy deliberations. They have accumulated credibility, which seems to pay large dividends in a risky world.

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