Is the United States Devaluing Its Way to Prosperity?

Joseph E. Gagnon and Edwin M. Truman discuss the global debate over the risks for other countries of the Fed's preparations for more monetary stimulus.

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Steve Weisman: Now that Ben Bernanke, the chairman of the Fed, has signaled the possibility of the Fed engaging in further monetary stimulus, a new debate has arisen about whether that's advisable in terms of domestic US concerns. We've talked about that at Peterson Perspectives with Joe Gagnon and Mike Mussa. But a separate debate is underway about the international consequences of what has become known as quantitative easing. This is Steve Weisman at the Peterson Institute for International Economics with Joe Gagnon and Ted Truman to talk about those consequences. Joe Gagnon, what is the Fed signaling that it might do? What is the objective?

Joseph Gagnon: The Fed is signaling that it's going try to push down longer-term interest rates in the United States. To a large extent, the market sees that and has already sort of done the work for the Fed. But now the Fed has to go forward and actually buy those assets to ratify that.

Steve Weisman: What assets?

Joseph Gagnon: The Federal Reserve would buy longer-term Treasury securities, possibly mortgage bank securities—meaning more than two-year maturities. Probably mostly 5- or 10-year maturity assets, which will lower interest rates—five-year interest rates—which has a big effect on mortgage rates and corporate bond rates, car loan rates and other borrowing rates.

Steve Weisman: You and some others here at the Institute, including our colleague Adam Posen, think this is a good idea. Why?

Joseph Gagnon: As Chairman Bernanke pointed out, the unemployment rate is far above what they think is the structural or sort of noninflationary rate of unemployment. One of the key objectives of the Fed set by Congress is to maximize employment. The other objective is price stability, and they believe that inflation is too low. They would like an inflation rate of about 2 percent and it's currently hitting below 1 percent. They think that's not only too low, but heading in the wrong direction and at a risk of going below zero, given the very high unemployment rate. So they really, really want to avoid that outcome.

Steve Weisman: Ted Truman, are there any concerns that we should have about taking this kind of step?

Edwin Truman: I think there are. One can argue on the one hand that this will have big impacts on the global economy. Some debate whether we should be doing this at all, because it has [an] impact on the rest of the world.

Steve Weisman: Explain how this impact would occur. Is it because the value of the dollar would go lower?

Edwin Truman: It would lower interest rates, it would tend to weaken the dollar, and it would tend to encourage capital flows from dollar assets to other assets and other currencies.

Steve Weisman: If the dollar's value is lower?

Edwin Truman: And that would operate in some sense indiscriminately. And it particularly would impact countries who now might be worried about inflation. They're raising their interest rates [in response] so that by lowering our 3-, 5-, 10-year interest rates on dollar assets across the board, we increase the relative attractiveness of investments abroad. And if those countries are trying to stabilize their own economies, because they're worried about the opposite problem that Joe pointed out, that would make that much harder for them.

Steve Weisman: Aren't the other countries also worried about exports?

Edwin Truman: Some of them are. Some of them aren't. Some of them may have current account deficits like Brazil. Or some of them are less legitimately [worried] because, like China, they have a current account surplus. But I think the international implications are not the problem. The fact is that the actions of the Federal Reserve in [the] monetary policy area are indiscriminate. They affect both those [whose trade surpluses we think should shrink] as well as those whose trade surplus deficits should shrink. That's the sort of broad international criticism, sometimes coupled with the fact that it may not have any impact domestically. We're not weighing the benefits to us as much as the benefits abroad. That is not particularly a view that I'm concerned about.

Steve Weisman: Ted, you mentioned international criticism. Is there much?

Edwin Truman: I think there's a lot of criticism coming from Europe and from Stan Fisher [governor of the Bank of Israel] when he was here in Washington, and from the Chinese, who have been able to use this criticism to some degree to deflect the currency debate into a debate about the US monetary policy. So in a sort of a broad, political economy sense, the international spin on [this policy] hasn't been handled as well as it might have been because it's allowed some countries, like China, to change the nature of the debate. And other countries—for example, our colleague Anders Åslund from Sweden—say we are doing this selfishly and not thinking about the impacts on the rest of the world.

Steve Weisman: Joe Gagnon, are these concerns worth taking into consideration when we think about this policy for the United States?

Joseph Gagnon: I think it's a legitimate issue: how this will play out around the world. But it's important to remember that the Federal Reserve is not doing what some countries are doing, which is to expand their monetary policy by buying other countries' assets, which deliberately, directly tries to push their currencies down. The United States is only buying US assets, and mainly trying to affect US asset prices and US interest rates. Now, as Ted said, that does spill over. It does spill over into other currencies, but it's indirect, not direct, first of all.

Second, we don't understand the challenge of monetary policy as well as we should. But to the extent that we do, we see that there are offsetting effects here. It's true that this tends to depreciate the dollar, which tends to make US exports cheaper and encourage US exports—hence the concern abroad. But, at the same time, it boosts spending in the United States. It gives households, when they refinance their mortgage at a lower rate, more money left over to spend. And corporations have more money to invest—they can borrow at cheaper rates, so that boosts spending in the United States. That actually increases imports. Our economic models typically say that there's a neutral effect on the rest of the world. But in the current circumstances with interest rates very low, I guess it's conceivable that more of the effect could come through the exchange rate than in normal times. We just don't know.

Steve Weisman: Ted, you're a veteran of international economic diplomacy. We have the G-20 just a few weeks away. What are President Obama and Secretary Timothy Geithner going to hear from their partners about this?

Edwin Truman: I suspect that Secretary Geithner and Chairman Bernanke will be hearing quite a lot this coming weekend when the G-20 finance ministers and central bank governors are meeting in Korea. The question, I think, is whether they will be able to put it to rest prior to the summit meeting itself next month in Seoul. I think the problem is that the president of the Federal Reserve says it's his policy, but also the secretary of the Treasury—

Steve Weisman: Do we know that the Treasury supports this policy?

Edwin Truman: We don't know that it supports this policy, and we never will.

Steve Weisman: You're a veteran of diplomacy.

Edwin Truman: In our case—we are getting a little bit off topic—normally the relations between the Federal Reserve and the Treasury are very respectful of each other's areas of responsibility. The secretary of the Treasury would say, "We respect the Federal Reserve's independence and their attention to their mandate." Sometimes it may go on to say, "Therefore, we approve their policy." But to the extent that you're dealing with the dollar component of this, the international spillover component, that's in both houses, both in 15th Street and on Constitution Avenue.

Jointly they have a communication problem. You saw just this week Secretary Geithner in answer to questions said, "We are not trying to devalue our way to prosperity," and was forced to repeat the mantra that we think on balance a strong dollar is in the national interest.

Steve Weisman: But is that going to fly?

Edwin Truman: It was necessary to say that, in my view. Let me get to the basic point. There are risks for the Treasury and the Federal Reserve and the country here. And I think there are two types. One is that people will lose track, as Joe said, that this is actually an effort to restore the health of the US economy, which is good for the world in a noninflationary way. And they'll see it as hurting them and take off-setting actions, in exchange markets, capital controls, trade controls, things like that, which will actually make their own circumstances worse, and lower global growth and therefore, hurt us, too. Because you actually [could] have a negative effect on the rest of the world.

The other risk is that things will get sufficiently bad, that there will be a mass heading for the exits in terms of sales of US dollar- denominated assets, which could depress equity prices and drive long-term interest rates in the United States back up. At a minimum [that] would blunt part of the positive effects that we're trying to accomplish through the policy. I mean if it got out of hand. And I think that's the reason why the Treasury secretary and the chairman need to put these actions in context—so that it's pretty clear that we're not trying to—to use that phrase—"devalue our way to prosperity."

Steve Weisman: Joe, is this a communication problem or a policy problem?

Joseph Gagnon: I think it's a communication problem, not a policy problem. I do agree with Ted's two points. But probably I'm less concerned about his second point about a mass rush from the

dollar. I think that could happen, and it could be tricky, and I don't think it would be good. So I am worried about it, but maybe a little less than Ted. Probably because I think it's less likely to happen and probably because if it does happen, I think it's actually possible for the Fed to try to then minimize the damage.

What I would like to stress a bit more, though, is the first point that Ted made. I think that the problem here is that foreign countries will make mistakes. The one thing that I believe certainly from my personal research is that countries are too concerned about when their currency appreciates. They are overly concerned. It's actually possible to show that there are countries like, say, Australia and New Zealand and even Canada, to some extent, that have done quite well despite very turbulent and very large movements in their exchange rates. Countries just need to see this and to accept that they'll be better off if the US economy is strong and they have a strong currency than if the US economy is weak and they have a weak currency.

Steve Weisman: Conversely, though, isn't the United States putting too much emphasis on trying to get China to let its currency appreciate?

Joseph Gagnon: I think the point would be to tell China that they don't have as much to lose as they think they do from letting their currency appreciate. I think that the problem for the United States is—if I understood you correctly—that, given that China isn't doing this and the dollar is strong, why are we worried about that?

Steve Weisman: Yes.

Joseph Gagnon: I think the answer has been up until now we weren't too worried about that. We were able to have good outcomes. I think one issue is that we're now at the zero bound on interest rates, and so that limits our room for maneuver. Another problem is that the Chinese actions are distorting global capital markets in a way that's not good in the long run; it's more of a long-run problem.

Steve Weisman: But, to emphasize, you're advocating this policy, not because of its effects on currency, but because of the need for our own domestic economy.

Joseph Gagnon: Yes. I mean, I'm happy if this policy works entirely through domestic spending effects of the lower interest rates and higher stock prices and other asset prices. It doesn't have to work through the dollar. But the dollar is part of the international linkages, and so it is a natural part of it, but it isn't the only part and it certainly isn't a necessary part—

Edwin Truman: I think it's probably appropriate under the circumstances. And at the extreme version of what we mean, [the criticism of what] the Federal Reserve is doing to the rest of the world is not justified. That's why I think it's important for the Federal Reserve or the Treasury to address the communications problems, so that it's clear what they're doing and why. Rather than just letting other people tell the story about what's going on. The problem is, sure, we can redress the balance after the damage afterwards, but it will be a distraction. So you're better off trying to think through your strategy, including a communications strategy, as you get started on this rather than play catch-up ball and react constantly to the flames fanned by media around the world.

Steve Weisman: On that note, thank you gentlemen.

Edwin Truman: Thanks.

Joseph Gagnon: Thanks, Steve.