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CONTINGENCY PLANNING MEMORANDUM NO. 1

If the U.S. Dollar Plummets

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OVERVIEW

The scale of financing needed to support the U.S. fiscal deficit—together with the Federal Reserve's policy of keeping U.S. interest rates low to ward off deflation[1]—has revived concerns about a sudden and sharp depreciation of the U.S. dollar. So far, however, there are few signs of this happening. The dollar has rallied against most currencies since August 2008. A global flight from risk favored safe U.S. assets, and thus the dollar—particularly relative to the financial assets of the emerging world. During the crisis, foreign central banks shifted out of agency (Fannie Mae, Freddie Mac) bonds, but not out of treasuries.

Even as the crisis increased the U.S. fiscal deficit, it reduced the U.S. external deficit. The trade deficit is currently running at about half its peak levels, and could be as low as 3 percent of U.S. GDP in the first quarter of 2009. U.S. demand for foreign assets has also fallen, dramatically reducing the amount the United States needs to borrow from the rest of the world. The dollar rallied because U.S. demand for foreign assets fell more rapidly than foreign demand for U.S. assets—not because of an increase in foreign demand for U.S. assets. For the first time in many years, inflows from other governments—whether central banks or sovereign funds—did not provide a large share of the financing the United States needs to sustain its external deficit. Many emerging economies are looking to increase their reserves—Abu Dhabi, Russia, and Korea all recently launched large Eurobond issues. This all combined to reduce the United States' short-term vulnerability to a dollar crisis. The risk could increase if the U.S. fiscal stimulus pulls the world economy out of its current tailspin, increasing the U.S. external borrowing need. America's largest creditor, China, also has signaled its growing concerns about the scale of its dollar exposure, a warning that should be taken seriously even if China's apparent desire to avoid adjusting its peg to the dollar and concerns about its export sector constrain China's policy options.

The United States' debts—both domestic and external—are still largely denominated in the U.S. dollar.[2] This limits the United States' vulnerability to a sell-off in the dollar. A sharp dollar depreciation would be a blow to American pride, but wouldn't increase the real burden of U.S. debts. *The risk to the United States stems from the possibility that a dollar crisis would be correlated with a bond market crisis, and thus linked to a sell-off in the Treasury market: think "Treasury crisis" as much as "dollar crisis."* Such a sell-off would reverberate through a host of other markets, including the mortgage market. It could also trigger—or in the current environment, amplify—a credit crisis, as the second-order effects of the crisis would reverberate through a capital-constrained financial sector.

The United States' options in a dollar crisis include: accepting a fall in the dollar, finding alternative sources of financing, or adjusting U.S. government policies to increase creditors' confidence in U.S. assets. The United States consequently could be forced to choose between paying a higher price to maintain its current policies and adjusting its policies—foreign as well as economic—to match the preferences of its large external creditors. This risk is not entirely theoretical: the U.S. threat to withhold financing from Britain during the 1956 Suez crisis led Britain to withdraw its forces from Egypt rather than risk a run on the pound. Less dramatically, the risk that a foreign creditor might withdraw financing may prompt the United States to refrain from certain policies, narrowing the U.S. policy choices in crucial regions of the world. Finally, one of the United States' long-standing strategic advantages is that geostrategic tension generally induces safe haven flows to the dollar. The United

States' rising external debt implies a growing risk that the United States could face a simultaneous foreign policy crisis and financial crisis that tests its capabilities in new ways.

POTENTIAL TRIGGERS

A dollar and Treasury sell-off could reflect a loss of creditor confidence in U.S. economic policies. For example, America's creditors might fear that the United States would allow a rise in inflation to erode the real value of U.S. mortgage debt, and try to sell before the rise in inflation eroded the real value of their bonds. Alternatively, a sell-off could be triggered by a U.S. foreign policy decision that a major creditor country believed threatened its interests. To take an extreme example, China would have difficulty continuing to buy U.S. Treasury bonds if the United States decided to recognize Tibet's claim for independence from China. Political upheaval in a major creditor—say, a popular revolution in Saudi Arabia—could also lead to large dollar sales.

Should foreign creditors' appetite for low-yielding, dollar-denominated assets wane or Americans lose confidence in dollar assets, one of the following would need to happen:

- The dollar would need to fall to a point where the United States imported less and exported more, reducing the United States' need for external financing;
- Yields on long-term U.S. bonds (and other financial assets) would have to rise to the point where investors once again found U.S. assets attractive;
- The Federal Reserve would have to raise U.S. short-term policy rates to "defend" the dollar;
- The Treasury could face pressure to curb its deficits to facilitate the reduction in the U.S. external borrowing need. This would include pressure to limit the budget the United States devotes to maintaining its global presence. The Treasury might also face pressure to raise financing by selling debts denominated in the currencies of America's creditors.

The impact of any one large actor's dollar sales hinges on the reaction of other players in the market. If China's central bank sold $100 billion of treasuries and bought $100 billion of German bunds, private investors necessarily would need to sell $100 billion of German bunds and buy $100 billion of treasuries. The critical issue is the price at which that trade takes place. If private investors increased their purchases of U.S. bonds as soon as China's sales drove down the price by a small margin, the market impact would be modest; the sell-off would be orderly. Conversely, if private investors proved reluctant to increase holdings of treasuries, sales by a major central bank could be quite disruptive; market equilibrium would be restored only after a substantial fall in the dollar or a large rise in Treasury yields.[3] In the worst scenario, significant private investors might perceive central-bank sales as the trigger for a sustained bear market in treasuries, in which case they would join in the selling, requiring the dollar and treasuries to fall even farther before buyers were enticed into the market. A dollar and bond market sell-off that triggered other market moves—say, a rise in oil prices and a rise in risk spreads—would be even more disruptive.

Similarly, the impact of a loss of confidence among private creditors would be magnified if a large government holder of dollar reserves simultaneously joined the selling. The impact of the sharp fall in private demand for U.S. assets after the subprime crisis was muted by a surge in emerging market reserve growth. For a time, central bank dollar reserve growth likely exceeded the U.S. current ac-

count deficit.[4] Had, by contrast, a major emerging economy abandoned its dollar peg back when the dollar was under pressure, the United States would have been forced to adjust much more quickly.

INDICATORS

The main indicators of a crisis are the most obvious—the market price of the dollar in foreign exchange markets that trade freely, Treasury yields, changes in the Federal Reserve's custodial balances, and the bid-to-cover ratios in the Treasury auctions (see figures below).[5] The internal debate in major creditor countries also bears watching: Chinese voices now publicly question China's interest in ongoing purchases of treasuries.

POLICY OPTIONS IN A CRISIS

If the U.S. wanted to avoid adjusting its policies—whether its macroeconomic or foreign policies—to try to assuage creditors' concerns, it would either have to accept a fall in the dollar or try to offset the market impact of large dollar sales.

The U.S. government lacks a large buffer stock of foreign assets that it could sell to offset dollar sales. The United States would rely on its capacity to borrow foreign currency—whether from the market or from other governments—on an as-needed basis. This could be done either by the issuance of foreign-currency-denominated Treasury bonds or (more likely) by drawing on swap lines with other major central banks. Alternatively, America's allies could intervene to reduce upward pressure on their currencies by buying dollars. The Federal Reserve could also intervene in the Treasury market directly to limit the rise in long-term interest rates—as it recently announced it would do in response to the current economic and financial crisis—though such a policy response risks adding to pressure on the dollar.[6]

The United States' need for cooperation among central banks and friendly treasuries to manage a dollar crisis suggests that there could be value in gaming out certain scenarios with America's allies—many of whom also have an interest in avoiding any disruptive rise in their own currencies.

POLICY OPTIONS TO LIMIT U.S. VULNERABILITY

The obvious long-term response to the risk of a dollar crisis is to limit buildup of the United States' external debt. The economic crisis has reduced the U.S. external deficit and many countries' surpluses. However, America's largest single creditor, China, continues to run a large external surplus. China's government already controls a dollar portfolio of at least $1.5 trillion—a portfolio that grew by $400 billion in 2008. China—along with a few other emerging economies—already holds more reserves than it needs to guarantee its own financial stability, increasing its strategic flexibility. The longer the United States relies on financing from governments that already have more reserves than they need to support their external deficits, the larger the United States' underlying vulnerability.

The United States' vulnerability would also increase dramatically if a large fraction of the U.S. debt stock were ever to be denominated in a foreign currency. Conversely, larger reserves—and well-understood mechanisms for borrowing foreign exchange reserves from major foreign central banks—would help to reduce the United States' vulnerability. The Federal Reserve's successful provision of dollar liquidity to European central banks to help manage a dollar shortage among Europe's

commercial banks suggests that the necessary institutions already exist. The United States' vulnerability is consequently reduced so long as the major alternatives to the dollar are close U.S. allies.

Figure 1: EM Dollar Reserve Growth vs. Euro/ Dollar

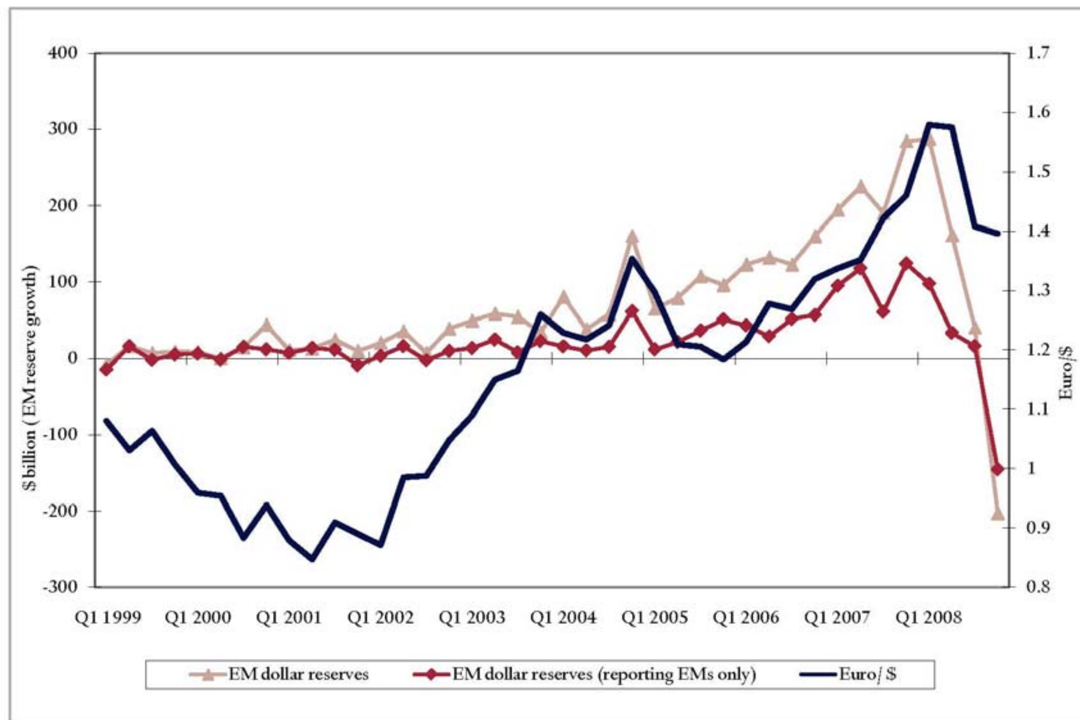


Figure 2: Estimated Official Asset Growth ($ billion, rolling 4th quarter sums)

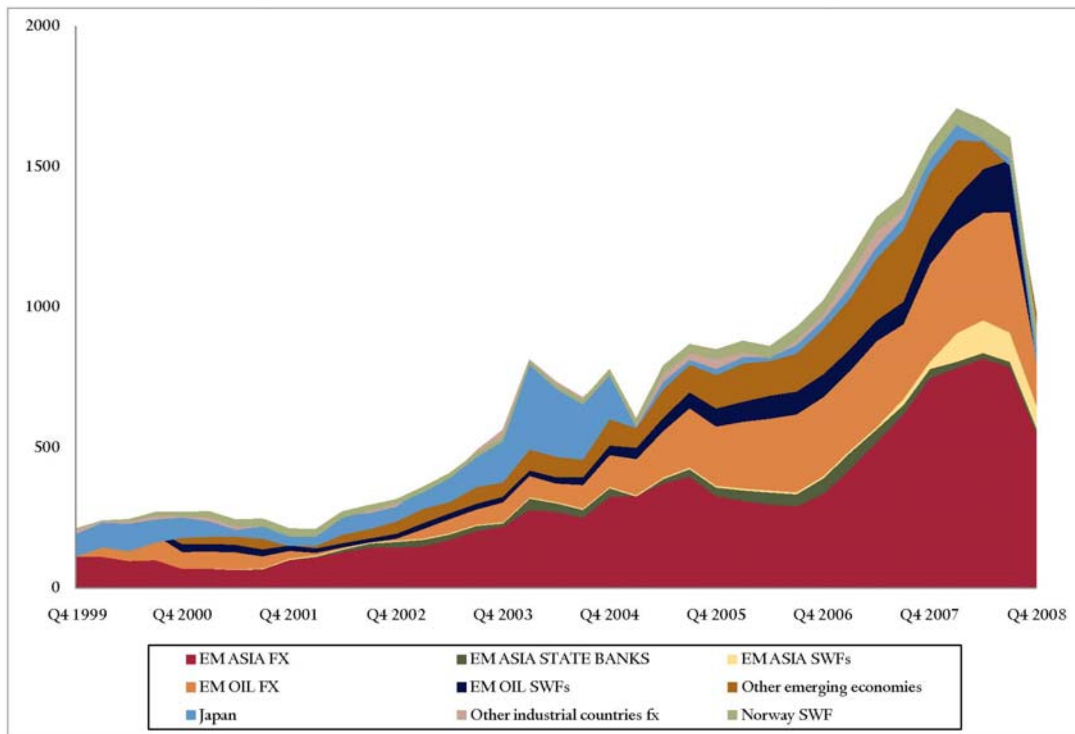


Figure 3: Running to Treasuries: 52-week Change in Custodial Holdings

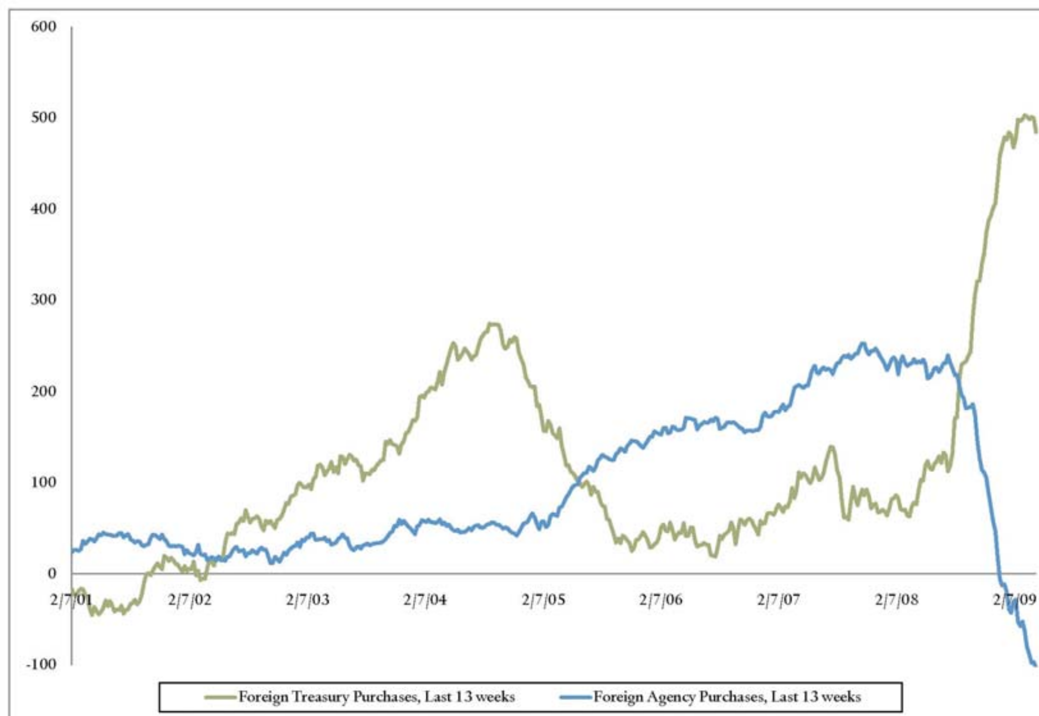


Figure 4: Estimated purchases of U.S. Treasury and Agency bonds vs. FRBNY Custodial Accounts (12 month sums, $billion)

Figure 5: Central Bank Demand vs. Net Issuance of Marketable Treasuries

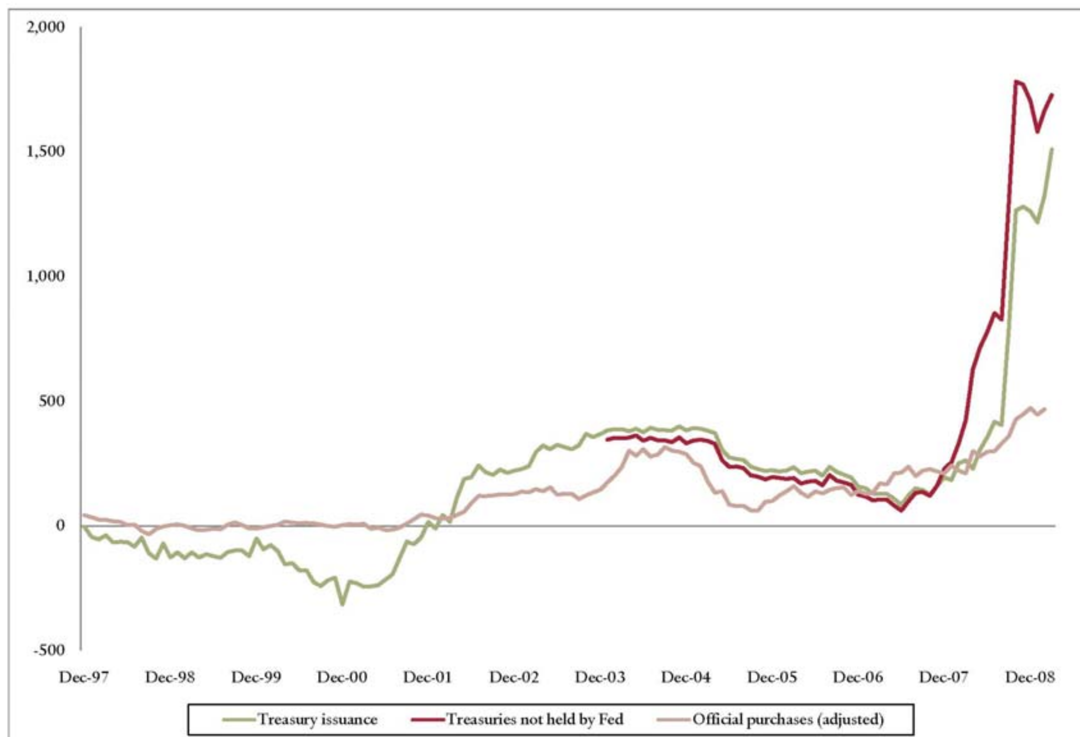


Figure 6: Treasury Yields: 3-month vs. 2-year vs. 10-year

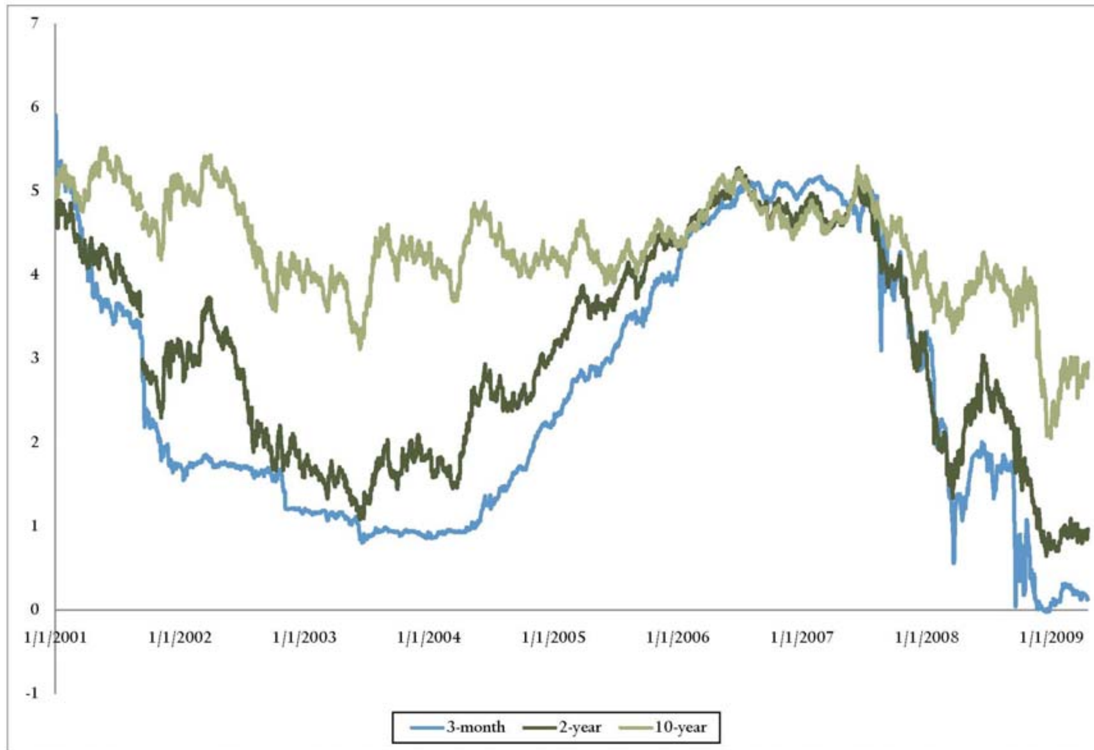


Figure 7: Official Inflows vs. Private Inflows (rolling 4th quarter sums)

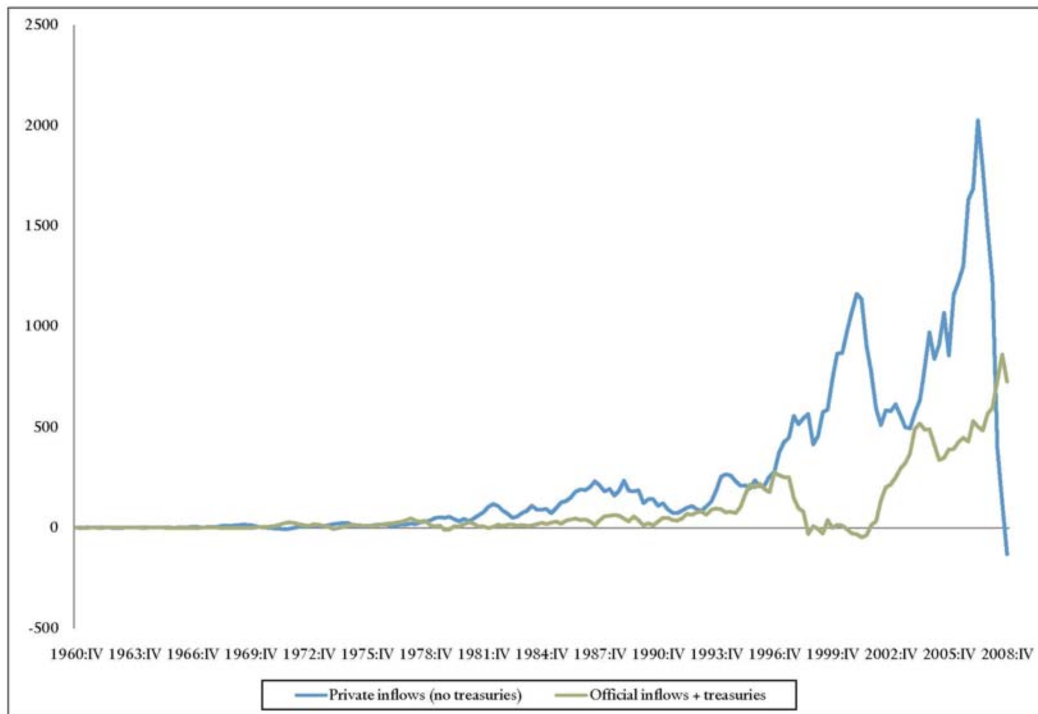


Figure 8: Gross Private and Official Outflows

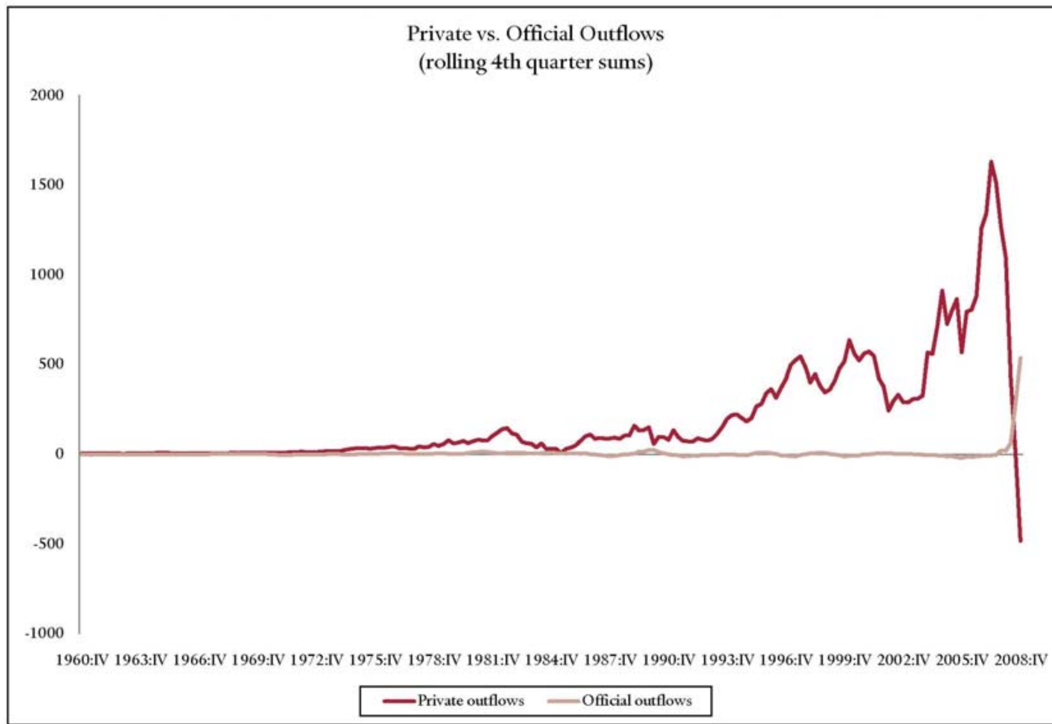
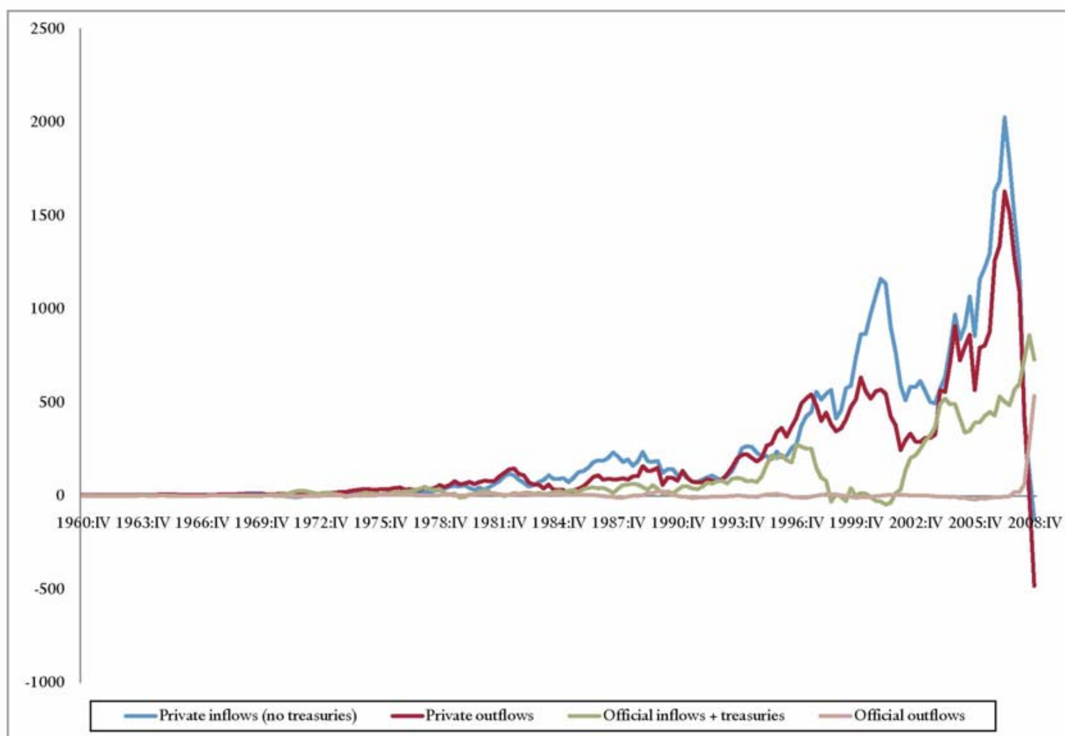


Figure 9: Official vs. Private Flows (BEA data, rolling 4th quarter sums)



Mission Statement of the Center for Preventive Action

The Center for Preventive Action (CPA) seeks to help prevent, defuse, or resolve deadly conflicts around the world and to expand the body of knowledge on conflict prevention. It does so by creating a forum in which representatives of governments, international organizations, nongovernmental organizations, corporations, and civil society can gather to develop operational and timely strategies for promoting peace in specific conflict situations. The center focuses on conflicts in countries or regions that affect U.S. interests, but may be otherwise overlooked; where prevention appears possible; and when the resources of the Council on Foreign Relations can make a difference. The center does this by

– *Issuing Council Special Reports* to evaluate and respond rapidly to developing conflict situations and formulate timely, concrete policy recommendations that the U.S. government, international community, and local actors can use to limit the potential for deadly violence.

– *Engaging the U.S. government and news media* in conflict prevention efforts. CPA staff and commission members meet with administration officials and members of Congress to brief on CPA's findings and recommendations; facilitate contacts between U.S. officials and important local and external actors; and raise awareness among journalists of potential flashpoints around the globe.

– *Building networks with international organizations and institutions* to complement and leverage the Council's established influence in the U.S. policy arena and increase the impact of CPA's recommendations.

– *Providing a source of expertise on conflict prevention* to include research, case studies, and lessons learned from past conflicts that policymakers and private citizens can use to prevent or mitigate future deadly conflicts.

Endnotes

1. Net exports subtracted from "real" quarter 4 growth, even as lower oil prices reduced the nominal deficit.
2. Ninety-five percent of short-term U.S. external debt is denominated in dollars. All U.S. Treasury bonds and most U.S. agency bonds are denominated in dollars, as are most U.S. corporate bonds held abroad.
3. The disruption in the agency market in the fall of 2008 after two major central banks started to reduce their agency holdings suggests that changes in the portfolio of a few large players can have a major market impact. Agency spreads only came down when the Federal Reserve stepped in to buy agency bonds. The ability of the United States to in effect sell treasuries to buy agencies limited the impact of the shift in the portfolios of foreign central banks. A "Treasury" crisis would constrain the U.S. government's ability to manage any associated disruption in other credit markets.
4. Ted Truman of the Peterson Institute argues that it is misleading to net private inflows against private outflows and official outflows against the current account deficit; the United States simply has a broad external financing need that is met by a mix of private and official inflows. However, gross private flows have collapsed recently, so official inflows account for a large share of gross as well as net flows.
5. A reasonable picture of official capital flows can be obtained by comparing data on global reserve growth to the TIC data showing foreign capital inflows, especially as we now know that central banks and sovereign funds account for a significant share of flows through Hong Kong and the United Kingdom.
6. See U.S.-China Economic and Security Review Commission, *Hearing on China's Financial System and Monetary Policies,* testimony of Francis E. Warnock, August 22, 2006.