

## The Cost of America's Free Lunch

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For decades, the world has complained that the dollar's role as global reserve currency has given the United States, in a term usually attributed to Charles de Gaulle but actually coined by his finance minister, Valéry Giscard d'Estaing, an "exorbitant privilege." As long as exchange rates were fixed under the Bretton Woods system, the nature of that privilege was clear: the US was the only country that could freely determine its own monetary policy. All others had to adapt to the policy dictated by the US.

This changed with the advent of floating exchange rates in the early 1970's, which allowed more stability-conscious countries, such as Germany, to decouple from a US monetary policy that they considered too inflationary. But, even under floating exchange rates, the US retained an advantage: given that the dollar remained the key global reserve currency, the US could finance large external deficits at very favorable rates.

Today, the US Treasury can still borrow unlimited amounts at rock-bottom interest rates. Indeed, the interest rate on inflation-protected bonds has now become -0.5%, even for a five-year maturity! The US government is thus essentially being paid in real terms to take investors' money – a generous offer that it is accepting on a huge scale, in the hope that channeling these resources to American consumers will boost household spending and thus generate more jobs.

The US seems to have come as close as one can imagine to getting the proverbial "free lunch" – except that, as economists are fond of pointing out, there is no such thing. And that is true here as well: performing the role of reserve currency enables the US to borrow on the cheap, but at the cost of any significant influence over the exchange rate, which is determined by the rest of the world's demand for dollar assets.

Germany discovered this during the 1960's and 1970's, and resisted the Deutschmark's trend toward becoming an international reserve currency. The German authorities feared that the country's export-oriented economy would suffer from the wide exchange-rate swings that are the norm for global reserve currencies. Given the weakness of other European currencies, however, and Germany's desire to keep markets open, there was very little that its officials could do.

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As the DM became a major international reserve currency during the 1980's and 1990's, large gyrations in the dollar exchange rate did, indeed, have at times a dramatic impact on the German economy. One reason why Germany agreed to merge the DM into the euro was the hope that a monetary union would distribute the burden of the reserve-currency role over a wider area.

The US economy is still rather closed (imports and exports account on average for only about 15% of GDP), and historically exports have never been the main engine of its growth. This is why the traditional US stance has been: "It is our exchange rate, but your problem."

So why is the US now singing a different tune? The answer is obvious: America's high unemployment rate, which hovers between 9% and 10%. This is the price that the US must pay for its lunch: Americans can continue to consume a lot, but the jobs are elsewhere.

Today, China has replaced Germany (and Japan) as the world's top exporter – but with one difference: it manages its exchange rate tightly, using capital controls and massive intervention in currency markets. As the only major economy with capital controls, China has created its own "exorbitant privilege": it can determine its exchange rate because no other big countries impose capital controls.

The two global economic superpowers resent each other's "exorbitant privilege." The US would like to have the Chinese jobs, and the Chinese would like to have better investment opportunities. Neither side is budging, although either could easily break the impasse.

The Chinese could abolish capital controls and let the renminbi's exchange rate float. But the US could easily end China's privilege by restricting sales of Treasury (and other US) debt to the Chinese monetary authorities. In doing so, the US would break no international commitments and would not start a trade war. Such a move is likely to be effective, given the sheer size of Chinese interventions (hundreds of billions of US dollars annually), which could not easily be recycled through offshore banks without exposing the China's central bank to many other risks.

Prohibiting the Chinese authorities from buying US debt would, of course, be tantamount to imposing capital controls, thereby breaking China's monopoly on such instruments. But it might also mean an end to America's position at the center of the world's financial system – and thus an end to its own "exorbitant privilege."

There really is no free lunch. The US must choose between job creation, which requires a more competitive exchange rate, and cheap financing of its external and fiscal deficits.

While China and the US battle it out, each trying to retain its own "exorbitant privilege," Europe seems to be stuck in the middle, suffering from the same disadvantages of the US position, but enjoying none of its privileges. The euro is also a global reserve currency (albeit of secondary importance), but most eurozone governments' financing costs are much higher than what the US Treasury pays. This is one of the costs of the incomplete nature of financial integration in Europe.