

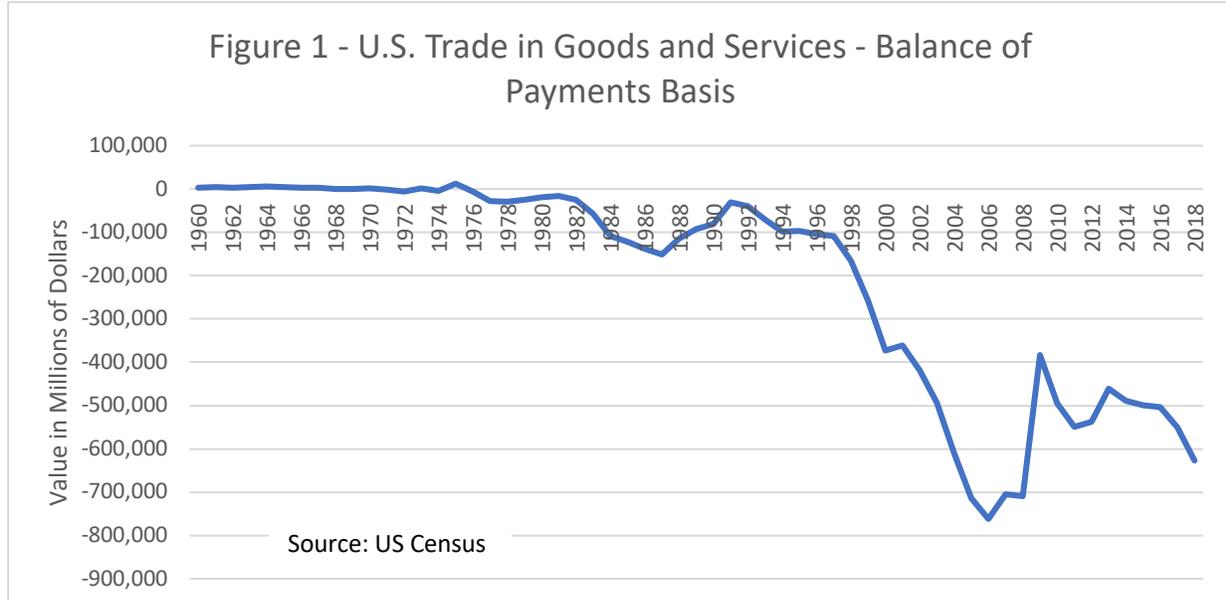


## Regulating Capital Inflows To Realign The Dollar Exchange Rate

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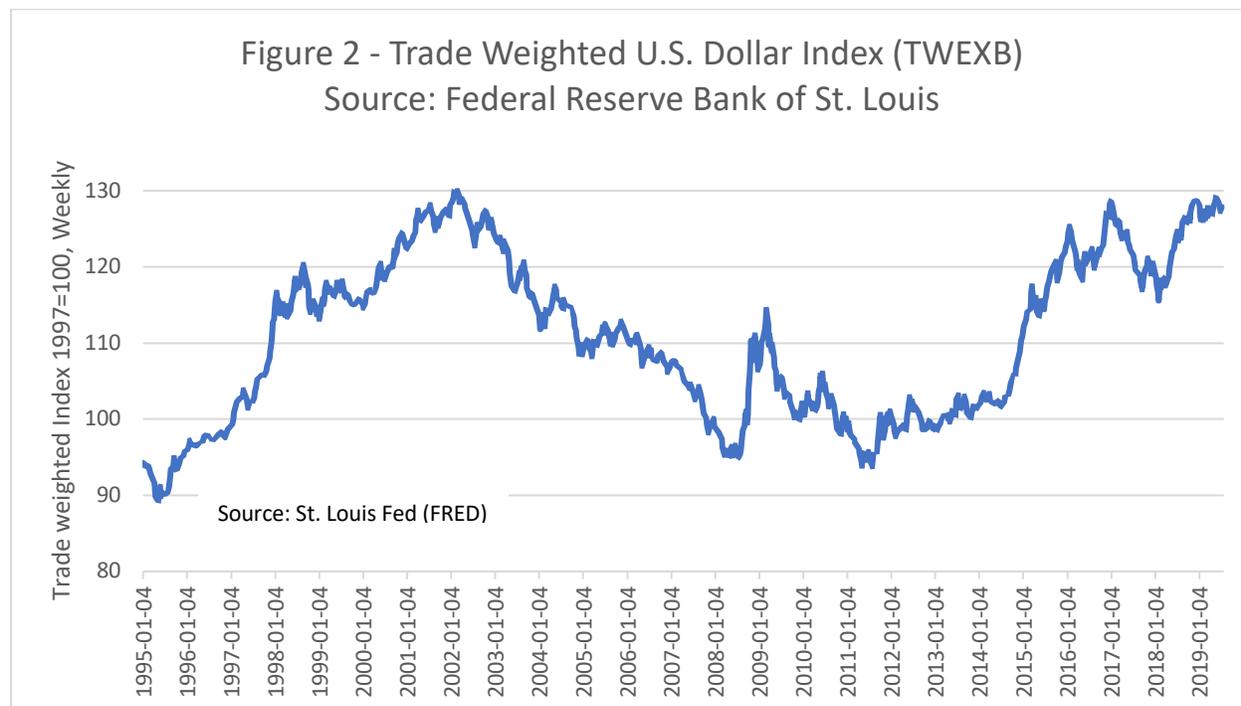
U.S. Senators Tammy Baldwin (D-WI) and Josh Hawley (R-MO) recently introduced a bipartisan bill called the Competitive Dollar for Jobs and Prosperity Act ([Senate Bill S.2357](#)) which would add exchange rate management to the portfolio of Federal Reserve duties. It would realign the US dollar exchange rate to make U.S. exports more competitive, boost American manufacturers and farmers, and eliminate our trade deficit. The *Act* would provide the Fed with a “Market Access Charge” (MAC) on foreign purchases of U.S. stocks, bonds and other assets as a capital flow management tool to carry out its current account balance goal.

Why is exchange rate management necessary? It is needed to correct the failure of the foreign exchange markets to allow the dollar to move to a rate that would balance the US current account. The U.S. has experienced an annual trade deficit every year since 1976, the primary driver of which is an overvalued dollar (see Fig. 1). The International Monetary Fund (IMF) estimates the dollar to be between 6 and 12 percent overvalued.<sup>1</sup> Other estimates have the overvaluation between 25 and 30 percent. The Coalition for a Prosperous America economic model estimated the overvaluation at 27 percent. Forty-three years of persistent trade deficit surely is a strong indication that automatic adjustment mechanisms are failing to correct the imbalance.



<sup>1</sup> IMF, *External Sector Report, The Dynamics of External Adjustment*, July 2019, pg. 95.

In a flexible exchange rate system, the dollar should depreciate in value on a trade-weighted basis to resolve current account imbalances. However, Figure 2 shows the trade-weighted value of the dollar has appreciated by 35 percent since 1995 rather than depreciated as economic theory suggests it should. Clearly structural factors are inhibiting the long-term adjustment mechanism for the trade-weighted dollar exchange rate.

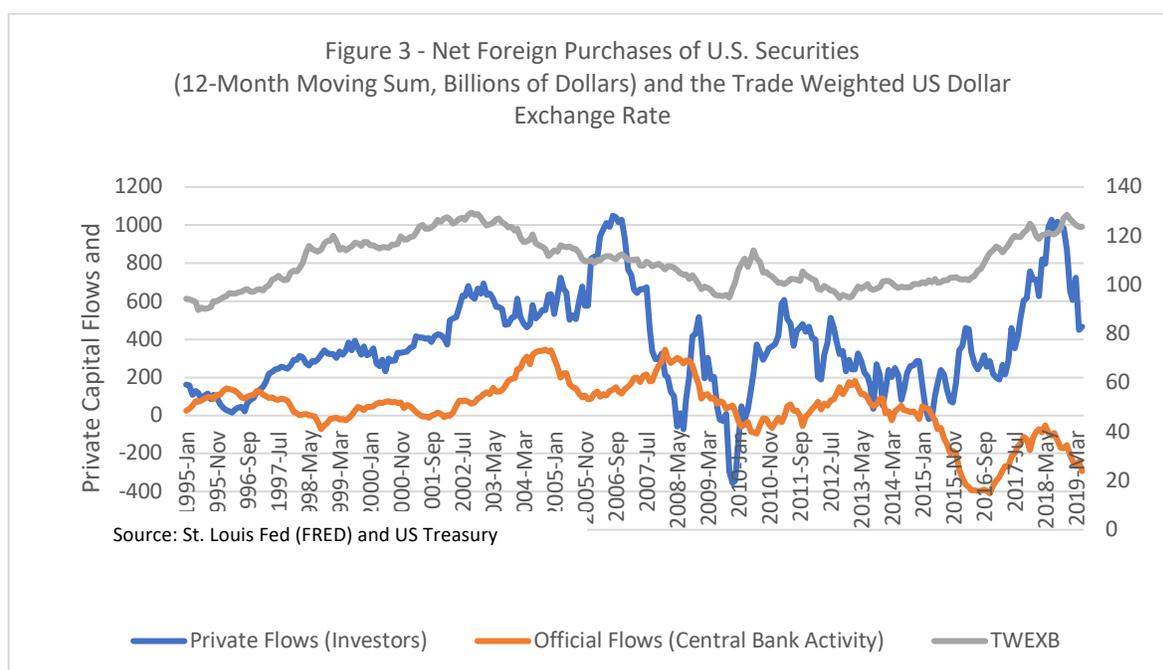


### **Inflows and the Dollar Exchange Rate**

What explains the continued strength of the dollar in the face of an ever-increasing trade deficit? Recent advances in international financial theory suggest that currencies are more influenced by capital flows than by current account balances. Current account flows result from payments for exports, imports, and the repatriation of profits. Capital flows represent investment capital crossing borders.. Financial globalization has enabled residents of many countries to diversify the portfolio composition of their assets. This diversification has increased the total size of these economies' external balance sheets. Whether they have been running surpluses or deficits, they now have balance sheets that are much larger in relation to their respective GDP's. This large increase in the size of the portfolios of international assets has implications for the determination of exchange rates, in that, even without central banks' interventions, it diminishes the impact of the accumulated current account balance which are much smaller in proportion. The demand for dollar-denominated investments, such as US Treasury debt or US corporate equity, can overwhelm the flows from current account transactions. Strong demand for dollar-denominated debt puts upward pressure on the trade weighted dollar exchange rate.

Figure 3 shows the trade weighted dollar exchange rate (gray line) and the level of capital flowing into the US on a 12-month moving sum. The capital flows are separated into official flows (orange line) and private flows (blue line). Official flows constitute central bank activity and private flows capture the flows of capital that are a part of the portfolio activity of non-central bank entities. These include hedge funds, sovereign wealth funds, wealthy individuals

and so on. Visually it is possible to see that private flows are correlated with the dollar trade-weighted exchange rate. For the period January 1995 through May 2019 the correlation coefficient between these two series is 0.58. This suggests that the volume of incoming capital flows explains more than half of the movement in the dollar trade-weighted exchange rate. When we lag the dollar exchange rate by nine months, we obtain an even higher correlation coefficient of 0.66. The higher correlation may be due to the effect of the dissemination of the reporting of the foreign purchases of US securities exerting a growing impact on the dollar's value over time, or it may be due to the influence of other variables.



### **Impact of the Overvalued Dollar**

Although high levels of incoming capital flows may be sustainable over a long period without damaging the financial stability of the economy, the higher exchange rate the flows generate can have detrimental effects on sectors of the real economy that do not experience increases in productivity to offset the disadvantageous effects of the overvalued dollar. Sectors that cannot offset the exchange rate effect through higher productivity have tended to lose market share to foreign competition. The US Department of Labor recently reported that since 2007, productivity growth has averaged just 1.3 percent a year, less than half the 2.7 percent annual gain during the period from 2000 to 2007. Without substantial productivity improvements to offset or overcome the overvalued dollar exchange rate, the US economy will continue to suffer.

The US has been and continues to be the world's preferred destination for financial capital as growth in Europe, Japan, and now China begin to slow. The differential growth rates are compounded by differential interest rates as central banks in Europe and Japan set zero or negative interest rates and US interest rates remain higher.

The Baldwin/Hawley bill would add a third mandate to the Federal Reserve, to achieve and maintain a current account balance through exchange rate management. It creates a new tool, called a Market Access Charge (MAC), which will moderate excessive capital inflows. The

Competitive Dollar for Jobs and Prosperity Act would empower the Federal Reserve Board to flexibly raise or lower the MAC rate to achieve the objective of a balanced current account over five years, and then maintain that balance through continued MAC rate management.

The IMF historically took a strong position in favor of unrestricted movement of international capital, but it has modified its stance in recent years. Following a series of international financial crises beginning in 1997, when emerging economies were hit by destabilizing, large-scale outflows of short-term capital, the IMF changed its guidance. The IMF's Institutional View on the Liberalization and Management of Capital Flows<sup>2</sup> acknowledged the legitimacy of capital controls as viable policies for addressing large, unwanted capital flows. It pointed out that "surges of inflows can pose problems for policymakers. Surges can lead to financial and macroeconomic volatility by overwhelming domestic financial markets and stretching the capacity of macroeconomic policies to adjust. They can lead to asset price volatility and bubbles, rapid exchange rate appreciation, credit booms, and unsustainable drops in risk premia, distortions in money markets, and disruptions in monetary policy transmission."<sup>3</sup>

The IMF advocates capital flow management policies when macroeconomic adjustment policies could not be implemented or were unable to address the problems. Conventional macroeconomic policies, such as reducing the government deficit, have been shown to be ineffective in halting appreciation of the dollar, as was seen in the 1990s. Empowering the Federal Reserve to manage policy so as to eliminate the US current account deficit is consistent with the fundamental goals of the IMF which include minimizing global imbalances. The MAC would be a temporary policy in the sense that once the US achieved current account balance, the MAC charge would fall to zero.

While the IMF Institutional View emphasizes capital flow management for the purpose of avoiding systemic financial instability, the Competitive Dollar for Jobs and Prosperity Act goes further in targeting persistent current account imbalances which affect the real economy as much as they affect the financial system.

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<sup>2</sup> IMF, *The Liberalization and Management of Capital Flows: An Institutional View*, Nov. 14, 2012.

<sup>3</sup> *Ibid*, pg. 17.