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A strong dollar: help or harm?

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Abstract
Strong policies that deliver stronger fundamentals and a stronger currency are very much in the national interest. There can be some short-term advantages to currency depreciation, but the United States is better served by making clear that we intend to pursue strong policies, and in turn that generates a well-functioning international order. There has been a lot of progress with internationalization of the Renminbi, but there are some pretty serious obstacles to its becoming a major reserve currency. Clearly the Chinese Renminbi is playing more of a role in international finance. However, there are foundations for being a major international currency, and right now China does not seem to be moving too quickly to build those. These include capital controls, heavy management of the exchange rate, and financial repression. The phase one managed trade deal with China has targets that are likely unachievable, and continuing protectionist US policies would more likely put upward pressure on the dollar. It would be nice for the US dollar to remain strong because we have really good policy and fundamentals. It seems more likely we're going to remain strong because looking at Europe, Japan, and China, nobody is an impressive competitor.

Keywords Strong dollar · Exchange rates · Protectionism · Renminbi · China

Nathan Sheets: I spent a number of years at both the Federal Reserve and the US Treasury working on issues related to the management of the dollar. It's very nice to have a chance to step back and think about the pros and cons of the strong dollar in a more analytical way. Let me start with the following observation: in a world with weak aggregate demand, and with broad disinflationary pressures, like the world we have today, a weaker currency may seem attractive to policymakers and to others.

The weaker currency, as you know well, holding all else equal, tends to shift expenditure from foreign goods onto domestic goods, and increases net exports, and can be supportive of growth. Further, the weakening currency will tend to put upward pressure on domestic inflation, and inflation expectations, at least for a while, and can help the Central Bank, at least through a transition period, achieve its inflation objectives. Another way to put this point is the exchange rate pass-through to inflation is low but it's not zero. Think of the standard macro channels. This pass-through channel might be the one that is still the most active, relative to slack or some of the other traditional drivers of inflation.

A third perspective on this is that the weaker currency can help support corporate earnings through translation effects. In other words, earnings abroad get translated into more dollars when the currency is weak or weakening. Some of that gets hedged away, but in practice a big chunk of it remains.

There are a couple of minor caveats and then a couple of big caveats. But one important note is that currency depreciation is very much a zero-sum proposition. If the dollar is weaker that means somebody else's currency has got to be stronger. Or as John Connally, who was Richard Nixon's Secretary of the Treasury, put it bluntly to a group of European finance ministers in 1971, "The dollar is our currency but your problem." Another caveat, and this is something that I felt acutely when I was in policymaking roles, is a recognition that a sharp depreciation of the currency can kick off endogenous dynamics that might undercut confidence in the economy, or importantly, undercut confidence in financial markets.

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So there are risks to quantum depreciation. Now, having said all that, I want to look at this issue from a somewhat different perspective. I think what I've said is intuitive, and holds at least a grain of truth, but it may be viewing this issue and the question in the wrong way. I think the opposite direction of causality is probably more important. Specifically, over long horizons, strong policies and strong economic fundamentals are likely to result in stronger growth, and bring with them a stronger currency. So strong policies yield a stronger currency.

In other words, if you go out and you look at countries where growth is strong, and innovation and technological progress are rapid—they have well-developed financial markets, effective institutions, reliable policy makers, and so forth—those fundamentals are likely to be associated with stronger, not weaker currencies. There's an interesting discussion here about appreciating equilibrium exchange rates versus where the real exchange rate sits relative to the equilibrium. But I'm comfortable with the assertion that countries with better policies will tend to have stronger exchange rates.

Another way to put this, which was often stated in central banking circles, when I used to travel in those circles, is that no country ever devalued its way to prosperity. I think that there are some interesting questions as to whether China is a counterexample of that, and I think David will be addressing some of those concerns. But at a minimum, what we can say, is that of all the countries that have tried to devalue their way to prosperity, that a lot more, by orders of magnitude, have failed than have succeeded. All of this I think provides useful background for what I see as the key question here, and that is was Secretary Rubin right when he said that a strong currency is in the national interest?

Putting my cards on the table, I'm a strong dollar guy, I do believe that Secretary Rubin was right. But what is clear is that the strong policies that deliver stronger fundamentals and a stronger currency are very much in the national interest. I see the strong dollar policy as a commitment by the United States to pursue policies that are going to deliver stronger growth and better economic outcomes, including a stronger dollar. Further, the strong dollar policy was a commitment to allow the dollar to be market-determined. I think that had beneficial implications for the United States, but it also had important positive implications for the global system more broadly.

The United States was saying, "We're going to pursue strong policies and we will accept a stronger dollar as part of that." We were essentially saying that we're not going to try to exploit the zero-sum gain of currency depreciation, that we weren't going to be in the market trying to fight market-determined moves in the exchange rate, and, to put it bluntly, that we would honor the rules of the game. This made it clear what the rules were for many other countries, and also gave the United States something of the moral high ground, so we could go to international meetings and say, "You know, we're following this set of rules, and we expect you to do it as well." And that's something that we have done, that the United States has done, for essentially a generation.

Let me just make a couple of other comments, and then bring up one final issue. As I say all of this about the strong dollar and accepting a stronger currency, importantly it's without prejudice to the flexibility of central banks to pursue their mandates, recognizing that monetary policy can influence exchange rates. But that's recognized as a tool of monetary transmission in pursuit of a domestic objective. Where this was particularly apropos was in 2013, when Japan was introducing Abenomics, and the Japanese were very careful as this program was being rolled out to say, "Our goal here is not to depreciate the currency. Our goal through this stimulus policy is to achieve 2% inflation." The mantra was "Domestic tools for domestic purposes."

The other point is that some might say, yeah, "the strong dollar policy" was just rhetoric. It certainly was largely a communications strategy. But my experience is it really did have substance. Let me give you one quick example. When I was at Treasury in mid-2014, we started to see the dollar appreciate significantly, and it continued to appreciate significantly through 2016. Our sense within the administration was that the appreciation of the dollar was in line with fundamentals. The US economy was stronger than many other economies at that point. The Federal Reserve was leaning toward monetary tightening more rapidly than many other central banks. As a result of that, the dollar appreciation was appropriate, and we did not complain about the movements of the currency publicly.

Nor did we take our counterparts to the woodshed about the dollar's appreciation in bilateral meetings behind closed doors. What we did do was emphasize to them that we expected them to play by the same rules, and to stay out of the foreign exchange market, and avoid intervention, which we were very categorical about. Well, finally, and let me just touch on this briefly, an issue that emerges from this discussion is what happens to countries that don't play by the rules, and seek a weaker exchange rate, and fight appreciation unduly through FX intervention and administrative means and so forth. What happens to them?

This is a tough question that I think the international system is still struggling with. I think it's, again, relevant to China in the years before the financial crisis and the years immediately afterwards. We have only imperfect solutions to this problem. IMF surveillance, that matters for something. We have G7, G20 commitments. When appropriate we can hold a country's feet to the fire, publicly, bilaterally, and in these multilateral, plurilateral settings. Treasury, of course, has the FX report, and the tool we used most aggressively when I was at Treasury was bilateral engagement.

We spent a lot of time with the Chinese pushing them on exchange rate issues, and acting responsibly as key stakeholders, and indeed leaders, in the international system. I used to quip, when I was at Treasury, that I spent more time with my Chinese counterparts than I was spending with my family, which was not literally true but it was approximately true, even though only an economist can say something's approximately true and get away with it. It's one of the occupational benefits that we have.

I think where the Trump administration has been the most different from its predecessors is that it has used these tools more vigorously, including the FX report. I don't think that the finding of China being an FX manipulator was justified, but Treasury was using these tools more aggressively, not to mention the very aggressive use of tariffs. This issue—how do we handle those countries that violate the rules—is the frontier in thinking about how the global system works.

My bottom line is I'm still a believer in a commitment to a strong dollar, recognizing that there can be some short-term advantages to currency depreciation. But I think the United States is better served by making clear that we intend to pursue strong policies. And I think in turn that generates a well-functioning international order. And with that, thank you.

David Dollar: Great pleasure to share this stage with Nathan. I think he made a convincing case in favor of a strong dollar policy, and that's one of the foundations of the dollar's role as the primary currency in the world. I'm going to address the question of whether the Chinese Renminbi is likely to rise up, to what extent it can become a major international currency, and is it going to challenge the dollar for primacy. The short answer is not any time soon.

I'd like to do is make two points. First, there has been a lot of progress with internationalization of the Renminbi, so I'll start with the positive. But there are some pretty serious obstacles to the Chinese currency becoming a major reserve currency, and I'll talk about those obstacles, including getting into some of the exchange rate issues that Nathan brought up. So first let me take the positive side. Clearly the Chinese Renminbi is playing more of a role in international finance. There was a rapid increase in the use of Renminbi in settlement. It started at close to zero, frankly, as recently as 2011.

There was virtually no settlement in RMB, and it rose up to 2.8 percent of global settlements by 2015. Now, that may sound like still a small number, but that put it as the number five settlement currency, and it seemed to be rising very rapidly. China has also by some measures become a pretty significant player in international finance. China has $7 trillion of foreign assets and $5 trillion of foreign liabilities, for a net foreign asset position of $2 trillion. That makes China one of the largest countries in terms of net foreign ownership, and almost certainly China will emerge as the largest net foreign creditor within a few years.

Another point I would make on the positive side is that in 2016 the IMF decided to include the Chinese currency in its artificial basket, the Special Drawing Right, joining four other currencies. I think that was recognition that it's one of the big five currencies in the world. I saw the IMF decision as somewhat forward-looking, recognizing that the Renminbi would inevitably end up as one of the top five currencies. It was perhaps a little premature in 2016. I think the US Treasury obviously supported it because it was an IMF decision. So good decision, Nathan.

We can point to these positive indicators of the growing role of the Chinese currency in the global financial system, and then you might just extrapolate from that that it was going to continue on, and eventually challenge the dollar in its role as the primary international currency.

The second main point I want to introduce into the discussion is a big however. There are foundations for being a major international currency, and right now China lacks some of the important foundations, and it does not seem to be moving too quickly to build those.

First, I would say that there are still extensive capital controls in China. They've tried to open up ways that investors can move money in and out, but in a very Chinese way it's all quite controlled. It's allowed those end results I mention, the $7 trillion of foreign assets, the $5 trillion of foreign liabilities, to develop, so obviously there's enough openness for China to play that role.

But it is hard moving money in and out. A different measure: look at all the foreign exchange transactions in the world. Only about 4 percent involve the Renminbi, and that's really a pretty small number. If you look at measures of China's role in trade and direct investment, it's always number one or number two in the world. When you look at these measures of financial integration, China does not particularly stand out as being very far up the scale.

Now, a second key issue is that the currency has more flexibility than it used to, but it is still a heavily managed currency. To address at least an implicit question coming from Nathan, if we look at the long history of China's exchange rate management, they pegged to the US dollar in 1994 at 8.3 to one. Prior to that they had a multiple currency system, a complicated mess, and that pegging involved a pretty significant real devaluation of their currency. I would argue for a poor developing country pegging to the US dollar is a reasonable choice.

They got lucky in the sense that that was an era where the dollar was appreciating, up till about the year 2000. So their trade-weighted exchange rate appreciated from 1994 to 2000, and they didn't have any particularly large external surplus. They were very close to balance throughout that period. I think the problem is that along with pegging, they had very rapid productivity growth, and after 2000 the US dollar started to depreciate and China followed the dollar down. I think it was a kind of honest mistake. Probably they liked some of the results, because this then led to a pretty seriously undervalued currency. Their exports were growing at 20 percent per year. There was a lot of pride in China that they began to develop these large trade surpluses. But I agree with Nathan's fundamental point that you don't devalue your way to successful growth. This entailed some pretty high costs.

In order to prevent inflation from developing, China ran a very conservative fiscal policy throughout that period. It underinvested in infrastructure and social spending. They were putting more and more resources into the external sector, building stuff for Americans, getting paid with IOUs when they could have been building their infrastructure, and their social networks. Looking at China now, it's hard to remember that infrastructure was somewhat deficient back in 2004, 2005, 2006.

But I think it was, as I said, kind of an honest mistake, because by 2005, China moved off the hard peg with the US dollar, started allowing more flexibility in the currency, but also keeping an eye on it vis-à-vis a basket. Since 2005, China's trade-weighted exchange rate has appreciated by about 50 percent, and that large surplus, which was a persistent problem for a few years in the mid-2000s, is pretty much gone. I often feel that a lot of the dialogue in Washington is based on facts from 10-plus years ago. There's no big Chinese external surplus. There's no evidence of misalignment of their currency. These are things that they took care of.

But the currency has still been managed, so its movement over time has been heavily managed. Nathan mentioned the period in 2014 when the US dollar was being driven up by market forces, and by not allowing too much flexibility the Chinese followed the dollar up, which was the last bit of this big trade-weighted appreciation. But then they got to a situation where their currency was probably overvalued, and that's when they brought about that mini-devaluation in 2015, and that was a big shock to the global market. I mentioned their role in trade settlements rising over time. That actually peaked in 2015. Their share of settlements has come down since then.

I think as they promoted the use of their currency in settlements, a lot of agents were saying as long as the currency looks to be appreciating we're happy to take Chinese Renminbi in payment. Once that seemed disappear with that mini-devaluation there was less appetite. Because ultimately, if you hold a lot of Renminbi, if you're a foreign company or a household holding Renminbi, you have very limited ability to move that into China, to put that into some kind of interest-earning or paying transaction.

The last point I would make on just the more general obstacles they face is they still do not have a very market-determined financial system. These things are hard to measure on paper. It looks like they've eliminated interest rate controls, but we don't really see much interest rate competition among financial institutions in China. The researchers who try to measure these things put China among the top 10 percent of countries in terms of financial repression, even today. It used to be just about the most financially repressed country.

Things have improved, but being among the top 10 percent in terms of financial repression, you don't have flexibility of interest rates, you don't have market forces operating. Most of the financial system is dominated by a small number of state-owned institutions. I'm trying to present a balanced picture. There's obviously been some financial liberalization in China, some liberalization of the capital account and flexibility of the exchange rate. All of that has allowed the currency to emerge as a fairly significant player in international finance and settlement. But it's kind of stalled. There are some institutional foundations that are well understood in the literature, about what China would need to do in terms of opening up the capital account, having a market-determined exchange rate, market-determined interest rates, and allowing in more foreign financial institutions and private sector institutions.

I think there's a pretty well-understood playbook and China has moved relatively slowly on that. I wouldn't expect that to accelerate too much any time soon, though it's possible the Chinese will surprise us. But I wouldn't expect the Chinese currency to be challenging the primacy of the US dollar any time soon.

Sara Johnson: One of the topics of interest from the audience is the future of the dollar as a reserve currency. For decades there's been speculation that its role would diminish but it certainly has not happened.

Nathan Sheets: Let me start with a comment on David's remarks that are also consistent with the question, and that is the dollar's role as a major reserve currency, the leading global currency, and particularly the Renminbi as a potential competitor. I pretty much agree with David's conclusion. What I would say, and maybe this risks being too blunt, but now that I'm in the private sector and not in the public sector I can actually occasionally risk that, is when I speak with clients often they'll ask me, "Well, what do you think about Renminbi-denominated assets?" And I say, "I think over a long horizon you'll probably make more in Renminbi-denominated assets than you'll make in investments and in assets in many other currencies. But if there are problems along the way you have to be prepared for a risk that there may be periods of illiquidity." And specifically, the last time we had a big disruption in '15, '16, down came the capital controls, and there might be periods where you can't get your money out.

For many investors, particularly fixed-income investors, that's a big concern. I think that before the Renminbi can really challenge the dollar, people have to be confident that during good times and bad times they'll have access to their resources, and I'm not sure it's there yet. More broadly, the other major competitor to the dollar is the Euro. I also don't see the Euro as a real challenger to the dollar with Brexit.

There are questions about the European Union. During the time I was at Treasury we worked closely with Greece and Minister Schäuble, and let me tell you it was really close, really, really close, to having a Greek exit from the Euro area. I can imagine scenarios where growth rates in Europe don't pick up over the next decade and Britain does relatively well outside the European Union. During that period maybe some country or some region returns to a narrative of, well, maybe we're better off on the outside. Now, I have great faith in the European policymakers to be able to deal with those kinds of issues, but I think there are questions that are still open, existential questions about Europe.

Further, the financial center that would have been the biggest challenge for the United States was London, and the British have decided that they prefer sovereignty to continued integration in Europe. I think that means London's role as a major financial center, as a competitor with the dollar, is also somewhat diminished. So the bottom line is I don't see any competitors. I do think we need to strengthen our policies significantly. I'm not happy about a lot of the places where economic policy is going, particularly on the fiscal side. But I think we're probably well entrenched, and we'll continue for the next decade, probably the next 20 years, as the reserve currency.

The way I like to put it is what we need to do is find a well-managed economy on Mars. If we did, then all the Earthly currencies could depreciate against that one, and that one could be the reserve currency. But as of now we haven't found that economy.

Sara Johnson: You both have collective experience of the Treasury and the Federal Reserve, two institutions that can influence the dollar, but I suspect that in the current administration we're seeing more tensions between those two. Could you comment on that?

Nathan Sheets: I did this on both sides of the table, as the International Finance Director at the Fed and then in a similar kind of position at the Treasury. In general, for many years, for decades, I would characterize the interactions between the Treasury and the Fed as broadly constructive. Maybe not always harmonious in certain chapters but also constructive. The general description of this is that the Treasury is the senior partner in determining exchange rate policy for the United States. The Federal Reserve is the junior partner. But to be clear, the Federal Reserve was a partner. It was not the Treasury dictating to the Federal Reserve what it was going to do, but it was a constructive dialogue with the recognition that at the end of the day the Treasury would take the lead.

There were cases where Treasury turned to the Federal Reserve and said, "Will you help us with dollar management?" One important example of that was in the summer of 2008 where Treasury was worried the currency was falling too much, and Ben Bernanke, in response to a request from the Treasury, included a paragraph on the dollar underscoring our commitment to a strong currency consistent with strong fundamentals in a speech. It got an enormous amount of attention, and was seen as the United States jawboning the dollar and preventing further depreciation.

So it's generally been successful. I'd say in this administration there seems to be a bit more divergence in perspective, and over the last year there's been some discussion about well, would be there intervention in the foreign exchange market? My sense was that if the general indicators of what would drive intervention—which is a massively overvalued currency, a huge appreciation of the currency, or a risk that currency moves are going to destabilize markets—are all absent, it would be very hard for the Fed to go along. For the Fed not to participate in the intervention with the Treasury would create some very difficult political harmonics. I know that this would be a voting issue for the Federal Reserve internally, probably an FOMC vote to participate in an intervention. It would be quite controversial if the underlying fundamentals weren't consistent with it.

Sara Johnson: I'd like to move onto China. We recently had phase one of the trade agreement. How do you see prospects for US/China trade relations after this agreement?

David Dollar: I think the positive aspect of the phase one deal is that it put a temporary halt to escalations of tariffs between the two, so I think there was a lot of relief on the part of markets. The US did not roll back much, just a tiny amount of tariff rollback. But the proposed round of escalation did not go through, and China has given a one-year exemption on a lot of the tariffs that they had put in retaliation. So I think that's the good part. A lot of the deal is about China committing to buy more from the US in specific product areas.

For most economists, this kind of managed trade does not appeal. When I saw the proposals, which add up to $200 billion of additional US exports over two years, it seemed extremely unlikely that the two countries could hit these targets. It would require US exports to China to increase by 40 percent this year, and an additional 40 percent next year. We don't normally see macro variables increasing like that.

A lot of pundits were skeptical that they could meet these targets, but probably China would make a good faith effort. It was supposed to include agriculture, energy, services, manufacturers.

Now, I have to say, even under the best case scenario [editor: statement made in February 2020] I think the virus now makes it absolutely impossible for China to meet these commitments, because clearly China's growth is going to be negative in the first quarter, but more importantly for the whole year it's certainly going to be closer to five than to six, and that's going to have an effect on various imports. Energy use in China is down 30 percent. It's not going to bounce back that quickly. China is abrogating some energy contracts it's got with Australia and other partners. It's just hard to see that they're going come in and buy the $50 billion that they were supposed to.

The deal also includes a small amount of action on structural measures, and I would say that most of that was already in the works, but some that are quite important. Part of that is opening up financial services so foreign firms can have 100 percent-:owned affiliates in China, in investment banking, in insurance, in a number of other financial services. If that's real that helps address one of the problems I raised in my remarks the lack of market-determined financial services in China. That can end up being fairly significant down the road. But, overall, I think the main thing from the phase one trade deal is just not escalating the trade war any further.

Let me throw one more thing in. I think people don't necessarily appreciate that protection is one of the things that tends to lead to currencies appreciating. Part of the appreciation of the US dollar has been because we've prosecuted this trade war against China. If you want a weaker dollar based on fundamentals, free trade is going give you a better outcome.

Nathan Sheets: I just wanted to agree strongly with David's point about managed trade. Administrations in the past have had discussions about whether to set some quantitative targets for China to meet in its trade relationships with the United States? Those proposals have been beaten back with an argument that quantitative proposals are central planning. That is exactly what we're trying to get the Chinese to move away from, toward a more market-based economy where quantities are allocated based on market-determined prices.

Previously, those proposals were rejected. If these targets are to be achieved, or even significant progress made toward being achieved, how's that going to happen? It's got to be SOEs (state-owned enterprises), SOEs playing a bigger role in the economy, which is antithetical to the reform agenda that the United States has had traditionally had, or stockbuilding in some kind of an unusual way, or re-exporting. I particularly struggle with the underlying conceptual drivers of those quantitative targets.

Sara Johnson: One audience question notes the persistent twin deficits, the US current account deficit of around $500 billion, the fiscal deficit around $1 trillion. Will these eventually weigh down on the dollar exchange rate?

Nathan Sheets: So on the current account side of it, before the financial crisis we had this gaping 5 percent, 6 percent of GDP current account deficit. I remember being in many international meetings where everyone else around the table was saying the dollar is going to crash. In the event, we had a global financial crisis, which you can argue was a reflection of some of those imbalances, and Bernanke's global savings glut would suggest that there were some linkages. But through the heart of the crisis, the dollar was a strengthening currency, from mid-'08 into early '09, from that Bernanke intervention that I mentioned into the spring of 2009. Now, a lot of models would suggest our current account deficit should be bigger than it is. The extraordinary revolution in the oil industry has been an important mitigating factor. US demand for imports has been a bit softer than what people have expected. It doesn't feel to me like there's a lot of pressure on the dollar from external side.

On the budget side, not only are we not seeing pressure, we're hearing the political narrative of modern monetary theory: more debt is unlikely to blow up the economy, so let's go for it. I don't see the markets imposing discipline on that front either. I'm more worried about the fiscal deficit than I am on the external issues, and if there is risk it's more likely to be there.

David Dollar: I would just add that it would be nice for the US dollar to remain strong because we have really good policy and fundamentals. It seems more likely we're going to remain strong because looking at Europe, Japan, and China, nobody is an impressive competitor.

Audience Question: You referred to the Euro. You said you have confidence but there are existential questions. 71 percent of Euro denominated transactions clear through London, but Boris Johnson just said he would not accept an EU regulatory level playing field in terms of those transactions. Could you examine the Euro as the second reserve currency, and the risk that there might be with that as a reserve currency?

Nathan Sheets: The points you're making regarding the uncertainties about London as a financial center, what that means for its role in Europe and the global economy through this period of transition and negotiation, how will Brussels respond, are all very much open issues. I have taken as my working hypothesis that the two sides will be able to find something that's not too disruptive, but that is a notable downside risk to Brexit, that you have a disruption in those relationships. More broadly, my feeling about the Euro is that key European policymakers are very committed to it, as we saw with Mario Draghi's "whatever it takes." But this is likely to continue to be a rocky road. It's rocky because of the economics, and specifically the profound heterogeneity of the economies that are sharing the Euro: when you think about Germany versus Greece, the Netherlands versus Spain, these are very different economies, and trying to do one policy that works for all is hard. To the extent that you're unsuccessful with that it's going to breed discontent, I think, about economic outcomes.

Separate from that, but maybe somewhat related, is the adverse politics. We saw Britain vote and say, "We want to leave the European Union, recognizing that there might be some economic costs associated with it, but we think issues of national identity, and from our perspective, national sovereignty trump (no pun intended) those economic considerations."

Similar kinds of populist pressures on the right and on the left sometimes bubble up in various other European economies, which as they interact with some of the economic challenges, might create further pressures during the coming decade. These are the kinds of existential concerns that I would point to about Europe, that I think are lurking in the backs of many people's minds over the long horizon.

Audience Question: If the Euro falls to pieces, is that a threat to the dollar?

Nathan Sheets: This is a really interesting question. I think it would be a threat to the global economy. But frankly, from what I've seen in my career, it would kick off a lot of safe haven flows into the dollar, and would press up the value of the dollar, so would not be a threat to the dollar's global role. But then we also would have to think about how we would manage a stronger currency through that period. So there absolutely are risks.

Audience Question: David, I'm glad you mentioned protectionism and the currency. My question is would you agree that Trump's tariffs policy and his interest in a strong currency conflict with each other?

David Dollar: I would say that a lot of the strengthening of the dollar during Trump's presidency relates to policies that the President put into place. I already mentioned that protectionism tends to appreciate a currency. It's hard to statistically estimate how much. No question that large fiscal stimulus has also led to a higher value of the dollar. Everyone's aware of the tax cut, but there's also been a pretty dramatic increase in government spending. I think of the exchange rate as largely endogenous, though there are times when jawboning and intervention can help markets get to the right place, but I think it's the fundamentals that matter. The big fiscal deficit is good for US growth in the short run. It can create a reckoning further down the road, but in the short run it's good.

It's not just President Trump, some of the Democratic candidates have also talked about a weaker value of the dollar. If you're sensible, what that means is you want to think about changing fundamental policies. Are people who want a weaker dollar talking about seriously contracting the fiscal deficit? I don't think so. I don't hear any talk about that.

Audience Question: One question I have is about the Commerce Department's role in designating a nation as a currency manipulator. It seems that the Department of Commerce is now more willing to have its own say. The law has been there for a while, but starting in April, the procedure is now clear that at the end of the day they can decide on their own. So considering that constructive dialogue between the Fed and the Treasury that you outlined, we can expect that to happen between Treasury and Commerce?

The second is somewhat related to a central bank digital currency. Do you think that would help maintain or is necessary to maintain the US dollar's role as a reserve currency? If yes, do you have any timespan for the US to implement, or to introduce a CBDC?

Nathan Sheets: Your second question about central bank digital currencies is a tricky one. I have to say that I'm not an expert. To the extent that I've looked at it, I think the key question for the central bank to think through as it creates that new digital currency is who are the eligible counterparties? Which, basically, is saying who can have an account at the Federal Reserve? If the eligible counterparties are basically commercial banks, I think it has the flavor of the reserves that are being created now, because you'd be creating that digital currency and then telling those large institutions to spread it out through the system.

If instead the Federal Reserve or another major central bank says to the public we're open for business and come, create your account, and you can have access to our digital currency, then it seems to me that would massively disintermediate the existing financial system. I don't know the way forward here. If you do it in a small way there's nothing new, and if you do it in a big way it's substantially disruptive to the existing system.

As to the first question, as a former Treasury official let me say that I had deep respect for my talented and highly skilled colleagues at the Department of Commerce. But I felt it was important that the Treasury be the place where currency decisions, and evaluations, and judgements were being made, that that was the expertise and the mandate of the Treasury, working closely on these issues with the Federal Reserve. Steps that have passed some of that responsibility to the Department of Commerce, which has different mandates, and different expertise, I find somewhat concerning, as I do the initiative to have countervailing duties on apparent currency misalignments. I'm not sure that is a promising way forward. It leaves me quite concerned.

Audience Question: My question is more in terms of the current ongoing trade war between US and China, and how will the strong dollar impact US exporters, and the overall economy?

David Dollar: Obviously the exchange rate between the dollar and the Chinese currency plays some role in trade, in both directions. Just intuitively, as long as the dollar remains strong, it's harder for US firms to export into China. I guess I wouldn't exaggerate the importance of that too much. I think there are just a lot of other factors. In this US/China trade dispute, there are some Chinese practices that really go against global norms in terms of subsidies, the role of state enterprises, and market access.

I think if China moved on more aggressively on the structural agenda that we're pushing that probably would have some effect on the currency. But I think mainly that would lead to more trade, probably in both directions, because market access is more important than the exchange rate for many producers.

Audience Question: So my question is in the event of a Democratic presidential election victory and we see implementation of the sorts of radical spending policies of Bernie Sanders or Elizabeth Warren. What would these do to the dollar? What might be the implications of a Medicare for all policy coming into play?

Nathan Sheets: This question, I think, cuts to the heart of the debate on modern monetary theory that I mentioned. Now, if the policies of one of those candidates were enacted I think that what we would see is a significant increase in taxes, and that might, depending on where the incidence of those tax increases ended up falling, imply some demand shifts for the dollar. For example, if it was higher corporate taxes, then maybe firms have incentive to again leave more earnings abroad. My sense is that however much these policies involve raising taxes, they would raise spending even more, and we would have bigger deficits, and more federal borrowing.

Now, the point is, do we have any confidence at all that we're hitting debt levels anywhere close to making markets uncomfortable or undercutting confidence in our institutions? We have no evidence of that. You know, as US debt levels have risen, frankly, yields have fallen. Further, there's Japan's experience of very high debt levels and very low bond yields. So there's no sense of any imminent trigger point. Do I believe that there is a trigger point? Yes. I just don't know where it is. But the analogy I draw, it's kind of as if you're driving down a sharp mountain road, and let's suppose there's no guardrail. Do you try to get close to the edge to show what a great driver you are, to highlight that there's another six inches of space that you can utilize, or do you stay as far away from the cliff as you possibly can? I think the answer to that is obvious.

Similarly, I think the prudent thing for US policymakers to do is to be disciplined in our fiscal policies and not run those risks. If you press me would I think that those policies would imminently destabilize the dollar? Probably not in the next decade. But at some point further debt accumulation is going to be a risk to the dollar and the economy more broadly.

Audience Question: How much of a role has the strong US dollar played a role in boosting US consumer spending last year, and do you think the dollar will continue to be a key driver for consumer spending?

Nathan Sheets: I haven't done a careful analytical study of that. But what we can say is a stronger dollar will tend to make imports cheaper, and support consumption. It should, importantly, also support investment, but we certainly haven't seen that. I think the fact that, to put it bluntly, we can get a lot of cheap goods from China, and many other countries abroad, has been an important supporter of consumer spending through this post-crisis period. But I think it's one of many. If I had to rank it, I'd say the strong labor market is much more important, the solid growth of wages we're seeing is more important, and the level of the dollar would be down the list.

Sara Johnson: Let me just ask one more question on China. There's been speculation that global supply chains will become less concentrated in China in the wake of the coronavirus, tariffs, and I'd add, rising relative labor costs in China and diminishing supply. If so, what are the implications for China's economy and its exchange rate?

David Dollar: I think global value chains are more regional than global. There's an Asian hub centered on China, a European hub centered on Germany, a North American hub centered on the US. Of course, a lot of what's produced in the Asian hub gets sold in the United States. I think the most important issue in the question is that wages and other costs have been rising in China. We already see some reallocation of value chains. Some of the more labor-intensive final assemblies have moved to Vietnam and Indonesia. That was already happening, and then the trade war accelerated that. The US imported less from China last year, but we imported more from Vietnam, Indonesia, and Mexico. We didn't import less overall, we imported more overall. This kind of bilateral conflict didn't have a measurable effect on the overall US trade balance, but it encouraged that movement.

But remember everybody pretty much is small compared to China, except for the United States. But I would argue that our cost structure is so different we're not really competing with China in most activities. When firms get worried about costs in China, now they're of course worried about the virus, they're worried about the US/China trade war, they are incentivized to move some of their production to other Asian countries. But I think there's a limit to how far that can go just because China is so much bigger than everybody else. I also think a lesson from the virus is that there's a lot of auto production concentrated in Wuhan. I would speculate that some of the auto companies would be thinking of diversification within China to prevent this kind of shock from happening in the future. There's a lot of potential for diversification within China. They produce 25 percent of the world's manufacturing value added. I'd be very surprised if we're not looking at a similar number ten years from now.

David Dollar is a senior fellow in the John L. Thornton China Center at the Brookings Institution and host of the Brookings trade podcast, *Dollar & Sense*. He is a leading expert on China's economy and U.S.–China economic relations. From 2009 to 2013, he was the U.S. Treasury's economic and financial emissary to China, based in Beijing, facilitating the macroeconomic and financial policy dialogue between the United States and China. Prior to joining Treasury, he worked 20 years for the World Bank, serving as country director for China and Mongolia, based in Beijing (2004–2009). His other World Bank assignments focused on Asian economies, including South Korea, Vietnam, Cambodia, Thailand, Bangladesh, and India. He also worked in the World Bank's research department. His publications focus on economic reform in China, globalization, and economic growth. He also taught economics at the University of California Los Angeles, during which time he spent a semester in Beijing at the Graduate School of the Chinese Academy of Social Sciences in 1986. He has a doctorate in economics from New York University and a bachelor's in Chinese history and language from Dartmouth College.

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