Speech

Remarks given by Mark Sobel, US chairman, OMFIF at an OMFIF round table in London, 30 January 2019

US international financial diplomacy - past, present, future

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*I thank David Marsh, Harold James, Stephanie Segal and Jim Haley for many excellent comments.

I have long been exhorted by David Marsh to speak on post-second world war US international financial diplomacy – the past, present and future. Today, I will do so, drawing heavily from my career.

From its founding through the Great Depression, the US was largely an inward-looking country.

Pearl Harbor and the second world war shattered America's introversion. The US economy was already the world's largest. US leaders knew America would arise from the war as the global hegemon. They knew the next existential challenge came from the Soviet Union.

Rather than retreat, US leaders built alliances and bound allies into an institutionalised rules-based order. Their vision was bold. At the end of the first world war, the victors drained the losers' lifeblood, sowing the seeds for the ruinous inter-war era and 1939-45. In contrast, at the end of the second world war, along with Nato, the US created the International Monetary Fund, World Bank and GATT to help rebuild Europe and provided massive assistance through the Marshall Plan. Alliances, monetary co-operation, liberal trade and strong economies were seen as containing the Soviet Union, bringing countries together, and avoiding reversion to the harmful beggar-thy-neighbour and competitive depreciation policies of the Depression.

THE PAST

In the following 70 years, Americans stood behind this remarkable vision of an open, rules-based order in which US support for and leadership in international financial institutions (IFIs) promoted shared prosperity and security.

But as other economies strengthened, new technologies emerged, globalisation increasingly impacted our shores, inequality grew and real income gains slowed, hesitations emerged among swathes of the public and Congress. America also increasingly became reluctant to pay for its international vision.

Post-second world war US international financial diplomacy was often about managing the tension between the internationalist vision and the changing economic landscape to maintain support for openness and multilateralism. Let me discuss three past dimensions of these tensions from my career – first, our efforts to promote a stronger global economy; second, steering the Gs and IFIs and. third, mobilising financing for these IFIs.

First, US financial diplomats dedicated enormous energy to promoting a stronger global economy, fighting harmful currency practices, and thus seeking to stave off protectionism at home.

I sometimes wonder if foreigners were perplexed that US international financial diplomats complained about the asymmetric bias of the international monetary system? After all, the bias is that deficit countries are forced to adjust rather than surplus nations, whereas the US can readily finance deficits. We give the world pieces of green paper, and get Mercedes.

Foreigners complain about the dollar's 'exorbitant privilege'. US financial diplomats recognise the benefits from the dollar's global role. But our large external deficits are partly seen as resulting from the dollar's reserve role, the world's desire to export to the US and mercantilist economic and currency practices by some. In short, there is a privilege, but there is also the dollar's 'indestructible curse'. That fuelled perceptions that America was unfairly bearing excessive burdens, leading to protectionist pressures at home that US financial diplomats constantly fought to ward off.

A few examples from my career.

In late 1979, Fed Chair Paul Volcker engineered a massive tightening of liquidity to wring out persistent inflation. But in the early 1980s, President Reagan adopted a supply-side tax cut and ramped up military spending. A bloated budget deficit emerged. The mix of tight monetary policy and expansionary fiscal policy further sent interest rates soaring. Recession ensued. Unsurprisingly, the dollar appreciated sharply, and the trade deficit rose. Soon the Midwest became known as the 'Rust Belt'.

With enormous protectionist pressure mounting, Secretary James Baker launched the Plaza Accord in 1985 to weaken the dollar. Plaza is seen as a heyday in international economic policy coordination. I'm sceptical about that. Serious protectionism was averted. The pressures did result in the 1988 Omnibus Trade and Competitiveness Act, compelling Treasury to write the semi-annual Foreign Exchange Reports. But Baker shot the exchange rate messenger. Despite hullabaloo about strengthening fundamentals to support currency actions, significant US budgetary deficits remained entrenched. European officials blamed the US for creating the mess. Still, fearing protectionism and given US dominance, the G5 had little choice but to go along.

Prior to the Global Financial Crisis (GFC), China's current account soared towards 10% of GDP, with the renminbi essentially pegged to the dollar amid massive reserve accumulation. Protectionist forces resurfaced with vengeance, epitomised by the Schumer-Graham bill, which would have slapped a 27.5% tariff on Chinese goods entering America. We undertook massive bilateral efforts – with success -- to engage China to appreciate the renminbi. Our efforts to gain European and IMF backing were far less successful as Europe saw opportunities in China and the Fund wouldn't fulfil its mandate to avoid upsetting the new kid on the block. But many American manufacturers were hollowed out. US financial diplomats were derided as Panda-huggers and for condoning currency manipulation. The legacy of this era is still reflected in current US political discourse, even as China's current account disappeared.

In the run up to the GFC, US officials felt the world's reliance on America as the engine of global growth was excessive and harmful. US authorities recognised their regulatory failings as a major crisis factor, but also believed that global imbalances were a cause. The saving glut pushed the US yield curve down, fuelling excess borrowing. Heavy reserve accumulation distorted currency markets.

In 2009, at the G20 Pittsburgh Summit, the US tabled a vision of 'Strong, Sustainable and Balanced' global growth. We argued that if US national saving rose in the post-crisis world, cutting our imbalances and reducing the chances of future crises, surplus countries needed to boost domestic demand. Otherwise, global growth would fall. The world agreed.

But by mid-2010, it was business as usual. Fiscal consolidation was strongly pushed by Berlin, and Canada, Australia and the IMF, even though the world was just climbing out of crisis. A new UK Tory government joined Germany in that endeavour.

Germany's post-crisis current account surplus surged. Germany and China teamed up at the G20 2010 Seoul Summit to derail efforts to focus more squarely on global imbalances.

Germany argued its surplus was a sign of virtue. Deficit countries should follow Teutonic discipline. Indeed, deficit countries needed to strengthen their performance. But the Schwarze Null imposed demand compression on the euro-area periphery, worsening a deep crisis and weakening global recovery. The IMF barely found its voice, perhaps because in its heart it has never seen an austere fiscal policy it didn't like.

Japanese currency practices – both jawboning and actual intervention – often gave rise to protectionist pressures. Japan expanded QE as the Abe administration came to power in early 2013. Predictably, the yen weakened. We understood Japan's desire to enhance QE. But many Japanese officials publicly cited yen depreciation as the main channel to spur inflation and growth. Detroit automakers and Congress screamed. A February 2013 G7 statement followed, noting that macro policy should be oriented toward achieving domestic objectives using domestic instruments, and exchange rates should not be targeted. Read differently, Japan should be quiet about the yen in pursuing QE. We inserted similar language into G20 communiques.

The EM currency war – that America pursued QE to weaken the dollar -- was a phony war. EMs often blame US monetary policy for capital flow volatility. Indeed, there are spillovers, but many studies show that US monetary policy explains only a small part of the volatility. When the US cuts rates, EMs complain about inflows and currency appreciation; when the US hikes they complain about outflows. US QE was directed at supporting US growth, a positive for the world economy. No EM ever complained about increased exports to America.

On balance, past US diplomatic efforts to promote a stronger world economy had mixed results, though protectionism was largely kept at bay. Our analyses of others' adjustment needs were often valid – there has been too much reliance on US demand, and currency practices at times have been unholy. But given at times poor US fiscal policies and political stalemates at home, we did not take sufficient responsibility for ourselves.

A second dimension of our diplomacy was working with the Gs – 5, 7 and 20 – and IFIs, especially the IMF, to support US interests and shape the system. On this front, we led – mainly with our ideas -- and were successful. Successive Administrations saw the IMF as the world's first responder, and the Treasury worked tirelessly to shape the Fund's response to crises. Books have been written on these topics.

US administrations exerted strong influence in the G7 and IMF in developing the macroeconomic response to Mexican crises of the 1980s and 1990s; putting the Fund in the driver's seat on reform and finance to the ex-Soviet states; providing exceptional access in the Asia crisis; helping emerging market countries grapple with the GFC's fallout; and keeping the IMF involved in the earlier stages of the European crisis.

Whatever sins America committed in allowing the GFC to erupt, we responded vigorously at home and internationally. We led the G20 in developing global financial sector reforms at the 2008 Washington Summit; working with the UK – both with Prime Minister Brown and his office, as well as Her Majesty's Treasury -- to mobilise massive resources at the 2009 London summit to halt a sudden stop in emerging markets and bolster advanced economies; and altering global governance by bringing emerging markets into the fold, including making the G20 the premier forum for global economic co-operation.

A third dimension was our struggles to mobilise financing for the IFIs. These struggles impeded our leadership, impelling creative thinking about what us bureaucrats called 'OPM' – 'other people's money'.

Aside from humanitarian support, Americans often see foreign aid as simply a waste of money on corrupt countries. We thus had to look increasingly to IFI finance.

With the fall of the Iron Curtain and collapse of the Soviet Union, the US had won the Cold War, leading many to believe America's global footprint could be lessened – the 'peace dividend'. The Bush and Clinton Administrations looked to the IMF to lead transitional reform and finance. Notably, whereas after the second world war the US offered the Marshall plan, following the collapse of the USSR there was no significant ramping up of economic aid. It took the Bush Administration two years to secure Congressional funding for an IMF quota increase.

The Clinton Team turned to the IMF to tackle the late 1990s Asian and emerging market crises. The US, while rebutting the proposed Asian Monetary Fund as weakening the IMF's central global role, was unable to provide balance of payments co-financing alongside Asia. Beyond congressionally approved funding, the only vehicle for doing so, the Exchange Stabilization Fund, was hobbled by Republican hostility after its use to contain Mexico's Tequila crisis.

We were able to put through a large increase in resources for the IMF in the middle of the GFC, but at political cost. The effort to secure legislation to implement the 2010 IMF quota package was a multi-year ordeal, realised in late 2015. Congress again treated the IMF as a political pawn. With Republicans controlling Congress and a Democrat in the White House, the politics were ugly, with complaints about the IMF fomenting moral hazard and bail-outs and being improperly involved in European programmes.

PRESENT

Which brings us to the present. To proponents of America's post-second world war vision, the Administration's deprecations of multilateralism are a depressing attack on core American values. Trump's America First message of economic nationalism, protectionism, and non-intervention is a throwback to the isolationism of the 1930s. It shatters global confidence in America.

But one cannot simply dismiss what Trump represents in the hope political change is around the corner. Abstracting from the gratuitous vitriol, aspects of Trump's beliefs tap into long evident societal crosscurrents.

The Bush team had a rocky relationship with allies, though not on fiscal issues. The Obama team defended openness and multilateralism. But many Democrats voiced scepticism about free trade and America's global footprint. Obama fretted about Chinese currency practices and took a dim view of rising Chinese state capitalism. Coinciding with the crisis and its aftermath, the Obama years were marked by growing worker anxiety over stagnating real incomes.

Still, the Trump administration's approach to financial diplomacy is fundamentally a break with the past.

The administration's recourse to protectionism, including unilaterally abandoning TPP, antipathy to the WTO, and imposition of tariffs, let alone with spurious national security justifications, seriously harms America's stature and the foundations of the post-war order. International financial diplomacy cannot be separated from this recklessness.

Treasury secretaries in the Bush and Obama administrations dedicated enormous energy to sustaining strategic economic dialogue with China on economic reform and managing currency and trade issues. They were not starry-eyed, but rather felt engagement over confrontation was the better path to progress with the world's No 2 economic power.

The Trump administration is justified in challenging China for its violations of intellectual property rights, wholesale subsidisation and industrial policy and forced technology transfer. But rather than engagement, it has sought to confront and contain China. Having abandoned TPP and alienated America's friends, Trump's team is unable to build an alliance to limit China's harmful practices and must rely on America's still considerable unilateralist powers.

President Xi is far more statist than his predecessor, adding to the relationship's complexity. The AIIB and Belt and Road Initiative can be seen as an effort to build a more Chinese-centric order. While the AIIB has sought to meet IFI standards for procurement and the like, the BRI has not. The BRI instead is associated with China's geopolitical ambitions and has often given rise to corruption and destabilising debt problems among recipients. The US administration has rightly focused on enhancing the transparency of Chinese BRI lending practices. But it should do so to gain China's commitment to embrace accepted norms, such as debt sustainability and join the Paris Club of official creditors, not geopolitical containment.

In contrast with two decades of US financial diplomacy, the Trump administration has spoken publicly about the dollar. Rather than the rote recitation of the 'strong dollar' mantra, it has in essence sought to weaken the dollar. This will embolden others to talk down their currencies, a practice that has stoked past problems.

It has done so while running an imbalanced policy mix akin to the early Reagan years. With Fed tightening and a growing US economy, fiscal policy should be oriented toward gradual consolidation. Instead, the Administration's tax cuts have further put fiscal policy on an unsustainable course, which will hobble America's future.

As before Plaza, pro-cyclical fiscal policy is underpinning higher rates and a stronger dollar. Rather than acknowledge the imbalanced mix and dollar's generalised appreciation, the administration errantly focuses on bilateral deficits and makes unfounded claims about Chinese currency manipulation. The Administration's attacks on the Federal Reserve, a hallowed institution, also fly in the face of central bank independence, which is now considered global best practice. Like the Obama Administration, the Trump team is fully justified in singling out Germany's excessive surpluses.

The IMF has largely flown under the radar screen, notwithstanding hostile administration rhetoric toward IFIs. On balance, this is probably for the better. The administration did strongly back the Fund's Argentina programme. But opposition to a quota deal, even a modest one, will further weaken America's role in the IMF and encourage more regionalism by Asia.

How the administration handles the World Bank succession of Jim Kim will also influence America's standing in the world.

Similarly, while Treasury often mobilised the G7 to guide the IMF in tackling past crises, the G7 is now much less of a steering group, even if it still plays a useful informal role on such issues as cyber security. Our European partners in the G7 face a period of introversion with Italian and French populism on the rise and leadership transition in Germany. So does the UK as it grapples with Brexit, which will weaken the UK economy, marginalise the UK's global standing and eviscerate the UK's helpful role to America as a voice for liberalism within the EU. Trump's behaviour at the 2018 G7 Summit will long reverberate to America's detriment.

The G20, while a useful convening forum, is too cumbersome a vehicle for crisis management, though it remains a useful venue for engagement and providing an umbrella for important technical work. Meanwhile, Treasury has disengaged from the G20 finance process and its efforts to promote a more balanced global economy, while decrying that very imbalance. With its heavy focus on trade, the US appears inattentive to key global risks such as the overleveraged Chinese economy or Italy's fiscal woes. In its quest for rollback, deregulation and streamlining international interactions, the administration's interest in global financial regulation and macroprudential work has been tepid.

The administration has been pro-active in raising the profile of national security investment screening and broadening coverage of the scope of FDI in a world of greater high-tech competition. This is a global trend.

It has also shown keen interest in applying financial sanctions. But rather than upholding a generally multilateralist posture, the Administration's leanings have been at times more unilateralist. This was evident in the abandonment of the Joint Comprehensive Program of Action with Iran. This decision weakened trust in America and gave rise to a chorus about liberating the world from dollar dominance. Its recent actions on Venezuela with our traditional allies are to be welcomed.

FUTURE

What will the future bode – will the US return to liberalism because Trump is an aberration; or will the US stay on a Trumpian course? Will the US and China cooperate or devolve into tension and confrontation? Or perhaps, from a clash of the thesis of the past and the antithesis of the present, is a future synthesis in the making?

Many Americans still strongly back the US post-war global vision. American firms are at the cutting edge of technological advancement. America remains the world's largest economy, at least for a while. Dollar dominance is not going away anytime soon, even if maligned. There will be times, such as currently on Venezuela, when working closely with our allies will be imperative.

Trump is a break from America's post-war traditions, but, putting to the side his inimitable ways of expression, perhaps not the shockingly wholesale departure from the recent past as many assert. Many Americans fret about their economic futures in the face of technological change and globalisation. Our nation's political class is mired in stalemate, unable to muster the leadership to run responsible fiscal policies and tackle looming challenges – such as the environment and entitlements. We are not keeping our house in order. In the decades following the second world war, the US dealt with like-minded G7 colleagues. Now, we increasingly deal with an ascendant China, while our G7 allies are preoccupied with travails at home. Our future relationship with China may be a la carte – we will cooperate here where feasible, and I believe we can cooperate on many financial issues, and tension will prevail elsewhere, such as technology and defence.

The crisis fall-out, lower global growth, high unemployment, real income stagnation, growing inequality and a changing order germinate the seeds of populism and despair, which now envelop the US and Europe and weaken US support for internationalism.

A future America with changed leadership is likely to return a good way toward more traditional values on international financial co-operation. Surely, we can only do a better job working closely with our allies than the current administration. But no matter how global American firms and society are, the post-war paradigm in some ways may be fading into the past. Belief in the fruits of multilateral co-operation has weakened. America may be hesitant about its seat at the international financial table if it means needing to pay to play. Trump has in all likelihood done lasting damage to the world's trust in the US. One cannot lead if others don't follow. Other nations too must manage complex domestic politics; they have far less patience with US administrations.

The need for international financial co-operation will be all the more pressing and challenging amid a fragmented and corroded world order with flagging US leadership. The world's financial diplomats, let alone America's, face a very bumpy and uncertain road.