THE BROOKINGS INSTITUTION
Dollar and Sense Podcast
Janet Yellen on monetary policy, currencies, and manipulation
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DOLLAR: Hi I'm David Dollar, host of The Brookings trade podcast, “Dollar and Sense.” My guest today is Janet Yellen, doesn't need much of an introduction. Many, many years in the Fed, as president of San Francisco Fed, vice chair and then chair of the Federal Reserve Board, and now a distinguished senior fellow at Brookings. So welcome Janet.

YELLEN: Thanks David, it's nice to be with you today.

DOLLAR: Our topic is going to be currencies and how currencies relate to international trade. A lot of concern about currency values and sometimes we hear accusations of currency manipulation. So just want to start with a general question: In your long career in the Fed how did you think about currency manipulation, is this an important issue is this less important, did it grow in value or importance over time, how do you think about it?

YELLEN: Great question. Well currency values are controversial in trade discussions and that's because movements and exchange rates have a big effect on import and export prices and flows, and a country's overall trade balance. They're controversial more generally because exchange rates have a wide variety of significant impacts. Movements in exchange rates affect the rate of inflation that sometimes necessitates shifts in monetary policy in other countries. When a country has dollar denominated liabilities such as debt and the non-financial sector, depreciation of the domestic currency raises the burden of that debt. Strengthening the dollar vis a vis, many countries also tends to put downward pressure on oil and other commodity prices, and that has significant effects on commodity exporters and consumers.

Currency manipulation is not something I think is easy to define. The best definition I would offer, and I think this is the definition generally agreed by the G7, is that it's policies, particularly direct intervention, in foreign exchange markets that's deliberately intended to alter currency values to affect a country's competitive position and its trade flows. It's really difficult and treacherous to define this though because it's generally agreed, I think internationally, that countries should be allowed to use key macroeconomic policy levers, particularly monetary and fiscal policy, to achieve domestic policy goals. I'm thinking about price stability and full employment. But for example, monetary policy does have a systematic effect on a country's exchange rate and, nevertheless, I think it's widely agreed that it should be available to be used for domestic purposes so we would want to be careful not to define domestic policy tools as currency manipulation.

During my time at the Fed, exchange rate movements, often occasioned by shifts in monetary policy, were a concern in the G20. And we heard frequent accusations that the U.S. was initiating currency wars. I particularly remember the international reaction that we got when the Fed in 2010, in November of 2010, we undertook a large-scale asset purchase program known as QE2—600 billion of asset purchases—to try to stimulate the U.S. economy. There was great concern, especially among emerging markets, that we were essentially flooding the world with liquidity which would have effects on those countries. Another of putting it is that we were trying to push down U.S. long term interest rates—and that could trigger capital outflows that would cause the dollar to depreciate, put upward pressure on other currencies, particularly emerging market currencies, and many policy makers in emerging markets were concerned about these capital inflows particularly because they could reverse and become a source of significant downward pressure on their currencies later.

They also worried that with currency appreciation taking place and lower interest rates, that would touch off unsustainable and dangerous financial sector credit expansion that later could become a source of danger to those economies. They also worried that they had limited tools to discourage these capital inflows — and we in the Fed were sensitive to these concerns. When we when we heard arguments that U.S. monetary policy routinely has negative spillovers on other countries, we often countered that that's something I don't generally agree with because, although downward pressure on the dollar an appreciation of those currencies may in and of itself have negative consequences for those currencies, it also tends to strengthen the U.S. economy, and stronger U.S. growth promotes stronger growth throughout the world. So generally, I don't see U.S. monetary policy as a negative for other countries, but it does have a variety of effects that are of concern.

Later on, of course, rather than easing policy we began a program of normalizing U.S. policy and our trade partners, particularly in emerging markets, worried that as we look to begin raising rates or shrinking our balance sheet that that would trigger capital outflows and depreciation of their currencies. In 2013, my colleague, Ben Bernanke, initiated a discussion of the Fed's plans to begin not shrinking our balance sheet, but just diminishing the pace of our purchases of long-term treasuries and mortgage backed securities and that triggered an episode known as the taper tantrum. U.S. long-term rates rose over 100 basis points in the following months. Higher rates in the United States triggered massive capital outflows from emerging markets. Some of the countries with greater vulnerabilities really experienced significant difficulties and so that did become a concern.

When I became chair, I heard the concerns loud and clear of emerging markets that they were worried about our normalization plans and I pledged to at least try to communicate as clearly as I could to avoid sharp market reactions to surprises.

Now, I've talked a lot about foreign concerns about the U.S. and our impacts—particularly in the Fed on exchange rates—but it's not the case that concerns have always been confined to U.S. policies and their impacts on the dollar. As you know, David, for a very long time the U.S. was concerned about Chinese intervention in the foreign exchange market to hold down the value of the wand to stimulate growth and large current account surpluses. And we did view that as currency manipulation, and perhaps that does meet a reasonable test.

More recently though, of course, the United States became concerned about downward pressure on the Chinese currency. Around 2015, China had been pegging its exchange rate for some years to the dollar. The dollar began massively appreciating in mid-2014 which pushed up the value of China's currency against a broad basket of currencies, and China decided to try to offset part of that by devaluing its currency in the summer of 2015. And that touched off a big period of disruption in global financial markets.

And so, we've had concern more recently about China's policies towards its exchange rate, and we've had concerns about Japan as well. During that same period in 2015-2016, the yen began to appreciate. Of course, Japan's long had a problem with deflation and trying to achieve an inflation goal and it looked like Japan was poised to undertake direct intervention to push down the yen. And this was a source of tension with the U.S.

DOLLAR: Right, so that's a fascinating insight into how the Fed is looking at policies of other partners, monetary exchange rate policies, and how the policies of those countries react back on the U.S. economy. I’d like the follow up and ask a little bit more about China, which is the most important emerging market. I know you've been to China many times.

YELLEN: Yes.

DOLLAR: When I was representing the U.S. Treasury in Beijing, I had the privilege of organizing logistics for a few of your visits and sat in on some of the meetings, and always interesting to watch the the Fed leaders come to China. So, I like to hear a little bit from you about the Fed's relationship with particularly the Central Bank of China, PBOC, but the Chinese financial regulators more generally.

YELLEN: Well the Federal Reserve has had very close and cordial relations with China's central bank, the PBOC, and also with financial regulators in China, the banking regulators and the security regulators, senior officials, and as you mentioned we visited regularly back and forth with our colleagues. We met routinely with Governors Zhou, Yi Gang, and other top PBOC officials. And that occurred in one on one visits, but also in a variety of international venues, particularly in Basel, where the leading central bank governors meet around six times a year. And that is a format for very rich discussion and exchange of views.

There are also many formal and informal meetings, around G20 meetings…meetings of the IMF and World Bank. We tried at the Fed to have a deep and serious relationship with the Chinese, particularly with the PBOC. We sponsored joint conferences [and] had regular personal exchanges. Our meetings were not tense. We sought to understand economic developments in China, and Chinese policy and to explain how we saw the U.S. outlook evolving in monetary policy strategy. We certainly discussed regulatory issues., We discussed financial market developments. Occasionally we had concerns as in 2015, but I would not describe our relationships as in any way contentious or tense.

DOLLAR: You mentioned that the Fed action got some criticism, particularly from emerging markets, and listening to you it strikes me as ironic that when you started the quantitative easing you got criticized.

YELLEN: Yes.

DOLLAR: And then when you move to end the quantitative easing, you got criticized by a lot of the same officials.

YELLEN: Well, countries tend neither to like large appreciations nor depreciations in their exchange rates and so it turns out on either side the spillovers can be unwanted.

DOLLAR: So, a lot of these developing world officials expressed the view that they think the Fed should take their interest more into account. So, I'd like to ask you just from a statutory point of view, I'm guessing that that's not really feasible—but how would you respond to officials who would like to see the Fed take emerging economy interests more into account in setting Fed policy? [The] Fed's basically making monetary policy for the whole world.

YELLEN: Well, there is a sense in which, as I indicated, Fed policy does have repercussions around the world. And I heard many foreign policy makers express concern and indicate that the Fed should think of itself and try to take all of those repercussions into account and do what was in the best interest of the global economy rather than the U.S. The problem is that the Federal Reserve's mandate comes from Congress, and that mandate is to pursue U.S. objectives of price stability and maximum employment. And I don't think that Congress would regard it as acceptable for the Fed to indicate it had undertaken an action for the benefit of other countries that harmed domestic interests.

That said, the Fed recognizes that its own policies do have international spillovers, and, in turn because they affect global performance, they are going to have spillbacks to U.S. economic performance and it's necessary to take those into account. More generally, it's necessary to take global economic developments into account.

I still remember back in 1998, during the Asian financial crisis, Alan Greenspan argued for an interest rate cut in spite of the fact that the U.S. economy was doing very well. And, in justifying it, he said “it's just not credible that the United States can remain an oasis of prosperity unaffected by a world that is experiencing greatly increased stress.” And I think that remains as true today as it was then.

So, we are part of an integrated global economy. What happens outside our borders affects the United States, it affects monetary policy, and it's also recognized that U.S. monetary policy, to the extent that it affects the global economy, then has spill backs to the U.S. and it's important to take those into account.

More generally, the Federal Reserve has at many times in different ways justified supporting foreign economic policy and argued that it is broadly in the U.S. interest. I'm thinking particularly about the financial crisis. Major central banks coordinated a rare interest rate cut. We felt that it would increase global confidence and stimulate faster recovery. We activated Fed swap lines with a number of other countries to provide liquidity to banks engaged in dollar-based finance around the world. There have been many occasions also in which global developments including impacts that are directly attributable to U.S. monetary policy and have had repercussions back on the U.S. that have affected the stance of policy.

You know I think even if you look at what's happening now, global economic developments have played a role in encouraging the Federal Reserve to moderate its interest rate stance and take a wait-and-see-approach. And part of that set of developments, global developments, is impacts of monetary tightening that's occurring in the United States.

DOLLAR: Right, it seems to me that 2015-2016 as a good example of this kind of feedback process.

YELLEN: Yes.

DOLLAR: As we started 2015, there was an expectation of a series of Fed hikes, but that's when we started getting these large capital outflows from China—over five quarters about a trillion dollars net capital outflow from China raising the specter of possibly a large depreciation—and it seemed the Fed paused and that seems like a good example of this kind of realistic feedback.

YELLEN: Well, I agree with you, and I think it's a great example. It's the best one I can think of why these feedbacks matter. The Fed ended up in 2015-16 raising interest rates by much less than they anticipated at the beginning of 2015. And conspiracy theorists often speculated that there actually been a secret handshake agreement which referred to is the Shanghai accord.

China hosted the G20 in 2016. In February they hosted a meeting in Shanghai, and people judged when they saw what happened after that, that perhaps there had been some secret accord that involved China changing its exchange rate policy in return for the U.S. easing off on monetary policy.

Now, let me quickly say there was no Shanghai Accord if that's interpreted to mean an explicit agreement or some secret handshake deal. There were meetings in Shanghai, macro developments were discussed, exchange rate developments, but there was certainly no secret agreement. Let me just try to set out what actually happened. What happened was that the U.S. had been recovering very smartly in 2015. Most people at the Fed and the Federal Open Market Committee began the year 2015 expecting to start raising interest rates in the second half of the year. But in the summer, in August, China devalued the Renminbi and global financial markets became quite turbulent. There were fears that there would be further devaluations coming later. Stock prices fell, credit spreads rose, financial conditions generally tightened, and weak global growth became a big concern for Fed policy. We decided to pass on an interest rate increase since September that I think earlier in the summer most of us would have thought would most likely take place.

We proceeded to actually move for the first time in seven years. We raised our short-term interest rate in December, but shortly after that move there was another period of turbulence in early 2016. And again, it was partly related to Chinese exchange rate developments, the fear that the Chinese currency might be more significantly devalued. China had been suffering significant reserve losses. It was intervening heavily at that time to prevent the decline in the Renminbi, and these fears again led to financial conditions tightening—not only globally but also in the U.S.—downward pressure on commodity prices, and all of this presented a real shift in the U.S. outlook.

We ended up in the Fed marking down the U.S. outlook and reaching the conclusion that the drags from abroad, and partly drags generated by widespread expectations that the Fed would be tightening policy, we concluded that these spill backs were significant enough that we really couldn't go through with what looked like a plan or an expectation in December of 2015 that we should raise interest rates four times. By March, the median view in the committee was that two increases were appropriate, and the way things worked out we only ended up in 2016 raising rates once.

So, I think this is a good example of the ways in which U.S. monetary policy affects other countries and affects their policies, and, in turn, causes readjustments in thinking in the U.S. So, we ended up taking global considerations into account and it was quite justified by repercussions for the U.S. outlook.

DOLLAR: That's a great story. I know you are always a big advocate of data driven decision making and clear communication, and that's a really nice example.

YELLEN: Thanks.

DOLLAR: For our last topic, I want to shift gears and ask you—I know you've been one of the leaders of an effort to promote a carbon tax, an effort among liberal and conservative economists—so I'd like to ask you a little bit about that. It may seem unrelated to trade, but then I have a quick follow up on the relationship to trade. But perhaps, first, just what's the plan for this carbon tax?

YELLEN: So, I've been involved in a bipartisan climate change initiative and have taken the lead in developing an economist's statement on climate change. We support what we call a climate dividends plan. Everyone who signed this statement, it includes now 27 Nobel Prize winning economists, all four living Fed chairs, 15 chairs of the Council of Economic Advisers, and two former Treasury secretaries. I think we're up to about 3,500 economist signatures. So, we all believe that global climate change is a serious problem that calls for immediate national action, and what we support is a carbon tax because we see it as the most efficient means to counter a negative environmental externality. It would be a tax imposed upstream at the source of these emissions on all sources of carbon emissions – coal, natural gas, oil – when either they entered the country or are sold. In contrast to cap and trade schemes that are sometimes discussed, this would discourage all forms of emissions.

I think the plan would likely be to start around 40 dollars a ton and to increase the tax more rapidly than the rate of inflation over time until emissions goals are achieved. And we see this increasing carbon tax over time is encouraging technological innovation and encouraging infrastructure development.

I think a sufficiently robust and gradually rising carbon tax would replace the need for various carbon regulations that are less efficient, and because of that potential to put in place a carbon tax and get rid of some cumbersome regulations, many of the leading oil companies have signed on and agreed to the statement. So, Republicans, Democrats, also major businesses including oil companies. But importantly, we propose that to maximize the fairness and political viability of a rising carbon tax, that the revenue should all be returned directly to U.S. citizens through equal lump sum rebates. And the majority of American families, including the lower part of the income distribution, would benefit financially by receiving more in carbon dividends than they would pay for increased energy prices. Initially, the carbon dividend would amount to something like 2,000 dollars for a family of four, so it's quite significant. So, that is essentially the plan, and it's received widespread and bipartisan support.

DOLLAR: So that last element is very important. In France they have this fuel tax – that's what has the Yellow Vests out there protesting. If you only have the tax it's regressive.

YELLEN: That’s right.

DOLLAR: But the redistribution is progressive?

YELLEN: The redistribution is certainly progressive. It’s actually been analyzed in a study by the Treasury Department, and essentially the bottom 70 percent... the analysis suggests that most people, you know, of course, an individual who has unusually high energy expenses wouldn't benefit, but on average the bottom 70 percent of the income distribution would benefit from the redistribution.

DOLLAR: Right, so, last question, we bring it back to international trade. If the U.S. followed this kind of policy and any of our important partners did not, there's a risk that carbon intensive industries would shift to those locations. we'd end up importing, and that would actually counteract the effect of this kind of policy. So, what can we do on the trade side?

YELLEN: Yes, so that is absolutely a significant concern. We would be quite worried that imposing a carbon tax would drive production of energy intensive goods offshore and then encourage new investment in places with less ambitious climate policies.

So, our proposal involves a border carbon adjustment system. We would impose a tax on goods entering the country from localities with less ambitious climate change policies or lower carbon taxes. So, this would offset the environmental loss that would come from shifting production to places that generate more greenhouse gas emissions. It would also level the playing field competitively, and we think that a set of border tax adjustments would also encourage other countries to come into compliance and join the club of countries imposing carbon taxes. I guess there is a question as to whether or not such a border adjustment tax would be WTO compatible. As I understand it – I think this is something that would have to be determined – but, as I understand it WTO trade rules do permit countries…would permit countries with carbon taxes to adopt non-discriminating, harmonizing tariffs. I think the case would be similar to the use of border taxes by countries that impose VAT taxes. I suppose this would still have to be determined, but I think one could make a strong case that these would be WTO compatible.

DOLLAR: Well will you make a very sound case I've signed up for this initiative.

YELLEN: Great.

DOLLAR: Congratulations.

YELLEN: Well thanks, David. Appreciate your support.

DOLLAR: Thanks, Janet Yellen. We've had a fascinating discussion about monetary policy, currencies, and then also global climate change and carbon. So, thank you very much.

YELLEN: Thanks for the invitation to join you.

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DOLLAR: Thank you all for listening. We'll be releasing new episodes of Dollar and Sense every other week, so if you haven't already, make sure to subscribe on Apple podcasts, or wherever else you get your podcasts and stay tuned.

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And until next time, I'm David Dollar, and this has been Dollar and Sense.