International finance has come to resemble a morality play, but one mostly featuring government mandarins and assorted knaves, with few heroes to speak of. The moral is ultimately that virtue is not necessarily its own reward; rather, an excess of virtue may be harmful. Do pay careful attention to all the twists and turns in the plot—reality turns out to be stranger than anything the fevered imagination of a playwright could muster.

Let us pick up the plot from not too long ago.

Stage Set for Dollar Collapse

In 2007, the U.S. recorded a third successive year of current account deficits of over $700 billion, roughly equivalent to 5 percent of annual U.S. gross domestic product (GDP). The current account deficit represents the amount a country borrows from abroad to finance its consumption and investment. Fears that foreign investors would stop lending to the U.S., precipitating a plunge in the dollar’s value, were palpable. This was also the year the U.S. housing market began to unravel after a prolonged period of rising housing prices, accentuating fears about prospects for the U.S. economy and the dollar. Financial market bigwigs, prominent academic economists, government officials, the press, and international financial institutions were all warning of a looming dollar collapse.

Jim Rogers, the co-founder of the Quantum Fund with George Soros, was quoted as saying, “If [Federal Reserve Chairman] Ben Bernanke starts running those printing presses even faster than he’s already doing, we are going to have a serious recession. The dollar’s going to collapse,
the bond market’s going to collapse.” Many financial analysts joined the chorus warning of a dollar crisis, with that phrase appearing increasingly frequently in their reports and interviews. An editorial in the leading German magazine Der Spiegel warned of nothing less than an economic Pearl Harbor, noting that “an attack on the US economy is probably the most easily predictable event of the coming years.”

Paul Krugman of Princeton University wrote that “Almost everyone believes that the US current account deficit must eventually end, and that this end will involve dollar depreciation . . . there will at some point have to be a ‘Wile E. Coyote moment’—a point at which expectations are revised, and the dollar drops sharply.” Kenneth Rogoff of Harvard University pointed to “a greatly increased risk of a fast unwinding of the U.S. current account deficit and a serious decline of the dollar. We could finally see the big kahuna hit.” Eisuke Sakakibara, a former top Japanese finance ministry official, warned that a dollar plunge was coming in 2008. The International Monetary Fund (IMF) and the World Bank both sounded the alarm that, if the U.S. did not reduce its reliance on foreign capital, a disorderly decline in the dollar’s value was likely and that there would be devastating consequences worldwide.

The drumbeat of warnings intensified as 2008 dawned. Then, the economic picture in the U.S. took a sharp turn for the worse, and financial markets braced for the dollar crash prophecies to be validated. That is when the drama surrounding the dollar began to diverge from the script.

Act One

In October 2008, U.S. financial markets were reeling. The meltdown of the housing market earlier in the year and the fall of the financial giant Lehman Brothers in September were sending waves of panic through every part of the financial system. The corporate paper market had nearly frozen, the stock market was collapsing, and a major money market fund, the Reserve Primary Fund, had “broken the buck” (its net asset value had fallen below par) and was threatening to take the entire money market down with it. Shock waves from the crisis were reverberating around the world.

Historical precedent made clear what was coming. When other countries have been hit by financial or currency crises, the outcomes have been similar—investors, both domestic and foreign, run for the exits, pull cap-
ital out, and dump the currency. Surely, the financial crisis would not just be a gentle fall from grace but rather the coup de grâce for the dollar’s dominance in global finance.

Then something remarkable happened. A wave of money flooded into the U.S., the very epicenter of the crisis. U.S. investors pulled their capital back home from abroad, while foreign investors in search of a safe haven for their money added to the inflows. From September to December 2008, U.S. securities markets had net capital inflows (inflows minus outflows) of half a trillion dollars, nearly all of it from private investors. This was more than three times the total net inflows into U.S. securities markets in the first eight months of that year. The inflows largely went into government debt securities issued by the U.S. Treasury (finance ministry). In contrast, many other advanced economies, including Germany and Japan, experienced overall net outflows of capital in that period.

The dollar, which should by all rights have plunged in value, instead rose sharply against virtually every other currency. It even rose against other major advanced economy currencies except for the Japanese yen.

Prices of U.S. Treasury securities increased as demand for them soared. As a consequence, interest rates stayed low even after the government instituted a massive fiscal expenditure program to stave off the collapse of financial markets and the economy. This was the opposite of the typical response of interest rates, which tend to rise when the government borrows more to finance its spending. In fact, yields on three-month Treasury bills even turned slightly negative on certain days that December —nervous investors were in effect willing to pay the U.S. government for the privilege of holding those securities.

Act Two

In November 2009, as global financial markets were slowly getting back on their feet, concerns about Greece’s debt situation began to grow. Greek officials admitted that their fiscal books had been cooked and that the country’s government debt amounted to 113 percent of GDP, nearly double the upper limit of 60 percent that euro zone members had agreed to abide by at the time of the euro’s inception a decade earlier. In January 2010, the European Commission issued a scathing report concluding that Greece’s budget deficit for 2009 was likely to be even higher than
the government’s estimate of 12.5 percent of GDP and well over the euro zone limit of 3 percent.

As it became clear that Greece was facing an economic collapse, concerns began to mount about fiscal and banking problems in other economies on the euro zone periphery. Ireland and Portugal were seen as especially vulnerable, and there were even concerns about Spain and Italy. On May 2, 2010, the European Commission, the European Central Bank (ECB), and the IMF agreed to a bailout package for Greece. In November, the Irish government also signed up for a bailout package, and concerns intensified that the other periphery economies of the euro zone might start reneging on their debt and would need bailout packages as well.

Once again, troubles abroad drove money into the U.S. From December 2009 to November 2010, as the debt crisis cascaded across the euro zone and built up to catastrophic proportions, yields on U.S. ten-year Treasury notes fell by more than 1 percentage point, from 3.6 percent per year to 2.5 percent. In the third quarter of 2010, when the euro zone debt crisis seemed in danger of spiraling out of control, the U.S. had net inflows of nearly $180 billion into its securities markets. In the first two quarters of that year, net inflows into those markets had averaged just $15 billion. Foreign private investors accounted for about two-thirds of these net inflows in the third quarter; the remainder was from central banks and other official investors.

Act Three
Even as centrifugal forces were threatening to tear the euro zone apart, there was more drama to come in the U.S. In 2011, political brinksmanship led to a standoff between President Obama’s administration and the Republican-controlled U.S. House of Representatives over the debt ceiling. If the ceiling was not raised, the U.S. Treasury would lose the authority to raise money from financial markets, and the government would essentially run out of money to pay its bills and meet repayment obligations on its debt.

The Treasury Department made it clear that failure to raise the debt ceiling would be devastating and that patchwork solutions like “prioritizing” payments on the national debt above other obligations would not prevent default. It released a document laying out the consequences:
Failing to increase the debt limit would have catastrophic consequences . . . [it] would precipitate another financial crisis and threaten the jobs and savings of everyday Americans . . . it would call into question the full faith and credit of the United States government—a pillar of the global financial system.

The fear of a technical debt default by the U.S. government cast a pall over financial markets as the deadline drew near. Neither side—President Obama or the Republicans—blINKed until the very end. On July 31, 2011, a Sunday, the two parties finally reached an agreement to raise the debt ceiling and trim government expenditures by about $2.4 trillion over the next decade. The agreement was signed into law on August 2, 2011, the day before the government would in principle have hit its borrowing limit. By all counts, this deal was nowhere near enough to tackle the long-term deficit problem.

On August 5, the rating agency Standard & Poor’s (S&P) did the unthinkable—it cut the rating on U.S. government debt from AAA to AA+ and kept the outlook on the long-term rating at “negative.” According to S&P, the safest financial instrument in the world was no longer as safe as it had been thought to be. In a statement accompanying its downgrade, S&P had this to say:

The downgrade reflects our opinion that the fiscal consolidation plan that Congress and the Administration recently agreed to falls short of what, in our view, would be necessary to stabilize the government’s medium-term debt dynamics . . . we believe that the prolonged controversy over raising the statutory debt ceiling and the related fiscal policy debate indicate that further near-term progress containing the growth in public spending, especially on entitlements, or on reaching an agreement on raising revenues is less likely than we previously assumed and will remain a contentious and fitful process.

In other words, the deal had kicked the proverbial can down the road and done nothing to change the trajectory of U.S. debt, which would continue its inexorable rise beyond levels that some economists thought were already too high and unsustainable. The S&P statement then went...
on to excoriate the politics surrounding the debt ceiling and fiscal negotiations:

The political brinksmanship of recent months highlights what we see as America’s governance and policymaking becoming less stable, less effective, and less predictable than what we previously believed.

This action by S&P was expected to be the wake-up call for financial markets. Finally, reason would prevail. The dollar would have its come-uppance and fall in value, the absurdly low interest rates on U.S. government bonds would finally spike up, and capital would flee from the U.S.

Or not. What effect did the ratings downgrade have on U.S. debt markets? The effect was indeed big, only it was exactly the reverse of what had been expected. Yields on ten-year Treasury notes, which should have risen now that U.S. government debt had been deemed riskier, instead fell by 1 full percentage point from July to September of that year. Net capital inflows into U.S. securities markets jumped to nearly $180 billion in August and September, again driven mostly by private inflows. The dollar spiked up in value once more, repeating its pattern over the past decade of falling gradually in normal times and rising sharply in perilous times—even when the peril originated in the U.S. economy.

**Act Four**

The political debate in the U.S. had gotten increasingly rancorous in the lead-up to the presidential elections in 2012. Democrats and Republicans were at loggerheads on economic and social policies, as Barack Obama and Republican nominee Mitt Romney laid out very different (if not very specific) visions of how the country ought to be run. With the economy still sputtering, economic issues dominated the elections.

The biggest concern in financial markets was the gun the U.S. Congress had put to its own head. Unless a budget agreement could be reached by December 31, 2012, a set of automatic tax increases and government expenditure reductions would kick in, holding down the budget deficit but dealing a body blow to the U.S. economy. The estimated size of the fis-
cal contraction—a combination of across-the-board spending cuts and an expiration of the Bush tax cuts—was about $500 billion. If nothing were done, the economy would face a drag of about 4 percent of GDP relative to optimistic forecasts of 2.5 percent GDP growth in 2013. In other words, the economy could be headed for another recession.

The Republicans were hoping to capture the White House, displace the Democrats as the majority party in the Senate, and retain their majority in the House of Representatives. Whatever the outcome, most analysts were betting that rationality would return to the U.S. political scene in the lame duck session of Congress, the period between the elections and the start of the next legislative session. Once the election season was out of the way, surely the bitter partisanship would recede, and both parties would work together to avoid fiscal and financial doom.

On November 5, 2012, the day after the elections, Americans woke up to a political outcome that left the balance of power virtually unchanged. The days wore on and December arrived, with budget negotiations going nowhere as positions on both sides hardened. Emboldened by his new mandate, President Obama indicated there would be no deal without an increase in tax rates for the wealthy. The Republicans referred to the Administration’s proposals as “not serious” and noted that “we’re almost nowhere” in making progress toward a deal. With no resolution in sight, the economy trudged inexorably toward the “fiscal cliff.” Christmas and New Year’s Day came and went with no deal. It was only on January 2, 2013—technically, the day after the economy had gone over the cliff—that a deal was reached.

While these events were playing out in the fall of 2012, stock markets in the U.S. rose and fell, as every surge of optimism that a deal would be reached was almost invariably followed by some other obstruction to a compromise. As for bond markets, however, the yield on ten-year Treasury notes stayed in the narrow range of 1.6–1.9 percent through this entire period. The dollar barely moved against other major currencies. Yields on ten-year notes started to drift back above 2 percent in January 2013, raising concerns that interest rates were now on their way up. But there was little further increase in the ten-year Treasury note yield, leaving it at a far lower level than in any period since the 1960s.
The Drama Goes On

The U.S. fiscal drama continued into 2013, with the budget “sequester” taking effect in March. The sequester took a blunt hatchet to public expenditures, cutting them by about $100 billion per year through 2021 and hurting the tenuous economic recovery. Anticipation of further rounds of the debt ceiling fight raised concerns about continued economic and political gridlock. Through all this, the yield on ten-year U.S. Treasuries remained stable in a narrow range around 2 percent. Even minor increases in interest rates raised concerns about the tide turning and Treasuries falling out of favor with investors. But these panicky reactions to small perturbations have proved to be overhyped.

It is of course unlikely that such low rates will last for long. Indeed, by early September 2013, the yield on ten-year notes was creeping toward 3 percent. Yields on U.S. Treasuries are likely to rise further as economic conditions in the U.S. and the rest of the world normalize. But such increases should be considered in their proper context—relative to the average ten-year bond yield of about 4.5 percent during 2000–2007, the period of the “Great Moderation,” when the U.S. economy was growing at an average rate of roughly 2.6 percent per year and annual inflation averaged 2.8 percent. In other words, even a significant increase in interest rates from their low levels as of mid-2013 might signal a return to normalcy rather than an exodus from U.S. Treasury debt and the dollar.

It is hardly surprising if turmoil in other financial markets causes money to flow into the U.S. in search of safe investments, thus keeping U.S. interest rates low and pushing up the dollar’s value. But, as the episodes described in this chapter have illustrated, the dollar also tends to strengthen even when its home economy gets pounded with financial and fiscal problems.

How did we end up in such a topsy-turvy Bizarro World, where everything seems inverted or backward (as in the American comic series of that name)? How do we make sense of a world in which money flows into the U.S. in search of a safe haven from the fallout of financial market troubles, even if those troubles originate in U.S. financial markets themselves? Therein lies a tale.