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Time for a Plaza II?

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The Plaza-Louvre in Retrospect

The Plaza Accord of September 1985—and its successor Tokyo Summit and Louvre Accord over the following 18 months—represents the high-water mark of international economic policy cooperation and indeed coordination over the entire postwar period.[1] These agreements created a model that has not been replicated during the past 30 years.

Numerous other international efforts have been undertaken to correct current account imbalances and currency disequilibria. They have taken place under both fixed and flexible exchange rates, both before and after the Plaza-Louvre.

A number of emergency meetings of the G-10 sought to resolve sterling crises in the 1960s. The Franco-German imbalance was addressed in 1968–69. Much more prominently, the 1971 Smithsonian Agreement established a new set of parities after the United States suspended the convertibility of the dollar into gold and adopted an import surcharge.

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1. This account of the Plaza-Louvre draws heavily on the definitive study of the period by Yoichi Funabashi (1989). Funabashi interviewed all but one of the ministers and central bank governors who negotiated the agreement (including Secretary James Baker, Assistant Secretary (later Under Secretary) David Mulford, Assistant Secretary Charles Dallara, and Fed Chairman Paul Volcker and his chief lieutenant, Ted Truman) as well as a who's who of other government officials and outside observers.

The Bonn Summit of 1978 broke new ground by implementing quantitative growth targets and energy policy initiatives to remedy international imbalances rather than addressing exchange rates per se. The dollar defense program conducted by the United States in 1978–79 relied heavily on cooperation by a few key surplus countries, especially Germany and Switzerland. The yen/dollar rate was a policy focus for the United States and Japan from the mid-1970s through the mid-1990s, before and after the Plaza-Louvre. Chinese manipulation of the relationship between the renminbi and other currencies, especially the dollar, has been a centerpiece of global concern for most of the last decade.[2]

Achievements of the Plaza-Louvre

Two characteristics distinguish the Plaza-Louvre from these other episodes. First, the Plaza Accord worked. The near-term goal of reducing the value of the dollar by 10–12 percent was achieved on time, with less intervention than countries agreed to (Gyohten 2013). The dollar ultimately fell by about 50 percent against its main targets (the yen and the deutsche mark), with 36 percent of the decline occurring between the Plaza and the Louvre Accords.

One reason for the success was the unique and, to this day, unprecedented degree of dollar overvaluation that clearly had to be corrected (see chapter 8 of this volume). Another was the complete surprise with which the initiative was launched and the shock generated by the lead of the United States, which had intervened very little in the previous five years and had made clear its hostility to the very concept.

The three main current account imbalances—the US deficit and the Japanese and German surpluses—all declined as a share of their respective GDPs by about 50 percent by 1990 (Krugman 1991, 278). The US current account deficit, which had risen to unprecedented heights—peaking at a then-record 3.4 percent of GDP in 1987, as a result of the two-year lag between currency movements and recorded trade outcomes—virtually disappeared by 1991, after prolonged doubts that the currency realignments of 1985–87 would pay off.[3] The acute protectionist pressures in Congress, which had been a major motivation for the Baker Treasury to initiate the process (see below), were largely quelled, and the relatively open world trading system was preserved. Thus the fundamental goals of the Plaza policy were almost totally achieved.[4]

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2. Europe has experienced a series of currency crises as well, most notably the exits from the European Monetary System in 1992 and the flare-ups that have occurred in different forms since the creation of the euro. These crises affected the world economy but were primarily regional. This chapter addresses only issues that involved direct participation by wider groupings of countries.

3. Although the total elimination of the US deficit in 1991 was a one-shot result of payments of about $50 billion, which are treated as "unilateral transfers" in the balance of payments statistics and thus part of the current account, by several Gulf countries to the United States for the First Gulf War. Those payments were largely negotiated by Secretary of State James Baker.

4. Krugman (1991) analyzes the period carefully, concluding that the adjustment worked in almost precisely textbook fashion. His paper summarizes the results of a conference held by the

None of the other postwar international currency initiatives recorded remotely equivalent payoffs.[5] The new parities agreed at the Smithsonian held for only a few months, a new round of realignments was negotiated in early 1973, and generalized floating commenced within a month when they too failed. The Bonn Summit commitments were pursued in good faith, but the Iranian Revolution and second oil shock derailed them in less than a year. The US dollar defense program stopped the currency's free fall, but lasting stabilization (and indeed reversal) occurred only with the fundamental changes in monetary policy implemented by Paul Volcker after he became chairman of the Federal Reserve in 1979. Years of negotiation on the yen/dollar rate failed to appreciably reduce US and Japanese imbalances, aside from the Plaza-Louvre, or to overcome the Japan bashing of that era; only the collapse of the Japanese economy and resurgence of the US economy in the 1990s eventually accomplished the latter (Bergsten, Ito, and Noland 2001). The exchange rate of the renminbi has risen substantially and the Chinese current account surplus declined considerably in recent years. These changes occurred only after a decade of huge imbalances, however, and repeated displays of impotence by the United States and the International Monetary Fund (IMF) in resolving the problem, which produced deep congressional concern over currency manipulation, as dramatically revealed in its debate on US trade policy in 2015 (also see below).

Second, the Plaza-Louvre also produced a degree of international cooperation that remains historically unique (see chapter 10). All participating countries agreed that the markets had grossly overshot, that protectionist pressure in the US Congress posed a major risk to the world trading system and thus had to be countered, and that coordinated direct intervention in the foreign exchange markets could make a major contribution to resolving these problems. All of the other episodes cited above generated considerable enmity among the parties, both at the time the issues were addressed, usually amidst crises in the financial markets, and on a more lasting basis. The Plaza-Louvre could not avoid tensions and disputes altogether, and the degree of rancor apparently increased as the process evolved over its roughly two-year duration. But there was a true convergence of views at the initial Plaza phase that clearly separates it from its predecessors and successors.

The Plaza-Louvre had three sequential components. The Plaza Accord aimed to correct the substantial overvaluation of the dollar, especially against the yen and the deutsche mark. Its G-5 participants (France, Germany, Japan, the United Kingdom, and the United States) agreed to take significant adjust-

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Institute for International Economics in late 1990 to assess the validity of concerns that the Plaza adjustment was not working.

5. Eichengreen (chapter 10) suggests that the much earlier Tripartite Agreement of 1936 was modestly successful in stabilizing the French franc but that none of the other interwar cases he considered had much effect.

ment initiatives, which they did not follow through on, and to intervene directly in the exchange markets to promote that outcome, which they did.[6]

The Tokyo Summit of 1986, which has received much less attention than either the Plaza or Louvre, was the most ambitious part of the entire initiative. In an attempt to both clarify the goals of the Plaza Accord and provide more policy tools to achieve them, Tokyo adopted an unprecedented (before or after) set of guidelines for international coordination of a wide-ranging set of national economic policies. While well-intentioned, those commitments soon proved to be too extensive to sustain, and most of them were never implemented.

The Louvre Accord of early 1987 reverted to the narrower exchange rate focus of the Plaza itself. It adopted a set of target zones (called "reference ranges") between the major currencies to try to limit further declines of the dollar, which were judged to have become too rapid, but also to avoid a renewed rise of the dollar, as indicated by subsequent sales of dollars by the Federal Reserve on several occasions (see chapter 9). The chief goal was to restore stability in the currency markets and the world economy more broadly. The agreed yen/dollar zone had to be rebased shortly; it held for about a year, plus or minus a few months, depending on one's definition. The mark/dollar range did not hold for long (see chapter 7). The Louvre Accord was thus less successful than the Plaza Accord, though it did head off any free fall or hard landing for the dollar.

Criticisms of the Plaza-Louvre

There are five criticisms of the Plaza-Louvre. The first is that it relied too heavily on exchange rate corrections and produced very little change in underlying policy stances ("the fundamentals"). In particular, the United States failed to explicitly address its burgeoning budget deficits. The landmark tax reform of 1986 did produce a temporary improvement of about $100 billion, however, and Secretary Baker told me at the time that "maybe 10 percent" of his success on that front could be attributed to his using the international coordination argument (see chapter 9). In addition, in late 1985 Congress passed the Graham-Rudman-Hollings procedural reforms, which placed some checks on future deficit increases. But Secretary Baker, who viewed the Plaza Accord as a "beginning" to "coordination of the fundamentals" (Baker 2006), was clearly disappointed by the meager results on that front.

The second criticism of the Plaza-Louvre is that it occurred outside the multilateral institutional framework, centered on the IMF, that obtained at the time (and now). The subgroups (the G-5 and later the G-7 [the G-5 plus Canada and Italy]) that carried out those initiatives, however, had come to be

6. The G-5 deputy from Japan, Toyoo Gyohten, visited my office on the day after the Plaza Accord was signed. From my office he called his lieutenants in Tokyo, instructing them to sell $1 billion, a very large (unprecedented?) intervention at the time. Ito reports that Japanese dollar sales on that first post-Plaza market day in Tokyo amounted to $1.3 billion (see chapter 7).

widely regarded as legitimate steering committees for the system, including the IMF itself; they had been the locus of all former currency cooperation efforts. Confidentiality concerns alone required keeping the operations as small as possible. Indeed, the powerful impact on markets of the Plaza and Louvre Accords was caused largely by their shock effects. The IMF did come into the process extensively for the Tokyo Summit. The entire process was multilateral, in the sense that almost all the major players of the time were involved.

The third criticism, raised by Martin Feldstein and others (including Taylor, in chapter 12), is that the Plaza had no real effect on exchange rates and that the dollar correction would have occurred anyway solely through market forces. In fact, the markets had gone wildly off course in overvaluing the dollar in the first place, and the dollar had begun rising again (after several months of depreciation) just before the accord. No one can know the counterfactual.

A very specific fourth criticism is that the stock market crash of late 1987 resulted partly from disagreement between the United States and Germany over implementation of the Louvre Accord. In fact, that event had very little impact on the real economy.

The fifth—and most profound and probably most lasting—criticism of the Plaza-Louvre is that it "forced" bad policy choices on Japan that set the stage for that country's financial crash in the early 1990s and subsequent "lost two decades." That interpretation has been widely cited in China, for example, to justify its rejection of proposals by the United States and others over the past decade to let its currency strengthen substantially to help address the very large imbalances of the recent period.

This argument, especially its application to the more recent Chinese and other undervaluation cases, has several major flaws (see also chapter 7). First, if anything, the Plaza led the Japanese to maintain excessively high interest rates to help strengthen the yen rather than the low interest rates that brought on the bubble (see chapter 12). Second, although the Louvre arguably led to Japanese interest rates that were too low, Japan could have stimulated its economy at the time, to counter the dampening effect of Plaza-induced appreciation, through fiscal rather than monetary policy; it was only the (since corrected) bureaucratic control of the Ministry of Finance over the Bank of Japan that produced the erroneous policy mix. No such parallels could be envisaged in the recent situation with China anyway, as the goal would have been to emulate the Plaza (that is, to strengthen the renminbi) rather than Louvre (that is, to weaken it). Third, the Japanese crash resulted primarily from a failure of financial regulation rather than changes in monetary policy. Hence this view, which is still heard, does not detract from the success of the Plaza or even the Louvre Accord.

The bottom line is that the Plaza-Louvre was a uniquely successful and relatively harmonious interlude in the generally ineffectual and contentious history of postwar international economic and monetary relations, which continues to this day. Secretary Baker (2006) did not overstate the case when, upon leaving the Treasury in 1988, he told President Reagan that "a new system of multilateral economic policy coordination" would be one of his three initiatives that "will be widely judged to have lasting significance" (the other two were tax reform and the United States–Canada Free Trade Agreement).

On the 30th anniversary of that initiative, it is thus instructive to assess its implications for contemporary and prospective policy. In the next section, I attempt to do so. In the section that follows I argue that, while it is not yet time for a Plaza II, we may need its equivalent in the relatively near future to address the new set of international imbalances and currency misalignments that are already developing, could expand much farther, and so far have failed to stimulate any similarly constructive policy response.

Lessons from the Plaza-Louvre

Six lessons can be drawn from the Plaza and Louvre Accords.

Lesson 1: The United States Must Lead

The United States failed to participate actively in international monetary cooperation, let alone lead it, during the first Reagan administration. Coming on top of a sharp rise in budget deficits and consequent continuation of sky-high interest rates (the Reagan-Volcker policy mix), that failure permitted—indeed strongly encouraged—the massive dollar appreciation and buildup of huge (for that time) imbalances that triggered intense congressional protectionist pressure and necessitated the Plaza Accord.[7] The other limited successes cited above, from the Smithsonian to the more recent yen and renminbi cases, occurred only because the United States pushed for them (with greater or lesser skill and determination). There is no example of successful global monetary cooperation that was not led by the United States.

It is unclear whether, even if it tried, US leadership could prevail today as it did in 1985–87. The United States failed to satisfactorily resolve the yen and, especially, renminbi problems in more recent decades (albeit partly because it did not really try to mobilize international coalitions on these issues as the Baker team, led by assistant secretaries Mulford and Dallara, did so effectively before Plaza, as described in their chapters in this volume). Like the global political order, the international monetary system has become increasingly multipolar, and the relative power of the United States has declined. Monetary affairs appear to be moving, over the next decade or two, toward an essentially tripartite structure resting on the euro (if the zone recovers, as I think it will) and the renminbi along with the dollar (see chapter 13).

7. I predicted those consequences of Reaganomics in my testimony before the House Subcommittee on International Economic Policy and Trade of the Committee on Foreign Affairs, on February 24, 1981, just after Reaganomics was launched, and in subsequent articles. The only comparable analysis was by Otto Eckstein, but he expected the high interest rates that would accompany the Reagan budget deficits to crowd out private investment and cause an economic downturn rather than the boom that was enabled by the huge inflow of foreign capital, the rising dollar, and the soaring trade deficits that I predicted (Bergsten 1981).

The United States is nevertheless likely to remain primus inter pares for the foreseeable future, especially as the eurozone continues to falter and China maintains a measured pace in internationalizing the renminbi and faces its own economic problems. We may, however, increasingly experience a no-leadership, or G-0, world. Kindleberger (1973) blamed the Great Depression largely on the advent of a leaderless nonsystem in the 1930s, when "the United Kingdom was no longer able to lead and the United States was not yet willing to do so." As a result, no one provided the necessary global public goods (open markets, adequate lending, an international currency) to ward off the proliferation of competitive currency devaluations and trade restrictions that cut world commerce in half between 1930 and 1933 and converted national recessions into the Great Depression.

The United States continues to provide those global public goods today, running large (and again growing) current account deficits, thanks in part to its open markets and the key currency role of the dollar, which permit the rest of the world to enjoy export-led growth. The United States, however, has its own pressing problems of lagging employment, wage stagnation, and worsening income distribution. The antiglobalization backlash of the past two decades raises the question of whether unilateral US leadership of the traditional type will be sustainable for much longer—an issue to which I return in the next section.

Lesson 2: The Other Key Players Must Cooperate

Unilateral actions by the United States via the "Nixon shocks" forced the far-reaching currency realignments and eventual systemic adoption of floating exchange rates in the early 1970s. Exchange rates are inherently two-sided, however; the grudging acquiescence of France, Germany, and Japan was essential even then. The willingness, indeed eagerness, of the other key players was central to the success of the Plaza-Louvre.[8] Japan was especially helpful, particularly with respect to supportive domestic (notably monetary) policies, presumably because it was the primary target of congressional trade pressure and thus had the biggest stake in reducing currency misalignments.

Even the surplus countries with undervalued currencies (especially Germany and Japan in that case), which are usually the least willing to cooperate, were ready to participate. Their economies were doing reasonably well at the time, which helped a great deal. So did the patient and persistent efforts of top Treasury officials, including David Mulford and Charles Dallara, to build a plan of action through three months of "long and exhaustive" negotiations before the Plaza Accord (see chapter 3). The increasing doubts of Germany after the Louvre were key to its erosion. The lessons are that there can be no leadership without followership but also that effective leadership can beget followership.

8. The Europeans had already intervened on their own to weaken the dollar in early 1985.

The continuing trend toward multipolarity renders such cooperation even more essential today. The inability of the United States over at least a decade, dating from 2003, to get China to let the renminbi appreciate more quickly and more extensively is the current exemplar of that reality. That failure included the inability to win enough support from its usual allies to produce meaningful policy response through the IMF (Blustein 2013). The fiasco of US opposition to the creation of the Asian Infrastructure Investment Bank in early 2015, when most of its traditional supporters in Asia and Europe abandoned it, makes the point even more forcefully.

The advent of China means that the traditional reliance on the G-7 (or previously the G-5 or G-10) of high-income democracies is no longer adequate. The G-20 has become the predominant steering committee for the world economy, but it is too large to function effectively as an operational body. A de facto G-3 (the United States, the eurozone, and China) or G-4 (adding Japan) is needed to restore any prospect for effective international monetary cooperation. No Plaza II could be envisaged without China; indeed there were calls for a "new Plaza Accord" about a decade ago, including by Secretary Baker (2006), when the major systemic need was an appreciation of most or all of the Asian currencies, which would have required cooperation from several Asian countries (Cline 2005).[9]

Lesson 3: Domestic Politics, Especially Trade Policy, Drive Most Major International Monetary Initiatives

In their memoirs and their chapters in this volume, James Baker and David Mulford write that the threat of congressional protectionism was the main cause of their switch from the "benign neglect" exchange rate policy of the first Reagan administration to the Plaza Accord (Baker 1996, Mulford 2014). The sharp deterioration of US price competitiveness generated by the soaring dollar, which brought unprecedented and rapidly growing trade and current account deficits, had already triggered the passage of protectionist bills in the House and threatened the global trading system. Congressman Bill Frenzel, the highly respected ranking minority member of both the full Ways and Means Committee and its subcommittee on trade, commented later that "the Smoot-Hawley Tariff itself would have passed the Congress" had it come to the floor during this period. This congressional pressure provided the administration with enormous leverage over the other countries (Baker 2006). Fortunately, they understood the risk and shared the desire of the Baker Treasury to counter it constructively and effectively through currency action rather than new restrictions on trade. The use of a multilateral forum, the G-5, added to the policy's antiprotectionist impact in Congress by demonstrating that other

9. The IMF sponsored a multilateral consultation on global imbalances in 2006–07 that included those G-4 countries plus Saudi Arabia (representing the oil exporters). There were no noticeable results.

key countries (including oft-targeted Japan) were helping the United States and acting to resolve the problem.

Somewhat similar developments marked the other major US foray into aggressive exchange rate action in 1971. On that occasion there were genuine external pressures from actual and threatened dollar conversions into gold by some foreign central banks. Then, too, however, the House had passed protectionist bills, notably the Mills bill of 1971, with its import quotas on textiles and shoes, and the "Byrnes basket," which could have established quotas in numerous other sectors.[10] In addition, the Burke-Hartke bill, which would have limited foreign direct investment by US firms as well as imports across the board, was being prepared and attracting widespread attention. In both 1985 and 1971, the administrations of the day were rightly motivated by a desire to maintain control of trade and currency policy rather than letting it shift by default to Congress, as well as by the desire to maintain an open trading system (and prevent the United States from being blamed for replicating the huge policy errors it made in the 1930s).

The current situation has clear echoes of these past episodes. An important part of the congressional opposition to the Trade Promotion Authority (TPA) legislation in 2015 and the subsequent Trans-Pacific Partnership (TPP) agreement was motivated, or at least justified, by the rise in the US trade and current account deficits to record levels—as a share of GDP, twice the levels that prompted the Plaza Accord in 1985—a few years earlier and especially the currency misalignments, driven by overt manipulation by China and a few others, that helped generate them. Congressional initiatives usually lag real-world events by several years; imbalances had fortunately declined considerably by the time Congress began acting on these trade policy issues in mid-2015. The Obama administration therefore felt able to reject this Plaza (and 1971) lesson and to largely stonewall Congress rather than respond positively to its concerns or even take preemptive action, even though that jeopardized its own trade policy legacy. The carryover impact has nevertheless been substantial enough to force significant changes in US currency policy, which I describe below.

This lesson is very important, because most of the analytical work on the sustainability of exchange rates focuses on its international financial dimension (i.e., whether a given level of external deficits and debt can attract adequate funding to avoid problems or, in extreme cases, "sudden stops" and currency crises). There is also a critically important domestic political dimension to currency sustainability; the domestic constraint can sometimes bind before (or even in the absence of) its international counterpart. The Plaza was motivated by just such a pattern, as is the contemporary debate in the United States. There was no shortage of external financing for the US deficits in either case—indeed, the deficits were being overfinanced, as indicated by the strong rise of the dollar, but the overvaluation of the day was aggressively attacked from within.

10. C. Fred Bergsten, "Crisis in U.S. Trade Policy," *Foreign Affairs,* July 1971.

Lesson 4: The Fed Must Be on Board

The Plaza program to drive down the dollar largely ended—prematurely, as it soon turned out—when the Federal Reserve decided to let market interest rates rise in early 1987, after a renewed depreciation of the dollar (triggered to some extent by another round of jawboning from the Treasury) became excessive in the view of Chairman Volcker and his colleagues (or, as Truman puts it, the Plaza Accord "overperformed"). The definition of a hard landing for a currency—which all officials, including US officials via the Plaza-Louvre, seek to avoid—is that interest rates rise while the exchange rates decline.[11] Even more immediately, and with an eye on the upcoming 1988 elections, the administration of the day did not want to see higher interest rates. The other countries were also ready to call a halt to the dollar's decline. Secretary Baker and his team made the best of their circumstances by working out the Louvre Accord, putting in place the new target zones to at least protect against a renewed rise (as well as disorderly fall) in the dollar.

The lesson is that successful international monetary cooperation requires internal as well as external coordination by a US administration (and especially Treasury). US law authorizes the secretary of the Treasury to determine the country's exchange rate policy, but the Federal Reserve views its independence in conducting monetary policy as providing it with autonomy in the currency area as well (Volcker and Gyohten 1992, 233–35). Volcker, in fact, concludes that "the net result (between Treasury and the Fed) is a kind of mutual veto that in practice gives the last word to the agency that is most reluctant to intervene," confirming that they must work out a compact if any intervention initiative is to succeed.[12, 13]

Lesson 5: Exchange Rates Are Less Difficult than Macroeconomic or Structural Policies to Coordinate Internationally

The Plaza worked. The Louvre worked to some extent. Tokyo never got off the ground. The lesson is that currency cooperation or even coordination, difficult as it is, is much more likely to succeed than similar efforts centered on the alternative (and more fundamental) macro and structural policy areas.

Numerous other examples support this conclusion. The "Nixon shocks" of 1971 and the subsequent Smithsonian Agreement succeeded to a degree on

11. Under normal circumstances, an increase in interest rates can be expected to strengthen a country's currency. It is the major policy instrument usually used for that purpose. A hard landing for an economy has much wider implications.

12. Ironically, Volcker would have supported pre-Plaza intervention to counter the sharp rise of the dollar toward the end of the first Reagan administration, but Treasury vetoed it (see chapter 2). He then vetoed Treasury's decision to continue pushing the dollar down in 1987 and forced the stabilization agreement of the Louvre.

13. For his part, Secretary Baker indicated the need for Fed concurrence privately to me in 1987 and in his memoirs (Baker 2006).

exchange rates, including ultimately changing the exchange rate system, but on little else. The Europeans could create a common currency, but, despite having previously agreed on a comprehensive customs union and extensive internal liberalization, they have been unable to support their monetary union with an economic union. The Bonn Summit potentially provided a counterexample, but its accord on macroeconomic goals and policies was aborted by the second oil shock.

This lesson can be carried further. Exchange rate cooperation, perhaps embodied in firm rules, can be deployed in an effort to forge internationally compatible and thus more sustainable domestic economic policies, at least in the major countries. This was the basic concept underlying both the gold standard and the "fixed" exchange rates of the original Bretton Woods system. Thoughtful European leaders believed that creating a common currency would inexorably lead to the additional reforms needed to create an optimal currency area. The Plaza Accord sought to expand its agreement on currency into cooperation on much broader "fundamentals" at Tokyo and, to a degree, in the Louvre. None of these agreements worked perfectly, to put it mildly, but they seemed to run more successfully from exchange rates to macro/structural policies than vice versa. At the same time, based on his careful examination of a number of historical episodes, Eichengreen (chapter 10) cautions that it is a huge mistake to maintain inappropriate domestic policies to support "arbitrary exchange rate targets." Great care must be exercised to design any currency regime accordingly.

Lesson 6: Ideas Matter

The Plaza Accord was initiated in part to promote an orderly realignment of the major currencies of the day and to avert the risk of a hard landing for the dollar. That concern, which was deeply shared by Fed Chairman Volcker (see chapter 2), had been propagated most vocally by Stephen Marris (1983, 1987), the former chief economist of the Organization for Economic Cooperation and Development (OECD), with strong support from me.[14] A more immediate push for such action came in the statements by me, Richard N. Cooper, and Paul Krugman at the annual Jackson Hole conference sponsored by the Federal Reserve Bank of Kansas City (1985) less than a month before the Plaza Accord itself.

John Williamson and I invented target zones, which were actively discussed by top US and other officials in the period just before the initiation of the Plaza-Louvre (Bergsten and Williamson 1983). At a briefing session hosted for him by the Institute for International Economics in early 1985, Deputy Treasury Secretary Richard Darman embraced the idea but indicated that target zones would be called something else, in order to avoid endorsing its sponsors.

14. Marris (1991) later explained how the hard landing was averted, importantly including via the Plaza-Louvre initiative itself.

The term “reference ranges” was developed for that purpose. (Darman’s only other objection to the scheme was that it gave too big a role to central banks, a concern that turned out to be justified—from his standpoint at Treasury—as indicated above.)

Williamson and Miller (1987) subsequently concluded that the “reference ranges” of the Louvre failed to persist because they differed from the proposed target zones in five important ways:

- The ranges were not publicly announced; private capital flows were therefore not mobilized to support them.
- The bands were too narrow, limited to +/–2½–5 percent instead of 10 percent.
- They were defined as nominal bilateral exchange rates against the dollar instead of real effective exchange rates (REERs).
- They had a provisional rather than permanent nature, as indicated by their early “rebasing,” which reflected the fundamental problem that they did not rest on any analysis of sustainable equilibrium levels; they were simply set “around current levels,” because that is what the negotiators at the Louvre could agree on and deemed least disruptive to the markets.
- The only obligation when a rate reached the edge of the zone was to consult rather than to implement a prespecified policy action.

The lesson is that concepts and proposals that are developed outside official circles can often have important and even decisive policy impact, even, or perhaps especially, over relatively brief periods of time if the need for new ideas is as acute as when crises of the magnitude of 1985–87 arise. But the lesson is also that official adoption of outside policy proposals can misfire if applied incorrectly, as at the Louvre and in the latest debate, when the currency issue came uncomfortably close to derailing the entire TPP negotiation.[15]

Is There a Need for Plaza II?

Does it matter that the Plaza success has not been replicated in 30 years? Have there been any problems of similar type and magnitude that called for such a policy response? Is there any practical need to absorb the lessons from the Plaza-Louvre?

The international imbalances run by the United States and the largest surplus country of the day, China, reached shares of GDP in the mid-2000s

15. Ideas developed outside government also heavily influenced that debate. The unusual letters to the president on the issue from bipartisan majorities of both the House and Senate in 2013, which triggered the debate on linking currency policy to trade agreements, cited and largely rested on the analysis in Bergsten and Gagnon (2012). Some of the mandates that survived the legislative process derived directly from Bergsten (2014), although I, unlike some supporters of including “enforceable currency disciplines” in the TPP itself, never argued that TPP should be rejected unless it included such provisions.

that were far higher than those that motivated the Plaza Accord in 1985. The US current account deficit hit about 6 percent in 2006 and remained near 5 percent in 2007–08, compared with its earlier peak of 3.4 percent in 1987. The Chinese current account surplus peaked at 9.8 percent in 2007–08, almost three times the surpluses of Germany and Japan in 1985. Other Asian countries were also running large surpluses at the time that cumulated to a total about equal to that of China. The US economy was doing well (although edging toward the crisis that hit in 2008), however, and the dollar remained below its long-term average. Congressional support for new trade restrictions was not as great as in the earlier period although the Schumer-Graham proposal for a sizable import surcharge against China attracted considerable attention in 2005–07. The Chinese felt sufficient pressure to let the renminbi start appreciating gradually in mid-2005.

The Great Recession intervened in 2008, deflecting attention away from the international imbalances (Blustein 2013) and sharply reducing them (though taking the US deficit down to only a little below the level at which it had peaked in 1985–87). The issue arose again, in Congress and through its pressure on the administration, in 2010–11, when the muted recovery from the recession was under way. The House and Senate separately passed currency bills in 2010 and 2011, respectively, authorizing the use of countervailing duties against undervalued currencies (especially if they were "manipulated"), with the Senate bill adding "remedial currency intervention" by the United States itself (see below). Largely as a result, China let the renminbi start appreciating again. Congress ratcheted up the pressure even more intensively in 2013–15, when it began addressing the TPP trade agreement and the associated TPA legislation, acquiring substantial leverage in dealing with the administration on the issue. But the administration rejected the lesson from the Plaza-Louvre that suggested preemptive currency action to protect the trade agenda, arguing instead that its "quiet diplomacy" had largely resolved the major problem (China) and that linking the issue to trade policy could torpedo the TPP negotiations.

Notably absent from these latest congressional concerns were the factors that drove the trade policy backlash and thus the Plaza initiative in 1985: large changes in exchange rates driven by market reactions to sharp differences in national growth rates and monetary policies. In the mid-1980s, the US economy boomed as a result of the massive fiscal stimulus provided by the Reagan administration and the sky-high US interest rates that made sure that rapid inflation would not return (the Reagan-Volcker policy mix). In the mid-2010s, the United States was again growing considerably faster than Europe and Japan, and US monetary policy had begun to tighten (the end of quantitative easing) while monetary policy in Europe and Japan was still easing aggressively. The dollar soared in the 1980s and strengthened sharply from late 2014 into 2015.

Congressional anxiety over exchange rates on this occasion focused solely on "manipulation," defined as direct intervention in the currency markets by foreign monetary authorities. It was viewed as an unfair trade practice as well as a monetary distortion and thus fully appropriate for consideration by trade policy, especially in the context of new liberalization (TPP), to make sure that deliberate currency moves did not undermine it. The G-7 and IMF made a clear distinction between these two sources of potential currency misalignment, condemning "manipulation" but largely exonerating market-driven movements, despite the protests of some countries on the receiving end (most vocally Brazil) that the effects on their economies are identical (see chapter 11). Congress, and the US political process more broadly, accepted this distinction and thus did not criticize the sharp general run-up in the dollar. This reaction may have been in part because, in light of the lags between currency movements and subsequent trade effects, the US trade and current account deficits had yet to climb very much or do much additional damage to the US economy, which was recovering and moving steadily if slowly back toward full employment, as conventionally defined. It also presumably reflected the fact that, in light of the limited alternatives to the dollar and the preference of weak economies around the world for a strong dollar to enhance their own competitiveness, the United States has had no difficulty financing its imbalances (and was thus again running "deficits without tears").

The questions going forward are whether continued large and rising dollar overvaluation and external deficits are sustainable domestically for both the US economy and US politics, as Congress will presumably have to vote on both the TPP (probably in 2016 or 2017) and subsequently the Transatlantic Trade and Investment Partnership (TTIP) (probably in 2018 or beyond). In economic terms the United States is approaching full employment. The requirements of the TPA/fast-track legislation sharply limit the ability of Congress to tie its approval of the pending trade deals to currency questions. However, the expansion remains moderate, wage growth is modest, income distribution continues to worsen, and the employment ratio remains disturbingly low. The US economic situation is thus far from satisfactory. An external imbalance headed back toward 5 percent of GDP by 2020 (Cline 2015b), at the exchange rates of late 2015 and likely to evolve in 2016, raises questions that are only likely to intensify (including as the political campaigns heat up during the course of 2016).

The dollar could, of course, rise significantly if the United States maintains, or even increases, its growth advantage over Europe and Japan. It could do so if Fed tightening proceeds, especially if that tightening turns out to be quicker and larger than anticipated by markets. The dollar could rise especially if the currencies of key emerging markets, including China, weaken as Fed tightening and their own economic problems promote capital outflows.

Is the dollar significantly overvalued, as it was in 1985? In his May 2015 estimates of "fundamental equilibrium exchange rates," using the methodology developed at the Peterson Institute for International Economics, my colleague William Cline concludes that the dollar is only modestly overvalued (by about 8 percent) and that the euro and yen are only modestly undervalued (by about 3 percent each) (Cline 2015a). He posits no misalignment in the exchange rate of the renminbi.

But the traditional approach of Cline (and the Institute) seeks only to keep countries' current account positions within 3 percent, plus or minus, of their GDPs. Hence the US deficit (4.3 percent), eurozone surplus (3.8 percent), and Japanese surplus (3.4 percent) that he projects for 2020 called for only minor corrections, which would presumably not require an international initiative like the Plaza Accord. China's even smaller projected surplus (2.5 percent) would require no change at all.[16]

The rationale for this analytical approach is that only deficits larger than 3 percent of GDP are likely to produce increases in a country's foreign debt position that could become unsustainable, from an international financial standpoint, and that symmetry calls for permitting surpluses of similar magnitudes. In the real world, the projected imbalances are very large in absolute terms: almost $1 trillion for the United States, more than $500 billion for the eurozone, and about $400 billion for China. These imbalances can make a great deal of difference to the world economy.

Moreover, there are sound reasons to believe that the United States, as a mature high-income country, should again become a net capital exporter and thus run current account surpluses. There are equally powerful reasons to believe that China, as a low-income developing country, should again become a net capital importer and thus run current account deficits. The IMF, as part of its 2015 External Sector Report (IMF 2015), has not gone quite that far, but it has suggested current account "norms" of a much smaller deficit for the United States of 1.6 percent of GDP, a zero balance for China and Japan, and a surplus of 2.25 percent of GDP for the euro area.

Using these IMF norms, let alone setting current account targets at zero for the four main economies, produces a dramatically different picture of whether current exchange rates, let alone future rates that moved further away from equilibrium levels, reflect underlying economic fundamentals. Tables 14.1 to 14.4 set current account targets on both bases and use Cline's model and parameters to calculate the implied misalignments for the four major currencies. Table 14.5 summarizes their main implications.

In essence, today's misalignments are in the same ballpark as the two negotiated currency corrections of the earlier postwar period (Plaza and Smithsonian).[17] The dollar came down by about 50 percent against both the deutsche mark and the yen after the Plaza Accord. Its trade-weighted depreciation was about 30 percent, compared with an overvaluation of 18–25

16. In his subsequent update, in November 2015, Cline (2015b) took account of the further rise of the dollar in late 2015 and concluded that the US current account deficit would rise to 4.8 percent of its GDP by 2020. This level would approach its previous highs and substantially exceed its pre-Plaza level.

17. Using a completely different methodology, Green, Papell, and Prodan (chapter 8 of this volume) reach the same conclusion.

Table 14.1 Target current account positions for 2020 using IMF Staff norms for China, Japan, euro area, and United States

Country	IMF projection of 2015 current account (percent of GDP)	IMF 2020 GDP forecast (billions of US dollars)	IMF 2020 current account forecast (percent of GDP)	Cline (2015a) adjusted 2020 current account (percent of GDP)	Target current account[a] (percent of GDP)
Pacific					
Australia	–4.0	1,491	–3.4	–2.6	–2.6
New Zealand	–4.8	240	–4.6	–4.9	–3.0
Asia					
China	3.2	16,157	3.0	2.5	0.0
Hong Kong	2.0	438	3.1	1.6	1.6
India	–1.3	3,640	–2.5	–2.7	–2.7
Indonesia	–3.0	1,307	–2.6	–2.3	–2.3
Japan	1.9	4,933	2.3	3.4	0.0
Korea	7.1	2,012	3.6	4.8	3.0
Malaysia	2.1	538	1.4	4.9	3.0
Philippines	5.5	510	3.0	1.5	1.5
Singapore	20.7	390	14.5	15.5	3.0
Taiwan	12.4	776	9.9	10.8	3.0
Thailand	4.4	504	0.7	0.2	0.2

Middle East/Africa					
Israel	4.5	315	3.8	4.5	3.0
Saudi Arabia	–1.0	902	5.4	5.9	5.9
South Africa	–4.6	409	–4.2	–3.5	–3.0
Europe					
Czech Republic	1.6	203	–0.7	0.2	0.2
Euro area	3.3	14,160	2.5	3.8	2.3
Hungary	4.8	165	1.2	–0.4	–0.4
Norway	7.6	502	4.8	5.2	5.2
Poland	–1.8	673	–3.5	–3.1	–3.0
Russia	5.4	2,081	4.3	1.5	1.5
Sweden	6.3	677	5.6	6.9	3.0
Switzerland	5.8	769	5.3	3.7	3.0
Turkey	–4.2	1,012	–5.0	–5.1	–3.0
United Kingdom	–4.8	3,731	–3.3	–2.3	–2.3
Western Hemisphere					
Argentina	–1.7	631	–1.5	–2.6	–2.6
Brazil	–3.7	2,354	–3.2	–1.9	–1.9
Canada	–2.6	2,044	–1.8	1.0	1.0
Chile	–1.2	325	–2.4	–1.6	–1.6
Colombia	–5.8	483	–3.6	–2.2	–2.2
Mexico	–2.2	1,653	–2.3	1.0	1.0
United States	–2.3	22,489	–2.6	–4.3	–1.6
Venezuela	–4.7	274	1.4	2.3	2.3

a. IMF (2015) for current account targets for China, Japan, euro area, and the United States; Cline (2015a) for the rest.

Sources: Cline (2015a); IMF (2015).

Table 14.2 FEER estimates based on IMF Staff norms for current accounts of China, Japan, euro area, and United States

	Changes in current account as percent of GDP		Change in REER (percent)		Dollar exchange rate		
Country	**Target change**	**Change in simulation**	**Target change**	**Change in simulation**	**Actual April 2015**	**Percent change from actual April 2015 rate to FEER**	**FEER-consistent dollar rate**
Pacific							
Australia*	0.0	0.2	0.0	–1.2	0.77	22.1	0.94
New Zealand*	1.9	2.1	–7.2	–8.2	0.76	12.3	0.85
Asia							
China	–2.5	–2.2	10.3	9.2	6.20	27.8	4.85
Hong Kong	0.0	0.3	0.0	–0.6	7.75	24.5	6.23
India	0.0	0.2	0.0	–1.0	62.7	15.3	54.4
Indonesia	0.0	0.2	0.0	–1.1	12,946	24.1	10,428
Japan	–3.4	–3.3	23.0	21.9	120	41.1	85
Korea	–1.8	–1.4	4.2	3.3	1,086	23.8	878
Malaysia	–1.9	–1.4	3.8	2.7	3.63	27.3	2.86
Philippines	0.0	0.2	0.0	–1.0	44.4	23.3	36.0
Singapore	–12.5	–11.9	25.1	23.9	1.35	44.9	0.93
Taiwan	–7.8	–7.4	17.6	16.7	31.0	39.6	22.2
Thailand	0.0	0.5	0.0	–1.1	32.5	21.4	26.8

Middle East/Africa							
Israel	–1.5	–1.3	5.0	4.3	3.93	19.1	3.30
Saudi Arabia	0.0	0.3	0.0	–0.8	3.75	19.8	3.13
South Africa	0.5	0.7	–2.2	–2.9	11.99	15.0	10.43
Europe							
Czech Republic	0.0	0.3	0.0	–0.6	25.4	19.0	21.3
Euro area*	–1.5	–1.2	6.3	4.8	1.08	21.0	1.31
Hungary	0.0	0.3	0.0	–0.6	277	18.1	235
Norway	0.0	0.2	0.0	–0.7	7.88	17.8	6.69
Poland	0.1	0.4	–0.3	–1.1	3.72	17.8	3.16
Russia	0.0	0.2	0.0	–0.6	53.0	15.4	45.9
Sweden	–3.9	–3.5	10.2	9.3	8.63	26.8	6.81
Switzerland	–0.7	–0.5	1.7	1.1	0.96	20.2	0.80
Turkey	2.1	2.3	–8.7	–9.4	2.65	6.3	2.50
United Kingdom*	0.0	0.2	0.0	–0.8	1.50	16.8	1.75
Western Hemisphere							
Argentina	0.0	0.2	0.0	–1.1	8.86	14.0	7.77
Brazil	0.0	0.2	0.0	–1.3	3.05	15.4	2.64
Canada	0.0	0.1	0.0	–0.4	1.23	7.3	1.15
Chile	0.0	0.3	0.0	–1.0	614	16.7	526
Colombia	0.0	0.1	0.0	–0.8	2,493	10.0	2,266
Mexico	0.0	0.1	0.0	–0.4	15.2	7.4	14.2
United States	2.7	2.9	–16.4	–17.6	1.00	0.0	1.00
Venezuela	0.0	0.2	0.0	–0.6	6.29	9.5	5.75

FEER = fundamental equilibrium exchange rate; REER = real effective exchange rate

* The currencies of these countries are expressed as dollars per currency. All others expressed as currency per dollar.

Sources: Cline (2015a); table 14.1.

percent today. The euro and yen are now undervalued against the dollar by 20–40 percent and 40–50 percent, respectively, with the yen approaching its 1985 peak, according to Green, Papell, and Prodan (see chapter 8). Fortunately, their trade-weighted average exchange rates (their real effective exchange rates, or REERs) are undervalued by much less, because they would need to rise by roughly equivalent amounts against the dollar and thus by very little vis-à-vis one another (and against most other currencies).

In terms of the magnitude of today's projected imbalances and misalignments, there is thus a strong case for a Plaza II. Tables 14.1 to 14.5 show that the current situation is very similar to the one that prevailed before the Plaza. The dollar is substantially overvalued, not only in the aggregate but vis-à-vis every significant currency. The currencies of China and several other Asian economies, notably Korea and Taiwan, are substantially undervalued (especially against the dollar) and should be included in order to avoid their free-riding on the agreement.[18] These economies, especially China and Japan, are the major targets of congressional ire. The absence of any significant currency intervention by the United States for more than 15 years suggests that a Plaza-type initiative would have substantial shock and thus market impact. The main participants would need to be the same countries as at the Plaza itself (the United States; Germany, through the eurozone; and Japan).

The policy issue is whether a Plaza-type agreement to correct these misalignments is now called for. There are three major arguments against it. The most compelling is the relatively good economic performance of the United States, a major source of the dollar's strength. Despite its large and gradually (so far) growing external deficit and the problems cited above, the US economy is performing much better than the economies of Europe and Japan (itself a major cause of the rising trade imbalance). China is looking shaky, with its slowdown and stock market fall in 2015 and early 2016. At the time of the Plaza Accord, by contrast, US growth and monetary policy were easing while German and Japanese growth were picking up and monetary policy was tightening. Hence a Plaza-type agreement at this time to raise the value of the euro, yen, and renminbi to anything like the equilibrium levels suggested above would be inconsistent with "fundamentals" and thus difficult to justify, as Eichengreen argues in chapter 10.

A second argument is that until recently, the major imbalances have been moving in the right directions. The Plaza took place as the US deficit, and the European and Japanese surpluses, had been soaring to record highs for several years. In contrast, in 2015 both the US deficit and the Chinese surplus remained significantly below their recent peaks (though both were starting to

18. After the Plaza Accord, Korea and Taiwan retained their dollar pegs; their currencies depreciated sharply with the dollar on a trade-weighted basis. They began running sizable surpluses as a result (Korea for the first time) and soon became the targets of global currency policy (Balassa and Williamson 1987), including via the Louvre communiqué, which led to substantial "catch-up" appreciations of their own exchange rates.

Table 14.3 Target current account positions for 2020 using zero targets for China, Japan, euro area, and United States

Country	**IMF projection of 2015 current account** (percent of GDP)	**IMF 2020 GDP forecast** (billions of US dollars)	**IMF 2020 current account forecast** (percent of GDP)	**Cline (2015a) adjusted 2020 current account** (percent of GDP)	**Target current account**[a] (percent of GDP)
Pacific					
Australia	–4.0	1,491	–3.4	–2.6	–2.6
New Zealand	–4.8	240	–4.6	–4.9	–3.0
Asia					
China	3.2	16,157	3.0	2.5	0.0
Hong Kong	2.0	438	3.1	1.6	1.6
India	–1.3	3,640	–2.5	–2.7	–2.7
Indonesia	–3.0	1,307	–2.6	–2.3	–2.3
Japan	1.9	4,933	2.3	3.4	0.0
Korea	7.1	2,012	3.6	4.8	3.0
Malaysia	2.1	538	1.4	4.9	3.0
Philippines	5.5	510	3.0	1.5	1.5
Singapore	20.7	390	14.5	15.5	3.0
Taiwan	12.4	776	9.9	10.8	3.0
Thailand	4.4	504	0.7	0.2	0.2

(table continues)

Table 14.3 Target current account positions for 2020 using zero targets for China, Japan, euro area, and United States *(continued)*

Country	IMF projection of 2015 current account (percent of GDP)	IMF 2020 GDP forecast (billions of US dollars)	IMF 2020 current account forecast (percent of GDP)	Cline (2015a) adjusted 2020 current account (percent of GDP)	Target current account[a] (percent of GDP)
Middle East/Africa					
Israel	4.5	315	3.8	4.5	3.0
Saudi Arabia	–1.0	902	5.4	5.9	5.9
South Africa	–4.6	409	–4.2	–3.5	–3.0
Europe					
Czech Republic	1.6	203	–0.7	0.2	0.2
Euro area	3.3	14,160	2.5	3.8	0.0
Hungary	4.8	165	1.2	–0.4	–0.4
Norway	7.6	502	4.8	5.2	5.2
Poland	–1.8	673	–3.5	–3.1	–3.0
Russia	5.4	2,081	4.3	1.5	1.5
Sweden	6.3	677	5.6	6.9	3.0
Switzerland	5.8	769	5.3	3.7	3.0
Turkey	–4.2	1,012	–5.0	–5.1	–3.0
United Kingdom	–4.8	3,731	–3.3	–2.3	–2.3

Western Hemisphere					
Argentina	–1.7	631	–1.5	–2.6	–2.6
Brazil	–3.7	2,354	–3.2	–1.9	–1.9
Canada	–2.6	2,044	–1.8	1.0	1.0
Chile	–1.2	325	–2.4	–1.6	–1.6
Colombia	–5.8	483	–3.6	–2.2	–2.2
Mexico	–2.2	1,653	–2.3	1.0	1.0
United States	–2.3	22,489	–2.6	–4.3	0.0
Venezuela	–4.7	274	1.4	2.3	2.3

a. Author's current account targets for China, Japan, euro area, and the United States; Cline (2015a) for the rest.

Sources: Cline (2015a); IMF (2015).

Table 14.4 FEER estimates based on zero targets for current accounts of China, Japan, euro area, and United States

	Changes in current account as percent of GDP		Change in REER (percent)		Dollar exchange rate		
Country	Target change	Change in simulation	Target change	Change in simulation	Actual April 2015	Percent change from actual April 2015 rate to FEER	FEER-consistent dollar rate
Pacific							
Australia*	0.0	0.1	0.0	–0.4	0.77	32.0	1.02
New Zealand*	1.9	1.9	–7.2	–7.5	0.76	21.8	0.92
Asia							
China	–2.5	–2.4	10.3	9.9	6.20	37.1	4.52
Hong Kong	0.0	0.1	0.0	–0.2	7.75	34.2	5.78
India	0.0	0.1	0.0	–0.4	62.7	24.3	50.5
Indonesia	0.0	0.1	0.0	–0.4	12,946	33.9	9,671
Japan	–3.4	–3.3	23.0	22.6	120	50.2	80
Korea	–1.8	–1.6	4.2	3.8	1,086	32.7	818
Malaysia	–1.9	–1.7	3.8	3.4	3.63	36.9	2.65
Philippines	0.0	0.1	0.0	–0.4	44.4	32.8	33.5
Singapore	–12.5	–12.3	25.1	24.6	1.35	54.7	0.87
Taiwan	–7.8	–7.7	17.6	17.3	31.0	48.8	20.9
Thailand	0.0	0.2	0.0	–0.4	32.5	30.8	24.9

Middle East/Africa							
Israel	–1.5	–1.5	5.0	4.7	3.93	29.3	3.04
Saudi Arabia	0.0	0.1	0.0	–0.3	3.75	29.2	2.90
South Africa	0.5	0.6	–2.2	–2.4	11.99	25.3	9.57
Europe							
Czech Republic	0.0	0.1	0.0	–0.2	25.4	35.9	18.7
Euro area*	–3.8	–3.6	15.5	15.0	1.08	40.9	1.52
Hungary	0.0	0.1	0.0	–0.2	277	33.6	207
Norway	0.0	0.1	0.0	–0.3	7.88	32.1	5.97
Poland	0.1	0.2	–0.3	–0.6	3.72	34.0	2.78
Russia	0.0	0.1	0.0	–0.2	53.0	26.8	41.7
Sweden	–3.9	–3.7	10.2	9.8	8.63	41.4	6.10
Switzerland	–0.7	–0.7	1.7	1.5	0.96	35.4	0.71
Turkey	2.1	2.1	–8.7	–9.0	2.65	17.9	2.25
United Kingdom*	0.0	0.1	0.0	–0.3	1.50	30.6	1.95
Western Hemisphere							
Argentina	0.0	0.1	0.0	–0.4	8.86	23.9	7.15
Brazil	0.0	0.1	0.0	–0.5	3.05	25.4	2.43
Canada	0.0	0.0	0.0	–0.2	1.23	11.6	1.11
Chile	0.0	0.1	0.0	–0.4	614	25.9	488
Colombia	0.0	0.1	0.0	–0.3	2493	16.8	2,134
Mexico	0.0	0.0	0.0	–0.2	15.2	11.5	13.6
United States	4.3	4.4	–26.1	–26.5	1.00	0.0	1.00
Venezuela	0.0	0.1	0.0	–0.2	6.29	15.0	5.47

FEER = fundamental equilibrium exchange rate; REER = real effective exchange rate

* The currencies of these countries are expressed as dollars per currency. All others expressed as currency per dollar.

Sources: Cline (2015a); table 14.3.

Table 14.5 Currency misalignments in 2015

	Trade-weighted average		Bilateral rates against dollar (equilibrium level)	
	To achieve:		*To achieve:*	
Economy	**IMF norms**	**Zero balances**	**IMF norms**	**Zero balances**
United States	–17.6	–26.5	—	—
Euro area	+4.8	+15.0	+21.0 (1.31)	+40.9 (1.52)
China	+9.2	+9.9	+27.8 (4.85)	+37.1 (4.52)
Japan	+21.9	+22.6	+41.1 (85)	+50.2 (80)

Note: + means undervaluation and thus needed appreciation; – means overvaluation and thus needed depreciation. The numbers in parentheses are the implied equilibrium levels of the bilateral dollar rates for the euro, renminbi, and yen.

trend up again as the year progressed, toward the much larger imbalances projected for 2020, and the Chinese surplus had already doubled as a share of its GDP from 2013 through the first half of 2015). The surpluses of the large oil exporters had dropped sharply with the fall in world energy prices. The surpluses of the eurozone, especially Germany, continued to climb, but the overall pattern of imbalances was not getting much worse.

The third argument against early action is the slackening, at least for the moment, of protectionist pressure in Congress. The TPA votes were very close in both houses, and fairly intrusive currency amendments lost by even smaller margins in the Senate Finance Committee and on the Senate floor (see next section). But the administration largely won that battle, and little appetite to reopen the issue has yet developed or is likely to develop, at least directly on the trade bills themselves, when the TPP and TTIP legislation come up for approval, because of the up-or-down and time-limited nature of those votes under TPA/fast-track procedures.

It is thus likely that Plaza II ideas will come onto the policy agenda only under three conditions: the US economy turns down, in part as a result of rising trade deficits; the dollar takes another sharp upward climb, producing widespread complaints from US firms and workers about the impact on their competitiveness; and/or Congress begins to worry again about growing trade deficits caused by dollar overvaluation, whatever its causes.

How much further dollar appreciation would be needed to trigger these reactions? Cline's model indicates that every 10 percent rise in the dollar adds about $350 billion to the trade deficit and reduces the level of US economic activity by about 1.65 percent (with a corresponding loss of about 1.5 million jobs, although easier monetary policy could in principle produce a full offset, unless interest rates are already at the zero lower bound). On these parameters, the current account deficit was headed toward $1 trillion, with the dollar at the levels of late 2015. A further rise of 10 percent in the dollar would take the imbalance close to $1.5 trillion a year by 2020, with correspondingly higher output and job losses.[19] This increase would presumably attract considerable attention and spur calls for action in some quarters.

When, if ever, might such further dollar appreciation occur? The timing probably depends on four key variables: the extent of Fed tightening, the speed of Fed tightening, differences between economic growth in the United States on the one hand and Europe and Japan on the other, and the success of China's reforms in sustaining rapid growth without which they will both lose further market confidence and be tempted to revert to export expansion via renewed manipulation. One can imagine combinations of these variables that would push the dollar significantly up or down. It can move a great deal in a short period (between August 2014 and August 2015 it rose about 15 percent on a real trade-weighted average basis). Policy should be ready to respond if it does. Each of the two major dollar appreciations of the postwar period—from 1978 to 1985 and from 1995 to 2002—took seven years. The current appreciation has proceeded for only four years, so a good deal more could still be in store.

The developments most likely to produce a sharp new rise in the dollar and thus make the case for a Plaza II—namely, a sharp tightening of Fed policy and continued stagnation in Europe and Japan, as the United States becomes an island of growth in a weak world economy, and continued lags in reform in China—would simultaneously reinforce the case against such an initiative, however, as indicated above. Cooperation from the other key countries to weaken the dollar, and thus strengthen their own currencies and further cloud the outlook for their economies, would be highly unlikely in such circumstances. Any US currency initiative in such a setting, perhaps driven by renewed congressional pressure, would almost certainly have to be unilateral—which could undermine its provision of the needed global public goods described above. The final question is thus the current status of US currency policy in the wake of the debate in Congress in 2015, the most active public discussion of the topic since the Plaza-Louvre period itself.

Does the United States Have a New Currency Policy?

Currency was a central topic in the trade policy debate in both the Senate and House in May–June 2015. That debate was foreshadowed by letters conveyed by unusual bipartisan majorities of both houses to the president and his top officials in 2013 calling for "enforceable disciplines" on currency manipulation in the TPP and all future US free trade agreements.

The currency debate itself encompassed five major features. The first was the direct linkage of the currency issue to trade policy, which was largely unprecedented (Bergsten 2014). Congress found the lever to address currency, which it had been seeking for some time, when the administration was forced to approach it for negotiating authority to pursue the TPP and TTIP. There

19. The market consensus in late 2015 was for a trade-weighted average dollar appreciation of about 2.6 percent in 2016, including rises of 7–10 percent against the euro and yen.

was also compelling logic in the linkage, despite the administration's continuous denial and delayed recognition of it: For the past decade, currency manipulation has distorted trade flows far more than any tariff or conventional tool of trade policy (Bergsten and Gagnon 2012; chapter 11 of this volume). Paul Volcker famously opined that trade flows respond more to 10 minutes of movement in exchange rates than to 10 years of trade negotiations.

The second feature was the focus on currency manipulation as an "unfair trade practice" as well as a monetary distortion. This outcome stemmed directly from the linkage to trade policy. No attention was paid to the sharp market-driven rise in the dollar, in response to differential growth rates and monetary policies, that was occurring just as the congressional debate was getting under way in early 2015. This ignoring of aggregate misalignments was presumably in part because the inevitable sharp increase in the US current account deficit had not yet taken place, because of the usual time lag of two to three years between currency change and trade outcomes and the fact that the deficit had declined sharply from its recent peak. Complaints from adversely affected US firms and even labor unions were limited. The muted reaction to macro-induced dollar appreciation also probably occurred because the Republican majorities in both houses believe in flexible exchange rates and respect the outcomes generated in them by market forces even when they may be objectively excessive.

The administration implicitly endorsed this clear distinction between "manipulation" (defined as direct intervention in the foreign exchange markets to limit a currency's appreciation) and market-driven movements in exchange rates. It did so because it feared that any new constraints on "manipulation" might be used to attack its own macroeconomic policies, especially quantitative easing by the Federal Reserve, which some countries view as affecting their exchange rates just as much as (or more than) direct intervention by China. Some members of Congress shared this fear. Both the IMF and the G-7 have drawn a clear distinction between the two types of policy action. However, as the impact on recipient countries can appear very similar, some might very well accuse the United States (and other countries deploying quantitative easing) of currency manipulation. Hence the administration reinforced the congressional focus on manipulation as it emphasized this distinction.

A third interesting feature was the country focus of the debate. China had, of course, been the major target of congressional (and administration) concerns on the currency front over the preceding decade, and Senator Schumer and some others continued to emphasize its previously heavy intervention. However, the renminbi had risen substantially over the preceding five years, especially on a trade-weighted basis, and it had recently appreciated with the dollar, to which it remained essentially pegged, against most other currencies. The Chinese current account surplus had dropped from almost 10 percent of GDP at its peak in 2007–08 to less than 3 percent. Chinese intervention in 2015 shifted from primarily buying dollars, to keep the renminbi from strengthening further, to largely selling dollars, to keep the renminbi from departing its fixed exchange rate on the downside in the face of large private capital outflows. While rhetorically maintaining its traditional position that China should let market forces determine its exchange rate, the administration in practice reinforced this "reverse intervention" by letting China know that it would be displeased with a "disorderly" or sharp fall in the renminbi, especially after China engineered a small devaluation in August 2015, undoubtedly using the congressional pressures (some of which resurfaced for a short time after that Chinese action) as usual to reinforce its case. The administration could thus claim with some validity that its policy of patient diplomacy had succeeded, and the decline in manipulation probably weakened congressional concern over the issue (although some members had simply used it as an excuse to justify antitrade positions that were based on other considerations).

These changes in circumstances, including the sharp decline in the US deficit as well as the Chinese surplus from the levels of 7 to 10 years ago, also probably meant that no countries (and almost certainly no TPP countries with the possible exception of Singapore) could reasonably be indicted for manipulation any time soon. The anti-Chinese invective that had been common in earlier years declined substantially, and Congress quite sensibly came to view the legislation as a potential vehicle to provide deterrence against future bad behavior on the currency front, especially vis-à-vis countries that were about to enjoy increased access to the US market via new trade agreements, rather than a trigger for immediate retaliation.

The chief political driver of the currency issue was the automobile industry, especially Ford Motor Company, whose emphasis was on Japan and, to a lesser extent, Korea. Japan had not been guilty of overt manipulation for more than a decade, as even the auto companies acknowledged. The incoming Abe government in late 2012 had vigorously talked down the yen by about 30 percent, however, with subsequent "validation" by the aggressive quantitative easing monetary policy adopted by the Bank of Japan (but also with stern rebukes by the Treasury and a strong G-7 statement in February 2013 that committed Japan, along with the other members, to avoid targeting exchange rates and indeed all currency intervention without prior consultation with the group).[20] In its most recent semiannual currency reports, the Treasury Department had singled out Korea as the major intervener over the past year or so (though Treasury did not label it a "manipulator," any more than it had China for the previous decade, and noted that it, like China, had also recently intervened on the other side of the market to keep its exchange rate from weakening further).

20. Frankel (chapter 6) calls this G-7 statement an "anti-Plaza agreement" because it "rules out intervention." The statement clearly permits intervention, including joint intervention, that is agreed to by the group, however; it therefore also authorizes a repetition of the (agreed) Plaza strategy. More generally, Frankel fails to distinguish between intervention that is agreed to and intervention that is adopted unilaterally and may therefore be guilty of contributing to "currency wars."

A fourth feature is the fact that the issue remained bipartisan to an important extent. Democrats provided most of the votes for strong action on currency in the Senate (there were no recorded votes in the House), but Republicans took the lead on key aspects of the issue. Senator Rob Portman, the former US Trade Representative under President George W. Bush, led the effort in both the Finance Committee and on the floor to require that "enforceable disciplines" against manipulation be negotiated in the TPP (the vote lost by very small margins in both). Senator Lindsey Graham continued to cosponsor, with Senator Schumer, the amendment that would authorize the application of countervailing duties against imports subsidized by currency manipulation (the measure passed the Senate by a wide majority as part of separate legislation but was dropped in the conference committee as a result of opposition by the House leadership).

A fifth feature was the administration's adamant opposition to any new legislation that would be legally binding on either it or its trading partners in the TPP. The strategy was risky, because it appeared at several points that such stonewalling could block passage of the entire TPA bill, possibly killing the TPP negotiations. But the administration claimed that its consultations with TPP partners indicated that US insistence on binding currency rules would itself kill the negotiations. (It is impossible to validate that claim, because the administration never sought agreement on binding rules; to the contrary, the trading partners knew that the administration opposed such rules, so they could have simply been giving it ammunition to use in the congressional debate.) It also feared, as noted above, that other countries might attack the macroeconomic policies of the United States, especially quantitative easing by the Fed, as constituting currency manipulation. In the end the administration conceded enough ground on nonbinding alternatives (see below) to persuade just enough advocates of new currency action to support the TPA legislation that permitted the trade policy agenda to move ahead. However, the absence of stronger action on currency is emphasized by many opponents of the TPP itself and could jeopardize congressional approval of that agreement.

Where does the congressional debate leave US currency policy? There were four major components of that debate (and a fifth that was considered informally). First, Congress inserted two "principal negotiating objectives" into the TPA legislation itself: an insistence that TPP members "avoid manipulating exchange rates to prevent effective balance of payments adjustment or to gain an unfair competitive advantage" and "establish accountability with respect to unfair currency practices... by other parties to a trade agreement." Both provisos authorize the administration to adopt various techniques to achieve its purposes, including "enforceable rules." Neither objective needs to be achieved through the TPP itself, however, and the law also authorizes such softer options as "cooperative mechanisms, reporting, monitoring, transparency or other means."

The administration's primary response was to negotiate a Joint Declaration of the Macroeconomic Policy Authorities of Trans-Pacific Partnership Countries that reaffirms their commitments, from the IMF Articles of Agreement and numerous G-7 and G-20 communiqués, to avoid "manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage," "persistent exchange rate misalignments," "competitive devaluation," and targeting of "its country's rate for competitive purposes." Countries also commit to greater transparency and reporting, including public disclosure of their foreign exchange reserves and intervention data. They also agree to create a Group of TPP macroeconomic officials that consults with one another at least annually on macroeconomic, including currency, issues and to issue reports on its results. All of this will take place outside the TPP itself and with no legal obligations.[21]

The other TPP countries acknowledged the US need for some such initiative to respond to the new Congressional mandate and broader currency pressures. They were pleased that the concept of "enforceable disciplines" in the TPP itself was dropped. But they were not enthusiastic about the watered-down version either, which an aggressive US administration could use to put considerable pressure on them. Japan publicly expressed doubt about it.[22] It remains to be seen what, if any, practical impact the new group will have. Treasury will, of course, continue its bilateral efforts and its use of existing forums, including the G-7 and G-20, to pursue US currency goals.

Second, the proposed Portman-Stabenow amendment greatly strengthened the "negotiating objectives" by requiring their implementation through "enforceable disciplines" in the TPP itself. This approach, maintaining the insistence of the congressional letters of 2013, elicited the strongest opposition from the administration and indeed a pledge by Treasury Secretary Jacob Lew to recommend that the president veto any TPA bill that included it (though never a veto threat from the president himself) on the grounds that it would torpedo the entire TPP negotiation. The amendment lost by a narrow margin both in the Senate Finance Committee (18–14) and on the floor (51–48).

The two other alternatives considered by Congress were, through a parliamentary maneuver to protect the TPA bill, included in a parallel customs and enforcement bill that was initially adopted in different forms by the two houses. The stiffer of the two was the Schumer-Graham amendment authorizing countervailing duties against exports subsidized by currency manipulation. It passed the Senate by a large majority (after passing both the House and Senate in separate bills in 2010 and 2011, respectively) but was strongly opposed by the Republican leadership in the House (as well as by the administration). It was dropped when the conference committee met to reconcile the two versions of the full bill and in the final legislation, which passed in early 2016.

21. For more details, see Bergsten and Schott (2016).

22. The G-7 antimanipulation statement of February 2013, whose main target was Japan, can be viewed as a US-Japan precursor to the joint TPP declaration in the same way that the Baker-Miyazawa bilateral agreement of late 1986 on the yen/dollar exchange rate was a precursor to the broader target zones agreed by the G-7 at the Louvre.

The less aggressive alternative, and the one most likely to have a lasting impact on US currency policy, is the Bennet-Hatch-Carper amendment, worked out by the administration and the key committees, particularly the Senate Finance Committee (where most of the detailed discussion took place). It has three parts: specification of the criteria that will lead a country to be confronted for currency manipulation; a new procedure to guide such confrontation, culminating in "enhanced engagement" by the United States; and a series of remedies to be considered once such engagement is undertaken.

The amendment requires Treasury to include in its semiannual reports an "enhanced analysis" of any major trading partner of the United States that has "a significant bilateral trade surplus with the United States… a material current account surplus and… engaged in persistent one-sided intervention in the foreign exchange market." It goes on to require that "the President, through the Secretary of the Treasury, *shall* [emphasis added] commence enhanced bilateral engagement with each country for which an enhanced analysis… is included in the report…." It is difficult to see how Treasury could have evaded these criteria with respect to China and a number of other countries over the past decade. However, the "enhanced bilateral engagement" has no required outcome; the closest is the requirement to "develop a plan with specific actions to address [the] undervaluation and surpluses." The bill also includes a clause authorizing the Treasury secretary to waive the requirements for economic or national security reasons.[23]

In addition, if the secretary determines that a country has failed to adopt appropriate policies to correct its undervaluation and surpluses after a year, the president *shall* [emphasis added] take "one or more" of four specified actions. One is to instruct the US executive director at the IMF to call for that institution to undertake "additional rigorous surveillance and, as appropriate, formal consultations on findings of currency manipulation" (though the United States of course cannot force the IMF to do so). Another is to "take [such failure] into account" in determining whether to pursue a bilateral or regional trade agreement with that country. This proviso, which acknowledges the linkage between currency and trade, might prove to be a powerful deterrent to manipulation by Korea, or even China, if it decides to seek membership in a second phase of the TPP. The secretary has discretion to determine whether a country has "failed to adopt appropriate policies," although the same objective criteria that require "enhanced analysis" in the first place would still presumably obtain.[24]

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23. The most likely immediate targets would be Korea and Taiwan, the same economies that were labelled "manipulators" in Treasury's first report after the previous law was passed, in 1988.

24. A fifth, much more informal and limited, policy consideration during the congressional debate was my proposal (first presented June 25, 2003, in testimony before the House Committee on Small Business ["The Correction of the Dollar and Foreign Intervention in the Currency Markets"]) for "countervailing currency intervention." Under this mechanism, the United States would buy the currencies of manipulators in amounts equal to their purchases of dollars, in order to neutralize

It may be a while before we know what impact, if any, the recent congressional debate will have on US currency policy. It could result in new procedures, both domestically (especially at Treasury) and internationally (including via the committee of TPP monetary authorities), but little or no new substance. Alternatively, it could lead to a tougher stance against recent (Korea?) and potential future (China or Japan again?) manipulators that would effectively deter such practices. The outcome will depend heavily on the degree of continuing congressional pressure on the administration, which in turn will depend at least partially on the extent of actual currency manipulation by countries that are major trade competitors of the United States.

More subtly, the congressional debate itself—especially the close votes regarding insistence on "enforceable disciplines" in the TPP and authorization of countervailing duties against all manipulators—may deter future manipulation, at least for a while. The extent and amount of manipulation has declined substantially in recent years (as Gagnon notes in chapter 11). The decline reflects market forces, where the flipside of strong dollar appreciation is the weakening of the currencies of most emerging-market economies and thus the disappearance of much (if not all) of the need for them to buy dollars to avoid appreciation. Many countries, such as China and Korea, have indeed been operating on the other side of the market—selling dollars on at least some occasions to limit the depreciation of their exchange rates. But the sharp decline in manipulation is also probably at least partially the result of the stepped-up concern over the issue voiced in Congress and more broadly in the United States and around the world. It may be sustained if that concern is maintained, as is likely to be the case. The test will come only when market pressures again start promoting stronger exchange rates for the renminbi and the currencies of other traditional manipulators, as they surely will, but the global currency regime may thus have achieved at least a bit of progressive de facto reform.

Conclusion

Recent developments regarding currency policy relate to prospects for a future Plaza II or similar initiative by the United States, which lessons from the Plaza Accord suggest would have to lead any such effort. Such initiatives do not require legislative authorization. But congressional pressure—especially related to trade policy—has been a central feature of past US efforts of this type, including the Plaza itself. On the most recent occasion, Congress stopped just short of forcing the administration to take new steps. Its widespread senti-

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and thus deter their manipulation. Such an authorization was passed by the Senate as "remedial currency intervention" in 2011 but never formally addressed by the House. Key members of the Senate Finance and House Ways and Means Committees raised the idea with top administration officials during the latest debate. They strongly opposed it, and the idea was not pursued further. It would be useful to add this remedy to the list authorized for deployment against countries subjected to "enhanced engagement."

ment for a more aggressive stance was clear, however, and has already led to potentially significant policy changes. This congressional attitude is likely to have continuing and even growing impact as the US trade and current account deficits increase as a result of the sizable recent (and potential future) run-up in the exchange rate of the dollar and as trade policy issues remain before Congress for action.

The congressional focus on manipulation by individual surplus countries, rather than on generalized currency problems in response to macroeconomic conditions and monetary policies, could on the other hand reduce the likelihood of multilateral action. It is possible that intervention by surplus countries could again become sufficiently widespread to warrant such an approach, as some analysts advocated a few years ago (Cline 2005, Bergsten and Gagnon 2012). But the thrust of US currency policy since the Plaza-Louvre period has been country specific and ad hoc, and that pattern is likely to prevail unless and until the conditions hypothesized in the previous section prevail again.

It is thus not yet time for a Plaza II. However, the underlying imbalances are about as great as the ones that triggered the Plaza Accord itself. The problem of currency misalignments remains acute. It would be desirable to erect new deterrents to manipulation (though it is likely to remain only part of the broader adjustment problem), including enforceable disciplines in trade agreements, if they could be negotiated, and the institution of a policy of countervailing currency intervention by the United States itself.

In the meanwhile it is extremely useful to recall the successes and lessons of the Plaza Accord. Secretary Baker and the Baker Institute for Public Policy are to be greatly commended for sponsoring this project to do so—and thus to remind current and future policymakers that a model exists for responding to such problems. It would probably take another Secretary Baker and an equally talented team to engineer such a replication, however. Future administrations should take note in assembling their lineups.

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