

A Call *for an* “Asian Plaza”

*Introducing an action plan for a new “G5”—
China, Saudi Arabia, Euroland,
Japan, and the United States.*

BY C. FRED BERGSTEN

From 1995 to early 2002, the dollar rose by a trade-weighted average of about 40 percent. Largely as a result, the U.S. current account deficit grew by an average of about \$70 billion annually for ten years. It exceeded \$800 billion and 6 percent of GDP in 2006. This posed, and continues to pose, two major consequences for the world economy.

The first was the risk of international financial instability and economic turndown. To finance both its current account deficit and its own large foreign investments, the United States had to attract about \$7 billion of foreign capital every working day. Any significant shortfall from that level of foreign demand for dollars would drive the exchange rate down, and U.S. inflation and interest rates up. With the U.S. economy near full employment but already having slowed, the result would be stagflation at best and perhaps a nasty recession.

The current travails of the U.S. economy are clearly related to these imbalances. The huge inflow of foreign capital to fund the external deficits held interest rates down and contributed significantly to the housing bubble that triggered the financial crisis and economic turndown. The sizeable slide of the dollar has indeed added to price increases, notably of oil as the producing countries seek to counter the losses it causes for their purchasing power, and thus greatly complicates the management of monetary policy as it tries to prevent a recession. The world economy is also

C. Fred Bergsten is Director of the Peterson Institute for International Economics.

adversely affected through the impact on other countries, as their currencies rise and they experience significant reductions in the trade surpluses on which their growth had come to depend.

Second is the domestic political risk of trade restrictions in the United States and thus disruption of the global trading system. Dollar overvaluation and the resulting external deficits are historically the most accurate leading indicators of U.S. protectionism because they drastically alter the domestic politics of the issue, adding to the pressures to enact new distortions and weakening pro-trade forces. These traditional factors are particularly toxic in the current context of strong anti-globalization sentiments and economic weakness. The spate of administrative actions against China over the past several years, and the numerous anti-China bills now under active consideration by the Congress, demonstrate the point graphically since China is by far the largest surplus country and its currency is so dramatically undervalued.

The U.S. current account deficit does not have to be eliminated. It needed to be cut roughly in half, however, to stabilize the ratio of U.S. foreign debt to GDP. That ratio was on an explosive path, which would have exceeded 50 percent within the next few years and an unprecedented 80 percent or so in ten. Avoiding such outcomes required improvement of about \$400 billion from the levels reached by 2006.

I and colleagues at our Peterson Institute for International Economics have been pointing to these dangers since the end of the 1990s, and calling for corrective

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action that would include a very large decline in the exchange rate of the dollar. We were confident that such a decline would, as in the past, produce a substantial turnaround in the U.S. external position and it is now doing so. The current account deficit has fallen by more than \$100 billion and is likely to drop by another \$100 billion or so over the next couple of years. The fall of the dollar by 25–35 percent over the past six years, depending on which index is used, has sharply increased the international competitiveness of the U.S. economy. Exports have been growing at more than 8 percent annually for the past four years and by about 12 percent for the last two. Especially with the recent slowdown in U.S. growth, they are now expanding four times as fast as imports.

The internal corollary is of course that U.S. domestic demand, initially residential investment but now also consumption, is rising more slowly than output. This inevitable reversal, after a decade in which internal demand climbed more sharply than production, means that the improving trade balance is cushioning the aggregate U.S. slowdown to an important extent. We are in fact experiencing the first episode of “reverse coupling,” through which the rest of the world continues to expand and pulls up the United States rather than being devastated by its turn-down. This is an early indication of the shift in global economic weights, with the rapidly growing emerging markets now accounting for almost half of world output, as well as a timely unwinding of the chief global imbalance of the early twenty-first century.

THE CURRENT AGENDA

Even on this modestly optimistic prognosis, however, the U.S. deficit will remain too large. The dollar needs to fall by another 5–10 percent to cut the imbal-



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ance to a sustainable 3 percent of GDP. This is one of the three key factors that underlie the current set of imbalances that should now be addressed by global economic policy.

The second factor is the continuing surge of China's global current account surplus. That imbalance reached about \$400 billion in 2007 and, while growing more slowly in the future, is likely to reach \$500 billion by next year. It will thus be almost as large as America's global current account deficit in absolute terms in an economy about one-third the size of the United States. The surplus exceeds 10 percent of China's GDP, an unprecedented level for the world's largest exporting nation. The Chinese authorities have let their currency rise more rapidly against the dollar over the past few months, and continued appreciation at that pace for another two or three years could cut their surplus to a manageable level, but the renminbi has still not climbed at all against a trade-weighted average of the currencies of its main trading partners since the dollar peaked in early 2002 and its own surpluses started to climb.

The third factor is the creation of the euro, which provides a real international monetary rival for the dollar for the first time in almost a century. The dollar has been the world's dominant currency since the abdication of sterling, around the time of the First World War, primarily because it had no competition. No other currency was based on an economy and financial system that even approached the size of the U.S. economy or its capital markets, and thus none could even begin to challenge the dollar in international finance. Former

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Euroland, has an economy about as large as the United States and exceeds U.S. levels of both external trade and monetary reserves. The euro has already outstripped the dollar in terms of currency holdings around the world and denomination of private bond flotations.

The dollar will obviously remain a major international currency and it may be some time before the euro overtakes it, if it ever does so. But we should expect a steady and sizable portfolio diversification from dollars into euros as private investors, central banks, and sovereign wealth funds seek to align the currency composition of their assets with the new structure of the world economy and global finance. One result will be steady upward pressure on the euro, and downward pressure on the dollar, in the exchange markets over the longer run. A somewhat similar portfolio adjustment took place from yen into dollars during the early 1980s, after Japan finally lifted its controls on capital outflows, adding substantially to the upward pressure on the dollar during that period.

A PROPOSED RESPONSE

The result of these developments is a series of imbalances, some old and some potentially new, that create major risks for the world economy, international financial stability, and the trading system (due to the protectionist impact of large currency overvaluations). They call for urgent new policy initiatives by the G7, the

International Monetary Fund, and probably new groupings of key countries that reflect the rapidly evolving power structure of the global economy.

First, there is now a substantial risk of a free fall of the dollar. Its sizable depreciation over the past six years has been gradual and orderly, and it is approaching an equilibrium level. As often happens in the last stages of a major currency swing, however, like the dollar's upward overshoot in 1984–85 and downward overshoot in 1995, that decline could now accelerate.

Both growth differentials and interest rate differentials have moved sharply against the dollar and are likely to continue doing so for a while. As noted, the current account imbalances remain too large and the maturation of the euro creates an additional incentive for shifts out of the dollar. Perhaps even more importantly, the acute slowdown in U.S. productivity growth undercuts the chief rationale for the strong dollar of the second half of the 1990s, and the advent of stagflation conjures up images of the 1970s, which witnessed three sharp dollar declines—including in 1978–79 its closest approximation to date of a “hard landing.”

The G7, in conjunction with the major Asian economies, thus needs to be ready with a contingency intervention plan to limit the pace (and perhaps extent) of dollar decline if a free fall begins to eventuate. They should not seek to block the further realignment of exchange rates that is needed to complete the adjustment process, especially against the Asian currencies as elaborated below. However, dollar depreciation of excessive speed and magnitude could exacerbate the present economic weaknesses in both deficit and surplus countries: raising inflation and interest rates in the United States, perhaps sharply, and weakening export and overall growth in Europe, Canada, Australia, and others. In the present fragile environment, it could also ignite another round of global financial turmoil. The results could be sufficiently severe to tip the current global slowdown into a world recession.

It should in fact be simple for the G7 along with the key Asians, most of whom are already intervening substantially, to agree to moderate the pace and amplitude of the dollar's final decline. One would indeed assume that the needed contingency plans have already been prepared. However, the failure of these same countries to anticipate and respond cooperatively to the current financial crisis generates little confidence in their ability to work together even when the benefits of doing so are blindingly obvious. A new initiative on this front, orchestrated particularly by the United States and Euroland as the issuers of the world's two key currencies, is likely to be necessary.

Second, the remaining decline of the dollar needs to be steered in geographically appropriate directions. It should take place, wholly or very largely, against the renminbi and the currencies of other Asian countries along with a number of oil exporters. These countries are running most of the counterpart surpluses to the U.S. deficit, and piling up massive foreign exchange reserves, and the International Monetary Fund has recently certified that most of them enjoy the option of expanding domestic demand to offset the adverse growth impact of declining trade surpluses.

If these surplus countries continue to resist significant appreciation of their exchange rates, the counter-

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parties to the dollar decline will be the currencies (mainly of Euroland, the United Kingdom, Canada, and Australia) that have already risen substantially and whose countries are not running substantial (if any) surpluses. The result would be the creation of sizable new imbalances that would produce new problems for the world economy and, due to the protectionist impact of large currency overvaluations, for the already-beleaguered global trading system. In the meantime, further increases in the Chinese (and other Asian and oil producer) surpluses, coupled with the declining U.S. deficit, will place considerable pressure on the trade positions and growth prospects of the rest of the world.

There is no effective monetary coordination, or even cooperation, among the Asian economies despite their Chiang Mai Initiative and the swap agreements that they have arranged over the past few years. Hence any individual Asian country understandably fears that permitting its own currency to appreciate unilaterally

Continued on page 70

Continued from page 15

could undercut its position against its neighbors and chief competitors, as has in fact happened to Korea since it let the won rise sharply. This collective action problem can be solved only by an Asian Plaza Agreement, or some informal equivalent, through which the main countries in the region agree to let all their currencies rise more or less in tandem with the renminbi once it is permitted to strengthen substantially. Such an agreement would make an important difference: if all the major East Asian currencies (including the yen) moved together, they would climb by trade-weighted averages of a very manageable 12–15 percent each even if they all appreciated by 30 percent against the dollar.

The International Monetary Fund should take the lead in forging such an “Asian Plaza.” Now that Euroland has joined the United States in sharply criticizing China’s huge surpluses and massive intervention to limit the rise of the renminbi, and especially as Asian and developing countries such as India and Mexico have expressed similar alarms, the International Monetary Fund should be able to forge a sufficient consensus to do the Asians the great favor of enabling them to act together on this issue. A dividend for the International Monetary Fund should be enhanced status in Asia and thus a major deterrent to any future consideration of a rival Asian Monetary Fund.

The third needed initiative would reinforce the first two but address as well the secular impact of the advent of the euro as a global key currency: creation of a Substitution Account at the International Monetary Fund to avoid some of the exchange-rate impact of dollar diversification by providing an off-market alternative for its realization. Such an account, which was actively negotiated and almost came into being during an earlier bout of dollar diversification in the late 1970s, would accept unwanted dollars from official holders in return for Special Drawing Rights at the Fund. The investors in the account would receive a widely diversified and highly liquid asset with a market interest rate while protecting the value of their (very large) remaining dollar assets. The Euroland countries would avoid additional appreciation of their currency. The United States would avoid excessive weakness of the dollar. The International Monetary Fund would gain a new lease on life.

Such an initiative should thus have widespread appeal and all parties should be willing to use part of the International Monetary Fund’s large gold holdings to protect the account against valuation losses if the dollar were to fall further in the future, which was the chief sticking point during the previous negotiation. Since the dollar is probably near its lows, at least for a considerable

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time, a rebound that would instead generate sizable profits for the Substitution Account over the next decade or so is in fact more likely—as would have occurred had it been agreed in 1980.

CONCLUSION

The partial and continuing correction of the world’s previously dominant imbalance, the U.S. current account deficit, highlights and indeed exposes several other actual or potential imbalances that pose major risks and must now join it at the forefront of the global policy agenda: avoidance of a free fall of the dollar, correction of the huge Chinese surplus (and other Asian and oil surpluses), the related prevention of a building of new deficits in Europe and other areas where currency appreciation may go too far, and the exchange rate impact of the advent of the euro as a global rival to the dollar.

Different groups should take the lead in addressing each of these problems. The United States and Euroland should devise the contingency plans to counter a free fall of the dollar against the euro, and spur the initial negotiations to create a Substitution Account to limit the market impact of diversification from dollars to euros. The Asians should work out a coordinated realignment of their currencies against the dollar. The International Monetary Fund is the chief institution to implement most of these plans.

This would also be an ideal agenda for the “new G5” recently created by the International Monetary Fund to conduct its revived multilateral surveillance program. The new group includes China and Saudi Arabia, for the oil exporters, as well as the United States, Euroland, and Japan. It could seize the moment to replace the G7 as the key steering committee for the world economy, greatly strengthening the position of the convening International Monetary Fund in the process. A failure to pursue all three components of the strategy will leave the world at substantial risk in the period ahead and deepen the threats to the world economy that are posed by the current financial crisis. ♦