CURRENCY WARS,
THE ECONOMY OF THE UNITED STATES
AND
REFORM OF THE INTERNATIONAL MONETARY SYSTEM

Stavros Niarchos Foundation Lecture

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Introduction

I am deeply honored to be invited to present this twelfth annual Stavros Niarchos Foundation Lecture at the Institute and want to take the occasion to add my personal gratitude to the Stavros Niarchos Foundation, led and represented here by Spyros Niarchos and Andreas Dracopoulos, for making this series possible and for supporting it so generously at the Institute over the past decade.

I began my professional career in international economic policy almost precisely fifty years ago and spent much of my first two decades in the US Government, first working for Dick Cooper (who is here) among others at the State Department, then as Henry Kissinger's deputy for foreign economic policy at the National Security Council and subsequently in charge of the international part of the Treasury Department under Secretary Mike Blumenthal (who is also here). With enormous help from many people in this room, especially Pete and Frank Loy, I

[1] I wish to thank Katherine Stewart for her enormous help in processing this presentation and Longxiu Tian for excellent research assistance. Many of my colleagues at the Institute provided helpful advice and I am especially grateful to Joe Gagnon, Morris Goldstein, Adam Posen and Bob Zoellick for their extensive comments.

began my stewardship of the Institute thirty-two years ago. In presenting today's lecture, I want to draw on both sets of experiences to analyze the dramatic evolution of the world economy, and especially the role of the United States within it, over the past half century. I will rely heavily on the research of my Institute colleagues, which has been responsible for its and much of my success, over the history of this institution. At the urging of my colleagues, I will also try to spice up the presentation with a few anecdotes drawn from my personal recollections – though I hope you will not conclude that I have moved too far into my anecdotage just yet. A full text of my lecture, which adds several arguments that I will not have time to address tonight and is replete with tables, footnotes and references, will be available after the presentation.

When I was discussing what topic to address tonight with Adam a few weeks back, he suggested that I might want to celebrate the triumph of competitive liberalization as the driving strategy for the global trading system, an idea which I conceptualized and helped implement in the middle 1990s as chairman of the APEC Eminent Persons Group and then in a series of papers after Carla Hills had gotten it going as USTR and as Bob Zoellick then carried forward so effectively during his tenure in that position, and which is now proceeding boldly with negotiation of the three megaregional agreements: throughout Asia, across the Pacific (beginning to fulfill the original APEC vision) and across the Atlantic. Alternatively, I could have reiterated my (and Jacob Kirkegaard's) conviction, which has proved correct so far, that the euro will survive its current crisis and perhaps emerge stronger as a result of the policy and institutional reforms that its member countries have been forced to adopt at an accelerated pace. But I decided instead to revert to the topic of my first book, which has concerned me deeply throughout my career, the shortcomings of the international monetary system and particularly their effects on the United States.

I do so in the hope that I can persuade you of six central points:

1. That currency conflict is very sizable and very widespread, and that it could get worse (maybe much worse);
2. That it has very large economic effects, especially on the United States and the weak peripheral countries of the Eurozone;
3. That these developments stem from a gaping hole in the international economic architecture, encompassing both the monetary and trading systems;
4. That there is a feasible set of effective policy options that can be adopted to counter the objectionable practices now and deter them in the future; and
5. That the United States, as both the systemic leader and the most injured party, should initiate a major effort to do so multilaterally but be ready to act unilaterally as well if necessary.
6. In short, it is time to declare war on the currency wars.

I address all this through the lens of the international monetary system because, as Joseph Nye has famously said about the security system, the monetary system is like oxygen: you never notice it until its absence poses serious, even existential, problems. I also do so because the system is clearly suffering from secular erosion. Crises have become much more frequent. They are intensifying, with the latest downturn the worst since the 1930s. They have afflicted all major regions: Asia in the late 1990s, the United States in 2007-09 and Europe now. The rich countries were the epicenter of the latest disruptions, broadening their impact. The calls are clearly getting closer. The system is undergoing its most severe stress test to date.

The international monetary system also now faces a clear and present danger: currency wars. Virtually every major country is seeking depreciation, or at least non-appreciation, of its currency to strengthen its economy and create jobs.[2] My colleague Joe Gagnon has identified more than twenty countries that have been intervening directly in the foreign exchange markets for this purpose for a number of years, resulting in cumulative buildups of reserves exceeding $10 trillion in total (Table 1) and averaging almost $1 trillion annually of late (Table 2).[3] They have done so mainly by buying dollars and euros, to keep those currencies overly strong and their own currencies weak, mainly to boost their international competitiveness and trade surpluses.

This list includes some of the largest economies in the world, both developing and developed. It is led of course by China but includes a number of other Asians as well as several oil exporters and a couple of Europeans (Table 1). They account for almost one third of the world economy and more than two thirds of global current account surpluses (Table 2). Broadening the list beyond China roughly doubles its magnitude.[4] Currency manipulation is very large and very widespread.[5]

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[2] Goldstein (1995) presciently raised this issue as early as 1995, noting that "the focus of attention is likely to shift away from G-7 exchange rate relationships to those between industrial and developing countries." He contributed extensively to the Institute's work on the topic with a series of papers from 2003 through 2011.

[3] Gagnon and I (2012) note that some reserve buildups, particularly by exporters of oil, are justifiable and we include only our estimates of the "excessive" buildups in deriving the cumulative annual average of about $1 trillion and in our calculations of its economic effects. We include holdings of foreign assets of sovereign wealth funds (Truman 2011) along with reported holdings of foreign exchange.

[4] The "target list" of manipulators for priority policy response identified by Bergsten and Gagnon (2012) includes China, Denmark, Hong Kong, Korea, Malaysia, Singapore, Switzerland and Taiwan, which accounted for half the estimated amount of unjustified intervention in 2011 (full data are not yet available for 2012). Cessation of intervention by these countries would probably persuade many of the other interveners to desist as well because much of their action is aimed at avoiding competitive loss to the largest manipulators (especially China); see Subramanian and Kessler (2012). Japan should be put on a "watch list," as it is in essence already by the G-7. Most of the remaining intervention is by major oil exporters, both members of OPEC led by Saudi Arabia and non-members such as Norway and Russia.

[5] The list excludes the many countries that intervene justifiably and solely for defensive purposes to keep their already overvalued currencies from becoming even more misaligned, like Brazil, though their reactions increase the international conflict that derives from the manipulation itself. See the discussion below.

Gagnon shows that the global surpluses of the currency manipulators have increased by $700-900 billion per year (Tables 3 and 4) as a result and created corresponding deficits in other countries, with consequent losses of output and jobs there under current and foreseeable conditions of slow growth and high unemployment (Figure 1, taken from Gagnon 2012 and Gagnon 2013).[6] The largest loser by far in absolute terms is the United States, whose trade and current account deficits have been $200 billion to $500 billion per year larger as a result, at least one half of our total external imbalances. The United States has suffered 1 million to 5 million job losses in the present and likely continuing environment of excess unemployment.[7] Correction of this situation would have a powerful positive effect on the US economy on a scale comparable to the fiscal stimulus of 2009 or the Fed's quantitative easing (QE) initiatives taken together.[8] For their part, most of the manipulators can and should be expanding domestic demand instead of relying on large trade surpluses – the famous "rebalancing" that has been a staple of G-20 statements but precious little accomplishment from the very outset of the global crisis.

Europe is the second largest loser, with trade deterioration of $150-200 billion annually and corresponding job losses. IMF research shows that several of the southern European crisis countries were particularly adversely affected by Chinese competition including through the "very sharp nominal appreciation of the euro" (Chen, Milesi-Ferretti and Tressel 2012). Studies by the European Commission, while also diplomatically refraining from explicitly calling out currency manipulation, concur that "strengthening in the nominal exchange rate of the euro"

[6] Gagnon (2013) demonstrates that reserve buildups, largely generated by intervention, lead to current account surpluses rather than the other way around as often argued. His work suggests that no more than 20 per cent of the increases in official foreign exchange reserves are offset by private capital inflows.

[7] There are two sources for these employment effects. One is a simulation of the Federal Reserve's general equilibrium model of the US economy, which implies 2 million to 5 million job losses. The other is the Commerce Department's finding that each $1 billion in exports creates 5,000 jobs. On that view, a reduction in the US trade deficit of $200 billion would create 1 million jobs and a reduction of $500 billion would create 2.5 million jobs. Edwards and Lawrence (2013, 83) conclude, using very different methodologies, that the trade deficit reduced manufacturing employment opportunities by 2.7 million in 2010.

[8] See CBO 2012 for estimates of job creation from the fiscal stimulus of 2009 and Yellen 2013 for QE.

especially hurt the eurozone's deficit members and inveigh against euro appreciation (European Commission 2012). <u>The global imbalances have clearly intensified the euro crisis</u>.

The reserve buildups and imbalances declined lately and China, in particular, has let its currency rise substantially and sharply reduced its current account surplus. But the currencies of all of the Asian manipulators, with the possible exception of Korea, remain substantially undervalued – several of them by considerably more than the RMB (Cline and Williamson 2012). Moreover, much of the adjustment progress is due to cyclical factors, mainly the sharp slowdown in growth in (especially) Europe and the United States, and <u>the IMF projects that the imbalances are likely to rise again in the near future, especially for China and the United States.</u>

There are signs that they have already begun to do so, especially in China. Its reserves have risen by more than $150 billion over the past two quarters, almost as rapid a pace as at the peak of its current account surpluses in 2007. The IMF estimates that its surplus will triple from 2012 to 2018, rising to almost $650 billion.

But those forecasts could well prove to be too conservative. China could maintain or even increase its renewed intervention if its recent slowdown continues and/or its stated goal of relying more heavily on domestic demand growth continues to progress slowly and/or it were to experience the long-feared banking crisis. The Treasury Department's latest semiannual report on exchange rate policies (Treasury 2013), while it again shamefully failed to designate any of the intervening countries as "manipulators," expressed concern about Korea and Taiwan, stressed that China had again "apparently resumed large-scale foreign exchange intervention" and that its current account surplus is likely to double as a share of global GDP by 2017, and once again concluded that the RMB is "significantly undervalued." The latest estimates of "fundamental equilibrium exchange rates" by Cline and Williamson (2012, 7) show that the RMB would need to rise by 14 per cent to eliminate the projected Chinese surplus (and that the dollar would have to fall by a trade-weighted 15 per cent to eliminate the US deficit).[9] The G-20 and G-7 continue to inveigh against the global imbalances and were sufficiently alarmed at their latest meetings in February 2013, with an eye especially to recent developments in Japan, to emphasize their "commitments to avoid exchange-rate targeting." Brazil has taken the issue to the World Trade Organization.

The outlook is most worrisome because <u>some of the world's largest and richest economies have already joined, or seem to be contemplating joining, the "currency wars."</u> <u>Switzerland</u> became the world's largest manipulator in 2012, most immediately for monetary policy reasons but also to preserve its huge current account surplus in the midst of continuing recession in its main trading partner, the eurozone. <u>Japan</u> triggered the latest wave of concern when its new government, both before being elected and immediately after taking office, aggressively talked down the yen by about 30 per cent against the dollar.[10] The President of France has called for a weaker <u>euro</u> and so have a number of economists, including in the United States (Feldstein 2012), indeed viewing that as the only feasible escape for Europe from many

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9 Their own finding that the dollar is overvalued by only 2.2 per cent (and the RMB undervalued by only 3 per cent) is based on a conceptual framework that aims only to keep countries' global imbalances within 3 per cent of their respective GDP levels. Edwards and Lawrence (2013, 169, 241) find that a 15 per cent depreciation of the real dollar exchange rate would be needed to eliminate the current US deficit of about $500 billion.

10 Widespread criticism of that behavior led Japan to cease its oral intervention and the subsequent adoption of aggressive QE by the Bank of Japan may justify the depreciation. The Cline-Williamson calculation of FEERs suggests that the yen has moved from being slightly overvalued to being significantly undervalued.

more years of stagnation or worse – especially if Germany continues to resist expanding domestic demand more rapidly to promote intra-eurozone rebalancing.

This reminds me of why, along with the overriding geopolitical basis for European integration, I always think of the euro as so hugely in Germany's interest and indeed as "the revenge of Helmut Schmidt". During our many discussions, especially when Dick Cooper and I were trying to persuade West Germany to become a locomotive for the world economy, he would fulminate every time a German export-led boom was thwarted by a sharp rise in the DM, which he always called "a fall in the dollar." He and all other Germans can now enjoy both the world's largest trade surplus and a weak currency, however, obviating the usual adjustment pressures even more than other surplus countries. The Germans have now protected themselves even further by insisting that the new Eurozone procedures for dealing with its internal imbalances go very easy on its surplus countries – unfortunately replicating the asymmetries of the global system.

The concept of defensive intervention enters the picture at this point. The currencies of a number of countries have become overvalued and produced external deficits, importantly due to the widespread manipulation. Counteractions by them are fully justified and have already been taken by some, such as <u>Brazil</u> and most recently <u>New Zealand</u>.[11] Some perceptive <u>British</u> observers believe that its officials have subtly "talked down the pound" (Brittan 2013, Ferguson

[11] Bergsten and Gagnon (2012) estimate that 91 countries accounting for 18 per cent of global output in 2011 were defensive interveners.

2013). Australia and Thailand are the latest countries to express anxiety about appreciation of their currencies and will be hard-pressed to maintain their policies of non-intervention.

There is also a degree of defensiveness in some of the manipulators themselves, particularly the Asians that emulate China's intervention policies to avoid deterioration of their own competitiveness against their formidable neighbor. However, they run large surpluses of their own and could let their currencies rise without suffering undue damage. Even recipients of "hot money" inflows, such as Switzerland, can hardly justify their protracted one-way intervention on such grounds when they continue to run very large current account surpluses.

The systemic problem arises with the maintenance of significant and continuing currency undervaluation generated primarily through substantial and prolonged intervention. Figure 2 illustrates the application of these principles to the present situation; its northwest cell constitutes the objectionable behavior.

Figure 2

	Undervaluation	**Overvaluation**
Intervention	China	Brazil
No Intervention	Sweden	United States

In the absence of agreement on which actions are justified, however, even legitimate defensive intervention intensifies the perception of growing currency conflict. The global macroeconomic picture heightens these risks considerably. Fiscal policy is constrained in almost all the "advanced" economies by their large debt burdens. The result is widespread reliance on QE, including in the United States, that has led to charges of "competitive devaluation" against it. Such charges are analytically foolish: the transmission of all monetary policy occurs to some extent through the exchange markets. QE aims primarily, if not solely, at domestic economic outcomes. It is conducted in domestic rather than foreign currency. Successful QE helps rather than hurts a country's trading partners by strengthening growth, and thus imports, of the country undertaking the policy (IMF 2011). The distinction between QE and direct currency manipulation should be crystal clear.

However, QE does move exchange rates in the same direction as direct manipulation. Hence countries on the receiving end of those policies, and the broader public, understandably conflate the two. Brazil, which leads the international criticism of "currency wars," has done so as have other Latin American countries (Larrain 2013) and more mischievously, China. Continued reliance on QE will sustain this tension. The three-way conflation among QE, aggressive manipulation and defensive intervention is analytically unjustifiable but psychologically understandable and adds to the perception of budding currency conflict.

In addition, QE along with fiscal policy has limits and doubts over its efficacy are widespread. Hence there is inevitably a search, in many countries, for additional policy tools to enhance growth and create jobs. Governor Mervyn King of the Bank of England worried at the end of last year "that in 2013 what we will see is the growth of actively managed exchange rates as an alternative to the use of monetary policy" (King 2012). This search is likely to be most acute where performance has been poor, notably Europe in addition to Japan. It of course heightens the risk of a new wave of currency conflict.

The bottom line is that we have witnessed extensive competitive depreciation for a number of years. The practice is widespread. Much more seems quite possible in the near future. The economic damage that has already resulted is immense and could become much worse.

This is similar to what occurred in the 1930s with such disastrous consequences.[12] The entire postwar economic order aimed to avoid replication of that experience. But it was not structured to deal effectively with surplus countries in general, let alone currency manipulation in particular, importantly because the United States as the surplus country of the day would not permit it to do so.[13] Thus it has done very little to head off such problems or respond when they occurred. The single greatest flaw in the entire international financial architecture is its failure to effectively sanction surplus countries, especially to counter and deter competitive currency policies. Indeed, this systemic failure almost assures that the problem will continue because the manipulators get away with it and thus are presented a policy option, especially attractive in tough economic times,[14] through which they can subsidize exports, import substitutes and jobs without budget costs domestically or effective restraint internationally.

[12] Irwin (2012) emphasizes that the flaws of the international monetary system of the day were instrumental in bringing on the Great Depression. That system, under the supposedly symmetrical "rules" of the gold standard, was also unable to bring effective pressure on surplus countries (notably France and the United States during the interwar period). Its dominant "gold standard mentality" prevented the most important countries, including Germany as well as the United Kingdom and United States, from moving off their increasingly overvalued fixed exchange rates in a timely manner.

[13] See Stiel (2013) for a recent account.

[14] For example, China started letting its currency appreciate gradually in 2005 but suspended the adjustment in 2008, when the global crisis hit, and only resumed in 2010 after it had restored rapid economic growth.

The Impact on the United States

The impact of this situation is particularly acute for the United States, with manipulation as already noted increasing the US current account imbalance by $200-500 billion annually and costing it 1-5 million jobs under current conditions of slow growth and high unemployment. Fiscal consolidation is likely to drag on the economy for at least several years. Monetary ease is thus essential but interest rates are near zero and most potential avenues of quantitative easing are being pursued. The private sector is sitting on huge amounts of investible capital but needs a more robust growth outlook to mobilize it. Improvement in the trade balance could provide crucial help but the IMF projects that the US external deficit will increase steadily between now and 2018[15]. It is thus imperative to terminate the adverse impact of currency manipulation by others.

During periods of slow growth and prolonged high unemployment like the present, external deficits cause particularly severe damage to the economy. Most estimates suggest that US GDP is 4-5 percent below potential. Eliminating excessive currency intervention would narrow the trade deficit by 2 to 3 percent of GDP and move the economy half or more of the way to full employment, with even larger payoffs once multiplier effects on domestic demand are taken into consideration. The full effects would ensue over two or three years and increase the

[15] The Administration announced in 2010 its intention to "double exports over the next five years." This was not a very ambitious goal, running off a 2009 base that was sharply depressed by the global recession, but virtually nothing has been done to implement it and it seems unlikely to be achieved. In any event, it addresses only one side of the trade balance and ignores that it is changes in net exports that affect economic growth and job creation.

US growth rate by as much as 1 percent annually over this period. There would be no cost to the US budget; indeed faster growth would reduce the budget deficit.[16]

The United States must of course put its own house in order. It must gradually but decisively reduce its budget deficits at least to a level that will stop the increase in its debt to GDP ratio (and we should in fact run small surpluses over the course of the business cycle to compensate for our low private saving).[17] It must strengthen fundamental components of its national competitive position, ranging from its shockingly poor K-12 education system to its antiquated infrastructure. It must foster rather than impede the huge creative potential of its private sector with reforms that include tax and immigration policies. But it must also insist that other countries stop intensifying its problems.

This is not a cyclical issue. The United States has run large trade and current account deficits for more than 30 years. The deficit has averaged almost 3 percent of GDP since 1980 and peaked at 6 percent in 2005-06 (figure 3). It is currently running at an annual rate of about $500 billion, or 3 percent of GDP, and the IMF expects it to grow to more than $700 billion over the next few years (IMF 2013) despite the likely reduction in energy imports due to the natural gas and oil revolutions. Cyclical factors were in fact responsible for the sharp decline in the deficit at the trough of the recession and continue to improve it now because of subpar US growth.

[16] A substantial reduction of the US trade deficit would also reduce or halt the buildup of US foreign debt, which exceeded $4.4 trillion at the end of 2012 and is probably on an unsustainable trajectory (Cline 2009).
[17] In an earlier Niarchos Lecture, Summers (2004) rightly emphasized the low saving rate in the United States as a central cause of our external imbalance.

During much of those past 30 years, US macroeconomic policies have been able to keep the United States at full employment despite continuing trade deficits stemming from dollar overvaluation and other competitiveness problems. But the deficits have distorted economic activity and damaged the US economy even when there was no excess unemployment. When the rising external deficit was slowing (as well as reflecting) US growth and destroying substantial numbers of US jobs in the early 2000s, for example, the Federal Reserve had to keep monetary policy easier to support full employment and thus began sowing the seeds for the coming housing bubble. When the deficits reached record levels in the middle 2000s, the large net capital inflows to the United States that arose largely from the surpluses of the intervening countries promoted continuation of the easy monetary conditions and lax regulation that brought on the subsequent crisis. The inflows of official money alone depressed US long-term interest rates by 50 to 100 basis points (Warnock and Warnock 2009) and go far to explain the famous "conundrum" enunciated by Chairman Greenspan when the Fed (belatedly) sought to tighten monetary conditions in 2004-05 but could not get longer term rates to rise. They reflect the "savings glut" that so troubled Ben Bernanke at the time and subsequently.[18]

The Chinese and other surplus countries of course did not force US banks to make stupid subprime loans.[19] <u>Their currency manipulation played a central role in creating the macroeconomic and monetary environment that laid the foundation for the crisis,</u> however,

[18] Bernanke (2009) argues that "whatever complex story we wind up telling about this crisis, clearly part of it was the fact that a lot of capital flowed into the industrial countries… There is a close interaction, I think, between capital inflows and (the shortcomings of) the financial regulatory system.".

[19] Although Darvas and Pisani-Ferry (2010) argue that "the low level of long-term rates resulting from capital inflows led investors to diversify from Treasury securities and look for higher yield paper, thereby encouraging investment banks to manufacture securities that were granted AAA status by rating agencies but which offered a higher return than Treasury bonds. This contributed to explain the success of structured products like CDOs." They conclude that the global imbalances "could have indirectly caused the crisis by contributing to failure within the financial system."

which had devastating effects on the world economy as a whole as well as on the United States at its epicenter.[20] In his definitive study of the international role of the dollar, Eichengreen (2011, 5, 179-80) concurs that "the cheap finance that other countries provided the US…underwrote the practices that culminated in the crisis" and that the capital inflows both helped explain Greenspan's "conundrum" and clearly exacerbated the crisis and its costs.

The Global Economic Order

Can we blame these developments at least partly on the failures of the international monetary system? The answer is unambiguously positive. From its very inception, the system has been unable to bring effective pressure on surplus countries.[21] This is particularly true with respect to currency undervaluations, whether of the Germans in the 1960s or the Japanese in the 1970s or the newly industrializing economies (mainly Korea and Taiwan) in the late 1980s or the Chinese over the past decade.

Nor is currency manipulation a new phenomenon (although it has grown much greater in recent years). We do not have comprehensive data for earlier years but one of my very personal experiences with this practice occurred in the middle 1970s, when on my first extended trip to Japan (ironically as a guest of MITI, as it was then) I discovered that the Japanese were intervening heavily to keep the yen from rising but parking the dollar proceeds in Japanese banks

[20] Pettis (2013) puts it even more strongly, arguing (155) that "it is just as correct, and probably more so, to say that foreign accumulation of dollars force (italics in original) Americans to consume beyond their means" and (157) that "foreign accumulation of dollar assets at best permits and, at most, exacerbates and even forces" the US trade deficit, low savings level and high levels of private and public debt.

[21] It was ironically the United States, as the dominant surplus country of the day, that rejected the inclusion of symmetrical adjustment responsibilities proposed by Keynes for the original Bretton Woods architecture. A new account of that dynamic can be found in Steil (2013). Williamson (2011) notes that Keynes "came to the conclusion that a system in which the surplus countries could sterilize reserve accumulation in unlimited amounts was bound to throw the entire burden of adjustment on deficit countries and therefore make the system suffer from a deflationary basis" – an apt description of present conditions.

to hide their actions. I was delighted to be able to return to Tokyo six months later, traveling as Assistant Secretary of the US Treasury with Vice President Mondale at the very outset of the Carter Administration, to tell them with the full authority of Secretary Blumenthal, and indeed the President, to get their "(censored) hands off the exchange rate". This was hardly the optimal way to manage the monetary system but, to the credit of the Japanese, they did so immediately.

There are two plausible and complementary explanations, one primarily political and one primarily financial, for these current shortcomings of the international economic order. The broader perspective returns to the seminal insight of my old professor in graduate school, Charlie Kindleberger, that the world economy collapsed in the 1930s because of the absence of leadership to save it: the United Kingdom was no longer able and the United States was not yet willing. Today's analogue would of course be that the United States is no longer able and China is not yet willing.

China is a unique economic superpower, however. It remains a relatively low-income country. Its economy has not yet fully marketized, and it retains extensive capital controls and a currency that remains far from full convertability. Its political system is hardly compatible with those of the traditional economic powers (Bergsten et al 2008). Despite the predictions of my colleague Arvind Subramanian (Subramanian 2012), it would be a bit premature to expect China to shoulder full global economic leadership. There are strong reasons to doubt that China will even become a "responsible shareholder," to use Bob Zoellick's famous term, any time soon.[22]

[22] The careful analysis of "China and Global Governance" in Shambaugh (2013, Chapter 4) is not encouraging. It concludes (153-5) that "China's distrust of global governance (is) deeply engrained in Chinese political culture" and that we "should not expect China to become a full-fledged "responsible stakeholder" any time soon. He sees a nation that "knows what it is against but not necessarily what it is for, and one that finds it easy to say no but still difficult to say yes," and "a China that is consistent in its view that the existing international system is unequal and unfair."

Indeed, as indicated throughout my remarks, China is a large part of the contemporary problem rather than a leader in resolving it.

But there is enough truth in the proposition from the US side to merit close perusal. The United States is caught in a scissors movement. On the one hand, it has become increasingly, and in some instances critically, dependent on the world economy – at least four times as much as when I entered this business in the early 1960s. On the other hand, it has become decreasingly able to influence, let alone dictate, the outcome of global economic developments – with half the share of global output it had half a century ago.[23] Figure 4 depicts this transformation, which represents nearly a mirror image of the two trends: US dependence on the world economy, defined as the share of trade in goods and services plus factor incomes in our own GDP, has risen from 10 to 40 per cent while the US share of global output has dropped from 40 to 20 per cent.

Since 2000, both trends have accelerated more rapidly than at any time since the 1970s. Time is not on the side of the United States in seeking to promote its global economic interests. It needs to start pursuing the needed systemic reforms as soon as possible.

I believe there is an even more fundamental if subtle reason, however, for both the systemic erosion and its adverse consequences for the United States: the international role of the dollar. Under either "fixed" exchange rates prior to 1971 or "floating" rates since, there is a basic asymmetry in the rules of the game. The dollar, by far the most widely used international

[23] However, the US share of the OECD economy has risen for the past 20-30 years as presciently observed by Posen (2004). National output of the EU15 (its members before 2006) exceeded that of the United States by 15 per cent in the early 1990s but is now 10 per cent lower, and is expected to be 17 per cent lower by 2017 (Darvas, Pisani-Ferry and Wolff 2013).

money, is the "nth currency" in a world in which only n-1 exchange rates can exist without conflict. Hence the United States is expected to remain passive in the currency markets and the exchange rate of the dollar, while obviously reflecting US fundamentals, is to a substantial degree determined by the combined actions of other countries including their direct, indirect and oral intervention in the currency markets. <u>Global monetary arrangements are based on an implicit "grand bargain" in which the United States accepts the deficits that result from the dollar's role and other countries finance those deficits without complaining too much</u> (Williamson 2011).

<u>The conventional wisdom is that the international role of the dollar is good for the United States and bad for the world. In reality, the opposite is true</u>: other countries clearly benefit from the convenience and cost reduction of a single currency, and the ability to set its price in terms of their own, but the United States suffers two very tangible costs (and the offsetting systemic benefits of the past have diminished sharply, as I have argued). <u>On the real side, other countries can determine the exchange rate between their currencies and the dollar by buying dollars in the foreign exchange markets to avoid appreciation.</u> As we have seen throughout the postwar period, this contributes importantly (if not always decisively) to substantial dollar overvaluation, large US external deficits and debt buildup, and loss of domestic output and employment. The Chinese clearly recognize this effect: in his famous pronouncements on the international monetary system in 2009, Governor Zhou Xiaochuan of the Peoples Bank of China seems to invite the United States to exit the international currency business by noting that "when a country's currency is no longer used as the ….benchmark for other economies, the exchange rate

policy of the country would be far more effective in adjusting economic imbalances" (Zhou 2009).

One advantage of the (otherwise dysfunctional) interwar monetary system was that gold was still the "nth currency" so that everyone could (and did) ultimately devalue against it. The resultant increase in the price of gold was expansionary and part of the remedy to the Great Depression. But <u>the dollar is now the closest equivalent of gold in the interwar period. Hence the United States inherently suffers the adverse consequences of the depreciations of other countries and must ultimately lose any "currency war" under the current system.</u>

On the monetary side, the "automatic" buildup of dollar balances by surplus countries, very directly when those balances accrue as a result of intervention, enables the United States to run large external deficits for prolonged periods of time.[24] This carries certain advantages for the United States, including cheaper imports and anti-inflationary pressure. It also conveys short-term macroeconomic benefits, mainly the ability to sustain excessive domestic spending including by the government via fiscal deficits, which is highly desirable during periods of crisis as we have just experienced.

The problem is that <u>this represents the ultimate moral hazard</u>: <u>an absence of market pressure on the United States to adjust its economic policies when it should be doing so,</u> like the boom period of the early and middle 2000s, to keep its imbalances from reaching unsustainable levels that may require very sharp and very costly correctives as we are in fact seeing now. <u>The</u>

[24] Bernanke (2005) agrees that "Because the dollar is the leading international currency…the saving flowing out of the developing world has been diverted relatively more into dollar-denominated assets, such as US Treasury securities." He added that "the dollar probably strengthened more than it would have if it had not been the principal reserve currency."

international role of the dollar does indeed create "deficits without tears" for prolonged periods but this provides the United States with such a long leash that it will be constantly tempted to hang itself.[25] We experienced this effect as far back as the late 1970s, when the United States was still the world's largest creditor country, when a sharp fall of the dollar contributed importantly to the onset of double-digit inflation for three consecutive years and the rise in interest rates beyond 20 per cent – which I can testify personally from sitting at the Treasury at the time, with the exchange rate falling by 2-3 per cent daily for a number of market sessions in a row, felt very much like a "hard landing" (Marris 1985). Our inability or unwillingness to tighten monetary or fiscal policy in time to head off the collapse of the housing bubble and the Great Recession provides recent evidence of this powerful impact.

There is some similarity between the huge inflows of capital to the United States and the huge inflows to southern Europe in the early years of the euro. Both reflected market judgments, driven by key features of the institutional framework, that kept interest rates very low in the capital importing area. We know the result in the European periphery and must be alert to a similar risk here.

But "dollar primacy mentality" is very potent. It seems virtually on a par with the "gold standard mentality" that prevented so many countries from moving off gold in the 1930s and thus suffering so needlessly from the Great Depression (Irwin 2012). In the early 1980s, the editorial page of the *Wall Street Journal* and many others extolled the soaring dollar of the first Reagan Administration even though it converted the United States from the world's largest

[25] Pettis (2013, 177) proposes that the traditional characterization of this effect as an "exorbitant privilege" for the United States be re-labeled an "exorbitant burden" and that the former phrase be abolished.

creditor country – where I had left it upon departing my responsibilities in that area in January 1981! – to world's largest debtor in just five years. (The *Journal* also excoriated my Secretary of the Treasury, Mike Blumenthal, for allegedly "talking down the dollar" while uttering nary a peep when Jim Baker drove it down by at least three times as much with the Plaza Agreement a few years later.) I also recall how Bob Rubin recounted in his memoirs that selling dollars for yen in 1998 was the hardest decision he had to make as Secretary of the Treasury, even though the yen at the time was approaching 150:1 against the dollar – a hugely undervalued rate. I believe that Larry Summers was also uneasy about selling dollars for euros in 2000 when the euro was approaching 80 cents to the dollar – another grossly undervalued rate. I regarded these actions as highly desirable, indeed indispensable, to restore a level playing field for the American economy and strongly supported Bob's and Larry's actions. But our best and brightest were seemingly reluctant, which I can only ascribe to "dollar primacy mentality." I believe it will have to be overcome if US policy is to effectively pursue termination of currency manipulation and thus provide an effective response to the current and systemic problem.

It is not necessary for the United States to take policy steps to drive or even talk the dollar down (though it should avoid repeating the meaningless "strong dollar" rhetoric of the past). It simply needs to make sure that other countries refrain from taking actions to push the dollar up. This should become the main thrust of US international monetary policy.

What Is To Be Done?

Systemic reform is clearly required. It should include both changes in the rules themselves and much tougher enforcement of those rules. The governance structures through which the rules are implemented must be substantially revised to legitimize the new regime and thus promote both its initial acceptability and then its sustainability. The United States has a major national interest in achieving such reforms.

An important part of the needed reform is likely to occur through the increasing multipolarization of the global currency regime. The role of the dollar has declined over the past three decades, from about 75-85 per cent to about 50-60 per cent of the global total (Figure 5), and will almost certainly continue to do so. Once the Eurozone has definitively resolved its current crisis and emerged with a stronger and comprehensive institutional foundation, including banking union and partial fiscal union, the euro is likely to trend upward as a global asset. Whenever China liberalizes its capital controls and embraces current account convertability, the RMB will become at least a third international money.[26] If the United States fails to put its own house in order, these alternatives could attract substantial diversification from the dollar and generate considerable market pressure on the United States.[27]

The advent of a multiple currency system cannot be relied upon to implant an effective adjustment process, however, and its establishment will in any event take many years or

[26] Eichengreen (2011, 150-2, 176), who has previously published definitive histories of the international monetary system, notes that the system has almost always embraced multiple key currencies (and that the dollar-dominated second half of the twentieth century was thus a historical aberration) and argues that there is no reason for the United States to fear or resist such an evolution.

[27] Eichengreen (2011, Chapter 7) devotes an entire chapter of his definitive study of the international role of the dollar to the risk of a "dollar crash," concluding that "The United States will suffer the kind of crisis that Europe experienced in 2010" if we fail to deal effectively with our budget and other domestic economic problems.

probably decades.[28] In the meanwhile, the perennial absence of effective means to prompt adjustment by surplus countries, especially to preclude their intervening in the foreign exchange markets to undervalue their currencies, will persist. <u>We should in fact seek to move as quickly as possible to a multiple currency system with manipulation-free floating, rather than today's dollar-based system with extensive competitive intervention, and specific changes will have to be adopted for that purpose.</u>

<u>Such changes should be implemented through both the International Monetary Fund and the World Trade Organization.</u>[29] Both already have rules against competitive undervaluation. The IMF rule is clearer but has no followup enforcement mechanism.[30] The WTO has an enforcement mechanism but its rule is much more ambiguous. The United States has tried for a decade to persuade China to let its currency appreciate much faster and by much larger amounts but its success has been modest, importantly due to the absence of effective international rules and procedures that it could mobilize for that purpose.[31]

In the case of the IMF, the chief need is to add effective policy instruments to enforce the two existing rules: the proscription of significantly undervalued exchange rates that are maintained by "protracted large-scale intervention in one direction" in the exchange markets, and

[28] That process could be accelerated by new policy actions, such as the creation of a Substitution Account in the IMF to enable countries to off-load unwanted dollar balances without disrupting markets and other measures to enhance the role of Special Drawing Rights, or the creation of credible new "global safety nets" to reduce the incentives for countries to build such excessive levels of foreign exchange reserves.
[29] Irwin (2011) agrees that "the solution is for the international community, in particular the IMF and the WTO, to work out new rules to help defuse current and future disputes over exchange rate policy and clarify the conditions under which trade sanctions might be considered an appropriate remedy."
[30] As Goldstein (2010) puts it, "There has to be some credible penalty in the middle between the Fund's opinion on exchange rate policy (easily dismissed) and expulsion from the Fund (too drastic to be useful)."
[31]The relevant US law, deriving from the International Trade and Competitiveness Act of 1988, is also imprecise and toothless (though its directive to Treasury to name and shame "currency manipulators," even though usually ignored, has attracted enormous attention despite its lack of operational follow-through).

a failure by violators to consult with the country in whose currency they plan to intervene before doing so. <u>The IMF rules should thus be reinforced to provide, for the first time, effective sanctions against countries that meet a two-part test: maintenance of significantly undervalued exchange rates *inter alia* through extensive intervention in the currency markets.</u>

<u>One sanction should be countervailing currency intervention (CCI) through which countries in whose currencies intervention took place, if their requests to stop the objectionable practice were unsuccessful, would buy the currencies of would-be manipulators in sufficient amounts to offset the impact on their own exchange rates</u> (Bergsten 2003, Bergsten 2011).[32] Such a measure would parallel the well-established WTO rule under which countries can apply countervailing duties against prohibited export subsidies. If the indicted manipulators felt they were being treated unjustly, they could protest to the Fund and the counter-interveners would have to desist if it found against them.[33]

<u>The second new policy instrument would be taxes on the buildup of foreign exchange holdings that result from the proscribed currency intervention</u> (Gagnon and Hufbauer 2011). These increments are of course the direct result of the intervention so penalizing them would be an appropriate remedy. For countries with inconvertible currencies, such as China, CCI could

[32] Pettis (2013, 195) agrees that "the only way" that a manipulator's trading partners can defend themselves is by "themselves intervening – effectively retaliating in the form of a currency war." There are of course some who believe that sterilized intervention is ineffective but, if so, it is hard to explain why so many important countries do it so extensively as integral parts of their economic policy.

[33] A variant would be to require advance IMF authorization for such national actions. As with countervailing duties themselves, however, this would risk substantial delay that would permit a great deal of damage to occur before remedial action could take effect.

probably not be fully effective (though it would still send a very powerful policy signal) so this second line of defense might be necessary.[34]

Whatever the enforcement mechanisms, the Fund will have to win widespread agreement on a methodology for identifying the key concepts of "misalignment" and "manipulation," perhaps including through the adoption of automatic triggers based on intervention (which can be monitored in real time) or current account surpluses.[35] Both new policy instruments would by definition be applied mainly by the reserve centers, which would imply a growing decision-making role for a limited number of countries that would clash with the multipolarization of the monetary system and thus underline the need for nesting the new procedures firmly within the global and rules-based context of the IMF. One possible tactic, suggested to me by Morris Goldstein, would be to start the reform process by seeking to negotiate a new code that ran the gamut on manipulation from definition of the problem through enforcement of whatever judgments were reached in specific cases.

Two changes should also be made in the rules of the WTO. <u>The simpler would be to explicitly add "manipulated currency undervaluation" to the list of proscribed export subsidies against which countervailing duties can be levied</u> by member countries. This could be quite

[34] Another key "technical" issue is how to handle oral intervention, which can often be effective at least over short periods of time. The early statements of Japan's new government, or even moreso by its future Prime Minister before he was elected, are a recent case in point.

[35] One could argue that working out these mechanisms for triggering Fund determinations are more important than installing new enforcement devices and should thus precede the latter. The absence of effective sanctions, however, discourages countries that are adversely affected by manipulation, like the United States, from seeking IMF remedies. Why go through all the trouble to define and designate if there are no operational consequences? Hence I believe it will be essential to add enforcement tools if the entire Fund process is to be made operational.

potent if a “coalition of the injured” then used the new authorization to countervail in a variety of their sectors that are injured by the manipulation.[36]

The second, and potentially even more significant, change would be to amend or re-interpret Article 15(4) to clarify that manipulated undervaluation by individual countries justifies the erection of across-the-board barriers against their exports by all members of the organization that choose to do so (Mattoo and Subramanian 2008). As under its current rules, the WTO would under both remedies first ask the IMF for a judgment as to whether a currency is “undervalued” and “manipulated” and then apply its own standards to the trade measures that were proposed in response. [37]

These changes could be made either through amendment of the charter or (more likely) via developing a consensus on the issue.[38] The latter approach, following standard WTO practice, could be achieved initially by a plurilateral group that fell short of the full membership of the organization as laid out in detail by my colleagues Gary Hufbauer and Jeffrey Schott.[39] Another tactic would be to begin including such mechanisms in bilateral or regional trade agreements, rather than or in addition to the WTO itself, that would suspend the benefits of the agreement to countries that were found to be manipulating their currencies; the United States

[36] See Lima-Campos and Gaviria (2012) and Lima-Campos (2013).

[37] More details can be found in Bergsten and Gagnon 2012. These WTO requirements reinforce the central role of the IMF on the issue and thus the importance of reforming the Fund’s rules and procedures.

[38] Consideration of trade sanctions was also recommended by the Palais Royal Group (2011) among its proposals for international monetary reform. Its report emphasized the “major risk… of the resurgence of prolonged and ultimately unsustainable current account imbalances” and the “accumulation of an unprecedented volume of international reserves as a result of policies to limit exchange rate appreciation,” and called for the establishment of exchange rate “norms” that *inter alia* would expect each country to refrain from exchange rate policies that pushed or kept its exchange rate away from its norm. That group was convened by Michel Camdessus, Alexandre Lamfalussy and the late Tommaso Padoa-Schioppa and included such luminaries as the late Andrew Crockett, Arminio Fraga, Toyoo Gyohten, Horst Köhler, Guillermo Ortiz, Ted Truman and Paul Volcker.

[39] Hufbauer and Schott (2012) provide a detailed proposal for such a plurilateral agreement.

should seek to add such chapters to the TransPacific Partnership, which already includes several current and former manipulators, and the Transatlantic Trade and Investment Partnership, where the negotiating agenda is still to be determined and the participating countries are more like-minded.

These trade policy responses would be decidedly inferior to the monetary alternatives because they would apply to only one side of the trade balance, imports from the manipulating country (and perhaps only a subset thereof via CVDs), and only to trade with countries that implemented the newly permitted devices. The monetary options, by dealing directly with the intervention itself or its proceeds, would by contrast be comprehensive both geographically and across the trade account. The trade policy approaches should nevertheless be part of an overall strategy because the WTO already has a culture of authorizing enforcement actions, and a dispute settlement mechanism to oversee their use, whereas the IMF would have to develop both and could thus take much longer to start playing its new role.

The fundamental purpose of these systemic reforms would of course be deterrence. Countries contemplating competitive undervaluation should be placed on clear notice that such policies would trigger prompt and forceful reactions by their trading partners under agreed rules and procedures. This was the central goal of the original Bretton Woods arrangements but their absence of precision and teeth, due ironically to US resistance, rendered the effort impotent and now needs to be revived.

Some observers will view these proposals for systemic reform as quixotic but it is essential to launch such an effort now for the reasons noted at the onset. In fact, the US Administration will not be able to avoid addressing these issues for much longer. It will, at some fairly early point, have to seek Congressional approval for its pending new trade agreements across the Pacific and Atlantic, perhaps preceded by a request for renewed Trade Promotion Authority (aka "fast track") to facilitate both. Congress, encouraged by the auto industry and perhaps others, will almost certainly raise the currency issue in these contexts and, especially if it remains dissatisfied with the Administration's performance, insist on including relevant chapters in these and future trade agreements.[40] Hence it would greatly behoove the Administration, including to enable it to retain control of the issue, to anticipate such Congressional initiatives by attacking the problem pre-emptively along the lines outlined here.[41]

How to Get There?

The preferred approach is clearly to negotiate the proposed reforms internationally and the United States should seek to mobilize a coalition of non-manipulators to achieve the needed systemic reforms. Fortunately, there are a number of potential candidates. The eurozone as a whole floats freely, like the United States, and suffers the competitive effects of both direct intervention in its currency (as by Switzerland) and diversification into euros out of the dollar (as

[40] Congress could also link the currency issue to the legislation to authorize US approval of the latest increase in IMF quotas, which is required for that initiative (dating from the G-20 summit in Seoul in 2010) to become effective and to move to the agreed next stage of governance reforms. See Truman (2013).

[41] Sharp increases in dollar overvaluation, as in the early 1970s and middle 1980s, have traditionally generated sharp increases in Congressional pressure for protectionist trade policies. It is thus encouraging that the latest bout of overvaluation, coupled with the Great Recession, has produced relatively little trade policy erosion although the Global Trade Alert, created to monitor the situation, argues that the erosion has been much greater than is widely realized and that the G-20 has repeatedly failed to implement its pledges to avoid adopting new restrictive measures. It is instructive that both the Nixon-Connally and Baker initiatives to weaken the dollar in 1971 and 1985, respectively, were undertaken partly to keep Congress from seizing control of trade policy.

with China and others).[42] There are at least thirteen countries whose currencies are held as foreign exchange reserves (counting the Eurozone as one) and thus can experience unwanted appreciation as a result of diversification by national monetary authorities.[43] Japan, despite being charged with manipulation itself, has criticized China's manipulation and successfully negotiated at least a temporary response to it, [44]and would find it difficult to line up against the United States due to its geostrategic problems and likely participation in the TransPacific Partnership. Brazil has adopted the most aggressive stance on the issue of any country. Russia too is a vocal critic of manipulation. India, Mexico and a number of other emerging markets have spoken out against it.[45]

<u>The G-7 has maintained a reasonably effective commitment that its members will consult each other before intervening</u> and recently added agreement that "our fiscal and monetary policies have been and will remain oriented towards meeting our respective domestic objectives using domestic instruments," i.e., warning Japan not to conduct its QE by buying foreign assets as mooted by some advisers to the new government there. The G-20 has agreed that "we will not target our exchange rates for competitive purposes." These pledges give the United States and other aggrieved countries a basis for exerting peer pressure on the manipulators.

[42] Gagnon and I (2012) estimate that the eurozone economy loses $150-200 billion of output annually from recent levels of currency intervention.

[43] The countries include the two major reserve centers, the United States and Eurozone; the three traditional minor reserve centers of the United Kingdom, Japan and Switzerland; and at least eight others including Australia and Canada, which have just been added to the official list by the IMF, and Denmark, Korea, Singapore, Sweden, New Zealand and Norway (Truman 2012). Some of these minor reserve centers have begun meeting together in recent years, initially in an effort simply to find out the extent to which their currencies are being used.

[44] Japan recently instituted a unilateral variant of "countervailing currency intervention". When China began diversifying its reserves into yen by buying Japanese bonds, Japan protested that it could not buy Chinese bonds reciprocally and eventually won Chinese agreement to do so. More broadly, Pettis (2013, 158) suggests that Japan's heavy intervention in 2011was intended at least partially to offset diversification into yen "by certain Latin American and Asian central banks."

[45]"Emerging market solidarity" or even "BRICS solidarity", along with fear of China per se, may limit the willingness of some countries to criticize their "brethren." This recalls how many developing countries cheered on the OPEC cartel in the 1970s, on the thought that it would both champion their position in the global economy and provide unlimited financing for them, when many of them in fact turned out to be the largest losers from the sequential oil shocks and then suffered a "lost decade" as a result of their unsustainable debt buildup via petrodollar recycling through the commercial banks.

But they do not go very far. G-7 members can proceed with intervention even if their consultations elicit negative responses. G-20 countries can and do claim they are intervening for other than "competitive purposes." It would be worthwhile to continue the efforts to strengthen the G-7 and especially G-20 understandings on these issues. But these informal pledges cannot substitute for changing the permanent and binding rules of the formal international institutions and those initiatives should command priority attention.

As with most systemic change, however, it may be necessary for one or several major countries to break some crockery to galvanize serious consideration of the issue and launch the multilateral reform process. This was the case with the most far-reaching systemic reform of the postwar period, the shift from the adjustable peg ("fixed exchange rate") system of Bretton Woods to (relatively) free floating. The United States made tentative efforts to negotiate such systemic change, both at the end of the Johnson Administration in 1968 and in the early part of the Nixon Administration in 1969-70 (led by Paul Volcker with support from yours truly). Those efforts were rebuffed by the Europeans, however, and change occurred only when the United States floated the dollar in August 1971 by abandoning its link to gold and – thanks to Pete Peterson! – adopted an across-the-board import surcharge to strengthen its negotiating posture. The US "unilateralism" of the time, which was then almost universally excoriated (including by Bergsten 1972), turned out to be essential to achieve systemic reform and produce a better world economy although that was certainly not its original intent.

If I may be permitted a personal observation at this late point in the evening, I believe that the Nixon-Connally-Peterson-Volcker initiative of the early 1970s reflected a profound revolution in how the United States viewed its position in the world economy. When I became Kissinger's economic deputy in 1969, at the tender age of 27, my responsibility was to coordinate US foreign economic policy through the National Security Council. There was no National Economic Council or any analogue and Volcker has famously recounted finding a memo on his desk when he arrived at Treasury (which I wrote!) that suggested he worked for Kissinger rather than his own Secretary (Volcker and Gyohten 1993). Globalization's impact on the United States was proceeding so rapidly, however, that by late 1970 George Shultz, then Director of the Office of Management and Budget, could (with my collusion) persuade the President to lift foreign economic policy out of the NSC and create a new Council on International Economic Policy, to be run by one Peter G. Peterson, to henceforth provide at least an equal voice for domestic economic concerns. The CIEP itself did not last very long but the institutional handoff from Bergsten to Peterson personified a fundamental shift in the orientation of US foreign economic policy that persists to this day.

A somewhat similar US initiative to the Nixon-Connally effort of 1971 occurred in 1985-87 when the second Reagan Administration, led by Secretary of the Treasury James Baker, reversed the "benign neglect" approach of the first Reagan Administration toward the soaring dollar by initiating the Plaza Agreement and driving down its hugely overvalued exchange rate by 30-50 per cent. The other major countries largely agreed on this occasion so there was much less conflict than in 1971-73. Indeed, Japanese Vice Minister Toyoo Gyohten visited me in Washington the day after the Plaza and called his office in my presence to direct them to sell $1 billion for yen – which was a lot of money in those days. However, there were important holdouts as there undoubtedly would be today: the newly industrializing countries of the period, particularly Korea and Taiwan, maintained their dollar pegs for some time, became substantially undervalued and started running huge surpluses, and had to be brought into the program via a second round of (mainly US) initiatives (Bergsten 1986, Balassa and Williamson 1987).

Dramatic ad hoc national actions again initiated efforts to negotiate systemic reform. The first was an agreement at the G-7 summit in Tokyo in 1986 on a wide-ranging set of economic indicators that were supposed to guide adjustment policies. The biggest change came with the Louvre Accord in 1987, to halt the excessively rapid decline of the dollar that was then emerging and the subsequent risk of a hard landing, by initiating a system of target zones (called “reference ranges” at the time) as proposed by Bergsten and Williamson five years earlier (Bergsten and Williamson 1982). Both Tokyo and Louvre included important obligations for surplus countries. This effort to inject a degree of coordinated management into the system of exchange rates prevailed for only a short time, however, permitting the return of unmanaged flexibility and contributing to the problems that we face today.

<u>The contemporary analogue to 1971 and 1985-87 would be for the United States on its own, or preferably, with as many allies as could be assembled, to implement one or more of the four steps proposed above: countervailing currency intervention against manipulation; taxes on further dollar buildups by the manipulators; application of countervailing duties against imports that are subsidized by currency manipulation and injure domestic industries; and/or submission of an Article 15(4) case to the WTO that would seek authorization to apply across-the-board import restraints to offending countries</u> (as spelled out in detail in Bergsten and Gagnon 2012). A wide range of tactics could be deployed, from prior warning to the target countries in a final

effort to get them to cooperate voluntarily to initiation of CCI by one or more aggrieved parties in one or more currencies without any announcement at all to a highly public launch of "all of the above." The goal, to repeat for the sake of emphasis, would be to galvanize the needed global systemic reforms in the only manner that would seem to have much chance for doing so.

Conclusion

Such systemic reforms and/or unilateral actions to terminate the contemporary currency wars would have substantial payoff for the countries that are adversely affected by the competitive depreciations or non-appreciations. The United States could see its current account deficit cut by $200-500 billion per year and its unemployment rolls drop by 1-5 million. The Eurozone would be the second largest beneficiary, to the tune of more than $100 billion and a very large number of jobs, and one would in fact hope that it would take on a leadership role with respect to those parts of the problem, like the massive Swiss intervention, that affect it much more than the United States. The threat of protectionist trade policies and hard landings in deficit countries with overvalued currencies should recede substantially.

For the longer run, the greatest flaw in the global economic order of the past seventy years – the absence of effective mechanisms to prompt adjustment by surplus countries and avoid currency wars – would be overcome. The system would become much stronger in responding to large imbalances and to heading them off by deterring predatory currency policies. Its institutional pillars, the International Monetary Fund and the World Trade Organization, would become far more effective and credible.

I would like to close with a historical footnote from over 40 years ago that bears some resemblance to where we stand today. Four days after the Nixon shocks of August 1971, their architect John Connally asked four outsiders (I had left the government a few months earlier) to spend most of a day with him and his top team, led by Paul Volcker, at the Treasury. He began by saying "you know what we have done, please tell us what we should do next" – at which point I really began to worry! He then personally led us through six hours of intense discussion, during which I stressed the opportunities they had created for systemic reform – especially moving to flexible exchange rates. It became increasingly clear that Connally did not have systemic goals in mind, however, and he finally brought the session to a close with the following statement: "I appreciate the advice from you gentlemen and want to share my own philosophy with you before we break up: the foreigners are out to screw us and our job is to screw them first. Thank you and goodbye."

Having spent most of the previous three years as Henry Kissinger's deputy for foreign economic policy, I thought I was fairly sophisticated about the ways of both Washington and the world – but even I was stunned by Connally's xenophobia (which I immediately conveyed to Kissinger, who had not been aware of it, but that is another story). The relevance to today is of course that some of the foreigners have again been screwing the United States (and much of the world), to use Connally's colorful terminology. The choice, now as then, is whether to respond nationalistically and unilaterally or systemically and multilaterally – or, as is most likely, a combination of the two, hopefully with a clear strategic decision to use national actions to achieve global reform. Our goal must be to start resolving these crucial problems by reforming the global system decisively before the arrival of the next John Connally.

Addressing another vital issue of US national interest in which China also plays a central role, cybersecurity, President Obama used these words in his State of the Union message in February: "We cannot look back years from now and wonder why we did nothing!" I would submit that we should adopt the same attitude toward widespread currency manipulation, which violates the most basic precepts of the international economic system while destroying growth and jobs in our own economy and in numerous other countries. The time for action has clearly come. <u>It is time to declare war on the currency wars</u>.

Table 1 - Foreign exchange holdings of currency manipulators, 2012

	Foreign exchange holdings, end of year	
	Billions of dollars	Percent of GDP
Country		
Asia		
China	3,407	41%
Hong Kong	318	121%
Japan	1,194	20%
Korea	364	31%
Malaysia	136	45%
Singapore	519	188%
Taiwan	404	85%
Thailand	172	47%
Oil exporters		
Algeria	189	91%
Angola	35	29%
Azerbaijan	39	56%
Kazakhstan	72	37%
Kuwait	308	177%
Libya	95	115%
Norway	651	130%
Qatar	132	72%
Russia	476	24%
Saudi Arabia	643	88%
United Arab Emirates	799	223%
Others		
Denmark	82	26%
Israel	74	31%
Switzerland	467	74%
Total		
Total	10,576	--

Foreign exchange holdings include estimated foreign assets of sovereign wealth funds.

Sources: IMF, International Financial Statistics (IFS) and World Economic Outlook (WEO) databases; Truman (2011, table 1); US Bureau of Economic Analysis and US Census Bureau; and central bank and finance ministry websites of the above countries.

Table 2 – Changes in foreign exchange holdings of currency manipulators (USD Billions), 2006-2012

Country	2006	2007	2008	2009	2010	2011	2012
Asia							
China	284	654	534	343	413	139	145
Hong Kong	6	15	34	71	9	20	32
Japan	49	14	-74	130	-11	151	-31
Korea	27	22	-55	78	36	22	29
Malaysia	9	14	-3	2	0	5	7
Singapore	16	43	25	24	38	-12	33
Taiwan	13	4	21	57	34	16	18
Thailand	13	18	25	23	31	6	6
Oil Exporters							
Algeria	29	30	37	2	15	8	8
Angola	8	2	5	-7	3	8	7
Azerbaijan	4	7	18	6	15	9	6
Kazakhstan	15	2	9	6	11	11	8
Kuwait	36	23	37	26	29	74	73
Libya	19	28	22	7	8	11	-3
Norway	8	65	30	66	37	144	104
Qatar	14	16	27	18	12	1	31
Russia	143	145	-36	-17	41	31	33
Saudi Arabia	71	80	137	-33	35	123	116
United Arab Emirates	72	76	99	53	17	15	20
Others							
Denmark	-6	0	7	34	5	16	4
Israel	-4	1	17	16	13	1	1
Switzerland	-7	-1	6	47	125	225	196
Total							
Total	818	1,257	923	953	915	1,024	844

Foreign exchange holdings include estimated foreign assets of sovereign wealth funds.

Sources: IMF, International Financial Statistics (IFS) and World Economic Outlook (WEO) databases; Truman (2011, table 1); US Bureau of Economic Analysis and US Census Bureau; and central bank and finance ministry websites of the above countries.

Table 3 – Current account balances of currency manipulators (USD Billions), 2006-2016

Country	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Asia											
China	231.8	353.2	420.6	243.3	237.6	201.7	213.7	238.5	287.5	364.4	453.2
Hong Kong SAR	22.9	25.5	29.5	18.0	12.4	12.9	6.1	5.5	7.5	9.4	12.1
Japan	170.9	212.1	159.9	146.6	204.0	119.3	59.0	63.5	97.8	108.2	109.5
Korea	14.1	21.8	3.2	32.8	29.4	26.1	43.1	34.6	31.5	32.8	30.8
Malaysia	26.2	29.7	39.4	31.4	27.3	31.7	19.4	19.6	20.0	19.3	19.5
Singapore	36.1	46.3	28.8	33.5	62.0	65.3	51.4	48.4	51.1	51.8	50.9
Taiwan	26.3	35.2	27.5	42.9	39.9	41.2	49.6	51.2	51.9	54.1	55.7
Thailand	2.3	15.7	2.2	21.9	10.0	5.9	2.7	4.3	5.1	4.9	3.2
Oil exporters											
Algeria	29.0	30.6	34.5	0.4	12.1	19.8	12.3	12.8	9.6	8.1	7.6
Angola	10.7	12.1	8.7	-7.5	6.7	13.1	11.3	4.3	1.7	-0.5	-4.1
Azerbaijan	3.7	9.0	16.5	10.2	14.8	17.1	14.0	8.2	5.3	2.9	0.7
Kazakhstan	-2.0	-8.3	6.3	-4.1	1.8	13.6	9.0	8.6	5.1	5.1	4.6
Kuwait	45.3	42.2	60.2	28.3	38.3	70.8	78.1	70.8	65.9	63.7	63.3
Libya	28.1	29.8	37.1	9.4	14.6	3.2	29.4	24.9	17.8	9.4	4.7
Norway	55.8	49.0	72.4	44.4	50.2	62.7	71.2	63.1	59.4	55.2	52.3
Qatar	15.3	20.2	33.0	10.0	34.1	52.6	54.2	55.3	46.6	36.0	26.2
Russia	94.3	77.0	103.7	49.5	70.0	98.8	81.3	56.4	38.7	23.0	7.3
Saudi Arabia	99.1	93.4	132.3	21.0	66.8	158.5	177.2	143.1	122.3	109.5	105.6
United Arab Emirates	36.1	17.7	24.8	9.1	9.1	33.3	29.4	30.9	30.1	30.1	32.6
Others											
Denmark	8.2	4.2	9.9	10.5	18.4	18.8	16.5	15.4	15.8	16.2	16.7
Israel	7.0	4.6	2.2	7.3	8.1	3.4	-0.2	4.2	6.6	7.1	7.4
Switzerland	58.2	38.8	10.9	53.7	78.6	55.7	84.7	81.8	81.1	79.1	80.0
Total											
Total	1019.4	1159.9	1263.6	812.5	1046.2	1125.7	1113.3	1045.3	1058.4	1089.8	1139.5

Source: IMF World Economic Outlook (WEO) database April 2013

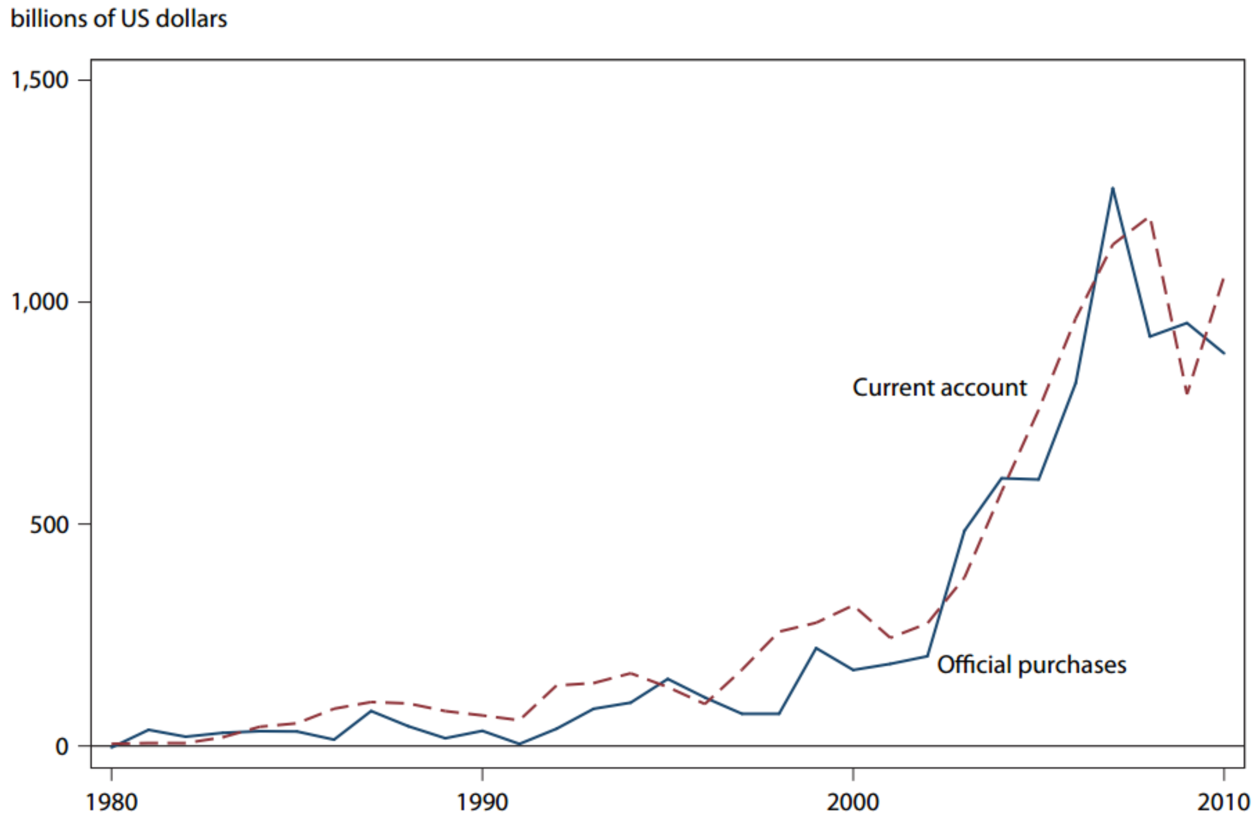
Shaded cells indicate IMF estimates

Table 4 – Current account balances of currency manipulators (Percent GDP), 2006-2016

Country	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Asia											
China	8.5%	10.1%	9.3%	4.9%	4.0%	2.8%	2.6%	2.6%	2.9%	3.3%	3.7%
Hong Kong SAR	11.9%	12.1%	13.4%	8.4%	5.4%	5.2%	2.3%	2.0%	2.5%	2.8%	3.4%
Japan	3.9%	4.9%	3.3%	2.9%	3.7%	2.0%	1.0%	1.2%	1.9%	2.0%	2.0%
Korea	1.5%	2.1%	0.3%	3.9%	2.9%	2.3%	3.7%	2.7%	2.4%	2.3%	2.0%
Malaysia	16.1%	15.4%	17.1%	15.5%	11.1%	11.0%	6.4%	6.0%	5.7%	5.1%	4.8%
Singapore	24.8%	26.1%	15.1%	17.7%	26.8%	24.6%	18.6%	16.9%	17.2%	16.9%	16.0%
Taiwan	7.0%	8.9%	6.9%	11.4%	9.3%	8.9%	10.5%	10.3%	9.8%	9.5%	9.1%
Thailand	1.1%	6.3%	0.8%	8.3%	3.1%	1.7%	0.7%	1.0%	1.1%	1.0%	0.6%
Oil exporters											
Algeria	24.7%	22.6%	20.1%	0.3%	7.5%	10.0%	5.9%	6.1%	4.5%	3.8%	3.4%
Angola	25.6%	19.9%	10.3%	-9.9%	8.1%	12.6%	9.6%	3.5%	1.3%	-0.4%	-2.7%
Azerbaijan	17.6%	27.3%	35.5%	23.0%	28.0%	26.5%	20.3%	10.6%	6.0%	3.0%	0.6%
Kazakhstan	-2.5%	-8.1%	4.7%	-3.6%	1.2%	7.4%	4.6%	4.0%	2.2%	2.0%	1.6%
Kuwait	44.6%	36.8%	40.9%	26.7%	31.9%	44.0%	45.0%	40.8%	37.6%	35.5%	34.2%
Libya	51.1%	44.1%	42.5%	14.9%	19.5%	9.1%	35.9%	25.8%	17.7%	8.8%	4.1%
Norway	16.4%	12.5%	16.0%	11.7%	11.9%	12.8%	14.2%	11.7%	10.9%	9.9%	9.1%
Qatar	25.1%	25.3%	28.7%	10.2%	26.8%	30.4%	29.5%	29.3%	23.7%	17.2%	11.7%
Russia	9.5%	5.9%	6.2%	4.1%	4.6%	5.2%	4.0%	2.5%	1.6%	0.9%	0.3%
Saudi Arabia	26.3%	22.4%	25.5%	4.9%	12.7%	23.7%	24.4%	19.2%	16.1%	13.9%	12.8%
United Arab Emirates	16.3%	6.9%	7.9%	3.5%	3.2%	9.7%	8.2%	8.4%	7.9%	7.6%	8.0%
Others											
Denmark	3.0%	1.4%	2.9%	3.4%	5.9%	5.6%	5.3%	4.7%	4.7%	4.8%	4.9%
Israel	4.8%	2.7%	1.1%	3.8%	3.7%	1.4%	-0.1%	1.7%	2.5%	2.5%	2.5%
Switzerland	14.4%	8.6%	2.1%	10.5%	14.3%	8.4%	13.4%	12.6%	12.3%	11.8%	11.8%
Total											
Total	16.0%	14.3%	14.1%	8.0%	11.2%	12.1%	12.1%	10.2%	8.7%	7.5%	6.5%

Source: IMF World Economic Outlook (WEO) database April 2013 *Shaded cells indicate IMF estimates*

Figure 1 - External balances of currency manipulators, 1980−2010

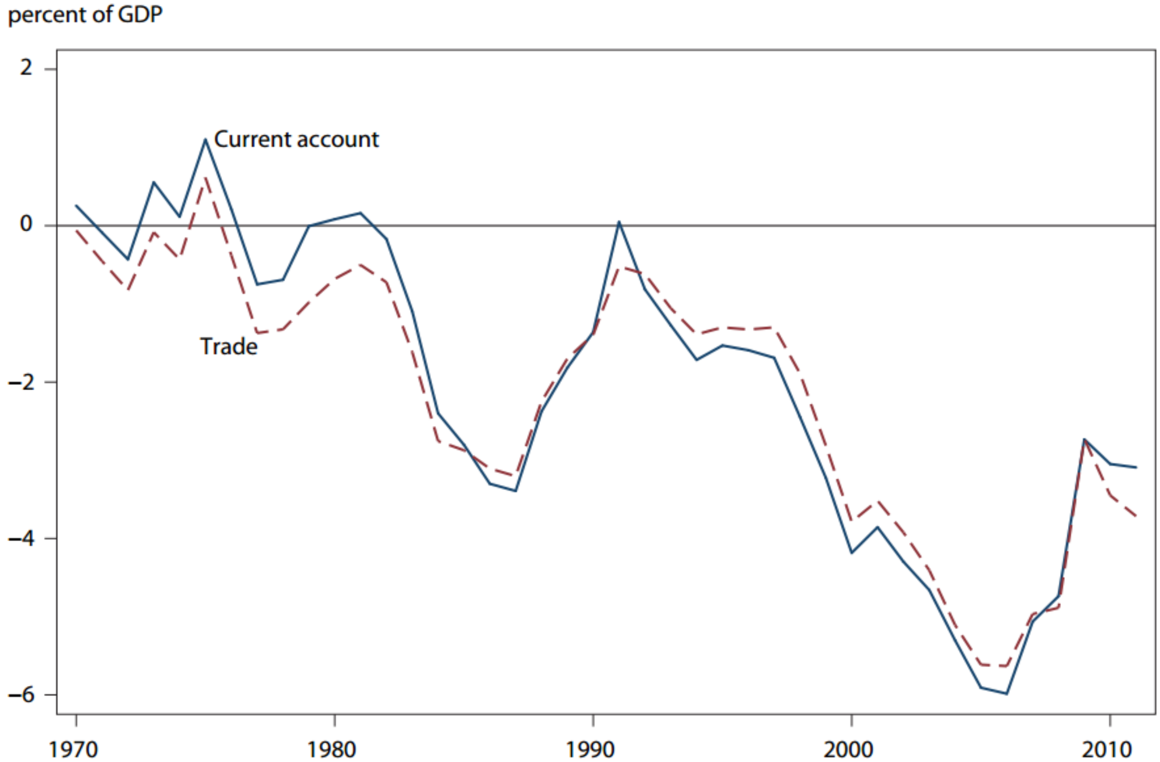


Source: Adopted from Gagnon (2013)

Figure 2 – Currency intervention and valuation

	Undervaluation	**Overvaluation**
Intervention	China	Brazil
No Intervention	Sweden	United States

Figure 3 - US current account and trade balances, 1970−2011



Source: Adopted from Gagnon (2013)

Figure 4 - US "Scissors Movement", 1960-2012

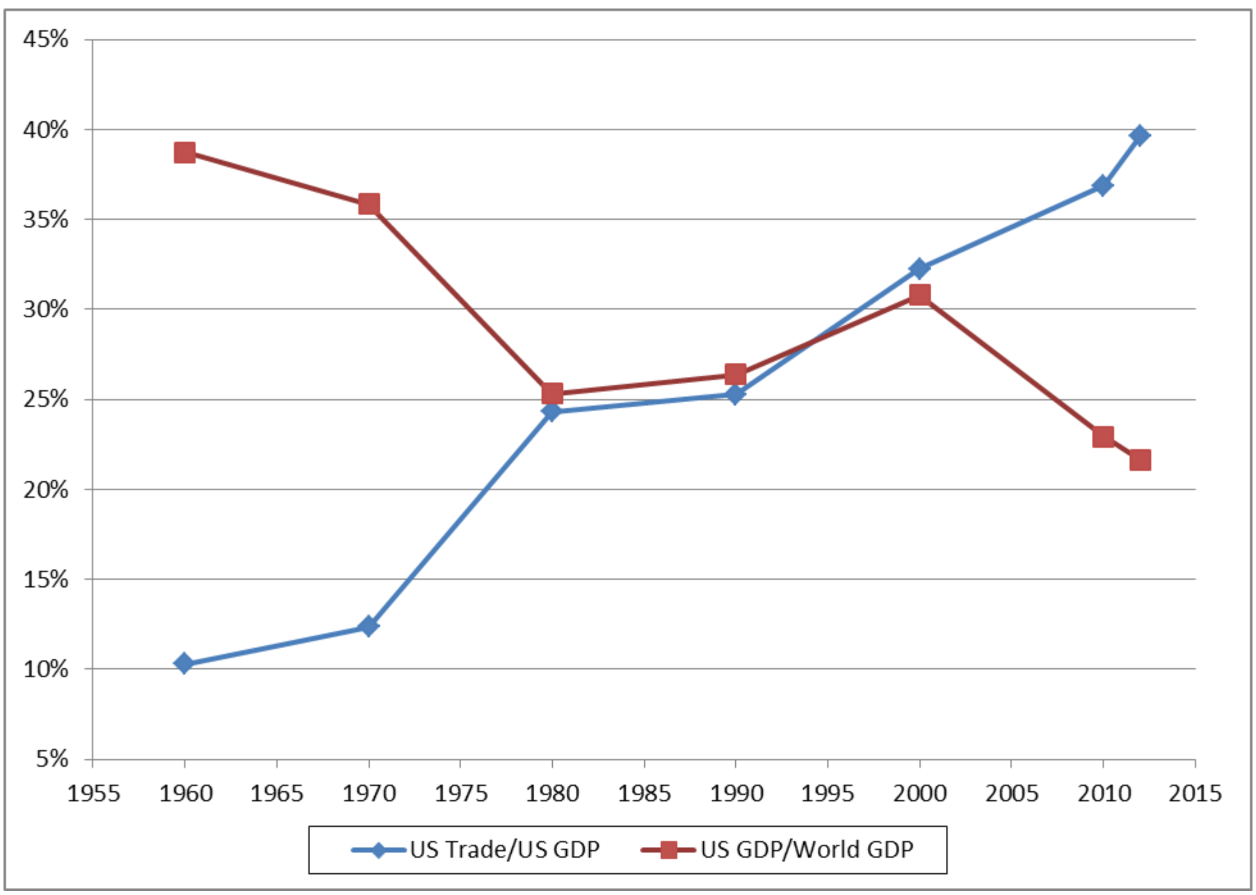
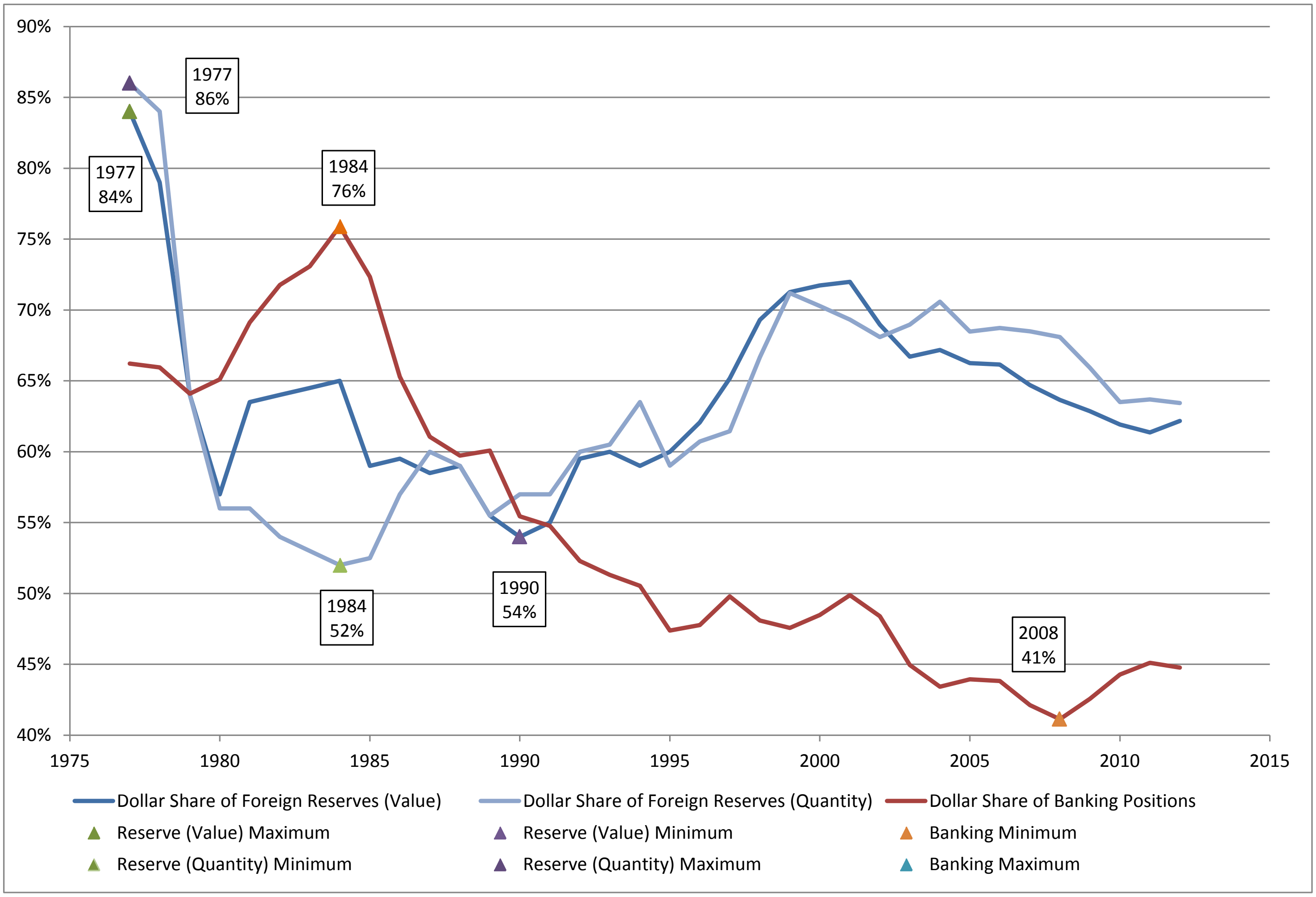


Figure 5 - Dollar Share of Global Finance, 1977-2012



Sources: IMF Currency Composition of Official Foreign Exchange Reserves (COFER), Truman and Wong (2006), BIS Locational Banking Statistics (Table 5)

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