Transcript of Question and Answer Session
Starvos Niarchos Foundation Lecture

Currency Wars, the Economy of the United States, and Reform of the International Monetary System

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Adam S. Posen: Fred, it is an honor for me to preside when you speak. And I'm sure this will not be quite as seared in everyone's minds as your experience with John Connally, but it is, as you promised, a substantively memorable evening with your declaration of war. And I mean that genuinely.

I would like to open the floor, as we always do, for comment and question. I would like to suggest that our senior fellows who've already had a chance to speak to Fred about his views internally let our guests speak first.

Just a mechanical matter, people in the front tables, we have a roving mic that will come to you if you indicate. And people at the back if there is a standing mic or two that if you could come up and go.

Would anyone care to say something about what Fred had to say? Who dares to be first? Wow. Thank you. Please if you can come to the mic. I believe this is Herbjorn Hansson, one our board of directors.

Herbjorn Hansson: I have a very short question for Fred. What is the roles of the politicians? I'm from Europe and see the problems in which Europe is finding itself. You did not mention the politicians. Is that because they didn't do anything wrong, or they didn't understand it, or they wouldn't do anything? Thank you.

Fred Bergsten: It's the latter, Herbjorn, because they didn't do anything. As I described, the way that the system is created, in my view at least, provides an enormous amount of inertia to avoid dealing with this kind of problem, particularly from the standpoint of the United States.

The current dollar-based monetary system is based on kind of an implicit grand bargain, where the United States essentially agrees for other countries who intervene in its currency and therefore set its exchange rate against them. And the other countries don't complain too much when they finance the resulting US deficits.

And that's fine in a full employment world, with rapid growth, where strong currency may be useful to US to help fight inflation. But it's not very helpful in a world of protracted slow growth, high unemployment, when the US would rather have adjustment rather than financing.

The two examples that I mentioned, 1971 and 1985, were the two cases in post-war history where the US government of the day decided that it didn't like that grand bargain. It didn't really want to keep financing big external deficits. It wanted to correct those deficits in order to strengthen its own economy. And as I described, it had to be break crockery in both cases to do so.

Those incidents to me displayed the shortcomings of the system. What's occurring now is displaying its very high cost, both for us and the world as a whole. And I think the time really has come to do something about the fundamental component of the problem.

You're right. That would require the politicians and politicians certainly got involved when Pete and Paul did their thing in 1971, went to the top, and it was of course a Nixon announcement. The same thing in 1985 when Jim Baker, a quintessential politician ran the show, did it very effectively and achieved an enormous adjustment, correction, that was very positive to US economy and turned out to be a good thing for the world. So the politicians would have to get involved and I hope they'll do so.

Adam S. Posen: Gentleman at the mic.

Colin Bradford: Colin Bradford from Brookings. Fred, I guess the question I want to ask you is can you contain the John Connally in order to realize the multilateralist intent that you have behind your proposal?

In other words, if there is a choice between a unilateralist approach by the United States to this and a multilateralist one and you feel or the government, the Obama administration, feels compelled to take the unilateralist one because it can't find enough countries to join it, don't you end up using a currency war, countervailing currency war, to stoke up the fires of the currency war itself and risk losing the multilateralist rules changes that you want to instill?

Fred Bergsten: It's a fair question. It's probably the most salient question about the whole thesis. I was very clear in my remarks that the preferred approach would be to negotiate the changes. And I therefore took a little time to describe how that had been tried back before the 1971 episode, including by Paul.

And also in the Baker example how they used the—they got basically a multilateral approach because the Plaza was agreed as I said by other countries. Then they tried to embed that more deeply into the system. So you clearly want to try to multilateral approach. And I think the US would have a number of allies for the reasons I indicated.

The question, of course, is what happens when and if that doesn't work. And I'm not confident it would because there are a number of countries who clearly would see it as offending them. And so I think you do have to then contemplate breaking some crockery, as I put it, taking action that I would hope would not be unilateral because I think you would have at least some allies and compatriots and a coalition that are willing.

But the crucial thing, and this would really require political leadership and some skillful diplomacy, would be to carry out the "unilateral measures" in a way that was always promoting, at the end of the process, changes in the multilateral system. So you didn't have to do it again. And I'd be the first to say with my own experience that's a very tricky course and there could be slips between cup and lip.

Some people are deterred by that fear and wouldn't take it on at all. My response to that is, the costs are too big. If you put it in terms of whether you should do nothing or take the risks that you rightly laid out, I think it's gotten to a point where you really have to take those risks that there are certainly risks.

But to do nothing, to let the situation prevail, and as I suggest perhaps get much, much worse over the next few years, I think would be very dangerous. If you think the situation has calmed down a little bit right now, all the better, go ahead and try to start putting some systemic reforms in place.

Remember, if you have to go unilateral at the end of the day, it's much better to have tried multilateral first, because then at least you've tried the high road. You've begun to soften up opinions as to what needs to be done. You've prepared the ground and it's not such a great shock when you actually move otherwise.

So for a whole host of reasons, you want to go the multilateral route first, make every sincere effort to do it. If it succeeds even with a small group, a plurilateral group, like I said in the WTO [World Trade Organization]. I mean you don't have to do all these things at the same time. I mean the US I think could get a coalition if it tried to change those WTO practices.

I mean there's legal ambiguity right now as to whether manipulated currency intervention counts or does not count as a countervailable export subsidy. It's ambiguous in terms of our US domestic law. It's ambiguous in terms of the subsidy code that Gary Hufbauer and Jeff Schott negotiated at the WTO way back in the Tokyo round. It's never been tested.

And so you could just do that unilaterally. The administration could do that tomorrow morning, bring a case or two. If the Chinese or whoever it is then want to take us to the WTO to protest, let them do it and let's try it out.

So I mean there are some things that are not all that dramatic but which could have significant effect and could begin to build an international rule of law, an international jurisprudence, a systemic response, that could over time I think have a very significant effect.

I deliberately put out a wide-ranging package of policy measures. But you don't have to do them all. You could take one and do it against one country where there was countervailing currency intervention or countervailing duties for the WTO system. I mean you could ease into it a step at a time, a country at a time.

And so with clever implementation of ideas like this, which is what governments are all about hopefully, you could begin to achieve the purposes I'm talking about without running the risk of breaking so much crockery certainly at the outset.

Adam S. Posen: Okay. We actually now have a bunch of questions. This is good. Could we bring the microphone over there to Andreas. Peter and the gentleman at the back, could I ask you, Peter, to go to the microphone, and then John?

Andreas: Thanks. Fred, how do you define currency manipulation? In other words playing devil's advocate, isn't QE [quantitative easing] part of currency manipulation? And if yes, who is left to fight them, since everybody now is effectively manipulated directly with the currency?

Fred Bergsten: It's a crucial question in the real world, because as I said, countries on the receiving end of QE or direct manipulation see a similar result and so quite understandably conflate the two. I think the distinction is very clear and my definition is as follows:

Currency manipulation is when a country intervenes in the currency markets to manipulate the price of its currency against another, usually the dollar. They're intervening in foreign currency, not their own. They're operating in the currency markets, not their domestic markets. Those criteria are very clear, very observable.

QE is very different. It's carried out in domestic currency. It's carried out through the domestic economic policy instruments. It has spillover to the currency markets, as you say. And as I said, one standard normal acceptable transmission belt of any monetary policy is through the exchange rate.

But that's not its purpose. Its purpose is strengthening the domestic economy with the external effect as spillover. The currency manipulation is aimed directly at the trade balance, competitiveness, price relationships with another country. And I think the distinction in analytical terms cannot be clear. But again I'd stress, that to recipients it can be viewed similarly and that I think is a very significant factor in perceptions, policy responses.

We saw a fascinating case when Brazil took this issue to the WTO a year or so ago. They wanted to get at least a discussion going. Guess who leaped to the—and Brazil conflated the two. Brazil said, "Terrible thing. The US is doing QE. The Chinese are intervening."

So guess who leaped to the defense of the United States in the WTO? China. China and the US were forced onto the same side of the issue by the Brazilian conflation of the problems, showing it's not a very constructive or healthy thing to do. So we've talked to the Brazilians. Many of them now understand and they're trying to turn that around.

But it's again an illustration of the potential escalation of the concern and the reactions. And therefore in that case, the Brazilians' reaction, again and what I think is a justifiable measure what I call defensive intervention but that too can get caught up in the noise.

Adam S. Posen: Thank you. Thank you all for continuing to push Fred to spell things out. And as he mentioned, we will have the full text of his lecture available along with a few other parting gifts and publications as you leave this evening. I have Peter and John at the back mic.

Peter: My question was actually the one that was previously asked, so let me just augment it. So Fred, if we're going to have individual countries throwing crockery at each other and they're going to have their own individual estimates what currency manipulation is, and you're defining currency manipulation as motivated by a foreign exchange dimension in intervention in the foreign exchange.

What about for example countries that are doing both? Are you really going to be able to parse out the QE effect and the foreign exchange intervention if that quantitatively in a way that doesn't just wind up having the countries throwing dishes at each other and messing up the whole kitchen?

I think this question is crucial, because behind your entire talk was confident that you not only knew when a country was doing it, but you knew how much.

Fred Bergsten: I think the answer to the question is yes. We can make the distinctions you mentioned and can put them into play quite readily. That calls for having a simple test or simple criteria in mind. Direct intervention is, of course, directly observable.

Now, countries are supposed to report on what they do to the Fund. Many do. Some don't. You have to start by making that a requirement, so you would know when and by how much countries were intervening. But if they do that and the observable result is a surplus in their external accounts, you've got a pretty clear case that you're combining the two necessary criteria; manipulation and currency undervaluation.

As I said, in the case of our friend, Stan Fischer, in Israel, if a country does two things simultaneously it certainly makes it more difficult to analyze the economic impact and how much of their surplus was due to one and how much was due to the other. But I don't think you have to find the amount to which they are contributing into their surpluses by the direct intervention. All you have to do is establish that their manipulation is having the effect of undervaluing their currency, and thereby, exporting some of their economic problems to the rest of the world.

I stressed it would be crucial to have some legitimate mechanism for determining those criteria. And that's why I stressed the IMF [International Monetary Fund], which now has multiple methods that it uses for trying to parse out currency misalignments. That is not, to put it mildly, fully agreed within the fund at the board and elsewhere. One would have to do that or again have unilateral interpretations that then force the multilateral process to come to agreement.

The way to start then is obviously to take extreme cases. And I'll take an easy one for my purposes. Five years ago when China was intervening to the tune of $2 billion every working day in the currency markets and running a current account surplus of 10 percent of the GDP, there could not be much question that met the two criteria. And no reasonable person, economist or otherwise, could doubt that China met those two criteria.

Switzerland now is an interesting case, where it's running a huge current account surplus, intervened more last year than any other country and indeed about as much as China at the height of its intervention, seems pretty clearly to meet the two criteria. But then some of you will immediately say, "They do it for monetary policy reasons et cetera, et cetera, so that doesn't prove the case."

But I would start with the extremes. Try to establish the principles through cases like that. They were easy ones in terms of answering your questions. Not try to fine tune it too much.

One of the things I've been proudest about at the Institute over these 30 plus years is that we have tried to develop and publish and have everybody comment on every six months for the last five years our estimates of what John Williamson invented and Bill Cline now carries forward, fundamental equilibrium exchange rates. And it's the basis for one of the three methodologies that the IMF uses. It's the basis for the Goldman Sachs Index that they put together, which they now put out widely in the private markets.

It's a highly plausible, intellectually defensible, internally consistent method of determining an answer to your question. Does everybody agree with it? No. But it's widely used, widely assessed as valid. And I think, with some real effort and a policy push, which would be required from key governments, those questions could be answered.

Adam S. Posen: Okay. I've received the high sign from my chairman that we are coming to the end of this part of tonight's gala. So I'll ask John and then Larry to pose the last two questions and ask Fred to give us some of his marvelously concise bumper stickers.

John: Fred, you have said that the United States should take the lead either unilaterally or multilaterally, or a combination of the two. But as I look at the United States leadership today, I'm wondering if there is either the capacity, or the inclination more so, within the Office of the Treasury or Council of Economic Advisers, the National Economic Council, the USTR [US Trade Representative], et cetera, to attempt to make the issue of currency exchanges part and parcel of our negotiations on the Transatlantic Agreement, the Trans-Pacific Agreement, or within the WTO. And I wonder if you would opine on that.

Fred Bergsten: Well, the revealed preference of the administration is not to do so and you're right. But I suggested in my remarks that I think that's an important part of the discourse now. I don't think they'll be able to duck it much longer, because those two trade initiatives, which I applaud, are going to have to get voted by the Congress.

And as you know, because you were one of the leaders in the Congress on these issues for many years, the Congress cares a lot about these currency questions has been dissatisfied, to put it mildly, with the performance of the administration resolving them. And therefore, I think unless things change pretty rapidly and pretty substantially, are going to be forced down the administration's throat in the context of the legislation to approve the big trade agreements or to do fast track in order to provide a legislative basis for proceeding with them. So I don't think the administration is going to be able to duck it.

It's very interesting to think back to the '71 and '85 initiatives. In both cases, the administrations of the day were at least partly motivated by reasserting administration control over trade policy or to put it the other way not letting it go to the Congress. Because in '71, the Congress was chafing it a bit to pass protectionist legislation, Mills Bill, Burke-Hartke, all that stuff. Pete we remember very well.

In '85, the House had already passed the [inaudible 18:22] legislation, which would have put very widespread import controls on US trade. And they did it because the Reagan dollar was so overvalued that it converted the US from the world's largest creditor country to the world's largest debtor country in five years and ran massive deficits with devastating effects on agriculture and a lot of parts of US industry.

Congress was ready to go protectionist. And Jim Baker, to his great credit, saw that, and for that as well as the economic reasons, rested control back to the administration by doing the Plaza and getting the currency issue resolved. And I think we're potentially heading toward a similar situation now.

So I say to my friends here in the administration, some of who I know secretly harbor some interest in this area, the faster you can convince the political bosses to move, the more they protect themselves against protectionism.

Adam S. Posen: Okay. And the last word before Fred gives his last word for the section goes to Larry Summers.

Larry Summers: Thank you, Fred, for an extraordinary and provocative presentation. I just want to clarify my understanding. If I understand right, Germany, despite its substantial surplus, would not be touched by this proposal. If I understand right, Japan in its current incarnation, would not be touched by this proposal.

But if there was a country out there that was actively operating a currency board, had been for a dozen years, and was currently running a trade surplus, even a trade surplus with inflation significantly higher than the United States, it would become an automatic object of scrutiny under the plan. Am I grasping the plan correctly?

Fred Bergsten: You are, with the following important caveats. I share your implied anxiety and disapproval of the huge German surplus and I did take one pot shot, as you may have noticed, by saying as long as they don't do more to boost domestic demand within Europe, Europe is going to continue in the tank.

But as you well know, there's no German currency to address in the context that I'm addressing here. I do want to avoid competitive deprecation of the euro and that's not an idle risk for the reasons I said.

The president of France has talked about it. Many economists in both Europe and in this country, and I mentioned our good friend, Martin Feldstein, have said the only way Europe is going to get out of its box is to depreciate the euro substantially, basically to a level that will make the peripheral countries competitive, which of course, would make Germany super-competitive. Well, my program would try to stop the hell out of that. And so in that sense, I come at it.

On Japan, a very complicated story. Again, I mentioned in my remarks when the Abe government was just coming in last fall, indeed before it even came in, Abe was kind of clearly going to become prime minister, they did a lot of oral intervention. They talked the yen down and that, I think, was objectionable. And I would certainly try to catch it in my program.

They in fact triggered quite an international response, as you know. And the latest G-7 pronouncement in February was very much aimed at getting them to cease and desist. They did cease and desist any direct intervention certainly in the markets, but even oral, and now are conducting QE just like we, just like the Brits, just like the European Central Bank. And for the reasons I indicated before, I would not regard that as an indictable offense.

But given the mixed nature of what's happened in Japan over the last six months, and I must say it's checkered history on this front, I would say in the longer version, which you'll get if you want to pick it up on the way out, I'd put Japan on kind of a watch list, which is what the G-7 essentially has them on now.

I think you would have to do that, because if their preferred program, the Abenomics program, which Adam is the great expert much more than I, but if it does not pan out and achieve the kind of resumption of growth that they hope, I'm afraid that they might go back to trying to promote a weaker currency to whatever measures. And then I think all hell would break loose.

It is interesting that even with Japan flying right at the moment, as I would define it, they're eliciting all sorts of very strong reactions, particularly from Korea next door, but from many other countries as well, some of them mischievous like China. But many countries are citing what's happened in Japan as an excuse for them to go down the same road.

And that was the point I was making, that even when the actions are justified or justifiable, there's a huge risk out here. And unless we can get some agreed rules, make these distinctions, figure out what is okay, what is not okay, I really do think all hell could break loose.

Adam S. Posen: And I think that's where we'll leave it. I will resist any urge to comment. Fred has set a new standard for oral intervention in its power, its sweep, and perhaps even on its impact on markets, although maybe over the longer term.

On behalf of Pete and the entire Institute staff and our friends at the Stavros Niarchos Foundation, I'd like to invite you all to now take a well-earned break from such really intellectual discussion. Head towards the outdoors, the beautiful Tony Solomon Sculpture Garden, and raise a toast to Fred Bergsten, Pete Peterson, and enjoy the evening. Thank you very much.