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International Monetary Regimes and Current Account Adjustments

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The international monetary system today is characterized by deep and persistent current account imbalances between developed states and emerging markets. One of the most important questions for economic policy in the coming decade, is how the United States and China will chose to tackle such imbalances. The United States has undergone periods of current account adjustments, both as a deficit and surplus nation. Looking at how such imbalances were addressed, if not entirely corrected, will help us understand how the United States and China will- or should- address their own imbalances.

The Early Bretton Woods Years: Great Britain and the United States

One of the main goals of the United States, going into the Bretton Woods negotiations, was to avoid a return to protectionism. Many officials at the Department of the Treasury believed that protectionist measures, like the Smoot-Hawley Tariff Act in the United States, had been one of the big errors of the Great Depression. Therefore, the American delegation was pushing, above all else, for the establishment of an open multilateral trading system that would bring about economic prosperity and political stability after the war. “The restoration of open, multilateral trade was to be the tonic that would invigorate the Bretton Woods System. The entire agreement was oriented towards this goal” (Eichengreen 2008, 97). In order to establish a free multilateral trading system, the participating nations needed not only to lower tariffs and eliminate traditional non-tariff barriers to trade, but also to restore currency convertibility and eliminate other current-account restrictions. Indeed, going into the negotiations, the United States was pushing for free movement of capital as well as goods. For the American delegation, "peace was seen as linked with world prosperity, and prosperity, with free trade, free capital movements, and stable exchange rates" (Mikessel 1994, 4).

The establishment of fixed exchange rates after the war was also designed to promote trade. The American delegates believed that exchange rate instability, and competitive devaluations in particular, would obstruct the reestablishment of world trade. Thus, "the Americans' insistence on a system of pegged exchange rates to be changed by substantial amounts only by I.M.F. approval was intended to avoid the kind international monetary turmoil that would hinder the reconstruction of trade" (Eichengreen 2008, 98). At least on paper, the outcome of the negotiations reflected the desire to promote free trade. In fact, Article XIV of the Articles of Agreement of the International Monetary Fund instructed its members' states to substantially reduce or eliminate "monetary restrictions to trade" within five years of the establishment of the organization (IMF 1944, 39). Meanwhile, the International Trade Organization was supposed to coordinate the reduction or elimination of more traditional barriers to trade.

The reestablishment of international trade was not only a policy aim, but also one of the main driving ideas behind American policymaking in the early postwar years. The collapse of the European infrastructure during the war meant that most European nations were almost entirely reliant on imports for their survival, and utterly incapable to reestablish their pre-war export patterns in the immediate postwar years. Against this background, it was inevitable that the United States would dominate international trade. During the Bretton Woods negotiations and in the early postwar years, American policy objectives would- if carried out- exacerbate the trade and balance of payment imbalance between Europe and the United States. However, the driving goal of the United States was not to increase the country's trade surplus, but rather to advance the reestablishment of international trade. Free trade was the ideology behind American policymaking. Unfortunately, the United States vastly underestimated the ability of its trading partners to withstand- in the immediate future- the establishment of the system it envisioned.

The British lessons from the Great Depression were somewhat different. John Maynard Keynes not only led the delegation, but colored its understanding of the Depression and of the sort of international monetary system that should be established after the war. The British wanted to create a system that would allow them to have an independent monetary policy, and macroeconomic management that would allow them to pursue full employment. In other words, the British delegation wanted to ensure that their government would not have to adopt contractionary policies to settle balance of payment problems. In order to do this, some capital controls had to remain in place and exchange rates had to be more flexible.

The United Kingdom could only manage to eliminate current account controls and a return to convertibility of the pound, if it substantially increased its exports, which it could not accomplish in the immediate future, if it raised interest rates, which was politically unattainable since the postwar governments had a strong mandate to pursue full employment, or if it devalued the pound. A devaluation of the pound would drastically reduce the purchasing power of its citizens since Britain was reliant on imports for staple goods, its industry having been redirected to serve the war effort. The British government "resisted trade liberalization on the grounds that it would have worsened the terms of trade and lowered their living standards. Import restrictions acted like tariffs; they turned the terms of trade in Europe's favor at the expense of the United States" (Eichengreen 2008, 98) Wishing to maintain monetary barriers to trade, such as convertibility restrictions, the British were in no position to embrace the early establishment of the free international trade regime the American delegation favored.

The outcome of the Bretton Woods negotiations was a compromise of the American and British policy goals. While the system was designed to promote international trade, it also sought to allow countries to rebalance their current accounts, while maintaining autonomous monetary policies. In order to do this, the system established strict capital controls and "adjustable pegs." The United States initially opposed capital controls since it envisioned "a world free of controls of both trade and financial flows" (Eichengreen 2008, 96). Yet, without capital controls countries with current account deficits, like Britain, would have to tighten monetary policy to ameliorate their deficit. As previously mentioned, this policy option was unacceptable to the British delegation.

Thus, the adjustable peg was a system that would allow for exchange rate stability, as the United States desired, and flexibility to help rebalance balance of payments, as the British desired. "The adjustable peg was an instrument for eliminating balance-of-payment deficits- an alternative to the deflationary increases in central bank discount rates that proved so painful between the wars" (Eichengreen 2008, 91-92). However, the exchange rates could only be altered with the consent of other members, and only if there was a "fundamental disequilibrium." Yet, there was no definition as to what a fundamental disequilibrium was. American Treasury officials "proposed neither a precise definition nor an objective formula for detecting it. Indeed, fundamental disequilibrium has never been defined in fewer than ten pages" (Mikesell 1994, 18). Deftly, the American delegates allowed for exchange rate flexibility on paper, but ensured that parity changes would be rare, thus maintaining stability. Furthermore, "the exchange rate could be changed only in a climate of crisis; therefore, in order to avoid provoking crisis conditions, the authorities could not even contemplate the possibility" (Eichengreen 2008, 93).

Yet, there were instances of adjustment, such as in 1949 when most European currencies were devalued by an average of 30% against the dollar (Eichengreen 2008, 96). The devaluation of 1949 was both a result of the sterling devaluation following a failed experiment with convertibility (see below), and of a realization that the exchange rates established after the Bretton Woods Conference did not reflect the postwar world's new trade imbalance. Britain accepted the original pound-dollar exchange rate because the government feared that devaluations would lead to inflationary spirals since the country's monetary base had grown during the war and the country remained extremely dependent on American imports (Metzler 1947, 32). Although the 1949 devaluation approached a truer reflection of both countries' trading position, it was not without effect on the US economy, which (although primarily for other reasons) entered into a short recession in 1949 (Balogh 1979, 236). Although the new system allowed for parity changes to adjust balance of payments imbalances, the changes were rare and controversial. They did not serve as a policy tool to manage the capital account on a short-term basis.

In order to remedy more immediate balance of payment problems, the negotiators established the International Monetary Fund to provide "balance of payment financing" to countries in dire need. Since the United States maintained the largest balance of payment surplus, the deficit nations, like Britain, argued that the United States should bear the burden of adjustment. At least as much as contributions to the new fund were concerned. Indeed, the amount of American contribution to the International Monetary Fund was one of the most hotly debated topics at Bretton Woods. The debate also touched on the conditionality of financing. The

American proposal stated that the fund could "constrain drawings by a member that was not adopting *proper* measures to correct a prolonged disequilibrium in its balance of payments" (Mikesell 1994, 19). Presumably, "proper measures" would have amounted to internal adjustments since the United States opposed any source of external adjustments that might have stiffened demand for imports. Again, exchange rate adjustments were a policy that the United States could tolerate, albeit not happily. As discussed above, however, the presumption of internal adjustments posed difficulty for the British delegates because they established early on that their priority was the maintenance of full employment. Therefore, Keynes' proposal established that measures to correct the imbalance "could include devaluating the member's currency, controlling outward capital movements, and surrendering liquid reserves to reduce its debit balance" (Mikesell 1994, 19).

The contradictory American and British understanding of the role of financing and the I.M.F. more generally are reflected on their desired composition of the organization. The American delegates wanted a "Fund heavily influenced by the United States in order to promote U.S. economic objectives of stable exchange rates, nondiscriminatory trade, and financial equilibrium… Keynes' desire to have the Fund operated by international civil servants in part reflected his desire to make drawing rights unconditional, rather than subject to judgment by a political body" (Mikesell 1994, 52). A clash of heads took place on this topic in 1951, when the United States tried to use the Fund to push for sterling convertibility. The United States wanted to condition I.M.F. financing to Britain on the reestablishment of convertibility for the pound, and the elimination of other capital controls that were thought to inhibit trade. "The American view… was clearly that the Fund was primarily on organization to seek and maintain trade; the British view was that the Fund existed to supply international liquidity and to help stabilize the balance of payments" (Scammell 1975, 135). Both because the Fund did not have enough money to finance Europe's balance of payment deficit, and because its strategic direction was somewhat politicized, financing by the I.M.F. was a deficient adjustment mechanism.[1]

The last adjustment mechanism available under the Bretton Woods system was the scarce currency clause, although it was never invoked. The clause was an American concession to the British since it authorized "controls on imports from countries that ran persistent balance of payment surpluses and whose currencies became scarce within the fund" (Eichengreen 2008, 96). The United States was the only country capable of running persistent surpluses, and the dollar was very scarce in Europe, so the clause was obviously targeted on the United States. Indeed, "between 1945 and 1950 the American balance of payment problem was one of acute and continuous surplus" (Scammell 1975, 125). Furthermore, the clause explicitly sanctioned the sort of controls on the movements of capital and goods that the American delegation sought to eliminate. For this reason, no country ever invoked the scarce currency clause, even though the dollar was scarce throughout Europe for most of the 1940s and 1950s.

The Bretton Woods system did not have a true, viable, adjustment mechanism. Exchange rate adjustments were rare. Monetary policy was not used to maintain the current account. I.M.F. financing was not large enough to cover the large postwar imbalances and, in any case, did not adjust the deficits; they simply facilitated them. Finally, the scarce currency clause was non-existent for all practical purposes. Therefore, adjustment took place outside the Bretton Woods framework, at least until 1959. Between 1945 and 1959, deficit nations tightened capital controls, exchange controls, and licensing requirements for importers in order to stiffen demand

[1] Actually, balance of payment financing would not serve to adjust current account imbalances, but rather to sustain them as they would give the deficit nation the hard currency it needed to finance its imports.

for imports, although all these policies were officially shunned upon. “Countries experiencing persistent balance-of-payments deficits and reserve losses tightened not just capital controls but also exchange restrictions and licensing requirements for importers… in order to strengthen their trade balance” (Eichengreen 2008, 93). Thus, although the scarce currency clause was never invoked, the United Kingdom and other European nations acted as if it had. The premier adjustment mechanism in the early years of the Bretton Woods years was the tightening or relaxation of the enforcement of the agreement.

Even as early as 1947, it was already clear that the United States’ European allies were not yet ready to weather free trade competition with the United Sates. Thus, the first time the United States was forced to concede on its principle of nondiscrimination and free trade was during the first G.A.T.T. round in 1947, where it was pushed to cut tariffs by a third, with minimal European concessions in return (Eichengreen 2008, 99). Even if it had not been clear to them during the Bretton Woods negotiations, American officials soon began to comprehend the enormity of Europe’s economic problems. A year after the first G.A.T.T. round, the Marshall Plan was announced. The Marshall plan can also be understood as an effort by the United States to finance, and in the long run adjust (by reconstructing infrastructure), Europe’s balance of payments problem. Yet again, this was a necessary adjustment that took place outside of the Bretton Woods system. Between 1948 and 1951 “the United States extended $13 billion in intergovernmental aid to finance Europe’s deficits (under the provision of the Marshal Plan)” (Eichengreen 2008, 96). The establishment of the Marshall Plan reflected the United States’ acceptance that Europe’s balance of payment position was unsustainable.

Confusingly, in 1947, even as it undertook efforts to ameliorate Europe’s balance of payments through uneven trade agreements and the Marshall Plan, the United States attempted to force Britain to reestablish free convertibility of the pound. In order to achieve this, the United States extended Britain a large loan that would allow it to finance American imports. In exchange, Britain committed to reestablish convertibility of the pound. The goal reflected American policymakers' desire to push for trade liberalization even as other parts of the administration already accepted that Europe's current account liberalization would have to be a more gradual process than originally thought. More cynical observers will see the loan as an effort by a dominant exporter to increase its export market share, at a time when its political and economic leverage allowed it to do so. Still, at the time it was not clear that Britain was willing to give up its system of imperial preference. The system amounted to trade discrimination, and the United States vociferously opposed such practices. "American insistence on the early resumption of convertibility was motivated by Washington's anxiety over imperial preference. Convertibility was the obvious way of guaranteeing American exporters a level playing field" (Eichengreen 2008, 101)

Officials at the Department of State advocated for the loan because they believed that the success of the program "of restoring multilateral trade rested on the hope that at the earliest possible moment the pound would join the dollar as a freely convertible world currency" (Scammell 1975, 133). According to Fred L. Block, officials at the Department of State thought that the deadline for trade liberalization and current account convertibility agreed upon at the Bretton Woods conference- primarily by Treasury officials- was too lenient on Britain and would delay the reestablishment of a free multilateral trading system (Block 1977, 56) Therefore, State Department officials saw the loan as a way to go around the Bretton Woods arrangement and push Britain to liberalize its current account at a faster pace than the previously agreed upon (Block 1977, 56). They also thought that reviving an international reserve role for sterling would ameliorate the dollar shortage in Europe, since European countries would be able to use sterling to clear transactions not involving the United States, while using dollars to buy American goods (Block 1977, 57). American officials clearly believed that Sterling could recoup at least part of its former role as Europe's premier reserve currency. Once again, this shows that American officials did not fully comprehend the severity of Britain's financial condition after the war.

Britain needed to accept the terms of the loan and its conditionality because its terms of trade had worsened considerably after the war. Since its economy was so geared towards the war effort, Britain needed to import large amounts of agricultural and manufactured goods just to maintain acceptable levels of consumption for its citizens. After the war, "there was a sharp decline in production, especially agricultural production, which resulted in a decline in exports while imports had to be maintained in permit the maintenance of a tolerable standard of life" (Balogh 1979, 2) With the end of the Lend-Lease Act, Britain sorely needed the dollar loan to finance its imports. In fact, Britain had needed a previous stabilization loan in 1945, when "the sudden ending of the American Lend-Lease Program left British balance of payments in a critical state. If the flow of vital imports was not to be interrupted, reconstruction imperiled and heavy unemployment incurred, some means of paying for imports had to be found" (Scammell 1975, 126). Britain had no choice but to accept the terms of the loan, even though many officials believed that such an early return to convertibility would be painful at best.

Some British and American officials believed that British industrial capacity allowed for exports. Yet, other European countries maintained high tariffs, limiting the amount of foreign currency Britain could accumulate (Eichengreen 2008, 100). Other believed that although the British had the capacity to export before the war, "there had been a total switch of the British economy to war production and renunciation of exports… trade patterns had to be reestablished and the surge of essential imports matched by a massive export effort" (Scammell 1975, 126). Furthermore, "the terms at which Europe could obtain primary products, food and raw materials in exchange for her own mainly manufactured exports became considerably less favorable" (Balogh 1979, 2). In 1947, American demand for European imports was meager, and Britain found itself unable to export in considerable volumes to either its continental partners, or the United States. Therefore, many believed that absent increases import restrictions, Britain would only ameliorate its trade deficit through a devaluation of the pound. The problem was that devaluation would prove highly inflationary because such a large percentage of staple goods were imported from abroad (Balogh 1979, 236).

The United States also attempted to use the loan to force Britain to reestablish convertibility in the Sterling area. During the war, Britain has paid for imports from territories in the Empire (and other nations that accepted the pound, like Egypt and Argentina), with Sterling reserves. However, the British government and those of the exporting territories agreed that they would hold their Sterling balances in reserve. That is, they would not use them to finance imports or seek to exchange them for foreign currency. Should they have attempted this, Britain would have either faced extremely high inflation as the reserves returned home, or struggle to maintain the pound's exchange rate with the dollar (Eichengreen 2008, 101). Indeed, "the main source of pressure on sterling in 1947 arose from the current balance of payments of Britain and the sterling area and from conversions by non-sterling area countries" (Schenk 2010, 63). Therefore, "these debts were an obstacle to Britain adopting freer payments and they provided an additional incentive for discriminatory trade against the United States, since they were not convertible" (Schenk 2010, 44) The United States considered these convertibility restrictions as discriminatory policies since they prevented members of The Commonwealth, from using their

Sterling reserves to finance imports from the United States (Mikesell 1994, 24). Therefore, "the sterling balances quickly became inseparable from the prospect of American post-war financial assistance" (Schenk 2010, 43).

The deal went through. "In 1946 the United States extended Britain a $3.75 billion loan on the condition that the latter agree to restore current-account convertibility within a year of the loan's approval." Thus Britain restored convertibility five years before the initial Bretton Woods deadline (Eichengreen 2008, 101). The agreement stipulated that the previously mentioned balances would remain inconvertible, but "new" sterling reserves could be freely exchanged for dollars (Schenk 2010, 43).

Unfortunately, the experiment failed. Britain exhausted the loan in less than a year and saw its foreign reserves dwindle. Britain had to abandon convertibility and devalue the pound, which in turn gave other European countries the confidence to follow suit (Eichengreen 2008, 103). "The failure within six weeks of this premature exercise in multilateral clearing not only demonstrated the existing weakness of sterling (which in 1947 was extreme) but also ensured that the second experiment in convertibility would not be lightly made" (Scammell 1975, 127). The devaluation of the pound was successful in alleviating Britain's deficit. After devaluation, "British reserve losses halted immediately, and the country's reserves tripled within two years" (Eichengreen 2008, 104)

Yet even as the British government announced that it could not maintain convertibility, American officials remained committed to convertibility and nondiscrimination against American exports. In fact, the American government asked Britain to suspend convertibility rather than abandon it indefinitely, and added that once convertibility was resumed, the remainder of the loan would be disbursed (Schenk 2010, 63). Some in the American administration either did not comprehend at all the enormity of the Britain's financial difficulties, or chose to disregard them entirely. Thankfully, the convertibility folly showed the United States how serious Europe's balance-of-payment problems truly were. Within a year, the United States acceded to modest trade discriminations against American exports, and ratified the Marshall plan (Eichengreen 2008, 102).

Two years later, Britain was forced again to devaluate the pound because its current account position still remained unsustainable, exchange controls notwithstanding. During the convertibility crisis officials at Whitehall had called the pound to be allowed to float. These proposals failed because officials at the Treasury and the Bank of England argued that it was "too much of a departure from the Anglo-American post-war vision" (Schenk 2010, 69). Yet the fact that some officials advocated for at least a partial abandonment of the Bretton Woods agreement showed how far Britain's discontent with its current account position had become. Likewise, "the decision finally to devalue in September 1949 had less to do with the specific problems of the British external position and was more the result of a gradual build-up of evidence and opinion, in the United Kingdom and the rest of the world alike, the U.S. dollar was undervalued in comparison with all the main European currencies, not just the pound" (Schenk 2010, 71) The devaluation of the pound paved the way for a widespread reassessment of the parity rates established at Bretton Woods. "European countries could not initiate an adjustment themselves without sterling leading the way, however, because of the important role that sterling played in intra-European payments" (Schenk 2010, 71). Thus, The devaluation of the pound was both a policy tool for adjusting Britain's current account balance, but also of alleviating the dollar scarcity in the continent more generally. After the devaluation, "the United States' current account surplus dropped by more than half between the first half of 1949 and the first half of 1950" (Eichengreen 2008, 104). Thomas Balogh argued that the reduction of the American trade surplus in 1949 could have contributed to the contraction in manufacturing employment in the United States in 1949 (Balogh 1979, 236). This shows that adjustments during the early postwar years were somewhat improvised and politically controversial.

After the war "the United States was the only large manufacturing nation capable of exporting in large volume, but for such export to take place, the problem of massive current account surplus had to be accepted or contained. By stabilization loans and the grant-gift system of the European Recovery Program on the American side and by import and exchange controls and discriminatory currency practices on the European side" (Scammell 1975, 124). The British maintained modest trade discriminations against the United States, and withheld convertibility, until 1958. Even as late as 1952, many in the United Kingdom pushed for another devaluation, or even a float (which would have meant the same thing at the time) (Eichengreen 2008, 123). The early period of Bretton Woods studied here, showed that although the United States was extremely dominant and was using all its policy tools to promote trade liberalization, the imbalances proved too great. Throughout this period, deficit countries used restrictive trade policies periodically to control their balance of payment problems and maintained discriminatory policies particularly against American exports (Eichengreen 2008, 132).

American policy towards Britain during this time was complicated because for much of the 1940s and 1950s Britain did not acquiesce to American demands. Yet, "Britain was seen as a kind of bridge between the United States and the rest of the world. If the United States could count on British economic, political, and military resources in the pursuit of U.S. global aims, it was thought that it would the be infinitely easier to gain the acquaintance of other countries"

(Block 1977, 59). Thus American policymakers saw Britain as a tool for the advancement of the United States' global aims. Eventually however, American officials reluctantly realized that Britain, and Europe's, current account problems were so severe that they could not tolerate liberalizing policies in the prescribed time period. The surplus country pushed the deficit countries to give as much as possible, but it soon realized that they could not give much.

The early Bretton Woods period shows us that deficit nations are prone to restrictive controls in order to maintain a workable economy even as its capital flows remain very unbalanced. On the other hand, the surplus nations are prone to see any external attempt to control movement of goods and capital as protectionism and oppose them vociferously, until it too realizes that the system is unworkable. It is also important to remember that, at least as the Bretton Woods system was agreed upon, there were adjustment mechanisms available to Britain, and some that the United States had originally opposed during the negotiations. "Relative to the implications of hegemonic stability theory, a suspiring number of British priorities were incorporated [into the Bretton Woods agreement]. One was the priority Britain attached to exchange rate flexibility. The United States initially wished to invest the IMF with veto power over a country's decision to change its exchange rate. Another British priority incorporated into the agreement was tolerance of exchange controls. Originally, the White plan obliged members to abandon all exchange restrictions within six months of… joining the I.M.F." (Eichengreen 1989, 26). The system, both as it was designed, and as it worked in practice, shows us that deficit nations have considerable influence over their trading partners when it comes to current account adjustments. Even as Britain became increasingly dependent on the United States for economic and security assistance, its government was able to maintain policies that were anathema to the early postwar American administrations. Finally, the period in question also shows us that a sustainable mechanism to adjust balance of payment imbalances takes time to develop. In the meantime, a disorderly process of trial and error will ensue. This was also the case with the United States' trade imbalance with Japan in the 1980s.

Japan Inc. and the Return of Global Capital: Japan and the United States

In the 1980s, the United States' economic position differed vastly from that of the 1940s and 1950s. After having enjoyed a stable balance of payments during most of the 1970s, the country began to succumb to persistent savings, budget, and current account deficits during the 1980s. In a very general way, the structure of the American economy we know today began to take form in the 1980s, during the Reagan administration. The structure of the international economic system was also very different from that of the Bretton Woods years. "Although the 1970s were the decade when foreign exchange rates broke free of the confines of the Bretton Woods system, under which governments since 1944 had been committed to keeping them fixed, the 1980s were the decade when large movements in exchange rates first became a serious issue in the political arena" (Frankel 1994, 293). The abandonment of fixed exchange rate regimes and strict capital controls meant that countries could now rely on international capital flows to finance balance of payment deficits. Exchange rate movements could now serve to stabilize balance of payment imbalances. "There was not a lot of money to be made operating within the Bretton Woods margins of less than 1 percent, and with parity changes taking place only at long intervals. But when exchange rates were freed, bank traders soon found out they were very good at making money from the fluctuations" (Volcker & Gyothen 1993, 230). The era of global finance arrived in earnest.

In theory monetary policy remained independent of current account movement. In reality, countries' tolerance to exchange rate movements was limited and politicized, which meant that central bankers had to re-learn how to manage the capital account, or at least how to perform their traditional mandates in an environment of free capital flows.

Much like the 1940s and 1950s were characterized by constant alterations of convertibility, capital, and trade controls, adjustment in the 1980s was also messy. During this time, constant and radical exchange rate swings were the focal point of current account adjustments. The threat of protectionism was also a policy tool, especially once the United States Congress became interested in the country's growing and persistent trade deficit.

The dollar rollercoaster that characterized the 1980s began in 1981 when the Federal Reserve, under new Chairman Paul Volcker began to raise interest rates in order to contain the high inflation rates that had plagued the country during the preceding decade. Of course, during the Bretton Woods years, the Federal Reserve need not had been concerned with the exchange rate. Still, high interest rates helped increase the value of the dollar, and between 1980 and 1985 the dollar rose

> "59 percent in the Fed's trade-weighted index… [Subsequently] U.S. exporters lost price competitiveness on world markets, and other U.S. firms faced intense competition from cheaper goods imports. Most analysts considered the appreciation of the dollar to be the primary cause of the subsequent deterioration of the U.S. merchandise trade deficit, which rose $123 billion from 1982 to 1987" (Frankel 1994, 294).

The Federal Reserve's aggressive tightening was not the only factor raising interest rates in the United States and thus contributing the dollar's appreciation. The federal government's persistent budget deficit during the Reagan years, the country's new savings deficit, and slow economic growth among the country's main trading partners, especially West Germany and Japan, all contributed to rising rates in the United States.[2] The Chairman of the Bank of Japan during the 1980s later reflected that in the United States, "after 1980, the balance between savings and investment of the private sector deteriorated, and the federal deficit increased further. The combination of these developments contributed to a higher interest rate, a stronger dollar and a large external deficit" (Volcker & Gyothen 1993, 248). Since all of these factors were domestically in nature, the 1980s saw the first significant attempts by leaders of industrialized nations to align their macroeconomic policies in order to try to manage global capital flows. Their attempts were more than often improvised, short-lived, and deficient.

Monetary policy was the main driving force of the dollar's rise between 1979 and 1982. Even after the Federal Reserve began brought inflation under control and gradually began to loosen monetary policy, the dollar continued to rise up to 1984. "The U.S. long-term interest rate continued to rise until its peak in mid-1984. The differential vis-à-vis trading partners during 1983-1984 averaged about 1 percentage point higher than in the previous two years" (Frankel 1994, 296). During this time, the interest rate differential was driven primarily by the country's savings deficit and the federal government's fiscal deficit.

> "As the Reagan administration cut income tax rates, indexed tax brackets for inflation, and bean a massive buildup of military spending, the budget deficit rose from 2 percent of GNP in the 1970s to 5 percent of GNP in the mid-1980s… The increase demand for funds that these deficits represented readily explains the increase in U.S. interest rates, the inflow of capital from abroad, and the associated appreciation of the dollar" (Frankel 1994, 296)

[2] Slow growth in West Germany and Japan had no effect on interest in the United States, but it did exacerbate the interest rate differential between such countries and the United States.

At the same time as a large Federal Deficit began to establish itself as the new normality, the country's savings rate ceased to be enough to finance the country's investment needs, further fueling the demand for international capital. During this time, "three-fifths of the increase in gross investment had to be financed by a rapidly rising inflow of foreign savings which, by early 1985 were financing 45 percent of U.S. net investment" (Marris 1985, 45). The United States had not been a net capital importer since the nineteenth century. In 1985, some observers began to argue that "it [seemed] improbable that the United States, in a growing world economy, and in the absence of major economic or political disturbances, could or would go back to its nineteenth century status as a structural capital importer" (Marris 1985, 81). Yet, that was precisely what happened. To this day, the United States remains a structural capital importer.

Even as fiscal and savings deficits drove the dollar's appreciation, and exporters began to suffer, the Reagan administration remained indifferent as to the status of the currency. Much like the free trade ideology drove American policymaking during the Bretton Woods negotiations, a deep-seated adherence to neo-classical economics drove American policy during the 1980s- at first fanatically, and then more pragmatically during Reagan's second term. Between "1981-84, the Reagan administration had an explicitly laissez-faire (or benign neglect) policy toward the foreign exchange market. The policy was noninterventionist in the general sense that the movement of the dollar was not seen as requiring any sort of government response or, indeed, as a problem" (Frankel 1994, 297). The administration's economic advisors strongly believed that the free market was the most efficient determinant of the price of the currency, fixing the price of the dollar was the same as price fixing in any other market; in either case, it would only distort the market and create inefficiencies (Frankel 1994, 297).

By 1984, the country’s trade deficit had become a major political issue, and the administration wanted to avoid protectionist legislation making its way through the Congress. In fact, “by 1984 the trade deficit moved above $100 billion for the first time” (Volcker Gyothen1993, 238). While American elites had carried the banner of free trade for most of the postwar world, the 1980s saw the first time that the American people demonstrated concerted objections to international trade and its effect on the American economy. “Growing U.S. sensitivity to the domestic effects of trade policy reflected growing U.S. dependence on exports and imports, the decline in U.S. hegemonic and market power… and a decreasing need for trade policy to function as foreign policy as the Cold War cooled” (Richardson 1994, 629). The American people, for the first time in the postwar world, considered themselves to be vulnerable to international competition.

Subsequently, the government launched the yen/dollar campaign in “an attempt to respond to the political issue of the appreciating dollar and widening trade deficit, without abandoning the administration’s free market orientation” (Frankel 1994, 299). As part of the campaign, the United States tried to push Japan to reduce or eliminate its capital controls, in hope that capital-account liberalization in Japan would promote more American investment in the country, pushing appreciation pressures on the yen. Yet, Japan had begun to liberalize capital flows in 1980. “Prohibitions against foreign acquisitions of most Japanese assets did in fact exist in the 1970s, but were formally eliminated in the Foreign Exchange Law of December 1980” (Frankel 1994, 299). The yen/dollar campaign was no more than a political more to discourage protectionist measures in the United States. It did little or nothing to reduce the imbalanced between Japan and the United States.

In fact, in the years preceding the yen/dollar campaign, the Japanese government's policies did little to increase the country's current account surplus. Rather, they tended to resist yen depreciation. Japan had not only began to liberalize its capital account, but also resisted enforcing excessively expansionary monetary policies that would have depressed the value of the yen, even though Japan had gone through a recession in 1980-81 (Haynes et al. 1986, 22). Furthermore, there was "little evidence to support the charge that the Bank of Japan deliberately depressed the exchange rate of the yen by means of intervention in the exchange rate market. Rather, the Bank of Japan usually followed a policy of leaning against the wind" (Haynes et al. 1986, 22). To be sure, Japan's fiscal contraction in the following years did put downward pressure on the yen (Haynes et al 1986, 22). Yet, the United States' fiscal expansion during the same time put upward pressure on the dollar, and the Reagan administration maintained that the exchange rate did not affect its fiscal policy (Haynes et al 1986, 22). Why should Japanese fiscal take the exchange rate into account if the United States did not reciprocate?

Even after the yen/dollar campaign ran its course, the dollar continued to appreciate. Indeed, between 1984 and 1985 it rose at an accelerated pace. Many at the time argued that "the dollar's new-found strength [represented] a speculative bubble soon to burst" (Krugman 1985, 103). Weather based on fundamentals or not, the trade deficit worsened with the rising dollar. "The trade deficit reached $112 billion in 1984 and continued to widen" (Frankel 1994, 301). It was during this period that the Reagan administration began to seriously consider the exchange rate, and the current account deficit to be a serious problem. "The new Treasury team of James Baker and Richard Darma was clearly sensitive to those pressures and problems" (Volcker & Gyothen 1993, 229). James Baker's appointment as Secretary of the Treasury marked the beginning of a more pragmatic management of the dollar.

The second Reagan administration was characterized by a more active involvement in the exchange rate markets and, more efforts to correct the country's external deficits. Government officials also began "to admit that the budget deficit was a problem and (implicitly) to admit that the country did indeed need to borrow from abroad to finance the deficits" (Frankel 1994, 302). In January 1985, the United States called, for the first time, for international coordination bringing the dollar down. The country's allies dutifully acquiesced. In a G-5 meeting American, Japanese, British, German, and French officials agreed to intervene in international exchange markets to push the dollar down (Funabashi 1988, 10). The bursting of the "dollar bubble" took place soon after. The Japanese government favored that sort of adjustment policies since they could help avoid protectionist legislation in the United States. "The Japanese were alarmed by growing protectionist pressures in the United States and were ready to accept a huge appreciation of the yen in the hope that those pressures would be diverted" (Volcker & Gyothen 244). In fact, the Japanese government began "to look into the possibility of a comprehensive strategy, including realignment, to cope with the imbalance problem threatened the U.S.-Japan partnership. The Japanese decided to use bilateral meetings… to persuade the Reagan administration to move toward intervention" (Funabashi 1988, 11). Thus far, the United States and Japan had aligned their interests. Both governments wished to avoid protectionist measures in the United States and sought to do so by targeting the monetary sources of their current account imbalance. If exchange rate interventions were not enough, they had already begun to contemplate coordination of macroeconomic policies (Funabashi 1988, 11).

On September of 1985 the same groups of countries met again to coordinate another round of exchange rate interventions to lower the value of the dollar. The meeting came to be known as the Plaza Accord. At the meeting, "a figure of 10-12 percent depreciation of the dollar over the near term had been specified as the aim in a never-released 'nonpaper' drafted… for a prepararoty meeting [for the accord" (Frankel 1994, 304). The participants did not seek to establish any further policy coordination other than the exchange rate interventions, putting in question the sustainability of the agreement they reached. "No bidget, trade, or structural policy was changed as a result of the Plaza" (Volcker & Gyothen 1993, 245). Yet, for the time being, "Plaza had widely become considered a great public success" (Frankel 1994, 305). Furthermore, "the agreement was remarkable for the cooperation of the Japanese in sharply raising the price of the yen" (Volcker & Gyothen 1993, 229). Indeed, seldom before in history had a nation voluntarily chosen to finance exchange rate interventions designed to appreciate its currency by more than 10%, just because one of its trading partners maintained a large balance of payment deficit.

With the success of Plaza behind them, the American officials pushed for more macroeconomic coordination. At a G-7 meeting held in Tokyo a year later,

> "the United States persuaded the others to adopt a system of so-called objective indicators. The list of indicators included the growth rate of GNP, the interest rate, the inflation rate, the unemployment rate, the ratio of the fiscal deficit to GNP, the current account and trade balance, the money growth rate, and international reserve holdings, in addition to the exchange rate" (Frankel 1994, 305)

That level of policy coordination never materialized. Otherwise, it would have amounted to a near abandonment of sovereignty in the management of the economy, as a collection of international actors jointly determined fiscal, monetary, financial, and trade policy for the participating nations. With no enforcement mechanism, it was extreme hubris to presume such coordination could be achieved, especially if the policy was designed to alleviate the external deficits of one particular state. With the negotiations, the American officials hoped to "pressure [the other states] into greater economic expansion, as a way for the United to reduce its trade deficit without having to undertake unpleasant fiscal retrenchment" (Frankel 1994, 305). The United States clearly believed that the burden of adjustment lay with the surplus nations. Furthermore, it believed that domestic adjustments were necessary in the surplus nation. Let us remember that in 1944, the United States had argued at Bretton Woods, that the countries receiving balance of payment financing- that is, deficit nations- were responsible for undertaking the necessary reforms in order to rebalance its current account. Behind the new American insistence, however, there now was an implicit threat of protectionism, something that had long been anathema to the United States.

While the efforts at greater policy coordination came to nothing, the dollar kept falling, as it had since the Plaza Accord. "By September 1986, the dollar/yen rate had declined from its peak of 260 to about 154. Japanese exporters were feeling heavily squeezed" (Frankel 1994, 306). After this point, the goal alignment and trust that had characterized American and Japanese efforts to redress their countries imbalances began to evaporate.

A rising yen now became a politically unsustainable in Japan. With this in mind, the G-7 finance ministers met in the Louvre in Paris to stabilize the dollar. That is, to stem its decline. At the meeting, "the United States had agreed that the dollar should be stabilized 'around current levels,' and in return Japan had agreed to expand domestic demand in General" (Frankel 1994, 306). Again, although the United States committed to intervene in foreign exchange markets to stabilize the dollar, it committed to no domestic macroeconomic adjustments. Meanwhile, it demanded that Japan intervene in its own economy to boost demand. The irony was not lost on Japanese politicians.

Japanese politicians strongly resented American demands of domestic economic policy adjustments. "In Japan any new proposal by foreign governments, especially the United States, that aimed to influence Japanese economic policy in a significant way was perceived as *gaiatsu* (foreign pressure) and provoked an immediate assumption that Japan was being bashed or victimized" (Funabashi 1988, 143). The Japanese people were conscious that the policies in discussion would deliberately help American exporters at the expense of Japanese ones. It became even more difficult for them to tolerate such polices if once they began perceiving them as foreign impositions. Gaiatsu or not, this is not a solely Japanese phenomenon.

Even after the agreement, strong downward pressure remained on the dollar. In response, "periodically in 1987 and 19888, Japan's Ministry of Finance used administrative guidance to encourage Japanese institutional investors to hold more U.S. assets than they might chose on profit-maximizing grounds, in order to keep the dollar from depreciating further than it already had by then" (Frankel 1994, 309). Exchange rate adjustment in the new era of free capital mobility proved difficult to coordinate politically. Indeed in less than a decade the dollar had gone from being severely overvalued, to very overvalued. Observers noticed that "increases of 50 percent and decline of 25 percent in the value of the dollar or any important currency over a relatively brief span of time raise questions about the functioning of the exchange rate system" (Volcker & Gyothen 1993, 246). To be sure, another short round of dollar appreciation, and subsequent depreciation took place between 1988, and 1989 until the currency truly stabilized (Frankel 1994, 309). Crucially, once the country's trade balance became a political issue, true estimates of the relative valuation of the currency became irrelevant. What was important was the perceived valuation of the currency by the people of the countries involved. Finally it is crucial to mention that for the energy devoted to manipulating the exchange rate, changes in the value of the dollar, did little to alleviate the United States' current account deficit. Toyoo Gyothen summarizes the decade's efforts neatly as follows,

> "After discovering that a weaker dollar and a new set of exchange rates did not produce the quick adjustment in the balance of payments that they desired, they shifted the focus to macroeconomic policy at the Tokyo summit in May 1986 and then at the Louvre meeting in 1987. But even those macroeconomic changes did not produce sufficient and quick enough adjustments in the balance of payments, so the objective shifted again, from 1988 onward, to microeconomic policy" (Volcker & Gyothen 1993, 251)

The clearest lesson from this period is that prolonged balance-of-payment imbalances depend on more than just exchange rates. More likely than not, the causes are deep-seated and structural, and more likelier still, the countries involved will be unwilling to undertake the sort of structural reforms that would truly redress the imbalance. Even macroeconomic management coordination is not enough to eliminate a structural deficit, but it can ameliorate it substantially. Yet, efforts to coordinate macroeconomic policy after the Tokyo Summit show that even this goal is presumptuous. Depressingly, the 1980s also show us that even superficial efforts to address balance of payments imbalances, such as exchange rate interventions, will require extensive coordination and will be erratic before a stable balance is found.

It is also important to mention here that although much of the policies discusses above, were implemented in attempts to avoid protectionism in the United States, protectionist legislation did make itself through Congress, and was later signed by President Reagan. In this sense, the adjustment policies of the 1980s failed both to redress the balance of payment imbalance, but also to stem off protectionism. In fact, some of the protectionist measures enacted during the 1980s were quite extreme. During this period, the United States negotiated voluntary restraint agreements with Japan, covering automobile exports, and later machine tools. The government also signed Semiconductor Agreement with Japan in 1986 (Richardson 2994, 639). The semiconductor agreement remains one of the most intrusive and restrictive trade agreements negotiated by the United States. "The United States leaned on Japan to monitor (raise) its firms' chip prices in the United States and third-country markets and to work to allow U.S. firms a 20 percent share of the Japanese chip market by 1991… Third-country price maintenance/monitoring was for all purposes extra-territorial price fixing" (Richardson 1994, 645). It is shocking that an administration that put so much weight on the free market, and in the evils of government intervention in it, was willing to manipulate prices and dictate the exact percentage of sales in a market that a group of producers should hold. Never mind that the details of the agreement were virtually unattainable without drastic government intervention in the Japanese markets. How else could the Japanese government guarantee that 20% of all semiconductor sales in the country would be from American firms? Milton Friedman would not be proud. Yet, this policy serves to show us that all options are on the table when the people truly feel that the trade balance is unsustainable.

Lessons for the Future: The United States and China Today

One of the characterizing features of the international economic landscape of our time is the United States' persistent current account deficit, especially vis-à-vis China. There has been a lot of discussion as to what sort of measures the United States or China should undertake to correct these imbalances. In the 2012 Economic Response of the President, the Obama administration, "Several countries characterized by large, persistent current account surpluses, including Germany, Japan, and China, relied too heavily on unsustainable growth in net exports to drive economic growth" (Council of Economic Advisors 2012, 131). In making this statement, the administration is arguing that the source of the imbalances lies with surplus nations, rather than with the United States. The Obama administration has thus often called for China in particular to boost domestic demand and liberalize its capital account in order to reduce its current account surplus. Meanwhile, congressional leaders in the United States continue to push the administration to label China a currency manipulator, and enact countervailing tariffs to help American firms. At the same time, the executive branch continues to push China to allow the yuan to appreciate, with the implicit threat that failure to do so would boost protectionist forces in Congress. This description would have applied perfectly to the United States' relationship with Japan during the 1980s. History is certainly repeating itself. What else can the case studies teach us?

Both periods of adjustment discussed above, show us that once states begin to undertake reforms address balance of payment imbalances, the process takes years. Furthermore, periods of adjustment are disorderly, full of controversy and, and plight with disagreement even among allies. Britain and Japan both enjoyed extremely close political relationships with the United States in the periods discussed above and still communication between the states was fragile at best. Communication between the United States and China is not ideal to say the least. We should expect American efforts to redress the deficit to be met by angry Chinese accusations of protectionism, and probably by retaliatory measures.

The period of adjustment in the 1980s also shows us that measures to liberalize the capital account and alter the exchange rate are not sufficient to correct the balance of payment imbalances. Successful measures require coordination of macroeconomic policies among the states involved. Japanese feeling of *gaiatsu* could be replicated again if the Chinese people feel that the United States is unfairly trying to control Chinese economic policy. Regardless, the level of macroeconomic coordination that would be required to correct the imbalances would be difficult to achieve even in the best of circumstances.

Finally, the case studies discussed above show us that even though adjustment procedures are difficult and painful, surplus countries are eventually persuaded to coordinate efforts to reduce the imbalances. A prolonged period of large imbalances is unstable for both countries, and at least theoretically, surplus nations would benefit from a more endogenous growth strategy.

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