



Center for Strategic & International Studies
Washington, DC

SENATOR CHUCK HAGEL'S CONFERENCE ON GLOBAL ECONOMIC
IMBALANCES AND U.S. CURRENT ACCOUNT DEFICITS JUNE 10, 2005

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LESSONS LEARNED FROM THE SECOND REAGAN ADMINISTRATION'S
EFFORTS TO CONTAIN THE U.S. CURRENT ACCOUNT PROBLEM OF THAT
ERA. IMPLICATIONS FOR THE MANAGEMENT OF THE PRESENT GLOBAL
ECONOMIC IMBALANCE PROBLEM.

Because of the strong dollar in the first Reagan Administration, which had roots in the global economic weakness of the time and very high U.S. interest rates, America's manufacturing companies faced increasingly serious pressure from foreign competitors, particularly from Japan.

Whole industrial regions in America became known as the Rust Belt, as steel and auto plants, and related service industries, began closing in the face of foreign competition. As America's current account deficits and unemployment began to mount, so too did political pressures from Congress to address the perceived causes.

There was a tremendous battle in the Administration over what to do. The University of Chicago group, which included Secretary of State Shultz, felt that the market should be allowed to resolve any problems. One heard such comments as: "Why should we complain if foreigners are willing to give us real goods, very cheaply, and are willing to accept pieces of paper in return?"

Congress, on the other hand, felt that foreign trade had become a rigged game in many parts of the world, driven by the mercantilism of export led economies. There was a perception in Congress that Japan and others had erected a web of non tariff barriers screening the Japanese economy from imports, while our economy was relatively open. The Defense Department worried about the loss of the American industrial and high tech base that supported potential war fighting capabilities.

President Reagan instinctively supported the idea of free trade, but he was also a realist. Gradually he launched a more aggressive program to stabilize the U.S. trade deficit, and the political and economic problems that flowed from it. He began with a voluntary restraint agreement on automobiles with Japan.

After the elections in 1984, President Reagan launched a broader effort to reverse the U.S. current account deficit, which at that time stood at 3% of the U.S. gross domestic product, about 90 billion dollars annually.

The President decided that the strong dollar had become a liability. He directed the Secretary of the Treasury to correct the problem. Markets were aware of the soaring U.S. trade deficits and of Administration's concerns. They preemptively began to sell dollars. Secretary Baker then met with his counterparts from the G-5 at the Plaza Hotel in New York and engineered an agreement that resulted in a steady further weakening of the dollar against the currencies of the major surplus countries, such as Japan. This cooperation was not purely voluntary. It was absolutely clear to our trading partners that if they did not cooperate in addressing the U.S. trade deficit, Congress would impose its own solutions.

Then the Administration and Congress began applying pressure on countries like Japan to relocate auto plants in the United States, and adopted a number of other micro economic policies to assist specific sectors of the U.S. industrial base.

Throughout this period, there were steady efforts by the finance ministers of the U.S., Japan, the United Kingdom, France, and Germany, the G-5, to intervene in markets to stabilize the currencies at a rate deemed appropriate by the G-5 decision makers. Markets, however, did not cooperate. Instead, the dollar plummeted against the European and Japanese currencies.

The G-5 then decided that the dollar weakening had gone too far, since it threatened to put American markets out of the reach of many overseas exporters, beyond the levels wished by all parties. Secretary Baker was then persuaded to support a coordinated effort by central banks to link G-5 monetary policy to targeted exchange rates. The theory was that if a country's currency strengthened excessively, monetary policy would be more expansive. If it fell below the level set by the G-5 target zones, central bank monetary policy would then be tightened. This was the unpublicized part of the Louvre Agreement.

There was only one problem with the Louvre Agreement. While it did accomplish its objective of moderating the dollar's earlier rate of decline, it also resulted in U.S. monetary policy being made on the basis of the 10% of the American economy involved in international trade. It starved the larger 90% of the American economy that was not involved in international trade by an excessively tight monetary policy.

This alarmed a number of people, including Beryl Sprinkel, then Chairman of the President's Council of Economic Advisors. It so happened that Sprinkel was my frequent fishing companion during his time in Washington. Throughout the spring and summer of 1987 he grew more and more upset about what he predicted would happen to U.S. financial markets if monetary policy remained locked into the Louvre Agreement. Finally, unable to convince his colleagues of his concerns, he decided to resign. The day after his retirement party at the White House in October of 1987, the President invited him

to make his case in the oval office, with the Administration's key decision makers attending. Sprinkel predicted a crash of the stock market unless the Louvre Agreement was abandoned, and a more accommodative monetary policy launched. That was on a Friday. That night he called me to say that his efforts had failed.

The following Monday, the largest one day drop in the stock market since 1929 occurred. The President insisted that Sprinkel rescind his resignation, and elevated him into the Cabinet. The Louvre Agreement was immediately abandoned, and frantic efforts were launched throughout the G-5 to refloat financial markets.

An accompanying part of the Administration's strategy to improve America's current account deficit encouraged other countries with large trade surpluses to open their markets and stimulate more domestic led demand. The two Miyazawa Reports in Japan reinforced this effort. This involved substantial expansion of Japanese monetary policy, which produced a stock market and real estate asset inflation. It did increase Japanese purchasing power, for a while...

In 1990, of course, Japan experienced a crash in stock and land prices that eventually erased literally tens of trillions of dollars of wealth. Japan is still living with the legacy of the bubble era and its deflationary aftermath. Lack of sustainable domestic demand, due in part to structural problems, causes Japan to remain reliant on export led growth, and on a huge trade surplus. Like China, Japan intervenes in currency markets directly through the central banks and indirectly through administrative guidance to other cash rich parts of the economy.

LESSONS LEARNED

1. Regardless of the mistakes made by the G-5 in the late 1980s, the overall American objective of stabilizing the U.S. current account deterioration was successful. The U.S. current account deficit remained less than 2% of the GDP for more than 10 years after the Plaza Agreement. It was only with the onset of the Asian financial crisis of 1997 that changes occurred leading to an accelerating collapse of the U.S. current account position
2. Attempts to fine-tune the Plaza Agreement with its Louvre Agreement successor were obvious failures. There are limits to the ability of governments to manage international currency ratios. In the absence of strong underlying supportive policies that are market based, not only do such efforts fail, but they often bring with them disastrous unintended consequences. .
3. It doesn't take a central bank very long to create an asset inflation, as the Japanese experience richly demonstrates, but the long term consequences of an asset bubble can weaken an economy for many years.
4. The Plaza Agreement could not have been achieved without the threat of protectionist legislation from Congress. It is also true that earlier efforts of the United States to

address its current account problem in the early 1970s were also accomplished by unilateral protectionist pressures. However much Congressional pressure on trade and currency policy is deployed, it remains an essential ingredient of any program to modify on a timely basis currency regimes in Asia.

Protectionist pressures in democracies, however, can spin out of control if the public impression deepens that there is no other solution to a massive current accounts problem. Any future recession would multiply such risks.

5. The multi trillion dollar losses on financial markets during the 1987 crash dwarfed the earlier 90 billion dollar current account problem that the Reagan Administration was trying to fine tune. Today's U.S. current account problem is twice the size of the Reagan era deficits as a percentage of GDP, and we are approaching an annual deficit that will soon explode from 660 billion to a trillion dollars a year, with no end in sight.

Each trillion dollars of debt accumulated by our trade deficits will require a long term interest service charge of 5% or so, a fifty billion dollar annual service charge. These debt service charges will be on top of our future import bills, which means that we will have to export even more goods and services to pay for them.

6. The United States has an absolute future requirement to sell more goods and services abroad, buy less of them from overseas suppliers, or some combination of the two. The challenge we face in this country is to create the market based conditions needed to produce more tradable goods and services for domestic and global markets. This will require millions of investment decisions at all levels of the economy and strategies for increasing sustainable domestic demand in a number of under performing and over saving economies elsewhere in the world.

7. In accomplishing these objectives, we need to learn from the successes of the past, namely the Plaza Agreement, and avoid blunders like the Louvre Agreement and the Japanese bubble.

We also need to remember that the global economy today contains a number of potential fragilities. America must not only address an unsustainable current account problem, but also engineer a soft landing to the double-barrelled asset inflation of recent years. Europe faces a crisis of leadership, and soaring unemployment in major countries. Japan's public debt exceeds 180% of GDP, much more if contingent liabilities are included. This debt at 1% interest rates today consumes 20% of the Japanese government budget. Imagine the budget crisis that will occur when inflation and normal interest rates arrive in Japan, on top of ever increasing competition from China and a demographic problem. China hopes to contain its titanic banking problems, which probably exceed a half trillion dollars of bad loans, and potential real estate bubbles, by an export led strategy involving continued 30-40 percent annual compound increases in its exports for the indefinite future. Energy prices and terrorist threats are other wild cards in this deck.

There is absolutely no room for blunders in coping with this potential witches brew. If we do not find a way to address some of these problems, pressures will inevitably build for a return to inflation to ease debt burdens and public entitlement programs. This means a return to the instabilities of the 1970s, and a de facto inflation tax on bond holders and savers in many countries. This will also destabilize politics in some countries, as divergent interests polarize societies.

Yes, in my view, we urgently need to address our current account problem, unsustainable as it is. We need to accomplish this objective in such a way that the global economy doesn't crash and burn in the process. This will require a serious effort by the major trading economies to begin easing the pressure from the global savings imbalance problem, domestic structural, fiscal, and banking problems, as well as broader concerns in the trading system as a whole, including the currency issues now under discussion. .

Delaying this effort just means that the pressures will build. More U.S. long term debt, more export capacity built in Asia that will not have long term U.S. markets, more banking problems, more public debt burdens, and ultimately a much harder landing for the whole world. It also means that the U.S. and the world will remain vulnerable to any unexpected shock to financial markets that could produce general instabilities in currency markets in many countries, and great strain on financial and political systems..

Correcting these problems will require a major conceptual and political effort, beginning with G-7 leaders. The eventual solutions will entail serious macro and micro economic reforms, throughout the global trading system.