

From Neglect to Activism: American Politics and the 1985 Plaza Accord*

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ABSTRACT

US exchange rate policy shifted in 1985 from unilateralist nonintervention to actively promoting dollar depreciation and multilateral cooperation. Pressures from producer interests, particularly multinational companies making manufactured goods, and from sympathetic members of Congress were the most important of multiple forces pushing the US Treasury toward dollar depreciation. Once the Treasury had chosen an activist course, a multilateral strategy had several benefits over a unilateral approach to depreciation. It could better counter the immediate threat to Administration trade policy from Congress, orchestrate depreciation, strengthen Treasury's influence within Washington and shift the burden of adjustment away from US fiscal policy, then frozen, onto other governments. When the trade account is in balance, individual policymakers have flexibility in determining exchange rate policy. But when large trade deficits arise, the domestic political pressures of trade-exposed sectors will dominate personalities and ideas.

When United States Secretary of the Treasury James A. Baker announced a new international monetary accord among the Group of Five (G-5) countries at the Plaza Hotel in New York City in September 1985, he signalled a dramatic change in US exchange rate policy. After having

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cheered the appreciation of the dollar during its first four years in Washington, the Reagan administration suddenly and visibly sought its depreciation. After one full term of unilateralism in international monetary policy, during which key policymakers criticized and rejected macroeconomic policy coordination, the administration turned actively to multilateral cooperation and international forums to pursue its newly adopted goals.

How can we account for this shift? To what variables should analysts turn in explaining this – or other changes in US international monetary policy? One important variable is certainly the international system, particularly the structure of power among states, which sets broad limits on the possibilities for international monetary arrangements and the outcomes of conflict. Changes in that power structure, for example, can help to explain such shifts in US policy as the Nixon administration decisions of the early 1970s to suspend gold convertibility of the dollar, and to depreciate and then float the currency. (Keohane and Nye 1977; B. J. Cohen, 1977; Odell 1982; Eichengreen 1987).

But explanations relying on the international system are not so helpful when we examine fluctuations in US policy over the short or medium term. In the postwar period the global power structure has changed only gradually, but US exchange rate policy has often shifted suddenly: from neglect (benign or malign), to conflict, to cooperation and back again (B. J. Cohen, 1977; Bergsten, 1986; Henning 1987). To develop a fuller, richer explanation of this sort of policy shift, we find it fruitful to examine politics and policymaking at the national level.

In stressing national-level determinants, we follow other studies of US international monetary policy formation of the 1960s and 1970s (Bergsten 1975; Kelly 1977; Krasner 1978; S. D. Cohen and Meltzer 1982; Destler and Mitsuyu 1982; Gowa 1983; Putnam and Henning 1989) and the 1980s (Funabashi 1988; S. D. Cohen 1988). But what we believe would ultimately be most productive is not simply to set against one another two starkly defined alternative explanations, one grounded in international factors and the other in domestic, but to develop analyses which address the interplay between domestic politics and international bargaining. (Destler 1976; Putnam and Henning 1989; Putnam 1988; Ikenberry, Lake, Mastanduno 1988) This might make us better able to predict when in international monetary policy formation, for example, domestic factors lead to unilateralism and noncooperation and when they generate multilateralism and cooperation.

In this article, we work toward this goal. We use the change in US exchange rate policy in 1985 to examine two main questions: (1) What accounts for the change in policy content, away from nonintervention

toward actively promoting depreciation of the dollar? (2) What accounts for the change in strategy, away from unilateralism and toward multilateral cooperation? We argue here that domestic politics, driven by dismal American trade performance, was at the heart of the decision to depreciate the dollar. We then argue that the existence of an international forum, the G-5, from which the Treasury could dominate policymaking within the administration, and the desire to induce other nations to facilitate US current account adjustment, led Baker to adopt a multilateral strategy.

Our analysis assumes the existence of a sphere of government activity we would label 'direct' exchange rate policy, separate from fiscal and monetary policy. By direct policy we mean actions whose explicit and primary purpose is to influence the market price of the dollar, including in particular official (sterilized) intervention in foreign exchange markets and declarations concerning what value the dollar *ought* to have. The extent to which the government can succeed in altering the exchange rate through these instruments is a question beyond the scope of our analysis. We recognize conflicting views on this matter. We ourselves believe that, while the more fundamental forces of monetary and fiscal policy and savings and investment dominate over the long term, the government can influence exchange rates through direct market intervention and through declaration of government views and intentions. Furthermore, the effectiveness of such action can be greatly enhanced if it is undertaken by several governments acting in concert. (For supporting arguments see Willett and Wihlborg, 1988 and Islam, 1988; for a contrary view see Feldstein, 1986, 1987.) Our aim is to explain the behavior of the US government, in the form of exchange rate policy, rather than the behavior of the foreign exchange markets or the depreciation path of the dollar.

We acknowledge that whether officials believe in the effectiveness of 'exchange rate policy', so defined, is likely to bear on both their decisions to adopt specific exchange rate goals and their choice of instruments by which to pursue them. We specifically address the impact of economic ideas on US exchange rate policy below. If our assumptions about the effectiveness of exchange rate policy introduce a bias, it is not in our interpretation of but in our central focus on the 1985 case study as a reversal of the policy introduced in 1981. Someone who believed sterilized intervention and declaratory statements to be inconsequential would focus instead on watershed points in monetary and fiscal policymaking – the importance of which we have acknowledged in our analysis – and how they were affected by exchange rate and balance of payments developments. However, we believe such an approach would understate the room for maneuver of governments vis à vis the foreign exchange markets, and

overlook how the Reagan administration used or failed to use that leeway to manage domestic trade politics, for example, and international cooperation. The macroeconomic policy focus would make for a very worthwhile study, complementary to our own, but would fail to pick up changes in government behavior which have been politically as well as economically important.

Nonintervention Policy under the First Reagan Administration

The Reagan economic program of tax cuts, nondefense spending cuts, inflation reduction and deregulation was adopted without any serious analysis of its international impact. The President defended the domestic focus of his program by saying, 'The most important contribution any country can make to world development is to pursue sound economic policies at home'. (*Washington Post*, Sept. 30, 1981) The implication was that the latter could be defined without reference to its impact on the former! The mix of loose fiscal policy and tight monetary policy – which later became very loose fiscal policy and moderate monetary policy – kept real interest rates high for the duration of the first administration, attracting internationally mobile capital, putting tremendous upward pressure on the dollar, (Cf. Marris 1985) and causing (as we shall see below) unprecedented pain for American producers of traded goods.

Why did the administration allow this to happen? President Reagan's managerial style was to set strong – if not always consistent – policy guidelines and leave it to others to fill in the details. (Regan 1988, 142; Destler 1988) Hence it was left to his cabinet and subcabinet officials to deal with the international consequences of his economic program. Treasury Secretary Donald Regan and his Undersecretary for Monetary Affairs Beryl Sprinkel did not press for changes in the President's program to address the exchange rate consequences just described. They repeatedly resisted the suggestion that monetary policy should be loosened to bring down the dollar. They did not push to lower the burgeoning budget deficits on account of the exchange rate. They even denied – save at fleeting intervals – that any link existed at all between the budget deficit, the strong dollar, and the growing trade deficit.

Finally – and particularly important for this analysis – they renounced one instrument they could have employed without compromising the main elements of the Reagan economic program. They announced in Spring 1981 that Treasury would no longer intervene in the foreign exchange market to stabilize the dollar except on extraordinary occasions. This was a reversal of the strong interventionism practiced by the late Carter administration. Once the Reagan recovery got underway in 1983,

however, Treasury leaders recognized that capital inflows were important to sustaining it. So they encouraged foreign investment in the US. And the administration repeatedly cited the dollar's rise as a global vote of confidence in the Reagan program! By February 1985, when it reached its peak, the dollar had risen by 67 per cent from its 1980 average according to the IMF's multilateral measure, and 88 percent using the measure of the Fed. In that same month, the President even called, in his State of the Union Message, for making the US the 'investment capital of the world', apparently with complete disregard for the impact of this sort of declaration on the exchange markets, the worsening trade balance, and the burgeoning pressures for trade protectionism. (State of the Union 1985)

Despite private differences with the Treasury on intervention policy, Federal Reserve Board Chairman Paul Volcker adopted a public position on intervention which tended to minimize those differences. Testifying before Congress, he said that intervention could have an impact on the markets in some circumstances, but was a 'subsidiary tool' to be used with caution, unable to work against basic monetary or fiscal policy for any sustained period of time. (Funabashi 1988: 68; US House, Committee on Banking 1983: 204–5, 244). Preventing the appreciation of the dollar without the help of the administration on intervention or budget deficit reduction, would have required monetary policy so expansionary that it would jeopardize the hard-won gains against inflation, which the Federal Reserve was unwilling to do. And if Volcker were to press the administration too hard to change its non-intervention policy, he risked opening himself to pressure to ease monetary policy – at cost to both Fed autonomy and the anti-inflation campaign.

For four years, therefore, the first Reagan administration pursued a policy of fundamental neglect of the exchange rate of the dollar, a basic policy of 'nonintervention' both directly and indirectly (through changes in monetary or fiscal policy). And that policy was unilateral at the core. Treasury remained unmoved by the strong objections of the European finance ministries and central banks. When placed on the defensive, Regan and Sprinkel would at times suggest greater openness to concerted intervention, but would later retreat from these statements to the dismay of foreign officials. The pervasive attitude was that if foreign governments disliked the depreciation of their currencies against the dollar, they should adjust their macroeconomic policies to better emulate those of the US (*International Herald Tribune*, March 2, April 26, and May 18, 1982; Nau 1984) This Treasury doctrine of 'convergence' was not intended to imply any readiness to change American macroeconomic policy to achieve exchange rate stabilization.

*Policy Change in 1985**The move to depreciate the dollar*

From the standpoint of US interests, Congress, and agencies shut out of the exchange rate policymaking process, the situation in 1985 was intolerable and threatening to get even worse. As is universally recognized, the *value* of American imports shot up from \$249.5 billion in 1982 to \$341.0 billion in 1985 and \$367.5 billion in 1986. The *volume* went up even more, because, with the rising dollar, import prices were (on average) declining. Measured in 1982 dollars, imports were \$370.2 billion in 1985 and \$420.2 billion in 1986. Or, if one examines the variable that best measures the impact of international competition on US-based producing interests, the *ratio* of the volume of imports to that of total US goods production shot up from .19 in 1980–82 to .21 in 1983, .23 in 1984, .24 in 1985, and .26 in 1986. The rise for *manufacturing* imports as a share of manufacturing output was even greater, from .21 in 1981 to .29 in 1984, then to .32 in 1985 and .34 in 1986. (Calculated from statistics reported in US Council of Economic Advisers 1988) These ratios were higher than any in US postwar experience. More important, the change was unprecedented in rapidity. These developments created a demand for strong administration action and a political 'market' which would welcome policy change on trade and exchange rates.

These growing pressures greeted Reagan's new Secretary of the Treasury, James Baker, when he took office in February 1985. Secretary Baker responded first by quiet diplomacy with the other G-5 countries, and then by a well-publicized show of the result at the Plaza Hotel in September. There, the G-5 finance ministers and central bank governors confirmed their agreement to attack exchange rate misalignment. With understatement typical of such communiques, the Group of Five declared that 'fundamental' economic conditions and policy commitments among their countries had 'not been reflected fully in exchange markets', and that 'exchange rates should play a role in adjusting external imbalances'. In the operative sentence, they declared, '[S]ome further orderly appreciation of the main non-dollar currencies against the dollar is desirable'. (US Department of the Treasury 1985)

This was a dramatic, if understated, departure from previous Treasury policy, one underscored when US authorities sold dollars for yen and D-marks in the New York market the following day. There followed a downward movement of the dollar on the foreign exchange markets which proved at least equally dramatic.

Why did Baker move as he did? In the words of an administration insider, he had come to office with few economic convictions other than 'a

Texan's aversion to high interest rates and a politician's indifference to longer-range policy effects'. (Niskanen 1988: 173) As White House chief of staff, however, he had carved out a formidable reputation for effectiveness. Like others of similar mold, his bent was toward action, toward addressing problems where he personally could have an impact. The Treasury portfolio gave its holder a license to seek economic policy leadership, international as well as domestic. The particular circumstances which Baker faced, moreover, made it clear that *some* significant administration action was required.

Most important as a driving force was the clamoring for action by interest groups and Congress. In particular, the movement of many US multinational companies to the trade-activist camp was decisive. The loss of core supporters undercut the administration's capacity to maintain the liberal trade policies it clearly favored, and it threatened to create formidable domestic political problems as well. Furthermore, while Walter Mondale had been unable to capitalize on the strong dollar and trade deficit during his campaign in 1984, pressure from imports was growing – as the above numbers show.

Moreover, Republican businessmen and Senators and Representatives, freed from the campaign's constraints, were now joining the call for strong action. It was John Danforth (R-Mo.), Chairman of the Senate Trade Subcommittee, who joined with senior Republican colleagues such as Bob Packwood of Oregon and John Chafee of Rhode Island to press a strong resolution condemning Japanese trade practices and the administration's inadequate response. As this example illustrates, the specific steps they proposed were frequently in the trade policy field. But there was a broad consensus that the 'overvalued dollar' was central to the trade imbalance problem.

The political circumstances, then, created both pressure to get the dollar down and the prospect of reward for doing so – in reputation, and in future policy leeway. The question was *what* to do, what specific steps to take to bring this about. Most who called for action pointed to the egregious budget deficit, which was heading toward a record \$212 billion in the 1985 fiscal year. But the Treasury Secretary – unlike his Finance Minister counterparts abroad – is not the central executive branch official in this sphere. And he faced, of course, the same reluctant President who was frustrating Senate Majority Leader Robert Dole (R-Kan) and his colleagues on Capitol Hill. A second possibility for driving the dollar down would be a more expansionary monetary policy lowering US interest rates, but Baker was not the key player in this game either. He could seek to influence Paul Volcker at the Fed, but the domestic credit markets were Volcker's sphere of action.

Baker and his deputy Richard Darman had strong incentives, then, to

focus their initial efforts on something Treasury *could* dominate, what we have labelled 'direct' exchange rate policy. This was a matter on which Treasury had the 'lead', and on which it could act alone: privately through intervention in public exchange markets; publicly through official statements. Exchange rate policy was also more susceptible than alternative instruments to a change in declaratory policy. The new leaders could gain credit and some leverage just by saying that the dollar needed to drop. And while the administration could not be absolutely certain that the exchange markets would respond to either intervention or declaration by actually depreciating the dollar, the economic and policy conditions for that outcome were favorable, and the payoff if they did so respond was correctly anticipated to be substantial. Prospects for foreign cooperation were also favorable: since US trading partners both feared US protectionism and had criticized the *laissez faire* attitude then prevailing; they could be expected initially to cooperate in bringing the dollar down.

If the hands-off policy continued, however, and the dollar did not come down, the Treasury would have to fight a two-front battle to retain its autonomy in exchange rate policy: against efforts in Congress to legislate guidelines, on the one hand, and against other agencies within the Executive on the other. Finally, it should be added, one important disincentive to depreciate the dollar, present in the early 1980s (and present again in 1988), had been removed. The economic recovery had matured, yet inflation remained at satisfactory rates and under control: the increase in the Consumer Price Index would be below 4 per cent in 1985, for the fourth consecutive year. Thus, Treasury could 'talk' the dollar down without fear that import price increases would soon push inflation back up to unacceptable rates. And Baker could be more certain of Volcker's cooperation – though the Fed chief was already concerned, by summer 1985, that the dollar might fall too fast and too far.

In any event, the Plaza strategy was – in policy terms – a clear success. Economists will forever debate whether the dollar wouldn't have come down anyway at about the same rate, and properly so. For Baker as domestic and international economic policy politician, however, it sufficed that clear action had been followed by desired market movement. The action bought time on trade policy, as producers and politicians now literate about exchange rates had reason to believe that better trade balances lay ahead. While the trade balance has shown a clear decline in nominal terms only in early 1988 (improvement in real terms had started earlier), the policy of targeting the exchange rate played a key role much earlier, defusing pressures for trade policy changes far more ominous than those in the bill which President Reagan signed in August 1988.

The move toward multilateral cooperation

What explains the administration's decision to seek multilateral cooperation in its effort to deal with the domestic political pressures on trade and exchange rates? Why did the key officials in the Treasury, with the support of the Federal Reserve, not simply overturn the policy of nonintervention as unilaterally as they had imposed it? It would have been possible to hold a well-staged press conference to announce that the dollar was overvalued and should depreciate, and that the US would aggressively purchase foreign currencies (a good buy at rates prevailing at that time) until exchange rates reached more reasonable levels. Such a statement could have added that the US government would encourage the Fed to lower interest rates while it sought to reduce the budget deficit, with the need to achieve international adjustment specifically in mind. Without a doubt, such a unilateral declaration would have produced a sensation in the foreign currency markets.

Instead, the second Reagan administration clearly opted for the multilateral path. The degree of cooperation actually achieved should not be overstated. Intense conflict accompanied real cooperation in exchange rates, monetary policy, and fiscal policy over the years which followed the Plaza accord. But, regardless of the outcome of G-5 negotiations, the strategy of US policy had clearly become more outward reaching in 1985. It was at the US initiative that the G-5 ministers had been convened. While the idea of an orchestrated realignment might have been broached by the Japanese (Funabashi 1988: 88–93), the new leadership of the Treasury had already begun to reexamine policy and was therefore quick to seize on the opportunity to collaborate with other key-currency governments. Indeed, throughout the summer, the Treasury approached each of the three other members of the G-5 in succession to sound them out and outline the contours of an accord. Not only were national obligations to intervene in the foreign exchange markets discussed in detail, but the US persistently pushed for consideration of macroeconomic policy adjustments, going so far as to promote (successfully) the economic indicators exercise announced at the Tokyo economic summit meeting in May 1986.

The Regan Treasury had not totally neglected multilateral strategies and forums. It had agreed nominally to the process of multilateral surveillance, announced at the 1982 Versailles economic summit, and had participated in the preparation of the Jurgensen and G-10 Deputies Reports, the latter released in June 1985. After some wavering, Treasury had endorsed and promoted the increase in IMF quotas in 1983. But the IMF effort was a response to the debt crisis and the other steps were

designed primarily to deflect pressures and criticism of US exchange rate (and other international economic) policies.

The Baker Treasury's approach, by contrast, was a bold and persistent effort to employ and strengthen multilateral institutions *as a means of helping to solve US as well as international economic problems*. Furthermore, the Treasury became willing to negotiate a *quid pro quo* for partners' commitments on monetary and fiscal policy. Admittedly, concessions took the form of intervention and declaratory commitments, rather than reducing the federal budget deficit. But the recognition of the need for *mutual adjustment*, even if unbalanced, is the hallmark of a cooperative strategy.

Once a change in policy objective was decided, the second Reagan administration had several incentives to adopt a multilateral strategy. First, in order to forestall protectionism in Congress, Baker and other administration officials were eager to show that foreign governments were making a contribution to solving the US trade problems. The view that foreign governments' trade and exchange rate policies were unfair and contributed to the US trade deficit was the source of much of the momentum of trade legislation and frustration with administration complacency. With the Plaza and subsequent accords, the administration could argue that Japan and Europe were economic allies as well as competitors. It did not go unnoticed on Capitol Hill that the Bank of Japan was particularly active in selling dollars in the fall of 1985 – and even raised interest rates to reinforce the Plaza message. A unilateral approach would not have been useful in this way.

Second, aside from the immediate rhetorical advantages in the Congress, the actual adjustment of the trade and current account deficits over the medium term would be facilitated by an expansion of foreign demand. The ill-fated attempt by Republican senators to put together a deficit reduction bargain with the administration in the spring of 1985 had underscored just how politically painful US fiscal adjustment would be. Foreign demand growth – while clearly 'second best' to US budget deficit reduction in its impact on the US trade imbalance – could contribute to adjustment while forestalling domestic political pain. It could accelerate the beneficial effects of the currency realignment. Had the US substantially reduced its budget deficit, export growth born of foreign stimulus would have been especially important to avoiding a recession; but, with the economy operating below capacity constraints, foreign stimulus was desirable even without decisive action on the fiscal policy.

Third, the realignment initiative would be more effective if undertaken multilaterally. Because exchange rates can be influenced from either end, the foreign exchange markets are inevitably more impressed with concerted action by finance ministries and central banks than they are by

unilateral initiatives. Moreover, foreign governments had already endorsed such collaboration; concluding an agreement would not require that they change position. Throughout the first Reagan administration, and as recently as February 1985, they had urgently called on the Treasury to intervene in the foreign exchange markets more decisively. Such coordination would be easy to arrange once the Treasury agreed to join in.

Fourth, the efficiency of the G-5 as a forum made the multilateral course relatively low cost and low risk. Unlike the IMF, OECD, or even G-10, the G-5 was small. This simplified deliberations and coalition building and maximized the ability to conduct delicate negotiations in private. The G-5 was the exclusive forum of finance ministers, and central bankers when invited, those officials responsible for exchange rate policy. At the same time, the G-5 was large enough to encompass those governments whose cooperation was critical, those representing the key currencies and major international financial centers. Moreover, the G-5 had been specifically granted the task of 'multilateral surveillance' of members' macroeconomic policies by the heads of state and government and had been engaged in this exercise since the 1982 Versailles economic summit. There were problems, of course, in minister-banker relationships, complicated by the fact that in some countries the central bank had substantial autonomy (United States, Germany), while in others the finance ministry was clearly dominant. Yet compared to other international institutions, the number of domestic and international actors in the G-5 grouping was small and inherently manageable.

This highlights one final attraction of multilateralism to Baker and Darman in 1985. By using and strengthening the G-5, the Treasury leaders could buttress their economic policy role in Washington. Though their counterparts in other agencies might resent it, it was possible to treat the G-5 as a Treasury (or Treasury-Fed) preserve. One could act there with minimal interagency consultation. Thus the key policy step – reversal of the policy of nonintervention in exchange markets – could be taken after only minimal intra-government debate. The quotes in Funabashi (1988: 77, 79) are instructive on this point. 'Sprinkel [now Chairman of the President's Council of Economic Advisers], generally speaking, didn't know what was happening.' In the words of a senior administration official, 'I think we informed most of the key people in the US government within 24 hours of [the Plaza], so there wasn't a lot of time to organize opposition'. And, the President 'supported it and had no problems with it' when informed 'only a few days before the Plaza meeting'. The Treasury Secretary *could* conceivably have made a unilateral declaration reversing exchange rate policy without such consultation – this was, after all, within his sphere of responsibility. But

the G-5 framework enhanced the legitimacy of the action, and afforded both domestic and international political protection.

Among the multiple forces pushing Treasury in the direction of policy change in 1985, pressure from producer interests and sympathetic members of Congress was the most important, particularly from multinational companies producing manufactured goods. This pressure created a situation in which the costs of policy persistence were high and rising, and the benefits from change were likely to prove substantial, particularly for the new Secretary of the Treasury.

Once it had been decided to abandon the nonintervention policy in favor of an active policy of dollar depreciation, a multilateral strategy could most readily counter the immediate threat to the administration's trade policy, bring down the value of the dollar, strengthen the Washington hand of its Treasury proponents, and shift some of the adjustment burden onto economic partners when US fiscal politics had all but deadlocked. A continuation of the more unilateral strategy could not offer any of these advantages, as the administration had already learned in other issue areas (Keohane and Nye 1985; Oye, Lieber, Rothchild 1987).

Connecting Domestic and International Economic Influences

How do domestic and international economic circumstances affect the actions of top economic policymakers on exchange rates? These policymakers are concerned, above all, with the dollar's relevance to successful political management of the national economy. If international accounts are in balance, for example, and hence not perceived as a major economic or political problem, then exchange rate policy will not be an important domestic issue, and policymakers will have flexibility on whether or not to intervene actively in currency markets. If domestic economic performance is a source of political difficulty, and if exchange rate misalignments and external imbalances are present, key economic policymakers will likely be driven toward exchange rate activism, and toward trying to persuade foreign governments to assist.

This formulation of the mix of international and domestic economic influences on policymaking is nicely illustrated by the experience of the 1980s. Though the US economic situation in 1981 was widely seen as intolerable and unacceptable, the international economic balance was not an apparent constraint on the Reagan economic agenda or the economy's near-term performance. A *laissez faire* approach toward the exchange rate was therefore practicable, though it was not the only stance that could have been taken. When it became clear in 1982 that the economy was experiencing the worst recession of the postwar period, the Treasury, on the defensive, sent mixed signals about its expectations of future dollar

movement. But at that time, external influences were not the cause of the recession, and the Treasury did not change its basic policy.

Nor did the Treasury see any reason to change its nonintervention policy in the warm glow of the 1983-84 recovery: the political reward for the strong growth of employment and GNP (and the dampening of inflation) more than offset the political penalty for deteriorating international competitiveness, as the results of the 1984 election showed. Foreign borrowing enabled the administration to temporarily escape the national savings constraint on investment and growth. But when the recovery slowed dramatically in late 1984 and 1985, the political threat posed by the overvalued dollar and deteriorating trade balance could no longer be offset. Moreover, that deterioration was accelerating, as were the resultant political pressures on trade policy. So the second Reagan administration actively sought dollar depreciation.

In early 1987, however, after substantial dollar decline, inflation began to displace trade as a potential source of political difficulty, as perceived by the Treasury. At that point, Baker sought a stabilization of the dollar in the Louvre accord. (Similarly, the Carter administration allowed the dollar to depreciate until domestic inflation became the more serious domestic political problem, whereupon it organized a dollar rescue package in late October 1978.) This formulation shares with Odell (1982) an emphasis on the domestic exigencies of US international policy.

This formulation is not meant to diminish the importance of national-level processes and institutions in determining exchange rate policy. Trends in the exchange rate and overall domestic economic performance do offer us a first cut at explaining basic swings in US exchange rate policy, by giving us important information about the policy and political environment within which officials operate. But these trends do not tell us how economic conditions are translated into political pressure from the private sector and through government institutions into policy. And they do not tell us about how officials pursue particular economic performance goals independent of private pressure.

If institutions and processes remain constant, the interplay of international and domestic economic conditions is likely to account, in large measure, for changes in exchange rate policy. But it would be misleading to conclude that such institutions and processes are therefore insignificant. For one thing, they do not remain constant. And even when they do, while they might not explain short-term changes, processes and institutions nonetheless bear substantially on the scope and timing of policy change through the opportunities they offer or deny to private interests and public officials. These are beyond our present discussion, though we intend to treat them in greater depth elsewhere.

Personalities and Ideas as Supplementary Explanations

The job swap between Baker and Regan at the outset of the second term is widely credited with the subsequent change in policy. We agree that this might have stimulated interest group lobbying. Groups which had been rebuffed by Regan–Sprinkel might have sensed new opportunities to affect policy under the new Treasury leadership. The job switch might also have advanced the *timing* of policy change, and it almost certainly contributed to the professional skill with which the Plaza strategy was pursued. Baker had met with businessmen who pressed for a lower dollar at the White House before having contemplated his move to Treasury, and undoubtedly brought awareness of this problem with him.

But even Baker would probably have seen little value in adopting a new exchange rate policy had the trade deficit and tradeable sector interests not created a political ‘market’ for it. And even Regan, who had responded fitfully to this market from time to time, would have been unlikely to resist policy change indefinitely had he retained the Treasury portfolio. The former Treasury Secretary did not apparently object to Baker’s change of course from his new position in the White House as chief of staff and counsel to the president.

The suggestion that the change in policy was the result of changing analytical views about exchange rates – that is, the efficacy of direct exchange rate policy – is also popular, particularly among economists. While economic ideas and analytical frameworks (monetarism, Keynesianism, supply-side economics) can exercise significant influence on government policy, we believe it is usually misleading to see this influence as independent of interests, institutions, and political organization. (Analysts attaching special importance to analytical frameworks are: Frankel, in this volume; Cooper 1986; Odell 1982; Whitman 1979: 283–5; Willett 1978: 96) In our judgment, changes in economic ideas and analytical frameworks do not explain either the rise of the exchange rate as an issue or the change in exchange rate policy in 1985. If anything, the fraternity of professional economists and government practitioners was marginally more skeptical in 1985 of the efficacy of intervention and declaratory policy than it had been in 1981.

However, we do believe that economic ideas can be influential under certain circumstances, and the adoption of the policy of nonintervention in 1981 is illustrative. It reflected the conviction that such markets *ought* to be free, and the analytical belief that government intervention was unlikely to be effective in any case. Then, ‘external constraints’ were not binding and the President had no strong views or commitments on exchange rate or international monetary issues. The personal predilec-

tions and monetarist views of Sprinkel and other top officials in the Treasury did affect exchange rate policy at that point.

Ideas mattered in another very basic sense. In the 1980s there was a much more widespread recognition in the private sector, Congress and the Executive of the causal link between the exchange rate and the trade deficits. Much more emphasis was given to this link than in the past. That the dollar affected the US trade position was not a new idea; the link between exchange rates and trade flows had long been standard fare in undergraduate economics courses. The idea was not influential just because the link was accepted by economists of all persuasions. Persistent policy advocacy (which we treat elsewhere) was crucial in selling the notion – counterintuitive to many politicians – that something other than trade policy was causing trade imbalances and might help cure them.

The general philosophical preference of the Reagan administration for free markets was consistent with both the policy of nonintervention and capital market liberalization. But, in our judgment, this philosophical predisposition would not have survived for long had it not been consistent with domestically desired macroeconomic performance. (And the appreciating dollar in 1981–83 did, we must remember, aid in the fight against domestic inflation.) Once domestic political problems became acute, however, the Treasury and the President appear to have had little philosophical difficulty in making an exception to free markets in the case of exchange rate policy.

That an administration with such strongly held free market views would follow the neglect-to-activism pattern exhibited by previous administrations testifies to the strength of that pattern. The evolution of exchange rate policy under the Bush administration will provide an additional case, helping to measure the importance of continuity of party control, personnel and ideas in this cyclical pattern. The case we have chosen is unique in some respects, particularly the extremity of the trade deficit and the strength of interest group and congressional pressures on trade and exchange rate policy. We would not want to generalize about US exchange rate policy on this basis alone, and certainly not about exchange rate policies of other countries.

Nonetheless, we see important similarities with other notable cases of US exchange rate policy change, for example the devaluations of the dollar in the early 1970s. Further, the 1985 episode offers some analytical insights precisely because external imbalances were unprecedented. Specifically, the ‘sustainability’ of the trade deficit, a term more often used than defined, was determined by American politics and not the willingness of investors to lend to the US at that time. Perhaps more importantly, the 1985 case helps to explicate how domestic and international economic conditions affect the relation between trade

deficits and exchange rate policy in the US. When the recovery slowed in 1985, due not only to the growing trade deficit, the pressures for policy change which resulted could not have been ignored, or offset with countervailing political pressures, by any administration or Treasury Secretary. Thus, we believe that this case, in structured comparisons with other historical and future episodes, can yield fruitful further insights into the relationship between domestic and international factors in exchange rate policy determination.

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