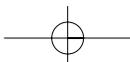
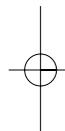
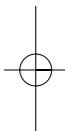


PART THREE

Monetary Statecraft



CHAPTER SIX

The Exchange-Rate Weapon and Macroeconomic Conflict

C. Randall Henning

Monetary statecraft, understood as efforts to influence the policies of other states by manipulating monetary conditions, has been a recurring feature of the global economy since World War II. At critical moments over the last four decades, the United States has exploited the vulnerability of countries in Europe and East Asia to changes in their currencies' exchange rates vis-à-vis the dollar in an effort to extract policy adjustments from their governments and central banks. More successful in some episodes than in others, this "exchange-rate weapon" has played a central role in international conflicts over balance-of-payments adjustment. This instrument of leverage is critical to explaining the behavior of governments and central banks and the distribution of the costs of adjustment among conflicting states. When collective management of the international monetary system has been required, currency coercion has often underpinned agreements among the larger players.

The exchange-rate weapon—a concept that I have developed elsewhere and elaborate here—can take two forms, one passive and the other active.¹ U.S. officials can

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1. My earlier treatments of the exchange-rate weapon include C. Randall Henning, *Macroeconomic Diplomacy in the 1980s: Domestic Politics and International Conflict among the United States, Japan, and Europe*, Atlantic Paper, no. 65 (London: Croom Helm for the Atlantic Institute for International Affairs, 1987): 1–4, 30–39; "Europäische Währungsunion und die Vereinigten Staaten," in *Europa auf dem Weg zur Währungsunion*, ed. Manfred Weber, 317–40 (Darmstadt: Wissenschaftliche Buchgesellschaft, 1991); "Systemic Conflict and Regional Monetary Integration: The Case of Europe," *International Organization* 52, no. 3 (summer 1998): 537–73. Cases of deployment of this weapon are treated in I. M. Destler and C. Randall Henning, *Dollar Politics: Exchange Rate Policymaking in the United States* (Washington, D.C.: Institute for International Economics, 1989), 50–56; Robert D. Putnam and C. Randall Henning, "The Bonn Summit of 1978: A Case Study in Coordination," in *Can Nations Agree? Issues in International Economic Cooperation*, Richard N. Cooper, Barry Eichengreen, Robert D. Putnam, C. Randall Hen-

allow the exchange rate to shift, perhaps even overshoot, in the knowledge that a partner country is more vulnerable and thus subject to incentives to adjust its fiscal or monetary policy. U.S. authorities can also actively encourage a shift in the rate to induce a shift in a partner's macroeconomic policy. The two forms are deliberate, often coincide empirically, and have similar effects, namely the encouragement of domestic policy change on the part of partners. When successful, they can both delay the continuing costs and deflect the transitional costs of adjustment, in the terminology advanced by Benjamin J. Cohen (chap. 2 in this volume).

By deflecting and deferring adjustment costs, deployment of the exchange-rate weapon has helped to sustain political support for open trade and investment policy in the United States at junctures when that support has been in jeopardy. However, this leverage has also generated resentment on the part of foreign partners, who consequently developed defenses against currency coercion. Both unilateral and regional in nature, these countermeasures contributed substantially to altering the international terrain over which balance-of-payments conflicts will be fought in the future.

This chapter provides an overview of the conceptual foundations of the exchange-rate weapon and then surveys the use of this instrument of international monetary statecraft since the dissolution of the Bretton Woods regime. I then address the countermeasures pursued by Europe, Japan, and East Asia and the resulting changes in the structure of international monetary relations. The chapter concludes by evaluating the limits of the weapon's effectiveness in light of structural shift.

The Exchange-Rate Weapon: Concepts and Mechanisms

The exchange-rate weapon becomes particularly relevant when current account imbalances become unsustainable and conflict erupts among key states over remedial action. In this situation, each country individually faces three basic choices: (1) persuade other states to change their macroeconomic policy, (2) accept a change in the mutual exchange rate, and (3) alter its own monetary and/or fiscal policies.² The hi-

ning, and Gerald Holtham (Washington, D.C.: Brookings Institution, 1989), 49–53, 82–84. Other authors who examine the concept include Eric Helleiner, *States and the Re-emergence of Global Finance: From Bretton Woods to the 1990s* (Ithaca: Cornell University Press, 1994); Jonathan Kirshner, *Currency and Coercion: The Political Economy of International Monetary Power* (Princeton: Princeton University Press, 1995); Michael Webb, *The Political Economy of Policy Coordination: International Adjustment since 1945* (Ithaca: Cornell University Press, 1995); Keisuke Iida, *International Monetary Cooperation among the United States, Japan, and Germany* (Boston: Kluwer Academic Publishers, 1999).

2. The extent to which these choices are alternatives is partial because changes in macroeconomic policy might well effect adjustment through changes in the exchange rate. The extent to which adjustment is effected through expenditure switching (exchange rate) versus expenditure changing (aggregate income) depends on the particular economic circumstances, including size, openness, and capital mobility. The steepness of the trade-off between choices is specified by the particular open economy model that applies under the circumstances. Under most conditions, however, both expenditure switching and expenditure changing will apply and there will thus be scope for trading off changes in macroeconomic policy for changes in the exchange rate in securing adjustment.

erarchy of each government's preferences is generally as just presented: each prefers the others to adjust their policies and is averse to changing its own, with a shift in the exchange rate lying between these two alternatives. Because states generally confront partners with the same preference ordering, a change in the exchange rate is generally the solution of least resistance.

When negotiating, or groping, toward a solution to the adjustment problem, however, governments can trade off one type of solution for another, choosing a mix. Anticipating a large and painful appreciation of the currency, for example, a government might ease monetary policy, thereby selecting a combination of currency appreciation and policy change. But the trade-off between solutions will differ across countries, with some governments more fearful of exchange-rate movements and willing to limit them with shifts in monetary and fiscal policy. Aware of the greater vulnerability of others, some countries might countenance or encourage exchange-rate movements in the hope of inducing policy adjustments on the part of their partners. The use of the exchange rate by one state to secure policy change on the part of another defines the concept.

Causal Mechanisms

When two states conflict over macroeconomic and exchange-rate policies, macroeconomic effects are transmitted from the large, dominant state to its smaller partners. When capital mobility is high, the transmission of macroeconomic effects occurs under both fixed and flexible exchange rates and in the cases of both monetary and fiscal policy. The case of monetary policy under flexible exchange rates could be an exception, depending on other conditions.³ Generally, however, flexible exchange rates do not fully insulate countries from policy shocks abroad in the presence of high capital mobility.⁴

These cross-border transmission effects create domestic economic and political pressure within other countries for policy adjustment. In this way, a larger and more powerful state can alter the payoffs to existing policy settings in its smaller and weaker partners and thereby force a reconsideration of macroeconomic policies and domestic political agreements that underpin them, inducing policy change.

3. On the differences among econometric models on this point, see Ralph C. Bryant, Dale Henderson, Gerald Holtham, Peter Hooper, and Steven Symansky, *Empirical Macroeconomics for Interdependent Economies* (Washington, D.C.: Brookings Institution, 1988).

4. This is the subject of an extensive literature in open economy macroeconomics. Richard E. Caves, Jeffrey A. Frankel, and Ronald W. Jones, *World Trade and Payments: An Introduction*, 9th ed. (Boston: Addison-Wesley, 2002); and Maurice Obstfeld and Kenneth Rogoff, *Foundations of International Macroeconomics* (Cambridge, Mass.: MIT Press, 1982), for example, present textbook treatments of standard theories of open economy macroeconomics. The academic literature on the international transmission of national macroeconomic policies, particularly as it relates to coordination, is reviewed by Ralph C. Bryant, *International Coordination of National Stabilization Policies* (Washington: D.C.: Brookings Institution, 1995); Torsten Persson and Guido Tabellini, "Double-Edged Incentives: Institutions and Policy Coordination," in *Handbook of International Economics*, ed. Gene M. Grossman and Kenneth Rogoff (Amsterdam: Elsevier, 1995), 1973–2030; among others.

Consider the example of a large country embarking on a fiscal stimulus under flexible exchange rates in an environment of high capital mobility. As the fiscal expansion is transmitted abroad, the small country experiences an increase in prices, employment, and income. The existing policies of the small country have targeted a combination of inflation, employment, and growth that was considered optimal by its government. The transmission effects strengthen an incentive for the small country to tighten policy (avoiding inflation) while easing a constraint (avoiding unemployment). If the existing policy is not changed in the face of the stimulus from abroad, it will contribute to an overshooting of the targets for inflation, employment, and growth. In this way, the fiscal stimulus in the large country creates economic pressures for a tightening of macroeconomic policy in the small country.⁵

The strength of these pressures rises as we consider three additional factors. First, until now we have assumed that the large country generally neglects the policies of others and the external consequences of its own policies (as discussed by David M. Andrews, chap. 5 in this volume). Such a country, however, rather than being simply passive or indifferent, might deliberately attempt to induce a change of policy in the smaller country in order to ease its own balance-of-payments constraint. Aggressive policies such as these give rise to international policy conflict.

Second, we have also assumed until now that the exchange rate is completely endogenous to the open economy macroeconomic model and the transmission process. However, governments and central banks can influence the exchange rate to varying degrees without changing monetary and fiscal policy through, for example, declarations, signaling, and foreign-exchange intervention. Less vulnerable to precipitous exchange-rate swings and prolonged exchange-rate misalignments because its economy is more closed, among other factors, the large country might well employ exchange-rate policy in its effort to extract policy adjustment from the small state.

The scope of government capacity to affect exchange rates without altering underlying policies (monetary, fiscal, or structural) is widely disputed. Economists' models of exchange-rate determination are notoriously weak, depriving analysts of reliable counterfactuals against which to measure the effects of government action in foreign-exchange markets. The professional consensus on the effectiveness of intervention, for example, has swung back and forth over the decades. The availability of daily intervention data over the last ten years has improved these studies. More recent studies have also addressed more sophisticated questions, differentiating the circumstances under which intervention is and is not likely to be effective. As a result of this evolution, these more recent studies generally find intervention to be more effective than did studies conducted during the 1980s.⁶ Experience with mas-

5. Martin Feldstein, "US Budget Deficits and the European Economies: Resolving the Political Economy Puzzle," *American Economic Review* 76, no. 2 (May 1986): 342–46; Henning, *Macroeconomic Diplomacy in the 1980s*, 21–23.

6. For a review, see Lucio Sarno and Mark P. Taylor, "Official Intervention in the Foreign Exchange Market: Is It Effective and, If So, How Does It Work?" *Journal of Economic Literature* 39, no. 3 (2001): 839–68. Ramana Ramaswamy and Hossein Samiei, "The Yen-Dollar Rate: Have Interventions Mattered?" in *Japan's Lost Decade: Policies for Economic Revival*, ed. Tim Callen and Jonathan D. Ostry, 224–

sive Chinese and Japanese interventions during 2002–4 suggests they can indeed be effective with and without capital controls. Extended discussion is beyond the scope of this paper. Suffice it to say that government action can be successful under a variety of circumstances, such as when it is publicly announced, conducted jointly by two or more central banks, consistent with the underlying fundamentals, and the exchange rate is far from equilibrium.⁷

The conditions that create scope for intervention to be at least partially effective also create scope for other, more subtle instruments. In the presence of high capital mobility, flexible exchange rates are often driven by herd behavior and expectations, and are thus frequently disconnected from the underlying economic fundamentals. In addition, the foreign-exchange markets often exhibit multiple equilibria. When private expectations are easily swayed, governments are more likely to be able to induce a shift from one equilibrium to another. Particularly when the rate moves far from equilibrium, governments might well coordinate the expectations of private participants by articulating an emerging consensus on the direction of movement.⁸

Government officials can influence these expectations, depending on market sentiment, by signaling their desire for a stronger, weaker, or stable currency; forswearing intervention; and intervening. Under some market conditions, such as a profound current account imbalance, a “no comment” in the face of a significant exchange-rate movement can be interpreted by the market as a clear signal of approval. Conflict over trade policy and market access can enhance the markets’ sensitivity to official statements. Thus, even if U.S. policy makers have only partial influence over the exchange rate, that influence can be substantial at particular junctures.

Third, we have not yet referred to the international roles of currencies, the importance of which is emphasized by Cohen (chap. 2 in this volume). When a large share of international trade is invoiced in the currency of the large country—the most prominent example being the pricing of oil in dollars—a depreciation affects

50 (Washington, D.C.: International Monetary Fund, 2003), find intervention specifically in the yen-dollar market to be reasonably effective.

7. See Pietro Catta, Giampaolo Galli, and Salvatore Rebecchini, “Concerted Interventions and the Dollar: An Analysis of Daily Data,” in *The International Monetary System*, ed. Peter B. Kenen, Francesco Papadia, and Fabrizio Saccomanni (Cambridge, UK: Cambridge University Press, 1994), 201–49; Kathryn M. Dominguez and Jeffrey A. Frankel, *Does Foreign Exchange Intervention Work?* (Washington, D.C.: Institute for International Economics, 1993); John Williamson, *Exchange Rate Regimes for Emerging Markets: Reviving the Intermediate Option*, Policy Analyses in International Economics no. 60 (Washington, D.C.: Institute for International Economics, 2000); Sarno and Taylor, “Official Intervention”; Takatoshi Ito, “Is Foreign Exchange Intervention Effective?: The Japanese Experiences in the 1990s,” NBER Working Paper no. 8914, National Bureau of Economic Research, Cambridge, Mass., 2002; Mark Taylor, “Is Official Exchange Rate Intervention Effective?” CEPR Discussion Papers no. 3758, Centre for Economic Policy Research, London, 2003; Christopher Kubelec, “Intervention When Misalignments Are Large,” paper presented at the conference of the Institute for International Economics, Dollar Adjustment: How Far? Against What?, Washington, D.C., May 2004. Marcel Fratzscher, “Communication and Exchange Rate Policy,” ECB Working Paper Series no. 363, European Central Bank, Frankfurt, 2004; and Hans Genberg and Alexander Swoboda, “Exchange-Rate Regimes: Does What Countries Say Matter?” paper presented to the conference of the International Monetary Fund, Mussa Fest, Washington, D.C., June 2004, find official declarations to be significantly effective.

8. Taylor, “Is Official Exchange Rate Intervention Effective?”

the small state beyond the extent of its trade with its large partner. When foreign investors accept financial assets denominated in the large country's currency, they facilitate the financing of current account deficits and enable the large country to deflect the exchange-rate risks associated with foreign borrowing. When, under conditions of fixed exchange rates, foreign central banks hold the large country's currency in reserves, the monetary policy of the large country dominates monetary conditions of the system as a whole. The role of the currency, in sum, magnifies the asymmetry in macroeconomic interdependence between the large and small state.

Consider now the small state's response to the pressures for policy change by referring again to the case of a large country's fiscal stimulus under flexible exchange rates. Preconflict policy settings presumably represent a bargain that satisfies a governing majority within the target state. The economic pressures arising from the stimulus abroad satisfy demands for jobs and growth but aggravate fear of inflation and its consequences, altering the political demands on the policy-making process. Because macroeconomic policies are set through an elaborate architecture of political and governmental institutions, the politics of renegotiating the original bargain in order to adjust policy are unlikely to be smooth. Moreover, domestic bargains, carefully and delicately crafted, often have broader purposes than simply attaining the macroeconomic targets; these might include the satisfaction of key constituency demands, pursuit of ideological priorities, and fulfillment of election promises. Any decision to tighten fiscal policy, for example, would have to specify the particular spending programs to be cut or the particular taxes to be raised. The adjustment of macroeconomic policy will therefore probably be fraught with domestic political conflict and, therefore, resisted.

Assumptions and Preconditions

The ability of one state to use the exchange rate as a tool in international conflict over adjustment and macroeconomic policy hinges on a number of conditions and assumptions. These include (1) asymmetry in the size and openness of the states concerned, (2) asymmetry in the domestic political influence of traded- and non-traded-goods sectors, and (3) global macroeconomic conditions.

The first assumption, asymmetry in size and openness, has already been made explicit. A pair of countries of equal size and openness would have more equal vulnerability to exchange-rate change than a pair composed of one large closed economy and one small open economy. As the exchange rate shifts, two equally large economies experience effects that are roughly equal in magnitude, although opposite in sign. Differences in economic conditions (recession versus overheating), flexibility of domestic prices and wages, and domestic political bias (toward trade versus nontraded sectors) might still impart differences in sensitivity to exchange-rate change. But the scope for the use of the exchange rate as a tool in conflict is circumscribed in the presence of symmetry. Given the differences between the United States and its partners during the second half of the twentieth century, the assumption of asymmetry is historically realistic.

The magnitude of the effects of an exchange-rate change is also equal, in princi-

ple, in the traded- and nontraded-goods sectors within each country. By reducing the price of traded goods, for example, an appreciation of the currency hinders traded-goods producers and benefits traded-goods purchasers, principally the nontraded-goods sector. If the political power of the traded and nontraded sectors were equal, there would be little reason to expect policy outcomes to favor one over the other. There would be little reason to expect that central banks would ease monetary policy, for example, to blunt an appreciation of the currency if the interests of both sectors weighed equally on the policy process.

But there are a number of reasons to believe that the political power of traded and nontraded sectors is in fact not equal.⁹ To begin with, because the nontraded sector is usually the larger of the two, while the economic effects are roughly equal, firms and workers in the traded-goods sector feel the effects with greater intensity than those in the nontraded sector. In addition, owing to differences in the organization of firms and workers in these sectors for political action, the traded sector may have more sway over policy than the nontraded sector. Manufacturing constitutes a large share of the traded sector and is often well represented in the policy process. Its general dominance of trade also imparts greater homogeneity of interests to that sector compared to the nontraded sector. Critically, moreover, the links between manufacturing and the banking system in bank-dominated systems consolidate the interests of the two sectors and confer access to government financial agencies that determine exchange-rate policy.¹⁰ Again, the assumption of asymmetrical political influence of the traded- and nontraded-goods sectors appears realistic for a large number of countries during the second half of the twentieth century.

The potency of the exchange rate as a tool for inducing policy change also hinges on the international macroeconomic environment and the particular conditions in the target. When governments are primarily concerned about restraining generally high inflation, they are more averse to the depreciation of their currencies than when prices are generally stable. When governments are primarily concerned with avoiding deflation, they are more averse to the appreciation of their currencies than when prices are generally stable. The effectiveness of the exchange-rate weapon is thus likely to depend on both the inflationary (or deflationary) conditions and the direction of the exchange-rate shift called for by the particular adjustment problem.

Because the availability and potency of the exchange-rate weapon hinges on these conditions and assumptions, the tool is not consistently available even to large closed states. However, the junctures at which this lever becomes available tend to be formative episodes in international economic relations. The resolution of macroeconomic conflict involves political choices with continuing effects that give rise to path

9. On the ramifications of the distinction between traded and nontraded goods for the political economy of exchange-rate policy see, among others, Jeffrey A. Frieden, "Invested Interests: The Politics of National Economic Policies in a World of Global Finance," *International Organization* 45, no. 4 (autumn, 1991): 425–51; C. Randall Henning, *Currencies and Politics in the United States, Germany, and Japan* (Washington, D.C.: Institute for International Economics, 1994); James I. Walsh, *European Monetary Integration and Domestic Politics: Britain, France and Italy* (Boulder: Lynne Rienner, 2000); Lawrence J. Broz and Jeffrey Frieden, "The Political Economy of International Monetary Relations," *Annual Review of Political Science* 4 (June 2001): 317–43.

10. Henning, *Currencies and Politics*; Walsh, *European Monetary Integration and Domestic Politics*.

dependency. During the crises of the early 1970s, late 1970s, and mid-1980s, for example, U.S. administrations confronted strong protectionist pressures that were defused in part by the use of the exchange rate to secure adjustment. Had the U.S. Treasury simply let market forces bring adjustment in their own good time, and in their own good measure, U.S. trade policy could well have been overwhelmed by domestic protectionism and taken a turn toward closure, or at least considerably slower liberalization, with effects for years to come.

This example raises two additional points worthy of mention. First, domestic politics, and in particular the struggle over the openness of international economic policy (with respect to trade, investment, etc.), has been at the root of the motivations of the United States in using the exchange-rate weapon. Historically, U.S. administrations and congresses have tended to resort to manipulating the dollar when the trade deficit was large and in the midst of resulting conflict over adjustment. Pressure for macroeconomic expansion on the part of other states was an explicit part of the strategy, in several cases, of maintaining open policies in international economics. Deflecting the responsibility for adjustment was considered crucial for maintaining a coalition of politically active societal interests in favor of openness and further liberalization. Thus, it was considered politically necessary to adopt coercive methods to extract policy concessions on the part of others or at least to attempt to extract them.

Second, the exchange-rate weapon also tends to be deployed not only in the presence of adjustment conflict but also during conflicts over trade policy. Threats to close the U.S. market, or part of it, and to raise the cost of access (tariffs) are additional arrows in the quiver of administrations confronting balance-of-payments problems, and they reinforce the exchange-rate instrument. Serious threats over trade policy tend to alert foreign-exchange markets to the policies and preferences of the antagonists. To the extent that they provide information about the intensity with which the U.S. government is likely to pursue adjustment on the part of others, trade threats can affect foreign-exchange markets directly, at least in the short term, or can sensitize them to officials' declarations about rates and intervention.

The empirical coincidence of exchange-rate and trade coercion creates an explanatory problem in some cases. In the language of an econometrician, if we were to regress adjustment outcomes on both, we would encounter multicollinearity—that is, it would be difficult to disentangle the independent effects of each on observed outcomes. However, for purposes of prediction, it may not be necessary to separate the effects of the two factors—provided they continue to coincide in the future. More generally, trade and exchange-rate coercion should be considered together because there are interaction effects between them.

History

Over the last half century, international monetary relations have exhibited distinct cycles, each containing a period of relative harmony, followed by heightened con-

flict over adjustment and then some degree of cooperation. Because U.S. payments difficulties lie at the heart of each conflict episode, these cycles also correspond to shifts in U.S. international economic policy between neglect and activism.¹¹ With the international system now in the midst of the fifth adjustment conflict since the 1960s, these cycles are an entrenched feature of global political economy. Each cycle can be identified by its phase of acute tension: (1) the breakdown of the Bretton Woods regime in the early 1970s; (2) conflicts over world reflation that were resolved at the Bonn summit of 1978; (3) hostility in the mid-1980s, at the center of which stood the Plaza and Louvre accords; (4) recession and recovery in the early and mid-1990s; and (5) the present adjustment dispute.¹²

During each cycle, U.S. administrations pressed European and Japanese governments and/or central banks for expansionary measures and often actively encouraged a depreciation of the dollar.¹³ The United States used the exchange-rate weapon with more success in some episodes, such as 1971–73, 1977–78, and 1985–87, than in others, such as during the 1990s. Each of these episodes, which are summarized briefly next, highlights strategic considerations in monetary statecraft. Specifically, the wielder of the exchange-rate weapon confronts a trade-off between securing adjustment on favorable terms in the short term and creating incentives for the targets to insulate themselves against future episodes of monetary coercion over the long term.

The First Episode (1971–1973)

Confronted with payments imbalances that had become chronic by the late 1960s (although small by present standards), the Bretton Woods regime would have required agreement on fundamental adjustments of macroeconomic policy to be preserved.¹⁴ Unable to reach agreement on this politically charged question, for reasons

11. Benjamin J. Cohen, "An Explosion in the Kitchen? Economic Relations with Other Advanced Industrial States," in *Eagle Defiant: United States Foreign Policy in the 1980s*, ed. Kenneth A. Oye, Robert J. Lieber, and Donald Rothchild (Boston: Little, Brown, 1983), 105–30; C. Fred Bergsten, "America's Unilateralism," in *Conditions for Partnership in International Economic Management*, C. Fred Bergsten, Etienne Davignon, and Isamu Miyazaki, Report to the Trilateral Commission 32 (New York: Trilateral Commission, 1986), 3–14; Henning, *Currencies and Politics*.

12. There were certainly adjustment conflicts between the United States and its major economic partners during the fixed-rate Bretton Woods era as well, but these did not involve use of the exchange-rate weapon as I develop the concept here.

13. Relatively recent overviews of episodes of policy coordination can be found in Iida, *International Monetary Cooperation*; Laurence H. Meyer, Brian M. Doyle, Joseph E. Gagnon, and Dale W. Henderson, "International Coordination of Macroeconomic Policies: Still Alive in the New Millennium?" International Finance Discussion Papers no. 723, Board of Governors of the Federal Reserve System, Washington, D.C., April 2002; David M. Andrews, C. Randall Henning, and Louis W. Pauly, eds., *Governing the World's Money* (Ithaca: Cornell University Press, 2002); Edwin M. Truman, "A Critical Review of Coordination Efforts in the Past," paper presented to the Kiel week conference, Macroeconomic Policies in the World Economy, June 2003.

14. Classic references include John S. Odell, *International Monetary Policy: Markets, Power, and Ideas as Sources of Change* (Princeton: Princeton University Press, 1982); Joanne Gowa, *Closing the Gold Window: Domestic Politics and the End of Bretton Woods* (Ithaca: Cornell University Press, 1983); Robert

well-documented in the literature on this episode, the United States suspended gold convertibility and imposed a 10 percent surcharge on imports in August 1971—measures known in Japan as the “Nixon Shock.” After a brief floatation of the dollar, the G-10’s Smithsonian Agreement repegged it to the yen at a level 17 percent below the Bretton Woods parity, to the deutschmark at about 14 percent below, and to the British pound and French franc at about 9 percent below. These rates proved to be unsustainable by early 1973, when the currencies were permanently floated.

Because U.S. macroeconomic autonomy was never seriously constrained by the Bretton Woods regime, it would be an overstatement to suggest that the shift to floating rates unshackled the United States from its “constraints.” Federal Reserve Board Chairman Arthur Burns explicitly stated in early 1973 that monetary policy would not be tightened to preserve the revised parities. The fundamental cause of the regime’s collapse was that the United States refused to submit to those constraints or, more judgmentally, to “play by its rules.” However, the shift to floating rates did expand the range of options available to U.S. exchange-rate policy and unshackled the exchange-rate weapon.

Although greater exchange-rate flexibility afforded an opportunity to others to halt the “importation” of U.S. inflation, most governments did not take advantage of it. Japanese Prime Minister Kakuei Tanaka engineered an extraordinary expansion using both monetary and fiscal policy during the early 1970s in an effort to maintain the Smithsonian parity and offset the contractionary effects of the yen appreciation. That policy response produced not only high growth but also hoarding of several commodities and double-digit inflation in Japan. At the same time, partly attributable to the 1973–74 oil shock, Japan’s external surplus temporarily evaporated.¹⁵ European governments also generally responded with expansionary policies, although there was considerable dispersion among them. Germany was the least accommodating; it eased monetary and fiscal policy in 1972, tightened both in 1973, eased fiscal policy early in 1974, and then monetary policy in late 1974.¹⁶ With

Solomon, *The International Monetary System, 1945–1981*, rev. ed. (New York: Harper & Row, 1982); Paul A. Volcker and Toyoo Gyohten, *Changing Fortunes: The World’s Money and the Threat to American Leadership* (New York: Times Books, 1992); Benjamin J. Cohen, *Organizing the World’s Money: The Political Economy of International Monetary Relations* (New York: Basic Books, 1977); John Williamson, *The Failure of World Monetary Reform, 1971–1974* (New York: New York University Press, 1977); Otmar Emminger, “The D-mark in the Conflict between Internal and External Equilibrium, 1948–75,” in Princeton Essays in International Finance no. 122, Princeton University International Finance Section, Princeton, N.J., June 1977; Gunter D. Baer and Tommaso Padoa-Schioppa, “The Werner Report Revisited,” in *Delors Report*, 53–60 (Luxembourg: Office of Official Publications of the European Community, 1989); C. Fred Bergsten, *The Dilemmas of the Dollar: The Economics and Politics of United States International Economic Policy* (New York: New York University Press, 1975).

15. Gardner Ackley and Hiromitsu Ishi, “Fiscal, Monetary and Related Policies,” in *Asia’s New Giant: How the Japanese Economy Works*, ed. Hugh Patrick and Henry Rosovsky, 153–247 (Washington, D.C.: Brookings Institution, 1976); Ryutaro Komiya and Miyako Suda, *Japan’s Foreign Exchange Policy: 1971–82* (Sydney: Allen & Unwin, 1991); Robert C. Angel, *Explaining Economic Policy Failure: Japan in the 1969–1971 International Monetary Crisis* (New York: Columbia University Press, 1991).

16. See, for example, Stanley W. Black, *Floating Exchange Rates and National Economic Policy* (New Haven: Yale University Press, 1977).

the partial exception of Germany, therefore, policy changes within most European countries and Japan contributed to the substantial correction in the U.S. current account position.

U.S. officials did not exactly encourage the weakness of their currency in order to secure adjustment on the part of foreign partners during this episode. When domestic macroeconomic choices placed downward pressure on the dollar, however, they did precious little to support it themselves. They bargained aggressively for larger rather than smaller devaluations, coercing partners into agreeing to larger parity changes than these governments would have preferred, and accepted substantial depreciation after the switch to floating rates. In doing so, U.S. officials were acutely conscious that the devaluations and depreciation of the dollar created substantial incentives for Europeans and Japanese officials to deliver expansionary policies.

The Second Episode (1977–1978)

U.S. policy makers deployed the dollar weapon more actively during the 1977–78 conflict. Because economic recovery in the United States preceded that in Europe and Japan, a substantial U.S. current account deficit reemerged in 1977. The Jimmy Carter administration responded by advocating the “locomotive theory,” under which the surplus countries would stimulate their economies to restore robust growth not only for themselves but also for the world economy more broadly. Both Japan and Germany, the countries to which this strategy was primarily directed, resisted this advice. U.S. authorities let it be known that they would be content to allow the dollar to depreciate against the surplus-country currencies in the absence of macroeconomic stimuli.¹⁷ The subsequent appreciation of the yen and deutschmark reduced the U.S. current account surplus, dampened growth and inflation prospects in Japan and Germany, and placed formidable domestic political pressure on these governments to provide the stimulus demanded by U.S. officials.

The government of Prime Minister Takeo Fukuda therefore agreed to a fiscal stimulus, first in an agreement between U.S. Trade Representative Robert Strauss and Japanese economic Ambassador Nobuhiko Ushiba in early 1978 and subsequently among the heads of government themselves at the Bonn Summit in July. German Chancellor Helmut Schmidt also acceded to expansionary fiscal policy at the summit as part of a package of mutual concessions.¹⁸ Although controversial, these policy adjustments, coupled with the second oil shock, eliminated the Japanese and German current account surpluses in 1979 and 1980. During this episode, as during the early 1970s, the exchange rate proved to be a powerful weapon in the

17. Stephen D. Cohen and Ronald L. Meltzer, *US International Economic Policy in Action* (New York: Praeger, 1982).

18. I. M. Destler and Hisao Mitsuyu, “Locomotives on Different Tracks: Macroeconomic Diplomacy, 1977–1979,” in *Coping with US-Japanese Economic Conflicts*, ed. I. M. Destler and Hideo Sato, 243–70 (Lexington: Lexington Books, 1982); Putnam and Henning, “The Bonn Summit of 1978,” 12–140.

hands of U.S. officials trying to extract macroeconomic policy change from foreign governments.

The Third Episode (mid-1980s)

The second Ronald Reagan administration again benefited from the exchange rate as an inducement for macroeconomic stimulus abroad and the reduction of current account imbalances. During the first half of the 1980s, the first Reagan administration and Japanese governments largely ignored the extraordinary appreciation of the dollar and record current account imbalances.¹⁹ This laissez-faire stance proved to be unsustainable in the face of mounting protectionist pressure in the U.S. Congress, which boiled over in summer 1985. In the Plaza accord in September, the United States and Japan agreed with their European partners in the Group of Five to intervene in the foreign-exchange market to appreciate the yen and deutschmark against the dollar to redress the payments imbalance. Mutual agreement on this strategy proved to be ephemeral, however, and the United States again began “talking down” the dollar further in order to encourage stimuli to domestic demand in Japan and Germany. Unprecedented appreciations of the yen and mark occurred, prompting calls from within these countries’ private sectors for expansionary measures to offset the contractionary effect.

U.S. support for exchange-rate stability, in conjunction with European and Japanese policy accommodations, were the essence of the resulting bargain struck at the Louvre in February 1987. Rather than providing a strong fiscal stimulus, however, the Japanese government chose to boost domestic demand primarily by substituting a dramatic monetary expansion.²⁰ For their part, the German government and Bundesbank responded with a mix of fiscal and monetary stimulus.²¹ This combination of exchange-rate movement and macroeconomic policy change helped reduce the U.S. current account deficit during 1988–91 to low levels.

The Fourth Episode (mid-1990s)

The subsequent episode, by contrast, suggests a significant weakening of the influence of the exchange-rate weapon. The U.S. economy experienced a recession in

19. The exchange-rate weapon also played a critical role in the standoff between the first Reagan administration and the François Mitterrand government during 1981–83. See Jeffrey Sachs and Charles Wyplosz, “The Economic Consequences of President Mitterrand,” *Economic Policy* 1, no. 2 (April 1986): 261–306; Henning, *Macroeconomic Diplomacy in the 1980s*; Michael Loriaux, *France after Hegemony: International Change and Financial Reform* (Ithaca: Cornell University Press, 1991); John B. Goodman, *Monetary Sovereignty: The Politics of Central Banking in Western Europe* (Ithaca: Cornell University Press, 1992); Christian de Boissieu and Jean Pisani-Ferry, “The Political Economy of French Economic Policy in the Perspective of EMU,” in *Forging an Integrated Europe*, ed. Barry Eichengreen and Jeffrey Frieden, 49–89 (Ann Arbor: Michigan University Press, 1998). This episode suggests that the United States could employ such coercion in the absence of a current account adjustment problem and, depending on the economic circumstances, could deploy both appreciation and depreciation coercively.

20. Yoichi Funabashi, *Managing the Dollar: From the Plaza to the Louvre* (Washington, D.C.: Institute for International Economics, 1998); Henning, *Currencies and Politics*.

21. Henning, *Currencies and Politics*, 203–8.

1991 and a slow recovery in 1992, with a delayed response in the labor market.²² When Bill Clinton became president in January 1993, his administration encountered a global pattern of staggered business cycles similar to that confronted by the early Carter administration: the U.S. economy was beginning to recover while those of Europe and Japan lagged behind, poised for export-led growth at the expense of the U.S. current account position. Japan became the particular focus of the administration's attention, as President Clinton and Treasury Secretary Lloyd Bentsen signaled the desirability of yen appreciation. The Japanese currency quickly moved to the 100 level against the dollar briefly in summer 1993 and reached an all-time high of 80 to the dollar in mid-1995.

The Japanese response contrasts with earlier episodes, however. Although successive governments introduced a number of supplemental budgets during 1993–95 and exchange rates might have played a role in prompting one of these (the 1995 supplemental), the expansionary content of these budgets was frequently less than advertised. Stimuli were also retracted at critical points, such as in 1996, aborting a promising recovery. Over the decade as a whole, Japanese fiscal policy was not particularly responsive to exchange-rate pressure, nor was it managed in a fashion as to produce a sustained recovery.²³ In the second half of the 1990s, robust U.S. growth eased concern about the current account position.

Countermeasures and Structural Shift

As with other forms of coercion, the deployment of the exchange-rate weapon generates defensive countermeasures on the part of the targets. The cumulative effect of such countermeasures over time, along with the progressive internationalization of the U.S. economy, has shifted the structure of global monetary relations.²⁴ Struc-

22. During 1991 and 1992, the George H. W. Bush administration objected to the tightening of European monetary policy in the wake of German unification and, belatedly, to the restrictiveness of the convergence criteria embodied in the Maastricht treaty sections on monetary union. Exchange-rate coercion did not come into play on this occasion, however, notwithstanding a neglectful posture on the part of the Treasury secretary and White House.

23. On the variability of the effectiveness of foreign pressure on Japan across different issue areas, see Leonard J. Schoppa, *Bargaining with Japan: What American Pressure Can and Cannot Do* (New York: Columbia University Press, 1997); “Two-Level Games and Bargaining Outcomes: Why Gaiatsu Succeeds in Japan in Some Cases but Not Others,” *International Organization* 47, no. 3 (1993): 353–86. C. Randall Henning, “Japan’s Resistance to Macroeconomic Gaiatsu,” American University and Institute for International Economics, Washington, D.C., June 2003, addresses the particular question of the role of the exchange-rate coercion in the 1990s.

24. *Structure* in this sense refers to the distribution of power assets in the international system and thus coincides with its traditional use by international relations scholars, within the realist tradition in particular. Determined by the size, openness, and vulnerability of states, structure confers on some states the ability to use the exchange rate as an instrument of coercion. Eric Helleiner’s discussion of *structural power*, by which he means the ability to alter the behavior of others indirectly by controlling the monetary environment within which they operate, is broader but compatible with sense in which *structure* is used here. Indeed, Helleiner specifically cites the exchange-rate weapon as a macro-level example of the exercise of structural power.

tural shift, in turn, reduces the ability of the United States to use the exchange-rate weapon effectively. We review these changes before turning to the fifth (and current) episode of macroeconomic conflict.

Europe

The postwar cycles of policy conflict and cooperation greatly assisted the process of European monetary integration.²⁵ Forward progress in regional monetary cooperation was very closely associated with periods of transatlantic conflict over adjustment and exchange rates, including use of the exchange-rate weapon. Periods of calm in transatlantic monetary relations, by contrast, were followed by partial backsliding in European monetary integration.

When, over the decades, the members of the Community were divided over or uncertain about exchange-rate stabilization, global monetary and exchange-rate instability helped to nudge the most reticent among them along the path toward regional integration. Although systemic instability created incentives for all European states to augment regional cooperation, it placed particularly strong pressure on the “outliers”—France in 1973, Germany in 1978, France in 1983, and Germany in 1987, for example²⁶—contributing to intraregional accommodation. France gradually relinquished its attachment to monetary autonomy and accepted a price-stability orientation. The Bundesbank, hostile to the European Monetary System (EMS) at the time of the system’s creation, became a defender of the system by the mid-1980s, and Germany gambled on the durability of the stability orientation of its partners when concluding the Maastricht treaty. Although U.S.-generated disturbances did not extinguish intra-European disputes, in short they did increase the payoff to European monetary integration.

Since Europe’s commitment to form a monetary union became clear in the 1990s, one big question facing transatlantic relations has been whether the euro area might act as a counterweight to the United States and the dollar in the international monetary system. The European Commission, in a major report on Economic and Monetary Union (EMU) in 1990, explicitly argued that greater symmetry in the international monetary system—read less U.S. dominance—would contribute to better macroeconomic policy outcomes in this way.²⁷

Indeed, the formation of the euro area in January 1999 created, in one fell swoop, a new monetary region of roughly equivalent weight to the United States. The GDP of the euro area is about three-fourths that of the United States, its external trade is

25. This theme is developed in Henning, “Systemic Conflict and Regional Monetary Integration,” on which this and the following paragraph draw. See, as well, Loriaux, *France after Hegemony*; Kenneth Dyson, *Elusive Union: The Process of Economic and Monetary Union in Europe* (London: Longman, 1994); Peter H. Loedel, “Enhancing Europe’s International Monetary Power,” in *The State of the European Union: Vol. 4, Deepening and Widening*, ed. Pierre-Henri Laurent and Marc Maresceau, 243–62 (Boulder: Lynne Rienner, 1997).

26. See, as well, Loriaux, *France after Hegemony*, 248–52, 260–64.

27. European Commission, “One Market, One Money,” *European Economy* 44 (October 1990).

comparable, and the euro area population exceeds that of the United States. The euro area thus carries far more weight than any other partner of the United States since World War II. With new members of the European Union anxious to join, the euro area's relative position is likely to increase rather than decline in the future. Although the euro certainly has some distance to go before it rivals the dollar as an international currency, the establishment of the monetary union makes a challenge to its hegemony possible. Should the euro area develop and implement external monetary policy in a deliberate, proactive, and assertive fashion, it could throw its own weight around in international monetary affairs.²⁸

The creation of the euro area also rendered Europe less susceptible to pressure from the United States for policy change and to fluctuations in the U.S. dollar. Reduced susceptibility derives from several factors, including the elimination of the "wedge effect," by which fluctuations of the dollar affected European currencies asymmetrically; modest diversion of European trade to other members of the euro area; denomination of a larger share of European trade in European currency; and denomination of a larger share of European international financial assets in euros as opposed to dollars.²⁹ In each of these ways, the euro area reaps benefits from EMU in terms of insulation from the dollar. The completion of EMU is therefore the most profound transformation of the structure of international monetary relations since the 1960s, or perhaps even since the Bretton Woods conference of 1944. It has succeeded in large measure because the United States induced European states to cooperate by neglecting the stability of the international monetary system at critical junctures and by exploiting the asymmetry in vulnerability to exchange-rate changes on several occasions since the late 1950s.³⁰ EMU thus demonstrates that, over the long run, even the structure of the system can respond to the policy behavior of the dominant state.

Japan and East Asia

While Western European states were pursuing monetary integration, Japan, by contrast, lacked a plausible regional partner. With more limited options, Japan relied principally on unilateral measures to blunt the impact of the strong yen. Over time, however, U.S. actions with respect to Korean, Taiwanese, and Chinese ex-

28. C. Randall Henning, "US-EU Relations after the Inception of the Monetary Union: Cooperation or Rivalry?" in *Transatlantic Perspectives on the Euro*, C. Randall Henning and Pier Carlo Padoan, 5-64 (Washington, D.C.: Brookings Institution, 2000); C. Randall Henning and Sophie Meunier, "United Against the United States?: The European Union as International Actor in Trade and Finance," in *The State of the European Union: Vol. 7, With US or against US? European Trends in American Perspective*, ed. Nicolas Jabko and Craig Parsons, 75-102 (New York: Oxford University Press, 2005).

29. See European Commission, *Quarterly Report on the Euro Area* (Brussels: European Commission, 2003).

30. This chapter is not a normative assessment of the economic merits of U.S. policy. Sometimes the use of the exchange-rate weapon was appropriate and at other times it was not; but such normative questions are separate from the causes, mechanisms, and consequences of the exchange-rate weapon.

change-rate policies and the Asian financial crisis of 1997–98 contributed a strong impetus for a regional movement.

Conflicts between the United States and Japan in the 1990s differed from earlier episodes in that Japan was less responsive to U.S. pressure for fiscal reflation.³¹ In particular, Japan was less responsive to the exchange rate as a weapon of macroeconomic conflict. Internal adaptation to the strong yen and direct investment abroad rendered many Japanese companies that had previously been susceptible to currency appreciation considerably less vulnerable. Greater distance between banks and industrial corporations weakened the coalition favoring a stable, competitive currency value. These changes in the Japanese economy resulted in different private preferences with respect to exchange-rate policy. Less vulnerable to yen appreciation, private actors petitioned less for intervention to weaken the currency or for fiscal stimuli to offset the contractionary effects. In addition, domestic political realignment and electoral reform afforded less latitude for party and cabinet officials to satisfy external pressure in the 1990s. Meanwhile, U.S. threats over trade policy declined after 1995, easing upward pressure on the yen. Changes in the Japanese political economy, driven by previous exposures to yen appreciations, had deprived the exchange-rate weapon of much of its potency.

This is not to say that the exchange-rate weapon has lost all potency, nor does the Japanese experience of the 1990s suggest that the exchange-rate weapon would be ineffective if applied to other countries. To the contrary, many states are still vulnerable to currency shifts vis-à-vis the dollar, as suggested by continued large foreign-exchange interventions, especially in East Asia. Were these countries to become the target of exchange-rate pressure, trade threats, and moral suasion, they might well alter their macroeconomic policies.

With respect to Japan, however, the 1990s demonstrate that the exchange-rate weapon was sometimes irrelevant because the yen was moving in the wrong direction (as in 1998) and sometimes unusable because, owing to financial fragility and deflation in the target, recession undermined the desired external adjustment. And even at those moments when the exchange-rate weapon was both relevant and usable, the yen would have needed to move farther than in the past to induce significant policy adjustments.

The investments of Japanese multinational corporations elsewhere in Asia, spawned in large measure by yen appreciation, effectively regionalized the adjustment problem. Owing to regional corporate networks,³² as well as to progressive

31. See Yoshiko Kojo, "Japan's Changing Attitude toward Adjusting Its Current Account Surplus: The Strong Yen and Macroeconomic Policy in the 1990s," in *New Perspectives on US-Japan Relations*, ed. Gerald L. Curtis, 146–74 (Tokyo: Japan Center for International Exchange, 1998); Schoppa, *Bargaining with Japan*; Saori Katada, *Banking on Stability: Japan and the Cross-Pacific Dynamics of International Crisis Management* (Ann Arbor: University of Michigan Press, 2001); Henning, "Japan's Resistance to Macroeconomic Gaiatsu," on which this section draws.

32. This factor is emphasized by Peter J. Katzenstein, Kozo Kato, Ming Yue, and Natasha Hamilton-Hart, *Asian Regionalism* (Ithaca: Cornell University Press, 2000).

economic advancement of members of the region, East Asia as a whole and China in particular have largely replaced Japan as the focus of U.S. policy makers seeking to reduce U.S. external deficits.

U.S. officials began to scrutinize the exchange-rate policies of other East Asian countries in the 1980s. Taiwan, South Korea, and China became the focus of attention of the second Reagan administration when their central banks did not allow their currencies to float upward with the Japanese yen after the Plaza accord. These three countries were cited in the late 1980s by the Treasury Department, in semi-annual reports mandated by the Omnibus Trade and Competitiveness Act of 1988, for manipulating their currencies to achieve unfair competitive advantage.³³ Their currency policies were publicly reviewed in hearings before the banking committees of the U.S. Congress. The Treasury Department pressed bilaterally and successfully for these governments to allow appreciation of their currencies.

Meanwhile, the dramatic rise of China in international trade and investment over the course of the 1990s intensified scrutiny of Beijing's exchange-rate policies. After receiving widespread acclaim for holding its currency steady against the U.S. dollar during the Asian financial crisis of 1997–98,³⁴ by 2003 Chinese authorities became the focus of U.S. as well as European pressure for revaluation or appreciation to facilitate adjustment.

In fact, the 1997–98 crisis (and profound resentment with the multilateral response) provided strong incentives for East Asian governments to cooperate on a regional basis.³⁵ A regional network of currency-swap agreements, known as the Chiang Mai Initiative, emerged as a direct consequence. Governments of China, Japan, Korea, and Southeast Asia (the ASEAN+3) concluded a framework agreement and sixteen bilateral swap agreements to help shield themselves against future crises.³⁶ Although their size appears to be modest, these swaps are large compared

33. See, for example, U.S. Department of the Treasury, *Report to Congress on International Economic and Exchange Rate Policy* (Washington, D.C.: U.S. Department of the Treasury, October 1988).

34. Hongying Wang, "China's Exchange Rate Policy in the Aftermath of the Asian Financial Crisis," in *Monetary Orders: Ambiguous Economics, Ubiquitous Politics*, ed. Jonathan Kirshner, 153–71 (Ithaca: Cornell University Press, 2003).

35. See Jennifer Amyx, "Japan and the Evolution of Regional Financial Arrangements in East Asia," in *Beyond Bilateralism: US-Japan Relations in the New Asia-Pacific*, ed. Ellis S. Krauss and T. J. Pempel, 198–220 (Stanford: Stanford University Press, 2004); Saori N. Katada, "Japan's Counterweight Strategy: US-Japan Cooperation and Competition in International Finance," in *Beyond Bilateralism*, 176–197; C. Randall Henning, "Systemic Contextualism and Financial Regionalism: The Case of East Asia," *American University and Institute for International Economics* (photocopy, August 2005); Jonathan Kirshner (chap. 7 in this volume).

36. East Asian financial cooperation is analyzed in Edwin M. Truman, "Remarks of the Assistant Secretary for International Affairs," presented to the 33rd annual meeting of the Asian Development Bank, U.S. Department of Treasury, press release, Washington, D.C., May 7, 2000; Barry Eichengreen, "What to Do with the Chiang Mai Initiative," *Asian Economic Papers* 2, no. 1 (winter 2003): 1–49; Gordon de Brouwer, "Financial Markets, Institutions, and Integration in East Asia," *Asian Economic Papers* 2, no. 1 (2003): 53–80; Yung Chul Park and Yunjong Wang, 2004. "Chiang Mai and Beyond," http://soback.kornet.net/~ycpark/pub/Chiang%20Mai%20and%20Beyond_Fondad_%200206%2006 (accessed March 15, 2004); C. Fred Bergsten and Yung Chul Park, "Toward Creating a Regional Monetary Arrangement in East Asia," ADBI Research Paper no. 50, Asian Development Bank Institute, Tokyo, 2002, 112; Haruhiko Kuroda and Masahiro Kawai, "Strengthening Regional Financial Cooperation in

to Southeast Asian countries' quotas in the International Monetary Fund (IMF). Given the prodigious foreign-exchange reserves held by Japan, China, and Korea, the creditors under the Chiang Mai Initiative, the amounts of the swaps could easily be raised at short notice. Notwithstanding the formal agreement to link most disbursements to adjustment programs negotiated with the IMF, these arrangements lay the basis for members of the region to reduce their reliance on the United States and the IMF for balance-of-payments financing in the future.

Despite this progress toward regional financial cooperation and despite periodic advocacy on the part of some Asian leaders for an Asian Monetary Fund and even an Asian currency, some perspective is in order. The governments and central banks of East Asia have made little progress toward genuine exchange-rate or monetary cooperation. China does not appear to be attracted to Japanese proposals for the joint pegging of currencies within the region to a common basket. Mutual surveillance of economic and exchange-rate policy in the region is at a preliminary stage of development. The obstacles to regional monetary cooperation remain high, higher than within Western Europe during the 1960s, when the intra-European market was similarly integrated.

Nonetheless, any future U.S. pressure on East Asian states for adjustment would give the governments in the region a strong incentive to suspend (although not dismiss) their considerable differences and to reach a *modus vivendi* on financial questions of common interest. Irrespective of the economic merits of Asian currency appreciation, advocating those exchange-rate changes generates resentment on the part of target states and key private constituents. Regional cooperation and dialog, particularly within the ASEAN+3 group, potentially opens new options for East Asian states. The dramatic increase in foreign-exchange holdings by East Asian central banks, another unilateral aspect of the response to the 1997–98 crisis, moreover, gives material backing to additional financial agreements that governments of the region might eventually develop.

East Asia," paper presented to the European Central Bank seminar Regional Economic, Financial and Monetary Cooperation: The European and Asian Experiences, Frankfurt am Main, April 15–16, 2002; Masaru Yoshitomi and Sayuri Shirai, "Technical Background Paper for Policy Recommendations for Preventing Another Capital Account Crisis," Asian Development Bank Institute, Tokyo: July, 2000; Graham Bird and Ramkishan S. Rajan, *The Evolving Asian Financial Architecture*, Princeton Essays in International Economics no. 226 (Princeton, N.J.: Princeton University, 2002); C. Randall Henning, *East Asian Financial Cooperation*, Policy Analyses in International Economics no. 68 (Washington, D.C.: Institute for International Economics, 2002); C. Randall Henning, "The Complex Political Economy of Cooperation and Integration," in *Financial Governance in East Asia: Policy Dialogue, Surveillance and Cooperation*, ed. Gordon de Brouwer and Yunjong Wang, 83–101 (London: Routledge Curzon, 2004); C. Randall Henning, "East Asian Financial Cooperation and Global Adjustment: Building on the Chiang Mai Initiative," paper presented to the conference of the Institute for International Economics and Japan Economic Foundation, Economic Relations between the United States, Japan, and East Asia, Washington, D.C., 2004; Yunjong Wang, "Financial Cooperation in East Asia," paper presented to the Institute for International Economics, Korea Institute for International Economic Policy, and Korea Economic Institute workshop on The State of East Asian Financial Regionalism, Washington, D.C., February 2004.

United States

Important changes in the relative sensitivity and vulnerability of the world's major monetary actors are not limited to the leading partners of the United States; they have taken place within the United States as well. To begin with, consider the country's macroeconomic profile. Analysts are generally accustomed to thinking of the United States as a "large, relatively closed economy." But, although it is large, it is also considerably more open than it was four decades ago. The ratio of merchandise imports and exports to GDP has increased threefold, from 6.6 percent in 1960 to 20.3 percent in 2000. Including service imports and exports increases the ratio to 25.6 percent.³⁷ On this measure, the openness of the United States slightly exceeds that of Japan while remaining somewhat more closed than euro area.³⁸

Greater openness alters the costs and benefits of using the exchange rate as an instrument of adjustment and coercion. Openness increases the impact of changes in the exchange rate on domestic output, employment, and prices and consequently increases the feedback effects of pushing the currency down (or up) to coerce others to pursue more expansionary (or restrictive) macroeconomic policies. For example, as a consequence of the larger share of imports in U.S. total expenditure, greater openness causes not only greater output and employment gains when the currency depreciates but also larger increases in the domestic price level.

U.S. financial markets have also become increasingly internationalized. As of March 2004, foreign ownership of U.S. Treasury securities has risen to about 50 percent of the total federal debt held by the public. Foreign official holdings, including the dollar reserves of central banks in East Asia, accounted for about 34 percent and foreign private holdings 16 percent of this total. Foreign official and private holdings of U.S. securities and corporate bonds together represent about 18 percent of U.S. bond market valuation. Foreign portfolio investment in corporate stocks amounts to about 11 percent of stock market valuation. Foreign-owned assets in the United States totaled \$10.5 trillion at the end of 2003, roughly equal to U.S. GDP. The foreign assets-to-GDP ratio for the United States was thus roughly the same as for the euro area and considerably larger than for Japan.³⁹ The U.S. net international investment position at the end of 2004 was negative roughly \$3 trillion, about 25 percent of U.S. GDP.⁴⁰ The greater the ratio of foreign-owned assets to total assets, the greater the possible increase in domestic interest rates in response to a depreciation of the dollar. These figures thus indicate that the po-

37. Calculated from U.S. Council of Economic Advisors, *Economic Report of the President* (Washington, D.C.: White House, February 2004), tables B-1, B-103, B-106.

38. The figure for the euro area during 2000–2 was about 38 percent. Robert Anderton, Filippo di Mauro, and Fabio Moneta, "Understanding the Impact of the External Dimension of the Euro Area," ECB Occasional Paper no. 12, European Central Bank, Frankfurt, April 2004, chart 1.

39. Anderton, di Mauro, and Moneta, "Understanding the Impact," 29, chart C.

40. Calculated or reported from U.S. Treasury Financial Management Service, table OFS-2 "Estimated Ownership of U.S. Treasury Securities," <http://www.fms.treas.gov/bulletin/b25ofs.doc> (accessed April 2004); U.S. Department of Commerce, Bureau of Economic Analysis, *US Net International Investment Position at Yearend 2003* (Washington, D.C.: U.S. Department of Commerce, 2004).

tential costs to the United States of deploying the exchange-rate weapon are increasing.

Adjustment Conflict in the Early Twenty-First Century

With the preceding analysis as background, let us consider the conflict over adjustment since 2003, the fifth major episode of macroeconomic conflict since the breakdown of the Bretton Woods regime. In several respects, this case displays the classic characteristics of conflict over U.S. current account deficits. Although China, with its pegged exchange-rate regime, is a new actor in the story, the central dynamic is familiar: the conflict between the deficit and surplus countries over measures to secure adjustment and the depreciation of the dollar.

A number of elements of the mid-2000s conflict, however, differ substantially from previous cycles. Unilateral countermeasures (such as reserve accumulation and Japanese direct investment), regionalism, and greater internationalization of the U.S. economy have combined to reduce the asymmetry in exchange-rate vulnerability among the United States, Europe, and East Asia. Put differently, the structure of international monetary relations has shifted substantially.

What are the consequences of these changes? We would expect structural shift to erode the effectiveness of the dollar weapon and, hence, the influence of the United States over adjustment outcomes. To be sure, we would not expect the dollar weapon to be completely impotent; it will continue to be at least partially effective vis-à-vis, especially, smaller and more vulnerable targets. But the scope of its effectiveness is likely to be significantly circumscribed.

Moreover, whereas the United States could make macroeconomic policy errors (overexpansionary monetary policy during the 1970s and overexpansionary fiscal policy in the 1980s) with near impunity in the past, similar macroeconomic policy errors could be more costly in international monetary terms in the future. Owing to the formation of Europe's monetary union, partial insulation of Japan, reserve accumulation in East Asia, and nascent financial cooperation in that region, the United States might well be confronted with greater penalties for policy errors in the future, including the erosion of the international value of the dollar or of the dollar's international role.

The year 1987 offers a potentially revealing comparison. Owing partly to the depreciation of the dollar since the Plaza accord of September 1985, private capital flows into the United States largely dried up in that year. The large current account deficit at that time was instead financed through foreign-exchange intervention by European central banks and the Bank of Japan. These central banks were willing to purchase dollars because they wanted to stem the appreciation of their own currencies and the reduction in their trade surpluses. By these actions, they hoped to maintain overall growth and employment in their domestic economies.⁴¹

Private capital markets have already balked at financing the U.S. current account

41. Henning, *Currencies and Politics*, 151–58, 205–8, 285–86.

deficit during particular moments over 2003 and 2004. East Asian central banks, of Japan and China in particular, filled much of the breach with unprecedented amounts of foreign-exchange intervention. If Asian central banks were to reduce their dollar purchases, the question of whether to finance the imbalance or adjust to it would be thrust on to U.S. and European officials. This time, however, the United States would face a consolidated monetary union rather than individual European monetary authorities. The euro area would be less vulnerable to exchange-rate fluctuations than the separate European countries were prior to the euro's creation. Europe might request joint intervention with the United States to support the dollar nonetheless, especially if European growth were anemic. But if the United States instead were to be the *demandeur*, European authorities would be in a stronger position than in any previous adjustment cycle to insist on U.S. policy adjustments as a quid pro quo. Any such insistence by euro-area officials would signal a new era in international monetary relations.

As of this writing,⁴² China has maintained the renminbi peg to the dollar and Japan has succeeded in limiting the appreciation of the yen. With a potentially overheating economy, prodigious and growing foreign-exchange reserves, and a significant trade surplus, however, the economic case for the revaluation of the renminbi is strong.⁴³ The case strengthens as the dollar depreciates further against other currencies, principally the euro, taking the renminbi along with it. Because Japan, Korea, and Southeast Asian countries are reluctant to appreciate against their most feared competitor, the stakes are greater than simply China's role in the adjustment process. The revaluation or floatation of the renminbi is the key to wider participation in the adjustment process of East Asia as a whole.

The contrast between heavy Asian intervention and the absence of European intervention to date suggests that East Asia is more vulnerable to dollar depreciation than Europe. The heavier reliance of East Asian production networks on the U.S. market, the lingering threat of deflation in Japan, and the less advanced state of regionalism perpetuate a greater degree of vulnerability in East Asia than in Europe. Because the United States has an interest in adjustment, we might yet see the exchange-rate weapon deployed in East Asia before the present conflict is resolved. The weapon could, however, be counterproductive in deflation-prone countries or those with fragile banking systems, thus giving further impetus to forms of regionalism that could be antagonistic to U.S. interests. U.S. policy makers would therefore be wise to exercise caution in the deployment of exchange-rate coercion in this region.

Europe countenanced a substantial appreciation of the euro vis-à-vis the dollar during 2001–4. This movement strengthened pressures on European governments to pursue structural reform and on the European Central Bank to keep monetary

42. The final draft of this chapter was written in May 2004.

43. John Williamson, "The Renminbi Exchange Rate and the Global Monetary System," outline of a lecture given at Central University of Finance and Economics, Beijing, October 29, 2003; Morris Goldstein and Nicholas Lardy, "Two-State Currency Reform for China" (commentary), *The Wall Street Journal Online* (accessed September 12, 2003); Morris Goldstein, "Adjusting China's Exchange Rate Policies," Working Paper Series no. 04-1, Institute for International Economics, Washington, D.C., June 2004.

policy relaxed. Because EMU is still evolving, the full extent of the eventual change in the relative position of Europe and the United States remains unclear at this point, with Europe's position dependent in part on its ability to stimulate growth and streamline external monetary policy making. The outcome of the present conflict over global current account adjustment will reveal just how much the relative bargaining positions of the United States and Europe have changed.

Conclusion

The essential arguments of this chapter can be summarized in four points. First, during several conflicts over adjustment during the last forty years, the United States has used the exchange rate as an instrument to coerce partners to alter macroeconomic policy. This exchange-rate weapon is thus an important element of the dynamics of adjustment conflict and helps to explain the outcomes of such episodes. Exchange-rate coercion is specifically useful in explaining patterns of policy coordination and the distribution of the costs of adjustment.

Second, the deployment of the exchange-rate weapon creates strong incentives for targets to develop countermeasures. Such countermeasures include regional arrangements that reduce vulnerability to external exchange-rate shifts, such as EMU, and unilateral measures, such as reserve accumulation and production relocation through direct investment. Regional monetary integration is, of course, motivated by more than simply a desire to deflect exchange-rate coercion; but a desire to reduce exchange-rate vulnerability powerfully reinforces other motives to build regional cooperation. Countermeasures can take decades to develop, typically after multiple rather than single instances of exchange-rate coercion; but they can be developed nonetheless.

Third, these countermeasures—the monetary union in the case of Europe and a mix of unilateral action and regional cooperation in the case of East Asia—have collectively shifted the structure of the international monetary system so as to reduce the likely effectiveness of exchange-rate coercion by the United States on some of its major economic partners in the future. Structural shift has been accentuated by the progressive internationalization of the U.S. economy. Four decades of periodic exchange-rate coercion strongly suggest that, at least over the very long term, the exchange-rate weapon is a dissipating asset: if you use it repeatedly, you run the risk of eventually losing it.

Fourth, the exchange-rate weapon is nonetheless likely to have continuing relevance as an instrument of economic influence. The United States will continue to have residual power in this respect while Europe's monetary union, Japan, and China could conceivably begin to exercise a similar form of monetary statecraft in geographically contiguous areas (see Jonathan Kirshner, chap. 7 in this volume). The eventual resolution of the mid-2000s conflict over reduction of the U.S. current account deficit will provide useful insights into the future of the exchange-rate weapon.