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The Exchange Rate Weapon,  
Macroeconomic Conflict and Shifting  
Structure of the Global Economy

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***The Exchange Rate Weapon, Macroeconomic Conflict and Shifting Structure of the  
Global Economy***

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## **Abstract**

The United States used the exchange rate as an instrument to coerce partners to alter macroeconomic policy during several conflicts over the balance of payments since the dissolution of the Bretton Woods regime. The 'exchange-rate weapon' is thus an important element of the dynamics of adjustment conflict and helps to explain the distribution of the costs of adjustment among the key players. This chapter explicates the concept and mechanisms of the exchange-rate weapon and reviews the major episodes of its deployment. The chapter argues that the use of the exchange-rate weapon created strong incentives for targets to develop countermeasures. Combined with progressive internationalization of the U.S. economy, such countermeasures—monetary union in the case of Europe and a mix of regional cooperation and unilateral action in the case of East Asia—shifted the structure of international monetary relations and reduced the likely effectiveness of exchange-rate coercion. Conflict over the U.S. current account deficit in the mid-2000s constitutes another revealing case and facilitates assessment of the effects of structural shift.

## **Keywords**

monetary relations, exchange rate policy, macroeconomic policy

## Introduction

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 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' played a central role in international conflicts over balance-of-payments adjustment. Use of this weapon generated resentment on the part of America's partners, however, who consequently sought to develop defences against such coercion. Both regional and unilateral in nature, these countermeasures contributed substantially to altering the international terrain over which balance-of-payments conflicts will be fought in the future.

The exchange rate weapon is an important concept for several reasons. Although it comes into play only episodically, it is critical to explaining behaviour and strategies of the United States and its partners in the heat of adjustment conflicts. Exchange-rate coercion lies at the heart of the strategic interaction over adjustment and thus explains in large measure the ultimate distribution among the key players of the transitional and continuing costs of adjustment. Currency coercion has been closely linked to macroeconomic policy coordination when some degree of collective management on the part of the larger players is required to stabilize the international monetary system. Its use has thus helped to sustain political support for open trade and investment policy in the United States at junctures where that support has been in jeopardy.

This paper reviews the conceptual foundation of this source of international monetary influence; the use of the exchange-rate weapon since the dissolution of Bretton Woods regime; the countermeasures pursued by Europe, Japan, and East Asia; the resulting shift in the structure of the global economy; and the limits of the weapon's effectiveness in light of structural shift.

## 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 macroeconomic policy, (2) accept a change in the exchange rate, and (3) alter one's own monetary and/or fiscal policies.<sup>1</sup> The hierarchy of each government's preferences is generally as just presented: each prefers the other to adjust their policies and is averse to changing its own, with a shift of the exchange rate lying between. 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

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1 The extent to which these choices are alternatives is partial, as 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, though, 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.

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*<sup>2</sup>

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 upon other conditions.<sup>3</sup> Generally, however, flexible exchange rates do not insulate countries from policy shocks abroad in the presence of high capital mobility.<sup>4</sup>

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

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 been targeted upon a combination of inflation, employment and growth that was considered optimal by its government. The transmission effects strengthen an incentive to tighten policy (avoiding inflation) and ease a constraint (avoiding unemployment). If existing policies are not changed in the face of the stimulus from abroad, they will contribute to an overshooting of the targets

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2 The author's early treatments of the exchange-weapon are C. Randall Henning, 1987. *Macroeconomic Diplomacy in the 1980s: Domestic Politics and International Conflict Among the United States, Japan, and Europe*. Atlantic Paper 65, London: Croom Helm for the Atlantic Institute for International Affairs, pp. 1-4, 30-39; and, C. Randall Henning, 1991. 'Europäische Währungsunion und die Vereinigten Staaten', in: Manfred Weber, (ed.), *Europa auf dem Weg zur Währungsunion*. Darmstadt: Wissenschaftliche Buchgesellschaft, pp. 317-340, while the concept is developed further in, C. Randall Henning, 1998. 'Systemic Conflict and Regional Monetary Integration: The Case of Europe', *International Organization*, 52, pp. 537-573. Cases of deployment are treated in, I.M. Destler and C. Randall Henning, 1989. *Dollar Politics: Exchange Rate Policymaking in the United States*. Washington, D.C.: Institute for International Economics, pp. 50-56, and Robert D. Putnam and C. Randall Henning, 1989. 'The Bonn Summit of 1978: A Case Study in Coordination', in: Richard N. Cooper, Robert D. Putnam, C. Randall Henning, and Gerald Holtham, (eds.), *Can Nations Agree? Issues in International Economic Cooperation*. Washington, D.C.: Brookings Institution, pp. 49-53, 82-84. See, as well, Eric Helleiner, 1994. *States and the Reemergence of Global Finance: From Bretton Woods to the 1990s*. Ithaca: Cornell University Press, Jonathan Kirshner, 1995. *Currency and Coercion: The Political Economy of International Monetary Power*. Princeton: Princeton University Press, Michael Webb, 1995. *The Political Economy of Policy Coordination: International Adjustment since 1945*. Ithaca: Cornell University Press, and Keisuke Iida, 1999. *International Monetary Cooperation Among the United States, Japan, and Germany*. Boston: Kluwer Academic Publishers.

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

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

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.<sup>5</sup>

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. 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, signalling 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 policies) 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, the more recent studies generally find intervention to be more effective than did studies conducted during the 1980s.<sup>6</sup> Experience with massive Chinese and Japanese interventions during 2002-2004 suggest 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 many circumstances, such as when it is publicly announced, conducted jointly by two or more central banks, consistent with the underlying fundamentals, and when the exchange rate is far from equilibrium.<sup>7</sup>

The conditions that create scope for intervention to be at least partially effective also create scope for other, more subtle instruments as well. In the presence of high capital mobility, flexible exchange rates are often driven by herd behaviour and expectations and are thus frequently disconnected from the underlying

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5 Martin Feldstein, 1986. 'U.S. Budget Deficits and the European Economies: Resolving the Political Economy Puzzle', *American Economic Review*, 76 (May), pp. 342-46; Henning, *Macroeconomic Diplomacy in the 1980s*, pp. 21-23.

6 For a recent review, see Lucio Sarno and Mark P. Taylor, 2001. 'Official Intervention in the Foreign Exchange Market: Is It Effective and, if So, How Does It Work?', *Journal of Economic Literature*, 39, pp. 839-868. Ramaswamy and Samiei 2003 find intervention specifically in the yen-dollar market to be reasonably effective.

7 See, Pietro Catte, Giampaolo Galli, and Salvatore Rebecchini, 1994. 'Concerted Interventions and the Dollar: An Analysis of Daily Data', in: Peter B. Kenen, Francesco Papadia and Fabrizio Saccomanni, (eds.), *The International Monetary System*. Cambridge: Cambridge University Press, pp. 201-249; Kathryn M. Dominguez and Jeffrey A. Frankel, 1993. *Does Foreign Exchange Intervention Work?* Washington, D.C.: Institute for International Economics; John Williamson, 2000. *Exchange Rate Regimes for Emerging Markets: Reviving the Intermediate Option*. Policy Analyses in International Economics, No. 60, Washington, D.C.: Institute for International Economics; Sarno and Taylor, 'Official Intervention in the Foreign Exchange Market'; Takatoshi Ito, 2002. *Is Foreign Exchange Intervention Effective?: The Japanese Experiences in the 1990s*. NBER Working Papers 8914, Cambridge, MA: National Bureau of Economic Research; Mark Taylor, 2003. *Is Official Exchange Rate Intervention Effective?* CEPR Discussion Papers 3758, London: Centre for Economic Policy Research; and Christopher, Kubelec, 2004. 'Intervention When Misalignments are Large', Paper presented to the IIE Conference *Dollar Adjustment: How Far? Against What?*, Washington, D.C., May.; Marcel Fratzscher, 2004. *Communication and Exchange Rate Policy*. ECB Working Paper Series 363, Frankfurt: European Central Bank; and Hans Genberg and Alexander Swoboda, 2004. 'Exchange-Rate Regimes: Does What Countries Say Matter?', Paper presented at the IMF Conference *Mussa Fest*, Washington, D.C., June, find official declarations to be significantly effective.



economic fundamentals. 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.<sup>8</sup>

Government officials can operate on expectations by (a) signalling their desire for a stronger, weaker or stable currency, (b) forswearing intervention, (c) intervening, among other techniques. Under some market conditions, such as profound current account imbalance, ‘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 American policymakers 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 in Cohen’s paper.<sup>9</sup> 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 the small state beyond the extent of its trade with the large. When foreign investors accept financial assets denominated in the large-country 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 fixed exchange rates, foreign central banks hold the large-country currency in reserves, the monetary policy of the large country dominates the 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 fiscal stimulus under flexible exchange rates. Pre-conflict policy settings 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 while aggravating fear of inflation and its consequences, altering the political demands on the policymaking 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, often carefully and delicately crafted, have broader purposes than simply attaining the macroeconomic targets, such as satisfying key constituency demands, ideological priorities and 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 rise. The adjustment of macroeconomic policy will therefore probably be fraught with domestic political conflict.

### ***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: (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) the global macroeconomic environment.

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 equal economies experience effects that are roughly equal in magnitude though opposite in sign. Differences in economic conditions (recession versus overheating), flexibility of domestic prices and wages, and domestic political bias (toward trade versus non-traded sectors) might

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<sup>8</sup> Taylor, *Is Official Exchange Rate Intervention Effective?*.

<sup>9</sup> Benjamin J. Cohen, 2005. *The Macroeconomic Foundation of Monetary Power*. EUI Working Papers RSCAS No. 2005/08.

still impart differences in sensitivity to exchange-rate change. But the scope for use of the exchange rate as a tool in conflict would be 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 principle, in the traded and non-traded 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 non-traded-goods sector. If the political power of the traded and non-traded sectors were equal, there would be little reason to expect policy outcomes to favour 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.

There are a number of reasons to believe that the political power of traded and non-traded sectors is not in fact equal.<sup>10</sup> First, because the sectors differ in size, 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 non-traded sector. Second, owing to differences in the organization of firms and workers in these sectors for politics, the traded sector may have more sway over policy than the non-traded 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 non-traded 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.<sup>11</sup> Again, this assumption is quite realistic for many countries for most of 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 will be more averse to depreciation of their currencies than when prices are generally stable. When governments are primarily concerned with avoiding deflation, they will be more averse to appreciation of their currencies than when prices are generally stable. The exchange rate weapon is thus likely to depend on the inflationary (deflationary) environment 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 several conditions and assumptions, the tool is not consistently available to even 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 dependency. During 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, American 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.

These examples raise two additional points worth making here. First, domestic politics, and in particular the struggle over the openness of international economic policy (trade, investment, etc.), lies

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10 On the ramifications of the distinction between traded and non-traded goods for the political economy of exchange rate policy, see, among others, Jeffrey A. Frieden, 1991. 'Invested Interests: The Politics of National Economic Policies in a World of Global Finance', *International Organization*, 45 (Autumn), pp. 425-453; C. Randall Henning, 1994. *Currencies and Politics in the United States, Germany, and Japan*. Washington, D.C.: Institute for International Economics; James I. Walsh, 2000. *European Monetary Integration and Domestic Politics: Britain, France and Italy*. Boulder: Lynne Rienner; Lawrence J. Borz and Jeffrey Frieden, 2001. 'The Political Economy of International Monetary Relations', *Annual Review of Political Science*, 4, pp. 317-43.

11 Henning, *Currencies and Politics*, and Walsh, *European Monetary Integration*.

at the root of the motivations of the United States in using the exchange rate weapon. Historically, U.S. administrations and Congresses have resorted to the dollar weapon in the midst of conflict over adjustment and when the trade deficit was large. 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 favour 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 conflicts over trade policy. Threats to close the U.S. market, or part of it, and to raise the cost of access (tariffs), are also arrows in the quiver of administrations confronting balance-of-payments problems. Serious threats over trade policy tend to sensitize 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, trade threats can affect foreign exchange markets directly, at least in the short term, or 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. If we were to regress adjustment outcomes on both, in the language of an econometrician, we would encounter multicollinearity—it would be difficult to disentangle the independent effects of each on 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. Moreover, trade and exchange-rate coercion should be considered together because there are interaction effects between them.

### ***Two Types***

The exchange-rate weapon can thus take two forms: (1) allowing the exchange rate to shift, perhaps even overshoot, in the knowledge that the partner is more vulnerable and subject to incentives to adjust macroeconomic policy; (2) actively encouraging a shift in the rate to induce a resulting shift in a partner's policy. The former is passive, while the latter is active, corresponding broadly to the social and instrumental concepts of power advanced in Andrews' introductory essay.<sup>12</sup> The two forms are appropriately joined under the single definition here because they are (1) both deliberate, (2) difficult to separate empirically, and (3) have the same effect, namely encouragement of domestic policy change on the part of partners.

### **History**

Over the last half-century, international monetary relations have exhibited distinct cycles, each containing a period of relative harmony, heightened conflict over adjustment, and then some degree of cooperation. With the international system now in the midst of a fifth adjustment conflict, these cycles are an entrenched feature of global political economy. Periods of acute tension have coincided with: (1) the breakdown of the Bretton Woods regime in the early 1970s; (2) conflicts over world deflation that were resolved at the Bonn summit of 1978; (3) hostility in the mid-1980s, at the centre of which stood the Plaza and Louvre accords; (4) recession and recovery in the early and mid-1990s; and (5) the present adjustment dispute. As 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.<sup>13</sup>

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12 David M. Andrews, forthcoming 2006. 'Introduction', in: David M. Andrews, (ed.), *International Monetary Power*. Ithaca NY: Cornell University Press. Revised versions of EUI-WP RSCAS Nos. 2005/07-2005/15 will be included in this book.

13 Benjamin J. Cohen, 1983. 'An Explosion in the Kitchen? Economic Relations with Other Advanced Industrial States', in: Kenneth A. Oye, Robert J. Lieber and Donald Rothchild, (eds.), *Eagle Defiant: United States Foreign Policy in the 1980s*. Boston: Little, Brown, pp. 105-130; Fred. C. Bergsten, 1986. 'America's Unilateralism', in: Fred C. Bergsten,

During each cycle, American administrations pressed European and Japanese governments and/or central banks for expansionary measures and often actively encouraged a depreciation of the dollar.<sup>14</sup> The United States used the dollar weapon with more success in some episodes, such as 1971-73, 1977-78, and 1985-87, than in others, such as the 1990s. These episodes, which will be summarized briefly, highlight strategic considerations in the use of the dollar weapon. Namely, for the wielder there is a trade-off between securing adjustment on favourable terms in the short term and creating incentives for the targets to insulate themselves against monetary power over the long term.

Confronted with payments imbalances that had become chronic by the late 1960s (although small by present standards), preservation of the Bretton Woods regime would have required agreement on fundamental adjustments of macroeconomic policy.<sup>15</sup> Unable to reach agreement on this politically charged question, for reasons well-documented in the literature on this episode, the United States suspended gold convertibility and imposed a 10% 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 re-pegged it to the yen at a level 17 percent below the Bretton Woods parity, to the German mark at about 14 percent below that parity, 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 regime collapsed, fundamentally, because the United States refused to submit to those constraints, or, more judgmentally, to ‘play by its rules’. However, the shift to floating 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 American 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

(Contd.) \_\_\_\_\_

Etienne Davignon, and Isamu Miyazaki (eds.) *Conditions for Partnership in International Economic Management, Report to the Trilateral Commission* 32. New York: Trilateral Commission, pp. 3-14; Henning, *Currencies and Politics*.

14 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, 2002. *International Coordination of Macroeconomic Policies: Still Alive in the New Millennium?*. International Finance Discussion Papers 723, Washington, D.C.: Board of Governors of the Federal Reserve System; David M. Andrews, C. Randall Henning and Louis W. Pauly, (eds.), 2002. *Governing the World’s Money*. Ithaca: Cornell University Press; and Edwin M. Truman, 2003. ‘A Critical Review of Coordination Efforts in the Past’, Paper prepared for the Kiel Week Conference *Macroeconomic Policies in the World Economy*, June.

15 Classic references include John S. Odell, 1982. *International Monetary Policy: Markets, Power, and Ideas as Sources of Change*. Princeton: Princeton University Press; Joanne Gowa, 1983. *Closing the Gold Window: Domestic Politics and the End of Bretton Woods*. Ithaca: Cornell University Press; Robert Solomon, 1982. *The International Monetary System, 1945-1981*. New York: Harper & Row; Paul A. Volcker and Toyoo Gyohten, 1992. *Changing Fortunes: The World’s Money and the Threat to American Leadership*. New York: Times Books; Benjamin J. Cohen, 1977. *Organizing the World’s Money: The Political Economy of International Monetary Relations*. New York: Basic Books; John Williamson, 1977. *The Failure of World Monetary Reform, 1971-1974*. New York: New York University Press; Otmar Emminger, 1977. ‘The D-mark in the Conflict Between Internal and External Equilibrium, 1948-75’, in: *Essays in International Finance* 122. Princeton: Princeton University, International Finance Section, June; Gunter D. Baer and Tommaso Padoa-Schioppa, 1989. ‘The Werner Report Revisited’, in: *Delors Report*, 53-60. Luxembourg: Office of Official Publications of the European Community; and Fred C. Bergsten, 1975. *The Dilemmas of the Dollar: The Economics and Politics of United States International Economic Policy*. New York: New York University Press.

shock, Japan's external surplus temporarily evaporated.<sup>16</sup> European governments also generally responded with expansionary policies, although there was considerable dispersion among them. Germany eased monetary and fiscal policy in 1972, tightened both in 1973, eased fiscal policy early in 1974 and then monetary policy in late 1974.<sup>17</sup> With the exception of Germany, policy changes within most European countries and Japan therefore contributed to the substantial correction in the U.S. current account position.

American officials did not exactly encourage the weakness of their currency in order to secure adjustment on the part of 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 they would have preferred, and accepted substantial depreciation after the switch to floating. American officials were acutely conscious that the devaluations and depreciation of the dollar created substantial incentives for Europeans and Japanese officials to deliver expansionary policies.

U.S. policymakers deployed the dollar weapon more actively during the 1977-78 conflict. As economic recovery in the United States preceded that in Europe and Japan, a substantial U.S. current account deficit re-emerged in 1977. The 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.<sup>18</sup> The appreciation of the yen and mark reduced the current account surplus, dampened growth and inflation prospects in their countries, and placed formidable domestic political pressure on the Japanese and German governments to provide the stimulus demanded by American 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.<sup>19</sup> Though 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 hands of U.S. officials trying to extract macroeconomic policy change from foreign governments.

The second Reagan administration again benefited from the exchange rate as an inducement for macroeconomic stimulus abroad and reduction of current account imbalances. During the first half of the 1980s, the first Reagan administration and Japanese governments had largely ignored the extraordinary appreciation of the dollar and record current account imbalances.<sup>20</sup> This *laissez-faire*

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16 Gardner Ackley and Hiromitsu Ishi, 1976. 'Fiscal, Monetary and Related Policies', in: Hugh Patrick and Henry Rosovsky, (eds.), *Asia's New Giant*. Washinton, D.C.: The Brookings Institution, pp. 153-247; Ryutaro Komiya and Miyako Suda, 1991. *Japan's Foreign Exchange Policy: 1971-82*. Canberra: Australian National University, Australia-Japan Research Centre; Robert C. Angel, 1991. *Explaining Economic Policy Failure: Japan in the 1969-1971 International Monetary Crisis*. New York: Columbia University Press.

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

18 Stephen D. Cohen and Ronald I. Meltzer, 1982. *U.S. International Economic Policy in Action*. New York: Praeger.

19 I.M. Destler and Hisao Mitsuyasu, 1982. 'Locomotives on Different Tracks: Macroeconomic Diplomacy, 1977-1979', in: I.M. Destler and Hideo Sato, (eds.), *Coping with U.S.-Japanese Economic Conflicts*. Lexington: D.C. Heath, pp. 243-270; Putnam and Henning, 'The Bonn Summit of 1978'.

20 The exchange rate weapon also played a critical role in the standoff between the first Reagan administration and the Mitterrand government during 1981-1983. See, Jeffrey Sachs and Charles Wyplosz, 1986. 'The Economic Consequences of President Mitterrand', *Economic Policy*, April, pp. 262-306; Henning, *Macroeconomic Diplomacy in the 1980s*; Michael Loriaux, 1991.

stance proved to be unsustainable in the face of mounting protectionist pressure in the U.S. Congress, which boiled over in the summer of 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 D-mark 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 against the yen and mark to encourage stimuli to domestic demand. Unprecedented appreciations of both currencies occurred, prompting calls from within the private sector for expansionary measures to offset the contractionary effect in those countries.

American support for exchange rate stability and European and Japanese policy accommodations were the essence of the bargain struck at the Louvre in February 1987. Rather than provide a strong fiscal stimulus, during this episode, the Japanese government chose to boost domestic demand primarily by substituting a dramatic monetary expansion for fiscal measures.<sup>21</sup> The German government and Bundesbank responded with a mix of fiscal and monetary stimulus.<sup>22</sup> This combination of exchange rate and macroeconomic policy changes helped to reduce the U.S. current account deficit over 1988-1991 to low levels.

The fourth episode, by contrast, suggests a significant weakening of the influence of the exchange rate weapon. The U.S. economy experienced a recession in 1991 and a slow recovery in 1992 with only a delayed response in the labour market.<sup>23</sup> When the Clinton administration entered office in January 1993, it 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 the President and Treasury Secretary Bentsen signalled 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.

While successive Japanese governments introduced a number of supplemental budgets during 1993-1995, and exchange rates might have played a role in prompting the 1995 supplemental, however, the expansionary content of these budgets was frequently less than advertised. Stimuli were also retracted at critical points, such as 1996, aborting a promising recovery. Over most of the decade, Japanese fiscal policy was not responsive to exchange-rate pressure and, though potentially effective, was not managed in such a fashion as to produce a sustained recovery.<sup>24</sup> In the second half of the 1990s, robust U.S. growth reduced concern about the current account position.

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*France After Hegemony: International Change and Financial Reform.* Ithaca: Cornell University Press; John B. Goodman, 1992. *Monetary Sovereignty: The Politics of Central Banking in Western Europe.* Ithaca: Cornell University Press; Christian de Boissieu and Jean Pisani-Ferry, 1998. 'The Political Economy of French Economic Policy in the Perspective of EMU', in: Barry Eichengreen and Jeffrey Frieden, (eds.), *Forging an Integrated Europe.* Ann Arbor: Michigan University Press, pp. 49-89. This episode suggests that the United States could employ such coercion in the absence of a current account adjustment problem and that, depending on economic circumstances, the weapon could deploy both appreciation and depreciation coercively.

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

22 Henning, *Currencies and Politics*, pp. 203-208.

23 During 1991 and 1992, the 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.

24 On the variability of the effectiveness of foreign pressure on Japan across different issue areas, see Leonard J. Schoppa, 1997. *Bargaining with Japan: What American Pressure Can and Cannot Do.* New York: Columbia University Press; and Leonard J. Schoppa, 1993. 'Two-Level Games and Bargaining Outcomes: Why *Gaiatsu* Succeeds in Japan in Some Cases but Not Others', *International Organization*, 47, pp. 353-386. C. Randall Henning, 2003. *Japan's Resistance to Macroeconomic Gaiatsu.* Washington, D.C.: American University and Institute for International Economics, addresses the particular question of the role of the exchange-rate coercion in the 1990s.

## 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. Structural shift in turn reduces the ability of the United States to use the exchange-rate weapon effectively.

### Europe

The postwar cycles of policy conflict and cooperation greatly assisted the process of European monetary integration.<sup>25</sup> 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. While 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 example<sup>26</sup>—contributing to intra-regional accommodation. France gradually relinquished its attachment to monetary autonomy and accepted a price-stability orientation. The Bundesbank, hostile to the 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. U.S.-generated disturbances did not extinguish intra-European disputes, but they increased 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 its dollar in the international monetary system. The European Commission, in a major report on EMU in 1990, explicitly argued that greater symmetry in the international monetary system—read less American dominance—would contribute to better macroeconomic policy outcomes in this way.<sup>27</sup>

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 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 WWII. 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. Should the euro area develop and implement external monetary policy in a deliberate, proactive and assertive fashion,<sup>28</sup> it could throw its own weight around in international monetary affairs.

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25 This theme is developed in Henning, 'Systemic Conflict and Regional Monetary Integration', upon which this and the following paragraph draw. See, as well, Loriaux, *France After Hegemony*; Kenneth Dyson, 1994. *Elusive Union: The Process of Economic and Monetary Union in Europe*. London: Longman; and Peter H. Loedel, 1997. 'Enhancing Europe's International Monetary Power', in: Pierre-Henri Laurent and Marc Maresceau, (eds.), *The State of the European Union*. Boulder: Lynne Rienner.

26 See, as well, Loriaux, *France After Hegemony*, pp. 248-52, 260-64.

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

28 C. Randall Henning, 2000. 'U.S.-EU Relations After the Inception of the Monetary Union: Cooperation or Rivalry?', in: C. Randall Henning and Pier Carlo Padoan, (eds.), *Transatlantic Perspectives on the Euro*. Washington, D.C.: The Brookings Institution, pp. 5-64; and C. Randall Henning and Sophie Meunier, 2004. 'The European Union as International Actor in Trade and Finance', in: Craig Parson and Nicolas Jabko, (eds.), *Convergence and Divergence between the European Union and the United States*. (Photocopy, June).

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 (a) diversion of trade to other members of the euro area, though modest, (b) elimination of the wedge effect, by which fluctuations of the dollar affected European currencies asymmetrically, (c) denomination of a larger share of European trade in European currency, and (d) denomination of a larger share of European international financial assets in euros as opposed to dollars, among other factors.<sup>29</sup> In these ways, the euro area reaps benefits from EMU in terms of insulation from the dollar. Although the euro certainly has some distance to go before it rivals the dollar as an international currency, establishment of the monetary union makes a challenge to its hegemony possible.

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 exploiting the asymmetry in vulnerability to exchange-rate change on several occasions since the late 1950s.<sup>30</sup> EMU thus demonstrates that, over the long run, even the structure of the system can respond to the policy behaviour 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 exchange rate policies and the Asian financial crisis of 1997-98 galvanized a regional movement.

#### *Japan*

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. Japan was less responsive to the exchange rate as a weapon of macroeconomic conflict in particular. 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 favouring a stable, competitive currency value. These structural changes shifted 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. Domestic political realignment and electoral reform afforded less latitude for party and cabinet officials to satisfy external pressure in the 1990s; and U.S. threats over trade policy declined after 1995, easing upward pressure on the yen. Structural change, driven by previous exposures to yen appreciations, deprived the exchange-rate weapon of much of its potency.<sup>31</sup>

The 1990s do not demonstrate that the exchange rate weapon has lost all potency. Nor does this experience suggest that the exchange rate weapon no longer applies to other countries. Many are still vulnerable to currency shifts *vis-à-vis* the dollar, to the contrary, as indicated by the massive purchases of dollars by East Asian central banks to restrain the appreciation of their currencies during 2002-2004. Were they to become the target of exchange rate pressure and moral suasion, these countries could well alter macroeconomic policy.

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

30 This 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 its deployment.

31 This and the following two paragraphs draw on Henning, *Japan's Resistance to Macroeconomic Gaiatsu*.



With respect to Japan, however, the 1990s show that the weapon is (a) sometimes irrelevant, because the yen was moving in the wrong direction, as in 1998, (b) sometimes unusable, because, owing to financial fragility and deflation, recession would undermine the desired external adjustment, and (c) even when relevant and useable, the yen must move farther than in the past to induce a policy adjustment.

### *East Asian Regionalism*

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,<sup>32</sup> as well as to progressive economic advancement of members of the region, China in particular, East Asia as a whole has largely replaced Japan as the focus of American policymakers 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. When their central banks did not allow their currencies to float upward with the Japanese yen after the Plaza accord, Taiwan, South Korea and China became the focus of attention of the second Reagan administration. The three countries were cited in the late 1980s by the Treasury Department for manipulating their currencies to achieve unfair competitive advantage, in semi-annual reports mandated by the Omnibus Trade and Competitiveness Act of 1988.<sup>33</sup> These countries' currency policies were publicly reviewed in hearings before the banking committees of the U.S. Congress. Treasury pressed bilaterally and successfully for these governments to allow appreciation of their currencies.

Intensified scrutiny of China's policies with respect to the exchange rate became likely with the dramatic rise of that country's role in international trade and investment over the course of the 1990s. After receiving widespread acclaim for holding its currency steady against the U.S. dollar during the Asian financial crisis of 1997-98,<sup>34</sup> China had become the focus of American as well as European pressure for appreciation for the sake of adjustment by 2003.

The Asian financial crisis and profound resentment with the multilateral response galvanized governments within the region into cooperation.<sup>35</sup> 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 (ASEAN+3) concluded a framework agreement and fourteen bilateral swap agreements to help shield themselves against future crises.<sup>36</sup> Although their size appears to be modest,

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32 A factor emphasized by Peter J. Katzenstein, Kozo Kato, Ming Yue and Natasha Hamilton-Hart, 2000. *Asian Regionalism*. Ithaca; Cornell University Press.

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

34 Hongyin Wang, 2003. 'China's Exchange Rate Policy in the Aftermath of the Asian Financial Crisis', in: Jonathan Kirshner, (ed.), *Monetary Orders; Ambiguous Economics, Ubiquitous Politics*. Ithaca: Cornell University Press, pp. 153-171.

35 See, Jennifer Amyx, 2004. 'Japan and the Evolution of Regional Financial Arrangements in East Asia', in: Ellis S. Krauss and T.J. Pempel, (eds.), *Beyond Bilateralism; U.S.-Japan Relations in the New Asia-Pacific*. Stanford: Stanford University Press, pp. 198-218; Saori N. Katada, 2004. 'Japan's Counterweight Strategy: U.S.-Japan Cooperation and Competition in International Finance', in: Ellis S. Krauss and T.J. Pempel, (eds.), *Beyond Bilateralism: U.S.-Japan Relations in the New Asia-Pacific*. Stanford: Stanford University Press, pp. 176-197; C. Randall Henning, 2004. *Systemic Conflict and Regional Financial Cooperation: The Case of East Asia*. American University and Institute for International Economics, (Photocopy, August,); and Jonathan Kirshner, 2005. *Currency and Coercion in the Twenty-First Century*. EUI Working Papers RSCAS No. 2005/13..

36 East Asian financial cooperation is analyzed in Edwin M. Truman, 2000. *Remarks of the Assistant Secretary for International Affairs to the Annual Meeting of the Asian Development Bank, Chiang Mai, Thailand*. U.S. Treasury Department Press Release, Washington, D.C.; Barry Eichengreen, 2003. 'What to Do with the Chiang Mai Initiative', *Asian Economic Papers*, 2 (1), pp. 1-49; Gordon de Brouwer, 2003. 'Financial Markets, Institutions, and Integration in East Asia', *Asian Economic Papers* 2 (1), pp. 53-80; Yung Chul Park and Yunjong Wang, 'Chiang Mai and Beyond', [Online], available on: [http://soback.kornet.net/~ycpark/pub/Chiang%20Mai%20and%20Beyond\\_Fondad\\_%200206%20pdf.pdf](http://soback.kornet.net/~ycpark/pub/Chiang%20Mai%20and%20Beyond_Fondad_%200206%20pdf.pdf) [Accessed March 15, 2004]; Fred C. Bergsten and Yung Chul Park, 2002. *Toward Creating a Regional Monetary Arrangement in East Asia*.

these swaps are large compared to Southeast Asian countries' quotas in the IMF. Given the prodigious foreign exchange reserves held by Japan, China and Korea, the creditors under the CMI, the amounts of the swaps could easily be raised at short notice. Notwithstanding the formal agreement to link most disbursements under the CMI to adjustment programs negotiated with the IMF, therefore, 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.

Notwithstanding progress toward regional financial cooperation and periodic advocacy on the part of some Asian leaders for an Asian Monetary Fund and an Asian currency, however, the governments and central banks of East Asia have made little progress toward exchange rate or monetary cooperation. China is not attracted in particular 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, continued U.S. pressure on East Asian states for adjustment is likely to keep proposals for regional cooperation alive. Irrespective of the economic merits of appreciation of Asian currencies, this advice generates resentment on the part of target states and key private constituents. Regional cooperation and dialogue, particularly within the ASEAN+3 group, potentially opens new options for East Asian states. As the U.S. continues to press, East Asians will have an incentive to put aside (not dismiss) their considerable differences and reach a *modus vivendi* on financial questions of common interest.

### *United States*

Although many analysts are accustomed to thinking of the United States as a 'large, relatively closed economy', it is, while large, considerably more open than it was four decades ago. The ratio of merchandise imports and exports to GDP increased three-fold, from 6.6 percent in 1960 to 20.3 percent in 2000. Including the imports and exports of services increases the ratio to 25.6 percent in 2000.<sup>37</sup> On this measure, therefore, the openness of the United States presently slightly exceeds that of Japan and roughly equals that of the euro area.<sup>38</sup> For manufactured goods alone, U.S. imports and exports together now roughly equal domestic output.

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 up or down to coerce others to pursue more expansionary, or restrictive, macroeconomic policies. As a consequence of

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ADB Research Paper 50, Tokyo: ADB; Haruhiko Kuroda and Masahiro Kawai, 2002. 'Strengthening Regional Financial Cooperation in East Asia', Paper presented at the seminar *Regional Economic, Financial and Monetary Cooperation: The European and Asian Experiences*, European Central Bank: Frankfurt am Main; Masaru Yoshitomi and Sayuri Shirai, 2000. *Technical Background Paper for Policy Recommendations for Preventing Another Capital Account Crisis*. Tokyo: Asian Development Bank Institute; Graham Bird and Ramkishan S. Rajan, 2002. *The Evolving Asian Financial Architecture*. Essays in International Economics 26, Princeton: Department of Economics, Princeton University; C. Randall Henning, 2002. *East Asian Financial Cooperation*. Policy Analyses in International Economics No. 68, Washington, D.C.: Institute for International Economics; C. Randall Henning, 2004. 'The Complex Political Economy of Cooperation and Integration', in: Gordon de Brouwer and Yunjong Wang, (eds.), *Financial Governance in East Asia: Policy Dialogue, Surveillance and Cooperation*. London: RoutledgeCurzon, pp. 83-100; C. Randall Henning, 2004. 'East Asian Financial Cooperation and Global Adjustment: Building on the Chiang Mai Initiative', Paper presented to the conference *Economic Relations between the United States, Japan, and East Asia*, Washington, D.C.: Institute for International Economics and Japan Economic Foundation; Yunjong Wang, 2004. 'Financial Cooperation in East Asia', Paper presented to the Workshop on *The State of East Asian Financial Regionalism*, Washington, D.C.: Institute for International Economics, Korea Institute for International Economic Policy, and Korea Economic Institute; among other works.

37 Calculated from *Economic Report of the President*, February 2004, Tables B-1, B-103 and B-106.

38 Calculated from European Central Bank, 2004. *ECB Statistics Pocketbook*. Frankfurt: European Central Bank.

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. Foreign ownership of U.S. Treasury securities, for example, has risen to 24 percent of total federal debt outstanding as of March 2004. Excluding official holdings, foreign ownership of Treasury securities amounts to 15.5 percent of privately held debt at the end of 2003. Foreign holdings of corporate and government bonds together amounts to about 18 percent of bonds outstanding. Foreign ownership of corporate stocks amounts to about 11 percent of stock market valuation. Foreign-owned assets in the United States total \$10.5 trillion. The U.S. net international investment position at the end of 2003 was negative \$2.43 trillion, about 24 percent of U.S. GDP.<sup>39</sup> Although these ratios are still moderate, the greater the ratio of foreign-owned assets to total assets, the greater the possible increase in domestic interest rates in response to depreciation of the dollar and thus the greater the potential costs of using the exchange-rate lever.

### *Adjustment Conflict within the New Structure*

The global economy entered a new conflict over adjustment conflict during 2003, the fifth major episode since the breakdown of the Bretton Woods regime. This case replays the classic conflict over U.S. current account deficits in several respects. Some of the individual players, such as China, are new to exchange-rate conflict, and some of the particular circumstances, such as the centrality of the renminbi peg to the adjustment process, differ. But the central dynamic, conflict between the deficit and surplus countries over measures to secure adjustment and the depreciation of the dollar, is familiar.

The structural environment of the mid-2000s conflict, however, differs substantially from previous cycles. Unilateral countermeasures, regionalism, and greater internationalization of the U.S. economy reduce the asymmetry in exchange-rate vulnerability among the United States, Europe, and East Asia. The structure of international monetary relations has shifted significantly.

We would expect that structural shift would render the dollar weapon less effective and the United States less influential than in the past. 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 substantially circumscribed.

Whereas the United States could make macroeconomic policy errors (over-expansionary monetary policy during the 1970s and over-expansionary 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, insulation of Japan, and nascent East Asian financial cooperation, the United States might well be confronted with greater penalties for policy errors. Those penalties could take the form, for example, of erosion of the international value and/or role of the dollar.

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 by European central banks and the Bank of Japan through foreign exchange intervention. 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 Europe and Japan.<sup>40</sup>

Private capital markets have already shown reluctance at particular moments during 2003 and early 2004 to finance the U.S. current account deficit. If inflows were to dry up in the mid- or late 2000s as completely as they did in 1987, the United States would face a consolidated monetary union rather than

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39 Calculated or reported from U.S. Treasury Financial Management Service, Table OFS-2; U.S. Department of Commerce, Bureau of Economic Analysis, 'U.S. Net International Investment Position at Yearend 2003', June 30, 2004.

40 Henning, *Currencies and Politics*, pp. 151-158, 205-208, 285-286.

individual European monetary authorities. The euro area would be less vulnerable to exchange-rate fluctuations than the separate European countries had been prior to the euro's creation. If the United States were to ask for joint intervention to defend the dollar, European authorities are likely to be in a stronger position than in previous adjustment cycles 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.

East Asia, Japan and China in particular, has filled the breach with unprecedented amounts of foreign exchange intervention when private capital has balked at financing U.S. deficits. As of this writing, China has succeeded in maintaining the renminbi peg to the dollar and Japan has succeeded in limiting appreciation of the yen. With an overheating economy, prodigious foreign exchange reserves, and a secure trade balance, however, the economic case for appreciation of the renminbi is strong.<sup>41</sup> 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. 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 absence of European intervention to date suggests that East Asia is more vulnerable to dollar depreciation than Europe. Heavier reliance of East Asian production networks on the U.S. market, deflation in Japan, and the less advanced state of regionalism perpetuate a greater degree of vulnerability of East Asia compared to 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, such as Japan, and give further impetus to forms of regionalism that could be antagonistic to U.S. interests. U.S. policymakers would thus be wise to exercise caution in the deployment of exchange-rate coercion in this region.

Europe has countenanced a substantial appreciation of the euro *vis-à-vis* the dollar. This movement has strengthened pressures on European governments to pursue structural reform and on the European Central Bank to keep monetary 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. Europe's position will depend on its ability to streamline external monetary policymaking and stimulate growth, among other factors. The present global current account adjustment and conflict over how it is achieved will provide a window onto the evolving effects of structural shift.

## Conclusion

The essential arguments of this paper can be summarized in four basic 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. Regional monetary integration is of course motivated by more than simply a desire to deflect exchange-rate

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41 John Williamson, 2003. 'The Renminbi Exchange Rate and the Global Monetary System', Outline of a lecture, Beijing: Central University of Finance and Economics; Morris Goldstein and Nicholas Lardy, 'Two-State Currency Reform for China', Commentary for *The Wall Street Journal*, Online, <http://www.iie.com/publications/papers/goldstein0903.htm> [Accessed September 12, 2003]; Morris Goldstein, 2004. *Adjusting China's Exchange Rate Policies*. Working Paper Series 04-01, Washington, D.C: Institute for International Economics.

coercion. But a desire to reduce exchange-rate vulnerability powerfully reinforces other motives to build regional cooperation. Countermeasures take decades to develop and only after repeated use of exchange-rate coercion; but they are developed nonetheless.

Third, these countermeasures—monetary union in the case of Europe and a mix of regional cooperation and unilateral action in the case of East Asia—collectively shift the structure of the international monetary system so as to reduce the likely effectiveness of exchange-rate coercion 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 over the very long term the exchange-rate weapon is dissipating asset: if you use it repeatedly, you eventually lose it.

Fourth, the exchange-rate weapon is nonetheless likely to have continuing relevance. The United States will continue to have residual power in this respect. Europe could conceivably begin to exercise some of its own in geographically contiguous areas. The mid-2000s conflict over U.S. current account deficit reduction constitutes another revealing case. From this episode, we can expect to better assess the effects of structural shift on the potency of exchange-rate coercion. If diminution in the potency of currency coercion reduces the ability of the leading states to manage adjustment smoothly, however, it could undermine domestic political support for economic openness in the United States and elsewhere.

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