The Case for a
New Plaza Agreement

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THE PROBLEM

The United States is running its largest external current account deficit in the available historical record for nearly two centuries.[1] At an average of about 6½ percent of GDP in 2005, this deficit is already almost twice as large in relative terms as its previous post-19th century peak of 3.4 percent in 1987. My projections indicate that the deficit is on a path to reach more than 8 percent of GDP in 2010.[2] The United States has already swung from being the world's largest creditor to being its largest debtor nation, with net external liabilities amounting to 22 percent of GDP at end-2004. By 2010 net liabilities are likely to rise to about 55 percent of GDP.

This trajectory is highly undesirable for four reasons. First, the long-term burden of the external adjustment will be all that much greater when it finally does come if the needed adjustment is larger because it is delayed. My projections indicate that, with the dollar at its level of January-May 2005, the baseline current account deficit reaches 14 percent of GDP by 20 years from now, and net foreign liabilities reach 135 percent of GDP. That will almost certainly not happen, because some crisis would intervene, forcing a cutback in the deficit and curbing the buildup of external debt. To avert such a crisis, prudence strongly suggests that net liabilities should be held to no more than 50 percent of GDP.[3] So the sustainable long-term current account deficit is only about 3 percent of GDP.[4] The only question is whether the adjustment needed to limit long-term net liabilities to such a ceil-ing comes early and thus is smaller and less painful or comes later and thus is larger, more painful, and potentially much more disruptive.

With an early adjustment, the maximum cutback in domestic demand for investment, consumption, and the fiscal deficit would be only about 4 percent of GDP. If delayed until a decade from now, the cutback would be about 9 percent of GDP, requiring much more belt-tightening even if achieved smoothly. Chances are that such a large adjustment would not be smooth; the required exchange rate adjustment would be much larger, and a loss of confidence by foreign investors would likely lead to a larger run-up in interest rates and greater risk of recession.

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[1] The current account is the sum of trade in goods and services, capital income, and transfers. In the period 1895–1980 the US current account was typically in surplus, averaging about 1 percent of GDP and peaking at about 6 percent in 1917. There were deficits in the early 1870s and late 1880s, but these peaked at about 3 percent of GDP (Cline 2005, 2). In earlier decades, the deficit peaked during the period of large British lending for canals and railroads, reaching a maximum of 5 percent of GDP in 1836. The balance had been positive in the 1820s and swung back to positive in the 1840s. In the 1850s and 1860s it turned negative again, but the deficits were only in the range of 2 to 2½ percent of GDP. (These are rough estimates based on Maddison 2004 and US Bureau of the Census 1976.)

[2] The dollar appreciated by about 4.3 percent on a real, trade-weighted basis from the January-May 2005 base used in my book to its mid-November level (Federal Reserve, "Price-Adjusted Broad Dollar Index," www.federalreserve.gov [accessed December 8, 2005]). This boosts the baseline deficit for 2010 from the original range of 7.3 to 8.1 percent of GDP to 8.0 to 8.7 percent.

[3] Developing countries have typically encountered external debt problems at foreign debt ratios above 40 percent of GDP. In part because the government and corporations in the United States borrow abroad in dollars rather than foreign currency, the United States' margin for error is probably higher. Australia and New Zealand are two industrial countries with higher net foreign liabilities (60 and 80 percent of GDP, respectively), but their economies are much smaller relative to the world capital market.

[4] It can be shown that the long-term ratio of net foreign liabilities to GDP stabilizes at the ratio of the current account deficit as a percent of GDP to the long-term average percent growth rate of nominal GDP. If real growth is 3.5 percent and inflation 2.5 percent, nominal growth is 6 percent, and net foreign liabilities stabilize at 50 percent of GDP if the current account deficit is 3 percent of GDP.

Second, as the US external deficit rises, so does the risk of a hard landing for the dollar, the US economy, and the world economy. At some point foreign investors could cut back on sending new capital flows to the United States, either because of improved returns at home or because of a growing realization that the dollar is overvalued and that they face prospective exchange rate losses. Any sharp cutback in foreign financing would risk a sharp increase in long-term US interest rates, even if the Federal Reserve did not raise the short-term (federal funds) rate it controls. Sharply higher long-term interest rates would depress the US housing, bond, and equity markets and curb investment, potentially causing a recession. High interest rates and US recession in turn could trigger global recession. Although the chances of this hard-landing scenario likely remain well below 50-50, they are rising as the deficit rises.

Third, it is fundamentally perverse for capital to be flowing from developing countries to the United States, as is now occurring, instead of the other way around. Capital is scarce in developing countries but abundant in the United States and other industrial countries. This means that rates of return on capital tend to be higher in developing countries, and hence that under normal circumstances capital will flow from industrial to developing countries. Such flows of capital contribute to faster growth in developing countries and hence a narrowing of the income gap between industrial and developing economies. Persistent large net flows in the opposite direction—i.e., to the United States—are a symptom of ill health in the international economy.

Fourth, past experience has shown that overvaluation of the dollar and large trade deficits lead to an increase in protectionist pressure in the United States. This time around pressure for increased protection against China in particular is already evident.

FISCAL AND EXCHANGE RATE ADJUSTMENT

Two key economic changes are needed to curb the US external deficit. First, the dollar needs to depreciate substantially further to make US exports more attractive to foreign buyers and imports less attractive to American consumers. Second, the US fiscal deficit needs to be cut. US domestic demand needs to be curbed to make room for a shift toward output for exports. Lower domestic demand can come from higher private saving (lower consumption), lower private investment, or a lower fiscal deficit. Because there is no reliable policy instrument to boost private saving, and because it would be undesirable to curb private investment and hence limit the expansion of output capacity, the appropriate policy

is to cut the US fiscal deficit. The trade deficit is the excess of domestic use of resources over domestic availability, and the large fiscal deficit is a major reason domestic demand for resources exceeds domestic supply. My analysis suggests that overall, foreign currencies need to rise in real terms by about 25 percent against the dollar, and the fiscal deficit needs to be cut from its baseline future plateau of about 3.5 percent of GDP to zero, in order to curb the US current account deficit to about 3 percent of GDP by 2010.[5]

I do not have specific suggestions on how to eliminate the fiscal deficit. I would point out, however, that federal tax revenue has fallen from 20 percent of GDP in 2000 to 16 percent in 2004, largely because of tax cuts, so making the tax cuts permanent would greatly complicate the task of eliminating the fiscal deficit.

As for the correction of the dollar, for a time it appeared that market forces were on the path toward achieving that outcome (figure 1). From its peak in February 2002 to the end of 2004, the dollar fell by 36 percent against the euro and comparably against some other European currencies and the Australian dollar. It also fell significantly (but to a lesser extent) against the Canadian dollar and the pound sterling. It fell more moderately against the currencies of some emerging-market economies (Korea, Chile, and Argentina). There was far less correction of the dollar against the Japanese yen, however. Moreover, the dollar did not change at all against the Chinese renminbi, because of China's peg to the dollar, and other important East Asian economies also experienced minimal real appreciation (or even real depreciation) against the dollar, including Singapore, Taiwan, the Philippines, and Malaysia. On an overall trade-weighted basis, foreign currencies rose 16.7 percent against the dollar in real terms from the full year 2002 as a base to end-2004.[6]

This adjustment of the dollar through end-2004 was encouraging but far from complete. Because of the two-year lag from the exchange rate signal to the trade outcome, the trade balance in 2004 did not show adjustment but rather was at a record deficit. Nevertheless, some correction was finally in the pipeline. However, during the course of 2005 there was a serious retrogression in the adjustment process as numerous major currencies began to weaken once again against the dollar

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[5] My book (Cline 2005) called for a 21 percent foreign real appreciation against the dollar from the January-May 2005 base, but the recent rise of the dollar increases the amount of foreign appreciation needed.

[6] Federal Reserve, "Price-Adjusted Broad Dollar Index," www.federalreserve. gov (accessed December 8, 2005). The correction was even larger, at 19 percent, when measured from the dollar's peak in February 2002 to its recent trough in December 2004. Note that a 19 percent foreign appreciation is equivalent to a 16 percent depreciation of the dollar.

Figure 1 Real appreciation against the dollar, 2002 average to end-2004

percent
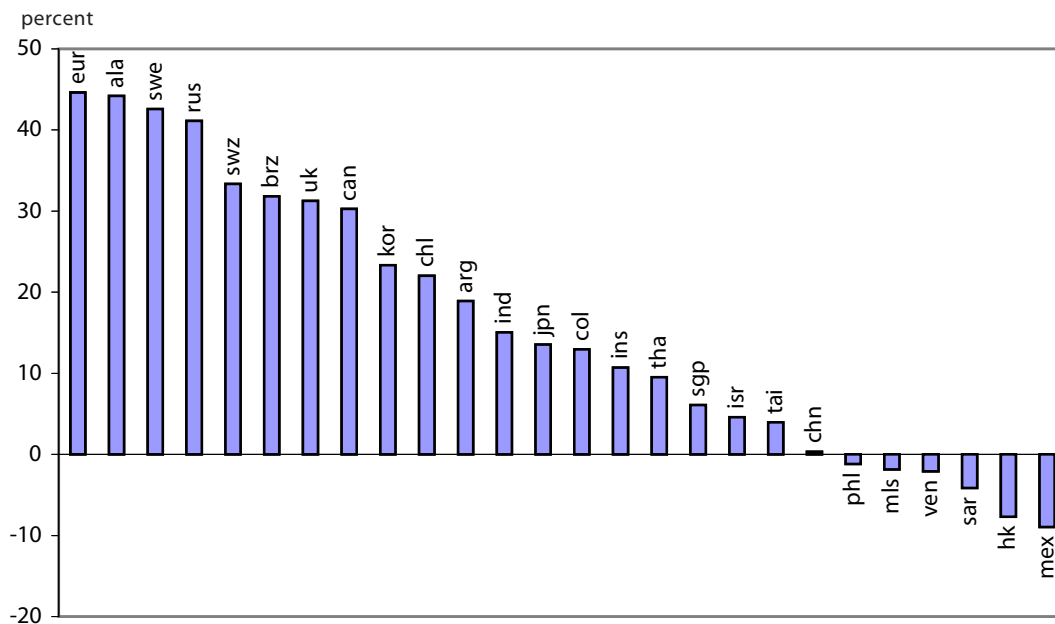
Abbreviations in order: euro area, Australia, Sweden, Russia, Switzerland, Brazil, United Kingdom, Canada, Korea, Chile, Argentina, India, Japan, Colombia, Indonesia, Thailand, Singapore, Israel, Taiwan, China, Philippines, Malaysia, Venezuela, Saudi Arabia, Hong Kong, Mexico.

Sources: IMF, *International Financial Statistics* and Central Bank of China (Taiwan).

(figure 2). The two most important nondollar currencies, the euro and the yen, both fell by about 16 percent in real terms against the dollar from end-2004 to November 15, 2005. In real terms this left the yen at its weakest level against the dollar in 20 years. The trade-weighted value of foreign currencies fell 5.7 percent against the dollar, leaving a net real foreign appreciation of only 10 percent from the 2002 base.

DESIRABLE EXCHANGE RATE REALIGNMENT

It is possible to construct the "optimal" profile of currency realignments necessary for US external adjustment.[7] Countries with relatively larger current account surpluses are the logical candidates to undertake the relatively larger currency appreciations. It turns out that if all countries with current account surpluses in excess of 1 percent of GDP were to cut their

current account surpluses by 40 percent and other countries also participated with modest reductions in trade balances, this would provide the needed counterpart of foreign adjustment to mirror a reduction in the US current account deficit from about 6 percent of GDP to about 3 percent. It is also possible to postulate an overall summary relationship between the change in each country's current account surplus relative to GDP and the change in its real exchange rate.[8]

On this basis, an exercise that calculates optimal real exchange realignments yields the results shown in table 1.[9] The first column shows the desired real appreciations against the dollar. The target for the overall US trade-weighted foreign appreciation against the dollar from the 2002 base is 39 percent (a real depreciation of the dollar by 28 percent). Most of the countries show optimal appreciations around this magnitude, although some countries that start with exceptionally high current account surpluses show considerably larger optimal appreciation amounts.

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[7] First, the target foreign trade-weighted appreciation against the dollar needed to accomplish the US current account adjustment is identified. For any given set of exchange rate realignments, the Federal Reserve's trade weights are applied to calculate the trade-weighted foreign appreciation against the dollar. Next, a set of target changes in current account balances of other countries is identified, sufficient to provide the counterpart for the target decline in the US current account deficit. Then the "optimal" realignment is identified as the one that exactly meets the identified overall target for foreign trade-weighted appreciation against the dollar and minimizes the difference of the resulting set of country current account balances from the target set of current account balances (Cline 2005, chapter 6).

[8] The impact of exchange rate change is based on simple assumed responsiveness of trade to the real exchange rate, combined with the size of trade turnover relative to GDP.

[9] The current account targets are as follows: Countries with current account surpluses of 1 percent of GDP or more reduce surpluses by 40 percent. Other countries reduce current account balances by 0.35 percent of GDP. As exceptions, Australia has no change (because its deficit is already large), and the European Union carries out a current account swing from +0.4 percent of GDP to –0.3 percent of GDP.

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Figure 2 Real appreciation against the dollar, end-2004 to November 15, 2005

percent
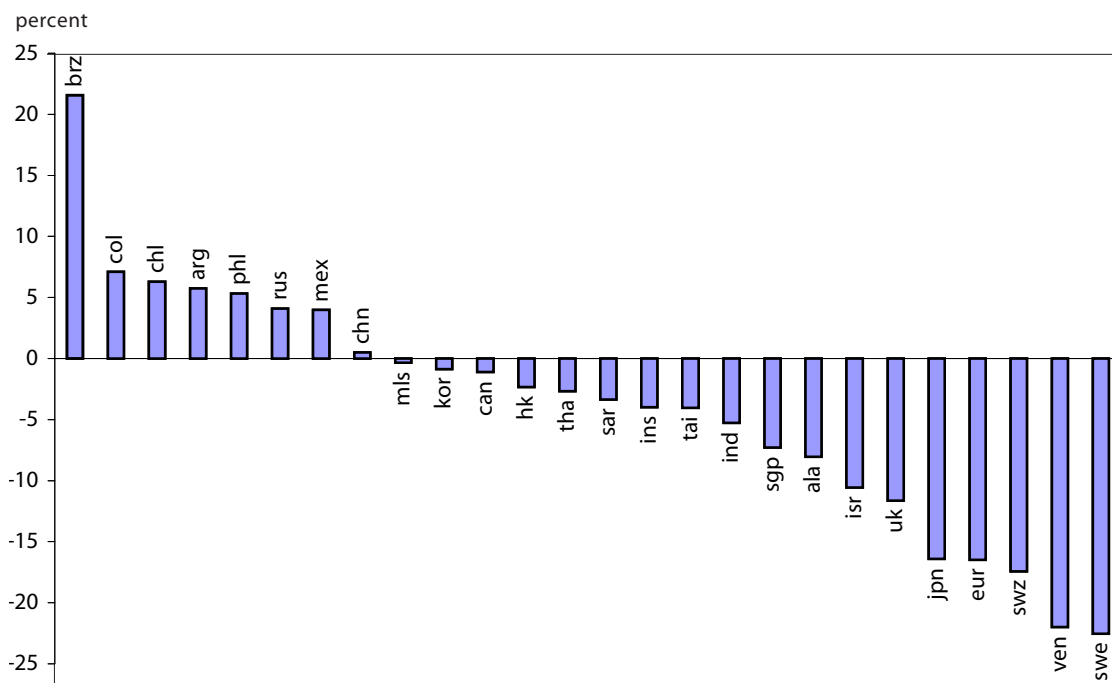
Abbreviations in order: Brazil, Colombia, Chile, Argentina, Philippines, Russia, Mexico, China, Malaysia, Korea, Canada, Hong Kong, Thailand, Saudi Arabia, Indonesia, Taiwan, India, Singapore, Australia, Israel, United Kingdom, Japan, euro area, Switzerland, Venezuela, Sweden.

Sources: IMF, *International Financial Statistics* and Central Bank of China (Taiwan).

It is important to note that, whereas these appreciations appear large bilaterally against the dollar, the magnitudes are much smaller in terms of overall trade-weighted appreciation for each currency in question (final column). The reason is that most of each country's other trading partners also experience large appreciations against the dollar in the optimal solution. For example, Korea's optimal appreciation against the dollar is 45.6 percent from the 2002 base. Because other key trading partners such as Japan and China would also be appreciating, however, the overall trade-weighted appreciation for Korea would be only 6.4 percent. Similarly, the euro area would have a real appreciation (from 2002) of 44.4 percent against the dollar bilaterally but only 7.3 percent on a trade-weighted basis taking all other trading partners into account.

The table also reports the actual extent of real currency appreciation against the dollar from 2002 to November 15, 2005. Although there are a few exceptions (including especially Brazil and Canada), most countries have experienced considerably less real appreciation than the calculated optimal amount. Several countries have depreciated in real terms rather than appreciated against the dollar, including the key cases of Japan and Mexico.

The table then shows the extent of additional real appreciation against the dollar from the November 15, 2005, level

that would be required to reach the optimal amount. These figures are positive for all but two countries (Brazil and Canada, which would instead depreciate back to the optimal levels). For 20 of the 25 countries plus the euro area, the needed remaining appreciations against the dollar are in double digits. For 7 of these, the desirable further appreciations against the dollar would be in the range of 10 to 40 percent (including the crucial case of the euro, at about 21 percent). For the other 13, the target appreciations against the dollar would be more than 40 percent, essentially because these countries (such as China) did not participate in the first round of appreciation against the dollar from 2002 through end-2004 and also because many of them have unusually large current account surpluses.

Before the reversal of the dollar's path during the course of 2005, the bulk of the unfinished currency appreciations was concentrated in the Asian economies, including Japan but especially China, Hong Kong, Malaysia, and Singapore, which had moved their exchange rates none at all (in the first three cases) or minimally against the dollar.[10] By late 2005, however, the pattern of needed further appreciation was more general. In particular, there was once again a need for large

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[10] This is why my book (2005), which used January-May 2005 as the base, called for an "Asian Plaza."

Table 1 Real appreciation against the dollar from 2002 level (percent)

Country/region	Optimal	Actual[a]	Remaining	Memorandum: Optimal trade-weighted
Argentina	40.7	24.5	13.0	5.2
Australia	44.2	31.9	9.3	2.6
Brazil	39.0	60.1	−13.2	7.2
Canada	16.9	27.8	−8.5	4.6
Chile	38.3	27.2	8.7	3.4
China	45.9	1.8	43.3	8.1
Colombia	25.7	20.8	4.1	3.4
Euro area	44.4	19.7	20.6	7.3
Hong Kong	55.9	−10.7	74.5	11.1
India	44.5	9.9	31.5	4.9
Indonesia	49.8	6.0	41.4	5.8
Israel	32.9	−8.4	45.1	2.5
Japan	53.3	−5.6	62.4	16.7
Korea	45.6	22.1	19.2	6.4
Malaysia	55.7	−3.1	60.6	13.3
Mexico	13.6	−4.7	19.1	2.1
Philippines	47.3	3.9	41.8	6.3
Russia	55.6	46.7	6.1	14.5
Saudi Arabia	60.7	−7.6	73.9	22.2
Singapore	87.5	−2.4	92.1	46.2
Sweden	49.9	10.1	36.1	10.2
Switzerland	55.7	10.0	41.6	14.9
Taiwan	47.7	−2.2	51.1	7.1
Thailand	47.2	3.2	42.6	5.2
United Kingdom	42.2	13.5	25.3	3.1
Venezuela	31.0	−24.2	72.7	17.7

a. To November 15, 2005
Sources: Cline (2005), IMF *International Financial Statistics*, and Central Bank of China (Taiwan).

further real appreciation of the euro against the dollar, in view of the sharp fallback of the euro during the course of 2005. Thus, against the January-May 2005 average level, the euro needed to appreciate only 5 percent more against the dollar to reach the target level, whereas from the November 15, 2005, base this gap had widened to 20.6 percent (Cline 2005, 242 and table 1). This means that only about half of the target real correction of the euro has occurred, instead of the five-sixths at the end of 2004.

The Plaza Agreement

There is considerable similarity between the situation today and that in mid-1985. At that time, although the dollar had begun to decline from its peak in February 1985, it still remained seriously overvalued. On September 22, the finance ministers of the five largest industrial countries (G-5) met at the Plaza Hotel in New York and agreed on a package to achieve further adjustment in the dollar. The United States was to tighten its fiscal policy, Japan was to boost private demand through tax reform, and Germany was to cut taxes. All five countries were to carry out exchange rate intervention policies to reduce the value of the dollar.[11] The results were substan-

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[11] On the basis of interviews, Yoichi Funabashi (1989, 15–21) states that the objective was to reduce the value of the dollar by some 10 to 12 percent in the short term. He also states that some $18 billion in total exchange market intervention was envisioned, apportioned about equally among the United States, Japan, and the European countries as a group. Other informed observers note, however, that some of the participants were adamant that there was no agreement on magnitudes, either for the change in the dollar's value or for

tial. On the first day after announcement of the agreement, the dollar fell an average of 4.3 percent against other major currencies (Funabashi 1989, 10). The German mark, which had appreciated against the dollar by 19 percent from end-February to end-August, appreciated another 13 percent by end-December. The Japanese yen, which had risen 9.4 percent against the dollar from end-February to end-August, appreciated by another 18.3 percent by end-December (International Monetary Fund, *International Financial Statistics*). Indeed, the package was so successful in moving the exchange rates that by early 1987 US officials became concerned that the pace of the dollar's decline might be getting out of hand.[12] In February 1987, the G-5 finance ministers met in Paris and agreed in the Louvre Accord to pursue intervention policies curbing the pace of the dollar's decline, to be accompanied by macro-policy adjustments.[13]

Plaza II

Today there is a need for an initiative comparable to the Plaza Agreement, probably by the G-20 group of major industrial and emerging-market economies, which on occasion has dealt with international financial issues in recent years.[14] Those countries that have been intervening in exchange markets to keep their currencies from appreciating against the dollar would pledge to quit doing so. Although Japan was accumu-

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the amount of intervention to take place (C. Fred Bergsten, personal communication, December 5, 2005).

[12] According to Funabashi (1989, 179), "The precipitous decline of the dollar since early 1987 had made foreign investors in the United States more anxious. The joint communiqué announced by [US Treasury Secretary] Baker and [Japanese Minister of Finance] Miyazawa in January and subsequent US coordinated intervention to stop further dollar decline reflected the concern of the US Treasury over continuing decline of foreign capital inflows into the United States." The approaching 1988 presidential election likely also contributed to US officials' concern about the dollar's decline getting out of hand.

[13] The Louvre Accord "secretly established a narrow intervention grid for the currencies of the Group of Seven countries" (Coeuré and Pisani-Ferry 1999). Funabashi (1989, 186) states that the agreement set the February 20, 1987, rates of the German mark and yen against the dollar as the base and provided for voluntary intervention as the rates approached a "first line of defense" at ± 2.5 percent around these base rates, and for obligatory consultation on policy adjustments once the deviations reached 5 percent. The public statement of the accord referred simply to stabilization of the dollar "around the current levels." The Louvre Accord also involved German and Japanese pledges to implement economic stimulus through tax cuts (Funabashi 1989, 178–80).

[14] Formed in 1999, the G-20 includes finance ministers and central bank governors of 19 countries: Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey, the United Kingdom, and the United States, plus the European Union represented by the Council presidency and the president of the European Central Bank. For the case supporting use of the G-20 rather than G-7 to deal with international imbalances, see Bergsten (forthcoming).

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lating dollar reserves massively in most of 2002 through early 2004, it has not done so since March 2004, and the European Central Bank has largely refrained from intervening to limit the rise of the euro (a central reason why the euro rose sharply against the dollar in 2002–04, whereas the yen rose much

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less). However, the Bank of Japan and the European Central Bank could undertake sales of dollar reserves as part of the overall package, and the United States could similarly undertake purchases of euros, yen, and perhaps other currencies.

In principle, each country would persist in this approach until its exchange rate against the dollar had risen by a broad agreed range. The International Monetary Fund could be asked to provide technical support in confirming appropriate ranges for realignment of exchange rates for consistency with US adjustments and individual country circumstances. On the basis of table 1, it would be appropriate to specify perhaps three tiers of countries. The first tier would include those with currencies that appropriately would rise some 40 percent or more against the dollar; a second tier, currencies that should rise by 15 to 40 percent against the dollar; and in a third tier, there would be no specific initiative unless the currency began to fall against the dollar. A reasonable time horizon for phasing in this adjustment would be three years. On the basis of table 1, 13 countries would be in the top tier, including the key cases of China and Japan. Six currencies would be in the second tier, including the important cases of the euro, the Korean won, the Mexican peso, and the pound sterling. Again, however, even for most of the countries in the top tier, the overall trade-weighted real exchange rate movements would be far more moderate, at less than 10 percent for China and 15 percent for Japan. The euro area, in the intermediate tier, would also have a cumulative real trade-weighted appreciation of only about 7 percent from the 2002 base.

The United States would carry out its part of the adjustment process by setting forth credible plans for eliminating the fiscal deficit over the next five years. The economic reason for such a commitment is that an initial round of dollar depreciation without fiscal adjustment would tend to be frustrated because the resulting boost to US output with no curb in domestic demand would generate inflationary pressure, induce monetary tightening by the Federal Reserve, boost interest

rates, and as a result tend to bid the dollar back up. In terms of political economy, a US commitment to eliminate its fiscal deficit would counter countries' otherwise understandable reaction against being asked to take action to solve a problem rooted in flawed US economic policies.

The need for a coordinated package along the lines of this Plaza II Agreement is especially great for a number of developing countries that have kept their exchange rates closely tied to the dollar, either in exchange rate pegs (as pursued formally until recently by China and Malaysia and still by Hong Kong—and in practice still by China as well) or through aggressive exchange rate intervention and accumulation of reserves to limit appreciation of their currencies (in many other developing and newly industrialized countries, as well as Japan).

Any individual developing country following a managed flexible exchange rate regime (a "dirty float") could be concerned about loss of competitiveness if its government were to allow its exchange rate to appreciate against those of its peers. If a large number of countries appreciate against the dollar in a coordinated manner, in contrast, no individual country faces the penalty of making its exports uncompetitive against alternative suppliers. This is known as the prisoner's dilemma, which collective action resolves. This problem is at the heart of the case for a coordinated Plaza II designed to marshal coordinated action by many countries that otherwise have strong incentives individually to keep their currencies from rising against the dollar.

In addition to the notable cases of the Japanese yen, Chinese renminbi, and a number of East Asian currencies, the euro is now substantially undervalued against the dollar. The euro is the single most important currency in the world economy after the dollar, and the euro-area economy must play an important role in the adjustment needed abroad as the counterpart of the reduction needed in the US current account deficit. As suggested above, the euro's value could appropriately rise some 20 percent against the dollar as part of global exchange rate realignments. The optimal exchange rate exercise calls for a downswing in the euro-area current account balance by $64 billion, about the same as the correction of $68 billion envisioned for Japan's current account (Cline 2005, 250). The sharp decline of the euro during 2005 means that the currency is far from being on track to achieve this outcome.

Unlike in many East Asian economies, however, in the euro area the problem is not that intervention and reserve buildups are thwarting market forces. Instead, market forces are now driving the currency down in response to such influences as the rise in US interest rates, the prolonged growth gap

between Europe and the United States, and political shocks in Europe (rejection of the EU constitution, political uncertainty in Germany, and ethnic rioting in France). Under these circumstances, there is a case for active exchange market intervention to guide the euro back toward a level consistent with accomplishing the part of the international adjustment task that would appropriately be borne by the euro-area economy. Such action would be in Europe's long-term interest because otherwise, in the absence of a coordinated Plaza II, the eventual pressures associated with an ever-widening US current account deficit could trigger a sharp upsurge in the euro, not only against the dollar but also against many other currencies held down by wrong-direction intervention. The euro-area economy could then wind up bearing a disproportionate share of the burden of foreign adjustment.[15]

COUNTERARGUMENTS

There are three popular arguments against the Plaza II strategy, none of which in my view withstands scrutiny. The first is simply that the value of the exchange rate and the size of the current account deficit are not matters for policy but for the market to determine. Thus, in November 2005 retiring Federal Reserve Chairman Alan Greenspan stated:

> A nation's current account balance thus is essentially a market phenomenon that is not readily subject to rebalance by targeting one or more policy variables such as the exchange rate. . . . I doubt . . . whether, given the current size of global financial markets, locking together two major currencies such as the dollar and the euro is feasible any longer. Over time, the required large domestic adjustments would be quite unlikely to be accepted by the majority of the residents of either the United States or those of the euro area.

Leaving the dollar's value strictly to "market forces" was also the mantra before the first Plaza, as the first Reagan administration pursued what was then called "benign neglect" of the dollar's inexorable rise and the resulting rise in the trade gap. It was only the severe intensification of protectionist pressures in Congress that prompted the new team at the Treasury Department in the second Reagan administration to pursue a G-5 pact on exchange rate realignment. As suggested by the move of the dollar in the wrong direction in 2005, market forces with no guidance cannot always be counted upon to work in an equilibrating manner (as is even more evident in the recent stock market bubble and, arguably, real estate bubble).

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[15] This risk is increasingly recognized in Europe (Ahearne and von Hagen 2005).

Table 2 External reserves of selected economies at end of period, 2000–July 2005
(billions of dollars)

Country/region	2000	2001	2002	2003	2004	2005[a]
Euro area	260.0	253.3	266.1	243.8	232.0	213.4
Japan	355.2	397.3	462.5	666.4	833.6	829.0
China	168.5	216.9	292.1	410.3	614.4	714.6
Hong Kong	107.3	111.4	111.9	118.7	123.3	121.7
India	38.3	46.5	68.2	99.8	127.0	136.4
Korea	95.9	103.0	121.4	155.7	198.6	205.4
Malaysia	29.5	30.6	34.3	44.7	66.3	78.2
Singapore	80.0	75.6	82.1	96.0	112.0	115.6
Taiwan	107.1	123.1	162.4	207.9	242.0	254.9
Mexico	35.4	44.9	50.6	59.1	64.0	66.4

a. End-July, except for Taiwan (June).
Source: IMF, *International Financial Statistics*.

An array of major trading nations that patently are not allowing market forces to work are compounding the problem by building up larger and larger foreign exchange reserves rather than allowing the market to appreciate their currencies (table 2). This group included Japan until early 2004 and today includes most of the East Asian emerging-market economies. More broadly, the central question is whether policymakers should sit idly by if the market is providing the US economy with more than enough rope to hang itself.

The second counterargument is that a major US fiscal correction and decline in the dollar would impose a severe recessionary shock on the rest of the world economy.[16] This argument ignores the fact that the longer the imbalance persists and the wider it becomes, the greater will be the size of the inevitable adjustment and hence its impact on the rest of the world. A cutback of 3 to 4 percent of US GDP in the external deficit, spread over three to five years, would involve fully manageable adjustment magnitudes for the rest of the world. US GDP is about one-fourth of the world total, so the reduction in demand for the rest of the world would be about 1 percent of GDP, corresponding to about 1.5 percent after taking into account terms-of-trade effects. Spread over three years this amount would not be so large as to provoke a recessionary shock.

Other countries would need to take domestic expansionary measures (fiscal, monetary, and ideally structural reform as well) to offset fully the reduction in demand stemming from the lower net exports associated with US external adjustment. A new Plaza Agreement would thus usefully include the outlines of such measures, tailored as appropriate to the major economies. Even if expansionary measures abroad were not adopted, however, the direct effect of the US external adjustment would not thrust the rest of the world economy into recession; rather, it would only be large enough to trim the pace of rest-of-world growth temporarily, by perhaps half a percentage point annually over three years. But if adjustment were delayed until it becomes much larger, the chances of a recessionary shock would rise substantially.

The third counterargument is that not much impact on the current account can be expected from US fiscal adjustment. This remarkable recent argument, espoused surprisingly by several key figures in the US Federal Reserve, is highly questionable.[17] It is, of course, a complete reversal of the traditional macroeconomic policy mantra of the International Monetary Fund (IMF) in its dealings with developing countries that face external current account difficulties. Fiscal adjustment is such a standard part of the policy advice given to such countries that some have suggested that IMF stands for "It's Mostly Fiscal."

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[16] Richard Cooper (2005) is one who has made this argument.

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[17] Most recently, Greenspan (2005) stated: ". . . a discretionary reduction in our federal budget deficit would work toward narrowing the current account deficit but, if history is any judge, to an uncertain and possibly small extent." Similarly, Federal Reserve Vice Chairman Roger W. Ferguson (2005) not only cites a Federal Reserve model estimate showing that a dollar in fiscal adjustment only cuts the trade deficit by 20 cents but also his actual application of the model run over a long enough period finds that the cut is only 5 cents. The basic problem is that, as designed, such models set loose indirect, offsetting forces that eventually dampen or negate the original shock, but their application of the normal operation of such forces is inappropriate when the "shock" is a correction of an initial fiscal disequilibrium rather than a disturbance of fiscal equilibrium (Cline 2005, 201).

The Fund has both economic logic and decades of international policy practice on its side. There is an iron law of national accounts that states that the trade deficit equals the fiscal deficit plus the excess of private investment over private saving. Reducing the fiscal deficit may not guarantee an equal reduction in the trade deficit, but those who argue that it will do little at all must explain why reducing the fiscal deficit would cause a fully offsetting rise in private investment or

> **. . . the central question is whether policymakers should sit idly by if the market is providing the US economy with more than enough rope to hang itself.**

a reduction in private saving. Although there is a theory of "Ricardian equivalence" that says households will cut saving if the government cuts its deficit because they no longer need to set aside as much against inevitable future tax increases, this theory has been irrelevant in the United States in recent years, when private saving fell from about 8 percent of personal disposable income to zero even as the fiscal deficit was widening. Not only is this the wrong sign for Ricardian equivalence, but this theory now would also require households to plunge into deep negative annual saving if the government corrected its fiscal deficit. In short, the argument that fiscal adjustment would do little to help external adjustment is not only implausible, it is at best a recipe for policy paralysis in the face of widening external deficits and at worst a license for the federal government to pursue ever larger fiscal deficits with little care for external balance consequences.

CONCLUSION

The United States is running an increasing risk by allowing its external current account deficit to head ever higher, past levels already historically unprecedented for the United States and most other industrial countries. A credible program to eliminate the fiscal deficit by 2010 combined with a Plaza II Agreement to achieve appreciation of a wide array of foreign currencies against the dollar would provide a sound basis for arresting this trend and bringing the external deficit back to a range of about 3 percent of GDP, which would be consistent with keeping the eventual ratio of net foreign liabilities to GDP at a prudent ceiling of about 50 percent.[18]

Even without a formal Plaza II, US policymakers should begin to press foreign central banks much more widely to desist from accumulating additional reserves. US authorities should greatly expand their focus to include most of the East Asian exchange rates rather than concentrating solely on the Chinese renminbi, as they have done so far. In principle, central banks should stop accumulating reserves until their currencies are on a path toward the type of corrections against the dollar indicated above.

A Plaza II would greatly help in this process for three reasons. First, it would resolve the "prisoner's dilemma" for major developing and newly industrialized economies, in which each country acting in isolation fears loss of competitiveness. Second, it would provide a framework for coordinated intervention in exchange markets by major industrial economies (dollar sales by the European Central Bank and Bank of Japan and purchases of euros, yen, and possibly other currencies by the Federal Reserve). Third, by including a program for US fiscal adjustment, it would assure countries allowing their currencies to rise that the United States, too, was carrying out the needed policy corrections.

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[18] Tokyo or Shanghai could be appropriate venues for an "Okura" or "Grand Hyatt" Agreement, respectively. The Plaza in New York is no longer a hotel.

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