THE INTERNATIONAL ECONOMY
THE MAGAZINE OF INTERNATIONAL ECONOMIC POLICY
220 I Street, N.E., Suite 200
Washington, D.C. 20002
www.international-economy.com
editor@international-economy.com

An Asian Currency Plan

BY RICHARD C. KOO

The way to save free trade from Trump.

The reelection of openly protectionist Donald Trump as the forty-seventh president of the United States is threatening the survival of the American-led free trade system which brought unprecedented prosperity and economic growth to mankind. Asia, which probably benefited from the system more than any other region in the world, must decide how to respond.

KEY DRIVERS

To understand the key drivers of this challenge, it is necessary to go back to the factors that led to Trump's reelection. There are undoubtedly many reasons for Trump's electoral success. But his political journey since he first announced his presidential bid in June 2015 suggests that the core group of his supporters are those who lost their jobs and incomes because Washington allowed the nation to run massive trade deficits for more than four decades. Most countries would never allow such large deficits to continue for as long as the United States did, knowing that they represent a loss of income that directly reduces the country's GDP.

Since 1980, the United States has lost income equivalent to 153 percent of GDP due to the cumulative trade deficit. That adds up to $21 trillion in current dollars or $41 trillion in today's dollars. And this $41 trillion loss is not borne equally by all Americans, but largely by those in manufacturing, mining, and agriculture who compete directly with cheaper imports. Many of these industries and their workers suffered badly because the strong dollar made their products uncompetitive both at home and abroad.

Although some blame the deficit on globalization—outsourcing to cheaper emerging economies—other advanced countries facing similar

Richard C. Koo is Chief Economist at Nomura Research Institute.

globalization challenges such as Germany, Japan, Canada, and Italy gained from trade. These countries are not suffering from the kind of social divide that has become prominent in the United States. Some of their gains were undoubtedly made on the back of the strong dollar.

The last time the United States took action to correct over-valuation of the dollar was the Plaza Accord of September 1985. This policy action successfully reduced trade deficits and contained protectionist pressures in U.S. politics, and was completed with the signing of the Louvre Accord in February 1987. In the following decades, however, Washington has taken no action on the dollar even though overvaluation resurfaced again in mid-1990s.

Since the Louvre Accord and until Trump declared his candidacy in 2015, no mainstream politicians in the United States focused on the dollar and trade deficit issue, even though the country had lost income equivalent to 153 percent of GDP due to cumulative trade deficits since 1980. But as soon as Trump began proposing protectionist policies to save industries and jobs, a huge number of Americans stood up and became his avid supporters.

That shocked Hillary Clinton, his Democratic contender in the 2016 election, and forced her in 2016 to drop her support of the Trans-Pacific Partnership, the most advanced free trade agreement and one she herself had negotiated. President Joe Biden, who took over from Trump in 2021, also stayed away from the TPP, kept most of his predecessor's tariffs, and added some of his own, indicating that no political party in America today is in favor of free trade.

Meeting to depreciate the dollar at the Plaza Hotel in New York City in 1985: **Gerhard Stoltenberg** *of West Germany,* **Pierre Bérégovoy** *of France,* **James A. Baker** *of the United States,* **Nigel Lawson** *of Britain, and* **Noboru Takeshita** *of Japan.*

Plaza Legacy

The 1985 Plaza Accord demonstrated that if central banks coordinate their actions and push currencies in the direction implied by trade balances, they can move exchange rates. It also proved that many U.S. trading partners are willing to accept unfavorable strengthening of their currencies because they understand that that is the correct way to save free trade.

—R. Koo

The strong dollar was not bad for those in finance, academia, the media, and other service occupations. But it was hugely negative for those in manufacturing and agriculture.

BACKLASH ORIGIN

This backlash against free trade originated with the loss of any mechanism to correct trade imbalances after governments allowed portfolio investors to dominate the foreign exchange market starting in 1980. Prior to that, cross-border capital flows were restricted in most countries, and the foreign exchange market was largely occupied by exporters and importers, which tended to strengthen the currencies of surplus countries and weaken those of deficit countries. That kept trade imbalances between countries from widening too far. After 1980, however, portfolio capital inflows into the United States, together with the hands-off policy of Washington after the Louvre Accord, kept the dollar far stronger than warranted by the country's industrial competitiveness, resulting in massive trade deficits every year until the present.

The strong dollar was not bad for those in finance, academia, the media, and other service occupations. But it was hugely negative for those in manufacturing and agriculture who had to compete directly with foreign producers. This group, made up largely of blue-collar workers, bore the loss of $41 trillion in income previously mentioned. Four decades later, it has grown large enough to send openly protectionist Donald Trump to the White House first in 2016 and again in 2024. Similar forces may have been at work in the United Kingdom—which lost 180 percent of GDP due to cumulative trade deficits—when the country voted itself out of the EU free-trade zone in 2016.

Protectionism, however, has historically had a devastating impact on world economic growth, as demonstrated in the 1930s when the Smoot-Hawley tariffs introduced by the United States reduced the value of world trade by 66 percent. In other words, replacing free trade with protectionism hurts everybody, including the protected workers and those portfolio investors who brought about this outcome. In order to save free trade, a solution must be found, therefore, to reduce the number of U.S. voters who consider themselves victims of an over-valued dollar.

WRONG ECONOMICS

The world is facing this problem now because four incorrect notions in economics have dissuaded American and other policymakers from taking necessary actions during the last thirty-seven years.

First, the economics profession has argued that while free trade creates both winners and losers within the same country, the gains of the winners are greater than the losses of the losers. In other words, there should be more winners than losers from free trade.

The profession never recognized, however, that for this conclusion to hold, trade must be in balance or in surplus. When—as in the United States during the past forty years—a nation runs massive trade deficits, free trade will produce far more losers than the theory would suggest.

The Two Options

Asian governments are faced with two options. One is to do nothing on the exchange rate and respond in kind, that is, retaliate against the Trump administration's protectionism. This is the trade war scenario that is already unfolding between the United States and China. The other option is for Asian governments to proactively push their exchange rates higher against the dollar so that the Trump administration will feel less need to push for more protectionism.

—R. Koo

Asian governments must take the matter into their own hands.

But because of this mistaken theory, it never occurred to Democrats and traditional Republicans that the losers from free trade might one day outnumber the winners. The arrival of Trump, however, proved that it can happen.

But these losers are not the victims of free trade as alleged by Trump. They are the victims of an over-valued dollar which produced the trade deficits. As mentioned earlier, other advanced countries such as Germany, Japan, Italy, and Canada that faced the same globalization challenges actually gained GDP from free trade and are not facing the kind of social divide observed in the United States today.

The second mistake is the notion, propagated by many prominent economists as well as by the Japanese government forty years ago and by the Chinese government more recently, that trade imbalances are just a reflection of which country is investing more and which country is saving more. According to this investment/saving balance view, Americans are simply investing and spending more than they save, while Asians and others who are doing the opposite are merely making up the shortfall. In other words, foreigners are providing what Americans cannot provide for themselves. Some of these economists even argue that, unless the American investment/saving balance is changed, there is no point in changing the value of the exchange rate.

But if the investment/saving balance theory is correct, American manufacturers who were competing with imports should have been operating at full capacity and profiting handsomely because demand for their products far outstripped supply. And there were, in fact, many American manufacturers of television sets, household appliances, and other goods until around 1980. But instead of prospering, most of these companies went bankrupt because they could not compete with imports given such a strong dollar. In other words, the investment/saving balance theory cannot explain what happened to American industry and its workers, but overvaluation of the dollar can.

Economists espousing the investment/saving balance theory also argued that smaller budget deficits were needed in order for the United States to reduce its trade deficit. But the country's trade deficit doubled during the four years from 1998 to 2001—a time when the United States was running budget surpluses—because the dollar strengthened sharply during this period.

GOVERNMENTS CAN AND HAVE MOVED EXCHANGE RATES

The third mistake is the notion that even if governments want to adjust the exchange rate, they will not be able to do so because the amount of funds they can mobilize to intervene in the foreign exchange market is tiny in comparison to daily trading volume. But those holding this view cannot explain how the G5 (later G7) central banks managed to cut the value of the dollar in half following the Plaza Accord of September 1985.

The Accord was put in place by the Reagan administration precisely to fight the protectionism that was engulfing the country as a result of the strong dollar. The call for protectionism in the United States at that time was so strong that only two American companies were said to be still in favor of free trade, Boeing and Coca-Cola. Everyone else was against it.

The Plaza Accord worked because central banks are the only players in the foreign exchange market that do not have to worry about making money. When the G5 central banks took the offensive, portfolio investors got scared because they are in the market to make money, not to prove how strong they are. Moreover, central banks seeking to push the currencies of surplus countries higher and those of deficit countries lower have potentially unlimited ammunition. As a trade deficit nation, the United States can print unlimited amounts of dollars to sell in the foreign exchange market to lower the value of its currency.

These considerations altered the risk/return calculations of investors and prompted them to square their positions in order to avoid confrontation with the central banks. For those who were betting on a strong dollar, the squaring meant selling the dollar and buying the yen or European currencies to neutralize their positions. And it was this selling by the investors that pushed the dollar in the direction sought by the central banks.

The Plaza Accord demonstrated that if central banks coordinate their actions and push currencies in the direction implied by trade balances, they can move exchange rates. It also proved that many U.S. trading partners are willing to accept unfavorable strengthening of their currencies because they understand that that is the correct way to save free trade.

Unfortunately, that was the last time U.S. policymakers actually implemented an explicit foreign exchange policy to defuse domestic protectionist pressures. Today, most economists and policymakers in Washington do not know or remember how the Accord was put together and how successful it was in reducing the trade deficit and saving free trade.

The fourth mistake is the notion that government intervention in the market should be avoided because it distorts resource allocation and breeds inefficiency. This notion is correct if there is free movement of all factors of production—including labor and capital—as is typically the case in a domestic economy. But this is seldom the case in international trade, where many factors of production are not free to move across national borders.

Furthermore, governments in 1980 not only liberalized cross-border capital flows but also allowed, with their "hands-off" policies, those flows to dominate the foreign exchange market. This means the role of the market was changed from that of equilibrating trade among countries to that of equilibrating the return on capital across countries. While the latter may have some benefits, it will take decades if not centuries to equilibrate the return on capital across countries.

In the meantime, the resultant strong dollar and the loss of a mechanism to balance trade have created huge U.S. trade deficits. The political backlash is now threatening the very survival of free trade. But if free trade is replaced with protectionism, the loss of efficiency and the resultant fall in return on capital for the American and the world economies would be absolutely devastating. There will not be much return on capital to equilibrate either, because all the countries will be facing severe economic downturns in the midst of an ugly trade war, and nationalist sentiment and fear in individual countries are likely to restrict cross-border capital flows under such circumstances.

The Plaza Accord, which saved free trade by halving the value of the dollar, caused no discernable disruption or distortion to the global economy.

In contrast, the Plaza Accord, which saved free trade by halving the value of the dollar, caused no discernable disruption or distortion to the global economy. The pick-up in the American inflation rate was also minimal. The Accord indeed proved that there is absolutely nothing sacred or optimal about the post-1980 "market-determined" exchange rates.

The above four notions dissuaded Washington from taking actions to correct dollar over-valuation. And that led to the $41 trillion in lost income for those Americans who

Continued on page 53

Continued from page 43

were competing with imports. But if the four notions had actually been correct, it logically means that protectionism is the only redress left for those who are hurt by trade. It is no wonder that a letter signed by sixteen Nobel Prize winners in economics failed to dissuade American people from voting for Trump. If what those distinguished economists preach is correct, people who are hurt by trade have no choice but to vote for Trump.

TWO OPTIONS

In view of the fact that Trump is fully committed to reducing America's trade deficit, and Asia benefited more from free trade than any other region, Asian governments are faced with two options. One is to do nothing on the exchange rate and respond in kind, that is, retaliate against the Trump administration's protectionism. This is the trade war scenario that is already unfolding between the United States and China. The other option is for Asian governments to proactively push their exchange rates higher against the dollar so that the Trump administration will feel less need to push for more protectionism.

As mentioned earlier, the rapid spread of protectionism in the 1930s reduced the value of world trade by 66 percent and devastated global economic growth. This means option one is in no one's interest, certainly not the Asian countries that have benefited so much from export-led growth. Asian governments must therefore consider the second option of exchange rate adjustment before the ongoing trade wars spin completely out of control.

If some sort of exchange rate adjustment is unavoidable, the most effective and the least disruptive adjustment for Asia will be for everyone in the region to move up together *vis-à-vis* the dollar. If every country in Asia moved together by the same amount against the dollar, only trade with the United States and Europe will be affected, not the entire intra-Asia trade.

The benefit of this approach is immense. First, Asian countries will be able to show a much larger currency appreciation against the dollar than if the same countries all faced appreciation challenges separately. For example, if Japan had to raise its exchange rate without knowing what China might do, Japan would be reluctant to see much appreciation in order maintain competitiveness versus China. The same will be true for China versus Japan. Such reluctance, however, would not solve the exchange rate issues these countries have with the United States. But if all Asian countries knew in advance that everyone's currency was appreciating in sync, they would be able to accept a much larger appreciation.

The second benefit is that for the first time, the burden of exchange rate adjustment will fall on American consumers instead of Asian exporters. Until now, Asian exporters could never raise prices in proportion to the appreciation of their currencies because they feared that doing so would result in a loss of market share relative to other

Donald Trump is not likely to lead exchange rate adjustments to save free trade.

Asian competitors who might not face the same exchange rate appreciation. Thus, Asian currency appreciations in the past typically squeezed only Asian exporters, with very little impact on trade imbalances.

But if all the currencies in Asia were to move up together against the dollar, Asian exporters would be able to raise prices more easily. That in turn should affect both consumer and producer behaviors in the United States and help reduce the ranks of those who consider themselves losers from free trade in that country.

DON'T WAIT

Ideally, the United States should be the one to lead this initiative, as it did during the Plaza Accord of 1985. But at that time, the country was led by President Ronald Reagan, a staunch free trader, who pushed the dollar down to save free trade from protectionist pressures at home. The policy negotiations were also led by pragmatic U.S. Treasury Secretary Jim Baker, a lawyer by training who was not bothered by the four silly notions in economics mentioned earlier.

President Joe Biden, on the other hand, spoke of the strong dollar as "our currency, their [other countries] problem." His Treasury Secretary, Janet Yellen, also indicated that market-determined exchange rates were the most desirable. These remarks demonstrated that the Biden administration would do little to address the plight of those suffering from the strong dollar and the resultant trade deficit. Democratic presidential candidate Kamala Harris also failed to indicate what she would do to help these people, and it was this fatal omission that led to her 2024 election loss in every battleground state to Trump, who championed the victims of trade deficits.

Donald Trump, the current president, is a staunch protectionist who thinks that tariffs are great not only for reducing trade deficits but also for increasing government revenue. Such a person is not likely to lead exchange rate adjustments to save free trade. (If there is any hope here, however small, it is the fact that Trump used to view Reagan as his hero. And it was Reagan who led the Plaza Accord that saved free trade.)

Many prominent U.S. economists have also espoused the four mistaken theories mentioned earlier. This means it is difficult for them to recognize that exchange rates matter and that governments can do something about those rates.

In view of the political reality in the United States, Asian governments must take the matter into their own hands instead of waiting for the Americans to come up with solutions to save free trade. Asian countries as a group may want to offer the collective currency appreciation initiative in exchange for Trump dropping his threat to raise tariffs. For instance, Asian countries might start the negotiation by offering a 15 percent appreciation of their currencies against the dollar in exchange for Trump not raising tariffs on their exports to the United States.

Such a negotiation will require Asian countries to come together and agree among themselves first, and that is not easy. But this approach is far better than waiting for the fickle and unpredictable Trump to come up with outlandish demands and individual Asian governments having to react to those demands on their own.

ALL TOGETHER NOW

The fact that the present proposal requires Asian countries to come together to confront Trump's demands may unify these countries toward a common goal for the first time in history. Unlike Europe, the Americas, or even Africa, Asia has been the least-organized region in the world for a long time. This is because the two power centers of the region, Japan and China, have been at odds with each other since the end of the nineteenth century. Furthermore, after World War II, the Japanese were neither willing nor able to take up a leadership role in Asia, and the Chinese were espousing a different economic system altogether. With no one acting as the center of Asia, the region remained fragmented, with no Asia-specific organization to bring the countries together. Even today, the relationships between Japan and China, or between Korea and Japan, are shaky at best. China and Taiwan are still technically at war, and there is no official channel of communication between Taiwan and Japan.

The trade imbalance problem with the United States, however, is common to all Asian countries. They all have huge trade surpluses with the United States, and are under pressure from Washington to reduce their surpluses. Thus, this is one issue where Asian countries should put aside their political differences and come together in the interest of saving free trade. The Americans cannot complain, because it was their failure to implement follow-ups to the Plaza Accord that is jeopardizing the free trade they themselves introduced to the world in the form of the General Agreement on Tariffs and Trade in 1948.

This author actually made a similar proposal in the early summer of 2004 to the Japanese monetary authorities. At that time, they found that proposal very interesting, but stopped short of pursuing it further because they felt the Chinese were not likely to join the proposal. The author also made the same proposal to the Chinese authorities, and they too indicated that, while the proposal made perfect sense, following the Japanese initiative was not to their liking.

Unlike Europe, the Americas, or even Africa, Asia has been the least-organized region in the world for a long time.

This time around, the pressure from the second Trump administration on both Japan and China to reduce their trade surpluses with the United States is likely to be many times stronger than the similar pressure from the Bush administration in 2004. In this new and far more difficult environment, it should be in the interest of both countries to appreciate their currencies together to avert trade wars and save free trade. And if these two power centers of Asia decide to work together on this initiative, Korea and Taiwan, together with many others, are very likely to join the camp. Indeed, if China wants to put an end to the full-fledged trade war that is now unfolding with the United States, this may be one of the few policy options it has.

If the Europeans want to join the proposal, they should be welcomed with open arms. The fact that they now have a single currency, the euro, is a big positive here. At the time of the Plaza Accord in 1985, Europeans had to come up with an elaborate arrangement to coordinate the movements of the Italian lira, the French franc, and the German deutsche mark within the system known as the EMS, or European Monetary System. This time around, it should be much easier.

A TECHNICAL NOTE

Still, there are a number of technical matters to be worked out. For one thing, the Japanese yen is a freely floating currency, while the Chinese renminbi is not. The fact that the yen is floating means it cannot move up exactly the same way as the renminbi or stay with the renminbi.

However, it is still possible for the Japanese monetary authorities to indicate that they will or will not intervene in the foreign exchange market until a particular level of exchange rate is reached. The same approach can be used by the Taiwanese and Korean authorities for their respective currencies as well.

As for the amount of appreciation, something on the order of 15–20 percent may be a good starting point for discussion. Anything less than 10 percent is probably not worth the trouble, and appreciation greater than 25 percent may appear too disruptive for the involved economies. As for the question of how the 20 percent should be measured for floating currencies such as the yen and the New Taiwan dollar, it is suggested that the average of the previous six or twelve months should be used as the starting point.

UNLIKE ANY OTHER MARKET

Portfolio investors and foreign exchange traders who are betting on a stronger dollar never think about how many American workers will lose their jobs as a result of their bets. But every one of those affected workers has a vote. And today, as already happened once in 1985, the market-determined strong dollar is producing enough voters to kill free trade, the very foundation of economic growth for countries all around the world.

The present challenge makes it clear that, after the liberalization of cross-border capital flows in 1980 which stripped the foreign exchange market of its role as a balancer of trade among countries, governments cannot afford to treat this market like any other market. Unlike stock or commodity markets, the foreign exchange market has direct impact on the welfare of millions of working people and the country's GDP through its influence on trade.

Because it is difficult to return to the world that existed before 1980, governments must use all means at their disposal, as they did during the Plaza Accord, to ensure that the market does not diverge too far from trade-equilibrating exchange rates. The goal of such policies should not be to balance every bilateral trade, which is impossible, but to make sure that the losers from free trade do not outnumber the winners, which should be attainable. The problem that was allowed to fester for nearly forty years cannot be corrected overnight, but the option of maintaining the "hands-off" policy of doing nothing on exchange rates no longer exists if free trade is to be preserved. ◆