The "Nixon Shock" and the "Plaza Agreement" : Lessons from Two Seemingly Failed Cases of Japan's Exchange Rate Policy

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Abstract

The Chinese exchange rate regime is under increasing pressure from the international community. Chinese authorities respond that the stability of the renminbi under the current exchange rate regime is good for the Chinese economy as well as for the global economy. In this context, two seemingly failed cases of Japan's exchange rate policy, namely the "Nixon Shock" in 1971 and the "Plaza Agreement" in 1985, may provide some lessons for our consideration of the issue of China's exchange rate policy.

I. Introduction

The Chinese exchange rate regime, a *de facto* dollar peg system, is coming under increasingly severe criticism from the international community including the U.S. and other G7 countries, who argue that the renminbi is significantly undervalued and the competitive advantage China gains from the undervaluation is hurting their industries. They also argue that the fixed exchange rate regime for the renminbi hampers the international adjustment process and at the same time, risks a loss of monetary control in China.

To this, the Chinese authorities respond that the stability of the renminbi under the current exchange rate regime is good for the Chinese economy as well as for the global economy. Although they admit that they might change the dollar peg in the future, they argue strongly that strict sequencing will be necessary to avoid any disruptive impact on the economy: first, the financial system and state-owned enterprises would have to be

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reformed; second, capital controls would have to be gradually relaxed; and, finally, the exchange rate regime may have to be made more flexible.

In this context, two seemingly failed cases of Japan's exchange rate policy, namely the "Nixon Shock" in 1971 and its aftermath, and the "Plaza Agreement" in 1985 and its consequences may provide some lessons for our consideration of the issue of China's exchange rate policy. Let me first describe the two cases in detail, then draw some lessons from them, and finally suggest a possible, medium-term solution for China.

II. The "Nixon Shock" and Its Aftermath

The famous "Nixon Shock" occurred on August 15, 1971, when U.S. president Richard Nixon unilaterally announced that the government would impose a 10 percent import surcharge and discontinue gold convertibility in view of the deteriorating U.S. balance of payments. But, the seed of this decision had been sown well before that event.

In the late 1960s, the German and the Japanese economies had increased their export competitiveness, while the U.S. economy had been mired in chronic inflation during the Vietnam War and the "Great Society" social reform. Since under the Bretton Woods system the U.S. was unable to devalue its currency apart from raising the official price of gold, which it was loath to do, it exerted pressure on Germany and Japan to revalue their currencies, but without noticeable success. Germany revalued only slightly and Japan never did, and the U.S. balance of payments continued to deteriorate, haunting the U.S. with the specter of the dollar overhang being suddenly converted into gold.

Toward the end of the 1960s, the Japanese economy became overheated, but unlike similar cases in the past, this time its current account was still in surplus. Perhaps at that time the yen was already significantly undervalued, and the currency should have been revalued in order to restore internal as well as external balance. But, the government was not prepared to do so, and the Bank of Japan tightened its monetary policy in the fall of 1969, thus exacerbating external imbalances. The government repeatedly relaxed capital outflow controls and further liberalized imports of goods and services during the period, but these measures were not sufficient to eliminate the upward pressure on the yen in the currency market. Then came the "Nixon Shock" of August 15,1971.

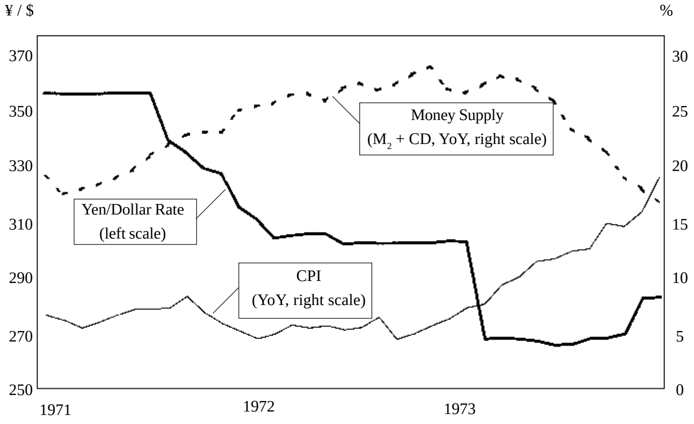
After the "Nixon Shock", the Japanese government temporarily resisted market pressures, but soon gave in by floating the currency. Immediately, the yen appreciated from the old parity of 360 yen to the dollar to 340, and it continued to strengthen, reaching 315 by the end of the year despite exchange market interventions. In order to counteract the deflationary impact of the yen appreciation, fiscal and monetary policy was relaxed.

Then, on December 18, 1971, after lengthy multilateral negotiations at the Smithsonian Institution in Washington D.C., it was agreed that the dollar should be devalued by 7.89 percent against gold, and most other currencies should be revalued against the dollar, with the yen being revalued by 16.88 percent, to 308 yen to the dollar. The extent of the yen's appreciation was much greater than generally anticipated and fiscal and monetary policy was further relaxed.

Even after the substantial appreciation of the currency, Japan's current account surplus continued to expand because of the "J-curve" effect. From the middle of 1972, the yen was stuck at the upper end of the band around 308 yen to the dollar, while the economy was gradually recovering. At that time, the Bank of Japan, trying to avoid another yen revaluation, further reduced its discount rate to 4.25 percent, the lowest in the postwar era, and the government introduced a large supplementary budget to further stimulate the economy. This was a fatal mistake because the money supply was already increasing by more than 20 percent, and the current account surplus had just started to decline. Yet, extremely loose monetary conditions were maintained, and an expansionary budget was compiled for Fiscal Year 1973. Despite these efforts, exchange rate stability was not restored, and the yen was eventually floated along with other currencies after the dollar crisis in February 1973.

By early 1973 inflation had started to accelerate, and the Bank of Japan raised the discount rate to 6 percent. But it was too late. The Consumer Price Index was soon rising to double digits, reaching 14 percent in September 1973, just before the oil crisis. The oil crisis exacerbated the hyperinflation, which would peak at 24 percent in 1974. In the

Figure 1. The movements of Japan's Money Supply, CPI, and Yen/Dollar Rate (Jan. 1971 Dec. 1973)



meantime, fiscal and monetary policy was sharply tightened immediately after the oil crisis, and the economy rapidly decelerated afterwards, recording negative growth in 1974 for the first time since the war. The Japanese authorities' long resistance to exchange rate flexibility from 1969 to 1972 had eventually resulted in hyperinflation in 1973-74.

III. The "Plaza Agreement" and Its Consequences

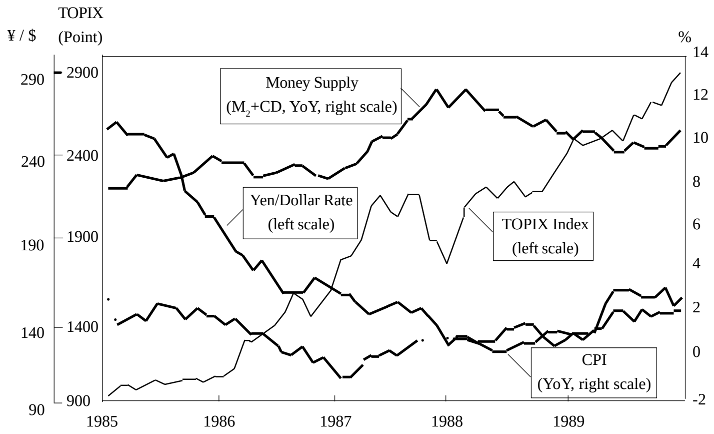
In the early 1980s, the U.S. economy had so-called "twin deficits”: the combination of a tight monetary policy to tackle double-digit inflation and a loose fiscal policy including huge tax cuts and increased military expenditure ("Reaganomics") had produced unusually high interest rates and strong dollar, and brought about a large government deficit and an equally large current account deficit. There were strong protectionist sentiments and movements among U.S. industries and Congress. By the mid-80s, other G5 countries had become exceedingly concerned about U.S. protectionism, such as the Super 301 and Omnibus Trade Bill, fearing it could jeopardize the multilateral trading system.

Then, on September 22, 1985 at the Plaza Hotel in New York, the G5 Finance Ministers and Central Bank Governors agreed that they would jointly intervene in the exchange market in order to depreciate the dollar, which was significantly overvalued. This decision to depreciate the dollar is the famous "Plaza Agreement". The dollar fell from around 240 yen to below 200 in three months, and continued to decline throughout 1986 till it reached 160 yen. Most G5 countries became worried about this huge depreciation, which had certainly not been anticipated by them. But the U.S. was not at all concerned about the weak dollar, as its economy was enjoying export-led growth.

The Japanese economy was greatly depressed by the sudden, sharp appreciation of the currency, and the authorities introduced a series of economic policy packages aimed at stimulating the economy. However, the economy did not respond to these stimulus measures under continuing uncertainty about the exchange rate. Following strong criticism from politicians and industrialists, the Japanese government negotiated with the U.S. government to stop any further depreciation of the dollar, and the final outcome was the "Louvre Agreement" reached by the G6 countries (Italy defected from the G7 at the last moment) on February 22, 1987 at the Louvre Palace in Paris.

Even after the "Louvre Agreement", the dollar continued to slide, but it was to gradually stabilize around 130-140 yen in the following years. The Bank of Japan reduced the discount rate four times in 1986, and further reduced it to 2.5 percent in

Figure 2. The movements of Japan's Money Supply, CPI, Stock Price Index, and Yen/Dollar Rate (Jan, 1985 Dec. 1989)



February 1987. The money supply was increasing rapidly, and the economy began to recover steadily in early 1987. And yet, prices were quite stable, even declining slightly in late 1986 and early 1987, reflecting the substantial appreciation of the yen.

In reality, however, the economy was becoming overheated by the fall of 1987; the trade surplus was declining fast and the asset prices, such as stock prices and land prices, were rising rapidly. Fiscal policy had already become tight thanks to the automatic stabilizer, and monetary policy should have been tightened too. Unfortunately, on October 19, 1987 the "Black Monday" crash occurred, and the Bank of Japan could not raise the discount rate. Commercial bank lending expanded, particularly to the real estate and construction sectors, while the money supply continued to increase by around 12 percent. It was only in May 1989 that the discount rate was first raised. But it was too late; the "bubble economy" was in full force by that time.

The Bank of Japan raised the discount rate five times by August 1990. Soon thereafter, the asset bubble burst: first, stock prices in 1990, and then, land prices in 1991. The economy began to slow down in early 1991. Fiscal policy was relaxed, and the discount rate was rapidly reduced from July 1991. But the sharp economic downturn coupled with severe asset deflation created huge nonperforming loans in the banking sector, and the long growth slump of the Japanese economy began, which has continued until now. The authorities' efforts to stave off any deflationary impact from the yen's appreciation in 1985-89 created a huge asset bubble, which subsequently burst, leading the long economic stagnation of the 1990s and early 2000s.

IV. Lessons from Two Seemingly Failed Cases of Japan's Exchange Rate Policy

Let me now turn to the lessons that can be drawn from two seemingly failed cases of Japan' exchange rate policy. In both cases, the yen appreciated substantially; after the "Nixon Shock", the yen appreciated against the dollar by around 35 percent in two years, and after the 'Plaza Agreement", by around 70 percent in three years. However, it was not the exchange rate appreciation *per se* but fiscal and monetary policy during the period that subsequently brought about the serious problems of hyperinflation and the asset bubble.

More specifically, in the case of the "Nixon Shock", the authorities resisted too long the inevitable exchange rate adjustment, making fiscal and monetary policy too expansionary, particularly in 1972, and preparing ground for hyperinflation in 1973-74. In the case of the "Plaza Agreement", the authorities allowed the yen to appreciate substantially and rapidly, but injected too much fiscal and monetary stimulus for fear of deflationary impact from the appreciation, particularly in 1986-88, thereby creating the huge asset bubble of the late 1980s.

I would also note that fiscal policy and monetary policy have different implications for the economy; fiscal policy while not very flexible has an immediate impact on economic activity, although not long lasting (except for the debt effect, which can be slow, negative, and long lasting); by contrast, monetary policy is very flexible but its effects, particularly on prices, are slow and last for a long time. Consequently, the mismanagement of monetary policy, which is likely to occur if there is a misguided perception of the exchange rate, will have disproportionately large and serious implications for inflation including asset inflation, as shown in these two cases.

The timing of policy action is also quite important; if the government had not stuck to the Smithsonian rate of 308 yen to the dollar and the Bank of Japan had raised its discount rate in 1972, the hyperinflation would have been largely avoided, and if monetary policy had been tightened in 1987 or 1988, the asset bubble would have been much smaller and manageable. Of course, it is much easier to make these judgments in hindsight.

Sometimes, it is argued that foreign pressure, particularly from the U.S., caused Japan to make mistakes in its exchange rate policy. However, as the two cases show, if anything, Japan resisted too long foreign pressure to revalue the yen in the early 1970s, and Japan, with other G5 (G7) countries, initiated the "Plaza Agreement" and the "Louvre Agreement" in the late 1980s. In reality foreign pressure was directed more toward fiscal and monetary policy, where major mistakes were actually made. After all, exchange rate issues are intrinsically international, and so must be subject to strict international surveillance (I would refer you to Article IV of the IMF Charter), while fiscal and monetary policy is basically domestic, and should not be influenced too much by external pressure. If Japan made any mistakes, it did so by acquiescing too easily to foreign pressure to relax fiscal and monetary policy.

V. A Suggestion for a Medium-Term Solution for the Chinese Exchange Rate Regime

The Chinese exchange rate policy is currently subject to increasingly severe criticism and pressure from the international community. This should be seen as quite natural in view of the international nature of the exchange rate and China's rapidly increasing share of world trade; whether the Chinese currency is significantly undervalued or not matters both for the Chinese economy and the global economy.

When the official exchange rate was unified with the market rate and devalued by about 30 percent against the official rate in 1994, the renminbi may have been already undervalued. And China's rapid growth of about 9 percent a year during the past ten years and its low rate of inflation since 1996 must have caused the currency to be significantly undervalued. Although economists are divided as to the extent of its undervaluation, the currency, at the current rate of 8.28 renminbi to the dollar, may possibly be undervalued on the order of 30-40 percent.

The Chinese authorities support the fixed exchange rate regime through extensive capital controls and massive exchange market intervention. In 2002, the current account surplus was about $35 billion but, it will narrow sharply in 2003 because of the overheating economy. However, the capital account will show a huge surplus, reflecting strong foreign direct investment of more than $50 billion and other capital inflows. Capital outflow controls could be relaxed, as Japan did in the early 1970s, though its impact at this juncture might be limited. The "leads and lags" through the current account could hamper the authorities' ability to control market pressure. Consequently, the authorities could be forced to further increase exchange market intervention, which has already resulted in foreign exchange reserves growing by nearly $80 billion in the first eight months of 2003.

The implications of ever increasing exchange market intervention will be twofold: on the one hand the authorities will face huge exchange risk in the future, and on the other hand they may lose monetary control. Japan in the early 1970s faced less of problem because capital mobility was limited at that time, but China's situation is much more difficult. The money supply is increasing by more than 20 percent, and real estate prices are rapidly rising, showing early signs of an asset bubble, although hyperinflation is unlikely at this time. It was only natural that the central bank recently raised reserve requirements for commercial banks. However, it is unclear whether the central bank can effectively sterilize exchange market intervention under the fixed exchange rate regime.

In order to avoid boom and bust cycles, hyperinflation, or a sudden, steep currency appreciation in the future, the Chinese authorities need to start exchange rate adjustment sooner rather than later with a medium-term strategy in mind. There are basically three ways to do so. One solution, advocated by such market fundamentalists as Larry Lindsay, is to immediately float the currency and abolish capital controls. This is quite risky because the exchange rate might greatly overshoot, hurting the Chinese economy. The second solution, suggested by many economists including Morris Goldstein and Peter Kenen, is to revalue the currency by 15-25 percent and peg it to a basket of major currencies that should include the dollar, the euro, and the yen. This is a safer option since capital controls would be retained; However, such a large revaluation might damage the Chinese economy in the short run and still be insufficient in the long run.

The third solution, which I would recommend, is to allow the renminbi to adjust upward gradually, perhaps by 7-10 percent annually at the most over the next several years. (If an up front revaluation of some 15 percent is made, then only a 4-6 percent annual appreciation would be needed.) Such a gradual adjustment could be realized through a wider band with occasional adjustments, frequent revaluations, or a crawling peg. I prefer the crawling peg system, but it is a technicality to be decided by the authorities. In any case, capital controls must be maintained in order to mitigate the interest parity condition. This gradualist solution may not be particularly easy to manage, but it would avoid any shock to the Chinese economy, and consequently to the global economy.

After the necessary exchange rate adjustment is completed, the renminbi could be floated with appropriate management to avoid excessive fluctuations, and capital controls could be removed step by step. At that time, China should participate in the G7 Finance Ministers and Central Bank Governors Meetings to jointly monitor the exchange market and cooperate as necessary. By then, the Chinese economy will have become much larger than the German economy and an integral part of the global economy.