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A Personal Account of the Plaza Accord of September 22, 1985

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Secretary Baker was an entirely different personality from Don Regan. He was a skilled and experienced lawyer, an outstanding political operator, and very good with people of all kinds. He was always remarkably well prepared for the many and diverse meetings required of a Treasury secretary and seemed able to read every situation in a way to achieve maximum results. In short, he exercised power judiciously but with maximum effect. The more subtle and thoughtful approach to G7 issues was apparent immediately.

In February and March 1985 the long-strengthening dollar spiked to its peak against the deutschmark and the yen. U.S. current account and trade deficits were reported at new historic high month after month. Strong growth in the U.S. economy and weak domestic demand growth in Germany and Japan, both of which were enjoying the export benefits of weak currencies, were feeding rising imbalances. Traditional U.S. manufacturing industries were being hit hard by the strong dollar, the term “rust belt” began to appear to describe the destructive pressure of an “overvalued” dollar on the manufacturing industries of the American Midwest, and protectionist forces gathered momentum in the U.S. Congress. Work began in Congress on an omnibus trade bill that promised the possibility of a comprehensive protectionist rtrade regime ostensibly to save U.S. jobs and to protect U.S. industry.

There were alarming developments for the administration and especially at Treasury, the keeper over many years of the U.S. commitment to free trade. Secretary Baker, who was sensitive to and well connected with members of Congress, immediately began to seek an effective means of strengthening macroeconomic policy cooperation with our major trading partners and in particular to bring about a more realistic alignment of global exchange rates to relieve the growing protectionist pressures in Congress.

This was not an easy challenge. Previous overbearing U.S. attitudes within the G5 had left a residue of resistance and resentment. Continued strong growth in the U.S. exacerbated the prospect for continuing, if not growing, imbalances, and Treasury's passion for free-floating exchange rates, namely, a policy of no intervention in currency markets, seemed to leave us with little room for creative ingenuity on the international economic policy front.

This is where knowledge of the functioning of markets, their capacity to read and anticipate changing trends, and finally their susceptibility to unexpected surprise becomes invaluable to a policymaker who understands the power of open markets. I was just such a person, and with undersecretary Beryl Sprinkel now removed to the president's Council of Economic Advisors, and with a new secretary and deputy secretary of Treasury who were both deeply sensitive to the forces at work in Congress, the field was open for a new U.S. strategy in the international economic policy area. The components of any such strategy aligned themselves in my mind as follows.

It was obvious to me that we had arrived at the point where the emerging global financial market I had seen developing during my years in Saudi-Arabia had now fully emerged. Despite this new reality, which could be seen every day influencing the world around us, the realities of a global financial market were not fully understood in Congress or in the political class generally. To put it in terms of stark simplicity, when Americans began a new day they did not check global exchange rate movements overnight before looking at prices in the U.S. stock market or other U.S. economic data. The Treasury, for reasons beyond my understanding when I arrived in early 1984, had closed down its foreign exchange desk. This meant that the Treasury was not a participant in foreign exchange markets. How, I wondered, could we expect to read foreign exchange markets if we were not a participant? How could we communicate with the market, or even send a message to the market, without the contacts and working knowledge provided by a full-time presence in the market. Even if we were not an active trader and were intent on convincing the market beyond all reasonable doubt that we would never intervene in markets to influence or "manipulate" the value of the dollar, why would we cut ourselves off completely from the market? Within the international area of the Treasury I found that we had neither in-house expertise on foreign exchange markets nor any significant institutional memory of that critical field of activity. Before long I had re-established Treasury's foreign exchange desk and asked Jim Lister, a bright young economist with an interest in the functioning of markets, to open an ongoing dialogue with the market.

In the first quarter of 1985, Europe suffered one of the its coldest winters on record, especially Germany. It was estimated that with construction activity in Germany near standstill in those freezing winter months that Germany would report a significant flattening of its already inadequate domestic-demand driven growth. It was this suppression of growth, which the market seemed to anticipate spilling into the second quarter's economic activity, that had driven the deutschmark to new lows against the dollar.

The yen peaked (reached a new low against the dollar) in April, a month or so behind the deutschmark. By May it could be said that the strengthening dollar had "overshot" any reasonable fundamental value, a statement that was based on market feel as much, if not more, than on fundamental economic analysis. When currency markets "overshoot", just as with any other market, speculative momentum, or herd behaviour, may well carry forward for some indeterminate period.

As the second-quarter economic data unfolded in Germany, it suggested that a strong rebound was taking place that was not being fully reflected in foreign exchange markets. This was how I read the market situation in early June when I wrote Secretary Baker a memo outlining a new and dramatically different strategy for the United States to address the over valuation of the dollar.

U.S. economic policy in the first Regan administration was strongly driven by the belief that freely functioning markets were the best allocator of resources and the truest determinant of value. I was in general agreement with this market-based approach to economic policy. Following the debilitating years of the Carter administration, this refocus on market-driven activity as opposed to heavy-handed micromanagement by government was a necessary and welcome change, which in its full range of policy adjustment and change had brought vibrant growth back to the U.S. economy.

I did not, however, share the ideology that markets were perfect and would at all times and in all circumstances bring about correct and sustainable valuations in the shorter run. The Treasury of Don Regan and Beryl Sprinkel maintained a purist commitment to non-intervention in foreign exchange markets. The slightest consideration of market intervention was interpreted as challenging this basic philosophy and revealing a sinister belief that exchange markets, and therefore currency alignments, could and should be manipulated by governments. Intervention in foreign exchange markets by governments would be both damaging and completely ineffective.

I shared the view that markets could not be manipulated by central bank intervention, Daily trading volumes were far too large in modern markets to be manipulated by government intervention with perhaps impressive but essentially inadequate resources. Over time, currency values would reflect underlying economic fundamentals. However, the time element was important to me, and likewise the fact that markets are influenced by short-term developments and are reflective of trends often before a trend can be seen. In my view, one could and should communicate with markets and get on the inside of market thinking as a practitioner, as opposed to being simply an analyst. I also believe it was possible to signal markets as to underlying developments, not to manipulate or direct the market, but possibly to change its focus and priorities. Sending messages or signals to a market by government is an extremely sensitive matter, and if it is to be done must be done infrequently, with great skill, and especially with the right timing.

Given these considerations, I developed a proposal for changing the markets' perception of the currently high valuation of the dollar. When Europe, and especially Germany, reported their second-quarter economic figures and moved into the third quarter with more expansionist expectations, a trend would begin to be formed. Strong U.S. growth could coexist with strengthening domestic demand growth in Europe and Japan. If this pattern were sustained into the future and currencies began to realign, there would surely begin to be some adjustment of the world's largest imbalances, which were driving the United States toward protectionist policies in the trade field that would very likely undermine prospects for world growth.

These trends would take time to materialize and become recognized as sustainable by markets. What was needed, in my view, was a message, preferably something of a "shock", to the markets that would significantly and immediately transform market psychology. If the United States was perceived to be in favor of these trends and willing to transform its previous ideologically driven attitudes that had undermined G5 cooperation efforts, the world would respond in due course to this more favorable prospect. More important, if this “message” could be conveyed in some dramatic form, backed up by firm evidence of this new policy cooperation, the effect might be achieved more quickly. If the message came in the form of a shock or very significant surprise, the effect might well be instantaneous. Changing the U.S. policy of many years’ standing not to intervene with other major nations in foreign exchange markets would provide a message that markets could not ignore, especially if we achieved the all-important element of surprise.

This was the game plan for the Plaza Accord of September 22, 1985. Work began among the G5 deputies in July 1095 to see how much progress we could make with our European and Japanese colleagues in obtaining or encouraging clear policy commitments for stronger growth. If the United States held out the possibility of cooperation action in exchange markets, which the other G5 countries had been pushing for over the past four years, we might well achieve a credible critical mass of policy commitments from all the G5 countries. The deputies met repeatedly throughout July, August and early September. It was long and exhaustive work, but for the first time, thanks to the practice, intellectual clarity, and political acumen of my G5 colleagues, I truly began to understand how complex, important, and hopeful the outlook could be if the U.S. could exercise its views more judiciously and with greater imagination. The necessary responses were never going to be all we hoped for, but the willingness to put commitments and expectations to paper for eventual public review was impressive.

Eventually, in September the critical mass of credible cooperative understandings was judged to be sufficient to lay the plan for a G5 finance ministers meeting at the Plaza Hotel at the time of the United Nations annual meeting and just prior to the annual meetings in Washington of the IMF and World Bank. The plan was shared on a “need to know” basis within the administration (a very small number of officials), and rigorous emphasis was placed on secrecy within the small G5 group of finance ministry and central bank officials. In the final weeks we negotiated the arrangements between us for intervention operations in the currency markets, setting the amounts each country was to provide as ammunition for these repeated interventions.

The Plaza Accord that September day in New York was the world’s best-kept secrecy. The element of surprise was complete, the market effect immediate and dramatic, and the judgments of the written policy undertakings and observations were seen as credible evidence of change in markets in the weeks that followed. So stunning was the effect on currency markets that only a modest amount of the war chest resources agreed for market interventions by the central banks were deployed in the days and weeks that followed. The fact that the dollar had begun to move off its peak of the late spring was sharply accelerated into the balance of the year and throughout 1986. Eventually, the dollar declined by something close to 40 percent from its high against the other major currencies. Cynics and ideologues insisted that the currency adjustment would have happened anyway without the Plaza Accord, but these people did not understand the vital dynamics of markets, the importance and timing of trend identification by markets, and the influence these would have on political attitudes for the prospect of better international policy cooperation. I knew we had administered a successful market shock and that while we would not control foreign exchange markets or manipulate them, we had nevertheless successfully communicated with markets and demonstrated a new direction that in fact strengthened cooperation over the next few years. I was not troubled by the contrary opinions. I had played enough football to recognize Monday morning quarterbacks. Most of them never won a ball game.

The Plaza Accord won a big breakthrough for stronger international economic policy cooperation among the major countries and for the global economy as a whole. The dollar continued its downward adjustment for the next year, at which point as concern grew that perhaps the adjustment had gone far enough, we then agreed on a plan to stabilize currencies within certain broadly understood ranges.

This meeting, which became known as the Louvre Accord, took place at the Louvre in Paris in February, 1987. It was memorable for two developments. One was the successful inclusion in the G5 Group of two additional members, Canada and Italy. The second development was an understanding in the now G7 Group that we would establish certain appropriate ranges for our respective currencies in foreign exchange markets. If our currencies moved outside the consensus range, the understanding was the national policies would need to be reviewed.

This could not be a formal agreement announced in detail to the world at large, nor could it be treated as an arrangement to control particular targeted exchange rates. We would be attached and tested by world markets if we set specific targets for exchange rates. Instead, we had established a general consensus about the value ranges that should be considered by our various central banks to encourage or even defend with joint intervention in markets as we moved forward. The chief value of this accord was that it focused attention on the desired policy objectives of each country, and while implying certain broad value ranges for currencies in markets, it did not provide precise, inflexible guidelines. All markets knew was that at the approximate but unconfirmed edges of these broad and flexible ranges there was a possibility of certain cooperative central bank intervention in markets. Importantly, because of the success of the Plaza Accord and its aftermath in financial markets, G7 cooperation enjoyed high credibility in world markets.

The exercise in cooperation from Plaza to Louvre and beyond contributed greatly to a significant reduction in global imbalances. By 1991 Europe’s surplus with the United States had all but been eliminated and Japan’s large surplus had been cut by approximately two-thirds. Ministers and central bank governors now listened to each other and took seriously the group effort to recognize that each country’s domestic policies had implications for the global economy and world markets that could not be ignored. Once again, there were many critics of global economic policy cooperation. My own assessment of our success, however, is that we made important progress in a difficult and uncertain world of interdependent sovereign nations, and that as a result the global economy was embarked on a sustainable course where conditions remained essentially benign for over a decade.