# Gavyn Davies

## Is there a new Plaza Accord?

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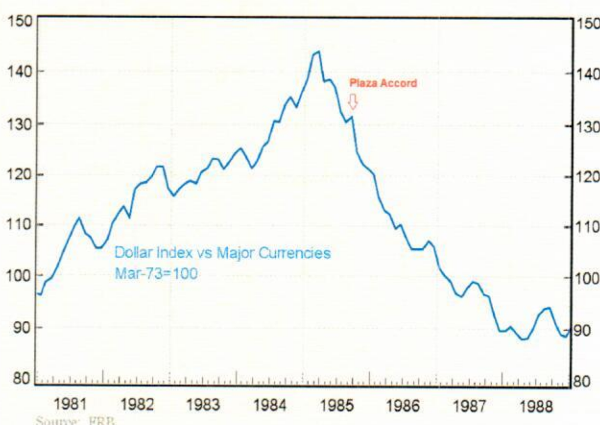
Foreign exchange traders are buzzing with talk of a new "Plaza Accord", following the marked change in the behaviour of the major currencies after the Shanghai G20 meetings in late February.

Since then, the dollar has weakened, just as it did after the Plaza meetings on 22 September 1985. The Chinese renminbi has been falling against its basket, in direct contrast with the "stable basket" exchange rate policy that was publicly emphasised by PBOC Governor Zhou just before Shanghai. The euro and, especially, the yen have strengthened, in defiance of monetary policy easing by the ECB and the Bank of Japan.

Following Shanghai, the markets have become loathe to push the dollar higher, believing that the G20 may now have come to a co-ordinated agreement, as they did at the Plaza, to reverse the direction of the US currency. Does this comparison make any economic sense?

The Shanghai communique did place increased emphasis on an agreement among the major economies to avoid "competitive devaluations". The main suspects here were Japan, the Eurozone and (sometimes) China, all of whom have good reasons to push their currencies down. The fact that the communique eschewed this course of action is therefore a reason to believe that the dollar might be subjected to less upward pressure. But that does not make it a new Plaza.

The 1985 Plaza Accord was probably the most dramatic coordinated intervention in the foreign exchange markets since floating currencies began in 1971. The dollar had been rising markedly for several years, largely as a result of Ronald Reagan's fiscal expansion, combined with Paul Volcker's monetary squeeze. By 1985, the rise in the dollar was widely agreed to have exceeded economic fundamentals, and most G7 governments thought there were speculative elements involved.




The strong dollar was at first warmly welcomed by the US Treasury, led by Treasury Secretary Donald Regan and Beryl Sprinkel, the Under Secretary for Monetary Affairs and the icon of free market currency policies at the time. But when the leadership of the Treasury passed to the much more pragmatic James Baker in February 1985, the US attitude began to change. The US manufacturing sector was being squeezed by the overvalued dollar, and Congress was seriously contemplating protectionist policies against Japan and Germany. Something had to be done.

The dollar actually started to fall in April 1985, many months in advance of the Plaza meeting itself. Earlier G7 meetings had discussed foreign exchange interventions, and the Bundesbank was believed to have sold dollars

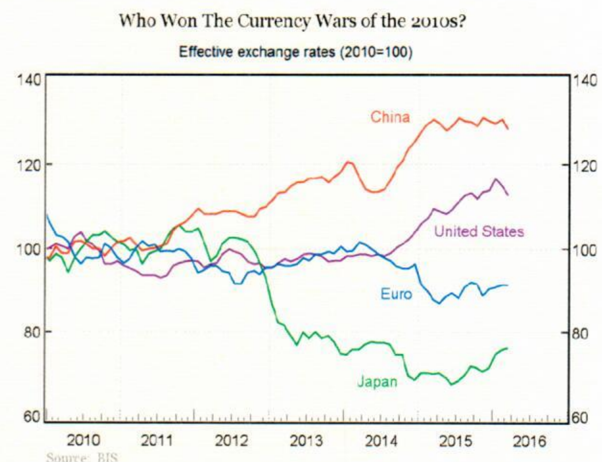
repeatedly in the spring. But it was only when the Plaza statement appeared in September that the slide in the dollar turned into a rout.

From start to finish, the international policy shift surrounding the Plaza meeting caused a 40 per cent decline in the dollar over a period of 3 years. It was the high water mark for co-ordinated global macro-economic policy, and for direct central bank intervention in the currency markets. (See this superb analysis of Plaza by Jeffrey Frankel at the Harvard Kennedy School.)

Could it happen again? At present, the formal agreements among G20 economies are predicated on two principles – no concerted intervention in the currency markets, and no deliberate attempts to engage in competitive devaluations. This does not seem to leave any room for a co-ordinated set of foreign exchange interventions to devalue the dollar.

Furthermore, there is no agreement among the major nations that the dollar needs to be devalued. It is not widely seen to be overvalued on fundamental grounds. Furthermore, in sharp contrast to 1985, when Germany and Japan were willing to accept rising exchange rates to head off US trade protection and dampen domestic inflation, there is no willingness anywhere in the G20 to accept a currency revaluation. Deflation pressures are too threatening for that, as Japan is now demonstrating.

There is a good case for arguing that, if there were to be a new Plaza Accord, it should be applied to the Chinese renminbi, not to the US dollar. China has been the main loser from the currency wars of the present decade. Its real exchange rate has risen by 40 per cent since 2010, while the dollar has risen somewhat and the other major economies have all depreciated sharply. Although there is no agreement that this has left the renminbi greatly overvalued (since it started in 2010 from an undervalued level) this rise has exacerbated deflationary pressures in China and left the currency in an unstable condition.




The global economy might benefit from a controlled downward float in the renminbi. This would puncture the exaggerated fears of uncontrolled Chinese devaluation in the global markets. But any such agreement seems completely off the international political agenda. In the US, no politician in an election year could contemplate any such thing.

So where does that leave the supposed Plaza Accord of 2016? There is no such thing, at least in a formal and explicit sense. And nor will there be. There is no consensus among the leading nations, either that the dollar needs to be pushed lower, or that the renminbi is overvalued. In an era of global disinflation, no country is willing to allow others to devalue.

However, it is possible that there has been a different form of accommodation, in which both China and the US Federal Reserve have independently decided that they have needed to adjust their strategy in response to the financial turbulence in January. One interpretation is that China seriously contemplated a major devaluation around the turn of the year, after experiencing difficulties in coping with the capital outflows that followed the Fed's rate hike on 15 December.

Having seen the international consequences of its initial rate rise, and the unintended tightening in US financial conditions that ensued, the Fed then decided that it could not persist with its intended pace of interest rate increases unless China stabilised its economy first. This was not so much an accord as an independent meeting of minds.

The effects of this meeting of minds on exchange rates will last only until the Fed reverts to its earlier determination to "normalise" interest rates for domestic reasons. That is unlikely to happen at the FOMC meeting on Wednesday, but it probably cannot be postponed for much longer.

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