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The IMF as Global Umpire for Exchange Rate Policies

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As a matter of logical necessity, an exchange rate involves two or more countries. The bilateral exchange rate of the Chinese renminbi against the US dollar, for example, necessarily involves both China and the United States, while the multilateral real effective exchanges rates of either China or the United States necessarily involve their exchange rates against an average of all their trading partners. For this reason, it follows that a country's exchange rate policy cannot be solely the concern of that country. China cannot unilaterally decide that eight renminbi should exchange for one US dollar while the United States simultaneously decides that one US dollar should exchange for four Chinese renminbi. Almost inevitably, controversies will arise when countries have inconsistent views and policies concerning the exchange rate that links their currencies and economies. This raises the question of how such controversies should be resolved, taking appropriate account of the interests of all countries.

This chapter presents the case for having the International Monetary Fund serve as the "global umpire" for exchange rate policies, with the key task of guarding against "currency manipulation."[1] The first section

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1. This chapter draws heavily on and extends the analyses presented in Goldstein (2004, 2005, 2006a) and my article "Exchange Rates, Fair Play, and the Grand Bargain," *Financial Times*, April 21, 2006. It also follows the line of argument laid out in my dinner speech on Currency Manipulation and IMF Reform, given in San Francisco on June 16, 2006, at the annual Pacific Basin conference, sponsored by the Federal Reserve Bank of San Francisco.

of this chapter explains why the issue of currency manipulation is particularly important and the second why it is attracting increasing attention. Next I outline the reasons for concluding that arguments denying the existence of currency manipulation, or maintaining that currency manipulation doesn't matter, or asserting that it should be tolerated, are misguided. Then I discuss the role of the IMF as the umpire for the exchange rate system. The final section lays out the steps that the IMF should take to discourage inappropriate exchange rate policies.

Why Currency Manipulation Is Important

When the IMF was established shortly after the end of World War II, its "founding fathers" were mindful of the unhappy experience with the competitive depreciations of the 1930s and 1940s and with the protectionist trade policy regimes of that period. They also recognized that it would be impossible to implement a desired watershed reduction in trade and payment restrictions without some assurance that there would be international safeguards against beggar-thy-neighbor exchange rate polices. Under the par value system then in force, these safeguards took the form of requiring IMF member countries to obtain the Fund's approval for proposed changes in exchange rates larger than 10 percent.[2]

When the Fund's charter was amended to accommodate the more diversified and more "flexible" exchange rate system of the early 1970s, the revised Article IV set forth obligations on exchange rate policy both for member countries and for the Fund itself. Specifically, members were directed (in Article IV, Section 1) to "avoid manipulating exchange rates or the international monetary system in order to prevent effective balance-of-payments adjustment or to gain unfair competitive advantage over other member countries." And the Fund was directed (in Article IV, Section 3) "to oversee the international monetary system in order to ensure its effective operation," "to oversee the compliance of each member with its obligations" (under Section 1), "to exercise firm surveillance over the exchange rate policies of members," and "to adopt specific principles for the guidance of all members with respect to those policies."

When the Fund in 1977 laid out principles and procedures for its surveillance over exchange rate policies, it identified a set of developments (originally thought of as "pointers") that might suggest the need for discussion with a country about its exchange rate policies. The first pointer on the list is "protracted, large-scale intervention in one direction in exchange markets." The other pointers address official or quasi-official borrowing, restrictions on trade and capital flows, monetary and domestic fi-

2. The Fund was to concur with a proposed change in exchange rates if it was satisfied that the change was necessary to correct a "fundamental disequilibrium."

nancial policies, and exchange rate behavior that appears unrelated to underlying economic and financial conditions. The basic idea of the pointers was to discourage policy actions that would either push the real exchange rate away from its equilibrium value or prevent the real exchange rate from moving closer to its equilibrium.[3]

The pointer on protracted, large-scale exchange market intervention was an obvious choice given the considerable difficulties in securing greater (nominal) exchange rate flexibility during the latter days of the par value system. It reflects a view that if large-scale exchange market intervention is taking place over an extended period and in the same direction, it is likely that authorities are seeking inappropriately to defend a disequilibrium exchange rate, be it an over- or undervalued rate. In other words, when the authorities' view of the right exchange rate is persistently under challenge by strong market pressure, one should give considerable weight to the market view that significant adjustment may be appropriate.

The pointers that cover official and quasi-official borrowing, trade and capital flow restrictions, and monetary and domestic financial policies are similar in spirit. That is, they were meant to discourage the use of policies (besides exchange market intervention) that might be used to substitute for a needed alteration in the exchange rate—particularly since these policy alternatives to exchange rate action could have adverse spillover costs on other economies. The inclusion of pointers in these areas was probably influenced by earlier efforts to mobilize such policies to delay needed exchange rate action during the Bretton Woods era and before. Their inclusion is also consistent with the position that the "equilibrium" real exchange rate should be defined with regard to a (theoretical) benchmark under which trade, capital, and financial policies are employed appropriately. In this connection, recall that Nurkse (1945) defined the equilibrium exchange rate as the rate that would produce equilibrium in the balance of payments but without wholesale unemployment at home or abroad, undue restrictions on trade, or special incentives to incoming or outgoing capital flows.

The final pointer on the list—exchange rate behavior that appears unrelated to underlying economic and financial conditions—was included to capture potential exchange rate misalignment under a floating exchange rate regime (a problem Fred Bergsten has stressed in some of his writings). It is different from the other pointers because it deals with market failure rather than policy failure and because it doesn't suggest an obvious policy antidote—except perhaps short-term coordinated exchange market intervention to give, if needed, the markets a nudge in the right direction.

Taken as a group, the pointers send the message that it is in neither the individual country's nor the international community's interest to seek to

3. In this sense, the IMF guidelines were similar in spirit to the proposals for "reference zones" recently reviewed by Williamson (2005b).

"manage" the exchange rate by heavy and prolonged reliance on exchange market intervention and sterilization operations and by manipulating restrictions on trade and capital flows.

A final historical note: The IMF's Articles of Agreement use the term "currency manipulation" to characterize inappropriate efforts both to push the real exchange rate away from the equilibrium rate and to prevent it from moving toward the equilibrium rate. Those who find the term "manipulation" misleading or too accusatory or dramatic for their taste can easily substitute "thwarting external adjustment" without loss of substance.

Why Currency Manipulation Is Important and Still Relevant

Despite the role assigned in the IMF's Articles of Agreement to IMF exchange rate surveillance in preventing currency manipulation, the issue has received little attention since two cases were considered in the 1980s. Accordingly, one may reasonably ask: Why is currency manipulation now of particular importance? There are three main answers to that question.

First, there is the problem of global payments imbalances, particularly the large US current account deficit—running at 6.5 percent of GDP in 2005 and on track to be about as large this year. The "sustainable" US current account deficit is probably no more than half as large (Mussa 2005, Cline 2005, Truman 2005, and Williamson 2005a). To get there at reasonable cost requires, among other measures, a further depreciation in the real, trade-weighted value of the dollar of between 15 and 35 percent.

But it will be difficult to achieve the needed further real depreciation of the dollar unless the Asian emerging economies and Japan—whose currencies have a combined weight in the Federal Reserve's dollar index of roughly 40 percent—participate prominently in the appreciation of nondollar currencies. If the dollar is to go "down," some other currencies have to go "up." Whereas the euro, the Canadian dollar, and the Australian dollar—among other market-determined exchange rates—exhibited strong real appreciations during the first wave of dollar depreciation (from the dollar peak in February 2002 until June/July 2006), many of the Asian currencies—including those of China, Japan, Malaysia, and Taiwan—did not;[4] indeed, some of them depreciated in real trade-weighted terms despite large current account surpluses.

If the Asian currencies do not lead the parade in the needed second wave of dollar depreciation, either the size of the overall dollar depreciation will be too small to promote substantial current account reduction in the United States or the appreciation of nondollar currencies will be

4. Two notable exceptions to this statement were the Korean won and the Indonesian rupiah.

skewed unreasonably toward those economies where economic circumstances would be poorly served by further large currency appreciation.[5]

Yes, the United States could and should make more of a contribution toward reducing its saving-investment imbalance by proposing a more credible medium-term plan of US fiscal consolidation, along with monetary conditions that would reduce the growth rate of domestic demand relative to that of output (Mussa 2005). But it's not an either-or choice. We need both more fiscal policy discipline in the United States and more currency appreciation in Asia. If we don't see the right amount of exchange rate adjustment, too much of the adjustment will fall on expenditure reduction in the United States, with adverse effects on growth in the United States and in its trading partners. And if we don't get appropriate fiscal and monetary policy action in the United States, there won't be enough room for the needed expansion in US net exports; instead, we will get increased inflationary pressures and higher US interest rates.

In short, an effective program of balance-of-payments adjustment requires use of both expenditure-changing and expenditure-switching policies. But if surplus countries use prolonged, large-scale, one-way sterilized intervention in exchange markets to prevent their currencies from appreciating, the expenditure-switching channel of external adjustment will be rendered impotent.[6]

A second reason for increased concern about currency manipulation is not only the recent occurrence of episodes that appear to represent departures from the IMF currency manipulation guidelines but also the fact that some of these involve systemically important economies.[7] The leading case in point is China—now the world's third largest trading nation and the second largest in terms of its GDP when calculated at purchasing power parity (PPP) exchange rates. The relevant facts about the Chinese case are as follows.

The Chinese authorities have been engaged in large-scale, one-way intervention in exchange markets for the better part of three years. The size and duration of that intervention have been dramatic—at roughly 10 percent of GDP in each of 2003, 2004, and 2005 (figure 13.1).

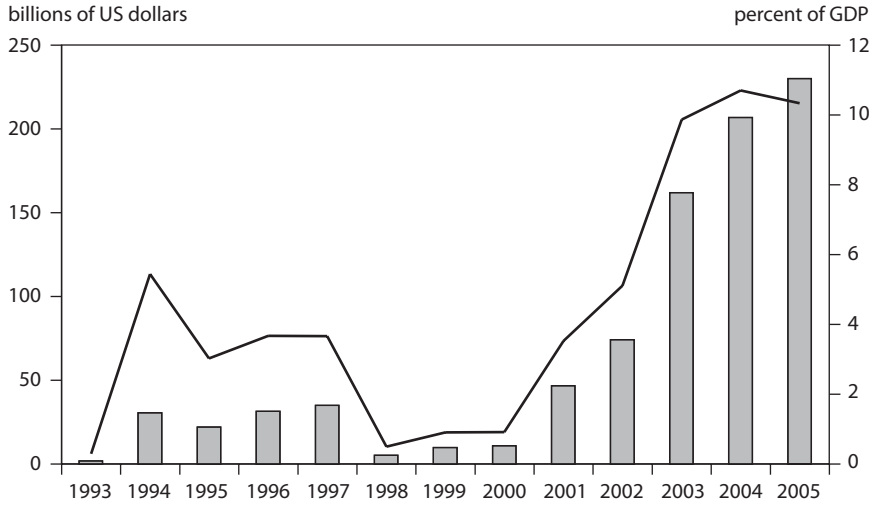
China's huge reserve accumulation has also coincided with a substantial increase in its global current account surplus—from approximately 2

5. As pointed out in Mann and Plueck (2005), a large share of the US current account deficit is in consumer goods and autos, import categories where Asian economies are large exporters to the United States.

6. In discussing the operation of the exchange rate system during the 1960s, Bergsten (1980) argued that the balance-of-payments adjustment process lacked symmetry because surplus countries were not willing to initiate the needed adjustment measures.

7. When we are dealing with exchange rate policies in systemically important economies (like China), the IMF's responsibility to "oversee the international monetary system in order to ensure its effective operation" comes into play—not just its complementary obligation to "exercise firm surveillance" over the exchange rate policies of its member countries.

Figure 13.1 Change in China's foreign exchange reserves, 1993–2005



Note: The bars show billions of dollars and the line tracks percent of GDP.

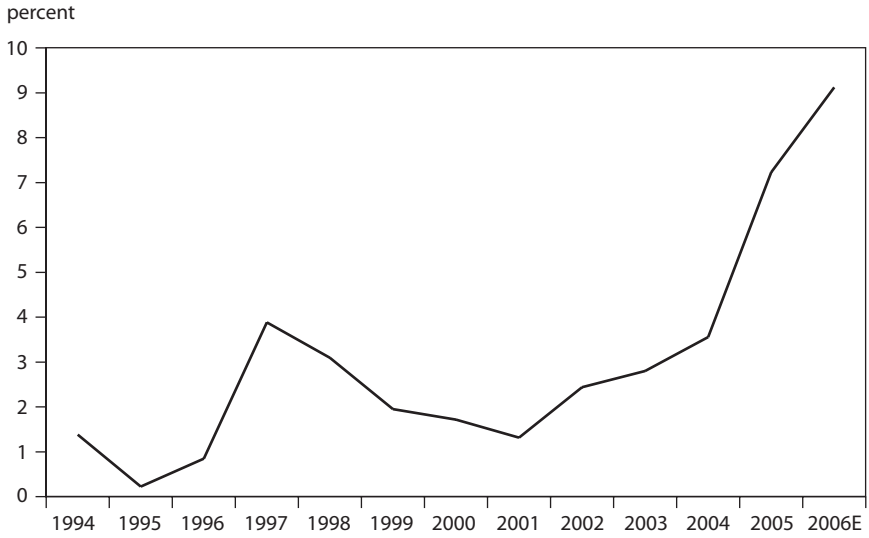
Source: China State Administration for Foreign Exchange.

percent of GDP in 2003 to 3.5 percent in 2004 and to over 7 percent in 2005[8] (figure 13.2). Although final current account figures for 2006 are not yet available, China's global trade balance surplus for the first six months of 2006 ran about 55 percent ahead of last year's surplus; a global current account surplus in the neighborhood of 9 to 10 percent of China's GDP looks likely for this year.

Despite these very large global balance-of-payments surpluses, the real trade-weighted value of the renminbi has actually depreciated on a cumulative basis since the dollar peak in February 2002; according to the index compiled by Citigroup, the cumulative real depreciation of the renminbi has been about 11 percent, while JPMorgan's index shows a smaller cumulative depreciation of about 2 percent (figure 13.3). True, the real, trade-weighted value of the renminbi went up in 2005, reflecting not only the real appreciation of the US dollar but also the real depreciations of the euro and the Japanese yen. But if one believes, as is the consensus view at the Institute, that the US dollar is likely to resume its decline in the period ahead—as the US interest rate–tightening cycle is completed earlier in the United States than in either Europe or Japan, and as the large US current account deficit exerts downward pressure on the dollar—then the renminbi will again follow the dollar down. In brief, not only has the real

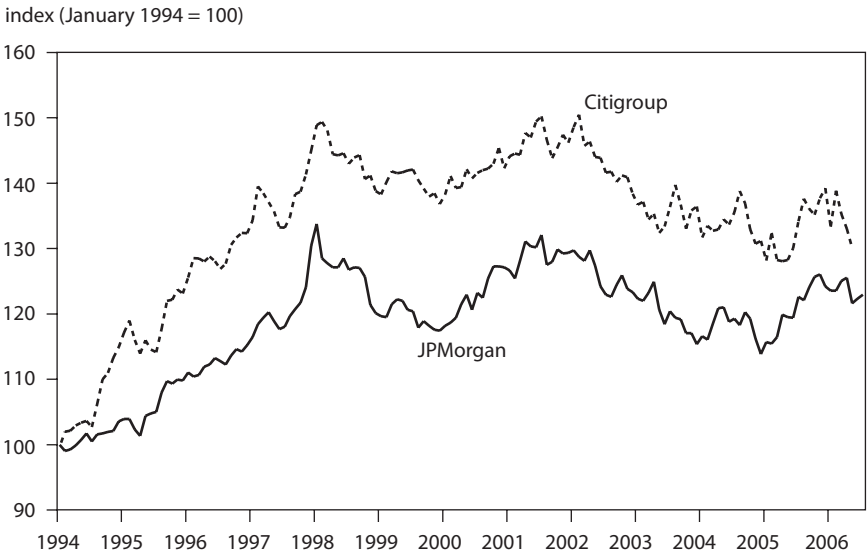
8. In 2003 and 2004 China's capital account surplus mushroomed and accounted for the largest part of the 10 percent of GDP reserve accumulation in those two years.

Figure 13.2 China's global current account position as a percent of GDP, 1994–2006E



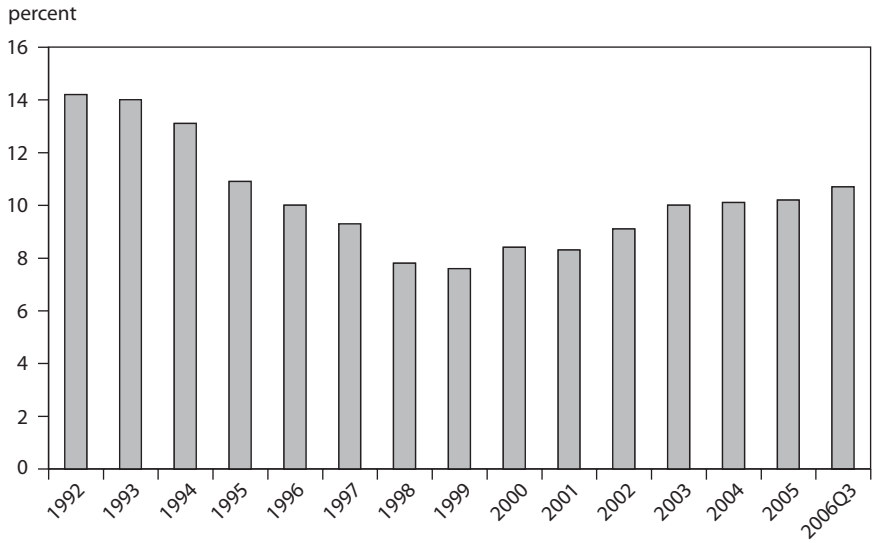
Source: China State Administration for Foreign Exchange.

Figure 13.3 Real effective exchange rate of the renminbi, January 1994–July 2006



Sources: Citigroup, JPMorgan.

Figure 13.4 China's real GDP growth, 1992–2006Q3



Sources: 1985–2005: *China Statistical Yearbook 2006,* p. 59, China Statistics Press; 2006Q3: National Bureau of Statistics of China, www.stats.gov.cn/index.htm.

exchange rate of the renminbi been moving in the wrong direction for most of the past three years but its misalignment could well get bigger unless more space is created soon between the renminbi and the dollar.

China's real GDP growth has been anything but weak during the 2002–05 period, averaging over 9 percent a year (figure 13.4). And during the first half of 2006, China's growth accelerated further, reaching 10.9 percent. As such, it's not persuasive to say that internal balance considerations militated against a renminbi appreciation.

China's "reform" of its currency regime in July 2005 has also so far done little to affect the renminbi's de facto behavior in exchange markets. Since the 2.1 percent appreciation of the renminbi with respect to the US dollar on July 21, 2005, the renminbi has appreciated vis-à-vis the dollar by roughly another 1.25 percent. This appreciation is small potatoes compared with the Goldstein-Lardy (2006) estimate that the renminbi is probably undervalued by 20 to 35 percent on a real trade-weighted basis and to Cline's (2005) estimate that it is undervalued by roughly 40 to 45 percent against the US dollar. At this pace, it could take a decade or more to eliminate the misalignment of the renminbi.

In July 2005, China also pledged to increase the influence of "market demand and supply" in the determination of the renminbi. But the Chinese authorities have continued to intervene by about the same massive amounts since then. Nor is there any evidence that China has been managing the renminbi with respect to a basket of currencies rather than to the

US dollar alone—thereby casting doubt on another of the key elements of the July reform (Eichengreen 2005).

While China is the most obvious and most serious case of currency manipulation, it is likely not the only episode. Malaysia, for example, has over the past several years displayed intervention, reserve, and real exchange rate behavior that appears to violate the IMF's currency manipulation guidelines. And in 2003 and the first quarter of 2004, Japan engaged in massive exchange market intervention; had that intervention continued, it certainly would have, given the accompanying circumstances, been a cause for concern. In the event, however, Japan ceased in mid-2004 intervening on a significant scale and has not resumed such operations.[9]

The worry of course is not simply with earlier episodes of apparent manipulation. It is that other economies will in the future come to the conclusion that they can benefit by using large-scale, prolonged exchange market intervention—together with sterilization of reserve inflows—to gain a competitive advantage on their trading partners.

The third reason for the increasing concern about currency manipulation is that there are preliminary signs—most evident in the United States—that it will be extremely difficult to sustain forward momentum on globalization and to resist protectionism if there isn't perceived "fairness" in exchange rate policy. As argued elsewhere,[10] the key long-term international economic challenge is to integrate further the larger emerging economies (China, India, Brazil, Russia, and some others) into the international financial and trading systems.

Both the industrial countries and the larger emerging economies should be pursuing a win-win "grand bargain." In this grand bargain, the larger emerging economies would get reliable access to the markets in industrial countries for their exports and their excess saving. They would also get increased "chairs and shares" in the international financial institutions consistent with their growing economic weight. In return, the industrial countries would get better access to fast-growing markets in the larger emerging economies as well as a commitment by the latter to play by the "international rules of the game" on trade, intellectual property, and exchange rates.

The catch is that this win-win bargain requires significant progress simultaneously on all the elements. If instead there is foot-dragging by any of the parties and if the designated umpires—the World Trade Organization (WTO) and the IMF—do not enforce the rules, then the game can descend into a lose-lose protectionist outcome.

9. Although it is not a member of the IMF, Taiwan's exchange rate policies over the past several years seem inconsistent with the Fund's currency manipulation guidelines.

10. Morris Goldstein, "Exchange Rates, Fair Play, and the Grand Bargain," *Financial Times*, April 21, 2006.

If, for example, certain emerging economies are perceived as having achieved large gains in market share unfairly via currency manipulation and if the IMF fails to investigate these charges, then the result may be national freelancing that would frustrate other elements of the grand bargain.[11] Likewise, emerging economies will not have the incentive to grant increased market access to industrial countries or to forgo regional alternatives to the IMF if the US Congress politicizes the approval of foreign investment plans in the United States (recall the China National Offshore Oil Corporation and Dubai Ports World cases) and if the industrial countries prevent the emerging economies from achieving a "fair" voting share in the IMF.

In short, codes of conduct on exchange rate policy may turn out over the next few years to be a necessary element in any wider proglobalization grand bargain, and IMF firm surveillance over exchange rate policies is likely to be the preferred approach to seeing that such codes of conduct are well designed and enforced. As with the WTO's role on trade policy, the most effective way to deal with high anxiety over alleged unfairness on exchange rate policy is to subject such charges to serious investigation and findings by a competent, unbiased global umpire.

Myths and Fallacies about Currency Manipulation

It is sad but true that not everyone agrees on the importance and relevance of the currency manipulation issue. This section summarizes the arguments of the skeptics as well as the reasons why their views are unpersuasive.

Fixed exchange rates can't be manipulated. Because the IMF's charter permits countries a wide choice of currency regimes (including fixed exchange rates) and because defense of a fixed exchange rate may require exchange market intervention, it is alleged that countries that maintain fixed rates cannot be guilty of manipulation.

This argument mixes up choice of currency regime with attempts to maintain a disequilibrium exchange rate. The former is allowed under IMF rules; the latter is not. IMF member countries can choose fixed rates, floating rates, or 'most anything in between; they are also free to intervene in exchange markets and indeed are expected to do so if and when they encounter disorderly markets. What is discouraged is a particular kind of intervention: large-scale, prolonged, one-way intervention in exchange

11. See, for example, the proposal by US Senators Charles Schumer and Lindsey Graham in early 2005 for a 27.5 percent tariff on China's exports to the United States if negotiations to end China's alleged currency manipulation did not bear fruit, or the more recent bill by Senators Charles Grassley and Max Baucus to deny an IMF quota increase and "market economy" status to any country found to be maintaining a "fundamentally misaligned currency."

markets. The latter is discouraged because it is regarded as symptomatic of a disequilibrium exchange rate that is assumed to be costly both to the home country and to its trading partners.

You can't be manipulating if you haven't changed the exchange rate. Since "manipulate" is an active verb, it is often argued that a country that has maintained the same parity over an extended period can't be guilty of manipulation because it "hasn't done anything."

This argument ignores the basic points that what matters for competitiveness is the real, trade-weighted exchange rate (that is, the trade-weighted nominal exchange rate, adjusted for cross-country differences in inflation performance) and that real exchange rate misalignment should be diagnosed against the backdrop of a country's overall balance-of-payments position. Viewed from this perspective, a misalignment of the real exchange rate could occur just as easily from nonmovement of the nominal exchange rate as from excessive movement; likewise, a given level of the nominal exchange rate might be fine when the country's balance of payments was in small surplus or small deficit but would no longer be appropriate when the balance of payments moved into persistent large surplus or persistent large deficit. Indeed, there are many cases of countries that started with reasonably valued pegged nominal exchange rates that subsequently saw their real effective exchange rates become substantially overvalued and their current accounts move into large persistent deficit. The outcome in these cases was often an eventual exchange rate crisis and a massive devaluation to correct the overvaluation. Although less frequently observed, it is obviously logically possible for a country with a pegged nominal exchange rate that is initially reasonably valued to find that its real effective exchange rate has subsequently become substantially undervalued with a large persistent current account surplus.

In 1995, China recorded a very small global current account surplus equal to 0.2 percent of GDP. By 2000, with an unchanged nominal exchange rate versus the US dollar, China's real effective exchange rate had appreciated by about 20 percent and the current account was still in modest surplus—indicating improvements in China's international competitiveness from sources other than the real effective exchange rate. By 2005, at a barely changed nominal exchange rate versus the US dollar, China's real effective exchange rate had depreciated by 7 to 15 percent from its 2000 level (depending on the exchange rate index), while the current account surplus had grown to over 7 percent of GDP. The evidence is clear that the combination of a pegged nominal rate leading to real effective depreciation together with continuing improvements in China's competitiveness from other factors led to a substantially undervalued real effective exchange rate. In short, "not doing anything" to the nominal exchange rate can thwart external adjustment and can thereby qualify as manipulation.

Undervaluation of the currency should be tolerated if it's necessary to ensure social stability. Yet a third fallacious argument is that the IMF should adopt a lenient approach to the currency manipulation guidelines for a country that purportedly needs an undervalued currency to generate enough growth and employment in its traded goods industries to keep the lid on social pressures.

But most countries have full employment objectives of one type or another, and it is difficult to see why or how some countries' concerns in this area should be elevated above those of others; should, for example, an extra worker hired in the export industry of China as a result of renminbi undervaluation be given more weight than an extra worker hired in the export industries of, say, Egypt or Bangladesh? Wholesale application of such an employment rationalization for currency manipulation would legitimize the beggar-thy-neighbor behavior that such international exchange rate guidelines were designed to prevent and that directly contradicts one of the fundamental purposes of the IMF stated in Article I, "to avoid competitive depreciation."

This is not to say that China, for example, with its large-scale migration out of agriculture and its recent history of significant employment losses in state-owned industries, does not face formidable employment challenges as part of its development strategy. But even there, the arguments that link exchange rate undervaluation with export-led growth and full employment are often exaggerated (Goldstein 2006b). In this connection, it should be recalled that between 1994 and early 2002 the real, trade-weighted exchange rate of the renminbi appreciated by almost 30 percent—yet the Chinese economy grew over this period at an average annual rate of about 9 percent and growth never dipped below 7 percent in any single year. Similarly, the appreciation in the real trade-weighted renminbi in 2005 did not prevent the value of China's exports from rising by 28 percent or its real GDP from growing by almost 10 percent. As highlighted in Anderson (2005), it is also well to note that employment in China's export industries accounts for roughly 5 percent of total employment, that China's high headline export-to-GDP ratio (35 percent) substantially overstates the value-added share of exports in GDP, and that empirical tests of export-led growth (such as correlations of net export growth with GDP growth) typically find that China's growth is much less "export-led" than growth in most other Asian emerging economies. As emphasized in Goldstein and Lardy (2004), net exports have a much lower weight (5 percent) in China's GDP than either government consumption (12 percent), private consumption (39 percent), or investment (45 percent); hence, net exports have a large effect on China's growth only in those years (e.g., 2005) when net exports change by a very large percentage. The lion's share of the time, it is investment and private consumption that lead and dominate China's economic growth.

Discussions of the impact of exchange rate changes should also not proceed as if the exchange rate were the sole instrument of macroeconomic policy. If there is concern that an exchange rate revaluation would have too negative an impact on economic growth, an option is to combine revaluation with an expansionary fiscal policy. In China's case, such an expansionary fiscal policy could be directed at its pressing social needs (pension, health, and education programs). In this way, the expenditure-switching role of the exchange rate can be retained while fiscal policy reduces the contractionary effect of revaluation on aggregate demand.

The effect of exchange rate changes on domestic financial stability should also be brought into the cost-benefit calculus. In the case of China, a much-undervalued renminbi contributes to excessive reserve accumulation, which, in turn, can spill over into excessively rapid expansion of bank credit and monetary aggregates. When bank credit expands too fast, the quality of loan decisions almost always suffers. China experienced just such a bank credit "blowout" in 2003 and the first part of 2004.[12] It was only through the use of both strong administrative controls (on bank lending, investment project approvals, and land use) and large-scale sterilization operations that runaway credit growth was contained. But the final tab for the lending excesses of 2003 and early 2004 is likely to be large (on the order of 15 percent of GDP), administrative controls and large-scale sterilization operations have their own costs, and bank credit growth has reemerged as a problem in the first half of 2006.

The de facto "fixed" nature of the renminbi currency regime has also of course limited the independence of China's monetary policy and in particular has greatly reduced the scope for using interest rate policy to rein in excesses in fixed asset investment.

In the end, one should not assume that currency manipulation is in a country's own interest—even if that country faces difficult employment challenges.

IMF guidelines on currency manipulation are not needed and will not be effective. This line of argument has a number of variants. One contention is that empirical research has demonstrated conclusively that sterilized exchange market intervention has no lasting significant effect on nominal exchange rates;[13] hence, there is no need for the prohibition on prolonged, large-scale, one-way intervention in exchange markets as such intervention will have little effect on exchange rates anyway. The rub is that while

12. Growth of the monetary aggregates also surged in 2003 and early 2004 and inflation rates moved up sharply for a time—contributing, inter alia, to a large fall in real interest rates. Control of the monetary aggregates again became an issue in the first half of 2006—even though inflation rates have so far remained relatively low.

13. See Jurgensen (1993); Sarno and Taylor (2001) provide more of a mixed verdict on the effectiveness of intervention.

this argument way well apply to sterilized intervention involving currencies regarded as close substitutes for one another (say, the dollar and the euro), it would not be applicable to many emerging-market currencies, which are not highly substitutable for the major reserve currencies. When it comes to emerging-market currencies (like the renminbi), there is a strong presumption that prolonged, large-scale, one-way intervention could have a significant effect on exchange rates (see Dooley 2006).

A related argument is that whatever their choice of currency regimes and whatever their interventions to affect the nominal exchange rate, countries will be able to exert little control over the real exchange rate, which after all is what matters for competitiveness. For example, a country that intervenes heavily in the exchange market in pursuit of an undervalued nominal exchange rate will eventually find that its inflation rate has risen sufficiently to restore the preintervention real exchange rate. The implication again is that IMF rules on currency manipulation are superfluous because countries will not be able via such operations to frustrate balance-of-payments adjustment or obtain an unfair competitive advantage over their trading partners. But the reality is that surplus countries can typically resist adjustment and can maintain a disequilibrium real exchange rate for longer than deficit countries. In China's case, for example, the authorities have over the past few years used large-scale sterilization operations and strong administrative controls to prevent inflation rates from rising to levels that would wipe out the real undervaluation of the renminbi; as such, the real, effective exchange rate of the renminbi has depreciated on a cumulative basis since early 2002 despite China's large balance-of-payments surpluses. If it were agreed internationally that countries engaging in large-scale exchange market intervention would refrain from sterilizing the effects on domestic monetary aggregates, then there would be a weaker link between nominal and real exchange rate movements than has in fact been the case. But obtaining agreement on and enforcing international guidelines on sterilization policy are likely to be even more difficult than for currency manipulation. In short, experience suggests that some surplus countries can, for several years if not longer, prevent the real exchange rate from adjusting much toward its equilibrium level, with adverse consequences for their competitors as well as themselves.[14]

Another claim one hears frequently is that citing countries as "currency manipulators"—be it by the Fund or by the US Treasury—would be counterproductive. The accused would "lose face," harden their positions, and delay reform; and a finding of currency manipulation might even induce

14. In support of this conclusion, Cashin and McDermott (2006) find that, for a sample of 90 industrial and developing countries, the half-life of deviations from purchasing power parity (PPP) is on average three to five years. Interestingly enough, they also report that departures from PPP tend to last longer for developing than for industrial countries and that they are also longer for countries with fixed nominal exchange rates than for those with flexible rate regimes.

the US Congress to adopt protectionist trade legislation. Again, this argument is not persuasive.

It is curious that the alleged link between external criticism and lack of policy reform in the accused country seems to be peculiar to exchange rate policy. The US government, for example, does not refrain from criticizing China's human rights abuses or its military buildup for fear that doing so will slow progress. Similarly, why does it make sense for the US government to bring complaints before the WTO on Chinese trade policy and to press publicly and loudly for better protection of intellectual property rights in China but not to enforce its own guidelines on currency manipulation?

Moreover, whatever might be the effectiveness of US government efforts to persuade China to adjust its exchange rate policy to conform with international norms, would it not plausibly be more effective for the IMF to press for the same policy adjustment on behalf of, and with the support of, most of the international community? Surely there can be no valid objection from the Chinese authorities to the IMF performing tasks that are assigned to it and that its members are committed by their own agreement to support.

The IMF as Umpire for the Exchange Rate System

The discussion above establishes the need for someone in the international community to play the role of establishing and enforcing a reasonable code of practice with respect to exchange rate policies. The IMF is clearly the institution that has been assigned that role—and properly so. The problem in practice has been that neither the IMF nor its major shareholders have shown much interest in ruling on what is and is not internationally acceptable exchange rate policy, and without enforcement no code of conduct can be expected to have much impact on behavior. Several observations are revealing.

Although the Fund's surveillance guidelines allow the IMF managing director to initiate an ad hoc or special consultation with a member country whenever there is concern about its exchange rate policy, only two such special consultations have been conducted in the past 26 years (Sweden in 1982 and South Korea in 1987) and none at all in the past 19 years.

Despite overwhelming evidence of renminbi misalignment for the 2003–06 period, it took the IMF more than three years to acknowledge publicly that the renminbi needed to appreciate. Before that, the Fund was willing to conclude only that China's currency regime needed to show "greater flexibility." Even today, the Fund has still not given any indication of the order of magnitude by which the renminbi is undervalued.

In the absence of IMF action on apparent cases of currency manipulation, activities by national governments have to some extent, and not particularly effectively or desirably, filled the gap. In particular, the US

Treasury has been required, since the passage of the Omnibus Trade and Competitiveness Act of 1988, to report twice a year to the US Congress on whether any countries are manipulating their exchange rates. The implicit analytical framework involved in making such a determination appears to have been based broadly on the IMF's exchange rate surveillance guidelines. In the early 1990s, several Asian economies, including China, were designated as currency manipulators, but no country has been cited for manipulation since the mid-1990s.

During the past three years, however, the Treasury's reports have become increasingly critical of China's exchange rate policies. For example, the May 2005 report (US Treasury 2005) found that China's (economic) policies were highly distortionary and posed a risk to China's economy, its global trading partners, and global economic growth. The report went on to warn that "if current trends continue without substantial alteration, China's policies will likely meet the statute's technical requirements for designation" as a currency manipulator; as suggested earlier, trends in China's exchange rate policies over the next year did in fact "continue without substantial alteration," but Treasury opted not to cite China for manipulation. In the May 2006 report, former US Treasury Secretary Snow admitted that "we are extremely dissatisfied with the slow and disappointing pace of reform of the Chinese exchange rate regime" but argued that he didn't have sufficient evidence to conclude that China was operating its exchange rate system with the intent of either preventing effective balance-of-payments adjustment or gaining an unfair competitive advantage in international trade. In a recent paper (Goldstein 2006c), I have characterized the US Treasury's policy toward China's currency manipulation as "whine, whine, huff and puff, but then decline" to indict.

Probably partly out of frustration with the ineffectiveness of unilateral efforts, the US Treasury has turned back to the IMF, which, however, has not proved very fruitful. In interviews given during 2005, IMF Managing Director Rodrigo de Rato[15] put forth the view that the Fund should not be a "special pressure group" for changes in country policies. The question of how the Fund could exercise firm surveillance over exchange rate policies and induce corrective action—without pressure—in cases where countries have apparently violated the currency manipulation guidelines is not answered.

Over the past year or so and in the resurgent debate about IMF reform, the IMF's passivity and lack of ambition on the exchange rate policy front has finally begun to attract some unprecedented criticism. In September 2005, Tim Adams, undersecretary for international affairs at the US Treasury, lamented that "the perception that the IMF is asleep at the wheel

15. See Leslie Wroughton, "Under Fire, IMF's Rato Wants to Get the Job Done," Reuters, July 29, 2005; Daniel Altman, "IMF Chief Draws Fire over Style as Leader," *International Herald Tribune*, July 27, 2005.

on its most fundamental responsibility—exchange rate surveillance—is very unhealthy for the institution and the international monetary system" (Adams 2006, 135). In February 2006 Mervyn King, governor of the Bank of England, warned that the IMF could "slip into obscurity" if its mission was not examined and the institution revitalized; also, in discussing the Fund's role as an "arbiter" of the international monetary system, he expressed the hope that "the players might in time come to realize that most games improve when played according to a clear and agreed set of rules."[16] And in March 2006, Bank of Canada Governor David Dodge argued as follows:

> Let me start with the so-called umpire role. This is one area where the IMF has consistently fallen short of the mark. Too often, surveillance has shied away from the "ruthless truth-telling" that Keynes—one of the main architects of Bretton Woods—called for. Instead of making the tough calls about the rules of the game, the IMF has sat in the umpire's chair and simply asked the players whether they thought that their shot was in or out. This needs to change.[17]

At the Fund-Bank meetings in April 2006, de Rato acknowledged that the Fund should step up its exchange rate surveillance. In addition, it was agreed at those meetings that, in an effort to make greater progress on reducing global payments imbalances, the Fund would initiate a set of "multilateral consultations' with some of the larger players (the United States, the European Union, Japan, China, and Saudi Arabia). Nevertheless, de Rato remained adamant that the Fund should not seek to serve as an "umpire" for the exchange rate system—maintaining that the umpire function would conflict with the Fund's role as a "trusted adviser" to its member countries.[18] I couldn't disagree more.

The facts that emerging economies, particularly those in Asia, have over the past five years been building up international reserves hand over fist and that the Fund's largest debtors have been paying back the Fund ahead of schedule—in part because they want in the future to be less subject to IMF policy conditionality—hardly seems consistent with the claim that the Fund's policy advice is highly "trusted" in all corners. Nor is it apparent

16. Mervyn King, Reform of the IMF, Speech to the Indian Council for Research on International Economic Relations, New Delhi, India, February 20, 2006. Not surprisingly, this view is widely shared at the Institute; see C. Fred Bergsten, Reform of the International Monetary Fund, Testimony before the Subcommittee on International Trade and Finance, Committee on Banking, Housing, and Urban Affairs, June 7, 2005 (Washington: US Senate); and Morris Goldstein and Michael Mussa, "The Fund Appears to Be Sleeping at the Wheel," *Financial Times*, October 3, 2005.

17. David Dodge, The Evolving International Monetary Order and the Need for an Evolving IMF, Speech before the Woodrow Wilson School of Public and International Affairs, Princeton University, March 30, 2006.

18. Rodrigo de Rato, A Call for Cooperation: What the IMF and its Members Can Do to Solve Global Economic Problems, Speech at the Institute for International Economics, April 20, 2006.

why the role of "trusted adviser" should conflict with the role of exchange rate umpire unless the Fund were giving countries advice on exchange rate policy that violated its own currency manipulation guidelines.

And to the extent that the two roles do conflict, why is not the umpire role the important one? After all, the IMF's Articles of Agreement do endow the Fund with responsibility for firm surveillance over exchange rate policies but contain no corresponding requirement for the Fund to be a "trusted adviser." Most games have two teams, two coaches, and at least one umpire—not two teams, three coaches, and no umpire. de Rato seems to want the Fund to be another coach, but what is needed is an umpire—a role that only the IMF can play successfully.

As hinted earlier, if the IMF does not carry out the umpire role by exercising firm surveillance over countries' exchange rate policies, two undesirable things may happen. First, national legislatures may increasingly be tempted to make and enforce their own laws on currency manipulation, leading to more politicized analysis of exchange rate policies and possibly to more protectionist trade policies for alleged violators. Second, more and more economies may be tempted to take advantage of the de facto free-for-all on exchange rate policy by pursuing undervalued real exchange rates via large-scale, prolonged, one-way intervention in exchange markets, combined with large-scale sterilization operations. This would be a volatile mix that is unlikely to be compatible with maintaining forward progress on globalization and protecting open markets for trade and investment.

Initiatives for Discouraging Currency Manipulation

If the Fund is to reclaim its mandate to exercise firm surveillance over exchange rate policies, it will need, among other tasks, to get serious about investigating and discouraging currency manipulation. Although the Fund already has the mandate and the tools to do this, its efforts would be more effective if it undertook the following initiatives and actions.

To begin with, the Fund staff should begin issuing a semiannual report on exchange rate policies, both to discuss exchange rate developments of interest and to identify potential cases of currency manipulation. This report would cover both industrial and developing countries (including of course emerging economies), and it would hopefully contain the best objective analysis of exchange rate polices that the Fund can muster. Important input for this report could be obtained from the regular and confidential briefings on exchange rate policies presented quarterly to the Fund's Executive Board by the IMF economic counselor; these briefings (called WEMD sessions) should include, among other elements, the staff's preliminary identification of cases where real exchange rates seem to be seriously misaligned as well as a discussion of country policies that appear to be contributing to misalignment. To give the published Fund report greater

authority, the US Treasury should use it as the basis for Treasury's findings on currency manipulation in the US Treasury's biannual *Report to Congress on International Economic and Exchange Rate Policies*. This would stand on its head the recent unsatisfactory practice where the evaluation of potential currency manipulation cases has been contained in the US Treasury report, with only a sentence or two reference as to whether the Fund concurs with Treasury's findings (and without any IMF report on the issue). The rest of the G-7 should also signal their support for the Fund's stepped-up surveillance over exchange rate policies by inviting the Fund to be a full and active participant in discussions of exchange rate policies during G-7 meetings. Over time, a case law would develop that would help define what is and is not internationally acceptable exchange rate policy.

The Fund should revive its special consultation tool by conducting consultations whenever another country or Fund staff has a strong concern about potential currency manipulation. Such special consultations should occur only after it becomes clear to the Fund's managing director—based on initial confidential meetings with the parties involved—that resolution of the issue requires further information and investigation. Since these special consultations are apt to take place infrequently and are likely to focus on a specific set of issues related to exchange rate policy, special consultations will probably most often be separate from both the Fund's normal Article IV consultations and the new "multilateral" consultations. Such special consultations would give the country involved a good opportunity to defend its currency policy and to explain what extenuating circumstances may have been involved in its use of, say, large-scale, prolonged, one-way intervention in exchange markets. The dialogue and information obtained in these special consultations would also serve as an essential input to the section of the Fund's semiannual report on exchange rate policies that deals with currency manipulation. If, after a special consultation, the Fund continues to believe that a member country is not complying with its obligations on exchange rate policy, the Fund can and should, subject to a 70 percent majority in the Executive Board, issue a published report criticizing the country's exchange rate policy. Although it would not likely ever come to that, prolonged noncompliance with the exchange rate policy obligations set forth in the Articles of Agreement could result in a country's expulsion from the Fund.

Finally, the Fund should review its existing guidelines for surveillance over exchange rate policies to determine if any changes are warranted. The existing guidelines are reasonable, but it is certainly possible that they can be improved. Emerging economies should participate fully in this review so that their concerns are reflected, inter alia, in the set of "pointers" used to signal potentially inappropriate exchange rate policies. It is important, however, that this review not serve as a lengthy excuse to avoid investigating current currency manipulation cases; the existing guidelines should be enforced while the review is going on.

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