4

Review of the Reports

The US Treasury has submitted 35 reports during the nearly 20 years since the Exchange Rates and International Economic Policy Coordination Act of 1988. The reports might be assessed by at least three standards. The narrowest test would be whether the reports meet the content requirements of the 1988 Act. A second test would be whether the reports provide the basis for informed oversight by Congress, including information that is not already openly available or at least has value added by virtue of its presentation or analysis. The broadest test would ask whether the reports address policies and problems that the markets, the public, and Congress care about.

This book is concerned with all three standards, so this chapter takes a broad approach and examines the reports' treatment of important questions confronting international monetary policy in general: early findings of manipulation, the Mexican peso crisis of 1994–95, the Asian financial crisis of 1997–98, the Economic and Monetary Union (EMU) in Europe, Japanese intervention in 2003–04, fiscal policy, and Chinese exchange rate policy during 2000–07. The chapter finds that, while the reports technically satisfy most of the content requirements of the 1988 Act, they are incomplete as a basis for oversight and often overlook major policy questions.

Appendix table 4A.1 provides a comprehensive overview and summary of the Treasury reports. Figures 4.1a and 4.1b present the exchange rate of the dollar against the Deutsche mark/euro and the Japanese yen over the period, respectively, while figure 4.2 shows the nominal and real effective rate of the dollar and figure 4.3 presents the US current account balance.

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Findings of Manipulation, 1988–94

In its first report, in October 1988, the Treasury Department found that Korea and Taiwan manipulated their exchange rates and announced that it would initiate negotiations with those countries. Both governments had resisted the rise of their currencies against the dollar and allowed only modest appreciations in real effective terms after the Plaza Accord (figures 4.4a and 4.4b). C. Fred Bergsten and then Assistant Secretary of the Treasury for International Affairs David C. Mulford had advocated appreciation of these currencies in 1986 and 1987, respectively, supported by analysis by Bela Balassa and John Williamson (1987, 1990). By 1988, these countries showed large increases in current account and bilateral trade surpluses. (See figures 4.5a and 4.5b for current account balances and figures 4.6a and 4.6b for trade balances.) They also maintained capital and exchange controls.[1]

Treasury's formal designation of Korea and Taiwan for manipulation came at a time when the United States was pressing trade partners for market access quite aggressively. One instrument being used toward that end was the separate provision of the Omnibus Trade and Competitiveness Act of 1988 called "Super 301." It is worth noting that congressional oversight hearings directly linked the exchange rate and Super 301 negotiations (US Senate 1989). Pressure on trade policy strengthened Treasury's bargaining position on exchange rate matters. Both countries also had an unusual relationship with the United States on military security, and neither could afford to jeopardize those ties. Accordingly, both Korea and Taiwan acceded to negotiations and allowed further modest appreciation of their currencies against the dollar after the October 1988 report (figures 4.4a and 4.4b).[2]

Taiwan had run an overall current account surplus of 18.5 percent of GNP in 1987 and, although appreciation that year improved the bilateral trade deficit during 1988, the New Taiwan dollar had not appreciated during January–September 1988, and Treasury expected Taiwan's external surpluses to reemerge (figure 4.5b). When citing Taiwan, Treasury also noted capital and exchange controls, particularly on capital inflows,

1. In testimony to the Senate Finance Committee in the spring of 1989, Bergsten and Williamson criticized the manipulation designation, arguing that by then the appreciation of the New Taiwan dollar and the Korean won had been sufficient to produce adjustment. See C. Fred Bergsten, statement before the Hearing on Currency Manipulation, Subcommittee on International Trade, Committee on Finance, United States Senate, Washington, May 12, 1989; and John Williamson, statement on exchange rate policy in Hong Kong, Korea, and Taiwan before the Hearing on Currency Manipulation, Subcommittee on International Trade, Committee on Finance, United States Senate, Washington, May 12, 1989. See also GAO (1989).

2. Kim (1993) and Wang (1993) argue that US pressure was important in producing this outcome. See also Mo and Myers (1993).

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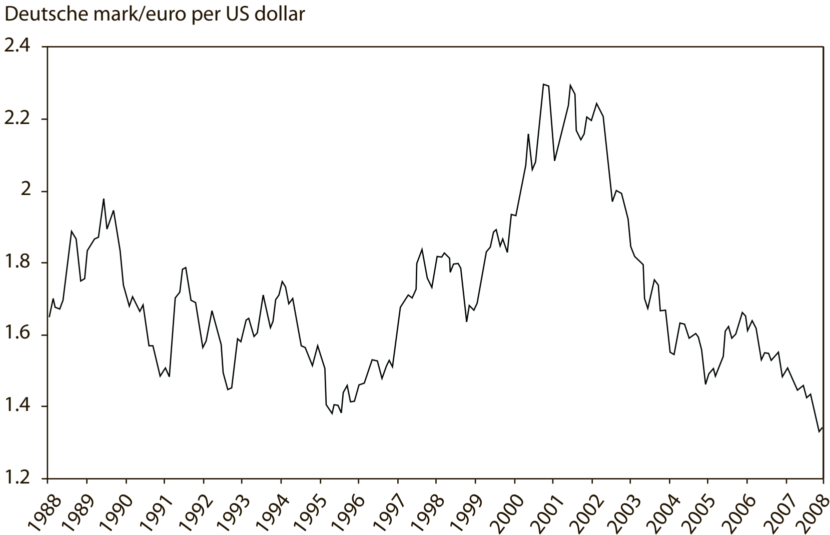
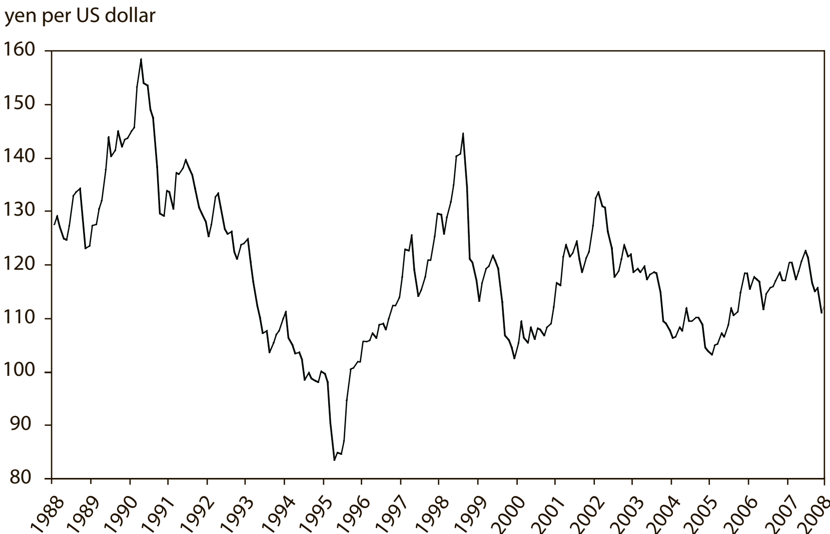
Figure 4.1a Exchange rate of US dollar against Deutsche mark/euro, January 1988–December 2007



Source: PACIFIC Exchange Rate Service, available at http://fx.sauder.ubc.ca.

Figure 4.1b Exchange rate of US dollar against Japanese yen, January 1988–December 2007



Source: PACIFIC Exchange Rate Service, available at http://fx.sauder.ubc.ca.

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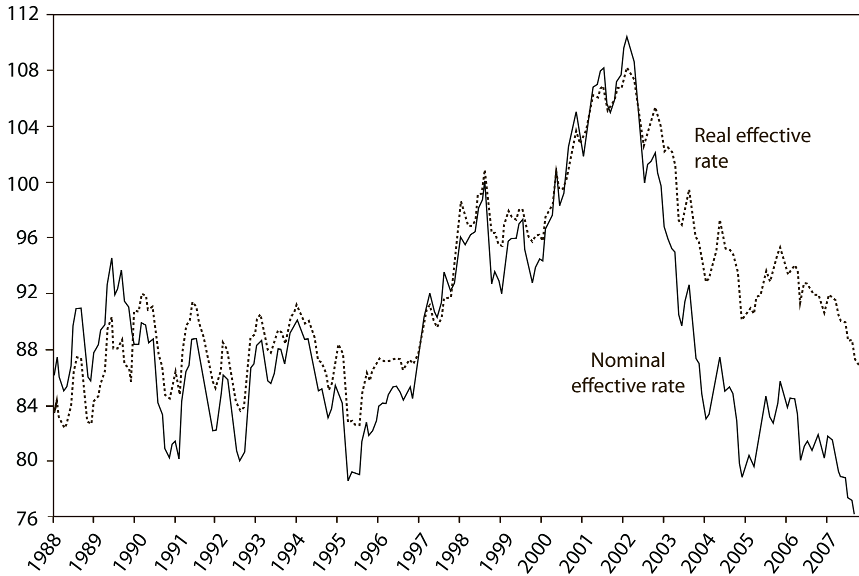
Figure 4.2 Nominal and real effective exchange rate of US dollar, January 1988–October 2007



Source: International Monetary Fund, *International Financial Statistics*, various years.

and large amounts of intervention. In response, Taiwanese authorities reformed their exchange rate system in April 1989 and allowed a 12 percent appreciation between October 1988 and October 1989. The bilateral trade deficit fell, but remained the largest among the Asian newly industrialized economies (NIEs) for some time (see figures 4.6a, 4.6b, and 4.6c). In its October 1989 report, nonetheless, Treasury declared that there was no further need for appreciation at that time and delisted Taiwan as a manipulator (US Treasury reports, October 1988, April 1989, October 1989).

In March 1990, the Korean government announced a change in its exchange rate regime, leading the US Treasury to remove the manipulation designation in the April 1990 report. While Treasury justified the removal by the liberalization of the foreign exchange market in Korea, the shift also coincided with the disappearance of Korea's current account surplus (see Frankel 1992).

Treasury nonetheless expressed its concern that both governments retained the ability to manipulate the exchange rate, noted that the currency should continue to contribute to adjustment of their external balances, and warned that it would continue to scrutinize the policies of both countries. In fact, the department relisted Taiwan in the May 1992 report,

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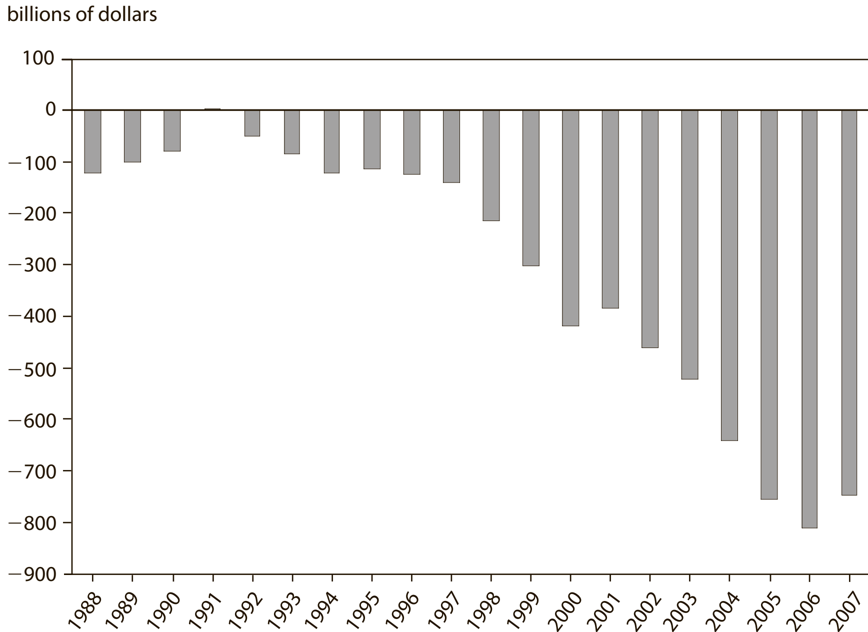
Figure 4.3 US current account balance, 1988–2007



Source: International Monetary Fund, *International Financial Statistics*, various years.

maintained the designation in the following report, and delisted the country again in May 1993.

China is treated for the first time in the November 1990 Treasury report, which noted that China had been running overall current account and trade deficits during most of the previous decade, but that its bilateral trade surpluses with the United States had been growing since 1985 (figure 4.6c). Although China had an administered foreign exchange system that was used to support exports, the principal cause of the bilateral imbalance was general administrative controls over trade.[3] China was not yet cited as a manipulator.

During the two subsequent reports, Treasury ratcheted up its analysis of the Chinese exchange rate system and its warnings to Beijing. The May 1991 report noted that China's overall current account balance shifted from deficit in 1989 to significant surplus in 1990 (figure 4.5c). In

3. In a passage that foreshadowed the economic diplomacy of the mid-2000s, Treasury said, "It is a matter of concern for the United States Government. There is, thus, an interagency effort to formulate a strategy for addressing this problem. Moreover, we aim to press China through any available bilateral contact and in the international financial institutions (especially the IMF and World Bank) to remove its restrictions" (US Treasury report, November 1990, 31).

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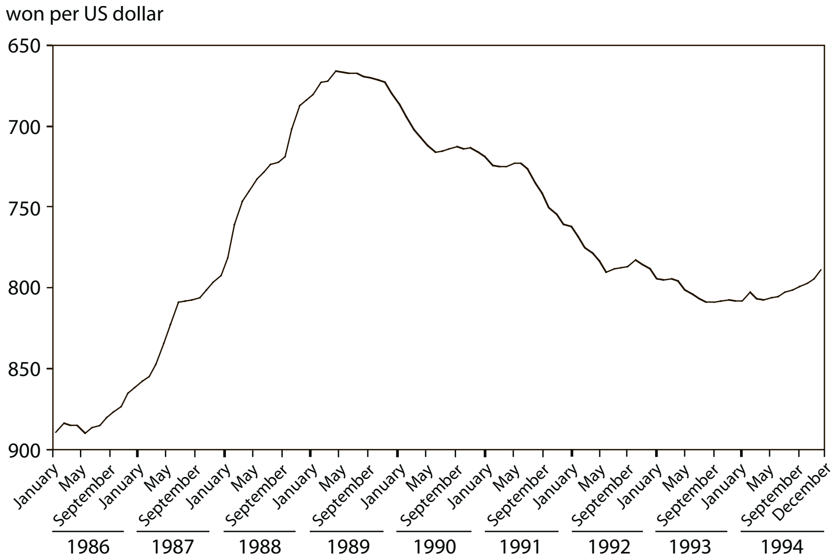
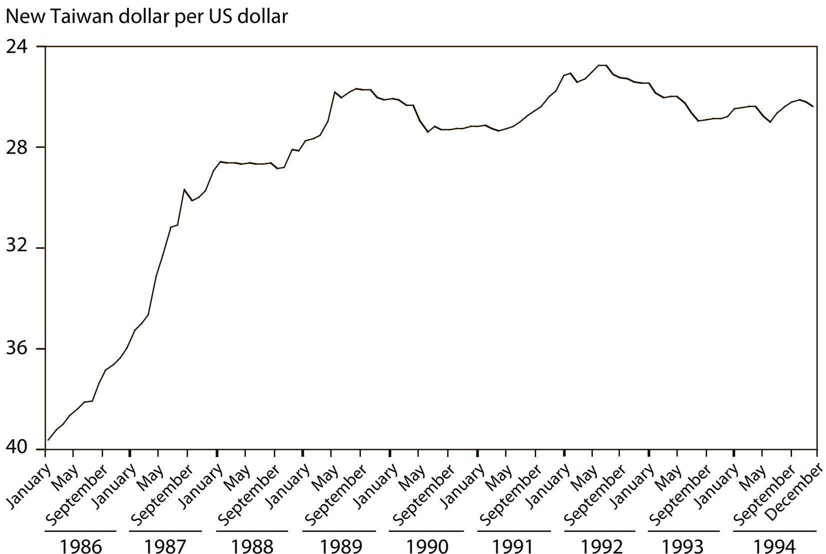
Figure 4.4a Korean won per US dollar, end of period, January 1986–December 1994



Note: Inverted scale applies.

Source: International Monetary Fund, *International Financial Statistics*, various years.

Figure 4.4b New Taiwan dollar per US dollar, end of period, January 1986–December 1994



Note: Inverted scale applies.

Source: Central Bank of Republic of China (Taiwan).

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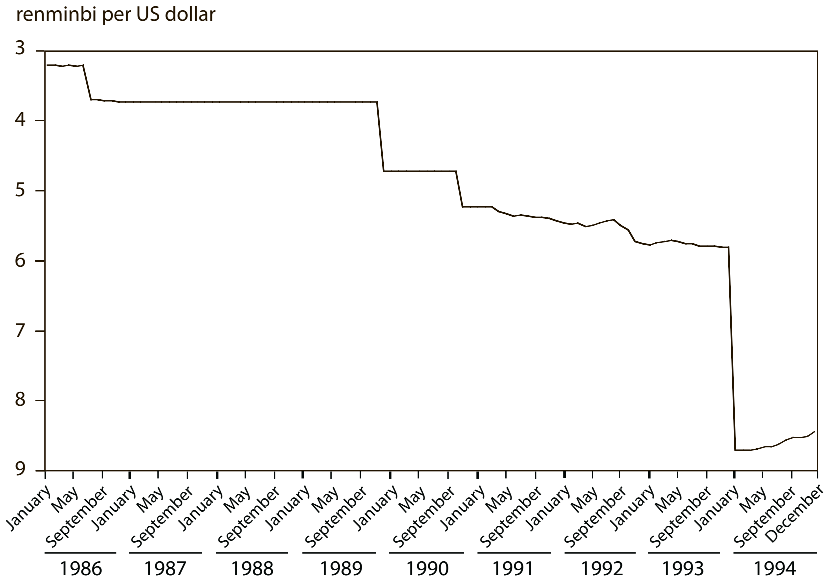
Figure 4.4c Renminbi–US dollar principal exchange rate, end of period, January 1986–December 1994



Note: Inverted scale applies. Prior to the dismantling of the dual exchange rate system in January 1994, the large majority of China's international trade was conducted at exchange rates markedly lower than the official rate shown in this figure, rendering the apparent devaluation at that time somewhat misleading.

Source: International Monetary Fund, *International Financial Statistics*, various years.

the November 1991 report, a quarter of which was devoted to China alone, Treasury announced that its officials had visited that country during the previous July and September to discuss these matters and to "seek concrete steps toward a more market-oriented system of exchange rate determination." While there was "no clear evidence that the authorities manipulate the exchange rate itself," the department remained "seriously concerned" about the size of China's external surpluses.

Treasury finally cited China for manipulation in the May 1992 report. It noted that the renminbi had depreciated in real terms during the previous two to three years in the face of growing external surpluses. (The nominal exchange rate is presented in figure 4.4c.) The rate was closely managed through the administered system, and foreign reserves were rising. Treasury thus concluded that Chinese authorities employed exchange rate policy, in addition to trade controls, to attain competitive advantage in international trade, justifying the designation as a "manipulator" (p. 32). Treasury asked China to take three specific steps: (1) eliminate the foreign exchange surrender system, (2) loosen controls on the swap centers, and (3) make foreign exchange laws and regulations more transparent (p. 33).

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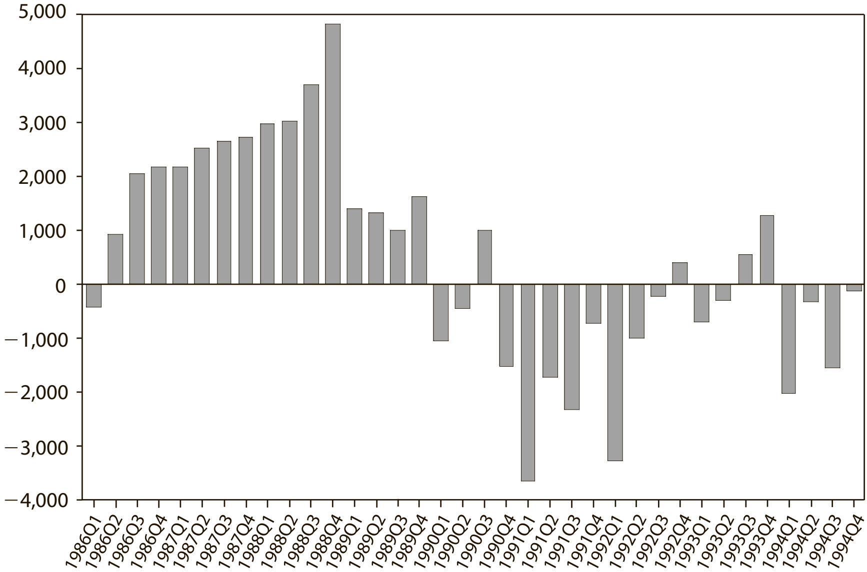
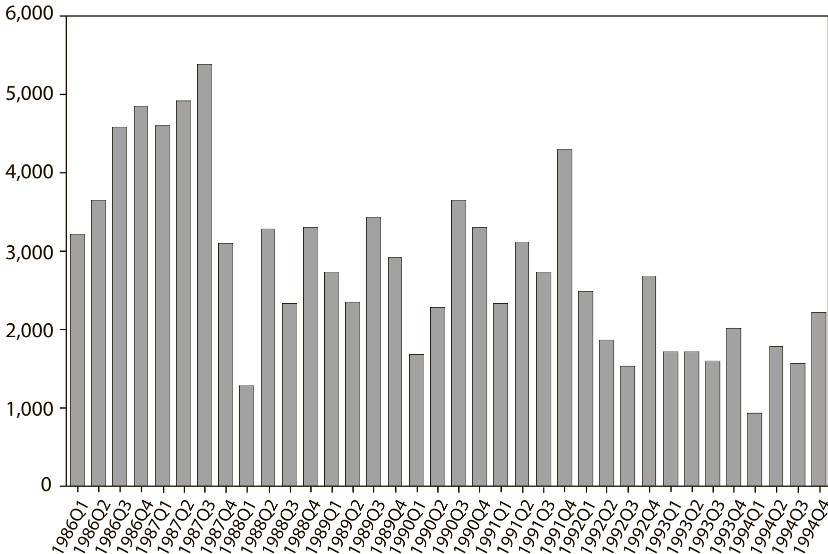
Figure 4.5a Current account balance of Korea, 1986Q1–94Q4



Source: International Monetary Fund, *International Financial Statistics*, various years.

Figure 4.5b Current account balance of Taiwan, 1986Q1–94Q4



Source: Central Bank of Republic of China (Taiwan).

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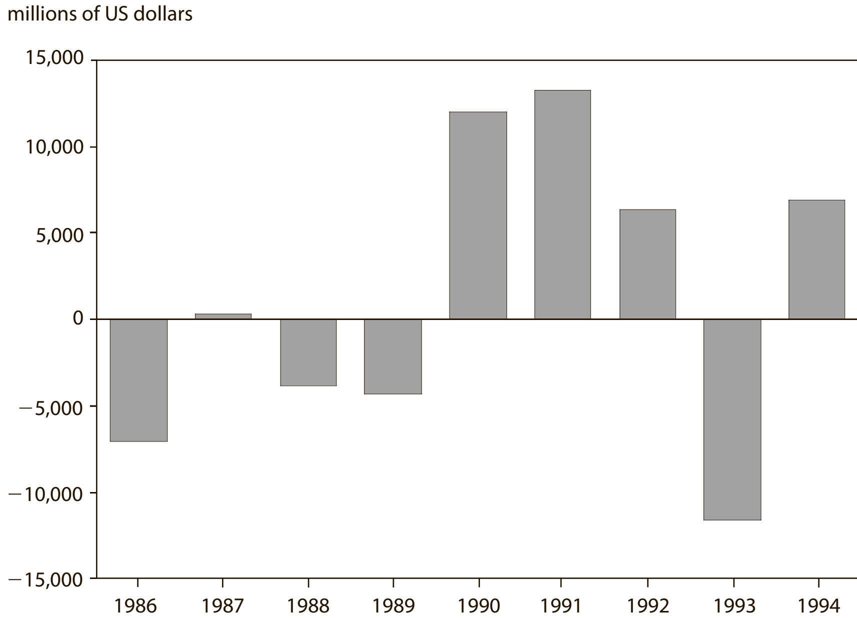
Figure 4.5c Current account balance of China, 1986–94



Source: International Monetary Fund, *International Financial Statistics*, various years.

The report also mentioned that China was the subject of a Super 301 trade investigation.

Subsequent reports mention at least four negotiations with Chinese authorities over their exchange rate system. The November 1993 report noted China's application to accede to the World Trade Organization (WTO) but declared, "China has not yet brought its foreign exchange regime into conformity with GATT Article XV," and urged China to do so. At the beginning of 1994, China unified its dual exchange system and introduced other liberalizing reforms. While welcoming these moves, Treasury objected to exclusion of foreign firms from the new interbank market in foreign exchange. Treasury nonetheless removed its manipulation designation in the December 1994 report. The operative passage is worth quoting:

> It is therefore Treasury's determination that China is not currently manipulating its exchange system to prevent effective balance of payments adjustment and gain unfair competitive advantage in international trade, but that it retains the capacity and bureaucratic means to do so in the future. (p. 26)

Treasury reported continued talks with Chinese authorities on these matters through the December 1995 report and occasionally during 1997 and 2001. Despite a steadily rising bilateral trade deficit with China,

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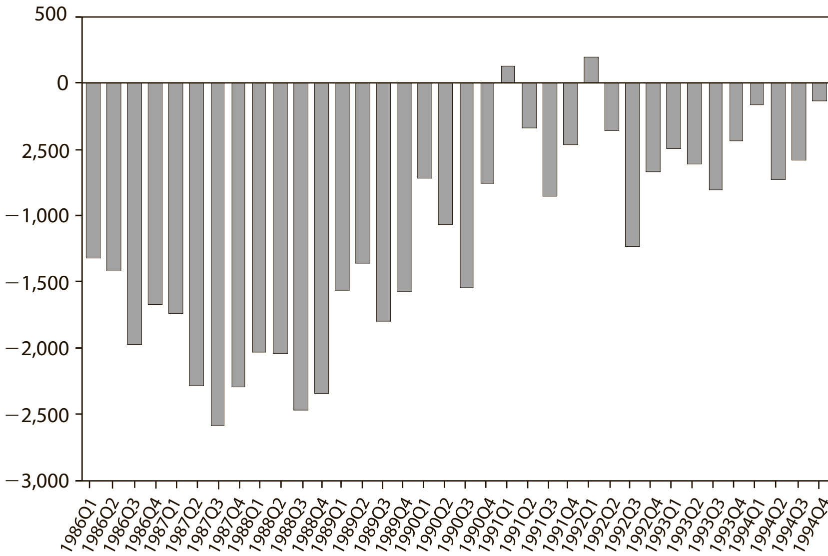
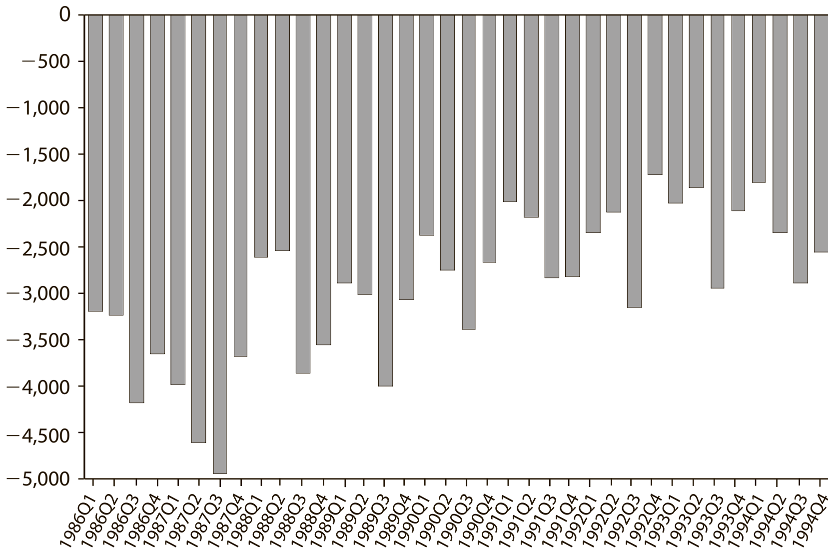
Figure 4.6a US-Korea trade balance, 1986Q1–94Q4



Source: US Census Bureau, Foreign Trade Division, Data Dissemination Branch, available at www.census.gov.

Figure 4.6b US-Taiwan trade balance, 1986Q1–94Q4



Source: US Census Bureau, Foreign Trade Division, Data Dissemination Branch, available at www.census.gov.

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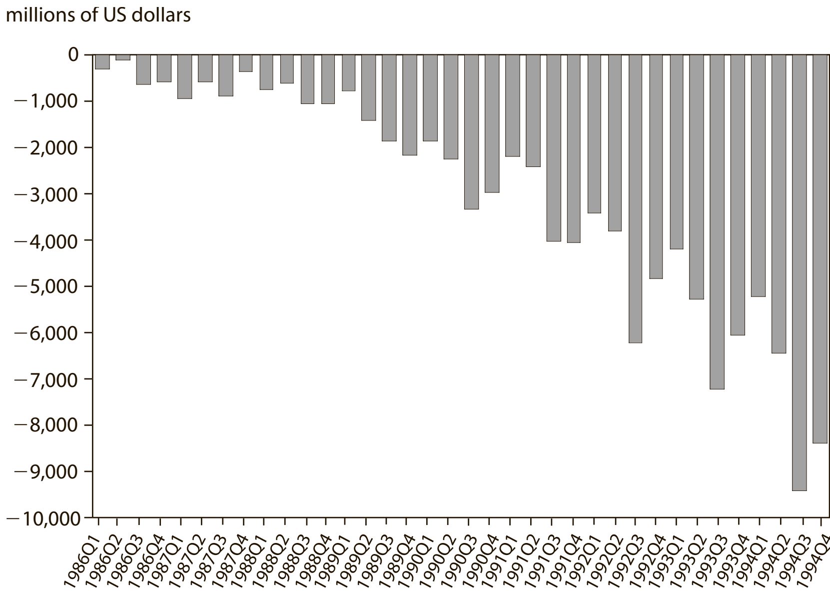
Figure 4.6c US-China trade balance, 1986Q1–94Q4



Source: US Census Bureau, Foreign Trade Division, Data Dissemination Branch, available at www.census.gov.

Treasury declined to cite China for manipulation. Although several countries have been reviewed, no other country has been cited in these reports for manipulating its currency since then.

Nicholas Lardy (1994, 86–90, 137) criticized Treasury's manipulation designation, arguing that the effect of Chinese authorities' foreign exchange operations prior to the unification of the dual exchange system in 1994 was to prevent rather than foster further depreciation of the swap market rate. Treasury failed to distinguish between important categories of foreign exchange reserves—those held by the central authorities and those held in state-owned banks and controlled by numerous trading firms—and to recognize that large net outflows of capital, not intervention, placed downward pressure on the renminbi during 1992 and 1993. In other words, Lardy concluded, China's "manipulation" had the opposite effect on the exchange rate of that suggested by Treasury.[4]

What factors explain Treasury's decisions to cite countries for manipulating their currencies in these reports? Why did Treasury cite only

4. Lardy added that if China moved toward convertibility on the capital account as well as the current account, as Treasury was urging, Treasury should expect the renminbi to depreciate, not appreciate, in real terms. Note, though, that Treasury later made a clear distinction between determining manipulation and determining undervaluation, which it argued was not required by the 1988 Act. See GAO (2005).

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China, Korea, and Taiwan and not others? The extensive use of exchange controls to manage the exchange rate and external trade is a factor common to all of these decisions on manipulation and is consistent with the timing of delisting. Treasury repeatedly referred to controls in the early reports and used this criterion as part of the justification for not citing China in the mid-2000s. External surpluses on the current account and bilateral trade, which are specifically listed in the 1988 Act as criteria for initiating negotiations, are also common to these three cases but do not explain the timing of China's delisting. Finally, all of these countries were important in the international trading system and had attracted attention on Capitol Hill. These factors appear to be Treasury's dominant considerations in deciding which countries should be cited and when.[5]

In a useful paper, Frankel and Wei (2007) test alternative explanations for Treasury's decisions against data for a broad set of US trading partners, including countries that were not cited for manipulation. They find that a country's overall current account balance and an undervalued currency increase the chances that Treasury will review it for manipulation, launch discussions with it, or actually cite it for manipulation. But they stress that the bilateral trade balance, as well as the US unemployment rate, are the more important determinants of Treasury manipulation decisions. They add that in this way, Korea, Taiwan, and China have been "scapegoats" in US policymaking. They do not specifically test the explanatory power of the maintenance of exchange controls.

Finally, it is worth noting that, at least with respect to exchange rate manipulation on the part of the NIEs, Treasury embraced the spirit and letter of the 1988 Act during these early years. Treasury officials appeared pleased to testify on their progress before the banking committees. Undersecretary David C. Mulford, who had opposed stronger versions of the Act before passage, praised the reporting process and stressed the importance of cooperation with Congress. Secretary Nicholas F. Brady called the reporting process "an enormously useful vehicle" (Destler and Henning 1989, 113–14).

Mexican Peso Crisis of 1994–95

During the mid-1990s, Mexico was the third largest trading partner of the United States, and as a neighbor it was also important to a host of other US foreign policy goals. The North American Free Trade Agreement (NAFTA), negotiated by the George H. W. Bush administration and passed by Congress during the Bill Clinton administration, had been the most widely debated trade measure in the United States since World War II.

5. See also the tabulation of rationales in GAO (2005, appendix III).

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The Mexican peso crisis of 1994–95 threatened political support in the United States for this agreement, and Congress was called upon to fund the largest-ever financial rescue package. Once the worst of the crisis had passed, Congress intensively scrutinized Treasury policymaking with respect to the peso-dollar rate.

The period leading up to the crisis illustrates Treasury's conflicted position. Privately, Treasury officials became increasingly concerned about the viability of Mexico's exchange rate regime. The flow of confidential memoranda, released by members of Congress after investigating the crisis, documents growing alarm in the Treasury and Federal Reserve over Mexican exchange rate policy.[6] However, as financial markets became increasingly concerned about political and economic events in Mexico over the course of 1994, Clinton administration officials continued to publicly express confidence in the Mexican economy.[7]

Accordingly, Treasury's exchange rate reports held no warning of the peso crisis. Despite Mexico's importance to US trade and the substantial amount of time Treasury officials had devoted to the peso problem, there was no significant treatment of Mexico in the department's reports either before or after the crisis. Perhaps neither the manipulation provisions (section 3004(b)) nor the report content provisions (section 3005(b)) strictly required such a discussion. But a forthcoming treatment of international monetary developments of primary concern to the country that went beyond the specific requirements of the law could certainly have included discussion of the peso.

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6. See US Treasury Department, "Bi-Weekly Report on Mexico," February 15, 1994, Treasury document no. 003280; "Memorandum to Summers and Shafer," March 24, 1994, Treasury document no. 002438; "Memorandum from Summers to Bentsen," April 26, 1994, Treasury document no. 003247-003253; "Memorandum from Geithner to Summers and Shafer: Mexico: Planning for the Next Stage," December 5, 1994, Treasury document no. 001209-210; "Memorandum to Geithner, Summers, and Shafer: Contact the Mexicans Before They Do Something," December 19, 1994, Treasury document no. 702690; "Memorandum from C. Pigott to Bennett: The Mexican Peso," June 3, 1994, Federal Reserve Bank of New York document no. 10003817-19, no. 94-81; Federal Reserve Board, "Memorandum from Siegman to Greenspan and Blinder," August 19, 1994; Kamin and Morton, "The Implied Probability of a Peso Devaluation," August 19, 1994, Federal Reserve Board document no. 94-119; and Kamin and Howard, "Options for Mexican Exchange Rate Policy," August 17, 1994, Federal Reserve Board document no. 94-115.

7. On March 24, 1994, Treasury Secretary Lloyd Bentsen issued a statement that "we have every confidence that Mexico is on the right economic path" (Reuters World Service, March 24, 1994). On November 21, 1994, after billions of dollars had fled the country, Bentsen stated that, "I have been impressed by Mexico's strong economic fundamentals, with falling inflation, stronger growth and a balanced budget. . ." (Memorandum from Summers to Bentsen, "Statement on Mexico," November 21, 1994). In December 1994, with the Mexican economy at a breaking point, President Clinton, at the Miami Summit of the Americas, cited Mexico as a model of successful economic development (Weekly Compilation of Presidential Documents, December 19, 1994).

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After the crisis broke in December 1994, the Clinton administration proposed a $40 billion loan guarantee for Mexico to Congress. When Congress refused to act, notwithstanding bipartisan leadership support for the guarantees, Treasury officials announced that they would instead lend up to $20 billion from the Exchange Stabilization Fund (ESF) as part of an international package that included up to $17.8 billion from the IMF (Henning 1999; Rubin and Weisberg 2003).

Feeling circumvented by the use of the ESF, members of Congress launched an investigation into administration policymaking prior to the crisis and into the loan package, holding multiple hearings in several committees (see US Senate 1995). Although Treasury officials testified, this did not satisfy members of Congress. The Mexican Debt Disclosure Act of 1995, passed in April, required Treasury to report in extensive detail on its financial support to Mexico (see Henning 1999, 66–70). The department did so separately from its exchange rate reports (US Treasury 1995a, 1995b, 1996). Senator Alfonse D'Amato (R-NY), who as chairman of the Senate Banking Committee was particularly active, used the legislative budget process to attach temporary restrictions on Treasury's use of the ESF. In the final analysis, Treasury's financial support for Mexico was a success, and the D'Amato restrictions were counterproductive (Henning 1999, 66–70). But the backlash against Treasury policy highlights the political consequences of presenting Congress with unpleasant surprises.

This episode generates several observations. First, the manipulation provisions of the 1988 Act do not mandate negotiations in cases of overvaluation; they are asymmetrical. Second, the peso crisis demonstrates that overvalued currencies can pose as much risk to the US economy as undervalued currencies. However, in contrast to the cases of undervaluation in East Asia during 1988–94, Treasury did not find the reports to be a useful vehicle to cajole Mexico toward greater exchange rate flexibility. Third, one might nonetheless ask whether the congressional backlash would have been muted if Treasury had given the peso more attention in these reports prior to the crisis. Exiting from an overvalued peg risks greater financial disruption than exiting from an undervalued one, and Treasury would have to be cautious. But that does not necessarily mean that Treasury can say nothing useful publicly in such cases in the future.[8]

Asian Financial Crisis of 1997–98

The crisis that swept across East Asia, extending to Russia and Latin America, dominated international financial policy during the second half

8. Goldstein (1997, 59–62) argues that a middle ground between saying nothing and causing a currency crisis, narrow as it might be, exists in the case of the IMF. As argued below, similar reasoning applies to Treasury reports.

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of the 1990s. US Treasury officials worked on this problem intensively, bilaterally, and in cooperation with G-7 partners and the IMF, issuing a number of important statements and testifying frequently on Capitol Hill (see US House of Representatives 1997, 1998a). Remarkably, however, Treasury suspended its exchange rate reports to the Congress. Distracted by weekly financial firefights and unwilling to telegraph their intentions to the markets, Treasury officials evidently saw little benefit in these reports to their handling of the crises.

When it finally released its report in January 1999, Treasury pinned much of the blame for the crisis on the weakness of domestic financial systems in the stricken countries. It urged Japan and its banks to clean up the financial system and duly reported intervention in June 1998 to support the yen, then at around 146 to the dollar. Treasury had also improved the format and readability of the statement, which thereafter stylistically resembled a JPMorgan or Goldman Sachs brief on the exchange markets.

The report cited no country for manipulating its exchange rate. Under the leadership of Secretary Robert Rubin and Deputy Secretary Lawrence Summers, in an effort to make the definition of manipulation more systematic and transparent, the Treasury had listed four criteria in its December 1995 report (pp. 11–13)—external balances, exchange restrictions and capital controls, exchange rate movements, and movements in reserves—and in its February 1997 report added a fifth criterion, macroeconomic trends. Although China had a record and growing current account surplus, a growing bilateral trade surplus with the United States, and controls on capital inflows, and had intervened to prevent appreciation of the renminbi, the January 1999 report cited a slowdown in growth—the newest criterion—when concluding that China had not manipulated its currency.

Japanese Yen

The dollar's rate against the Japanese yen had been one of the causes of the politicization of exchange rate policy during the mid-1980s and a motive for the 1988 Act. During most of the period covered by the reports, the Japanese economy was mired in prolonged stagnation, a consequence of the bursting of the asset bubble at the end of the 1980s. The yen-dollar rate reemerged as a political issue periodically, first under Clinton's first Treasury secretary, Lloyd Bentsen, second as the Japanese currency appreciated to a record 80 to the dollar in mid-1995, and third when it weakened to (nearly) 150 to the dollar in 1998 (figure 4.1b). The Treasury and Federal Reserve intervened in the yen-dollar foreign exchange market during these episodes and reported these operations accordingly (see US Treasury reports of April 1989, 9; October 1989, 8; August 1995, 12–13;

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and December 1995, 2–4). With the exception of brief statements that intervention was effective, the treatment in the exchange rate reports was largely descriptive rather than analytical and largely duplicated the report on foreign currency operations provided in the *Federal Reserve Bulletin*.

The Great Intervention of 2003–04 represents a fourth politically salient episode involving the yen. During this period, just as their economy was emerging from its prolonged slump, Japanese authorities purchased $320 billion to restrain the appreciation of the yen from about 120 at the beginning of 2003 to about 108 at the end of that year. US Treasury officials suspended their objections to intervention in principle in the belief that intervention would facilitate a monetary expansion in Japan that would help to sustain its recovery. As massive interventions continued, however, Undersecretary for International Affairs John B. Taylor insisted that his Japanese counterparts develop an "exit strategy," which they implemented in March 2004 (Taylor 2007).

This episode illustrates a missed opportunity to make the exchange rate reports more relevant. The Great Intervention was by far the most important official action in the international monetary system at the time. Treasury discussed the Japanese operations in its reports for 2003 and the first half of 2004, mentioned that the department supported monetary expansion in Japan, and indicated that the department was engaged in discussions with Japanese officials. Undersecretary Taylor testified on the intervention at least twice (October 1 and October 30, 2003), reiterating the treatment in the Treasury reports.

However, the extent to which the interventions assisted in the Japanese recovery is disputed (e.g., Fatum and Hutchison 2005), and Taylor himself objected to the Ministry of Finance that it intervened too much in March 2004. In an intriguing memoir after he left the Treasury, Taylor discussed the interventions, his response to the Japanese, and deliberations over target ranges with his counterparts in a new "G-3" (Taylor 2007). During 2006, US automobile companies complained that the yen's weakness was a lingering consequence of the interventions, and members of Congress quoted specifically from Taylor's book when making this case at hearings the following year. Taylor served the transparency of exchange rate policy by treating this episode in his book—but congressional oversight and public discourse would have also been improved by more complete analysis of the episode in the exchange rate reports.

Europe's Monetary Union

The creation of Europe's monetary union in January 1999 was the most momentous shift in the structure of the international monetary system in at least a generation. The new currency, the euro, replaced 11 national currencies (now 15), creating a monetary bloc three-quarters the size of

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the United States by GDP and a potential competitor to the dollar as an international currency. After the Maastricht Treaty was signed, and at the outset of the convergence process, the Treasury Department generally avoided making public comments on the desirability or feasibility of the monetary union, on the reasoning that the creation of the euro was something for the Europeans alone to decide. Privately, senior officials harbored serious doubts about whether Europe would introduce the economic reforms necessary to make the euro a success. When they began to speak on European monetary integration directly in 1997, Treasury officials affirmed that the United States had a strong interest in a prosperous Europe but warned that greater flexibility in the European economy, in particular labor markets, and greater fiscal consolidation would be necessary to make the project successful.[9] Congressional committees held hearings on the ramifications for the United States at which Treasury officials testified (US Senate 1997, US House of Representatives 1998b). But the treatment of this important topic in the exchange rate reports was limited to one and a half pages in February 1997 (pp. 8–9) and three paragraphs in January 1999 (p. 3). The gist of the passages, half of which were purely descriptive, was that the fate of the dollar remained in the hands of US policymakers and that the EMU's "direct economic impact on the United States was likely to be limited."

Fiscal Policy

The Reagan federal budget deficits were the most important cause of the current account deficits of the 1980s. Although the tax cuts and defense spending increases of that era stimulated the economy initially, that stimulus eventually leaked abroad in the form of capital inflows, dollar appreciation, and a (then) record current account deficit—leaving overall GDP only modestly higher, but with higher interest rates and larger external deficits and debt than would have otherwise been the case.

Lawmakers were guided partly by this lesson when drafting the exchange rate provisions of the 1988 Act, which embraced more than just exchange rate policy, but also fundamental underlying macroeconomic policies in both the United States and its economic partners. The provisions stressed the need for greater macroeconomic policy coordination

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9. See Lawrence H. Summers, speech entitled "EMU: An American View of Europe" at the Euromoney Conference, US Treasury Department press release, April 30, 1997; Timothy F. Geithner, speech entitled "The EMU, the United States, and the World Economy" to a conference of the Konrad Adenauer-Stiftung and Aspen Institute, Washington, May 7, 1998; and Edwin Truman, speech entitled "The Single Currency and Europe's Role in the World Economy" at the World Affairs Council, US Treasury Department press release, Washington, April 6, 1999. US official views are reviewed in Henning (2000, 12–17).

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and declared that it was US policy "to achieve macroeconomic policies and exchange rate policies consistent with more appropriate and sustainable balances . . ." (section 3002). The accountability of the president should be increased specifically for "the impact of economic policies and exchange rates on trade competitiveness" (section 3003). The section detailing the contents of the reports (3005) mandated treatment of the factors underlying exchange market conditions and "recommendations for any changes necessary in United States economic policy to attain a more appropriate and sustainable balance in the current account," among other things. The current account balance is by definition a simple function of the overall savings-investment balance; but the budget balance is the element of this equation that is most susceptible to government policy. Therefore, although the specific word "fiscal" does not appear in the reporting requirements section, it is hard to imagine how the section's mandate could be fulfilled without specifically addressing fiscal policy.[10]

The reports' treatment of fiscal policy varies over time from neglectful to substantial, with most reports treating the connection to current account balances fairly superficially. The reports give greater attention to fiscal policy when the budget deficit is decreasing than when it is increasing. Most treatments in the reports take decisions to cut the fiscal deficit as given and examine the consequences for the external balance, rather than analyzing the consequences of fiscal options for the current account in advance as input to decisions on budgets and taxes.

The reports submitted by Secretary Brady under the George H. W. Bush administration treated the connection between fiscal policy and the current account balances cursorily until late 1992. The first report noted the reduction in the federal budget deficit from 6.3 percent to just over 3 percent of GDP from 1983 to 1988 and duly reported the advice of the IMF in the Article IV consultations to reduce the deficit further (US Treasury report, October 1988, 4, 36). The reports that followed noted deficit reduction agreements between the president and Congress and argued that these agreements would contribute to macroeconomic policy coordination in the G-7, the relevant sections of whose communiqués were summarized. Far from declining, however, US budget deficits increased substantially from 1989 to 1993 and were projected to be roughly 5.5 percent of GDP at the close of the Bush administration. Treasury's final report devoted a page and a half to rebutting calls from

10. The 1988 Act also required the Office of Management and Budget (OMB), and the budget committees of both houses, to analyze the connection between the budget and the trade balance in their annual budget assessments. See the "Federal Budget Competitiveness Impact Statement," Omnibus Trade and Competitiveness Act of 1988, title V, subtitle D. The OMB provided only cursory analysis, and the provision lapsed after five fiscal years, leaving the exchange rate provisions as the one remaining requirement to address this connection.

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IMF staff to reduce the deficit by 5 percent of GDP over the following five years, arguing that this could harm the fragile recovery from the 1991 recession.[11] US current account deficits, which were nearly eliminated in 1991,[12] began to grow thereafter.

The December 1992 report acknowledged that the external deficit would grow—for the first time since the reports were inaugurated—and relayed the IMF argument that fiscal deficits would have "major implications for the health and durability of the economic recovery, domestic investment, and the US current account." In general terms, the report acknowledged that the savings-investment balance affected external balances and that "government dissavings" was part of that equation. But the report stopped shy of explicitly acknowledging that growth in the fiscal deficit would cause the external deficit to be greater than would otherwise be the case. The text instead dances assiduously around that explicit connection.

The first reports by the Clinton administration trumpeted the 1993 agreement with Congress that was projected to reduce the budget deficit by $500 billion cumulatively over the following years, and briefly reported consultations with the IMF on this score (US Treasury reports, May 1993, 12–13; and November 1993, 2, 18.) Indeed, under Secretaries Bentsen, Rubin, and Summers, the federal budget balance shifted from a $255 billion deficit in FY1993 to a $236 billion surplus in FY2000, a change of roughly 6½ percent of GDP. As this shift became apparent, Treasury officials might well have been tempted to forecast a substantial drop in the current account deficit. A couple of these reports made the connection more explicitly, one saying, "Continued progress in reducing the federal budget deficit will also tend to reduce the current account deficit over the medium term by reducing the disparity between levels of aggregate national saving and investment" (US Treasury report, February 1997, 11). A marked decline in private savings, however, ensured that the external deficit grew continuously, with the exception of 1995, throughout the Clinton administration.

The current account deficit for 2000 registered $416 billion.[13] There was already a growing discussion in academic circles and more broadly about how long the growth in external deficits could be sustained (see Mann 1999). Yet, upon taking office, George W. Bush proposed a large package of tax cuts, which, in combination with the slowing of the economy in 2001 and spending decisions, would eliminate the budget surplus and resurrect large budget deficits. One key test of the usefulness of the

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11. In the event, the deficit was in fact reduced by about that much over this five-year period. See the *Economic Report of the President*, February 1999.

12. Helped by a $42 billion transfer in connection with the "Desert Storm" invasion of Iraq.

13. See the *Economic Report of the President*, February 2007, 400.

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exchange rate reports is whether they highlighted the consequences of fiscal policy for external balances. Although the reports discussed the savings-investment arithmetic of the current account in broad terms, however, the specific connection between tax cuts, fiscal deficits, and the current account was virtually ignored during the second Bush's first term.

Once the deterioration in the budget balance was reversed, the reports acknowledged that reducing global imbalances in an orderly manner required "further reducing budget deficits and boosting national saving in the United States . . ." (US Treasury report, November 2005, 1). The reports after November 2005 gave more serious attention to the connection with external balances. As the current account balance continued to deteriorate into 2006, though, the reports warned that the connection was considerably more complex than a reduction in the fiscal deficit translating into a one-for-one reduction in the external deficit (US Treasury reports, November 2005, 6–8; May 2006, 10–15; June 2007, 4, 11–12). These reports stressed the sustained rate of investment in the United States and the attractiveness of US financial assets to international investors as the driver for the current account deficits.

The shift in the budget balance under the Bush administration's first term by nearly 5 percent of GDP—from a surplus of 1.3 percent in FY2001 to a deficit of 3.6 percent in FY2004—was the biggest fiscal expansion since the inauguration of the exchange rate reports. The absence of serious analysis in the reports for 2001–04 thus represents their most critical omission. This failure is especially striking when the broader context is considered. First, as mentioned, the substantive connection was a key lesson of the 1980s, and the external consequences of that decade prompted Congress to establish the reporting requirements. Second, US fiscal policy was being made in a dramatically changed international economic environment. By creating a potential alternative to the dollar, Europe's monetary union had potentially raised the cost to the United States of fiscal choices such as these, costs specifically in terms not only of external deficits but also of the role of the dollar in international financial markets over the long term.[14] If the dollar's role declines during 2008–15,[15] fiscal choices at the beginning of the present decade will likely prove to have been important causes, and the exchange rate reports to date have contributed little to our appreciation of the connection.

To some extent, the reports' neglect during 2001–02 was mirrored by a lack of attention to the external consequences in the broader public discourse over fiscal policy. Few analysts drew this connection in their commentary on fiscal policy at this time—one notable exception being C. Fred

14. See, for example, Masson, Krueger, and Turtelboom (1997) and Henning (1997).

15. The future of the international role of the dollar is treated by, among others, Helleiner and Kirshner (2008) and Cohen (2004).

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Bergsten.[16] This highlights a key reason for Treasury to address fiscal policy in these reports: the connection and the tradeoffs between fiscal and external policy choices should frame the public debate over policy as well as inform Congress.

The external consequences of the fiscal stance relate directly to foreign borrowing, the appropriate and sustainable limits of which Congress expected Treasury to discuss in the reports (US Congress 1988, 843). Prior to the first Treasury report back in October 1988, the chairmen of the House and Senate banking committees had asked Secretary Brady to specify what would constitute an "appropriate and sustainable" current account balance and "the appropriate goal for . . . the buildup of US net foreign indebtedness." Representative John J. LaFalce (D-NY) wrote Secretary Brady that it was "imperative" that the report specify these and determine whether the prevailing policies were consistent with them.[17] But Treasury has never provided these assessments.

There are, of course, compelling political and bureaucratic reasons why secretaries of the Treasury might wish to avoid drawing attention to the external consequences of fiscal policy decisions. Highlighting the shift toward external deficits produced by budget deficits can undercut political support for, and the political benefit of, tax cuts and spending increases. When key decisions on fiscal programs are set by the president, as they were under George W. Bush, drawing those connections can cause confrontation between Treasury and White House officials. The requirement to address this connection can therefore sometimes place the Treasury between a political rock and hard place.

This, however, was an essential point of the 1988 Act. While one might sympathize with officials who must bring unwelcome analysis to their counterparts in other agencies and the White House, drawing the substantive connection between fiscal policy, the exchange rate, and external balances is essential for good economic governance. The connection is best made by the executive, within which the Treasury is the best place to locate this important task because the secretary is the chief financial officer of the government, has responsibilities over fiscal and exchange rate policies, and represents the United States in the IMF, among other international organizations, and the G-7, where these connections are also often made. Having to acknowledge and manage the tradeoffs is the consequence of having broad responsibility over and leadership in these policy areas.

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16. See C. Fred Bergsten, "America Cannot Afford Tax Cuts," *Financial Times*, January 11, 2001.

17. See Senator William Proxmire, letter to Secretary Nicholas Brady, October 1988; Representatives Robert Garcia, Fernand J. St. Germain, and John J. LaFalce, letter to Secretary Nicholas Brady, October 14, 1988; Representative John J. LaFalce, letter to Secretary Nicholas Brady, October 13, 1988.

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In sum, (1) it is important to have a government document that clearly analyzes the connection between fiscal and external balances and the tradeoffs associated with it; (2) the Treasury Department should prepare and issue that analysis in these reports; and (3) Congress and the watchful public more broadly should ensure that Treasury carries out this important responsibility.

China, 2000–2007

During the Asian financial crisis, China maintained its peg to the dollar, to the relief of most governments in the region as well as the international community. China maintained this policy afterward as well, despite substantial increases in productivity and sustained emerging external surpluses (on both the current and capital accounts). The countries stricken by the crisis were determined not to repeat it and, among other strategies, managed their currencies at stable competitive rates by intervening in the currency markets. As a result, China and its East Asian neighbors began to accumulate large amounts of foreign exchange, mostly US dollars, at the beginning of the present decade. China stood out, however, as the most consistent and largest purchaser of dollars, surpassing Japan in total foreign exchange reserves in 2006.[18]

The case of China consequently riveted public attention on the Treasury reports and spawned legislative proposals in Congress on the reporting process and measures to remedy currency manipulation. The evolution of Treasury's position on Chinese manipulation raises several interesting points. This section reviews the findings of the reports, their analysis of manipulation, conflicts with congressional preferences, and the importance of designation.

Findings

In the "manipulation" section of its reports during 1999 and 2000, Treasury took note of China's peg to the dollar and its rising bilateral trade surplus with the United States. Although a declining overall current account surplus exculpated China from manipulation, the reports reproduced excerpts from a speech by Treasury Secretary Lawrence Summers

18. The China case has been treated, and debated, extensively. Critical contributions include Dooley, Folkerts-Landau, and Garber (2003); Eichengreen (2004); Goldstein (2004, 2005); Goldstein and Lardy (2005, 2008); and McKinnon (2006). See also C. Fred Bergsten, statement before the Hearing on US Economic Relations with China: Strategies and Options on Exchange Rates and Market Access, Subcommittee on Security and International Trade and Finance, Committee on Banking, Housing and Urban Affairs, United States Senate, Washington, May 23, 2007.

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warning against the type of peg that was common in East Asia prior to the 1997–98 crisis and that China continued to maintain: "[I]t is clear to us that a fixed, but not firmly institutionalized exchange rate regime holds enormous risks for emerging market economies . . ." (US Treasury report, March 2000, 13). The final report of the Treasury under Summers stated that in bilateral discussions, the department had "urged the Chinese authorities to move, over time, to a more flexible exchange rate regime" (US Treasury report, January 2001, 13).

Under Paul O'Neill, the first secretary under the Bush administration, Treasury reports became dramatically shorter in length, the format changed noticeably, and the treatment of potential "manipulators" was folded into the main analysis rather than examined in a separate section. Treasury did not use the report to send signals to China or Congress regarding its attitude toward the renminbi, despite steady increases in China's external surpluses. Under questioning from Senate Banking Committee Chairman Paul Sarbanes (D-MD) during oversight hearings in May 2002, Secretary O'Neill denied that China's exchange rate regime was a serious problem for the United States (US Senate 2002).

The October 2003 report marked an important change. Under the leadership of Secretary John Snow, Treasury officials stated clearly that the renminbi peg "is not appropriate for a major economy like China and should be changed." The document reported that Snow had proposed to Chinese officials that they move to a more "flexible market-based exchange rate regime" (it did not specifically call for appreciation or revaluation) and reduce controls on capital flows (US Treasury report, October 2003, 7).

Subsequent reports ratcheted up the tone of urgency on this topic, as attention from Congress grew with the size of the trade imbalances. Treasury's May 2005 report declared, "If current trends continue without alteration, China's policies will likely meet the statute's technical requirements for designation [for manipulation]. . . . It is now widely accepted that China is now ready and should move without delay in a manner and magnitude that is sufficiently reflective of underlying market conditions" (p. 2). This language was widely interpreted as a threat to cite for manipulation in the subsequent report. This statement and Treasury's discussions with Chinese officials behind the scenes probably contributed to the mid-course correction that followed.

In July 2005, Chinese authorities revalued the renminbi by slightly more than 2 percent and reformed the exchange rate regime (People's Bank of China 2005), abandoning the peg and allowing a gradual upward appreciation. The November 2005 report stated that Treasury refrained from designating China because of its abandonment of the fixed peg and its stated commitment to market-determined currency flexibility. Treasury added that China's commitment to emphasizing domestic sources of growth and financial modernization also contributed to the decision

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(p. 2). Since the July 2005 revaluation, the renminbi has appreciated against the dollar by a further 14 percent, but on a nominal effective basis by only a further 6 percent. By this broader measure, the renminbi's value has hardly changed since 2000,[19] and productivity in the tradable goods sector has increased rapidly. Accordingly, China's global current account surplus has continued to soar, reaching 9 percent of GDP in 2006 and probably about 12 percent in 2007. Treasury continued to say that Chinese exchange rate policy was inappropriate, that the Chinese should introduce greater "flexibility,"[20] and that the department discussed these matters with the Chinese authorities extensively. But Treasury waited until its June 2007 report to declare the renminbi "undervalued" (p. 32; see also the December 2007 report, 35)—after the IMF's bilateral surveillance report had announced that conclusion. As of this writing, Treasury has not cited China again for manipulation.

Analysis of Manipulation

The criteria that Treasury enunciates for determining manipulation have been vague and have shifted over time. Although IMF decisions provide some guidance on the meaning of the term, the 1988 Act does not define it, and each team of political appointees to the Treasury department has taken a somewhat different approach. During the early 1990s, Treasury did not enunciate clear criteria that it would use but made clear that it was citing China for its bilateral and global surpluses combined with its close management of the exchange rate through controls and intervention. Although Treasury sustained criticism for citing each of the three countries for manipulation (Korea and Taiwan along with China),[21] its application was a defensible interpretation of the language in the 1988 Act and was not challenged by the banking committees. The December 1995 report (pp. 11–13) contained four criteria—external balances, exchange restrictions and capital controls, exchange rate movements, and movements in reserves—which were expanded to five with the addition of macroeconomic trends in February 1997. Because it was on the new criterion that China, whose growth was slowing, was exonerated in January 1999, an independent outside observer should be forgiven for expecting that, when Chinese economic growth accelerated, the Treasury would cite China if the other criteria remained satisfied. But the O'Neill Treasury

19. Using the JPMorgan nominal effective exchange rate index.

20. The term "flexibility" could be construed to include a one-shot revaluation and an upward managed float, of course, but is ultimately ambiguous with respect to the expected direction of movement.

21. See Lardy (1994). See also statements by C. Fred Bergsten and John Williamson before the US Senate hearing in 1989, as detailed in footnote 1 of this chapter.

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reduced the criteria to two—exchange restrictions and exchange rate movements—qualifying the latter by saying that real equilibrium exchange rates are "difficult to define" (US Treasury report, October 2001, 10).[22] The Snow Treasury expanded the number of criteria to seven—exchange rates, external balances, reserves, macroeconomic trends, monetary and financial developments, state of institutional development, and financial and exchange restrictions—but did not elaborate on them as had the Rubin/Summers reports.

By 2004, members of Congress had become concerned enough about Treasury's reluctance to find manipulation that they took two actions. First, they attached to the department's FY2005 appropriation a requirement for a separate report on the criteria used to make the manipulation determination. Second, they initiated a study of these reports by the Government Accountability Office (GAO). Thus in March 2005, Treasury delivered to the appropriations committees a substantial, in-depth paper on the criteria it used to determine manipulation (US Treasury 2005). The GAO, which released its report in April, noted that the factors in Treasury's reports varied over time and that the weights attached to them by the department when assessing manipulation were not transparent. But the GAO complimented the March 2005 Treasury paper as a "high-level discussion" (GAO 2005).

Treasury responded in its November 2005 exchange rate report by attaching an appendix entitled "Analysis of Exchange Rates Pursuant to the Act." The appendix presented six specific measures, subjected to three weighting schemes, and evaluated 23 trading partners. These indicators—trade and current account balances, protracted large-scale intervention in one direction, rapid foreign exchange reserve accumulation, capital controls and payments restrictions, measures of undervaluation and real effective exchange rate movements, and unusually heavy reliance on net exports for growth—echo some of the criteria for identifying manipulation in the IMF guidelines for exchange rate surveillance. Given the absence of guidance on the interpretation of this term in the 1988 Act, and the fact that the act's language was borrowed from Article IV, these guidelines are certainly relevant.[23] But Treasury also adopted the interpretation of the guidelines that stressed intent and gave deference to the declaration of purpose of the target of the investigation. Thus, in the June 2007 report, after reviewing the data and concluding that the renminbi was undervalued, Treasury stated that it did not cite China for manipulation because it was "unable to determine that China's exchange rate policy was

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22. Treasury later argued, however, that determining undervaluation was distinct from determining manipulation and that the 1988 Act did not require the former (GAO 2005).

23. The reports do not refer explicitly to the IMF's guidelines on exchange rate policy, but such a reference is contained in the March 2005 report to the appropriations committees.

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carried out for the purpose of preventing effective balance of payments adjustment or gaining unfair competitive advantage in international trade" (p. 2). Note, however, that the question of intent had not barred Treasury from citing China, Korea, and Taiwan during 1988–94.

Since early 2005, Treasury officials have mounted a good faith effort to give greater analytical content to the concept of manipulation and to improve the exchange rate reports generally. The reports have become somewhat more detailed and incisive, and Treasury has produced occasional papers reviewing models of equilibrium exchange rates and international economic policy coordination (McCowan, Pollard, and Weeks 2007; Sobel and Stedman 2006). For these efforts, Treasury is to be complimented.[24] But Treasury waited until opposition to Chinese exchange rate policy built up a substantial head of steam on Capitol Hill. In March 2005, Senator Charles Schumer (D-NY) offered an amendment, on a procedural motion, to impose 27.5 percent tariffs on imports from China. The amendment received 67 votes, and since then Treasury has been on the defensive on this issue.

The Treasury papers are correct that analysis of equilibrium exchange rates is complicated, and different models produce different estimates. However, model uncertainty need not prevent a finding of manipulation. When a country intervenes massively in one direction over several years while running ever-larger external surpluses and accumulating unprecedented quantities of foreign reserves, a sophisticated model is not needed to know that its currency is below the equilibrium value and frustrating balance of payments adjustment. In China's case, model uncertainty would be a transparent excuse for failure to designate for manipulation, and in fact Treasury's reports during 2006 and 2007 affirm the need for a change in China's regime. The department's rationale for not designating the country for manipulation now rests entirely on the "intent defense."

Treasury has nonetheless pursued the bilateral negotiations that it would have been required to pursue under the 1988 law if it had cited China for manipulation. Beginning under Secretary O'Neill, but especially under Secretary Snow, Treasury conducted serious talks with the Chinese Ministry of Finance and the People's Bank of China, among other Chinese actors. Treasury Secretary Henry Paulson launched the Strategic Economic Dialogue, in which exchange rates figure prominently and which engages several US cabinet secretaries and the Federal Reserve chairman with Chinese ministers under the leadership of a deputy premier. Treasury clearly recognizes that the exchange rate is a critical issue, as does the administration more broadly, and is willing to press Chinese

24. For a review of Treasury's efforts in this regard, see Mark Sobel, statement before the Joint Hearing on Currency Manipulation and Its Effects on US Business and Workers, Ways and Means Committee, Committee on Energy and Commerce, and Committee on Financial Services, United States House of Representatives, Washington, May 9, 2007.

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counterparts, even if not as forcefully as many members of Congress and independent analysts would prefer.

The underlying explanation for President Bush's successive Treasury secretaries' refusal to cite China for manipulation appears to be threefold. First, the department and the US government more broadly have a number of other economic and foreign policy "fish to fry" with China, and securing renminbi revaluation, while important, is not a top government priority. Second, administration officials believe that citing China would be tactically counterproductive, making their Beijing counterparts more rather than less reluctant to revalue. Third, as of 2007, international support for the US position has been insufficient. The unwillingness of the IMF to pursue special consultations and cite China for manipulation was problematic for a US designation. Senior Treasury officials agree with the basic diagnosis that the Chinese currency is undervalued and should be revalued, and have pursued this objective in bilateral negotiations. It would be reasonable to conclude that, in this context, Treasury officials believe that it would be a mistake on political grounds, irrespective of the economic and legal merits, to designate China for manipulation. Treasury officials might also fear that citing China for manipulation would reduce their freedom of maneuver on the matter, incite members of Congress to invoke punitive measures if negotiations were not more fruitful, and increase pressure to cite other countries as well.[25]

Manipulation and Accountability

Morris Goldstein (2006), Goldstein and Lardy (2005, 2008), and Michael Mussa (2007), along with C. Fred Bergsten,[26] are among those who have made a compelling case that China has manipulated its exchange rate within the meaning of the IMF's Article IV (see appendix B in this book). Mussa (2007) forcefully advances an assertive interpretation, arguing that the injunction against manipulation should be read in the context of the purposes of the IMF, which are, inter alia, to facilitate "balanced growth of international trade," "avoid competitive exchange depreciation," and reduce "disequilibrium" in payments balances (Article I (ii), (iii), and

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25. On the other hand, renminbi hawks argue that citing China for manipulation could also garner greater credibility in Congress, increase bargaining leverage with Chinese authorities, and discourage other Asian countries from following the Chinese approach.

26. C. Fred Bergsten, statement before the Hearing on US Economic Relations with China: Strategies and Options on Exchange Rates and Market Access, Subcommittee on Security and International Trade and Finance, Committee on Banking, Housing and Urban Affairs, United States Senate, Washington, May 23, 2007.

27. The position of the IMF's General Counsel on the interpretation of these articles is presented in IMF (2006) and the members' response to the weaknesses in exchange rate surveillance in IMF (2007).

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(vi)).[27] He concludes that the Fund's surveillance of China's exchange rate policy "constitutes gross misfeasance, malfeasance, and nonfeasance."

A reasonable reading of the exchange rate provisions of the 1988 Act also generates a critical judgment of Treasury's nondesignation of China for manipulation. That reading must ultimately be guided by US law, legislative history, and congressional intent, rather than the IMF articles—although countries' IMF obligations might help to inform our understanding of congressional intent. The statute itself offers little guidance as to the meaning of the term "manipulation" or the relevance of intent in finding it. But the Congress clearly expected that the Asian NIEs that had restrained appreciation of their currencies during the mid-1980s would be cited for manipulation by Treasury, as indeed South Korea, Taiwan, and eventually China were (US Congress 1988, 841–42). Given that Chinese policy behavior during 2000–2007 was more extreme and more consequential than the NIE policies of the late 1980s, one can conclude that congressional intent would call for a designation in this case as well.

It is worth emphasizing that the problem of divining intent to prevent payments adjustment on the part of foreign authorities did not prevent Treasury from citing China, Korea, and Taiwan for manipulation during 1988–94. Treasury has not explained why determining intent was possible then but was not possible in 2007.[28] Moreover, the 1988 Act does not provide a waiver from the manipulation designation in cases where that designation could be tactically counterproductive or politically inconvenient; instead Treasury can waive the requirement to initiate negotiations once the designation is made. So, it is difficult to reconcile the refusal of President Bush's Treasury secretaries to cite China for manipulation with the letter and spirit of the 1988 Act—which raises the question of their accountability to the Congress in this important respect.

Importance of Designation

Some commentators might argue that as long as Treasury pursues the negotiations that were mandated by the 1988 Act, it makes little difference whether the secretary formally designates China as a manipulator. However, four considerations suggest the contrary—that using the "m word," when justified, has important consequences and is more likely than temporizing to produce policy change on the part of offenders.

First, the designation is important from the standpoint of process and accountability. The 1988 Act lays down a specific procedure: the Treasury Department is to assess, designate, initiate, or waive negotiations, and, if negotiations proceed, report on them. In the Strategic Economic Dialogue

28. GAO (2005, 13–16) discusses Treasury's rationales for its manipulation decisions regarding China but sheds little light on the problem of intent.

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with China, for example, the Treasury addresses the exchange rate issue along with a number of other negotiating objectives, and tradeoffs are inevitably made among them. But the law does not provide for using the manipulation issue as leverage for concessions on other issues (such as access to the Chinese market for US financial institutions); the negotiations are to ensure that manipulators "adjust the rate of exchange" to "permit effective balance of payments adjustments and to eliminate the unfair advantage." By moving to negotiations without designating China for manipulation, Treasury is not restricted to this objective and is not required to report on the negotiations or on the tradeoffs that they might involve. Treasury consults with members of Congress on the Strategic Economic Dialogue with China, but that consultation is voluntary, informal, and not transparent. It releases statements on the results of the dialogue,[29] but their release and content are voluntary. So, negotiating without designating redirects bargaining in ways the law might not intend and potentially weakens oversight.

Second, designating for manipulation would signal to the US public that the Treasury is serious about combating the practice. In the United States, as elsewhere, broad political support for economic openness depends in part on the perception that foreign governments are not intervening in the marketplace on behalf of their producers at the expense of American firms and workers. When investment, trade, wages, and employment in particular sectors or regions are affected by the intervention of foreign governments, confidence that globalization will operate with fairness wanes. Using plain language to describe a widely known practice—calling a spade a spade—gives greater confidence to interest groups and the public at large that the US government recognizes the problem, takes it seriously, and is moving to solve it.

Third, designating for manipulation would signal to the international community that the Treasury is not only serious about combating manipulation but also expects others to cooperate. Designating a country such as China would probably entail a backlash, which both international organizations and national governments would prefer to avoid. As an international organization that depends on the political support of its members, the IMF shies away from designating China for manipulation. By taking the lead and designating, the US Treasury would encourage and reinforce the IMF in its enhancement of exchange rate surveillance. Conversely, the US government cannot expect the IMF to challenge important members on their currency practices unless the US Treasury is willing to do so as well.

Finally, designation for manipulation could strengthen the Treasury's bargaining position with manipulators and improve prospects for

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29. The statements are available on Treasury's US–China Strategic Economic Dialogue website at www.treas.gov/initiatives/us-china (accessed March 19, 2008).

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remediation. Treasury officials have argued that the opposite is more likely to be the case, that the Chinese government would halt negotiations. Chinese officials would undoubtedly be offended. But the accomplishments of the Strategic Economic Dialogue to date are questionable and the Chinese current account surplus has continued to rise. So Treasury's tactics do not appear to have been particularly fruitful, and a new approach is warranted. Beijing has demonstrated pragmatism on a number of other economic matters, such as trade cases before the WTO. Moreover, designation proved to be a negotiating asset rather than a liability during the manipulation cases of the late 1980s and early 1990s.

Assessment

So, we return to the questions posed at the outset: How well has the accountability process worked? Do the Treasury's exchange rate reports present new information in a timely manner that Congress cares about and that allows the committees of jurisdiction to assess whether Treasury is meeting the objectives set for it under the 1988 Act and other legislation? This section considers the answers to these questions and briefly compares the exchange rate reports with the Federal Reserve's reports on monetary policy.

Overall Evaluation

The Treasury's approach to the reporting process has varied from one administration to the next. The George H. W. Bush administration integrated the reports into its strategy vis-à-vis both the G-7 countries and the NIEs. These early reports were longer and treated international coordination in more detail than subsequent ones. These reports and the reasonably diligent follow-up by the congressional committees make this initial period the "high point" of the accountability process. The Clinton administration, while improving the reports that it submitted over time, treated them as a sideshow to the crises in Mexico and Asia, which it addressed through different channels to the Congress. The first administration of Clinton's successor, George W. Bush, treated the reports as a pro forma exercise, drastically shrank them in size, and virtually ignored the consequences of the Bush tax cuts for the external balance. The reports of 2001–02 and the absence of follow-up on the House side make this period the "low point" of the accountability process.

Under Bush's second term, congressional scrutiny forced the administration to take the reports more seriously. The quality of the reports has improved substantially since 2005, with more attention to the relationship between fiscal policy and the current account and the potential risks of

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growing external indebtedness. Recent reports also contain appendices—on sovereign wealth funds and reserve adequacy, for example—that congressional staff have found useful. The most recent reports are critical of Chinese policy and recommend specific changes, including currency appreciation. Former Undersecretary Timothy Adams and officials in Treasury's Office of International Affairs deserve substantial credit for these improvements. Unfortunately, the secretary's refusal to designate China for manipulation—the main focus of political attention—overshadowed these constructive steps, and these improvements could be reversed by a future administration.

The 2005 GAO report concluded that Treasury had "generally complied" with the reporting requirements of the 1988 Act. It complained that the reports' discussion of the impact of exchange rates on the US economy had become less specific over time, but took some comfort from Treasury's assurance that it took these effects into consideration (GAO 2005, 16–19). But the scope of the GAO analysis was limited to the narrow standard of whether Treasury satisfied the strict requirements of the law. When one asks whether the reports provide a firm foundation for oversight and address policy questions of contemporary interest—more comprehensive standards—the conclusion is less favorable.

For much of the period since 1988, then, the reports have been disappointing. They have often been submitted quite late and in some cases not at all, avoided a number of policy questions that were the focus of contemporary attention and political interest, and were backward-looking and more descriptive than analytical. Too often, the reports have appeared to be drafted to satisfy the literal requirement of the law rather than to enunciate, explain, and advance Treasury's policy. While manipulation was found in some circumstances, Treasury failed to find it in one blatant and systemically important case that calls into question the secretary's accountability to the Congress under the 1988 Act.

Responsibility for the quality of the reports lies primarily with the senior political appointees at the Treasury, beginning with the secretary. It is they who make the basic decisions about how the legislative mandate for the reports is addressed, the level of analysis provided, the amount of detail about G-7 discussions, and whether countries will be cited for manipulation, among other basic parameters. On highly political questions, such as major fiscal programs and Chinese currency matters, the secretary might receive guidance from the Office of the President. The capable Treasury staff must work within these guidelines when preparing the reports.

Treasury officials have a natural and understandable desire to keep their exchange rate policy cards close to their vest, preferring to not telegraph their intentions to the markets and to maintain maximum room for maneuver in international negotiations. It might not be in the interest of the country or Congress to require Treasury to give advance notice of or

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commitment to, for example, exchange market intervention. Nonetheless, there is a middle ground between repackaging information that is already widely known and giving advance warning of policy changes or operations. Without tipping its hand tactically, Treasury could provide more useful and novel analysis, suggestions for which are presented in the concluding chapter.

Comparison with Monetary Policy Reports

Owing to the substantive linkage to monetary policy, and because the reports of the Federal Reserve Board were in the minds of legislators when they wrote the 1988 Act, Treasury's approach to the exchange rate reports merits comparison with the Federal Reserve's approach to its reports originally established by the Full Employment and Balanced Growth Act of 1978, commonly known as the Humphrey-Hawkins Act. First, the monetary policy reports are mildly informative about the future forecast for inflation and thinking in the Federal Open Market Committee (FOMC).[30] Additional documents, including the minutes of FOMC meetings, the *Federal Reserve Bulletin*, and statistics, supplement these reports. Collectively, these reports are considerably more informative about monetary policy and the Federal Reserve's approach to it than the Treasury's reports are about its approach to exchange rate policy. Second, although the Federal Reserve has a dual mandate to pursue "maximum employment" and "stable prices," it has a good record of meeting its statutory objectives, whereas Treasury's position on Chinese currency manipulation is arguably at odds with congressional intent. Third, and importantly, the Federal Reserve consistently delivers its reports on time, in stark contrast to Treasury's practice. The Federal Reserve has not delayed submissions even on the threshold of important international meetings or in the face of market instability—reasons the Treasury has sometimes used to delay submission of the exchange rate report.[31]

Notably, both the Federal Reserve and the Treasury department resisted their respective reporting requirements when first imposed by the Congress. But the Federal Reserve gradually warmed to them as a useful instrument for communicating its policies and intentions. Chairman Ben S. Bernanke's July 2007 testimony was almost effusive: "In establishing these hearings [30 years ago], the Congress proved prescient in anticipating the

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30. See, for example, Board of Governors of the Federal Reserve System, *Monetary Policy Report to the Congress*, July 18, 2007, 1–4, available at www.federalreserve.gov (accessed March 19, 2008).

31. Reviews of the monetary policy reports and relations between Congress and the Federal Reserve include Woolley (1984), Havrilesky (1995), US House of Representatives (1995), and Morris (2000).

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worldwide trend toward greater transparency and accountability. . . . Over the years, these testimonies and the associated reports have proved an invaluable vehicle for the Federal Reserve's communication with the public about monetary policy. . . ."[32] By contrast, although Secretary Brady and Undersecretary Mulford made similar comments about the exchange rate reports and hearings in 1989, any enthusiasm for the reporting requirement by Treasury officials since then has been difficult to detect.

There are, admittedly, several differences between monetary and exchange rate policy that might explain some of the differences in the two agencies' approach to their reporting obligations. The Federal Reserve is independent, whereas the Treasury is political. The Federal Reserve's report is primarily domestic, whereas Treasury's report involves relationships with foreign governments. Conventional wisdom has evolved to favor transparency in monetary policy, but not nearly so much in the realm of exchange rate policy. This comparison nonetheless suggests that there is considerable room for Treasury to embrace the reports as part of a modern communications strategy and to welcome its accountability to the Congress.

32. Ben S. Bernanke, statement before the Hearing on Semiannual Monetary Policy Report to the Congress, Committee on Banking, Housing and Urban Affairs, United States Senate, July 19, 2007.

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Appendix 4A

Table 4A.1 Overview of the US Treasury's reports on international economic and exchange rate policy, 1988–2007

Report number	Date due	Date submitted	Notable topics treated[a]	Countries reviewed for manipulation	Countries cited for manipulation	Committee and date of congressional hearings
1	October 15, 1988	October 24, 1988	▪ International economic policy coordination; G-7 commitment to exchange rate stability ▪ US current account and trade deficits; fiscal adjustment ▪ Asian newly industrialized economies' (NIEs) current account surpluses ▪ Structural reforms in developing countries	Korea, Taiwan, Hong Kong, Singapore	Korea, Taiwan	None
2	April 15, 1989	April 1989	▪ Slower pace of external adjustments ▪ US fiscal adjustment ▪ G-7 exchange market cooperation and intervention	Korea, Taiwan	Korea, Taiwan	Senate Banking, 101st Congress, 1st Session, May 5
3	October 15, 1989	October 27, 1989	▪ Inflationary pressures (Japan, Germany) ▪ US budget and current account deficit ▪ Bilateral exchange rate negotiations with Asian NIEs on financial policies and capital market restrictions	Korea, Taiwan	Korea	Senate Banking, Subcommittee on International Finance and Monetary Policy, November 16; House Banking, Subcommittee on Development, Finance, Trade and Monetary Policy, 101st Congress, 1st Session, October 31
4	April 15, 1990	April 18, 1990	▪ Reduction in global external imbalances ▪ Reforms in Eastern Europe ▪ Depreciation of yen ▪ Asian NIEs' current account surpluses	Taiwan, Korea	None	Senate Banking, April 19; House Banking, 101st Congress, 2nd Session, May 9

5	October 15, 1990	December 3, 1990	▪ The Gulf crisis, oil price, inflationary pressures, and twin risks ▪ Exchange market coordination ▪ Unification of Germany ▪ US fiscal adjustment ▪ Economic and exchange rate development in Asian NIEs	Korea, Taiwan, China	None	None
6	April 15, 1991	May 1991	▪ Slower global growth; US and UK recessions ▪ Reduction in current account imbalances ▪ Call for G-7 actions to reduce real interest rates ▪ Economic and exchange rate development in NIEs	Korea, Taiwan, China	None	Senate Banking, 102nd Congress, 1st Session, May 16
7	October 15, 1991	November 1991	▪ External imbalances (especially Japan) ▪ Interest rates (especially Germany) ▪ Economic reform in Eastern Europe, Latin America ▪ Uruguay Round ▪ Asian NIE current account surpluses	Korea, Taiwan, China	None	Senate Banking, Subcommittee on International Finance and Monetary Policy, 102nd Congress, 1st Session, November 12
8	April 15, 1992	May 12, 1992	▪ Decrease in inflation and strong growth ▪ G-7 fiscal deficits ▪ High real interest rates (especially Germany) ▪ Asian NIE current account surpluses, economic and exchange rate developments	Korea, Taiwan, China	Taiwan, China	Senate Banking, Subcommittee on International Finance and Monetary Policy, 102nd Congress, 2nd Session, May 12
9	October 15, 1992	December 1992	▪ Global expansion ▪ Japan's fiscal stimulus ▪ Need for better understanding of global capital markets ▪ Bilateral exchange rate negotiations with Asian NIEs	Korea, Taiwan, China	Taiwan, China	None

Note: The full texts of the reports between August 1996 and November 2005 are available on the US Treasury website at www.treas.gov/press/archives. The most recent reports are available at www.treas.gov/offices/international-affairs/economic-exchange-rates.

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Table 4A.1 Overview of the US Treasury's reports on international economic and exchange rate policy, 1988–2007 *(continued)*

Report number	Date due	Date submitted	Notable topics treated[a]	Countries reviewed for manipulation	Countries cited for manipulation	Committee and date of congressional hearings
10	April 15, 1993	May 23, 1993	▪ Weak growth in Japan and Europe ▪ Need to intensify international policy coordination ▪ US fiscal deficit; Japan's current account surplus ▪ Further trade liberalization ▪ Exchange rate volatility	Korea, Taiwan, China	China	Senate Banking, 103rd Congress, 1st Session, May 23
11	October 15, 1993	November 23, 1993	▪ US exports ▪ Low growth in Japan and (continental) Europe ▪ Employment ▪ US fiscal adjustment (especially health care) ▪ Yen appreciation and Economic and Monetary Union (EMU)	Korea, Taiwan, China	China	None
12	April 15, 1994	July 21, 1994	▪ Low inflation but high unemployment ▪ Expansion through adequate policy mix ▪ Depreciation of dollar against yen and deutsche mark ▪ Capital controls in Asian NIEs	Korea, Taiwan, China	China	Senate Banking, 103rd Congress, 2nd Session, July 21
13	October 15, 1994	January 3, 1995	▪ Global recovery ▪ US current account and budget deficit ▪ Strong dollar policy ▪ Capital controls in Asian NIEs ▪ Manipulation	Korea, Taiwan, China	None	None

14	April 15, 1995	August 25, 1995	▪ Low growth in Japan ▪ Exchange rate volatility and depreciation of dollar ▪ US current account deficit ▪ Mexico crisis ▪ Capital controls in Asian NIEs ▪ Liberalization in China	Korea, Taiwan, China	None	None
15	October 15, 1995	December 15, 1995	▪ Depreciation of dollar ▪ Exchange rate volatility ▪ US fiscal deficit ▪ Capital controls ▪ Inflation in Asian NIEs	Korea, Taiwan, China	None	None
16	April 15, 1996	August 9, 1996	▪ G-7 recovery ▪ Appreciation of dollar ▪ Growth in Latin America ▪ Exchange restrictions and capital controls in Asian NIEs	Taiwan, China, Singapore	None	None/extensive follow-up elsewhere
17	October 15, 1996	February 21, 1997	▪ Exchange rate stability ▪ Moderate global growth ▪ Reduction of Japan's current account surplus	Taiwan, China, Singapore	None	None
18	April 15, 1997	Not issued				
19	October 15, 1997	Not issued				
20	April 15, 1998	Not issued				
21	October 15, 1998	January 22, 1999[b]	▪ Asian financial crisis ▪ US current account deficit ▪ Appreciation of dollar ▪ Move to floating rates in Asia	Taiwan, China, Singapore, Malaysia	None	None/extensive follow-up elsewhere

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Table 4A.1 Overview of the US Treasury's reports on international economic and exchange rate policy, 1988–2007 *(continued)*

Report number	Date due	Date submitted	Notable topics treated[a]	Countries reviewed for manipulation	Countries cited for manipulation	Committee and date of congressional hearings
22	April 15, 1999	September 3, 1999[c]	▪ Economic weakness in emerging markets, Europe, and Japan ▪ Strong net capital inflow in the United States ▪ US current account deficit ▪ Repeats secretary's "strong dollar" language	Korea, Taiwan, China, Singapore, Malaysia	None	None
23	October 15, 1999	Joined with a subsequent report				
24	April 15, 2000	March 9, 2000[d]	▪ US current account deficit ▪ Strong net capital inflow in the United States ▪ Structural and financial sector reforms in Japan	Korea, Taiwan, China, Malaysia	None	None
25	October 15, 2000	January 18, 2001	▪ Strong growth in the United States ▪ Higher oil prices and acceleration of US imports ▪ Structural and financial-sector reforms in Japan	Korea, Taiwan, China, Malaysia	None	None
26	April 15, 2001	June 22, 2001	▪ Slowed US and global growth ▪ Strong net capital inflow in the United States ▪ Money laundering	Korea, Taiwan, China, Malaysia, Russia	None	None

27	October 15, 2001	October 24, 2001	▪ Slow US and global growth ▪ Depreciation in capital flows to and from the United States ▪ Money laundering and terrorist financing	Korea, Taiwan, China, Malaysia, Russia	None	None
28	April 15, 2002	April 24, 2002	▪ 9/11 attacks ▪ Export and import contraction in G-7 ▪ Strong net capital inflow in the United States	None	None	Senate Banking, 107th Congress, 2nd Session, May 1
29	October 15, 2002	November 12, 2002	▪ Continued trend toward exchange rate flexibility ▪ US current account deficit	None	None	None
30	April 15, 2003	May 6, 2003	▪ US current account deficit ▪ Depreciations in Latin America	None	None	None
31	October 15, 2003	October 30, 2003	▪ Agenda for growth ▪ High oil prices ▪ China's surplus	China, Japan[e]	None	Senate Banking, 108th Congress, 1st Session, October 30
32	April 15, 2004	April 15, 2004	▪ US current account and capital account ▪ Japan's recovery ▪ China's exchange rate regime	China, Japan	None	None
33	October 15, 2004	December 3, 2004	▪ US current account and capital account ▪ Rising interest rates and oil prices ▪ Japan's exchange rate interventions ▪ China's exchange rate regime	China, Japan	None	None
34	April 15, 2005	May 17, 2005	▪ External adjustments ▪ Greater exchange rate flexibility (especially Asia) ▪ China's exchange rate regime ▪ China's internal reforms	China, Malaysia	None	Senate Banking, 109th Congress, 1st Session, May 26

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Table 4A.1 **Overview of the US Treasury's reports on international economic and exchange rate policy, 1988–2007** *(continued)*

Report number	Date due	Date submitted	Notable topics treated[a]	Countries reviewed for manipulation	Countries cited for manipulation	Committee and date of congressional hearings
35	October 15, 2005	November 27, 2005	▪ US fiscal deficit and low saving rate ▪ Demand-led growth in Japan and Europe ▪ Greater exchange rate flexibility in Asia ▪ Doha Round ▪ China's exchange rate regime ▪ IMF to promote exchange rate flexibility ▪ Appendix on indicators used for analysis of exchange rates	China, Malaysia	None	None
36	April 15, 2006	May 10, 2006	▪ Rising oil prices ▪ China's exchange rate policy ▪ Multilateral approach to reforming China's exchange rate regime ▪ Appendices on (1) manipulation indicators; (2) fixed versus flexible exchange rates; (3) China's measures toward renminbi flexibility	China, Malaysia	None	Senate Banking, 109th Congress, 2nd Session, May 18
37	October 15, 2006	December 19, 2006	▪ Global imbalances ▪ Slow growth in Japan and Europe ▪ Oil prices and oil exporters' economic policies ▪ US fiscal deficit ▪ China's domestic demand, capital account liberalization, and exchange rate regime ▪ Appendices on (1) manipulation indicators; (2) methods for assessing misalignment; (3) adequacy of foreign exchange reserves	China	None	Senate Banking, 110th Congress, 1st Session, January 31

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38	April 15, 2007	June 13, 2007	▪ Global imbalances ▪ Strong growth in the United States, Europe, Japan ▪ Oil exporters' economic policies ▪ China's domestic demand, capital account liberalization, and exchange rate regime ▪ Appendices on (1) manipulation indicators; (2) China's trade data; (3) sovereign wealth funds	China	None	None
39	October 15, 2007	December 19, 2007	▪ Housing slump and subprime mortgage crisis ▪ Reduction in US current account deficit, and rapid growth of emerging markets ▪ Depreciation of the dollar ▪ Importance of implementing the June 2007 IMF decision on exchange rate policy surveillance ▪ Need for rebalancing of Chinese economy ▪ "Substantial undervaluation" of the renminbi ▪ Appendices on (1) capital flows and foreign exchange markets; (2) sovereign wealth funds	China	None	None

a. The reports generally treat the subjects of (1) World Economic Performance and Prospects, subdivided into separate treatments of industrial countries and emerging markets, (2) Exchange Market Developments, including foreign exchange market intervention when applicable, (3) US Economy and Balance of Payments, (4) International Coordination, (5) Currency Manipulation, and (6) a statistical appendix—although the emphasis and organization of these treatments vary considerably among reports. This column lists the treatments within these substantive headings that were especially noteworthy or exceptional in light of contemporary economic developments.

b. Period covered: November 1, 1996 to October 31, 1998.

c. Period covered: November 1, 1998 to June 30, 1999.

d. Period covered: July 1, 1999 to December 31, 1999.

e. Report indicated that Treasury was "actively engaged" in discussions with these countries' monetary authorities over their exchange rate policy and intervention practices—the criteria on which these countries and Malaysia are listed as reviewed for manipulation in later reports as well.