
Recommendations

With most current legislative proposals motivated by congressional discontent with Chinese exchange rate policy, there is a danger that Congress will lose sight of the broader purposes of the Exchange Rates and International Economic Policy Coordination Act of 1988. As legislation makes its way through Congress and toward the president’s desk, legislators should keep the broader aspects of US external monetary policy on the agenda: the overall value of the dollar, especially against other key currencies, the risks of external deficits, prudential limits to external debt, the dollar’s role in the international monetary system, and the mandate to cooperate with international partners.

With respect to these matters, as well as currency manipulation, the mechanism by which policymakers are held to account should be improved in several respects. The present mandate with respect to exchange rate policy is partial and should be made more complete, and the standards for assessing whether Treasury has satisfied it should be clarified. Treasury should be more timely, complete, and forthcoming in the reporting process. And Congress should be more systematic and diligent in its review of Treasury’s performance relative to its mandate. These goals should be advanced through several specific measures.

Preparation of the Reports

Treasury should change its general approach to the reports even if there is no change in the law. Too often in the past, Treasury’s approach could best be described as “legalistic minimalism.” The approach has become

substantially more forthcoming since 2005. But Treasury can further embrace the reporting process, using it to explain, defend, and advance its policy more fully, mold the terms of public and academic discourse, and signal its position to foreign governments and international organizations such as the International Monetary Fund (IMF).

Specifically, first of all, Treasury can provide more (but not necessarily complete) information on past events, negotiations, and interlocutors. It can provide more details on negotiations in the G-7 and other financial forums, as well as the bilateral surveillance consultations with the IMF. It can be more candid about the positions of other players on policy questions of interest to the United States, such as the reluctance of the Europeans to press China more strongly for revaluation prior to 2007 (Taylor 2007, Henning 2007a). The department must safeguard the confidence of its foreign counterparts, but this condition nonetheless leaves room for more transparency.

Second, the reports would benefit from more analysis about the relationships between the exchange rate and macroeconomic policies, the endogeneity of the exchange rate, and the instances when the exchange rate becomes disconnected from the economic fundamentals (as had the dollar/euro rate in the second half of 2000). Given the importance of the US federal budget deficit for the current account balance, although the relationship is not one-for-one, it is especially important that Treasury present deeper analysis of this connection. In this regard, Treasury could provide more analysis of the economic tradeoffs involved in policy decisions. A clear statement about tradeoffs would be a contribution to the policy debate, even if the report were agnostic on how the tradeoff should be decided.

Third, Treasury must revise the criteria by which it determines manipulation, regardless of whether it is required to do so by changes in the law, and should do so along the lines suggested below.

Fourth, because sustained overvaluation can pose risks for the US economy that are also substantial, as the Mexican peso and Asian financial crises showed, Treasury should treat such cases even though the 1988 Act might not explicitly require it to do so. The focus on undervaluation in the Act is more relevant at present, given the persistent US current account deficit and the substantial buildup of external debt. But the external position will evolve, and examining cases of overvaluation as well as undervaluation would give greater balance to the reports. Owing to the risk of sparking a crisis, Treasury must admittedly be more careful and nuanced in public statements about cases of overvaluation. But judicious treatment could nonetheless steer a middle course between silence and provoking a crisis (Goldstein 1997).

Finally, Treasury should be more punctual in the submission of its reports to Congress. Of the 39 reports required by the Act since October 1988, four were missed completely and folded into subsequent reports.

None of the 35 reports that were submitted were received before the technical deadlines of October 15 and April 15, and only 13 of those reports were received less than a month late (table 4A.1). The overshooting of the deadline is all the more significant when the report is lagged.

General Objectives

Although Congress has delegated exchange rate policy to the Treasury and Federal Reserve, as discussed at the outset, it has not specified a comprehensive mandate for these agencies in US law. The authors of the 1988 Act intended to make the objective of a “more appropriate and sustainable balance in the current account” the fulcrum against which to increase the accountability of the Treasury (US Congress, 1988, 840; US House of Representatives 1987). In the event, however, the statement of policy in the Act proved to be insufficient as a guide for evaluating whether the department lived up to the mandate. This and other legislated objectives amount to a patchwork of partial mandates that, taken as a whole, is incomplete. The accountability process would benefit from clarifying the general objectives of US policy in this area and the standards by which Treasury’s execution of policy could be assessed.

This new, broad mandate would place the exchange rate in a general equilibrium framework in which its essential purpose would be conceived as bringing equilibrium to the domestic and global markets in goods, services, and capital, or, more precisely, to the sum of these markets as they operate through the balance of payments. The exchange rate and its movements, in this conventional conceptualization, would reconcile ex ante incompatibilities between the domestic economy and the world economy. In the first instance, policy would allow the exchange rate to operate smoothly in this role. This objective will sometimes imply that the United States can make fiscal and monetary policy choices primarily on domestic macroeconomic considerations and treat the exchange rate as the residual. At other times, however, US officials cannot uncritically accept whatever exchange rates the markets might yield. US policymakers should not simply treat the exchange rate as a residual at present and, assuming the US economy continues to be progressively internationalized, they will be able to do so less often in the future than they have done in the past.

Policymakers, in particular, must become proactive with respect to the exchange rate in at least three circumstances.¹ First, even when capital markets might be willing to finance large current account deficits in

1. The literature on this subject is broad. See Williamson (2000, 2007), among other useful works.

the short term, such deficits might not be sustainable in the long term, and the buildup of external debt could be risky or inappropriate. Prudential limits on these external variables, with the exchange rate serving as the intermediate variable, should guide domestic choices on fiscal and monetary policies (and the macroeconomic policy choices of partners). Second, foreign exchange markets sometimes become unhinged from the economic fundamentals at home and abroad. When exchange rates become “exogenously determined,” in the jargon of some economists, there may be a case for government action in the markets, directly through declarations or intervention, or indirectly via changes in macroeconomic policy. Third, when foreign governments intervene directly or indirectly, the exchange rate is, by definition, not fully market-determined. In such cases, US policymakers must consider whether foreign intervention is consistent with the interests of the US and world economies and, if they find that it is not, they should consider countervailing action (discussed below).

In its general mandate, Congress should make clear that it expects the executive to (1) assess whether these circumstances apply and, when it finds that they do, (2) recommend or take appropriate action. This would clarify the standards by which Treasury’s broad mandate would be assessed and serve as a context for the specific mandate to target manipulation.

Current Account Balances and Real Effective Exchange Rates

The 1988 Act gave too much emphasis to bilateral trade imbalances between the United States and countries whose governments manipulate their currencies. International fragmentation of the production process and multilateralization of trade make bilateral imbalances nearly meaningless. Any basic university course in international economics will teach that a country’s overall current account balance should be the focus of policy analysis. China is a case in point: a more substantial appreciation of the renminbi is desirable, from the standpoint of both China and the United States, because it would reduce China’s large and growing global current account surplus and reduce the US current account deficit, not because of its impact on the bilateral imbalance with the United States. The reduction in the current account imbalance, not the bilateral imbalance, could raise American growth and employment and reduce Chinese overheating and inflation. Revision of the Act should shift the emphasis toward the overall current account balance when assessing manipulation and initiating subsequent negotiations.

As a consequence of placing the primary focus on the overall current account balance, findings of manipulation should focus on the real effec-

tive exchange rate rather than bilateral exchange rates. The real effective rate determines that balance more than any bilateral rate and captures competitiveness vis-à-vis third countries. If a currency that is found to be manipulated subsequently appreciates against the dollar but depreciates against the euro similarly, to choose a real-world example, global adjustment will not be served.

Emphasizing the current account balance could conceivably place the United States in the position of finding manipulation on the part of a country with whom the United States is not running a bilateral trade deficit, although such cases are not likely to be common. The United States would not, however, be advancing the interests of other countries at its own expense by initiating negotiations with such a country. Multilateral trade and capital flows bind the US external balance to that of manipulators and third countries inextricably. Because combating manipulation would facilitate global adjustment, including of the US current account, the United States would in fact be advancing its interests even in this case. That the United States would also be acting in the general global interest is a compelling reason to continue to vest the quest against manipulation primarily with the IMF. But that does not mean that the United States should not act when the IMF is not able to act or is unwilling to do so.

Manipulation

Some of the pieces of legislation currently under consideration by Congress introduce the concept of “misalignment” as well as “manipulation.” It would not be desirable to completely replace the latter with the former, for two reasons. First, the criteria for defining manipulation are generally more concrete than those for misalignment. While some instances of misalignment can be clearly identified, others do not command scientific consensus. Second, a country can experience a misalignment without being responsible for it. In many cases the exchange rate has simply lost its moorings, becoming unhinged from the economic fundamentals. While it might be desirable for governments to act to bring the rate into alignment in such cases, requiring governments to do so would be tantamount to introducing a new exchange rate regime and is well beyond the intent of Congress at the moment. A country should have to be shown to (1) manipulate the exchange rate and (2) maintain a misalignment to become the target of US authorities for negotiations and possible countermeasures.

“Manipulation” should also be defined more clearly. The new language should be broadly consistent with the spirit of the IMF language without becoming immobilizing through obscure and unnecessary requirements about intent. Although it must give members “the benefit of any reasonable doubt,” the IMF cannot simply take a government’s statement

of intent at face value. Ultimately, as the IMF general counsel has recently reiterated and the new guidelines confirm, the Fund itself must reach its own “objective” conclusion on the matter (IMF 2006, 2007). The US government must do the same. The new US legislation can reinforce the IMF, contribute to the smooth operation of the international monetary system, and enhance Treasury accountability to Congress by closing the loophole for exchange rate manipulation created by emphasizing intent. US legislation should target countries that manipulate simply “with the effect of preventing balance of payments adjustment.”

US legislation should follow the IMF Guidelines for Exchange Rate Policy, which were revised in June 2007 (see appendix C; for the full document, see IMF 2007). Intended to operationalize the Article IV obligations, those guidelines specify four principles and seven policy actions that guide members with respect to intervention, manipulation, and exchange rate policy generally and could indicate a need for special consultations between a member and the Fund. One of the indicators, foreign exchange intervention, deserves special emphasis, while the remaining indicators should stay as part of a separate basket. Thus, new legislation should provide for the finding of manipulation in one of two ways.

First, foreign exchange intervention that (1) is large in scale, (2) is protracted over two or three years, (3) is consistently in one direction, and (4) perpetuates or accentuates a significant current account imbalance should alone qualify as manipulation. Such intervention would clearly indicate that the relevant monetary authority was preventing the currency from moving toward a rate that would contribute to current account adjustment.² This criterion has the benefit of concreteness, avoids debates about intent, and focuses on a dominant instrument by which some monetary authorities have blocked adjustment in practice. But this criterion has the disadvantage of being relatively narrow; once it were adopted, some governments might be tempted to evade a manipulation designation by relying more heavily on other means of managing the exchange rate. So legislation should provide for manipulation to be found through a second route as well.

The second route would be a basket of the remaining indicators in the IMF guidelines, which would apply when a fundamental exchange rate misalignment is found. The presence of one or more of the following could create a presumption that manipulation had taken place:

- an unsustainable level of official or quasi-official borrowing (by a deficit country) or lending (by a surplus country),
- restrictions or incentives on current transactions or capital inflows or outflows,

2. Relatedly, see John Williamson’s reference rate proposal (2007).

- monetary or financial policies that provide abnormal encouragement or discouragement to capital flows,
- large and prolonged current account imbalances, and
- large external vulnerabilities arising from private capital flows.

Legislation should mandate that Treasury assess the key potential offenders along these presumptive indicators within a comprehensive analysis of the country's macroeconomic situation. Although Treasury should not be directed to apply the indicators mechanistically, placing them within the law would (1) foster convergence with IMF guidelines, (2) create more consistency on the criteria used in the exchange rate reports, and (3) make it more difficult for the report to avoid a manipulation finding in blatant cases. Finally, if Congress continues to be dissatisfied with the application of manipulation criteria, it is perfectly within its constitutional powers to consider delegating the job to another agency.

Countermeasures

How the United States should respond to a government that is found to manipulate its currency but persists is perhaps the most contentious aspect of the current batch of legislative proposals. Simply having the Treasury plead for appreciation in negotiations is too weak. But the original Schumer-Graham 27.5 percent across-the-board tariff was too blunt and was inconsistent with US obligations in the World Trade Organization (WTO). Several bills proposed during 2005–07 would provide for intermediate sanctions, including antidumping and countervailing duties, WTO cases, and the blocking of governance reforms in the IMF that could benefit manipulators (table 5A.2).

Currency undervaluation has effects on trade and current account balances that are similar to a tax on imports and a subsidy to exports of like amount.³ A 20 percent real effective undervaluation of a currency, for example, essentially subsidizes the issuing country's exports by 20 percent and taxes its imports similarly. In principle, the United States could redress part of the competitiveness consequences of such an undervaluation by levying a tariff of the same size on its imports from the country in

3. For a discussion of Chinese currency undervaluation as an effective subsidy, see Ben S. Bernanke, speech entitled "The Chinese Economy: Progress and Challenges" at the Chinese Academy of Social Sciences, Beijing, December 15, 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.

question. Several proposed bills aim to do this by adding the margin of undervaluation to antidumping and countervailing duties.

However, there are several caveats. First, such measures would do little to redress the competitiveness disadvantage faced by US exporters. Second, antidumping and countervailing duties are subject to multilateral discipline, and WTO rules govern them differently. Some analysts thus prefer challenging China's currency practices in the WTO on the basis of Article XV, section 4, which states that members "shall not, by exchange action, frustrate the intent of the provisions" of the General Agreement on Tariffs and Trade (GATT). Gary Hufbauer and Claire Brunel (2008) find that incorporating the margin of undervaluation into antidumping penalties would be less vulnerable to objections by China in the WTO than doing so for countervailing duties. But they conclude that such measures, or bringing an Article XV section 4 case against China in the WTO, would be best justified as a lever to prompt more forceful action by the IMF.

The merits of proposed countermeasures should be assessed in a broad, multilateral context. Foreign exchange intervention on the scale in which Chinese authorities have engaged creates large distortions in the international monetary and trade system. Their intervention pushes the system away, not toward, a market outcome, with considerable distributive consequences. US inaction would accept both these economic distortions and a unilateral choice on the part of Chinese authorities that has far-reaching consequences for the system as a whole. The ideal, first-best response would be for Chinese authorities to scale back their intervention. As of this writing, the IMF and Treasury Department have not achieved this result; although the renminbi has been allowed to appreciate against the dollar, the scale of intervention also increased substantially during 2007 compared with earlier years. Congress thus considers trade measures as a second-best remedy by default, not as the ideal solution. Trade measures that compensate for the distortion can in principle enhance *both* economic efficiency and fairness in international trade.

When implementing any such measures, however, several qualifications would be in order. Trade measures designed to counteract distortions created by currency manipulation should be (1) proportionate to the effect of the manipulation, as best as we can estimate it, (2) removed when manipulation ceases, and (3) removed if found to be irreconcilably inconsistent with US obligations in the WTO. Moreover, such countermeasures should not be applied in simple cases of undervaluation alone, but only in cases of undervaluation caused or perpetuated by manipulation. Even in the absence of manipulation, foreign exchange markets frequently undervalue and overvalue exchange rates, sometimes for prolonged periods. Selective, corrective intervention, cooperatively organized, is the better remedy for market-induced misalignments. Trade countermeasures should be reserved for cases of manipulation-induced undervaluation when the

manipulator refuses to desist and when the economic consequences for the United States and international community are substantial. Such cases are rare, perhaps very rare, but the United States and the international system should have a robust capacity to counter such policy behavior and thus to discourage it in advance.

Reinforcing the IMF

The manipulation sections in the 1988 Act and in the IMF Articles of Agreement are important to the proper functioning and legitimate governance of the international economic system as a whole. Limitations on currency manipulation help to maintain widespread acceptance of that system as fair to the participants in globalization. Most international institutions such as the IMF, however, have difficulty enforcing hard rules by themselves, because, among other reasons, they often entrust enforcement to bodies in which the targets themselves and potential targets are members.

When hard rules are effective in the international realm, they are often supported by national measures. In the United Nations, Security Council decisions are enforced by national military units placed at the disposal of the United Nations for a specific contingency. In the WTO, dispute settlement decisions are given force largely by authorized retaliation on the part of the contracting parties. In the IMF, however, no national instruments are specifically provided for reinforcing the rules of the institution and the decisions of its governing bodies. Its principal instruments to compel cooperation are denial of funding—which does not apply to a country accumulating massive foreign exchange reserves by undervaluing its currency—denial of voting rights, and, in extreme cases, expulsion from the organization. The June 2007 revision to the exchange rate policy guidelines took a step in the right direction by giving more emphasis to the importance of misalignment, but probably does not make these provisions more enforceable. Antimanipulation legislation in the United States should be deliberately designed to provide a monetary analog to national enforcement instruments at the disposal of other international institutions.⁴

4. Mattoo and Subramanian (2008) take a different approach, arguing that the WTO should instead take on a greater role in combating manipulation by adopting a new set of rules related to exchange rates and adjudicating them in the dispute settlement mechanism. Setting aside for the moment the question of whether such a set of rules could be negotiated, their approach and the approach of strengthening the IMF would both require strengthening in turn the national instruments to reinforce multilateral decisions against rule breakers.

The adoption of manipulation countermeasures could be roughly analogous to the United States' use of trade measures in the late 1980s. At that time, Congress also witnessed weaker enforcement of international trade rules and less countervailing action on the part of the administration than it would have preferred. In response, Congress passed "Super 301" and the administration pursued several cases under this provision in subsequent years. The provision was broadly condemned as unilateralist, which indeed it was. But it also arguably advanced liberalization in the target countries on a multilateral, nondiscriminatory basis. Critically, as part of the Uruguay Round agreements, the United States effectively traded off use of Super and Section 301 for an enhanced dispute settlement mechanism in the WTO—agreeing to use Section 301 to redress denial of rights under the GATT/WTO agreements only with a favorable dispute settlement ruling. The dispute settlement mechanism thus created is widely regarded as well functioning and has been accepted by the United States.⁵

Any prospective use by the United States of antidumping or countervailing duties to combat currency undervaluation would meet similar international objections as heavy-handed unilateralism. An appropriate US response to these objections would be to trade off these instruments for more robust enforcement of the rules on exchange rate policy in the IMF's Articles of Agreement. Strengthening the IMF in this way would also require shoring up domestic political support for the institution in its member states, which in turn would be facilitated in the case of the United States by effective enforcement of the injunction against currency manipulation (Henning 2007b). Although it would initially involve the use of trade measures, such an agreement would ultimately shift the system toward the first-best solution.

Reinforcing the IMF in this way would not mean that the United States could not act unless the Fund finds that a particular country has manipulated its currency. Although the IMF has several advantages as a forum in which to address currency questions, the United States does not and should not fully outsource this element of exchange rate policy to the Fund. The United States has retained and should continue to retain unilateral means of action for cases in which others' policies impair the effective functioning of the international monetary system or prevent balance of payments adjustment, but in which the IMF is unwilling or unable to act. In such cases, however, the United States should use unilateral instruments in ways that are consistent with the rules and principles of the Fund and US obligations under the Articles of Agreement. We hope that

5. For reviews of Section 301 and Super 301, the Uruguay Round bargain creating the Dispute Settlement Understanding, and subsequent jurisprudence, see Bayard and Elliott (1994); Bhala (2001, chapter 19); and Jackson, Davey, and Sykes (2002, chapter 7).

such circumstances will be rare, but the Fund's recent posture toward Chinese currency policy shows that they do arise.

Multilateral Fairness and Coordination

If US exchange rate legislation pursues narrow, mercantilistic interests, then it will neither deserve nor receive international support. US policy objectives under any amended version of the 1988 Act must be in the interest of the system as a whole. Fortunately, the enlightened interest of the United States and the interest of the system coincide, while not perfectly, at least substantially. US actions to combat manipulation under the Act should also be in the interest of the target as well as that of third countries—which is currently the case for China.⁶ Jettisoning the focus on the bilateral trade balance with the United States in favor of countries' global current account balances, and shifting analytical focus from nominal bilateral to real effective exchange rates, would also be helpful in this regard. These changes will support the multilateral legitimacy of US actions under the legislation. Just as Treasury must use its Exchange Stabilization Fund in ways that are consistent with its obligations in the IMF, Treasury should also have a mandate to adopt an internationalist perspective in exchange rate policy more broadly.

Relatedly, Congress should retain and enhance the obligation in the 1988 Act (section 3003) to pursue international coordination.⁷ This obligation is consistent with Anne-Marie Slaughter's (2004) general advocacy of mandates for domestic agencies to cooperate internationally, thereby creating dual mandates for bureaucracies that constitute transnational government networks. Treasury's mandate to coordinate in international monetary affairs should be pursued and reported more affirmatively in the future than it has been over most of the period since the 1988 Act (see also Bergsten and Henning 1996). Successful coordination of course requires willing partners.⁸ But if a partner makes a serious offer as part of a coordination package to smooth current account adjustment, for example, Treasury should have to explain any decision to reject. Congress should

6. Lardy (2006), for example, argues that exchange rate appreciation would advance the stated goals of senior Chinese policymakers to move toward consumption-driven growth. See also Lardy (2005).

7. Updated treatments of international macroeconomic policy coordination include Meyer et al. (2002); Canzoneri, Cumby, and Diba (2005); and Truman (2004). The political economy of coordination is discussed, among other places, in Andrews, Henning, and Pauly (2002); Henning (2006); and Andrews (2008).

8. Naturally, foreign partners of the United States should introduce similar mandates as well.

oversee this provision, and foreign governments should know that Congress would review Treasury's decisions in light of this mandate.

Report Consolidation

The US Treasury and Federal Reserve produce multiple reports related to exchange rate policy, as noted above. These reports nonetheless collectively (1) downplay, to put it mildly, the burning policy issues of the day, (2) are overlapping, (3) leave gaps, (4) cover different periods, and (5) rarely contain cross references. Congressional oversight and public discourse on exchange rate policy would benefit from streamlining and consolidating these reports. They need not be combined into one, but this still leaves room for substantial consolidation. Moreover, Congress should discipline itself when reviewing information requirements. Rather than mandating separate reports, as was done after the Mexican and Asian financial crises, Congress should insist that Treasury treat new, salient problems in the existing reports.

Preparing reports, testimony, and answers to questions from Congress consumes substantial staff time on the part of the Treasury. Congress must be realistic about allocating resources to support accountability if the process is to work well; this cannot be an afterthought. Congress must also devote its own staff resources to follow up on reports and prepare hearings where the secretary and other officials testify. To the extent that Congress cares more about exchange rate policy than it did in the past, its own staff and budget should reflect the shift. Neither Treasury nor the committees of jurisdiction should have to take on greater responsibilities without additional resources.

Congressional Oversight

Congress has not always been diligent in its oversight of exchange rate policy. The institutional separation of the consideration of currency and trade matters in the committees responsible for banking and trade, respectively, is one reason for the lapses in follow-up. This division of labor contributed to the lag in congressional activism during the mid-1980s, for example, and complicates Congress's follow-up on the broad international economic policy and specific manipulation issues in Treasury's reports. Making the linkage between trade, finance, and exchange rates is essential to understanding and redressing manipulation. To address this problem, I. M. Destler and I (Destler and Henning 1989, 155–58) recommended that the banking committee invite representatives from the trade and budget panels to participate in oversight hearings on the reports. The committees did this in several instances, both during the early years

of the reporting process and in recent hearings devoted to China—but not systematically. Congress should now regularize multicommittee participation in oversight of exchange rate and international monetary policies by inviting members of the trade and budget committees to hearings of the banking committee. Multicommittee participation would help to integrate financial, trade, and macroeconomic concerns in the oversight process, give greater continuity to oversight over time, and help to render oversight more proactive and less reactive. It would also help to resolve jurisdictional disputes over trade and currency matters among these committees.

