September 2005

# Currency Manipulation and Enforcing the Rules of the International Monetary System*

Morris Goldstein
Dennis Weatherstone Senior Fellow
Institute for International Economics

Paper prepared for conference on "IMF Reform"
Institute for International Economics
September 23, 2005

* I am grateful to Fred Bergsten, Nicholas Lardy, Michael Mussa, and Ted Truman for helpful comments on an earlier draft, and to Anna Wong for excellent research assistance.

## I. Introduction

There has been growing concern, at least in some quarters, that large-scale, prolonged, one-way intervention in exchange markets to limit or to preclude currency appreciation—primarily in China but also in some other Asian economies over the past two to three years—has been both thwarting global payments adjustment and violating the rules of the international monetary system (see Goldstein [2004, 2005a] and Bergsten [2004]).

In its communiqués of October 2004 and of February and April of 2005, G-7 Finance Ministers and Central Bank Governors stated: "… that more flexibility in exchange rates is desirable for major countries or economic areas that lack such flexibility to promote smooth and widespread adjustments in the international financial system, based on market mechanisms." On April 6, 2005, sixty seven US senators voted to support an amendment, sponsored by senators Schumer (D- New York) and Graham (R-South Carolina), that called for imposing an across-the board tariff of 27.5 percent on China's exports to the United States if negotiations between China and the United States on the value of the RMB proved unsuccessful. In its May 2005 "Report to Congress on International Economic and Exchange Rate Policies," the US Treasury [2005, p. 2] summed-up its evaluation of China's exchange rate policies as follows: "…current Chinese policies are highly distortionary and pose a risk to China's economy, its trading partners, and global economic growth…. If current trends continue without substantial alteration, China's policies will likely meet the statute's technical requirements for designation" (as an economy that is manipulating its currency). On July 27, 2005 the US House of Representatives passed by a 255-168 margin a bill sponsored by Representative English (R-Pa) that would not only extend countervailing duty or anti-subsidy law to non-market economies (China among them) but would also place additional requirements on the US Treasury in its reporting to Congress on the practice of currency manipulation. Many analysts argued that the Central American Free Trade Agreement (CAFTA) would not have passed the US House of Representatives later that same day (and then only by a two vote margin) had not the English bill been approved immediately before it.

In the remainder of this paper, I argue that there is a strong case for having international codes of conduct on exchange rate policies, that several popular arguments denying that currency manipulation has recently taken place are flawed, and that the IMF needs to take its monitoring and enforcement responsibilities in this area more seriously than it has in the past. I also put forward several specific suggestions for strengthening the IMF's role in this crucial area of surveillance.[1]

## II. Discouraging Beggar-Thy-Neighbor Exchange Rate Policies

A key reason for establishing the IMF was to discourage beggar-thy-neighbor exchange rate policies. After all, the world had just gone through an unhappy experience with the competitive depreciations of the 1920s and 1930s and there was a global consensus that the new rules of the

[1] This paper builds upon the earlier analysis contained in Goldstein [2005a].

road should prohibit such practices.[2] When the Fund's charter was amended (for the second time) against the backdrop of the more diversified exchange rate system of the 1970s, the new Article IV placed important obligations relating to exchange rate policy both on member countries and on the Fund itself.

Specifically, Article IV, Section I, paragraph iii of the IMF's Articles of Agreement stipulates that each member country shall:

> "Avoid manipulating exchange rates or the international monetary system in order to prevent effective balance-of-payments adjustment or to gain unfair competitive advantage over other member countries."

For its part, the IMF is directed in Article IV, Section III of these same Articles to:

> "…oversee the compliance of each member with its obligations…" and to "… exercise firm surveillance over the exchange rate policies of members," and "… to adopt specific principles for the guidance of members with respect to these policies."

In 1977, the Fund laid out principles and procedures for its surveillance over countries' exchange rate policies. In that document, a number of developments are identified that might indicate the need for discussion with the country. The first such development is "protracted, large-scale intervention in one direction in the exchange markets." Other developments cover official or quasi-official borrowing, restrictions on trade and capital flows, monetary and domestic financial policies, and behavior of the exchange rate that appears unrelated to underlying economic and financial conditions.

I think the Fund intended these developments to be a set of presumptive indicators or "pointers" of (inappropriate) efforts to "manipulate" the exchange rate or to maintain the "wrong" exchange rate.[3] The interpretation of these pointers was not intended to be mechanistic but rather judgmental within the framework of a comprehensive analysis of the general economic situation and economic policy strategy of the country.

Having the wrong real exchange rate has long been known to impose costs on both the home country and its trading partners: when this important relative price gets far out of line, it distorts resource allocation within the country as well as the pattern of international trade among countries. Significantly over-valued exchange rates have also been linked to currency crises in emerging economies, with large attendant costs in terms of real economic growth; and large under-valuations typically generate excessive accumulation of international reserves that, in turn, can threaten financial instability at home and protectionist responses abroad.

---

[2] In the Fund's original Articles of Agreement and under the then par value system, members countries were supposed to obtain the approval of the Fund for proposed changes in exchange rates larger than 10 percent and the Fund was to concur if it was satisfied that the change was necessary to correct a fundamental disequilibrium.

[3] By the "wrong" exchange rate, I mean a real exchange rate that differs from the equilibrium rate implied by economic fundamentals.

It is unlikely that the costs of misaligned real exchange rates are lower today than when the Fund's founding fathers established the Bretton Woods architecture. The higher international mobility of capital implies that speculative capital flows now respond more rapidly and more strongly to perceived one-way bets in exchange markets. The widespread rise in trade openness means that changes in net exports now have the potential to contribute more to real output changes than they did before. With the progressive lowering of tariffs and other barriers to trade, exchange rates have taken on a larger component of competitive advantage. And the large and increasing weight of developing countries in both global output and in global trade flows has given industrial countries a greater incentive to monitor more carefully the exchange rate policies adopted by emerging economies.[4]

On top of these longer-term trends, the current conjuncture has heightened concerns about currency manipulation in at least two respects.

First, the need to deal with an excessively large and rising US current-account deficit—in addition to putting the spotlight on the saving-investment imbalance within the United States itself—has focused attention on exchange rate policies and reserve developments in trading partners of the United States, particularly those in Asia. The US current-account deficit—at $660 billion or 5.8 percent of GDP last year and expected to be even larger this year—is about twice as large as is likely to be sustainable over the medium term. To bring the US current account down to this sustainable level at reasonable cost requires, inter alia, that the US dollar depreciate in real trade-weighted terms by another 15-25 percent from its current value. But it will be difficult to realize the needed further depreciation of the dollar unless the Asian emerging economies plus Japan—whose currencies have a combined weight in the dollar index of roughly 40 percent –participate in the appreciation of non-dollar currencies.[5] Whereas the euro, the Canadian dollar, and the Australian dollar, among some others, appreciated strongly in the first wave of dollar depreciation (from the dollar peak in February 2002 until now), the Asian currencies—with the notable exceptions of the Korean won and the Singapore dollar—did not—often in fact depreciating in real, trade-weighted terms despite large current-account surpluses.[6] If the Asian currencies do not lead the way in the second wave of dollar depreciation, either the resulting overall dollar depreciation will be too small to promote global payments adjustment, or the appreciation of non-dollar currencies will be skewed toward those economies where economic circumstances would be poorly served by further large appreciation.

Second, evidence of currency manipulation has become increasingly obvious over the past three years. The leading case in point is China. As shown in Chart 1, China has been engaging in large-scale, prolonged, one-way intervention in exchange markets for the better part of three years. In 2003 and 2004, the increase in China's accumulation of foreign exchange

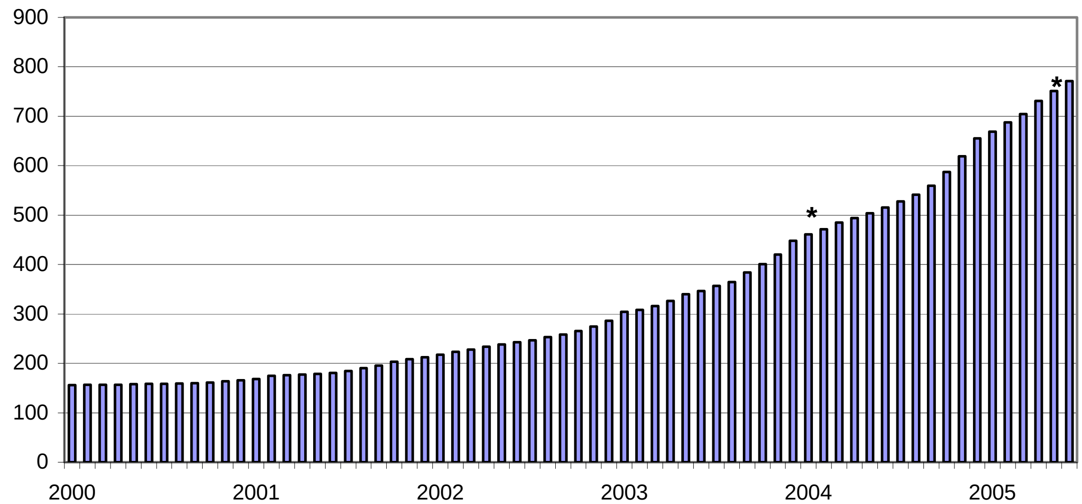
[4] Looking at 11 large emerging economies, Boyer and Truman report [2005] that they make up over 31 percent of world GDP (at PPP exchange rates) and 34 percent of global international reserves in 2004.

[5] This being said, one should not exaggerate the likely impact of Asian currency appreciation on the US current-account imbalance. A 20 percent appreciation of all Asian currencies would likely reduce the US current-account deficit by about $80 billion. This reinforces the basic point made above that the United States itself needs to take decisive action—including measures to lower its structural budget deficit—to reduce its savings-investment imbalance. The least-cost strategy for reducing the US current-account deficit is to employ *both* expenditure-reducing and expenditure-switching policy tools; see Mussa [2005] and Goldstein [2005b].

[6] See Goldstein [2005b].

reserves averaged nearly 12 percent of GDP—and this at a time when China's domestic economy was overheating, when its overall current-account position was in substantial and rising surplus, and when the real, trade-weighted value of the RMB was depreciating.[7] Thus, at a time when the dictates of both internal and external balance pointed toward the desirability of an appreciating RMB, the Chinese authorities were systematically thwarting adjustment by intervening heavily in the exchange market intervention to keep the real value of the RMB low and falling. All indications are that China's external imbalance and reserve accumulation will be even larger this year -- with the trade balance for the first half of 2005 already larger than for all of 2004 and with some respected China analysts, like UBS's Jon Anderson [2005], projecting both a current-account surplus in the range of 8-9 percent of China's GDP and reserve accumulation of roughly $25 billion per month. China's decision in late July 2005 to revalue the RMB by 2 percent relative to the dollar and to move de jure from a dollar peg to a currency basket have so far done little to affect its de facto behavior in exchange markets.

**Chart 1: China's Foreign Exchange Reserves (Billions USD), 2000-2005Q2**




*** After 12/2003, foreign exchange figures are adjusted to reflect $45bn transfer to BOC, CCB.**
*** After 4/2005, foreign exchange figures are adjusted to reflect $15bn transfer to ICBC.**

Japan intervened heavily in exchange markets to the tune of $200 billion in 2003 and an unprecedented $150 billion more in the first quarter of 2004 before suspending such intervention beginning in the second quarter of 2004; according to Ito [2004], Japan's intervention in the 15 months from January 2003 to March 2004 was larger than the cumulative intervention in the preceding twelve years. Malaysia and Taiwan also have engaged in large-scale, exchange-market intervention in recent years, without extenuating circumstances (e.g., weak domestic demand growth or the presence of current-account deficits). From February 2002 to July 2005, the real trade-weighted values of the Malaysian ringgit and the Taiwanese dollar depreciated by 15 and 2 percent, respectively; the corresponding figure for the Japanese yen was a depreciation of 3 percent.

[7] China's economy grew by over 9 percent in both 2003 and 2004, its overall current-account surplus (relative to GDP) was 3.3 in 2003 and 4.2 percent in 2004, and its real trade-weighted effective exchange rate depreciated by 7 percent from February 2002 to August 2005.

When current-account imbalances become excessively large, changes in real exchange rates in both deficit and surplus countries are a necessary (albeit not sufficient) element of effective and least-cost adjustment. No exchange rate system can function effectively if surplus countries take measures to prevent real appreciation of their currencies.

## III. Fallacies About Currency Manipulation

Not everyone agrees, of course, that currency manipulation has of late become a serious problem for the international monetary system or that China's use of large-scale, protracted, one-way intervention in exchange markets should be regarded as manipulation.[8] At least four fallacious arguments have often been put forward to rebut claims of manipulation.

The first argument is that since IMF rules permit countries a wide choice of currency regimes and since defense of a fixed exchange rate frequently involves exchange market intervention, there can be no manipulation for countries maintaining a fixed rate regime.

This argument confuses choice of the currency regime with efforts to maintain a disequilibrium real exchange rate. The former is fully consistent with IMF rules of the game; the latter is not. IMF members are free to pick fixed rates, floating rates, or practically any currency regime in between. They are also permitted to intervene in exchange markets and indeed, are expected to do so when they encounter disorderly market conditions. But what is not permitted under IMF rules is to engage in a particular kind of intervention—namely, large-scale, protracted, one-way intervention. That type of intervention is prohibited because it is typically symptomatic of a disequilbrium real exchange rate and a such a disequilibrium rate can impose serious costs on both the home country and its trading partners.

China can thus legitimately maintain that its choice of a currency *regime*—be it a fixed rate or a managed float -- is a matter of national sovereignty. But it cannot legitimately maintain that it alone gets to decide as a sovereign matter what the *exchange rate* between the RMB and the dollar should be (within that currency regime) for long periods of time regardless of the economic signals about whether that rate is or is not an equilibrium rate—any more than the United States gets to decide unilaterally what the dollar-RMB rate should be. Exchange rates are by definition two-sided variables. When it becomes increasingly apparent that the exchange rate is out of line, it becomes incumbent upon the home country to change it—lest it thwart the international adjustment process.

A second frequently heard argument is that since "to manipulate" is an active verb, a country that has maintained the same parity for an extended period of time cannot be guilty of manipulation (because it has not done anything).

[8] I use the term "currency manipulation" to describe socially inappropriate exchange rate policy because that is the term used in the IMF charter and in some key IMF surveillance guidelines. But the economic logic about what is and what is not appropriate exchange rate policy would be similar if we replaced the term currency manipulation with the perhaps less charged term of "thwarting international adjustment."

What this line of argument fails to see is that what matters for countries' competitiveness is the real trade-weighted exchange rate (that is, the average trade-weighted nominal exchange rate, corrected for differences in inflation rates across countries) and that the appropriateness of such a real exchange rate should be evaluated against the backdrop of the country's overall balance-of-payments position. Viewed from this perspective, a misalignment of the real exchange rate can come about just as easily from *"non-movement"* of the nominal exchange rate as it can from excessive movement. This same perspective also suggests that a given real and nominal exchange rate may be fine when the balance of payments is in deficit but will no longer be appropriate say, when the balance of payments goes into substantial surplus. As applied to China's circumstances, the RMB-dollar parity of 8.28 may not have been a problem when China was running either a very small payment surplus or when the real, trade weighted exchange rate of the RMB was appreciating, but that same parity became a problem when China simultaneously exhibited both a large external payments surplus and a depreciating real trade-weighted exchange rate.[9]

Fallacious argument number three is that even protracted, large-scale, one-way exchange market intervention to hold down the real exchange rate should be permitted if the country needs an under-valued exchange rate to generate sufficient employment in its traded goods industries to ensure social stability. In this connection, China faces a particularly difficult employment challenge, given both the large migration out of agriculture and the large employment losses in many state-owned industries.

The rub here is that many countries have full employment objectives and it would be difficult to elevate some countries concerns in this area over that of others; should, for example, one additional worked hired in the export industry of China count more than one in Bangladesh or one in Egypt? Wholesale application of this rationalization for currency manipulation would make it next to impossible to provide the right incentives for discouraging competitive depreciation in the international monetary system as a whole; indeed, the likely outcome would be continued conflict over exchange rate policy and greater resort to protectionist trade measures.[10]

Yet a fourth argument for downplaying concerns about currency manipulation is that whatever countries' choice of currency regime and whatever actions they take with respect to the nominal exchange rate, they will in the long-term exert little control over the real exchange rate and it is the real rate that matters for competitive advantage. Thus, if some countries use large-scale exchange market intervention to maintain an under-valued exchange rate, their domestic inflation rates will eventually rise enough to bring their real exchange rates back to equilibrium.

---

[9] Many commentators seem to forget that the real trade-weighted value of the RMB appreciated by nearly 30 percent between 1994 and early 2002—a period over which annual real economic growth still averaged about 9 percent.

[10] If there were a widespread protectionist response to currency manipulation, employment could fall in the export industries of the county doing the manipulating. There are also longer-term issues associated with chronic under-valuation that are relevant for stabilization policy and employment; Prasad [2005], for example, has argued that moving toward domestic demand-led growth would help put China on a more sustainable growth path. Goldstein and Lardy [2005a] point out that the large under-valuation of the RMB is a relatively recent phenomenon and argue that seeking to maintain a large under-valuation of the RMB is not a sensible development policy for China. Moving toward greater flexibility in the exchange rate also of course carries implications for the independence of monetary policy and for the use of monetary policy as a tool of stabilization.

The key weasel phrases here are “in the long term” and “eventually.” The fact is that surplus countries can typically resist adjustment and maintain a disequilbrium real exchange rate for longer than can deficit countries. In addition, low-inflation countries may be able to resist real appreciation pressures for a considerable period of time.[11] In China’s case, for example, the under-valuation of the RMB in 2003 and 2004 did induce much larger capital inflows chasing an expected revaluation of the RMB. In addition, the Chinese economy did experience during those years a “blowout” of bank credit expansion as well as a marked increase in inflationary pressures.[12] In the end, it took the implementation of strong administrative controls on bank lending, on investment project approvals, and on land use, along with heavy sterilization operations, to regain control of the credit and monetary aggregates. So China did pay a price in terms of domestic financial instability for seeking to maintain an under-valued exchange rate and the (temporary) rise in China’s inflation rate did reduce somewhat the real depreciation of the RMB. The larger the scale and duration of exchange market intervention, the greater presumably would be the pressures on the real exchange rate to rise. Nevertheless, it is important to note that the real, trade-weighted value of the RMB did depreciate in both 2003 and 2004. It is asking a lot—I would say too much—to expect the rest of the world to absorb much of the costs of a misaligned real exchange rate (especially for the third largest trading nation in the world) if the transition to an equilibrium real exchange rate takes years—not months.

In the end, the set of arguments suggesting that currency manipulation is not a serious problem either today or for the future does not withstand close scrutiny. Its proponents would have us believe that the international monetary system can function effectively as a free-for-all, without an agreed code of conduct. That view was firmly rejected by the experience of the 1920s and the 1930s and recent conflicts over exchange rate policy imply that the international monetary system will not manage itself in our time either. Why should international codes of conduct for exchange rate policy be any less necessary than those for trade policy? Through the rulings of adjudication panels in the WTO and in contrast to what has happened on exchange rate issues, a body of international case law is unfolding—making it clearer what is and what is not internationally-acceptable trade policy on everything from bananas to steel to domestic tax systems. Why isn’t a similar exercise going on for exchange rate policy?[13]

## IV. Enforcing the Rules: the IMF as an Umpire for the Exchange Rate System

If it is accepted that international codes of conduct for exchange rate policy are both necessary and desirable, the next relevant question is who should monitor and enforce those codes. As documented in Section II above, the founding fathers of the IMF and the framers of the new Article IV in the IMF’s charter had a ready answer: the IMF. Not only does the IMF have an obligation to exercise “firm surveillance” over the exchange rate policies of its member

[11] See Mohanty and Turner [2005] on the domestic consequences of exchange market intervention in emerging economies.
[12] See Goldstein [2004].
[13] I say a “similar” (rather than identical) exercise because formal disputes about currency manipulation are likely to be less frequent, subject to a wider margin of error, and resolved according to a broader set of principles than the more detailed disputes about trade policy.

countries, it is the only international organization with the unique mandate to oversee the functioning of the international monetary system.

But no set of rules, codes, or mandates can be expected to have much impact if they are not *enforced* and the reality is that neither the IMF nor its major shareholders have shown an inclination to get much involved in deciding what is and is not internationally acceptable exchange rate policy. Three observations are revealing.

First, although the IMF's surveillance guidelines permit the Fund's Managing Director to initiate and to conduct an "ad hoc consultation" with a country whenever there is a concern about its exchange rate policy, the Fund has conducted such special consultations only twice (Sweden in 1982 and South Korea in 1987) in the past 26 years and never at all during the past 17 years! Is it credible to argue that there have been no exchange rate problems throughout the world during the past 17 years that were of sufficient concern to justify a country visit by the IMF with the express purpose of investigating more thoroughly whether a serious infraction of the surveillance guidelines has taken place?

Second, even today after three years of enormous reserve accumulation in China, the IMF has made no public statement indicating either that China might have been engaged in currency manipulation or that the RMB is under-valued.[14] Instead, it has simply argued over and over again that it would be in the interests of both China and the global adjustment process if China's currency regime showed greater "*flexibility.*" A call for greater flexibility of the RMB is not the same as either a call for a more appreciated RMB or a call for less exchange market intervention by the Chinese authorities: if the RMB depreciated substantially (counter to the needs of the global adjustment process), it would have become more flexible; likewise, continued or even larger exchange market intervention could contribute to a further real depreciation of the RMB, again making it more flexible. I am not of course suggesting seriously that the Fund believes either that (further) RMB (real) depreciation would be desirable or that China should reduce the influence of market forces in the determination of its exchange rate. Instead, I am just highlighting the point that the Fund has been very timid and purposely non-committal on both the appropriate *level* of China's exchange rate, as well as on the intervention measures that China has taken to support the current and recent levels of the exchange rate. It has only been willing to say that the preferred currency regime in China should be one of greater flexibility—and it has not defined either by "how much" or "when" the RMB would need to change to meet the standard of greater flexibility.[15] To borrow a line from T.S. Eliott, "dare I eat a peach?"

Third, in recent interviews about his conception of the role of the Fund (Reuters [2005], International Herald Tribune [2005]), the current Managing Director, Mr. de Rato, has indicated that he doesn't think the Fund should act as a "special pressure group" for changes in country policies—presumably including exchange rate policies.[16] How the Fund is going to exercise firm

[14] In Goldstein [2004] and Goldstein and Lardy ([2003, 2004, 2005a, 2005b]), we have maintained for some time that the RMB is significantly under-valued—on the order of 15-25 percent.

[15] In Goldstein and Lardy [2005b], we argue that that the initial revaluation of the RMB included in the currency reform of late July 2005 was far too small.

[16] See Reuters [2005] and International Herald Tribune [2005]. My reaction to those interviews was similar to that of my IIE colleague, Mike Mussa, who remarked: "it's one thing to be a conscientious objector; its another to be a conscientious objector when you have recently been appointed Commandant of the Marine Corps."

surveillance and induce corrective action—without pressure—in countries that have prima facie tipped one or more of the "pointers" of currency manipulation is not clear. The Fund has followed an approach of using very quiet diplomacy toward China's exchange rate policies over the past two to three years and at least so far there has been only a trivially-small appreciation of the RMB.

In defense of the Fund, one might argue that its major shareholders did not seem to be pressing it much to take on a more activist role in identifying and in discouraging currency manipulation. Only the United States has been willing to speak out publicly on this issue; it has addressed the issue almost exclusively on a bilateral basis, and its procedures for identifying manipulation are at best inconsistent.[17]

Since 1988, the Omnibus Trade and Competitiveness Act requires the US Treasury to report to the US Congress any countries engaging in "exchange rate manipulation." The US Treasury named several Asian economies as "manipulators" in the 1988-94 period (including China in 1992-94) but no country has been cited since 1994—including in 2003 and 2004 when, as indicated earlier, there was strong evidence of manipulation by China and several others economies. If China was meeting—or was close to meeting—the technical requirements for manipulation, as argued in the May 2005 US Treasury Report to Congress (US Treasury [2005]), then these same technical requirements were also being met over much of the past 24 to 36 months. The criteria used by the US Treasury to evaluate manipulation and exchange rate misalignment are also partly flawed: specifically, the Omnibus Trade Act seems to require that bilateral US trade imbalances with partner countries be part of the analysis when these have no sound analytical basis for the purpose at hand; if you want external imbalances to enter the exercise, overall current-account positions are what you should look at.[18]

The fact that the US Treasury has been dragged kicking and screaming into the currency manipulation debate by the US Congress tells you something relevant: if there is a widespread perception that no-one is minding the store in enforcing the rules of the international monetary system, pressure for doing something about it doesn't disappear; instead, it gets funneled into calls for corrective action at the *national* level, where protectionist threats are apt to be greatest and where the analytical toolkit for identifying currency manipulation can be subject to outside pressures. Put in other words, if the IMF were minding the store, there would be less bilateral freelancing.

The message that I take away from this lack of enforcement of codes of conduct for exchange rate policy is the following: The IMF seems to have accelerated its retreat from the role its founders intended it to have as an "umpire" for the international monetary system—and just at the time when such an umpire is increasingly needed and when there are no other promising candidates to take up that role. Yes, the IMF has other roles to play—as a coach, as a banker, and

---

[17] There have been occasional public criticisms of China's exchange rate policy in other G-7 countries but not, I think, public criticisms charging China with engaging in the "M-word" (i.e., manipulation).

[18] As suggested earlier, looking at overall current-account positions should send up a warning flare for China: its overall current account surplus (relative to GDP) was over 3 percent in 2003, over 4 percent last year, and is likely to be at least 7-8 percent this year. Those who maintain that China's overall current-account position has been very modest over the past few years have just not been watching the data carefully.

as a crisis manager, but I submit that looking forward none of those roles will be more important than the umpire function.[19] True, the calls that the IMF will be asked to make will often be controversial—be it ruling on whether China is manipulating its exchange rate or ruling on whether Argentina was acting "in good faith" in negotiating with its private creditors in its recent debt restructuring.[20] Sometimes, the calls made by the IMF will be wrong. But not making those calls at all will be worse for the functioning of the system since the incentives will then become tilted over time toward beggar-thy-neighbor policies and these in turn will induce retaliation of one kind or another. The emerging economies, who have perhaps the most to gain from a further integration into the global economy, have a strong interest in supporting objective enforcement of the rules of the game by the IMF since without such an umpire, they will become increasingly vulnerable to nationalist policies in the advanced countries aimed at "leveling the playing the field." In a similar vein, the legitimate desire of emerging economies to obtain more "chairs and shares" in the fora where global economic initiatives are formulated and where countries' economic policies are evaluated will likely be frustrated if there is a perception that their gains in market share have not been "fairly" obtained.

## V. A Modest Proposal for Discouraging Currency Manipulation

Despite the disappointing track record, it is not yet too late for the Fund to reclaim its rightful place in exercising firm surveillance over countries exchange rate policies. Toward that end, I would suggest that the Fund alter its current operating procedures to accommodate the following three initiatives.[21]

First, *the Fund should begin issuing its own semi-annual report on exchange rate policies*, where it would not only discuss exchange rate developments of interest but also identify cases where there were concerns about potential currency manipulation practices. If, as I believe, the Fund is the institution that has a comparative advantage in monitoring and enforcing codes of conduct on exchange rate policies, its views on these matters should not appear, as has often been the case, as a one-sentence summary in the US Treasury's Report to Congress on International Economic and Exchange Rate Policies. It should issue its own report, with the best objective analysis it can muster. The report would cover industrial countries as well as developing countries. Since a finding by the Fund that a member has been engaging in currency manipulation would be seen as authoritative and as less influenced by national political pressures, it should act as a deterrent to engage in currency manipulation in the first place. Over time, a case law would develop that would help define what are and what are not internationally acceptable exchange rate policies.

---

[19] Mervyn King, Governor of the Bank of England, recently set out a similar view. He concludes as follows: "I believe that we need to rethink the role of the IMF in the international monetary system. I encourage the Fund to articulate a positive vision of the management of the international monetary system in its forthcoming strategic review. I am not convinced that the future of the Fund is primarily as an occasional international lender of last resort for middle-income countries suffering financial crises;" see King [2005, p. 4].

[20] See Truman [2005] on why the IMF should have been more involved as an umpire/advisor in the recent Argentinean debt restructuring exercise than it was.

[21] Going beyond the specific issue of currency manipulation, Fund surveillance over exchange rate policies would also be strengthened if the G-7 invited the Fund to become a full and active participant in its discussion of G-7 exchange rate policies during G-7 meetings.

Second, the *Fund should make more frequent use of the special/ad-hoc consultations* whenever either Fund staff or another member country has raised a serious concern about potential currency manipulation. Such consultations would also give the member country involved an initial opportunity to defend its currency policy and to explain why there may been extenuating circumstances in its use say of large-scale, prolonged intervention. The dialogue and information obtained during such special consultations would also serve as an input into preparation of the Fund's semi-annual reports on exchange rate policies. I make no presumption about how frequently such special consultations would take place or about how many countries would be involved—only that to be relevant they would have to take place more often than never in the last 17 years. Circumstances will dictate when such consultations should be activated.

And third, *the Fund should review as soon as possible its existing guidelines for surveillance over countries exchange rate polices to see if they warrant any modification*—particularly as regards the "pointers" that might be indicative of inappropriate exchange rate policies. I think the existing pointers are reasonable but it certainly possible that improvements can be made. Until such a time as agreement is reached on an amended set of guidelines, the existing guidelines should be enforced.

None of this is likely to make much of an impact unless both the Fund's larger shareholders and the Managing Director of the Fund give such enhanced surveillance over exchange rate policies the support and leadership it needs. It is about time that they do so.

## References


Anderson, Jon, 2005, "China By the Numbers (August 2005)," UBS Asian Economic Monitor, UBS, Hong Kong, August 22.

Bergsten, C. Fred, 2004, "The IMF and Exchange Rates," Testimony Before the Committee on Banking, Housing, and Urban Affairs, US Senate, Washington, DC, May.

Boyer, Jan and Edwin Truman, 2005, "The United States and the Large Emerging-Market Economies: Competitors or Partners?' in C. Fred Bergsten (ed)., *The United States and the World Economy: Foreign Economic Policy for Next Decade,* Institute for International Economics, Washington, DC.

Goldstein, Morris, 2005a, "The International Financial Architecture," in C. Fred Bergsten (ed)., *The United States and the World Economy: Foreign Economic Policy for the Next Decade*, Institute for International Economics, Washington, DC.

Goldstein, Morris, 2005b, "What Might the Next Emerging-Market Financial Crisis Look Like?" IIE Working Paper, No. 05-7, Institute for International Economics, Washington, DC, July.

Goldstein, Morris, 2004, "Adjusting China's Exchange Rate Policies," IIE Working Paper, No. 04-1, Institute for International Economics, Washington, DC, June.

Goldstein, Morris and Nicholas Lardy, 2005a, "China's Role in the Revived Bretton Woods System: A Case of Mistaken Identity," IIE Working Paper, No. 05-2, Institute for International Economics, Washington, DC, March.

Goldstein, Morris and Nicholas Lardy, 2005b, "China's Revaluation Shows Why Size Really Matters," *Financial Times*, July 22.

Goldstein, Morris and Nicholas Lardy, 2004, "What Kind of Landing for the Chinese Economy?" IIE Policy Brief, No. 04-7, Institute for International Economics, Washington, DC.

Goldstein, Morris and Nicholas Lardy, 2003, "Two Stage Currency Reform for China," Asian *Wall Street Journal*, September 12.

International Herald Tribune, 2005, "IMF Chief Draws Fire Over Style as Leader," By Daniel Altman, July 27.

Ito, Takatoshi, 2005, "The Yen and the Japanese Economy, 2004" in C. Fred Bergsten And John Williamson (eds)., *Dollar Adjustment: How Far? Against What?* Institute for International Economics, Washington, DC.

King, Mervyn, 2005, "The International Monetary System," Remarks at "Advancing Enterprise 2005 Conference, London, February 4.

Mohanty, M.S. and Philip Turner, 2005, “Intervention: What Are the Domestic Consequences?” in *Foreign Exchange Market Intervention in Emerging Markets: Motives, Techniques, and Implications*, BIS Papers, No. 24, May.

Mussa, Michael, 2005, “Sustaining Global Growth While Reducing External Imbalances,” in C. Fred Bergsten (ed)., *The United States and the World Economy: Foreign Economic Policy for the Next Decade,* Institute for International Economics, Washington, DC.

Prasad, Eswar, 2005, “Next Steps for China,” *Finance and Development*, September.

Reuters, 2005, “Under Fire, IMF’s Rato Wants to Get the Job Done,” by Leslie Wroughton, July 29.

Truman, Edwin, 2005, “International Monetary Fund Reform: An Overview of the Issues,” Paper prepared for IIE conference on “IMF Reform,” Institute for International Economics, Washington, DC, August.

US Treasury, 2005, “Report to the Congress on International Economic and Exchange Rate Policies, “ US Treasury Department, Washington, DC.