

Edited Transcript

Role of the IMF in Current and Future Financial Crises

Michael Mussa, former director of research at the International Monetary Fund, argues that the Fund should take a stronger stand on violation of norms for exchange rates.

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Sherman Katz: Welcome to Peterson Perspectives. Our guest today is Michael Mussa, senior fellow at the Peterson Institute, and we're talking about the role of the IMF in current and future financial crises. More specifically, we're going to talk about the problems currently being created by the Chinese exchange rate. Mike has been a senior fellow with the Institute since 2001. He served as economic counselor and director of the Department of Research at the IMF from 1991 to 2001. In that position, he was responsible for advising the management of the Fund and the Fund's executive board on broad issues of economic policy, and for providing analysis of ongoing developments in the world economy. Mike also served as a member of the US Council of Economic Advisers appointed by President Ronald Reagan from August 1986 to September 1988. Prior to that, he was a member of the faculty of the Graduate School of Business at the University of Chicago. His main areas of research are in national economics and macroeconomics, monetary economics, and municipal finance. He has published widely, and among those publications is his paper "The IMF's Surveillance over China's Exchange-Rate Policy" in the recently-published Institute book *Debating the Chinese Exchange Rate Policy*. Thanks very much for joining us today, Mike.

Michael Mussa: My pleasure.

Sherman Katz: Tell us to begin, Mike, what is the basic responsibility of the IMF in the area of exchange rates in this time of floating rather than fixed exchange rates?

Michael Mussa: Well, as you said previously, we used to have fixed exchange rates, and the IMF was supposed to supervise any decisions to change those rates. When that system collapsed in the early 1970s, it was then replaced by the responsibility of the IMF to oversee the international monetary system in order to ensure its effective operation; to oversee the compliance of members with certain obligations—which were spelled out in the Articles—and to support both of those activities; to engage in firm surveillance over the exchange rate policies of members; and to establish guidelines for members concerning those policies."

- Sherman Katz: If we look at our own situation, we have an enormous current account deficit. This is part of a situation of general global imbalance. To help us understand the IMF's role, what has it done in relation to the US position?
- Michael Mussa: Well, that relates to the first and the broadest of those responsibilities outlined above: to oversee the international monetary system in order to ensure its effective operation. A key aspect of this is that large payment imbalances that are viewed as unsustainable in the longer-term require correction, both by the country involved and, obviously, by the rest of the world when it is a country as large as the United States. So it would be the responsibility of the IMF to identify whether the US current account deficit, which reached 6 percent of GDP in 2006, was in fact so large as to pose serious concerns about its sustainability and about the need for adjusting it downward. I think, by and large, the IMF fulfilled that responsibility, by pointing to concerns about the overvalued dollar and the widening US current account deficit going back to at least 2001.
- Sherman Katz: Now let's look at another situation that is a concern to the United States and the rest of the global economy: the situation of China, which has reserves in excess of \$1.6 trillion. What has been the role of the IMF in relation to China and its situation in the global economy?
- Michael Mussa: I think general responsibility applies to China as well. When you identify a general global problem that requires adjustment, it is the responsibility of the Fund to identify what needs to be done, and the responsibility of its members to cooperate with the Fund and with each other in order to get that done, whatever needs to be done. In the case of China and in the context of the problem of global imbalances—the very large US deficit and the surpluses of other countries, including China—China had an obligation to contribute on the other side from the United States by allowing its exchange rate to adjust and thereby permitting its current account surplus either to contract or at least not to expand as enormously as it has since 2002–2003.
- Sherman Katz: Just to be sure all our listeners follow, when you talk about allowing exchange rates to adjust for a surplus country, what does that typically mean?
- Michael Mussa: There are two ways the exchange rate can adjust in real terms. In one case, if you have a pegged rate, the exchange rate can appreciate through domestic inflation that is more rapid than inflation in other countries. When we used to have pegged exchange rates, or we had goal-based monetary systems, that was the only mechanism of adjustment—differentials in national inflation rates—and that process was actually described by David Hume two and a half centuries ago. Now, in a situation of floating exchange rates, you can instead adjust the nominal exchange rate or allow it to adjust in response to market forces. In the case of China, there has been massive market pressure for

appreciation, and we know that because they've had to intervene in the foreign exchange market, buying dollars and selling their domestic currency in massive amounts in order to resist the market forces for appreciation.

Sherman Katz: In the past couple of years, since July 2005 when China changed over to a slightly more flexible system, the renminbi has appreciated by 15–20 percent. Do you think that China has begun to take the Fund's advice about the need for such appreciation?

Michael Mussa: I think there has been some response with the move to a gradual appreciation of the exchange rate. The difficulty is that it has really not kept pace with the problem because, during that period of time, the current account surplus of China has expanded from 4.5 percent of GDP to more than 11 percent of GDP last year. So the exchange rate in nominal terms against the dollar has adjusted, but actually the scale of intervention in the foreign exchange market—the resistance to market pressures for more rapid appreciation—has become stronger rather than weaker. So, yes, there has been some adjustment, but it's not been enough to address adequately the problem.

Sherman Katz: Perhaps it would be helpful for you to describe briefly Article IV consultations and what they mean, and what, in your view, the IMF has done or not done with respect to those consultations in recent times?

Michael Mussa: Well, Article IV was revised in the mid-1970s to deal with the move toward a mixed system of floating and pegged exchange rates. In conjunction with this, the Fund decided in its surveillance responsibilities that an appropriate means for carrying out that responsibility was to have an annual consultation with each member on its various responsibilities under Article IV. A report was prepared by the staff and discussed with each country's authorities, and then subsequently, the report and the authorities' response was discussed by the IMF executive board. That is the principal mechanism whereby the Fund co-exercises firm surveillance over members' exchange rate policies, and presumably, less-firm surveillance over other aspects of their policies.

Sherman Katz: Your paper in *Debating China's Exchange Rate Policy* argues that the Fund has not been nearly as strenuous, if you will, in encouraging China to appreciate. In counterpoint, the book also includes some comments from the deputy director of the Fund's Asian-Pacific department, Steve Dunaway. He refers to the Fund's 2004, 2005, and 2006 reports in which he argues that the Fund has been pretty specific. Do you think that's right? And, if not, what do you think remains for the Fund to do?

Michael Mussa: Well, the Articles of Agreement contains specific language, making it an obligation of all members of the Fund to avoid manipulating the exchange rates or the international monetary system in order to prevent effective balance-of-payments adjustment or to secure unfair competitive advantage

over other members. That's a specific legal obligation. That's the law. The question is: Have the Chinese authorities—by intervening massively and increasingly so in the foreign exchange market while at the same time sterilizing the domestic monetary consequences of that intervention—been preventing effective balance-of-payments adjustment? In my judgment, they clearly have for a number of years. That's a flat-out violation of the Articles of Agreement. It is much more serious than that we think their exchange rate is somewhat undervalued. Not only is your exchange rate somewhat undervalued, but your policies are aggressively seeking to keep it substantially undervalued—and that's a violation of the law. And the Fund needs to make the point, I think with increasing emphasis, that this is not just analysis and advice. The Chinese, as a member of the Fund, have agreed to these obligations and now they need to deliver on it.

Sherman Katz: Now, Dunaway also points out that there are other steps that the Chinese could take. For example, rebalance the economy away from emphasis on investments and exports for growth toward consumption, and that this might allow China to sustain rapid growth domestically and make a permanent contribution to resolving global imbalances. Do you agree with that?

Michael Mussa: I think we all have agreed, particularly Nick Lardy at the Institute here, and others, that the Chinese economy needs to be rebalanced in the direction of strong or more domestically-oriented growth, even the kind the Chinese State Committee has said for their five-year plan that that's what they want to do. The question is what policies are going to deliver that. And as I point out in considerable length in this paper, the overall effect of their policy of holding the exchange rate against depreciation, intervening massively in the foreign exchange market, and sterilizing that intervention—the monetary effects of that intervention—has the direct effect in the opposite direction of stimulating domestic demand growth. I go on to point out, not in that paper but in another one, that if United States pursued similar policies in this country, intervening massively and sterilizing the effects of that intervention, we would have in the U.S. the Federal Reserve contracting the available supply of credit so rapidly that the entire Federal Reserve balance sheet would be obliterated in four months.

Sherman Katz: Do you think that the change of leadership at the Fund, which has been rather recent, might lead the Fund in the proper direction? Or is it perhaps too soon to say?

Michael Mussa: Well, I think one of the key problems earlier was that the staff, I think, was suggesting the exchange rate was undervalued, the then-managing director, Mr. de Rato, was saying, "Well, the Fund is really not the policeman of the international monetary system, we need gentle persuasion," and so forth—ignoring the responsibility of the Fund to enforce international law in this area, denying indeed that it had such a responsibility. I think Mr. Strauss-

Kahn, his successor, has been much more explicit in saying that there's a clear problem with the Chinese exchange rate and that more rapid appreciation is needed. So I think there's certainly been an important change of tone at the top.

Sherman Katz: Finally, apart from what we have already discussed, do you see other aspects of future financial crises in which the IMF might play an important part?

Michael Mussa: I think yes. The IMF has a large pool of resources that it can draw on, probably \$200-\$250 billion, that can be lent to member countries, essentially at the discretion, first of the managing director but approved by the IMF executive board. So we really have pre-positioned resources that don't require legislative approval, and can be mobilized quickly in large amounts to support countries that are experiencing balance of payments difficulties. Now, very big countries—the United States and China—the magnitude of the resources is not that large. But when you get below that size, the resources that are potentially available are quite significant and have been deployed in a number of important international financial crises in recent years.

The last five years have been a period in which we've not had those problems, but it doesn't say they won't return. And indeed, right now, we are beginning to see some evidence of difficulties in a few countries. And of course, if we happen to see a drop in world commodity prices, rapid and substantial, that would, of course, benefit many countries, but it would cause exporting countries, at least a number of them, to suffer considerable difficulties with their balance of payments, and they might be calling on the Fund for some temporary support, particularly those who haven't built up huge quantities of reserves. So while Fund lending has been very small in the last few years, I don't think the need for it has disappeared entirely for looking out over the next decade or two. And I would guess that during the next five years we'll see some increased use of Fund resources.

Sherman Katz: Excellent. Thank you so much for giving us the benefit of your perspective. This is a fascinating conversation to be continued. Thank you.

Michael Mussa: You're welcome.