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Introduction

Exchange rate policy has become a particularly important issue for the US Congress in recent years. The issue's return to political prominence, a periodic feature of US international economic policies, has in this instance been driven largely by objections to China's exchange rate policy. Competition from China has placed economic pressure on US producers, who have complained to members of Congress that the Chinese currency, the renminbi, is substantially undervalued. Meanwhile, the US Treasury Department has refused to cite China in its semiannual reports to Congress as a country that "manipulates" its currency, despite unprecedented amounts of foreign exchange intervention by Chinese authorities to restrain their currency's appreciation. The Secretary of the Treasury, Henry M. Paulson, Jr. prefers a diplomatic approach to China in the form of the Strategic Economic Dialogue. Frustrated by what they perceive to be the modest results of these discussions, several members of Congress have proposed legislation that, if adopted, would reform the process by which Treasury identifies and responds to currency manipulation and could impose trade restrictions to compensate for undervaluation. The stakes are raised by the applicability of such provisions to countries beyond China whose economic strategies have also included substantial undervaluation of their currencies.

The relationship between Congress and the executive, in particular the Treasury Department, lies at the heart of the US response to China's economic policies and the broader challenge of international adjustment. The Exchange Rates and International Economic Policy Coordination Act of 1988, an important component of the large omnibus trade act that year, partly defined this relationship with respect to exchange rates. The Act

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mandated Treasury to report to Congress and the secretary to testify at follow-up hearings if asked to do so by the banking committees of the House and Senate. Proponents intended the Act to improve congressional oversight and Treasury's accountability on exchange rate policy. Congress thus involved itself in exchange rate policy more deeply than it had prior to the 1980s, and more deeply than the legislatures of most, if not all, of the other key currency countries.

Accountability in US exchange rate policy is important for two reasons. First, it is important to keep policies connected to the democratic process, both to sustain broad political support for those policies and to redirect them when they deviate in the extreme from broadly held preferences. Congressional oversight and legislation on exchange rate policy helped achieve both of these aims during the mid-1980s (Destler and Henning 1989). Second, the general and specific provisions of the 1988 Act bear heavily on the effective functioning and legitimate governance of the international economic system as a whole. In particular, they target currency practices that, if allowed to continue, would impede balance of payments adjustment and erode popular faith in the fairness of international trade and finance. In doing so, these provisions reinforce the rules and norms of the international monetary regime as reflected in the Articles of Agreement of the International Monetary Fund (IMF).

Three changes in the fundamental features of the US and global economies since the mid-1980s reinforce the importance of accountability and oversight in this policy area. First, the US economy is considerably more open to international trade than it was in the mid-1980s and far more open than at the outset of the postwar period. Exports plus imports relative to GDP was 9.3 percent in 1950, 18.4 percent in 1987, and 26.7 percent in 2005.[1] With a general increase in capital mobility, the US economy is also more open to international capital flows than in the early decades of the postwar period. Greater openness increases the magnitude of the macroeconomic and distributive effects of changes in the external value of the dollar. Second, with the rise of numerous emerging markets and more in the queue, the number and diversity of countries whose policies bear on US economic performance have risen apace. Third, within US politics, the partisanship of international economic policy has intensified, and splits in party control of the Congress and the executive create friction between the branches (see, for example, Destler 2005).

In light of these fundamental changes, and more immediately the disputes over Treasury's approach in its reports and numerous legislative proposals to change oversight, the time is ripe for an assessment of the Exchange Rates and International Economic Policy Coordination Act of 1988—hereafter referred to as the 1988 Act—and the reporting process

1. US Bureau of Economic Analysis data as reported in the *2007 Economic Report of the President*, tables B-24, B-25, and B-103.

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that they created. How have the provisions and the reporting process met key tests of accountability in practice? Has Treasury provided transparency sufficient for Congress to judge whether the department has met the objectives of this and other relevant legislation? Has Congress provided appropriate oversight? Has the process contributed to better policy and, if not, what reforms would be likely to improve policy outcomes? This book addresses these questions.

Premises

Before proceeding, it would be worth making the key premises of the analysis explicit. These relate to the location of authority over exchange rate policy, Chinese currency practices, the role of the IMF, and the scope for treating the exchange rate as a policy instrument.

First, this analysis proceeds from the fundamental assumption that the US Congress is the ultimate source of authority in exchange rate policy. Congress has delegated authority on this issue to the Treasury, and the Federal Reserve, and properly reserves the right to establish objectives for policy and exercise oversight. While these agencies exercise their mandate with considerable discretion, they are and should be answerable to Congress. This premise is developed further in the following section.

Second, Chinese foreign exchange intervention over 2002–07 was unprecedented in magnitude and contributed to growth in China's current account surplus to roughly 12 percent of GDP by 2007. Chinese policy is far outside the range of experience since the Second World War for systemically important countries. The analysis in this book rests on a basic judgment that this behavior harms the multilateral system and threatens its political underpinnings. Specifically, Chinese authorities' intervention has kept the renminbi substantially undervalued, prevented a desirable adjustment of current account imbalances, and constitutes "manipulation" as that term was meant to be interpreted by Congress.[2] It is important to point out that this is not an issue on which the respective countries' national economic interests, defined comprehensively, collide. To the contrary, by diverting resources to less productive uses, renminbi undervaluation both distorts Chinese development and harms growth elsewhere. Thus, China, the United States, and the rest of the

2. Goldstein (2006), Goldstein and Lardy (2005, 2008), and Mussa (2007) present compelling arguments that Chinese policy behavior violates the injunction against manipulation in the IMF's Articles of Agreement. 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, May 23, 2007. Similarly, the chapters that follow argue that Chinese behavior also contravenes the injunction against manipulation within the meaning of the 1988 Act.

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world would all be better off with substantial further appreciation of the renminbi (Goldstein and Lardy 2005, 2008). In order to reduce the US current account deficit on a more lasting basis, a substantial further reduction in the US federal budget deficit is also desirable over the medium term; but the persistence of US fiscal deficits does not diminish the desirability of renminbi appreciation.

Third, the IMF is the best venue for addressing currency alignment, exchange rate policy, and payments adjustment. Among international institutions, the IMF has the comparative advantage, and it is the preferable forum for challenging countries' exchange rate policies within a multilateral context. However, the Fund's governing bodies are sometimes manifestly unwilling to confront members on such practices and, even if willing to do so, probably lack compelling means of enforcement. The governance and resources of the IMF are not always sufficient to combat currency practices that threaten or harm the international monetary system. The United States and other countries should therefore retain the means and reserve the right to discourage exchange rate policies of other IMF member states that impede adjustment, threaten stability, or contravene their obligations in the Fund.

Fourth, analysis of relations between Congress and the Treasury in this area rests on the prior finding that "exchange rate policy" is a meaningful concept. Some economists argue that the exchange rate is not a policy instrument that can be separated from other macroeconomic tools, mainly monetary and fiscal policy. The premise of this book is that, although the exchange rate depends largely on foreign and domestic macroeconomic policies, having a policy toward the external value of the currency is justified, and even necessary under certain circumstances.

Those adopting the "rational expectations" view of foreign exchange markets believe that participants act on complete information about macroeconomic policy, underlying economic conditions and the relationship between them. If this were accurate, there would be little or no scope for movement of the exchange rate from the level dictated by the fundamentals, no speculative bubbles in exchange markets, and no room for effective foreign exchange intervention. However, experience demonstrates that currencies frequently become unhinged from the fundamentals and exhibit substantial and prolonged misalignments. Market participants do not have access to complete information by any means and this creates scope for intervention of various sorts to be effective (Williamson 1998, 2007; de Grauwe and Grimaldi 2006). Consider, in turn, (1) the evolution of the professional consensus on the effectiveness of government action in the foreign exchange market and (2) the desirability of sometimes adjusting macroeconomic policies to manage the exchange rate and balance of payments.

Evaluation of the scope of government capacity to affect exchange rates without altering underlying monetary, fiscal, or structural policies

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is hobbled by the weakness of economists' models of exchange rate determination, which deprives analysts of reliable counterfactuals against which to measure the effects of government action in foreign exchange markets. The professional consensus on the effectiveness of intervention, as a consequence, has swung back and forth over the decades. The availability of daily intervention data over the last 10 years has improved these studies. More recent studies have also addressed more sophisticated questions, differentiating the circumstances under which intervention is and is not likely to be effective. As a result of this evolution, these more recent studies generally find intervention to be more effective than did studies conducted during the 1980s.[3] Experience with massive Chinese and Japanese interventions during the last five years suggests they can indeed be effective, even when sterilized, with and without capital controls, for extended periods.

The conditions that create scope for intervention to be at least partially effective also create scope for other more subtle instruments. In the presence of high capital mobility, flexible exchange rates are often driven by herd behavior and expectations, and are thus frequently disconnected from the underlying economic fundamentals. In addition, the foreign exchange markets often exhibit multiple equilibria. When private expectations are easily swayed, governments are more likely to be able to induce a shift from one equilibrium to another. Particularly when the rate moves far from equilibrium, governments might well coordinate the expectations of private participants by articulating an emerging consensus on the direction of movement (Taylor 2003).

Government officials can influence these expectations, depending on market sentiment, by signaling their desire for a stronger, weaker, or stable currency, by foreswearing intervention, and by intervening. Under some market conditions, such as a profound current account imbalance, a "no comment" in the face of a significant exchange rate movement can be interpreted by the market as a clear signal of approval. Conflict over trade policy and market access can enhance the markets' sensitivity to official statements. Thus, even if US policymakers have only partial influence over the exchange rate, that influence can be substantial at particular junctures.

The debate among economists has moved a long way from asking simply whether intervention is effective, as was the tendency in the 1980s. Careful studies now ask under what circumstances intervention can be effective. Few if any would assert that particular settings of monetary and fiscal policy determine a unique exchange rate, or even a narrow range for the exchange rate, that is consistent with internal and external equilibrium. Further discussion is beyond the scope of this book, but suffice it to say that the balance of evidence suggests that government action can be successful under a variety of circumstances, such as when it is publicly

3. For a review, see Sarno and Taylor (2001).

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announced, conducted jointly by two or more central banks, consistent with the underlying fundamentals, and taken when the exchange rate is far from equilibrium.[4]

Irrespective of the exogeneity of the exchange rate, moreover, there are instances when monetary and fiscal policy should be adjusted with the exchange rate and external balance in mind. A large economy such as the United States will usually set monetary and fiscal policy primarily with a view toward managing domestic output, employment, and inflation. Normally, the external balance and value of the currency will enter into these calculations primarily through their forecast impact on these domestic variables. However, when large current account deficits become unsustainable and the buildup of external debt inappropriate, there might be a strong case for adjusting macroeconomic policy to manage the external risks, in which case the exchange rate will be a crucial intermediate variable.

As this discussion suggests, the term "exchange rate policy" takes on an expansive meaning in this book. Exchange rate policy has multiple components: official declarations, foreign exchange intervention, and adjustments of other policies with exchange rate or external balance objectives in mind. The term includes official adoption of a view as to an appropriate value for the dollar, either on an effective basis or against a particular currency, and representation to that effect in international fora or bilateral meetings. The term also includes instances where the timing of adjustments of macroeconomic policies is advanced or delayed to affect the external value of the currency.

Comparative Perspective

Because this book assesses the accountability mechanism and identifies weaknesses on the way to proposing remedies, some of the relative strengths of US institutional arrangements should also be acknowledged at the outset. These strengths are more apparent in comparative perspective. This section first provides an international comparison and then a domestic comparison with accountability in other policy areas.

International

The US model, characterized by the relatively strong role for the Congress, compares favorably with the arrangements within the euro area as far as

4. See Catte, Galli, and Rebecchini (1994); Dominguez and Frankel (1993); Williamson (2000); Sarno and Taylor (2001); Ito (2002); Ramaswamy and Samiei (2003); Taylor (2003); Kubelec (2004); Fratzscher (2004); and de Grauwe and Grimaldi (2006). Genberg and Swoboda (2005) find official declarations to be significantly effective.

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accountability and democratic control are concerned (Henning 2007a; see also Henning 2006). Indeed, the European Parliament's standing as the institution to hold the monetary authorities to account is weak, the relationship between the European Central Bank and the national finance ministers who constitute the Eurogroup is often contentious on exchange rate policy, and these institutions are not subject to oversight that is backed by a capacity to impose sanctions if standards have not been met or by any reporting requirement equivalent to the 1988 Act. When policy deviates from the preferences of a broad coalition of interest groups in the United States, as it did in the mid-1980s, Congress can threaten legislation on trade and exchange rates with credibility. No similar mechanism exists in the euro area. Institutional arrangements and accountability mechanisms, of which the exchange rate report is one example, give the legislature greater standing vis-à-vis core policymakers in the United States than in the euro area.

When compared against best practices in accountability mechanisms, however, exchange rate policy arrangements in the United States must be judged less favorably. Because US arrangements lie between best practices, on the one hand, and euro area arrangements, on the other, the comparison differs depending on the point of reference. It is quite consistent, therefore, to find that the US Treasury is more accountable than euro area monetary authorities, but that it has sometimes not lived up to the spirit of the 1988 Act. Although Congress plays a stronger role in the United States than any "outside" institution in the euro area, the US accountability process can certainly be improved.

Domestic

Exchange rate policy accountability can also be compared with executive branch reporting and congressional oversight in other policy areas. Treasury's exchange rate report is one of more than a hundred reports from the department mandated by Congress; these are in turn a fraction of the several thousand required of the executive branch as a whole.[5] Such reports have been a standard tool of congressional oversight and influence over policy administration since the 1930s. Treasury and other agencies report on foreign investment, trade policy and negotiations, and monetary policy, to name areas related to exchange rates, plus a number of foreign policy matters such as intelligence. Thus, rather than unusual, Treasury's reporting requirement on exchange rate policy is fairly typical of an area in which Congress takes an interest. Nor is the exchange rate report

5. See the list compiled by the Clerk of the House of Representatives (US House of Representatives 2007). Mullen (2006) estimates that 10,000 executive branch reports are received by the Senate alone.

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unique in terms of the balance of expertise between Congress and the executive, the sensitivity of financial markets, or the engagement of foreign governments.

It should also be noted that the struggle between Congress and the Treasury over Chinese exchange rate policy, particularly as to whether it constitutes "manipulation," is by no means unique in federal politics. In fact, it is symptomatic of the broader problem of congressional delegation to and influence over the executive branch that is played out across a host of policy areas on a regular basis. Relations between these two branches of government exhibit a well-known set of problems that inhibit the smooth functioning of policy and accountability mechanisms. These include conflicting objectives of the Congress and executive agency, slippage between the preferences of the principal and those of the agent, asymmetries in expertise, collective character of the principal, inconsistent oversight, and agency resistance to disclosure. These difficulties derive ultimately from the constitutional system of separation of powers and checks and balances among the branches of government, as well as from standard problems in the relationship between agents and principals.[6] The pervasiveness of these problems in American government should not lead us to accept weaknesses in exchange rate policy accountability, however. These weaknesses have far-reaching consequences not just for US policy but for the international monetary system. As the recommendations presented in this book will show, we have the means to strengthen accountability. This normative conclusion constitutes another premise of the book.

Congressional delegation to the executive in the area of exchange rates involves third parties—foreign monetary authorities in the case of currency manipulation and exchange rate cooperation, for example—which also characterizes delegation in some other policy areas. Focus on a third party as the target of a congressional mandate complicates the relationship between the Congress (principal) and Treasury (agent). To begin with, negotiations between Treasury and its foreign counterparts might be opaque to Congress, complicating verification that Treasury is faithfully pursuing its mandate. In addition, third parties might readily detect the conflicting preferences between the two branches and maneuver to exploit them. Some observers counsel leaving wide discretion in the hands of the Treasury with respect to its negotiations with China, for example, on the reasoning that constraining the department could block mutually beneficial bargains with Beijing. However, Thomas Schelling (1960) demonstrated long ago that flexibility can also work to a negotia-

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6. The political science literature on congressional delegation and oversight includes, but is by no means limited to, Aberbach (1990, 2002); Rosenbloom (2000); Epstein and O'Halloran (1994, 1995, 1999); McCubbins and Schwartz (1984); McCubbins, Noll, and Weingast (1987, 1989); and Shepsle (1992).

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tor's disadvantage, a finding reinforced by Robert Putnam's analysis of two-level games (Putnam 1988; see also Evans, Jacobson, and Putnam 1993). Following this logic, tightening the accountability of Treasury to Congress could potentially improve the outcomes of negotiations for the United States.

Organization of the Study

Chapter 2 examines the foundations of democratic accountability, that is, the definitions of key terms and debates over the role of the Congress and Treasury in exchange rate policymaking. Chapter 3 surveys the origins and key provisions of the exchange rate sections of the 1988 Act. Chapter 4 examines the treatment of key policy episodes and issues, including but not limited to currency manipulation, in the 35 reports that Treasury has submitted to Congress since 1988. Chapter 5 then examines how Congress has followed up those reports. Chapter 6 presents recommendations, including on how exchange rate provisions should be amended by prospective legislation. Relating these recommendations to democratic governance under globalization, the final chapter concludes the study.

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