13

Exchange Rate Manipulation to Gain an Unfair Competitive Advantage: The Case Against Japan and China

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Article IV of the International Monetary Fund (IMF) Agreement states that members should ''avoid manipulating exchange rates . . . in order . . . to gain an unfair competitive advantage over other members,'' and the related surveillance provision defines manipulation to include ''protracted large-scale intervention in one direction in the exchange market.'' In other words, if a US trading partner makes protracted large-scale purchases of dollars and other currencies (that is, one-direction intervention) that leads to a lower-than-market-based exchange rate and a larger-than-market-determined trade surplus, there is prima facie evidence of IMF-proscribed exchange rate manipulation to gain an unfair competitive advantage.

In this context, this paper examines four questions: Have Japan and China, among others, been manipulating their exchange rates in recent years, as defined by the IMF? And if so, what has been the impact of such currency manipulation on the dollar exchange rate and the US trade deficit? What are the consequences for US economic and foreign policy interests? How should the US government respond?

Have Japan and China, Among Others, Been Manipulating Their Exchange Rates in Recent Years, as Defined by the IMF?

The answer begins with an assessment of the two adjectives applied to intervention in the IMF rules: ''large-scale'' and ''protracted.'' In the cases

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Table 13.1 Indicators of currency manipulation by Japan

	1998	1999	2000	2001	2002[a]
Foreign exchange reserves (billions of US dollars)					
Total, end of period	203	278	347	388	436
Increase from previous period		75	69	41	48
Cumulative increase from 1998		75	144	185	233
Trade, current, and FDI accounts (billions of US dollars)					
Trade balance, goods	122	123	117	70	
Current account balance	121	107	117	89	
FDI net flow	−21	−10	−23	−32	
Basic balance (current account balance plus FDI net flow)	100	97	94	57	
Foreign exchange reserve increase, as a percent of:					
Trade surplus		61	59	59	
Current account surplus		70	59	46	
Current account surplus plus FDI net flow		77	73	72	
Adequacy of reserves					
Foreign exchange (end of period) as a percent of imports (goods and services)	73	90	92	111	

a. January to July.

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

of Japan and China, as shown in tables 13.1 and 13.2, they unquestionably apply. Japanese one-direction intervention to buy dollars and other foreign exchange has totaled $233 billion since 1998, with large purchases each year, including $48 billion during the first seven months of 2002. Chinese cumulative purchases have been $98 billion since 1998, with a sharp upward trend to $46 billion in 2001 and $31 billion, or more than $5 billion per month, during the first six months of 2002.

Even with this clear evidence of protracted large-scale intervention, two other tests are appropriate before concluding that the motivation was to gain an unfair competitive advantage. The first test is of the ''adequacy'' of reserve holdings. If a country has run down its reserves through previous sales of foreign exchange, the motivation for purchases may simply be to restore an adequate level of reserves. There is no precise definition of ''adequacy,'' although the World Bank benchmark over the years has been that a country should maintain reserves equal to at least 25 percent of annual imports. Japan and China, however, have levels of reserve holdings far above any comparable measure, as also shown in tables 13.1 and 13.2. Japanese foreign exchange holdings as a percentage of annual imports increased steadily from 73 percent in 1998 to 111 percent in 2001, while Chinese holdings have ranged between 81 percent and 104 percent of annual imports.

Table 13.2 Indicators of currency manipulation by China

	1998	1999	2000	2001	2002[a]
Foreign exchange reserves (billions of US dollars)					
Total, end of period	145	155	166	212	243
Increase from previous period		10	11	46	31
Cumulative increase from 1998		10	21	67	98
Trade, current, and FDI accounts (billions of US dollars)					
Trade balance, goods	47	36	34	23[b]	
Current account balance	31	21	21	21[b]	
FDI net flow	41	36	37	40[c]	
Basic balance (current account balance plus FDI net flow)	72	57	58	61	
Foreign exchange reserve increase, as a percent of:					
Trade surplus		28	32	200	
Current account surplus		48	52	219	
Current account surplus plus FDI net flow		18	19	75	
Adequacy of reserves					
Foreign exchange (end of period) as a percent of imports (goods and services)		104	93	81	91

a. January to June.

b. Data from *The Economist.*

c. Estimated.

Source: International Monetary Fund, *International Financial Statistics*, except as otherwise indicated.

The second test relates to balance-of-payments adjustment and whether a country is running a large deficit or surplus on current and long-term capital accounts. A country in a chronic large-deficit position, like the United States, could ''manipulate'' its currency to gain a competitive advantage, but such intervention might not be judged ''unfair'' if the objective is to bring external accounts back toward balance. Once again as shown in the tables, however, this rationale for justifying currency manipulation would not apply for Japan and China because they both run chronically large trade and current account surpluses, and China has a very large net inflow of foreign direct investment (FDI) as well. Japan had current account surpluses of $89 billion to $121 billion per year during the period 1998-2001, and even taking account of a net outflow of FDI, there was still a very large net overall inflow of foreign exchange of $57 billion to $100 billion on ''basic balance.'' In the case of China, the current account surplus ranged from $21 billion to $31 billion, while a very large net inflow of FDI raised the basic balance net inflow of foreign exchange to $57 billion to $72 billion. Indeed, for the balance-of-payments test, the presumption would be for Japan and China, if anything, to be selling

rather than buying foreign exchange in order to reduce chronically large surpluses on external accounts.

In conclusion, Japan and China, based on all criteria related to the IMF definition, have been persistently manipulating their currencies to gain an unfair competitive advantage.

There are also other likely official currency manipulators, but identifying the full list would require further research. The two most glaring suspects, however, are South Korea and Taiwan. South Korea increased its foreign exchange holdings from $52 billion in December 1998 to $103 billion in December 2001 and to $116 billion in July 2002. During the same period, Korea had a sustained current account surplus ($9 billion in 2001) and a large net inflow of FDI ($12 billion in 2001). Taiwan increased its foreign exchange holdings from $122 billion in December 2001 to $155 billion in July 2002, while running an annual current account surplus of $25 billion.

What Has Been the Impact of Such Currency Manipulation on the Dollar Exchange Rate and the US Trade Deficit?

IMF-defined currency manipulation, especially by Japan and China, is irrefutable, but how much impact this manipulation has had on exchange rates and the US trade deficit is a much more difficult question, and there is no precise answer. Although the unprecedentedly large market intervention by central banks from the late 1980s through 2002 might offer opportunity for econometric testing, the profession has not yet been able to meet the challenge. Thus the best that can be offered here are rough orders of magnitude based on the gross figures in play, and the conclusion drawn is that the protracted and very large-scale official intervention of the past several years, principally in East Asia, has had a substantial impact on exchange rates and the US trade deficit. The yen is probably at least 20 percent weaker than it would be based on market forces alone, while the Chinese renminbi is probably on the order of 40 percent weaker. As a consequence, the US trade deficit is probably about $100 billion larger than it would otherwise be, taking account of Japan, China, and other likely currency manipulators.

Before looking in detail at the derivation of these numbers, however, it is useful to make three analytic points that have often been ignored or misinterpreted by observers who conclude that currency manipulation has little actual impact on exchange rates and trade balances.

The great asymmetry. There is a world of difference between central bank sales of foreign exchange to keep a currency above market-determined levels and central bank purchases to keep a currency below market-determined levels. The former was the case for the series of financial

crises since the mid-1990s (Mexico, Thailand, Indonesia, South Korea, Brazil, Russia, Turkey, and Argentina). They all failed because the central bank had a known quantity of foreign exchange to sell, and as reserves approached zero, speculation against the currency accelerated and a financial crisis was precipitated. In the case of central bank purchases of foreign exchange, which is the currency manipulation situation discussed here, there is, in sharp contrast, no limit to official purchases, as starkly shown in tables 13.1 and 13.2. Japan and China together have bought more than $330 billion of foreign exchange over the past three and a half years, and they could buy another $330 billion or more in the next several years, with no end in sight. This is the ''great asymmetry'' of official currency intervention, and those who claim that intervention cannot work for very long based on the experience of Mexico, Thailand, and so on, are at the wrong end of the feasibility curve. The fact is that intervention usually does not work for very long to maintain an overvalued currency, but it can work to prolonged and substantial effect to maintain an undervalued currency.

Net versus gross flows. Some observers conclude that currency manipulation has no significant impact on exchange rates because annual official foreign exchange purchases of $40 billion to $70 billion per year by countries such as Japan and China pale by comparison with a trillion dollars or more per day of international financial transactions. The error in this assessment is to compare net and gross financial flows. The very large majority of gross market financial transactions are offsetting inflows and outflows, just as most trade consists of offsetting exports and imports in its impact on exchange rates. What really counts for upward and downward pressures on exchange rates is the net dollar inflow or outflow on trade, current, and long-term capital accounts, as shown in the tables. These are more comparable in their impact on exchange rates with the net increases in official foreign exchange holdings, although, as explained below, official purchases of foreign exchange can have an even greater impact on exchange rates, dollar for dollar, than do trade or current account surpluses and net inflows of FDI.

Currency manipulation is only one part of the equation. Yet another misleading observation about currency manipulation is to compare official purchases of foreign exchange with apparently contradictory movements of the exchange rate. Japan intervened heavily in the spring of 2002 while the yen still appreciated from 130 to 120 to the dollar. At the time of the Asian financial crises in 1997-98, there was little intervention by any of the East Asian central banks, and yet the dollar rose substantially, as did the US trade deficit. The obvious explanation for such developments is that there are various forces in play that influence exchange rates and trade balances. The prospect of record-level, unsustainable US current account deficits and corporate scandals put overriding downward pres-

sure on the dollar in the spring of 2002, while the dollar as ''safe haven'' for short-term capital inflow boosted the dollar rate in 1997-98 despite the temporary lull in currency manipulation. What is relevant for this discussion of the impact of ''currency manipulation'' is the *differential* impact of such intervention on exchange rates and the US trade balance. How much weaker would the dollar have been absent the protracted large-scale official intervention over the past several years, and how much smaller would the US trade deficit have been? It is to these questions that I now turn.

The Impact on Exchange Rates

As noted earlier, there are no precise estimates of the impact of official currency intervention on exchange rates. The gross figures on the relationship between such intervention and the balances of trade, current, and long-term capital accounts nevertheless provide indicators of the broad orders of magnitude involved. The way this interrelationship plays out, however, is very distinct between Japan and China, and each is thus addressed in turn.

In the case of Japan, official foreign exchange purchases equaled 59 to 61 percent of the trade surplus in the period 1999-2001 (table 13.1). For the broader basic balance measure of current account surplus plus FDI net flow, the figures rise to 72 to 77 percent. What this means is that the protracted intervention has directly offset, dollar for dollar, about 60 percent of the upward pressure on the yen from the very large trade surplus, and about 75 percent of the net inflow of dollars from the basic balance surplus. Moreover, in addition to this direct quantitative relationship, Japanese currency intervention policy has a strong reinforcing qualitative dimension, which can be called the ''credible threat multiplier effect.'' The experience has been that when faced with upward pressure on the yen, not only does the Bank of Japan buy large quantities of foreign exchange, but also the Ministry of Finance states emphatically that Japan will intervene as much as necessary to keep the yen down, as an overriding economic policy objective to ensure continued export-led growth.[1] Such statements strongly dissuade currency dealers from intervening in anticipation of market-generated upward pressures on the yen. The overall result is currency manipulation through a combination of large-scale intervention plus credible threats of further intervention, with the latter constituting the ''multiplier effect.'' A reasonable adjustment for this multiplier effect could raise the trade surplus offset from 60 percent to 75 percent and the basic balance offset from 75 percent to 100 percent.

1. Such statements, incidentally, constitute official admission that the intent of the intervention is to gain a competitive advantage in trade.

Based on these relationships, how much stronger would the yen be if currency manipulation were halted through a categoric statement by the government of Japan that it would indefinitely cease all purchases of foreign exchange? The rise in the yen would almost certainly be substantial, quite possibly by at least 20 percent, to 100 or fewer yen to the dollar. Such an assessment, moreover, is supported by another quantitative relationship related to the US trade deficit. The US trade deficit, as a share of total trade, is similar to that of the Japanese trade surplus, and considerable econometric work has produced the rule of thumb that a 1 percent decline in the dollar would reduce the US trade deficit by $10 billion, and thus a 20 percent decline would reduce the trade deficit by $200 billion, or by half of the total US trade deficit. This relationship can be compared with Japanese official intervention, to opposite effect, amounting to a 75 percent offset to upward pressures on the yen from the trade surplus, and thus to an implied strengthening of the yen from termination of the intervention of 30 percent. In other words, if a 20 percent decline in the dollar exchange rate can cause a 50 percent decline in the US trade deficit, currency manipulation to offset 75 percent of the Japanese trade surplus impact on the exchange rate would equate to a 30 percent weaker yen. To err on the conservative side, however, the conclusion drawn here is that Japanese currency manipulation probably results in a yen exchange rate at least 20 percent lower than it would be based on market forces alone.

In the case of China, the renminbi is fixed to the dollar but is nonconvertible on capital account. What this means in practice is that export earnings in foreign exchange, plus FDI not utilized for purchases on the current account, have to be sold to the central bank for renminbi at the fixed exchange rate. In effect, official intervention is carried out through mandatory foreign exchange sales to the central bank rather than central bank purchases in the market, as is the case in Japan and elsewhere. The net effect, nevertheless, is currency manipulation through protracted large-scale purchases of foreign exchange by the Chinese central bank.

As to how much stronger the renminbi would be if the central bank ceased to buy foreign exchange, the basic analytic approach would be the same as that applied to Japan, although with more indirect assumptions as to what would take place if the renminbi were freely convertible, and the appraisal is thus limited to an order of magnitude. The ratios of official foreign exchange purchases to the trade surplus and basic balance net dollar inflows have been rising sharply in 2001 and 2002. During the first six months of 2002, central bank purchases have been made at an annual rate of $62 billion, or roughly 200 percent of the trade surplus and about 100 percent of the basic balance inflow. These ratios, compared with Japan, indicate a rough order of magnitude for exchange rate impact almost double that caused by Japanese intervention. This should not be surprising, because in 2002 the dollar-linked renminbi has declined 10 percent

vis-à-vis the yen and the euro, with a consequent strong positive impact on the Chinese trade surplus (up 55 percent in the first half of 2002) and FDI inflow (up 22 percent between January and July). Moreover, even with the $62 billion annual rate of mandatory sales to the central bank, market pressures from the huge foreign exchange net inflow stimulate underground cash flows out of the country of billions of dollars per year, linked to massive official corruption.[2] Taking all of these factors into account, the conclusion drawn here is that Chinese currency manipulation probably results in a renminbi exchange rate on the order of 40 percent lower than it would be with a convertible rate based on market forces alone.

The Impact on the US Trade Deficit

The bottom-line question is how much smaller the US trade deficit would be if others did not manipulate their currencies as described above. In this case, the analysis is more straightforward. Assuming the renminbi 40 percent stronger vis-à-vis the dollar, and the yen, the Korean won, and the Taiwanese dollar (the latter two with intervention/trade surplus ratios similar to that of Japan) 20 percent stronger, the dollar exchange rate, weighted by US imports, would be 7 percent lower. Based on the rule of thumb that a 1 percent decline in the dollar would lead to a $10 billion reduction in the trade deficit, the net result would be a $70 billion reduction in the US trade deficit if these four trading partners ceased currency manipulation.

This calculation, however, understates the trade impact for several reasons. Exports of these four trading partners are almost entirely in manufactures, which have relatively high price elasticities[3] compared with other sectors of trade, and therefore this trade would have an above-average quantitative response to a given exchange rate adjustment. Moreover, their exports have grown rapidly in recent years, and thus the $10 billion per 1 percent benchmark, based on earlier econometric work, should be adjusted upward. There has also probably been some additional currency manipulation beyond the four cited here, particularly in 2002, when the effects of the recession in the United States and a declining dollar have weakened export performance around the world and created

2. See the *Financial Times,* August 22, 2002, 5, ''China Gears Up to Halt Capital Flight.'' The article cites estimates of capital flight as high as $20 billion per year, as well as a temper tantrum by Chinese Premier Zhu Rongji over the fact that nearly every corruption scandal in China in the past decade involves officials, or businessmen who have bribed them, fleeing overseas with large amounts of money.

3. The price elasticity relates percentage changes in relative prices and quantities of goods traded. For example, a −2 elasticity of demand for imports means that a 1 percent decline in the relative price of imports would lead to a 2 percent increase in the quantity of imports.

political pressures to intervene and keep currencies down relative to the falling dollar. For example, Russia, India, and Thailand made substantial official purchases of foreign exchange during the first half of 2002 even while running large current account surpluses. Bringing all of these factors together, the conclusion drawn here is that roughly $100 billion, or about one-quarter of the total US trade deficit, can be attributed to currency manipulation.

What Are the Consequences for US Economic and Foreign Policy Interests?

There are three distinct adverse consequences for US interests from the currency manipulation that has resulted in a US trade deficit roughly $100 billion larger than it would be based on market-determined exchange rates alone: the short-term impact on jobs and output; the longer-term economic impact on US productivity and growth; and the broader effects on US foreign policy interests. Only the first has received serious attention, while the second and third consequences are at least as important for overall US interests, and possibly more so.

The Short-Term Impact on Jobs and Output

The rising US trade deficit means less jobs and output for both US export and import-competing industries. The National Association of Manufacturers (NAM) estimates that since August 2000, 500,000 jobs have been lost from the decline in exports alone. Relating a $1 billion increase in the trade deficit to 15,000 jobs, a $100 billion larger trade deficit as a result of currency manipulation equates to 1.5 million fewer jobs, or more than 1 percent of the labor force, and a corresponding lower level of output.

Some observers contend that such lower levels of employment in export and import-competing industries are not a problem because they can be offset by more jobs created in other sectors. In effect, a larger trade deficit simply results in a shift of employment among sectors with no net loss of jobs. This analysis, however, is faulty on two counts. First, it assumes full employment, which has not been the case in 2001-02. Jobs lost to a rapidly growing trade deficit have not been offset by job creation elsewhere, as the unemployment rate has risen from 4 percent to 6 percent. Second, the composition of the labor force and output among sectors can have a substantial impact on longer-term productivity and growth in the US economy. The manufacturing sector is ten times more engaged in trade than the services sector, in terms of exports and imports as a ratio of domestic output, and has been bearing 80 to 90 percent of job losses

from the rising trade deficit.[4] The net result from a $400 billion trade deficit—$100 billion of which is related to currency manipulation—is thus a relatively smaller manufacturing sector within the overall US economy. And this, in turn, has a significant adverse impact on longer-term productivity and growth in the US economy.

The Longer-Term Impact on US Productivity and Growth

The manufacturing sector has long been the engine for growth in the US economy, and this central role strengthened during the 1990s as accelerated new technology development and application spurred much higher levels of productivity and growth throughout the ''new economy.''[5] More than 60 percent of R&D and over 90 percent of new patents derive from the manufacturing sector. Productivity growth within the sector was two to three times higher than in the services sector throughout the 1990s, while productivity growth in other sectors is largely a result of new technology-intensive products developed and marketed by manufacturing industry. In addition, the manufacturing sector is restructuring rapidly to become even more high powered in generating productivity and growth. Since 1950, the share of value added by production workers has progressively declined by more than half to 18 percent, with value added becoming more and more concentrated in R&D, new investment in plant and equipment, and higher-skilled and professional employees. US manufacturing as the engine for growth is further reinforced by the economic globalization process. Rapid growth in international trade and investment increases competitive pressures to cut costs and develop new products faster and broadens global markets so as to spread out the large fixed costs of R&D and investment.

It is in this overall growth-oriented context that record US trade deficits of $400 billion per year, of which over $300 billion is in manufactures, can have substantial adverse impact on the US economic growth course ahead. A smaller manufacturing sector means a smaller engine for growth and fewer productivity gains. Likewise, the currency manipulators identified here—Japan, South Korea, Taiwan, and China most of all—are keenly aware of the fact that technology-intensive manufacturing industry is the primary engine for their growth as well. They each pursue the mercantilist approach of maintaining a large trade surplus as an overriding policy objective, with central emphasis on technology-intensive manufactured exports. And their favored policy instrument for pursuing such mercantilism is currency manipulation.

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4. A full discussion of the contrasting roles of manufactures and services in trade is contained in Preeg (2001).

5. The transformation under way in US manufacturing summarized in this paragraph is analyzed in detail in Duesterberg and Preeg (2003).

The Broader Effects on US Foreign Policy Objectives

The motivation for protracted large-scale purchases of foreign exchange by currency manipulators is almost certainly to achieve the international competitive advantages described up to this point. In addition, however, there are a number of broader adverse consequences for US interests from the massive buildup of official holdings of dollars abroad, particularly in East Asia.[6] There is first the interest payments on official dollar holdings, which constitute a permanent flow of resources from the US to the other economies. At 5 percent interest, the $436 billion Japanese foreign exchange holdings, probably 80 to 90 percent in dollar-denominated assets,[7] would yield a United States-to-Japan annual payment of $17 billion to $19 billion. China is reported to hold some of its dollar holdings in Freddie Mac/Fannie Mae bonds in order to obtain a higher yield on its $243 billion of official foreign exchange holdings.

Other actual or potential adverse consequences for US interests are more in the foreign policy field. The huge official foreign exchange holdings of Japan and China provide a geopolitical opportunity to offer attractive trade and investment finance to regional trading partners, particularly in Southeast Asia, as a means of strengthening Japanese and Chinese economic engagement at the expense of the United States. A first step in this direction is the Chiang Mai Initiative, in which China, Japan, and South Korea have provided about $20 billion of bilateral financial swap agreements to Southeast Asian trading partners, or more than double the IMF quotas for these countries.[8] These initial agreements appear to be nondiscriminatory in financing imports from all sources, but such abundant financial support, with more in the offing, could provide leverage for preferential trading arrangements such as the recent Chinese initiative for a free trade agreement with the Association of Southeast Asian Nations. Press reports of these initiatives refer to the objective of weakening US economic hegemony in the region.

In the national security field, large Chinese purchases of weapons and other military equipment abroad, as regularly received from Russia in particular, can be made without financial constraint, having $243 billion of ready cash in the central bank.

More speculatively, China could use its official dollar holdings as foreign policy leverage against the United States by threatening to sell large

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6. The effects on US-China policy, in particular, are elaborated in Preeg (2002).

7. The actual composition of official foreign exchange holdings is kept secret, as explained below.

8. See Henning (2002). As Henning explains, it is too early to assess how these swap arrangements will operate in practice, since there has been very little loan implementation thus far.

quantities of dollars on the market, or merely to shift its reserves away from dollars and into euros and yen. This will not happen anytime soon, because the result would be a decline in the dollar with an adverse impact on Chinese exports. At some future point, however, if China were to become less dependent on exports to the United States for economic growth, such a threat could become credible. For example, the threat of substantial Chinese sales of dollars, with the implications for a disruptive decline in the dollar and the US stock market, especially during a recession or an election year, could influence the course of US policy toward Taiwan. Chinese military officers, in fact, in their studies of nonconventional defense strategies, include reference to George Soros and his attack on the British pound in 1992 as a template for disrupting a rival's (i.e., the United States) economic system.

These are the wide-ranging economic and foreign policy adverse consequences for the United States from continued large-scale currency manipulation by others. They certainly add up to a strong case for action to curtail such manipulation. Fortunately, the specifics of such a policy response are readily at hand.

How Should the US Government Respond?

A US response designed to end exchange rate manipulation for unfair competitive advantage would consist of four steps pursued in parallel, with a fifth step held in reserve on a contingency basis.

Step 1: A clear statement of US policy. US exchange rate policy, in the broadest terms, is to let market forces determine exchange rates, and US official intervention is rare and of token size.[9] US policy has been in denial, however, about exchange rate manipulation by others, which is in fundamental conflict with a system of market-determined rates. This should be rectified through a clear statement of policy by the Secretary of the Treasury along the following lines:

''US exchange rate policy is to let market forces determine the rates. Official intervention in currency markets to counter short-term disruptive market conditions should be of limited duration and carried out in concert among major currency nations. In recent years, however, some others have engaged in protracted large-scale intervention to buy dollars and other foreign exchange, thus pushing their exchange rates substantially below market-determined levels. One important consequence has been a much larger US trade deficit than would prevail based on market-determined exchange rates alone. The IMF Agreement explicitly proscribes

9. US net currency intervention has averaged $3 billion per year since 1995, in some years net purchases, in other years net sales. In contrast, with six times as much trade as China, US net purchases on the current Chinese scale would amount to about $370 billion per year.

such exchange rate manipulation to gain an unfair competitive advantage, and the United States will actively seek to curb further manipulation through direct consultations with trading partners and IMF review procedures.''

Such a statement would constitute a major change in US policy with respect to currency manipulation. The 1988 Omnibus Trade and Competitiveness Act requires the Secretary of the Treasury to report to Congress twice each year on currency manipulation by others, but the reports have been brief and essentially evasive. Japan, the most obvious manipulator, is routinely ignored. When Treasury officials are pressed, they dismiss the issue by claiming that the term currency manipulation is simply too vague and ill-defined. This, of course, is not the case, as explained in the first section above.

Step 2: G-7 consultations. The United States would pursue this newly stated line of policy among the Group of Seven (G-7) finance ministers, whose membership represents the principal international currencies. In fact, six of the seven—representing the US and Canadian dollars, the euro, and the pound sterling—do follow a market-determined floating rate policy, with very limited intervention, and they all suffer on the trade account from the mercantilist policies of currency manipulators. Japan, in contrast, would be the target within the group for curtailing manipulation, and the thrust of G-7 discussions would be about how Japan could restructure its growth strategy toward greater reliance on domestically generated growth and less reliance on a sustained trade surplus. Indeed, such a change would be as much in the Japanese interest as in that of the other six.

Step 3: Bilateral consultations. The United States would pursue bilateral consultations with targeted currency manipulators. Bilateral consultations with Japan would be an adjunct to the G-7 discussions. Consultations with such trading partners as South Korea and Taiwan would be along similar lines. Consultations with China would be more complex and would also be the most important, in view of the extreme degree of currency manipulation involved and the fact that the largest US bilateral trade deficit is with China. The short-term objective for China would be an upward adjustment of the fixed nonconvertible renminbi by at least 20 percent. The longer-term objective would be a transition by China to a fully convertible, freely floating renminbi, as a mutual economic interest and the best way to avoid trade conflict with the United States resulting from further unjustified currency manipulation.

Step 4: IMF transparency/consultations. The United States would approach the IMF to seek greater transparency in official market intervention and to curtail currency manipulation. As for transparency, members do not now publicly report currency intervention even though it is often the most important policy instrument utilized under a floating rate inter-

national financial system and has a significant impact on companies and banks engaged in international trade and finance. Current IMF disclosure is limited to a monthly statement of members' total foreign exchange holdings, with a two-to-three month time lag, in *International Financial Statistics.* The composition of the reserves—dollars, euros, yen, and so on—moreover, is never made public. In effect, China could shift $50 billion from dollars to euros, with a significant impact on the dollar/euro exchange rate, and the transaction would remain secret not only for private-sector traders but for other governments as well.[10] The United States, preferably together with like-minded free floaters, should therefore propose mandatory public reporting by central banks of significant purchases and sales of foreign exchange, including a breakdown by major currency.

Curtailment of currency manipulation would be pursued through the appropriate IMF review mechanism for Article IV commitments and related surveillance procedures. The specific objectives would be findings of currency manipulation against and commitments to cease such manipulation from targeted members, beginning with Japan and China. IMF Article IV stipulates ''the right of members to have exchange arrangements of their choice consistent with the purposes of the Fund and the obligations under Section 1 of this Article.'' Section 1 includes the obligation to avoid manipulating exchange rates to gain an unfair competitive advantage. This means that China, in particular, is free to maintain its current fixed rate to the dollar only to the extent that it is consistent with avoiding prolonged large-scale purchases of foreign exchange. The implication, of course, is that the renminbi is currently undervalued and that China needs to revalue the currency upward in order to be able to cease such large-scale purchases and to be in full compliance with Article IV.

These four steps would be advanced in parallel and hopefully would lead to agreement to curtail currency manipulation to gain an unfair competitive advantage. The question remains, however, as to what the United States and other adversely affected trading partners should do if currency manipulators ignore the bilateral and IMF admonitions and continue their manipulative exchange rate policies. Under such circumstances, a contingent fifth step would be taken in the World Trade Organization (WTO).

Step 5: WTO dispute settlement. The General Agreement on Tariffs and Trade (GATT) Article XV, now incorporated within the WTO, addresses ''Exchange Arrangements,'' and stipulates that members should not take exchange rate actions that ''frustrate the intent of the provisions of this Agreement.'' The intent of the Agreement, in turn, as stated in broadest terms in the Preamble, is the objective of ''entering into reciprocal and

10. The IMF publishes global official holdings by currency in September for the previous year, or nine months after the fact, but without a breakdown in such holdings by member country.

mutually advantageous arrangements directed to the substantial reduction of tariffs and other barriers to trade.'' Clearly, exchange rate manipulation that results in a $100 billion per year larger US trade deficit than would otherwise occur frustrates such reciprocal and mutually advantageous arrangements. The United States could thus file a complaint within the WTO dispute settlement mechanism against recalcitrant currency manipulators. GATT Article XV also provides for full consultation with the IMF, including that members ''shall accept all findings of statistical and other facts presented by the Fund relating to foreign exchange,'' which would link any such US initiative in the WTO to prior IMF consultations as described in step 4.

This is the five-step policy response readily at hand. Step 5 should clearly be held in reserve, to be avoided if at all possible, but at the same time the United States should not be hesitant to state that it would be obliged to pursue this course if other actions proved fruitless. The rationale throughout all steps of the policy response would be derived from the adverse impact on US interests described earlier. Currency manipulation to gain an unfair competitive advantage has simply become too important an issue within the evolving international financial system to ignore any longer, and the practice therefore needs to be sharply curtailed or eliminated.

Epilogue: Systemic Implications

This chapter has been about currency manipulation and its direct impact on exchange rates and the US trade deficit. The issue of currency manipulation has broader implications for the international financial system as it evolves into a ''two-corner'' system of floating exchange rates and monetary unions.[11] In this context, a thorough appraisal of currency manipulation leading to its sharp curtailment or elimination would constitute a major step forward for realizing such a system within a cooperative multilateral framework.

The international financial system has been essentially undefined for three decades. The dollar fixed-rate system created at Bretton Woods ended in 1971 when the United States closed the window on dollar convertibility into gold. This precipitated a potpourri of exchange rate relationships from fixed to floating rates, with various forms of adjustable pegs and currency bands in between. The lack of systemic definition was highlighted in 1994 at the 50-year anniversary of Bretton Woods, when a Bretton Woods Commission group of 47 distinguished financial leaders and experts, chaired by Paul Volcker, called for the ''establishment of a

11. The evolving two-corner system is analyzed in detail in Preeg (2000a), especially chapters 2 and 9.

new system . . . [because] the alternative to a new global system is to continue the present nonsystem.'' The commission report had little to offer, however, as to what form the new system should take except to note that ''this system could possibly involve flexible exchange rate bands.''

Five months later the Mexican peso crashed through the bottom of its dollar exchange rate band, and financial markets assumed the lead role in pushing governments toward a truly new postdollar floating rate system. Subsequent financial crises in Thailand, Indonesia, South Korea, Russia, Brazil, Turkey, and Argentina all resulted in shifts from some form of dollar-linked currencies to floating rates. Meanwhile, in the other monetary union corner, the European Monetary Union was launched and more modest steps were taken toward dollarization.[12]

The outstanding and indeed critical question for this new, predominantly floating rate system is to what extent the floating rates will be ''managed'' through official intervention in currency markets. Will rates be heavily managed, lightly managed, or allowed to float freely? Heavily managed rates, as described earlier, are subject to the ''great asymmetry,'' wherein heavy intervention through foreign exchange sales to maintain a currency above the market-determined level has consistently failed, resulting in much higher foreign debt obligations and more painful ultimate adjustment. A lightly managed or free float is clearly preferable at this end of the asymmetric curve, although painful lessons are still being learned in Argentina, Brazil, and Turkey.

At the other end of the curve, there is the heavily managed float through official large-scale purchases to maintain an exchange rate lower than the market-determined level, which usually translates into currency manipulation. The case made in this paper is that such heavy management to gain an unfair competitive advantage should also be sharply curtailed if not eliminated.

The net result for the evolving international financial system should thus be definitive movement to lightly managed or freely floating rates. Heavily managed rates in one direction do not work, while in the other direction ''currency manipulation'' should be at least sharply curtailed. And this outcome, in turn, has important implications as to how the overall international financial system would work, including the IMF role within it. For example, there would be little need for foreign exchange reserves since their only purpose is for official intervention, which would be small to nil under lightly managed or free floating rates. The United States, in this regard, is ahead of the curve, with a rate close to free floating and only $30 billion of foreign exchange reserves, equal to a mere 2

12. Ecuador has dollarized and Central American leaders are considering it. Based on ''optimum currency area'' analysis, the small, highly open Caribbean Basin economies that are heavily dependent on trade with the United States would be optimal candidates for dollarization. See Preeg (2000b).

percent of annual imports.[13] A lightly managed or freely floating yen, in contrast, would make the $436 billion of Japanese foreign exchange reserves grossly redundant, raising the question as to what should be done with them.

There would also be little further need for large IMF loans, and the $30 billion loan package to Brazil in August 2002 could turn out to be the last hurrah for such lending. This would follow the longer-term process of IMF ''graduation.'' None of the industrialized countries, which comprise two-thirds of world trade and investment, has taken out a large IMF loan in over 25 years. Emerging market economies that shifted to floating rates in the 1990s, such as Mexico, Thailand, and Russia, should not need further recourse to large IMF loans. Certainly the currency manipulators—Japan, China, South Korea, and Taiwan—who have accumulated such excessive reserve holdings, which would become even more excessive to the extent that they adopted lightly managed floating rates, will never need an IMF loan. Indeed, if the current financially troubled Argentina, Brazil, and Turkey, already with floating rates, could be nurtured away from largely counterproductive dependence on IMF lending, close to 90 percent of the global economy would be classified as IMF graduates.[14] And what would remain would mostly be the poorest countries, where highly concessionary loans and grant assistance from multilateral development banks and bilateral aid programs are more appropriate forms of official financial support than high-cost IMF borrowing.

There would still be a role for the IMF, but a much more modest role as a consultative forum, the repository for basic norms and financial market commitments of multilateral scope, and a provider of technical support for members adopting financial policy reforms. But the era of large-scale IMF loans, with all its political contention and painful economic aftermath, would be over. Members within the monetary union corner of the new financial architecture would by definition have no need for an IMF loan to defend internal national currency relationships that no longer exist, while members with lightly managed or free floating currencies would also have little or no need for IMF loans.

Graduation should be a joyous occasion, and graduation of the international financial system to a new cooperative order of floating rates and monetary unions would be worthy of celebration. We have not yet reached that point, however, and the biggest remaining obstacle is the persistent practice by some of currency manipulation to gain an unfair competitive advantage in international trade and investment.

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13. The United States also holds $262 billion of gold reserves, but they are essentially useless. If even $10 billion to $20 billion of the gold were sold on the market to prop up the dollar, the market price of gold would crash and the value of reserves along with it.

14. This transition is elaborated in Ernest Preeg, ''Argentina's painful graduation,'' *Financial Times,* August 3, 2001.

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