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Currency Manipulation and Enforcing the Rules of the International Monetary System

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Concern has been growing, 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 during the past two to three years—has been both thwarting global payments adjustment and violating the rules of the international monetary system (Goldstein 2004, 2005b).[1]

In its communiqués of October 2004 and of February and April 2005, Group of Seven (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, 67 US senators voted to support an amendment, cosponsored by Senator Charles E. Schumer (D-NY) and Senator Lindsey Graham (R-SC), 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 renminbi proved

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1. See also C. Fred Bergsten's testimony before the Senate Committee on Banking, Housing, and Urban Affairs titled "The IMF and Exchange Rates," August 22, 2005.

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unsuccessful. In a May 2005 report to the US Congress, the US Treasury (2005, 2) summed up its evaluation of China's exchange rate policies: "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 Phil English (R-PA) that would not only extend countervailing duty or antisubsidy law to nonmarket economies (China among them) but also place additional requirements on the US Treasury Department 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 by only a two-vote margin) had not the bill sponsored by Representative English been approved immediately before it. And on September 23, 2005, Timothy Adams (chapter 4 for this volume), the under secretary of the US Department of the Treasury for monetary affairs, emphasized that "the perception that the IMF is asleep at the wheel on its most fundamental responsibility—exchange rate surveillance—is very unhealthy for the institution and the international monetary system" and urged the IMF to be "far more ambitious" in its surveillance of exchange rates.[2]

In the remainder of this chapter, I argue that a strong case can be made 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.[3]

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

2. In the *Financial Times* of October 3, 2005 ("The Fund Appears to Be Sleeping at the Wheel"), Michael Mussa and I agreed with Adams's criticism of recent IMF surveillance over exchange rates; in addition, we concluded that if the IMF does not do its assigned job as the vigorous, competent, unbiased umpire of exchange rate policies others would take up the task with adverse global consequences.

3. This paper builds upon the earlier analysis contained in Goldstein (2005b).

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and 1930s, and there was a global consensus that the new rules of the road should prohibit such practices.[4] 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 on member countries and on the Fund itself.

Specifically, Article IV, section 1, paragraph 3 of the IMF's Articles of Agreement stipulates that each member country shall "[a]void 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 3 of these same Articles of Agreement to "oversee the compliance of each member with its obligations" [and] "exercise firm surveillance over the exchange rate policies of members" [and] "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 (IMF 1977). 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.[5] 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 overvalued exchange rates have also been linked to currency crises in emerging economies, with large attendant costs in terms of real economic growth; and large undervaluations typically gen-

4. In the Fund's original Articles of Agreement and under the par value system then in existence, member 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.

5. By the wrong exchange rate, I mean a real exchange rate that differs from the equilibrium rate implied by economic fundamentals.

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erate excessive accumulation of international reserves that, in turn, can threaten financial instability at home and protectionist responses abroad.

It is unlikely that the costs of misaligned real exchange rates are lower today than when the Fund's founders 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. In addition, the large and increasing weight of emerging economies in both global output and in global trade flows has given the industrial countries a greater incentive to monitor more carefully the exchange rate policies adopted by emerging economies and has also given the emerging economies an increased responsibility to take the global interest into account in formulating their own policies.[6]

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 has—in addition to putting the spotlight on the savings-investment imbalance within the United States—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 in 2004 and expected to be even larger in 2005—is approximately twice as large as is likely to be sustainable over the medium term. To bring the US current account down to a sustainable level at reasonable cost requires, inter alia, that the US dollar depreciate in real, trade-weighted terms by another 15 to 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 nondollar currencies.[7] Although 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 [late 2005]), the Asian currencies—with

6. Looking at 11 large emerging economies, Boyer and Truman (2005) report that these 11 made up more than 31 percent of world GDP (at purchasing power parity exchange rates) and 34 percent of global international reserves in 2004.

7. 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 approximately $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 (Mussa 2005, Goldstein 2005c).

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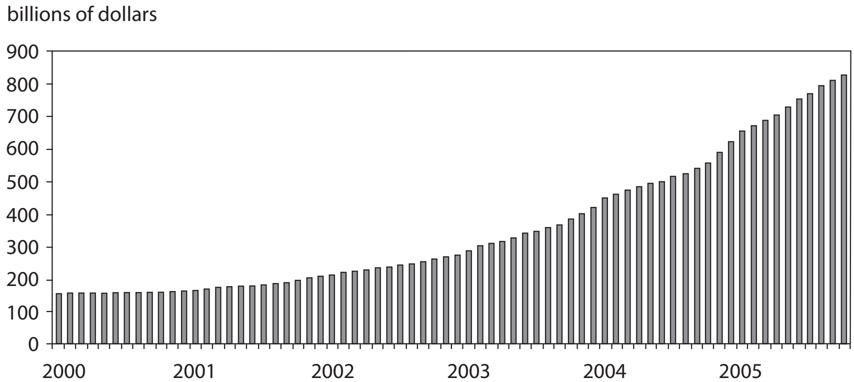
Figure 5.1 China's foreign exchange reserves, 2000–2005Q3



Notes: After December 2003, foreign exchange figures are adjusted to reflect a $45 billion transfer to the Bank of China and the China Construction Bank. After April 2005, foreign exchange figures are adjusted to reflect a $15 billion transfer to the Industrial and Commercial Bank of China.

Source: China State Administration for Foreign Exchange.

the notable exceptions of the Korean won and the Singapore dollar—did not; in fact, they often depreciated in real, trade-weighted terms despite large current account surpluses (Goldstein 2005c). 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 nondollar 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 during the 2003–05 period. The leading case in point is China. As shown in figure 5.1, 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 reserves averaged nearly 12 percent of GDP—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 renminbi was depreciating.[8] Thus, at a time when the dictates of both internal and external balance pointed toward the desirability of an appreciating renminbi, the Chinese authorities were

8. China's economy grew by more than 9 percent in both 2003 and 2004, and its overall current account surplus (relative to GDP) was 3.3 percent in 2003 and 4.2 percent in 2004. According to JP Morgan's index of real, trade-weighted exchange rates, the renminbi depreciated (in real terms) by 10 percent from February 2002 to December 2004. Citigroup's index of real, trade-weighted exchange rates places the real depreciation of the renminbi over this period at 12 percent.

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systematically thwarting adjustment by intervening heavily in the exchange market to keep the real value of the renminbi 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 to 10 percent of China's GDP and reserve accumulation of roughly $25 billion per month.[9] China's decision in late July 2005 to revalue the renminbi 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.

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 Takatoshi Ito (2004), Japan's intervention in the 15 months from January 2003 to March 2004 was larger than the cumulative intervention in the preceding 12 years. In recent years Malaysia and Taiwan also have engaged in large-scale, exchange market intervention without extenuating circumstances such as weak domestic demand growth or the presence of current account deficits. From February 2002 to October 2005, the real, trade-weighted values of the Malaysian ringgit and the Taiwanese dollar depreciated by 13 and 8 percent, respectively; the corresponding figure for the Japanese yen was a depreciation of 9 percent.

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.

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

9. Growth of China's real GDP is likely to exceed 9 percent in 2005 although tentative signs show that growth of final domestic demand is slowing. Reflecting, inter alia, the recent, real, trade-weighted appreciation of the US dollar, the real, trade-weighted exchange rate of the renminbi has also appreciated in 2005—by roughly 10 percent under the JP Morgan index and by 3 percent under the Citigroup index. If the February 2002–October 2005 period is taken as a whole, the renminbi has depreciated in real, trade-weighted terms by approximately 1 percent under the JP Morgan index and by a much larger 9 percent under the Citigroup index. If one concludes, as I do, that the dollar will have to fall (in real, trade-weighted terms) over the medium term to help correct the large US current account deficit, then any dollar appreciation in 2005 will prove to be temporary and its reversal in subsequent years will, ceteris paribus, induce a depreciation in the renminbi as well, unless the renminbi appreciates relative to the dollar.

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China's use of large-scale, protracted, one-way intervention in exchange markets should be regarded as manipulation.[10] At least four fallacious arguments have often been put forward to rebut claims of manipulation.

The first argument is that because IMF rules permit countries a wide choice of currency regimes and because 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, especially when they encounter disorderly market conditions. What is not permitted under IMF rules is engaging 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 disequilibrium real exchange rate, and 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 renminbi and the dollar should be (within that currency regime) for long periods regardless of the economic signals about whether that rate is or is not an equilibrium rate, just as the United States cannot decide unilaterally what the dollar-renminbi 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, because "to manipulate" is an active verb, a country that has maintained the same parity for an extended period cannot be guilty of manipulation because it has not done anything.

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 mis-

10. 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 words currency manipulation with the perhaps less charged term of "thwarting international adjustment."

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alignment of the real exchange rate can come about just as easily from nonmovement 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 renminbi-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 renminbi 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.[11]

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 undervalued 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 because of 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 other countries' concerns. Should, for example, one additional worker 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.[12]

Yet a fourth argument for downplaying concerns about currency manipulation is that whatever the country's choice of currency regime and whatever actions it takes with respect to the nominal exchange rate, it will in the long term exert little control over the real exchange rate—and it is

11. Many commentators seem to forget that the real, trade-weighted value of the renminbi appreciated by nearly 30 percent between 1994 and early 2002, a period during which annual real economic growth still averaged about 9 percent.

12. If there were a widespread protectionist response to currency manipulation, employment could fall in the export industries of the country doing the manipulating. Also, longer-term issues associated with chronic undervaluation are relevant for stabilization policy and employment; Eswar 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 (2005) point out that the very large undervaluation of the renminbi is a relatively recent phenomenon and argue that seeking to maintain a large undervaluation of the renminbi 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.

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the real rate that matters for competitive advantage. Thus, if some countries use large-scale exchange market intervention to maintain an undervalued exchange rate, their domestic inflation rates will eventually rise enough to bring their real exchange rates back to equilibrium.

Key phrases here are "in the long term" and "eventually." The fact is that surplus countries can typically resist adjustment and maintain a disequilibrium real exchange rate for longer than deficit countries can. In addition, low-inflation countries may be able to resist real appreciation pressures for a considerable period.[13] In China's case, for example, the undervaluation of the renminbi in 2003 and 2004 did induce much larger capital inflows chasing an expected revaluation of the renminbi. 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 (Goldstein 2004). In the end, it took the implementation of strong administrative controls on bank lending, investment project approvals, and land use along with heavy sterilization operations to regain control of the credit and monetary aggregates. Therefore, China did pay a price in terms of domestic financial instability for seeking to maintain an undervalued exchange rate, and the (temporary) rise in China's inflation rate did reduce somewhat the real depreciation of the renminbi. 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 renminbi 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. Proponents of these arguments 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 during 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 World Trade Organization—in contrast with 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 every-

13. See Mohanty and Turner (2005) on the domestic consequences of exchange market intervention in emerging economies.

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thing from bananas to steel to domestic tax systems. Why isn't a similar exercise going on for exchange rate policy?[14]

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

But no 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 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) during 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 had 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 renminbi is undervalued.[15] Instead, the IMF 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 renminbi is not the same as either

14. I say similar (rather than identical) 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.

15. Goldstein (2004) and Goldstein and Lardy (2004; 2005; *Asian Wall Street Journal* of September 12, 2003; *Financial Times* of July 22, 2005) have maintained for some time that the renminbi is significantly undervalued—on the order of 15 to 25 percent. The undervaluation of the renminbi is likely even larger in 2005 than it was in 2003 or 2004 (Goldstein 2005a).

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a call for a more appreciated renminbi or a call for less exchange market intervention by the Chinese authorities: If the renminbi 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 renminbi, again making it more flexible. I am not of course suggesting seriously that the Fund believes either that (further) renminbi (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 noncommittal on both the appropriate level of China's exchange rate and the intervention measures that China has taken to support the current and recent levels of the exchange rate. The IMF has been willing to say only that the preferred currency regime in China should be one of greater flexibility; it has not defined by how much or when the renminbi would need to change to meet the standard of greater flexibility.[16]

Third, in recent comments about his conception of the role of the Fund,[17] the current managing director, Rodrigo de Rato, indicated that he did not think the Fund should act as a "special pressure group" for changes in country policies, presumably including exchange rate policies.[18] How the Fund is going to exercise firm 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 quiet diplomacy toward China's exchange rate policies over the past two to three years and at least so far the results have been meager.

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 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.[19]

16. In the *Financial Times* of July 22, 2005 ("China's Revaluation Shows Why Size Really Matters"), Nicholas Lardy and I argued that the initial revaluation of the renminbi included in the currency reform of late July 2005 was far too small.

17. See Leslie Wroughton, "Under Fire, IMF's Rato Wants to Get the Job Done," Reuters, July 29, 2005; Daniel Altman, "IMF Chief Draws Fire over Style as Leader," *International Herald Tribune,* July 27, 2005.

18. Ibid. My reaction to de Rato's comments 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."

19. 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 (that is, manipulation).

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Since 1988, the Omnibus Trade and Competitiveness Act has required the US Treasury Department to report to the US Congress any countries engaging in "exchange rate manipulation." The US Treasury named several Asian economies as manipulators during the 1988–94 period (including China in 1992–94), but the Treasury Department has cited no country since 1994—including in 2003 and 2004 when, as indicated earlier, there was strong evidence of manipulation by China and several other economies. If China was meeting—or was close to meeting—the technical requirements for manipulation, as argued by the US Treasury Department in May 2005 (US Treasury 2005), then these same technical requirements were also being met during most 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 and Competitiveness 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.[20]

The fact that the US Treasury Department has been dragged kicking and screaming into the currency manipulation debate by the US Congress says 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 does not 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 tool kit for identifying currency manipulation can be subject to outside pressures. 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—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—coach, banker, crisis manager—but I submit that looking forward none of those roles will be more important than that of umpire.[21]

20. 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 more than 3 percent in 2003, more than 4 percent last year, and is likely to be at least 7 to 8 percent in 2005. Those who maintain that China's overall current account position has been modest during the past few years have just not been watching the data carefully.

21. Mervyn King, governor of the Bank of England, in remarks at a February 4, 2005, London conference on advancing enterprise, set out a similar view: "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

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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 during its recent debt restructuring.[22] 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 because 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, which 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 because, 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 forums 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.

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 should undertake the following three initiatives.

First, the Fund should begin issuing its own semiannual report on exchange rate policies, in which it would not only discuss exchange rate developments of interest but also identify cases where there are 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 Department's reports to Congress. The IMF should issue its own report, with the best objective analysis it can muster. The report should cover industrial countries as well as developing countries. Because a finding by the Fund that a member has been engaging in currency manipulation would be seen as authoritative and as less influ-

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."

22. See Truman (chapter 2 of this volume) on why the IMF should have been more involved as an umpire-adviser than it was during the recent Argentine debt restructuring exercise.

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enced by national political pressures, it could be expected to act as a deterrent to engaging in currency manipulation in the first place. Over time, case law would develop that would help define what are and what are not internationally acceptable exchange rate policies. The G-7 should signal its support for this exercise by inviting the Fund to become a full and active participant in its discussion of G-7 exchange rates during G-7 meetings.

Second, the Fund should make more frequent use of the special or ad hoc consultations whenever either Fund staff or another member country raises 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 explain why there may have been extenuating circumstances in its use of, say, 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 semiannual 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 past 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 whether they warrant any modification, particularly regarding the pointers that might be indicative of inappropriate exchange rate policies. I think the existing pointers are reasonable, but it is certainly possible that improvements can be made. Until such 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.

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