Peterson Institute for International Economics

In Brief

Accountability and Oversight of US Exchange Rate Policy

C. Randall Henning • June 2008 • 122 pp. ISBN 978-0-88132-419-8 • $22.95

The US Congress long ago delegated authority over exchange rate policy to the US Treasury and the Federal Reserve. But the heat of the international trade and monetary conflicts of the mid-1980s prompted Congress to involve itself more deeply in exchange rate policy than it had before and more deeply than the legislatures of most of the other key currency countries. The Exchange Rates and International Economic Policy Coordination Act of 1988 (the 1988 Act, for short), an important component of the large omnibus trade act of that year, mandated Treasury to submit reports on international economic and exchange rate policies 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.

During the early part of the 1980s, the United States pursued a combination of loose fiscal policy and tight monetary policy, which caused the dollar to appreciate and produced trade and current account deficits that set new records. Rather than altering domestic macroeconomic policy, the first Ronald Reagan administration actively encouraged capital inflows to finance the fiscal and current account deficits. These policies flooded the United States with imports and put pressure on traded-goods producers that was unprecedented in the postwar period. When these producers complained to the Treasury, they were told that Treasury would not attempt to cap the value of the dollar for their benefit. These groups then complained to Congress, which responded by passing the 1988 Act. Proponents intended this legislation to improve congressional oversight and Treasury's accountability on exchange rate policy.

Exchange rates have again become a particularly important issue for Congress in recent years. The issue's return to political prominence has this time been driven largely by objections to China's exchange rate policy. Competition from China has put pressure on US producers, who have complained to Congress that the renminbi is substantially undervalued. Meanwhile, Treasury has refused to cite China in its reports to Congress as a country that "manipulates" its currency, despite unprecedented amounts of foreign exchange intervention by Chinese authorities to restrain the renminbi's appreciation.

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 the resulting undervaluation. The stakes are high because such provisions would also apply to countries beyond China whose economic strategies have also included substantial undervaluation of their currencies.

In light of the disputes over Treasury's approach in its reports and numerous legislative proposals to change oversight, Henning assesses the exchange rate provisions of the 1988 Act and the reporting process they created. He finds that the accountability process has often not worked well in practice: The coverage of the reports was sometimes incomplete and did not provide a sufficient basis for congressional oversight. The reports underanalyzed the impact of the federal budget on the balance of payments, for example, and they failed to designate China for currency manipulation despite abundant evidence. Senior political appointees, beginning with the secretary, are principally responsible for these shortcomings. Treasury deserves credit for raising the quality of the reports over the last few years, but substantial room for improvement remains. Congress has not always performed its own role well, holding hearings on fewer than half of the reports and overlooking important substantive issues.

With most current legislative proposals motivated by congressional discontent with Chinese exchange rate policy, there is a danger that Congress will lose sight of the broader purposes of the 1988 Act. Legislators should keep the broader aspects of US external monetary policy on the agenda: the overall value of the dollar, especially against other key currencies such as the euro; the risks of external deficits; prudential limits to external debt; the dollar's role in the international monetary system; and the mandate to cooperate with international partners.

The present mandate for exchange rate policy is partial, and Congress should make it comprehensive. It should clarify the standards for assessing whether Treasury has met this mandate. Treasury should be more timely, complete, and forthcoming in the reporting process. And Congress should be more systematic and diligent in its review of Treasury's performance relative to its mandate. Henning offers several specific measures to advance these goals.

Preparation of Reports. Treasury can provide more information on past events, negotiations, and interlocutors and more detail on negotiations within the G-7 and other financial forums, as well as the bilateral surveillance consultations with the International Monetary Fund (IMF). It can be more candid about the positions of other players on policy questions of interest to the United States, such as the reluctance of the Europeans to press China more strongly for revaluation prior to 2007. Treasury must revise the criteria by which it determines manipulation and also treat cases of overvaluation because they too can pose risks to the US economy. Finally, Treasury should be more punctual in the submission of its reports to Congress.

General Objectives. Although Congress has delegated exchange rate policy to the Treasury and Federal Reserve, it has not specified a comprehensive mandate for these agencies in US law. Congress should clarify the general objectives of US exchange rate policy and the standards by which Treasury's execution of policy would be assessed.

Current Account Balances and Real Effective Exchange Rates. The emphasis in the 1988 Act should be shifted from bilateral trade imbalances to global current account balances when assessing manipulation and initiating negotiations. International fragmentation of production and multilateralization of trade make bilateral imbalances nearly meaningless. As a consequence, findings of manipulation should focus on the real effective exchange rate rather than bilateral exchange rates. The real effective rate determines the current account balance more than any bilateral rate and captures competitiveness vis-à-vis third countries.

Manipulation. Some pieces of legislation currently under consideration by Congress introduce the concept of "misalignment" as well as "manipulation." It would not be desirable to completely replace the latter with the former. First, the criteria for defining manipulation are generally more concrete than those defining misalignment. Second, a country can experience a misalignment without being responsible for it. "Manipulation" should also be defined more clearly. The new language should be broadly consistent with the spirit of the IMF language without becoming immobilizing through obscure and unnecessary requirements about intent.

US legislation should draw upon, though not replicate exactly, the IMF Guidelines for Exchange Rate Policy, which specify four principles and seven policy actions that guide members with respect to their obligation to avoid currency manipulation and could indicate a need for special consultations between a member and the Fund. A country could potentially be designated for manipulation on the basis of either (1) large interventions in one direction over a sustained period that frustrates balance of payments adjustment or (2) the remaining IMF indicators such as current or capital account restrictions and official borrowing or lending. Although Treasury should not be directed to apply the indicators mechanically, placing them within the law would (1) foster partial convergence with IMF guidelines, (2) create more consistency on the criteria used in the exchange rate reports, and (3) make it more difficult for the report to avoid a manipulation finding in blatant cases.

Countermeasures. How the United States should respond to a government that is found to manipulate its currency but persists is perhaps the most contentious aspect of the current batch of legislative proposals. While trade measures can in principle counteract distortions created by currency manipulation, they should be (1) proportionate to the effect of the manipulation, as best as can be estimated, (2) removed when manipulation ceases, and (3) removed if found to be irreconcilably inconsistent with US obligations in the World Trade Organization. Such countermeasures should be applied only in cases of undervaluation caused or perpetuated by manipulation.

Multilateral Fairness and Coordination. If US exchange rate legislation pursues narrow, mercantilistic interests, then it will neither deserve nor receive international support. US actions to combat manipulation under the 1988 Act should also be in the interests of the target and third countries. Shifting the focus from the bilateral trade balance with the United States to countries' global current account balances, and from nominal bilateral to real effective exchange rates, would also be helpful. These changes will support the international acceptance of US actions. Treasury should also have a mandate to adopt an internationalist perspective in exchange rate policy, and Congress should retain and enhance the obligation in the 1988 Act to pursue international coordination.

Report Consolidation. Treasury and the Federal Reserve produce multiple reports on exchange rate policy. These reports nonetheless collectively (1) downplay the burning policy issues of the day, (2) are overlapping, (3) leave gaps, (4) cover different periods, and (5) rarely contain cross references. Congressional oversight and public discourse on exchange rate policy would benefit from streamlining and consolidating these reports.

Congressional Oversight. Congress should regularize multicommittee participation in oversight of exchange rate and international monetary policies by inviting members of the trade and budget committees to hearings of the banking committee. Multicommittee participation would help to integrate financial, trade, and macroeconomic concerns in the oversight process, give greater continuity to oversight over time, and render it more proactive and less reactive. It would also help to resolve jurisdictional disputes over trade and currency matters among these committees.

To learn about C. Randall Henning, visit
http://www.petersoninstitute.org/staff/author_bio.cfm?author_id=12.

To preview and purchase the book, visit
http://bookstore.petersoninstitute.org/book-store/4198.html.