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CONGRESS SHOULD TIGHTEN DEFINITION OF “CURRENCY MANIPULATION” AND HOLD TREASURY ACCOUNTABLE FOR APPLYING IT

Washington—China has consistently blocked substantial strengthening of its currency for the past five years in order to maintain its strong international competitive position. Largely as a result, it is running by far the largest trade surplus in the world and has piled up more than \$1.7 trillion of foreign exchange. However, the US Treasury Department has consistently failed to designate that country for currency manipulation in its exchange rate reports and shifted the main focus of this week’s Strategic Economic Dialogue to other issues. Treasury’s reports should have also addressed the sustainability of capital flows into the United States in light of the fallout from the subprime crisis and the impact of growing federal budget deficits on the current account balance and international role of the dollar. Congress should amend the Exchange Rates and International Economic Policy Coordination Act of 1988, which mandates these reports, by (1) defining “manipulation” more clearly, (2) respecifying Treasury’s reporting requirement, and (3) strengthening Treasury accountability in a number of other ways.

These are the conclusions of a new study published by the Peterson Institute for International Economics, *Accountability and Oversight of US Exchange Rate Policy*, by C. Randall Henning. This study reviews the Treasury’s reports to Congress on exchange rate policy and Congress’s treatment of them. It 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. In addition to shortcomings with respect to China and fiscal policy, the reports gave insufficient attention to cases of currency overvaluation and were always submitted late—the responsibility for which rests principally with the Secretary and other senior political appointees in the department. Although Treasury has improved the reports over the last few years, there is a need for substantial improvement. Nor has Congress always performed its own role well, holding hearings on less than half of

the reports—including on neither of the last two—and overlooking important substantive issues.

Several recommendations can improve guidance to the Treasury, standards for assessment, and congressional oversight and contribute to the smooth functioning of the international monetary system. These include:

1. strengthening the 1988 Act by explicitly providing for a manipulation designation either on the basis of foreign exchange intervention or on the basis of official lending, encouragement of capital flows, exchange restrictions, or other actions with the effect, rather than intention, of preventing external adjustment;
2. reinforcing the rules and principles of the International Monetary Fund (IMF) on exchange rate policy by drawing on its guidelines when designating a country for manipulation and using any countermeasures to enforce countries' IMF obligations;
3. clarifying the general objectives of US exchange rate policy in the legal mandate to the Treasury to require, among other things, policy activism when external deficits are potentially unsustainable, the exchange rate is disconnected from the economic fundamentals, and other governments intervene;
4. reaffirming the mandate, which has often been ignored in practice, to seek international macroeconomic and currency cooperation bilaterally, in the Group of Seven and other forums; and
5. regularizing multicommittee oversight of exchange rate policy by Congress in order to facilitate needed linkages among trade, finance, and budget matters.

The study also examines the current legislative proposals to counteract currency manipulation. Official Chinese purchases of about \$400 billion per year in exchange for renminbi (foreign exchange intervention) currently keep the Chinese currency from rising substantially in value and create large distortions in international trade and the monetary system, which can in principle be counteracted by trade measures. Any such countermeasures should be (1) proportionate to the effect of the manipulation, as best it can be estimated, (2) removed when manipulation ceases, and (3) removed if found to be

inconsistent with US obligations in the World Trade Organization. Countermeasures should be applied only in cases of undervaluation caused or perpetuated by manipulation.

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; the risks of external deficits; the dollar's role in the international monetary system; and the mandate to cooperate with international partners. Any future legislation in this area—perhaps under the next Congress and administration—should reinforce these broader purposes in addition to targeting currency manipulation.

Even in the absence of new legislation, Treasury should be more timely, complete, and forthcoming in the reporting process. Treasury should provide more analysis on prudent limits to US external deficits and debt and more information on international consultations and the positions of partners. Its report should be more timely and more forward looking. Treasury should also revise the criteria by which it determines manipulation and treats cases of overvaluation of foreign currencies (like the Thai baht in 1997 or the Russian ruble in 1998) that risk financial crises that could affect the US economy. The department should embrace the reporting process as an opportunity to articulate and advance its policies.

Strengthening the accountability of US policy and targeting currency manipulation can reinforce the rules and norms of the international monetary system. Currency manipulation that prevents balance of payments adjustment is proscribed under the IMF's Articles of Agreement. But the IMF, like other international organizations, has difficulty enforcing strong rules. A more assertive US posture regarding manipulation would help the IMF to also take a stronger position and in so doing help to safeguard the fairness of the international monetary and trade system and political support for international economic openness.

About the Author

C. Randall Henning, visiting fellow, has been associated with the Institute since 1986. He also serves on the faculty of the School of International Service, American University. He specializes in the politics and institutions of international economic relations, international

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