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Currency Manipulation: Lessons From the Congressional Debate

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OVERVIEW

Bottom Line: President Barack Obama's proposal for trade promotion authority (TPA) hangs by a thread; whatever the outcome, the debate over currency policy will remain center stage on Capitol Hill. A better approach for dealing with serious policy misalignments and destructive exchange-rate policies is to empower the Group of Twenty (G20) and International Monetary Fund (IMF) to make better use of current tools.

On June 12, the U.S. House of Representatives rejected legislation authorizing trade adjustment assistance, stalling a package of measures that would provide trade promotion authority to the president. Without TPA, which provides a streamlined process for congressional consideration of trade bills, agreement is unlikely to be reached on the Trans-Pacific Partnership (TPP) deal that is the centerpiece of President Obama's strategy toward Asia and critical to efforts at expanding trade and demonstrating U.S. leadership.

Opposition to TPA/TPP among congressional Democrats reflects several concerns, including the perception that major U.S. trading partners in Asia manipulate their currencies to gain an unfair advantage in trade. The bill that passed the Senate and now sits in the House makes elimination of currency manipulation a principle negotiating objective. However, the bill does not require the United States to pursue dispute resolution or take other retaliatory actions; the inclusion of these measures could have threatened the trade agreement, prompting a veto. There are sound arguments for a more assertive approach to identify and challenge inappropriate currency and trade practices, a point made by my colleague Ted Alden (here and here). Although I am skeptical that legislation is the answer, the fundamental questions about how to address U.S. trading partners' unfair currency practices remain unresolved and are likely to reemerge in coming months.

DISAGREEMENT ON DEFINING THE PROBLEM

Although concern over currency manipulation is far from new, a consensus on its definition has proved elusive. Many economists define currency manipulation with reference to macroeconomic outcomes, including external imbalances or an exchange-rate "misalignment" relative to some estimated equilibrium level. The difficulty with operationalizing this test is that such a misalignment depends on the full range of a government's economic policies, and there is no accepted threshold above which an imbalance is too large. So, except for the rare cases of extreme imbalances, economic models of misalignment will seldom produce consensus for policy change.

At the other end of the spectrum, manipulation could be measured by the observed act of foreign exchange-rate intervention or other direct interventions to prevent markets from reaching their natural levels. The presumption is that such direct action reflects an intent to distort trade. This latter approach is more amenable to legislation, but subject to the critique that it imperfectly captures the unwelcome behaviors, and that countries can easily achieve similar outcomes through other policies.

Since 1977, the IMF has sought to bridge these competing perspectives with a seven-part test to determine whether the practices of member countries warrant IMF surveillance. Test factors include protracted, large-scale one-way intervention in the exchange markets, and large and prolonged current account surpluses. This is the approach of current U.S. law and the legislation now sitting in Congress. The U.S. Omnibus Trade and Competitiveness Act of 1988 requires the U.S. Treasury to issue a semiannual report identifying countries that "manipulate the rate of exchange between their currency and the United States dollar for purposes of preventing effective balance of payments adjustments or gaining unfair competitive advantage in international trade." Although the Treasury has provided broad guidance as to how it defines manipulation and relies in part on the IMF definitions, critics have argued that the definition is too general to be effective in deterring manipulation. Further, the unwillingness of the Treasury to cite any country for manipulation in this report since 1994 has strengthened criticism that the current law is ineffective.

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Any credible definition of currency manipulation should capture the most egregious cases of misalignment and address visible and active episodes of government intervention in the exchange markets. China provides the most obvious example of a consensus that something was wrong: its foreign-exchange reserves rose from just over $200 billion in 2001 to nearly $2 trillion in 2008, and its current account surplus rose from 1.3 percent of gross domestic product to over 10 percent. However, since then, China's current account surplus has fallen back to around 2 percent and reserve accumulation has slowed sharply. In April, the IMF reported that the Chinese currency currently was not misaligned.

Proposed legislation should also exclude the effects of monetary policies such as the U.S. quantitative easing measures from 2008 to 2014 and Japan's similar measures since 2013. However, monetary policy could have large effects on currency valuations and cause severe problems for trading partners, even if the intent of monetary easing was to spur domestic demand and not necessarily to weaken the currency. In the context of Japan's experience, the Group of Seven (G7) sought to find a workable distinction between monetary policy and currency manipulation. In their February 2013 statement, G7 ministers and central bank governors endorsed fiscal and monetary policies "oriented towards meeting our respective domestic objectives using domestic instruments," and reaffirmed their commitment not to target exchange rates. That formulation—allowing monetary easing that is aimed at domestic objectives (e.g., stimulating demand after a recession) as long as the country does not directly intervene in markets—protects monetary policy but potentially justifies a huge range of policy interventions. Further, it ensures that legislation in part driven by anger at Japan (and China) is unlikely to identify either country as a manipulator in the current environment.

Any definition will need to capture the most egregious cases of misalignment to be credible.

LEGISLATIVE PROPOSALS WILL NOT ADDRESS THE PROBLEM

Given the lack of consensus regarding definitions, it is not surprising that a wide range of legislative proposals exist to address the problem. The existing legislation foresees a beefed-up Treasury review process, backed by the threat of future legislative action. More aggressive proposals, defeated in the Senate, would have required binding dispute settlement or allowed for countervailing duties against countries that are found to manipulate.

There are a number of unconventional proposals also being discussed. C. Fred Bergsten, former head of the Peterson Institute for International Economics, suggests meeting manipulation with matching and offsetting sterilized foreign-exchange intervention, and other proposals recommend cutting off an offending country from trade and other benefits. Finally, there is already some language in the World Trade Organization (WTO) agreements designed to discourage competitive devaluations. Article XV of the General Agreement on Tariffs and Trade (GATT) states that member countries "shall not, by exchange action, frustrate the provisions of this agreement." In principle, this language could be tested through the dispute-settlement provisions of the WTO. No country has ever brought a case, though the U.S. Trade Representative's office has examined the possibility in some detail.

One problem with all of these proposals is that, if legislated through TPA or other trade agreements, they would only apply to countries participating in the agreement. This makes an agreement harder to achieve, punishes participants in these agreements, and creates impediments to other countries, such as China, joining these agreements at a later date.

Empowering the IMF will require strong international support.

A broader concern is that this legislation reflects a further turn away from multilateralism at a time when U.S. support for an open, multilateral trading system is in question due to the failure to pass IMF reform and to effectively deal with China's plans for an Asian infrastructure bank, among other issues. This is a point well made by the Peterson Institute's Ted Truman and others.

REAL PROGRESS WILL REQUIRE POLITICAL WILL

In recent years, the Treasury Department has made a meaningful effort to prioritize exchange-rate policies, pressing China and others on exchange rates in multiple forums. Arguably, these efforts have contributed to exchange rates that are better aligned now than in the past. But these efforts have mostly taken place behind closed doors, reflecting the judgment that public naming and shaming would be counterproductive. As a result, the perception exists that the United States, and the international community more generally, is not doing enough. Criticism has in particular focused on the IMF, given its mandate to oversee exchange rates, and the perception that past IMF initiatives have failed to deliver.

This is not to say that the Fund has stood still. In recent years, the IMF has developed new tools to address currency misalignment and analyze the costs of protracted imbalances, including better analytics and reports examining the multilateral effects of exchange-rate misalignments, but the political will has not existed to put them into effect. Critics have pointed out, for example, the IMF's muted criticism of apparent misalignments in recent years in leading countries such as Korea and Germany. Empowering the IMF to do a better job pursuing exchange-rate policies will require strong international support, which can only be provided by leaders through forums such as the G7 and G20. The G20, in particular, would appear to be an appropriate place to start any initiative, because it includes rising powers such as China, Korea, and Brazil that are essential for any strengthened effort to succeed. No approach, legislative or multilateral, will succeed unless there is political will at the leadership level to support a serious process.

Looking Ahead: Kahn's take on the news on the horizon

Finding the "Grexit"
Greece looks headed to capital controls and a possible exit from the eurozone, as prospects for an agreement with official creditors look remote.

Ukraine default looms
Ukraine's talks with creditors on a restructuring appear to have stalled, increasing the likelihood the government will stop payments on its debt.

A quiet taper . . . so far
Markets expect the Federal Reserve to raise interest rates before the end of the year, contributing to increased market volatility and higher market interest rates, but there is so far little evidence of a new "taper tantrum."