THE IMF AND EXCHANGE RATES

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I want to focus my remarks today on the issue I believe is both most important to the functioning of the international monetary system and has been least satisfactorily addressed over the past five years of debate on the future of the international financial architecture: the exchange rate levels and exchange rate systems among the major economies of the world. This includes China and several other large economies in East Asia along with the United States, Euroland and Japan. <u>I believe that the US Treasury and the International Monetary Fund are violating their respective mandates concerning exchange-rate policy and that the Committee should address priority attention to this issue.</u>

Before addressing this major problem, I should note that there has been a considerable amount of good news on the exchange-rate front in recent years. A large majority of emerging market economies, and other developing countries, have shifted from fixed to flexible currency regimes and have thus insulated themselves from the types of crises that were so prevalent in the 1990s. In my view, this is in fact the central reform that has taken place in the international financial architecture and it will substantially reduce the systemic instability that was so prevalent in the recent past.

Paradoxically, the chief problem now relates to the currencies of the major countries. The immediate issue is the massive intervention in the currency markets by China, Japan, Korea, Taiwan and perhaps a couple of other countries to keep their exchange rates from rising against the dollar. <u>China's intervention in 2003 exceeded the total increase in its GDP. Japan's intervention in the first quarter of this year exceeded the global total of the US current account and budget deficits, i.e., the Bank of Japan by itself more than financed all of our twin deficits.</u> As a result of this intervention, all four countries cited here amassed foreign exchange reserves far in excess of any conceivable needs they might have – to levels of $850 billion for Japan, almost $500 billion for China, $200 billion for Taiwan and $160 billion for Korea.

There are three very costly results of this process. First, much of the essential correction of the US current account deficit is blocked. Despite the substantial (though gradual and orderly) fall of the dollar from early 2002 to early 2004 against the euro, Australian dollar, Canadian dollar and a few other currencies, its trade-weighted average – which is what counts for purposes of trade adjustment – has only fallen by about 10 percent. This is largely because the Asian countries have resisted, partly or wholly, participating in the essential international adjustment.

Our external deficit has now largely leveled off as a result of the modest dollar decline and may fall by as much as $100 billion, though last week's record numbers for the deficit remind us of the severity of the problem. In any event it will remain unsustainably high. I believe that we need to cut the deficit by at least one half, from its present level of $550 billion to $250-300 billion, to achieve a sustainable position. This will require a dollar decline of 25-30 percent, from its highs of early 2002, 2½-3 times what has occurred to date.

Second, the distribution of the international currency (and thus economic) adjustment to date has been highly unbalanced. The euro and a few other currencies have risen by 40-50 percent against the dollar (and 10-25 percent on a trade-weighted basis). But the currencies of the Asian countries, which have been running the largest current account surpluses that are the primary counterparts of our deficits, have risen much less. In the key case of China, the currency has not increased at all because of its peg to the dollar. (Similar results obtain for Taiwan and a couple of the smaller countries.) This distorted distribution of currency movements has placed undue burdens on Europe, Australia, Canada and several other countries. Since most of the Asian countries are growing rapidly and most of the Europeans are growing slowly, this distribution has dampened world growth. It has also understandably led the countries that have already appreciated to now resist significant additional appreciation until the Asians join the adjustment process, further truncating the necessary correction of the U.S. deficit.

Third, China's peg to the dollar essentially blocks the participation of all of East Asia (even, to a partial extent, Japan) in the needed adjustment process. China is the world's most competitive major economy, and has become even more competitive as it has ridden the dollar down against virtually all other currencies, and its neighbors are understandably reluctant to let their currencies rise against the dollar because doing so would mean they would also rise against the renminbi. Thus Korea, Taiwan and Japan have resisted fully participating in the global adjustment process along with China; their own trade-weighted exchange rates have either risen minimally (Japan and Korea) or declined (Taiwan).

The obvious question is what to do about all this? The Treasury Department reported to the Congress on April 15 that it is "encourag(ing)…policies for large economies that promote a flexible market-based exchange rate." However, the report concluded that "no major trading partner of the United States met the technical requirements for designation (for currency manipulation) under the Omnibus Trade and Competitiveness Act of 1988." Moreover, the International Monetary Fund "concur(red) with our conclusions" when Treasury consulted with them, as required by the statute.

<u>These conclusions by both the Treasury and the IMF are patently incorrect</u>. China's huge intervention, which has prevented any appreciation of its currency against the dollar, is clearly intended to maintain an undervalued exchange rate to strengthen the country's international competitive position. Japan's even larger intervention has not precluded some significant rise in the yen but that rise would clearly have been much greater in the absence of Japanese official action. Similar conclusions obtain, on a lesser scale from a global standpoint, for Korea and Taiwan. <u>Hence the Treasury Department by failing to act against this widespread manipulation is clearly violating both the letter and spirit of US law</u>.

The IMF is likewise violating its own rules. Article IV, Section 1 (paragraph iii) of its Articles of Agreement stipulate that each member shall "avoid manipulating exchange rates…in order to prevent effective balance of payments adjustment or to gain unfair competitive advantage over other members." The Fund itself (Article IV, Section 3) is to "exercise firm surveillance over the exchange rate policies of members" and, under the principles and procedures adopted in 1977 (after the initial advent of floating exchange rates), the first indicator of the need for such surveillance is "protracted, large-scale intervention in one direction in the exchange market." This is exactly what is happening in all the East Asian countries cited yet no discernible Fund action has been taken.

The problem is further compounded by the erroneous nature of the advice that has been offered by the US Treasury and the Fund (and the G-7) in their discussions of the issue with the Chinese. They have urged China to liberalize or dismantle its exchange controls, and float its currency, despite the totally unrealistic nature of any such move for at least a few more years in light of the weakness of China's banking system. Such advice, if accepted, could even produce net capital outflows from China that would weaken the renminbi, and intensify the global adjustment problem. China should instead retain its capital controls and fixed exchange rate, for a while longer, and deal with the immediate international problem (as well as its drastic domestic overheating) through a one-time revaluation of 20-25 percent.

I conclude that the most urgent unresolved issue of the international financial architecture and the role of the IMF, at the current time, is how to get all major trading countries to participate fairly and effectively in the international adjustment process. Countries are never eager to adjust so rules of the game have been developed at the national and international levels to assure that they do so. Both the Treasury and the International Monetary Fund are violating their obligations to promote global adjustment, however, and I urge the Committee insist that they do so.