Paulson's First Challenge

Can the new U.S. Treasury chief confront China's currency manipulation?

BY MORRIS GOLDSTEIN

In May 2006, the U.S. Treasury issued its long-awaited report to Congress on international economic and exchange rate policies and concluded once again—despite overwhelming evidence to the contrary—that China was not "manipulating" its currency (the renminbi, or RMB for short). This can only reduce further Treasury's credibility with the U.S. public, the Congress, and the Chinese authorities.

Just a year before, in its May 2005 report to the Congress, the U.S. Treasury found that Chinese (economic) policies were highly distortionary and posed a risk to China's economy, its global trading partners, and to global economic growth. Treasury then went on to warn that "…if current trends continue without substantial alteration, China's policies will likely meet the statute's technical requirements for designation" (as a currency manipulator). In the November 2005 report, completed several months after China's alleged "reform" of its currency regime on July 21, Treasury admitted that the actual operation of China's new exchange rate system was highly constricted, that the distortions and risks previously identified still persisted, and that the constraints imposed on exchange rate flexibility were troubling. It also vowed in future reports to

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"…intensely scrutinize whether and to what extent China is practicing what officials have repeatedly committed to undertake."

Over the past year, the RMB has appreciated relative to the dollar by just over 3 percent—compared to a bilateral under-valuation of approximately 40 percent and to an overall RMB under-valuation of 20–35 percent against a trade-weighted and inflation-adjusted average of the currencies of China's main trading partners. At this pace, it could take a decade or more to eliminate the misalignment of the RMB with respect to the dollar.

At the time of its reform of the RMB regime in July 2005, the Chinese authorities pledged to allow the forces of "market supply and demand" to play a greater role in their exchange rate regime. But since then they have continued to intervene by roughly the same massive amounts to keep down the value of the RMB. Meanwhile, China's global current-account surplus has mushroomed to over 7 percent of its GDP; and in the first five months of 2006, China's global trade surplus is running 56 percent ahead of last year's figures.

In short, there has been no "substantial alteration" of China's exchange rate policies. Having Chinese leaders reaffirm the same promises on exchange rate flexibility and on tilting toward domestic demand growth that their government failed to keep during the past year hardly constitutes concrete action. No wonder then-U.S. Treasury Secretary Snow had to acknowledge in the May 2006 report that "…[W]e are extremely dissatisfied with the slow and disappointing pace of reform of the Chinese exchange rate regime."

Nevertheless, Secretary Snow argued that Treasury could not cite China as a "manipulator" because the evidence was not sufficient to establish that China was operating its foreign exchange system for the "purpose" (i.e., with the "intent") of preventing effective balance of payments adjustment or gaining an unfair competitive advantage.

This is nonsense. Did Treasury expect Chinese President Hu Jintao to confess that China's official objective all along has been to prevent balance-of-payments adjustment and gain unfair competitive advantage over its trading partners? In each of the past three years, China has engaged in large-scale, one-way intervention in foreign markets on the scale of at least 10 percent of its GDP; over this same period, the real, trade-weighted value of the RMB has shown a cumulative depreciation; China's global current-account surplus has grown ever larger; and all this while the Chinese economy has expanded at an average annual rate of over 9 percent. If, under these facts and circumstances, one cannot draw the inference that China has been acting to prevent effective balance-of-payments adjustment, when would the U.S. Treasury ever be able to make a finding of manipulation? If one needed psychoanalysis of the objectives of governments along with yet more data on excesses in exchange market intervention to reach judgments about internationally unacceptable exchange rate policies, then the currency manipulation guidelines of the U.S. Congress (as well as those of the International Monetary Fund) would be of no practical use.

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Secretary Snow noted in a recent report that Treasury is supportive of recent efforts

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Incoming U.S. Treasury Secretary **Henry Paulson** *should make it clear that in the interest of both China and the global economy, there needs to be before November 2006 a "significant down-payment"—say, on the order of a 10–15 percent appreciation from its current level—toward reducing the large undervaluation of the RMB with respect to the dollar.*

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to strengthen IMF exchange rate surveillance, and rightly so. But why should one expect the IMF to be more ambitious in identifying cases of currency manipulation if the U.S. Treasury cannot identify an obvious case of manipulation in its own report?

Some argue that citing China as a currency manipulator would only cause the Chinese leadership to harden its position and would thereby delay progress. Does the same alleged link also apply to U.S. criticism of China's military build-up or of human rights abuses? Why does it make sense for the U.S. government to bring complaints before the WTO on Chinese trade policies and to press publicly and loudly for better protection of intellectual property rights in China, but not to enforce its own guidelines on currency manipulation?

Other apologists for the "don't-tell-like-it-is" line maintain that labeling China as a currency manipulator would incite the U.S. Congress to enact protectionist trade legislation and would thereby make the United States look like the bad guy in this dispute. But since when is condoning currency manipulation the ally rather than the enemy of open markets? The unhappy experience with the competitive depreciations of the 1920s and 1930s not only contributed to the protectionist trade climate of that era but also led to a widespread call for an international code of conduct that would strongly discourage beggar-thy-neighbor exchange rate policies. Indeed, that was one of the main reasons for establishing the IMF. Why should the United States be regarded as "protectionist" for identifying currency manipulation? Does it make us "protectionist" to identify shortcomings in China's intellectual property regime? And why should the U.S. Congress be more inclined to intervene in the U.S.-China exchange rate policy debate when the U.S. Treasury is interpreting sensibly the law, than when it is not, thus creating the perception that unless the Congress itself acts, no one will be minding the store? Nor is trade retaliation along Schumer-Graham lines—that is, the imposition of a 27 percent tariff on China's exports to the United States—the only or smartest lever to deal with currency manipulation. Senators Grassley and Baucus have recently introduced a bill that would prevent the United States from supporting either a quota increase at the IMF or "market economy" status for any country found to have a "fundamentally misaligned currency."

Former Deputy Secretary of State Bob Zoellick has argued that the Bush Administration wants and expects China to act as a "responsible stakeholder." But what meaning does this concept have if the U.S. government is not going to have the gumption to call a spade a spade when China is acting "irresponsibly"? Whether or not Treasury cites China for currency manipulation, it will still have to negotiate about China's exchange rate policies. The difference lies in negotiating with China from

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a position of credibility based on a straightforward reading of the evidence and on enforcement of the law versus negotiating without that credibility. By identifying currency manipulation when and where it occurs, the U.S. Treasury would also send a strong signal that it expects all member countries of the Fund to take seriously their obligations on exchange rate policy spelled out clearly in the IMF's charter.

In his campaign for re-election, President Bush was fond of saying that he stood for "saying what you mean, and meaning what you say." So far, his Treasury's policy toward China's exchange rate policy has been anything but that. The appointment of a new Treasury Secretary is an opportunity to change that failed approach.

Incoming Secretary Henry Paulson should implement a three-prong strategy for encouraging China to move faster on RMB appreciation.

First, he should make it clear that in the interest of both China and the global economy, there needs to be before November 2006 a "significant down-payment"—say, on the order of a 10–15 percent appreciation from its current level—toward reducing the large undervaluation of the RMB with respect to the dollar.

It does not matter so much whether this down payment takes place via a step revaluation, or an upward managed float, or some combination of the two. What counts is the size of the exchange rate movement and that it happen soon. Secretary Paulson should explain to his Chinese counterparts that with the U.S. interest rate cycle further advanced than in Europe or Japan and with the large and rising U.S. current-account deficit, 2006 and 2007 could well be marked by dollar weakness. Failure to create more space between the RMB and the dollar could therefore mean that the RMB would follow the dollar down—increasing further the RMB's undervaluation in real, trade-weighted terms. At a time when China's global current account surplus is already huge and increasing and when growth of China's bank lending and its monetary aggregates are once again considerably above their targets, this would be precisely the wrong policy prescription. Moreover, he should convey the message that if China continues to block "significant" RMB appreciation and to thwart external adjustment by continuing to engage in large-scale protracted exchange market intervention, he will seek President Bush's approval to name China as a currency manipulator in the November 2006 report to Congress.

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Second, Secretary Paulson should redouble efforts to "multilateralize" the exchange rate issue by insisting that the IMF carry out its mandated responsibility to "exercise firm surveillance over the exchange rate policies" of its member countries. If the Fund were doing its job in this crucial area, the U.S. Congress and the U.S. Treasury would not need to be so involved in the currency manipulation issue. Secretary Paulson should reject IMF Managing Director Rodrigo de Rato's claim that the Fund cannot serve as the umpire for the global exchange rate system because it would conflict with the Fund's role as "trusted advisor." Why should the two roles conflict unless the Fund were giving countries advice on exchange rate policy that was counter to the Fund's own surveillance guidelines? And even if the two roles did conflict, why is not the umpire role the more important one?

It will be extremely difficult to sustain forward momentum on globalization and to resist protectionism if there is a widespread perception that trade and exchange rate policies are "unfair." The most effective way to counter such charges of "unfairness" is to subject them to serious investigation and findings by a competent, unbiased international umpire. The WTO is fortunately already playing such a role for trade policy disputes. It is past time for the IMF to step up to the plate and perform a similar function for exchange rate policy.

Toward this end, the U.S. Treasury should press the Fund to begin issuing its own semi-annual report on exchange rate policies, including the identification of cases where there are concerns about possible currency manipulation. Likewise, the Fund should make more frequent use of its "special" consultations tool whenever either Fund staff or another country has raised questions about currency manipulation—a tool that it has not used at all during the past eighteen years and only twice during the past twenty-six years. If Mr. de Rato refuses to carry out the Fund's mandate on exchange rate surveillance, the U.S. Treasury should withhold its support (thereby preventing the needed majority) for some other initiatives currently being pursued by IMF management, including a realignment of voting shares in the Fund. This could be done by having the Administration support the Grassley-Baucus bill in the Congress.

Finally, Secretary Paulson should indicate that the United States is prepared both to make its own contribution toward reducing global payments imbalances and to work with other countries to improve the analytical framework underpinning IMF surveillance over exchange rate policies. Just as a significant RMB revaluation is overdue, so too is a credible medium-term plan for fiscal policy consolidation in the United States that can help to raise the extremely low U.S. national saving rate. Such a credible plan cannot rely exclusively on expenditure cuts; tax increases must also be on the table. The outlines of such a fiscal policy plan should be ready by the time that the Fund mission visits the United States as part of its initial round of "multilateral" consultations—a new procedure that was agreed at the IMF-World Bank meetings last April. If the United States is not willing to go farther in putting its own house in order, its entreaties for China and others to do more will look more like finding scapegoats for the unsustainably large U.S. current account deficit than about promoting shared adjustment.

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Similarly, Secretary Paulson must convince China (as well as other key U.S. trading partners) not only that enforcing an international code of conduct is in everyone's interest but also that China and other emerging economies will have a hand in revising and interpreting the code so that it reflects their concerns—not just those of the United States.This is not about China bashing; it is about laying out guidelines for exchange rate policy that can sustain globalization over the next several decades when the challenges of integrating further the larger emerging economies into the international economy will be formidable.

Real reform of the exchange rate system and of the IMF cannot proceed without U.S. leadership that is determined, bold, and far-sighted but that is also receptive to constructive criticism from our partners. It's time for the U.S. Treasury to trade in its earlier policy of "whine, whine, huff-and-puff, and then decline" (to cite for manipulation) for something better. ◆