Assessing Progress on China's Exchange Rate Policies

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Introduction and Preview

Mr. Chairman, I appreciate the opportunity to testify before this committee on the important issue of China's exchange rate policies. In my remarks, I want to demonstrate how meager has been the progress over the past five years in improving those policies; why this lack of progress matters for the economies of China and the United States, and for the international monetary and trading system; why several popular arguments and excuses for why more can't be accomplished are unpersuasive; and finally, what can and should be done to accelerate progress over the next year or two.

Previewing what follows, I will be emphasizing the following broad themes.

First, over the past five years, things have gotten much worse – not better – on China's external imbalance and its exchange rate policies. China's global current-account surplus soared to 9 percent of GDP in 2006 and the renminbi (RMB) is now grossly under-valued – on the order of 30 percent or more against an average of China's trading partners and 40 percent or more against the US dollar. The 6 ½ percent appreciation of the RMB against the US dollar since June 2005 has not even been sufficient to halt the cumulative improvement in China's competitiveness over the 2002-2007 period – much less to make a real dent in China's huge external surplus.

Second, the international community is now operating without an enforced international code of conduct on exchange rate policies. Although China has been engaging in large-scale, one-way intervention in exchange markets for the better part of four years, the Chinese authorities continue to assert that they do not accept the concept of currency manipulation. Meanwhile, the US Treasury has refused to label China as a "currency manipulator" despite overwhelming evidence to the contrary and the Managing Director of the IMF continues to reject the role of global umpire for exchange rate policies that was laid out for the Fund in its charter.

Third, this lack of progress on improving China's exchange rate policies is bad news for China, the United States, and for the international monetary and trading system. China's seriously under-valued and manipulated exchange rate makes it much harder for China to move to a more balanced and consumption-driven growth path and to implement a more independent monetary policy. It likewise handicaps efforts to strengthen China's banking system and raises doubts about China's intention to become a responsible stakeholder in the international monetary and trading system. From the perspective of the United States, the failure of the RMB to appreciate significantly has limited the helpful contribution that exchange rate changes in Asia could make to bringing about an improvement in the US global current-account deficit and to reducing the risk of a dollar crash and a hard landing for the US economy. If China continues to stonewall by blocking a significant real appreciation in its currency, it could adversely affect the operation of the global exchange rate system by generating an unfavorable demonstration effect for currency policies in the rest of emerging markets; just as important, China's currency manipulation could lead to retaliatory trade responses in the

United States and perhaps in Europe and Japan as well – much to the disadvantage of all parties concerned.

Fourth, several popular arguments that maintain that it is neither feasible nor desirable for China to take faster and bolder action in reducing markedly the under-valuation of the RMB are anything but convincing. A significant appreciation of the RMB will not be disastrous for China's growth, employment, or social stability. Bolder exchange rate action on the RMB will not cause major disruptions to China's banks; nor is it necessary for bolder exchange rate action to await further financial-sector reform in China. The IMF does not have good reasons for rejecting the role of global umpire for the exchange rate system. And having the US Treasury label China as a currency manipulator will not be counter-productive in motivating the desired exchange rate outcome.

Fifth, China should deliver right away a meaningful "down payment" of a 10-15 percent appreciation of the RMB from its current level. Because China has waited so long to take decisive action on the growing under-valuation of the RMB, the under-valuation can no longer be eliminated in one go. A sizeable up-front adjustment is needed if China is to escape from being so far behind the curve. A modest upward rate of crawl of the RMB relative to the US dollar -- by say, 5 percent a year – is not going to get the job done in an environment where the dollar itself is likely to be falling to help reduce the US current-account deficit. Bolder exchange rate action should be accompanied by an expansion and redirection of government expenditure toward weaknesses in China's social safety net – so as to reduce the incentives for such high precautionary saving. The US Treasury should indicate to the Chinese that henceforth it will consider movements in China's global current-account surplus, in China's real effective exchange rate, and in

China's monthly intervention in the exchange market as the key benchmarks for assessing progress on external adjustment and on currency reform. The Treasury should press for putting the exchange rate issue at the top of the agenda for the May 2007 meeting of the Strategic Economic Dialogue and for keeping it there until greater progress is made. Failure by China to drastically reduce its large-scale, one-way intervention in the exchange market should result in a finding of "currency manipulation" in the Treasury's May 2007 Report to the US Congress. To ensure that the US approach to correcting global payments imbalances is seen as even handed, the US should indicate that it is prepared to offer a new longer-term plan for greater and more durable fiscal consolidation in the United States. Finally, the IMF should return to its roots by taking up in earnest the role that its founders set out for it as the global umpire for exchange rate policies. The problem with the IMF's existing guidelines for exchange rate surveillance is not in their design but rather in their enforcement. There is no such thing as effective no-fault exchange rate surveillance.

Four Indicators

If you just read the press releases coming out of Beijing and Washington DC over the past five years, you might think that a significant improvement was well underway in China's external imbalance and its exchange rate policies. Let me recap four indicators that are more meaningful than the press releases and that yield quite a different verdict.

Indicator number one. China's global current account surplus has grown without interruption over the past five years, mushrooming from about 1 percent of its GDP in

2001 to roughly 9 percent of GDP in 2006.[1] China now has the largest global current-account surplus in the world in absolute dollar terms and it is larger relative to the size of the economy than even the troublesome US global current-account deficit.[2] And for the first two months of 2007, China's trade balance – which typically makes up the lion's share of the current account – ran 225 percent above the pace for the first two months of 2006. In short, the Chinese government has been allowing China's global external imbalance to expand out of control.

Indicator number two. China's real effective exchange rate -- widely regarded as a more comprehensive and superior measure of China's overall competitive position than the nominal exchange rate between the US dollar and the Chinese RMB – has actually depreciated by about 2 percent since either the dollar peak in February 2002 or the dollar's average value in 2001.[3] External payment adjustments call for appreciations of real effective exchange rates, that is, for declines in competitiveness, in countries with large global current-account surpluses. But China's real effective exchange rate has moved in a direction opposite to what is needed. Some would have you believe that because the RMB-US dollar rate has appreciated by about 6 1/2 percent since June of 2005 – from 8.28 RMB to the dollar to roughly 7.73 (as of March 22, 2007) – we must be making real progress on the exchange rate front. The sad truth is that the RMB is

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[1] Note too that this large expansion of China's global surplus has occurred during a period when world oil prices have increased sharply (China is a net oil importer) and when China's growth rate of real GDP has been very rapid (pushing up its demand for imports).

[2] The U.S. global current-account deficit in 2006 was $857 billion – or 6.5 percent of our GDP. China's global current-account surplus in 2006 – expressed as a share of its GDP – was also considerably larger than was Japan's in the period of considerable bilateral trade friction with the United States.

[3] An "effective" exchange rate index is a weighted average of the country's exchange rate against its major trading partners, where the weights on individual currencies are typically related to the importance of that country in the home country's trade. A "real" exchange rate index adjusts movements in the nominal exchange rate for differences in inflation rates between the home and foreign country, since higher inflation represents a decline in price competitiveness just like an appreciation of the home currency. A "real effective" exchange rate index combines these two features.

now grossly under-valued – on the order of 30 percent or more against an average of China's trading partners and 40 percent or more against the US dollar – and that the appreciation of the RMB that has taken place to date against the dollar is completely inadequate to make a real dent in this huge surplus.[4]

Indicator number three. When it launched its much-heralded currency reform in July 2005, the Chinese authorities said that they intended to increase the role of market forces in the determination of the RMB. No such thing has happened. The Chinese authorities have continued to intervene in the foreign exchange market in massive amounts – to the tune of about $20 billion a month over the past year – to keep the RMB from rising; this is the same level of monthly intervention as in the six months prior to the announcement of the "new" exchange rate system. In each of the past three years, China's exchange market intervention has amounted to roughly 10 percent of its GDP – a truly extraordinary amount. Moreover, this heavy exchange market intervention has been accompanied by large so-called "sterilization" operations, thereby short-circuiting the process (of domestic monetary expansion and rising inflation) by which large reserve accumulation would otherwise lead to a deterioration in China's competitive position even with little flexibility in the (nominal) RMB exchange rate.[5] Whatever the rhetoric, the facts say that the RMB remains a heavily managed, quasi-fixed exchange rate.[6]

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[4] For estimates and analysis of the under-valuation of the RMB, see Morris Goldstein and Nicholas Lardy, "China's Exchange Rate Policy Dilemma," American Economic Review, May 2006; Morris Goldstein, "Renminbi Controversies," Cato Journal, Spring/Summer 2006; and William Cline, "Estimating Reference Exchange Rates," Paper presented at Workshop on Policies to Reduce Global Imbalances," Washington DC, Bruegel, Korea Institute for International Economic Policy, and Peterson Institute for International Economics, February 8-9, 2007.

[5] When the monetary authorities "sterilize" the effects of exchange market intervention, they take offsetting actions (e.g., selling bonds or bills to the public) to ensure that changes in international reserves don't have much effect on the domestic money supply (and hence on the domestic inflation rate). It is often argued that if countries engage in heavy exchange market intervention, then they should not be allowed to also engage in heavy sterilization -- lest they block the changes in competitiveness that are necessary for

Indicator number four: compliance with China's obligations on exchange rate policy as a member of the IMF. Although each member country is obligated under the Fund's charter to desist from "... manipulating exchange rates....," and although one of the leading pointers of currency manipulation is large-scale, prolonged, one-way intervention in exchange markets, the Chinese authorities continue to assert that they do not accept the concept of currency manipulation. Simultaneously, although that same IMF charter enjoins the Fund to exercise "... firm surveillance over the exchange rate policies of member countries..," the Fund's Managing Director, Mr. Rodrigo de Rato, has maintained repeatedly that he rejects a role for the Fund as global "umpire" of exchange rate policies. Meanwhile, the US Treasury Department, while increasingly critical of China's exchange rate policies, has ruled repeatedly in its recent reports to Congress that it cannot find China guilty of currency manipulation because it cannot prove "intent" to manipulate. The practical upshot of this is that the international community is operating without an enforced international code of conduct on exchange rate policies. Indeed, it's as if a new IMF charter has been informally agreed under which there are two guidelines on exchange rates. Guideline I covers the obligation of countries; it states: "member countries shall do as they wish on exchange rate policies." Guideline II covers the obligations of the IMF for exchange rate surveillance: it states: "Sorry, it's not our job."

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effective balance-of-payments adjustment. China has been engaging in both heavy exchange market intervention and heavy sterilization of increases in its international reserves.

[6] Yes, there have been some welcome steps to create a market infrastructure and financial instruments that would assist the development of a floating exchange rate for the RMB (e.g., the introduction of interbank foreign currency trading and allowing banks to act as market-makers in foreign currency) – but these steps pale in significance next to the bottom-line, external imbalance and real exchange rate developments emphasized above.

Why It Matters

If progress on correcting China's external imbalance and on removing the large under-valuation of the RMB has been very slow or non-existent, some might say that it doesn't matter that much. I beg to differ.

Obviously, China's exchange rate policies matter most to China itself. The Chinese authorities have concluded for good reasons that they want to move from an investment and export-led growth strategy to a more balanced path that is driven by consumption and domestic demand.[7] They also would like to move toward a more independent monetary policy, to continue to strengthen their banking system, and to be regarded as a "responsible stakeholder" in the international system, with a role commensurate with China's growing weight in the world economy.

But China's seriously under-valued and manipulated exchange rate puts at risk achievement of all these worthy objectives. It's hard to restrain investment and to reduce the volatility of aggregate demand growth when you can't raise interest rates by much because doing so might attract large speculative capital inflows – thereby putting stronger upward pressure on the exchange rate. It's hard to divert resources away from exports and to reduce excess capacity in important tradeable goods industries when a highly under-valued RMB is sending price signals that go in the opposite direction. It's hard to improve the performance of banks when they have to hold an ever larger share of relatively low-yielding sterilization bonds in their portfolios, when they are subject to repeated increases in reserve requirements, when an under-valued exchange rate generates large increases in international reserves – some of which, even with heavy

[7] See Nicholas Lardy, "China: Toward a Consumption Driven Growth Path," Policy Brief Number PB06-6, Peterson Institute for International Economics, October 2006.

sterilization operations still finds its way into excessively rapid increases in bank loans, and when central authorities tell local credit officers how much and to whom to lend. And it's hard to maintain reliable access to industrial countries' markets for your exports and foreign investments -- and indeed, to convince others that you merit a larger leadership role in helping to manage the international monetary system -- when you insist (contrary to your membership obligations at the IMF) that your exchange rate policy is solely a matter of your national sovereignty and that others should accept a timetable for your external adjustment that might run into decades rather than the medium term.

Although their impact is often exaggerated, China's exchange rate policies also matter for the United States. I say exaggerated because the US economy is operating at full employment, and China's exchange rate policies are clearly not a key driver of aggregate employment in the United States, although they may impact particular industry groups. Likewise, one only has to look at China's weight – about 15 percent – in the Federal Reserve's trade-weighted index for the dollar to realize that isolated movements in the RMB would only have a limited effect on the US global current-account deficit; for example, a 20 percent appreciation of the RMB would by itself translate into only a 3 percent depreciation in the trade-weighted dollar; such a small dollar depreciation might improve the US global current account by perhaps $40-55 billion – a modest contribution if the aim is, say, to reduce last year's US current account deficit of $857 billion by about half. It is also true that there are important measures that the United States can and should take on its own to improve our aggregate savings – investment imbalance --

especially efforts to produce a durable reduction in the US budget deficit over the medium term.

Still, it is a mistake to downplay the helpful role that exchange rate changes in Asia can make to bringing about an improvement in the US external imbalance and to reducing the risk of a dollar crash and a hard landing of the US economy. Here, a significant real appreciation of the RMB could be an important catalyst. If the real effective exchange rate of the US dollar has to depreciate by say, another 15-20 percent to bring the US current-account position and the trajectory for US net foreign assets into a more sustainable position without an undue sacrifice to US economic growth, some other currencies clearly have to go up in value. The euro, the Canadian dollar, the Australian dollar and some other market-determined exchange rates have already experienced significant real appreciations and cannot do that job all by themselves. Japan plus emerging Asia carries a 40 percent weight in the dollar's average value. To get any kind of reasonably balanced burden of adjustment, the Asian region should absorb its fair share of the aggregate appreciation of non-dollar currencies, particularly given the large current-account surpluses and high reserve holdings in that region. Some Asian currencies – especially the Korean won, the Indonesian rupiah, and the Thai baht – have already shown sizeable real appreciations but a group of other Asian currencies – including the Chinese RMB, the Japanese yen, the Taiwan dollar, and the Malaysian ringgit – have not; most of them actually have depreciated in real effective terms since the dollar's peak in February 2002. Since China is a key competitive benchmark for others in the region, a significant appreciation of the RMB would make it easier for others to countenance an appreciation in their currencies. <u>In short, what happens to</u>

Chinese exchange rate policies matter for the United States because it affects how real-exchange rates move in Asia more broadly and the latter is relevant for achieving an orderly correction of the over-sized US current-account deficit. To take an example, a 25 percent real appreciation vis-à-vis the dollar in China, Japan, and the rest of emerging Asia would probably improve the US current-account position by roughly $130-180 billion.

China's exchange rate policies also carry important implications for the future operation of the international monetary system and for efforts to maintain an open international trade and investment climate. If China continues to block a meaningful real appreciation of its currency, I see two risks for the system.

First, we could get a most unfavorable "demonstration effect" for currency policies in the rest of emerging markets. Suppose the lesson of China's exchange rate policies comes to be seen as follows: use a combination of heavy and persistent intervention in the exchange market, plus large-scale sterilization operations, and you too will be able to generate and sustain a highly under-valued real exchange rate that will be advantageous for achieving rapid economic growth. In such a case, we would see in the future much less real exchange rate appreciation in surplus countries and a smaller role for exchange rates in the correction of external imbalances. This would be distinctly bad news for the global economy and for the US economy.

The second risk is that China's currency manipulation will eventually lead to a retaliatory trade policy response in the United States—and perhaps in Europe and Japan as well. This will in turn destroy prospects for achieving what I have previously called a

win-win "grand bargain" between the industrial countries and the emerging economies.[8] In that grand bargain, the emerging economies would get good access to the large markets in the industrial countries for their exports and their foreign investments and they would obtain "chairs and shares" (greater representation and voting power) in the groups and institutions that manage the world economy that were consistent with their growing economic weight. In exchange, the industrial countries would get improved access to the growing markets in the emerging economies as well as a pledge from the emerging economies that the latter would play by the agreed "international rules of the game" on currencies, trade, and international property rights.

To believe that China can continue with its exchange market intervention policies for another say, five years and maintain a highly under-valued exchange rate that provides what Fed Chairman Bernanke rightly dubbed a "subsidy" to its exporters and still enjoy uninterrupted access to the US market is, I think, a fantasy.[9] Eventually, patience will run out and countervailing measures of one kind or another will be adopted – much to the long-run disadvantage of both sides. If there is not perceived "fairness" in exchange rate policy and not some agreement on what constitutes internationally acceptable behavior on exchange rate policies, it will be very difficult to sustain forward momentum on an open trade and investment climate or on globalization more broadly. If there is no competent and objective international umpire to referee disputes on exchange rate policy, then we will have lots of national "freelancing" as national legislatures step into the breach. Similarly, if the US Treasury sets a standard of proof for intent to manipulate

[8] See Morris Goldstein, "Exchange Rates, Fair Play, and the 'Grand Bargain,'" Financial Times, April 21, 2006.
[9] Ben Bernanke, "The Chinese Economy: Progress and Challenges," Remarks at the Chinese Academy of Social Sciences, Beijing, China, December 15, 2006.

that is in practice unreachable and rules "no foul" even after the third largest trading country in the world intervenes in amounts equal to 10 percent of GDP for three years running, sees its global current-account surplus grow eight to ninefold in five years, has its real effective exchange rate moving in the wrong direction, and is simultaneously experiencing booming economic growth -- then one shouldn't be surprised if the legislature comes to view those reports as a whitewash.

Myths That Thwart Progress

If progress on China's exchange rate policies has been slow or non-existent and if this carries adverse implications, what is preventing us from moving ahead faster? Well, one impediment has been a set of arguments maintaining that faster and bolder action on reducing China's external imbalance and its RMB under-valuation would be neither feasible nor desirable. Given time constraints, let me mention just four of these myths.

A very popular one is that a significant real appreciation of the RMB would be disastrous for China's growth and employment and hence, also for its social stability. I don't buy it. Between 1994 and early 2001, China's real effective exchange rate appreciated by roughly 30 percent; yet China's average growth rate during that period was 9 percent and in no single year did growth drop below 7 ½ percent. Employment in China's export industries accounts for roughly 5 percent of total employment—not 30 or 40 percent. During the period when China's investment and export-led growth has been most pronounced, employment growth has been noticeably slower than when growth was more oriented toward consumption and domestic demand.[10] If there is concern that

[10] See Nicholas Lardy, "China: Toward a Consumption Driven Growth Path," Peterson Institute for International Economics, October 2006.

significant RMB appreciation alone would be too contractionary, there is the attractive option of pairing it with an increase in government expenditures directed at health, education, and pensions. Such a strengthening of the social safety net would reduce the need for such large pre-cautionary saving and would contribute, along with the demand effects of increased government expenditure, to a larger reduction in China's external imbalance. Accepting the principle that countries should be allowed to manipulate the exchange rate so as to boost employment would make it impossible to discourage "beggar they neighbor" exchange rate policies at the international level: all countries have full employment objectives and it is not clear why some countries concerns in this area should be elevated above those of others. Why, for example, should an extra worker employed in China's export industry count for more than an extra one in Bengladesh, or Egypt, or South Carolina?

A second contention is that an appreciation of the RMB much beyond the rate of recent years would cause major disruptions to China's financial sector, particularly its banks, and that bolder exchange rate action has to wait until China's financial system is much stronger than today.

As outlined earlier, I think huge reserve accumulation, the need to place low-yielding sterilization bonds with the banks, and the reliance on window guidance to manage bank lending, actually makes large exchange rate under-valuation the enemy – not the ally – of bank reform. In the first two months of 2007, the growth of bank lending was again (as it was in 2003 and the first part of 2004) running far in excess of its target.

All of the major financial crises in emerging economies over the past dozen years or so have been characterized by large currency mismatches on the eve of the crisis.[11] But China's banks and their customers are much less vulnerable on the currency mismatch front than were the earlier crisis countries: China is a net creditor – not a net debtor -- in its overall foreign exchange position; where bank capital is required to be held in dollars, reports indicate that most of the currency risk is being hedged in the market; China's exporters have lower debt-equity ratios than firms in other sectors; and most of the largest exporting firms are foreign-owned and do not obtain the bulk of their financing in China's domestic market.

The most pressing constraints and challenges for China's banks do not stem from an appreciation of the RMB. China does have to be careful not to implement too quickly a wholesale liberalization of restrictions on capital outflows. This is because a completely open capital outflow regime could lend itself to a nasty bout of capital flight if Chinese banks were to suffer a spate of bad news. This is why I and my Peterson Institute colleagues have argued for some time that capital account liberalization should not be confused with currency reform in China and that the former should take place on a later time schedule than a significant appreciation of the RMB.[12] The correct diagnosis is that full capital account liberalization in China has to wait for a strengthening of China's banking and financial system – not that exchange rate appreciation has to wait for financial sector reform.

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[11] See Morris Goldstein and Philip Turner, Controlling Currency Mismatches in Emerging Markets, Peterson Institute for International Economics, 2004.
[12] See Morris Goldstein and Nicholas Lardy, "Two-Step Currency Reform for China," Asian Wall Street Journal, September 12, 2003; and Morris Goldstein, "Adjusting China's Exchange Rate Policies," Peterson Institute for International Economics, 2004.

The principal challenge facing Chinese banks is how to increase profitability as China's overall financial market is being further liberalized. Owing in large part to a high incidence of bad loans, the return on equity in China's banks has historically been extremely low. Going forward, the Chinese authorities have indicated that they want to expand the roles of commercial paper, bond, and equity markets. Given China's large external payments surplus, they also would like to liberalize gradually restrictions on capital outflows. The rub is that if China's savers and borrowers do obtain greater access to alternative sources of funds and alternative investment opportunities, the huge prevailing spread between lending and deposit interest rates in Chinese banks (on the order of 350-400 basis points) – which is currently being maintained by restrictions/controls on interest rates – is likely to fall sharply. Jon Anderson of UBS has estimated that even a 100 basis point decline in this spread would have been sufficient to completely wipe out the profits of the four largest state-owned banks in 2005.[13] How then is profitability going to be maintained or increased if international banks in this post-WTO-entry landscape have a comparative advantage vis-à-vis domestic banks in generating fee-based income, if state-owned banks are reluctant to close yet many more branches and lay off many more employees, and if restrictions on majority ownership by foreign banks limits what can be accomplished in improving the credit allocation process.

Myth number three is that the IMF should not act as a global umpire for exchange rate policy – notwithstanding the mandate in its charter – because doing so would conflict with the IMF's role as "trusted advisor" to its member countries. But why should the two roles conflict unless the Fund were giving countries advice on exchange rate policy that

[13] See Jon Anderson, "The Sword Hanging Over China's Banks," UBS Asian Focus, UBS, Hong Kong, December 15, 2006.

violated its own currency manipulation guidelines? And even if the two roles did conflict, why is not the umpire role the more important one? Most games have two teams, two coaches, and at least one umpire – not two teams, three coaches, and no umpire. When there is no umpire, the quality of play invariably suffers. The IMF is the only institution with the mandate and resources to carry out the umpire role successfully; in contrast, there are many others who can act as a trusted advisor to countries.

Yet a fourth weak argument is that having US Treasury name China (or others) as a currency manipulator would only be counter-productive in motivating the desired exchange rate outcome and would brand the US as protectionist to boot. One might ask: why is the alleged link between external criticism and lack of policy reform peculiar to exchange rate policy? The US government does not refrain from criticizing publicly China's human rights abuses or its military buildup for fear that doing so will slow progress. In a similar vein, if the US government is willing to challenge publicly the legality of various aspects of China's trade policy or its protection of intellectual property rights, why must currency manipulation be treated differently? What sense does it make to ask China to be a "responsible stakeholder" if it is not acceptable for the United States to speak out when China is acting irresponsibly? And since when is condoning currency manipulation the friend of open markets? Does it make the United States "protectionist" to identify shortcomings in China's intellectual property regime?

Whether or not the US Treasury names China as a "currency manipulator," the Treasury will need to negotiate with the Chinese on altering China's exchange rate policies. But there is an important difference. When the Treasury finds that China has not been engaging in manipulation, it reduces the dispute to a bilateral difference of

opinion about how fast China should move on increasing the flexibility of the RMB – with China preferring a slow, gradual approach and the US favoring a more rapid one. After twenty five years of favorable experience with a gradualist approach to policy reform in other areas, the Chinese authorities think they know better which approach works best and favor their own view. In contrast, if China were found to be engaging in currency manipulation –not just by the US Treasury but also by the IMF – it would send a strong signal that the international community regards China's exchange rate policy not only as ill-advised but also as illegal and as counter to China's membership obligations in the IMF. The latter finding is apt to be a more powerful catalyst for a policy change in China than is a simple difference of opinion on the optimal speed of moving to a higher RMB. But it will be difficult to persuade the IMF to conduct a serious inquiry into China's alleged currency manipulation practices if the US Treasury itself rules repeatedly in its own reports to the US Congress that no currency manipulation has in fact taken place.

What to Do?

If recent developments in China's exchange rate policy are worrisome and if the arguments against faster and bolder policy actions are weak, what should China, the United States, and the IMF do to prevent a train wreck from taking place sometime over the next few years?

The priority for China should be to deliver right away a meaningful "down payment" of a 10-15 appreciation of the RMB from its current level. This could be accomplished either by a step revaluation of the RMB or by cutting way back on China's exchange

market intervention so that the RMB floated upwards. If China had acted in 2003-2004 to deal in a timely manner with its growing current-account surplus and with the RMB under-valuation, it could perhaps have erased the misalignment in one go. But the under-valuation of the RMB has now become so large, that a phased approach to exchange rate adjustment has become necessary. That said, it should be clear by now that a very modest rate of upward crawl of the RMB relative to the US dollar is not going to solve the problem. If the dollar depreciates in real effective terms by say, 15-20 percent over the next two to three years time, then say, an annual 5 percent appreciation of the RMB with respect to the dollar is not going to deliver the needed large appreciation in China's real effective exchange rate, that is, the RMB's path in real effective terms will be heavily influenced by the decline in the dollar. China has to escape from being way behind the curve on exchange rate adjustment. Drawing out the needed appreciation of the RMB over too long also carries that risk that once a non-trivial upward crawl of the RMB comes to be widely expected by markets, it could induce large speculative capital inflows. All of this is why Nick Lardy and I have long called for a significant step revaluation in the RMB as the first part of "two-step" currency reform for China.[14] Bolder exchange rate action should also be accompanied by an expansion and redirection of government expenditure toward weaknesses in China's social safety net, that is, toward the health, education, and pension areas – so as to reduce the incentives for such high precautionary saving. China should also abandon the rhetoric that the RMB exchange rate is a matter of Chinese national sovereignty and should reaffirm its commitment to the exchange rate policy obligations placed on all members of the IMF.

[14] Morris Goldstein and Nicholas Lardy, "Two-Step Currency Reform for China," Asian Wall Street Journal, September 12, 2003.

For its part, the United States needs to clarify and to strengthen its message on what it wants China to do on exchange rate policy, while simultaneously demonstrating its willingness to make a larger contribution of its own toward reducing global payments imbalances.

The U.S. Treasury should indicate to the Chinese that henceforth it will consider movements in China's global current-account surplus, in China's real effective exchange rate, and in the monthly amount of China's intervention in the exchange market as the key benchmark indicators in assessing China's progress on external adjustment and on currency reform. The Treasury should press for putting the exchange rate issue at the very top of the agenda for next meeting in May 2007 of the Strategic Economic Dialogue (SED) with China, and for keeping it there at future meetings of the SED until there is much greater progress in reducing both China's global external imbalance and its exchange rate under-valuation. The US authorities should also seek to marshal support from both other industrial countries and large emerging economies for establishing the Fund as the global umpire for exchange rate surveillance – recognizing that the alternatives are apt to be either a "free for all" on exchange rate policy or a patchwork of disjointed manipulation findings and trade policy responses from national legislatures. As part of this role, the Fund would be expected to make more frequent use of its "special consultation" tool whenever either another country or Fund staff raised questions about potential currency manipulation; the Fund would also begin issuing its own semi-annual report on exchange rate policies. Until such a time as the Fund assumes this role, the US Treasury should continue to issue its twice-yearly reports to Congress on international economic and exchange rate policies – but with the expectation that failure by China to

make a significant change in its exchange rate policy would result in a finding of "currency manipulation" in the May 2007 report.[15] It is regrettable that at least so far US Treasury Secretary Paulson has given higher priority to policy proposals that lie outside the realm of exchange rate policy (e.g., reforming China's capital markets). While reforms and improvements in China's capital and financial markets would offer many dividends in the long term – including to US financial service firms that want to be more deeply involved in China's financial development, such reforms are not a necessary pre-condition for making faster progress on China's exchange rate and external imbalance problems; nor should one discount the distortions and competitive disadvantages faced by other segments of the US economy due to China's real exchange rate under-valuation.

As suggested earlier, the Chinese exchange rate problem is part of the wider issue of achieving a better and more equitable pattern of burden-sharing in correcting global payments imbalances. To ensure that the US approach to this problem is seen as "even handed," the US authorities should assure the Chinese (and others) that the same benchmarks and methodology used to evaluate progress on external adjustment and exchange rate policy in China will be applied to other economies – be they industrial economies or emerging markets. Equally important, the United States should indicate that it is prepared to offer a new longer-term plan for greater and more durable fiscal consolidation in the United States. This in turn should give more confidence to other

[15] My Peterson Institute colleague, C. Fred Bergsten, has argued that as a spur to negotiation and to galvanizing a multilateral effort to reduce existing payments imbalances, the US Treasury should inform its G-7 colleagues and the IMF of its intention to label China as a currency manipulator in its next report to the US Congress (unless China makes a significant down payment in correcting its RMB under-valuation); see C. Fred Bergsten, "The Chinese Exchange Rate and the US Economy," Testimony before the Committee on Banking, Housing, and Urban Affairs, January 31, 2007.

countries and to private markets that the United States is addressing adequately its low national saving rate while making room for an expansion in US net exports that would accompany a depreciation in the real effective exchange rate of the dollar.

Last but not least, the IMF should return to its roots by taking up in earnest the role that its founders set out for it as the global umpire for exchange rate policies. It should be apparent by now that the "multilateral consultation process," launched with much fanfare by IMF management in April 2006, is no substitute for that umpire role. The WTO is already serving in a parallel role as global umpire for trade policies. Through the rulings of its adjudication panels, it is becoming clearer over time what is and what is not internationally acceptable trade policy. A similar exercise has to begin for exchange rate policy at the IMF. The best protection against protectionist trade policies is the assurance that a competent, unbiased international umpire is considering seriously potential abuses of exchange rate policy and issuing fair, well-reasoned findings. A good place to begin that exercise would be with the two controversial cases of the Chinese RMB and the Japanese yen. Such an exercise would be helpful in clarifying, for example, whether the under-valuation of the Japanese yen should be regarded differently than the under-valuation of the RMB because the Japanese authorities have not been engaging in large-scale, prolonged, one-way intervention in exchange markets since the first quarter of 2004, whereas the Chinese authorities have been doing so for several years running. There is no point in having a set of internationally-agreed guidelines for IMF surveillance of exchange rates if these guidelines are not enforced.

Mr. Chairman, to sum-up, the role of currency in the US-China relationship – the very title of this hearing – has not been handled well over the past four years. The primary

responsibility for this unsatisfactory state of affairs lies with China itself. The Chinese authorities have waited far too long in dealing decisively with their rising external imbalance and the growing under-valuation of their currency and they have not honored their obligations on exchange rate policies as a member of the IMF. But the United States and the IMF have hardly covered themselves with glory either on solving these problems. The US Treasury's almost exclusive reliance on "quiet diplomacy," the vague pleas for "greater flexibility of exchange rates in countries with large current-account surpluses" instead of calls for an immediate and significant appreciation in the real effective exchange rate of the RMB, and the tortured reasoning to justify a conclusion that China has not intended to "manipulate" its exchange rate (when all evidence pointed to the contrary) -- have sent weak signals to China and have produced meager results.[16] In addition, the United States has not done enough on fiscal policy consolidation to make a sufficient contribution to reducing our own large saving-investment imbalance. Meanwhile, the IMF has been largely "asleep at the wheel" in carrying out its own obligation to exercise "firm surveillance" over the exchange rate policies of its member countries.[17] There is no such thing as "no fault" exchange rate surveillance and no set of exchange rate guidelines will work in the absence of the will to enforce those guidelines. All things considered, a different approach is needed if we are to achieve greater progress in reducing global payments imbalances and in deterring trade policy actions that would be in no country's best interests. In this statement, I have outlined what an alternative

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[16] The "greater flexibility" mantra has been a favorite in repeated G-7 communiques and in statements by US Treasury officials.

[17] The "asleep at the wheel" characterization of IMF surveillance on exchange rate policy was first offered by US Treasury Under-Secretary Tim Adams; see Tim Adams, "The IMF: Back to Basics," in Edwin Truman (editor), Reforming the IMF for the 21st Century, Peterson Institute for International Economics, April 2006. In a similar view, see Morris Goldstein and Michael Mussa, "The Fund Appears to be Sleeping at the Wheel," Financial Times, October 3, 2005.

approach might be and why I think it could generate better results. I look forward to answering your questions.