



Congress, the IMF, and Exchange Rate Reform: Legislative Proposals

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Summary

In recent years, Congress has been increasingly concerned that other countries—China, Japan, Taiwan and Korea in particular—are manipulating the value of their national currencies in ways injurious to the U.S. economy. A spate of legislation was introduced in the 109th Congress seeking to pressure foreign countries to revalue their currencies or seeking changes in the international financial system—particularly changes in the International Monetary Fund (IMF)—that would help accomplish that end. Similar bills are likely to be introduced in the 110th Congress.

Current law on this topic is defined by the Exchange Rates and International Economic Policy Act of 1988. Among other things, it requires the Secretary of the Treasury to analyze the foreign exchange rate policies of other countries, in consultation with the International Monetary Fund, to see if foreign countries are manipulating the value of their currency for the purpose of gaining unfair trade advantage or preventing effective balance of payments adjustment. When this is found, the Secretary is required to seek negotiations with the offending country multilaterally or bilaterally for the purpose of ending that situation. In recent years, many have thought that China is manipulating its currency for these purposes. The Treasury Secretary has not made a finding to this effect, however, on grounds that China does not meet all the criteria specified in the 1988 Act and that Chinese authorities have given assurances that they will raise the value of their currency.

The IMF Articles of Agreement specify, in Article IV, that countries may not manipulate their currency for the purpose of gaining trade advantage or for preventing balance of payments adjustment. The IMF is responsible for exercising “firm surveillance” over countries’ exchange rate policies and for assuring their compliance with the Article IV rule. The IMF has no effective tools other than persuasion, however, with which to enforce its oversight responsibility. Previously, most of the IMF’s surveillance was done bilaterally through its annual consultations with member countries. In 2006, the Fund instituted a new program of multilateral consultations and it brought together China, Japan, the United States, Saudi Arabia and Euro area representatives to discuss the major financial and trade imbalances currently affecting the world economy. A report and possible recommendations are to be received in early 2007.

Congress has sought in various ways to address trade problems which many believe are exacerbated by undervalued foreign currencies. Several bills were introduced in 2005 and 2006 to establish countervailing duties or special tariffs on goods entering the United States from countries with undervalued currencies. These are intended to raise the domestic price of those goods to levels that would prevail if those currencies were valued at their appropriate level. Many of these initiatives might violate international trade rules, however. Advocates argue that the United States must take action to protect itself regardless. Other legislation has sought to require the Secretary of the Treasury to make a finding that China and other countries are currency manipulators. Another group of bills proposed that the United States should pursue reforms in the IMF that would give that international agency more authority to enforce Article IV and to stop countries from manipulating their currency. Many of the sponsors of the bills discussed in this report are reportedly planning to introduce similar bills in the 110th Congress. This report will be updated as events warrant.

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Background

In recent years, Congress has been increasingly concerned that other countries—China, Japan, Taiwan and Korea in particular—are manipulating the value of their national currencies in ways injurious to the U.S. economy.¹ A spate of legislation was introduced in the 109th Congress seeking to pressure foreign countries to revalue their currencies or seeking changes in the international financial system—particularly changes in the International Monetary Fund (IMF)—that would help accomplish that end. This is not a new issue. For several decades, U.S. policy makers in the Executive Branch and Congress have sought through legislation and the IMF to influence international exchange rate policy in ways they believe compatible with U.S. interests.

Current U.S. Law on Exchange Rate Policy

Two decades ago, Congress enacted the Exchange Rates and International Economic Policy Coordination Act of 1988 (called here the 1988 Exchange Rates Act) out of concern that “policy initiatives by some major trading nations that manipulate the value of their currencies in relation to the United States dollar to gain competitive advantage continue to create serious competitive problems for United States industry.”² Congress also said in the same section of the law that it thought greater cooperation among the major countries could reduce the distortions and uncertainties in financial markets and in the international exchange rate system.

Economic theory holds that, if currencies are valued at rates that reflect their true relative value, the flow of world trade and investment will likely be based more on efficiency and comparative advantage and less on price distortions caused by exchange rate misalignment.³ This is expected to enhance, in turn, the benefits that countries realize from international trade and to promote a more balanced pattern of growth in the world economy.

The 1988 Exchange Rates Act requires the President (Section 3004) to confer with other countries on a multilateral basis to achieve better coordination in macroeconomic policies in order to ensure that their levels of trade and current account balances are sustainable. It also directs the Secretary of the Treasury to analyze the foreign exchange rate policies of foreign countries, in consultation with the IMF, to determine whether they are manipulating the exchange rate between their currency and the US dollar for the purpose of preventing effective adjustment or gaining unfair

¹ For a discussion of exchange rate issues for individual countries, see CRS Report RL33178, *Japan’s Currency Intervention: Policy Issues*, by (name redacted), CRS Report RL30566, *South Korea-U.S. Economic Relations*, by (name redacted), CRS Report RL32165, *China’s Currency: Economic Issues and Options for U.S. Trade Policy*, by (name redacted) and (name redacted), and CRS Report RL33322, *China, the United States and the IMF: Negotiating Exchange Rate Adjustment*, by (name redacted).

² Exchange Rate and International Economic Policy Coordination Act of 1988, Title III of the Omnibus Trade Act of 1988. P.L. 100-418, section 3002 (statement of findings).

³ Economists would say that the best measure of the real comparative value of two currencies would be the rate which prevails when the economies of both economies are at macroeconomic equilibrium and market forces determine exchange rates. In practice, this situation is difficult to achieve, as countries may not always operate at their macroeconomic equilibrium (or at least they may not operate at this level simultaneously) and it is often hard to calculate what their equilibrium condition might be because key data are unavailable or are incalculable when economies are experiencing rapid growth or systemic change. Nevertheless, most economists would say that currencies which are free to change according to market conditions are likely closer to their “real” value than are currencies whose values are determined by official choice.

trade advantage. When this is found, the Secretary must undertake negotiations in the IMF or bilaterally for the purpose of eliminating this situation. The Secretary need not pursue such negotiations, however, if he deems this detrimental to U.S. interests. In any case, the Secretary must inform the Senate Banking Committee and the House Financial Services Committee of his determination.

Section 3005 of the act requires the Treasury Secretary to report to Congress twice annually on currency market developments, the underlying economic factors that affect those developments, actions the United States has taken (“interventions”) to adjust the exchange rate of the dollar, and the impact of the dollar exchange rate on the U.S. international balance of payments, the U.S. economy and the competitiveness of U.S. industry. It also requires the Secretary to report whether countries are manipulating their currencies to the detriment of the United States and what steps he has taken to address that situation.

The IMF and International Exchange Rates

The IMF was created at the end of World War II to help stabilize the exchange rates among the world’s major currencies and to prevent a return to the patterns of currency manipulation and competitive devaluations which plagued the pre-war international economy.⁴ Initially, under the IMF’s original format, the world was on a fixed-parity exchange rate system. The value of the U.S. dollar was fixed in terms of gold and the value of all other currencies defined in terms of the U.S. dollar. Countries could change the value of their currencies relative to the dollar only with the permission of the IMF and only if they agreed to undertake economic policies that would stabilize their economies.

The system broke down after President Nixon announced in 1971 that the U.S. Treasury would no longer exchange dollars for gold. The United States devalued the dollar twice and it decreed that the dollar would “float” and its value would be determined by the daily interaction of supply and demand in world currency markets. A period of international financial instability ensued. In the end, there being no consensus among the major countries as to how to fix the situation, an amendment to the IMF charter was adopted in 1976 authorizing countries to adopt whatever exchange rate system—fixed, floating or other—they found appropriate.⁵ Thus, different exchange rate systems can be operating simultaneously in different countries. The 1976 amendment also provided that, if countries holding 85% of the IMF voting power should ever agree, a uniform exchange rate system could be mandated for all IMF member countries. Given the differences of view among the major countries, most analysts believe the prospect for such an agreement is very small.

⁴ See IMF. Articles of Agreement. Article I (Purposes.) Formulated at the United Nations Monetary and Financial Conference, Bretton Woods, New Hampshire, July 1 to 22, 1944. Signed at Washington, D.C., December 27, 1945 and effective that day. U.S. participation authorized by the Bretton Woods Agreements Act, P.L. 79-171. Instrument of U.S. participation deposited December 20, 1945.

⁵ Third Amendment to the IMF Articles of Agreement, adopted April 30, 1976. Countries must inform the IMF which system they will use. The only prohibited exchange system was one where currencies are valued in terms of gold. As discussed in the text, the amendment also changed the language of Article IV to prohibit currency manipulation for the purpose of gaining unfair trade advantage and to give the IMF responsibility for surveillance over the world exchange rate system.

Article IV of the IMF charter requires countries to cooperate with each other in order to assure orderly exchange arrangements and a stable exchange rate system. In particular, it says they must pursue economic policies which aim at fostering orderly economic growth with price stability, promote stable international monetary conditions, and avoid manipulating the exchange rate of their currencies in order to gain unfair competitive advantage in international trade or to prevent effective balance of payments adjustment.

Article IV says that the IMF shall “exercise firm surveillance over the exchange rate policies of members” and “oversee the compliance of each member with its obligations” to cooperate with other countries and not to manipulate the value of their currency in order to gain unfair trade advantage. The IMF charter gives the international agency no effective tools, however, to help it enforce its oversight responsibilities or its judgment whether countries are meeting their Article IV responsibilities. It can issue statements but it has no tools to force them to alter their exchange policies.

Previously, most of the IMF’s surveillance over countries’ exchange policies occurred during the Fund’s annual bilateral discussions with its member countries about their domestic and international economic policies. These discussions are mandated by Article IV and called “Article IV consultations.” The IMF also discussed international economic issues in publications—such as the annual World Economic Outlook report (WEO)—which focus on cross-national or regional trends. The Fund’s Independent Evaluation Office (IEO) estimates that only about 9% of the IMF’s resources are used for the preparation of such reports, however, while more than three times this volume of resources was spent for bilateral surveillance of individual countries.⁶ Surprisingly, IEO reports that for all the emphasis given in IMF commentaries to the importance of multilateral surveillance, discussion of foreign exchange issues accounts for only a small portion of the effort devoted to the analysis of global trends. Moreover, IEO says, “Conspicuously missing [from the Fund’s discussion of issues in the WEO and other major reports] was an analysis of China’s exchange rate, which in recent years has figured prominently in international policy debate.”⁷ IEO reports that “the IMF did not use the *WEO* to discuss whether the renminbi (or any other Asian currency for that matter) was undervalued and, if so, what the alternative paths to adjustment might be and their implications for the adjustment of global imbalances.”

In 2006, the IMF adopted a new approach to multilateral surveillance of exchange rates. Instead of discussing issues singly with countries, the IMF’s new program of multilateral consultations aims to bring together countries with shared concerns for debate and potential action. Changes are also reportedly being made in the Fund’s surveillance procedures in order to strengthen its oversight of exchange rate issues.⁸ The Managing Director told the International Monetary and Financial Committee (the smaller panel of key countries that meets midway between Fund’s annual meetings) in September 2006 that a policy dialog between five countries or groups of countries—the United States, China, Japan, Saudi Arabia and the Euro area—was underway in order to discuss the problem of global imbalances, their causes, and spillover and linkage effects.⁹

⁶ IMF. Independent Evaluation Office. *Multilateral Surveillance*. Washington, D.C. 2006, p. 12.

⁷ *Ibid.*, p. 16.

⁸ IMF. *IMF Surveillance: A Factsheet*. September 2006. Available from the IMF website at <http://www.imf.org/external/np/exr/facts/surv.htm>.

⁹ IMF. Report of the Managing Director to the International Monetary and Financial Committee on the IMF’s Policy Agenda. September 15, 2006. Available from the IMF website at <http://www.imf.org/external/pp/longres.aspx?id=3893>.

A report to the IMF Executive Board is planned for early 2007. Exchange rate issues would be a central element of this discussion.

These changes in the IMF's surveillance procedures may facilitate a deeper and more thorough review of exchange rate issues as well as dialog among the countries most affected. The IMF will also play a more active role in any negotiations which might occur. Nevertheless, the result of this process depends mainly on the willingness of the countries to reach settlement and not on the rules or guidelines of the IMF themselves. If countries do not wish to let the value of their currencies rise or to revise their exchange rate policies, there is nothing intrinsic in the new process that would require them to take action along those lines.

Legislation in the 109th Congress

In late 2005, Congress passed legislation which urged the President to create a comprehensive plan to address a range of issues concerning China. In particular, it said the Administration should encourage China to revalue its currency further against the U.S. dollar by allowing the yuan to float against a trade-weighted basket of currencies.¹⁰ The legislation did not say, however, how the President should seek to persuade China to act in conformity with that goal. This was the only legislation relating to exchange rate issues in 2005-2006 that was enacted into law.

At least 15 other bills were introduced in the 109th Congress which sought to indicate specific ways the United States might pursue that objective. Several would authorize the imposition of countervailing duties or special tariffs on goods imported from countries with undervalued currencies unless those currencies have risen to a level at or near their appropriate fair market rate. Others would change the reporting requirement in the 1988 Exchange Rates Act in ways that would make it more likely that the Treasury Department would find that countries are manipulating their currencies. Still others would press for international action to remedy the problem. Some wanted the IMF to be more active in promoting shifts in currency values, perhaps through institutional changes that would give it more authority over the international exchange rate system. Others wanted the United States seek redress in the World Trade Organization (WTO) for the damage some undervalued currencies may have done the U.S. economy.

Direct Action

Several bills considered in the 109th Congress would have had the United States impose special tariffs or duties on goods imported from countries with undervalued currencies unless they revalue their currency. They sought, in effect, to "level the playing field" by raising the price of those goods sold in the United States by an amount equal to the presumed undervaluation of the country's currency. Implicitly or explicitly, they also encouraged countries to negotiate with the United States or to raise the value of their currency as a way of making special tariffs or duties unnecessary.¹¹

¹⁰ The Fiscal 2006 Defense Appropriations Act, H.R. 1815, approved by Congress in December 2005 and signed into law by the President (P.L. 109-163) on January 6, 2006. The relevant language is found in Section 1234 of the act.

¹¹ For a discussion of relevant legislation, see CRS Report RL33550, *Trade Remedy Legislation: Applying Countervailing Action to Nonmarket Economy Countries*, by (name redacted); CRS Report RL32165, *China's Currency: Economic Issues and Options for U.S. Trade Policy*, by (name redacted) and (name redacted); CRS Report (continued...)

Several bills would have imposed special tariffs on Chinese goods if China did not promptly revalue its currency. Perhaps the best known was the bill S. 295, introduced by Senators Schumer and Graham. It would have imposed a 27.5% tariff on Chinese goods (a rate determined by averaging various estimates of the yuan's undervaluation) if China did not raise the value of its currency to levels closer to its true market valuation. In early 2005, the Senate voted 67-33 to attach the provisions of S. 295 to a State Department authorization bill but no further action was taken on that legislation. The Schumer-Graham bill was been scheduled for consideration several times and then postponed as discussion of the underlying issue continued. On September 28, 2006, Senators Schumer and Graham announced that they were withdrawing their bill from further consideration by Congress. Graham said the decision was a response in part to a personal request they had recently received from President George W. Bush urging them to give the new Secretary of the Treasury, Henry M. Paulson, Jr., time to negotiate the currency issue with the Chinese. Schumer and Graham said that they planned to work with Senators Grassley and Baucus in the next Congress to craft legislation on the Chinese currency issue that would force China to revalue its currency while still being compatible with international trade rules and capable of surviving challenge at the WTO.¹²

Two other bills, S. 14 by Senator Stabenow and H.R. 1575 by Representatives Myrick and Spratt, would have attached the same 27.5% tariff to Chinese goods. Two additional bills, H.R. 3004 by Representative English and S. 2357 by Senator Kennedy, would have directed the Secretary of the Treasury to calculate the rate by which the yuan is undervalued and to impose a tariff equal to that rate on all Chinese goods if China does not revalue its currency within a set number of days after enactment of the bill.

Other legislation proposed in the 109th Congress would not have imposed across-the-board duties on all imports. Rather, they would have made it easier for the U.S. Government to levy countervailing duties on products imported from countries that have currencies which are valued at levels below their presumed fair market value. Under this approach, exchange rate manipulation would be deemed a form of unfair competition and duties could be levied to offset the price advantage that goods would otherwise enjoy in the U.S. market because of their too-low currency valuation. Unlike tariffs, countervailing duties apply only to goods that cause injury to the U.S. producers of competing products. The prices paid by U.S. consumers for imports that were not deemed injurious to U.S. producers would not increase. China was the stated concern for many of these bills. However, in most instances, their provisions might apply to all countries with undervalued currencies and not just to China. Many of these initiatives would contravene international trade rules or WTO guidelines. Currency manipulation is not identified, in these rules or guidelines, as an appropriate basis for one country blocking imports from another.

Prominent among these were two bills: H.R. 3283, which was introduced by Representative English and passed by the House of Representatives in July 2005, and H.R. 1498, which was introduced by Representatives Ryan and Hunter. A bill introduced by Senator Collins (S. 1421) was the companion bill to the English bill on the Senate side. H.R. 3283 includes provisions relating to both countervailing duties and reporting requirements. In terms of the former, it would

(...continued)

RL33322, *China, the United States and the IMF: Negotiating Exchange Rate Adjustment*, by (name redacted); and CRS Report RL33178, *Japan's Currency Intervention: Policy Issues*, by (name redacted).

¹² Paul Blustein. "Senators Withdraw 'Nuclear Option' Bill in Trade Fight; Administration Wins More Time for Currency Negotiations with Chinese." *The Washington Post*. September 29, 2006, p. D5.

alter the Tariff Act of 1930 to make imports from non-market economies eligible for countervailing duties if they received a direct or indirect government subsidy with respect to their manufacture, production or export. Previously, non-market economies were excluded from consideration for such duties because of the difficulty of calculating levels of subsidy in conditions where prices are determined by official action rather than by market forces. The English bill also included language relating to the procedures which might be used to calculate the level of subsidy for products exported from China. However, its operative provisions covered goods exported from all non-market economies and not just those from China.

The Hunter-Ryan bill (H.R. 1498) sought to make it clear that exchange rate manipulation by China would make its exports to the United States actionable under the countervailing duty provisions of U.S. trade law.¹³ However, the language in this bill amending the Tariff Act of 1930—defining the term “exchange rate manipulation” and specifying that goods subsidized through exchange rate manipulation shall be subject to countervailing duties—was applicable to goods imported from all countries. Likewise, also applicable to all countries were the provisions of Hunter-Ryan bill which amend the Trade Act of 1974, specifying that exchange rate manipulation can be a cause of market disruption, allowing petitioners to complain about exchange rate manipulation, and specifying the steps the President must take when the International Trade Commission makes a finding that exchange rate manipulation has occurred.¹⁴

Other legislation also addressed these issues. H.R. 3306, introduced by Representative Rangel, would similarly have allowed the application of countervailing duties to products from non-market economy countries, though it also specifies that the antidumping provisions of current law would not be affected. It added currency manipulation to the list of unjustifiable acts, policies and practices (specified in the Trade Act of 1974) for which countervailing duties could be applied. The “findings” section of the bill focused on China but the language amending the operative provisions of existing law applied to goods exported from all countries. The Rangel bill also required the U.S. Trade Representative (USTR) to investigate the currency practices of China and to take action under Section 305 of the Trade Act of 1974 in accordance with the findings of that investigation. On the Senate side, S. 377, introduced by Senator Lieberman, would have required the President to begin multilateral and bilateral negotiations with the countries which engage most egregiously in currency manipulation, to report to Congress on the extent of the problem, and to institute proceedings under the provisions of the Trade Act of 1974 dealing with countervailing duties, dumping and market disruption if those countries do not stop manipulating the value of their currency within 90 days. The language of this proposal applies not only to China, Japan, Korea and Taiwan, the countries mentioned in the preamble to the legislation, but to all countries.

¹³ For more on this proposal, see CRS Report RL32371, *Trade Remedies: A Primer*, by (name redacted) as well as CRS Report RL33550, *Trade Remedy Legislation: Applying Countervailing Action to Nonmarket Economy Countries*, by (name redacted) cited in footnote 11.

¹⁴ However, other language that would have been added to the Trade Act of 1974 defined the term “exchange-rate manipulation” solely in terms of China. It is not clear whether or not the definition in the bill would be applicable to other countries and whether countervailing duties could be levied on goods imported from a country other than China if someone claimed that the export price of those goods was subsidized through exchange rate manipulation.

Reporting Requirements

Several bills were introduced in the 109th Congress that would have tightened the procedures by which the Treasury Department analyzes whether countries are manipulating the value of their currencies to the detriment of the United States. Perhaps the most far-reaching was S. 2467, introduced by Senator Grassley. It would replace the reporting requirements of the 1988 Exchange Rates Act with a new system which uses narrower criteria and involves more actors in exchange rate determinations.

The Grassley bill would have created a seven-member advisory committee to help the Secretary of the Treasury assess the exchange rate practices of other countries and prepare a twice-annual report on international exchange rate conditions and the practices and policies of the major economies and U.S. trading partners. The Secretary of the Treasury also would have been required to consult with the Chairman of the Federal Reserve Bank Board. The content of the report would have been similar to that required by the 1988 Act, though additional factors for consideration were included. The main focus would have been the identification of countries which have exchange rates that negatively affect the U.S. economy. The requirements of the law would apply to all countries and not just to China.

The Secretary of the Treasury has not found, in the past several years, that any country is manipulating the value of its currency even though many observers allege this to be the case.¹⁵ Some Members of Congress have expressed frustration and concern, in particular, that no finding of currency manipulation has been made as regards China. The Secretary said, in the four semi-annual reports issued in 2005 and 2006 under the Exchange Rates Act, that China was not manipulating its currency within the meaning of the law.

To make such a determination under the 1988 Act, the Secretary would be required to find that (1) China was manipulating its exchange rate for the purpose of gaining an unfair trade advantage or preventing effective balance of payments adjustment and (2) it had a material global current account surplus and significant bilateral trade surplus with the United States. The Treasury Department has said that it would make a finding that China is manipulating its currency only when all the conditions in the act are satisfied.¹⁶ The Secretary found that China's currency was undervalued because it sought stability in its economic relations and not because it sought to prevent adjustment or gain unfair trade advantage. He also found that China's trade surplus with the world was not as great proportionally as that with the United States. Therefore, the technical requirements of the 1988 Exchange Rates Act were not triggered. The Secretary also reported that Chinese officials had promised that China would revalue the yuan in the future and that procedures had been adopted to facilitate this change.¹⁷

The Grassley bill required the Secretary to determine solely whether a country's currency is "fundamentally misaligned" relative to its proper value in the international market. All the other

¹⁵ The Government Accountability Office (GAO) reports that the Treasury Secretary has previously cited Taiwan, Korea, and China as currency manipulators but none has been so cited since 1974. See *GAO Treasury Assessments Have Not Found Currency Manipulation, but Concerns about Exchange Rates Continue*. GAO report GAO-05-3512, April 2005. GAO analyzed the Department's assessment process and found that it had complied with the requirements of the 1988 Exchange Rates Act.

¹⁶ Ibid.

¹⁷ For a summary of the Secretary's 2005 and 2006 findings, see CRS Report RL33220, cited in footnote 11, pp. 14-16.

criteria in the 1988 Act are dropped. Extenuating circumstances, motivation or other criteria could not be used to mitigate the fact that a currency was misaligned or to justify a decision not to list the country or not to press officially for changes in its exchange rate policies. The provisions of the Grassley bill would have applied to all countries and were not limited just to China.

The Grassley bill would require the Secretary to seek bilateral negotiations with any country found to have a currency in fundamental misalignment and to seek the advice of the IMF with respect to the issue. The Secretary must also encourage other countries to involve themselves in discussions aimed at persuading the country with the mis-valued currency to eliminate the fundamental misalignment. If the country in question fails to enter into negotiations with the United States or it fails to subsequently revalue its currency, the U.S. Government must take further steps aimed at pressuring it to change. The Overseas Private Investment Corporation (OPIC) must provide no more financing or coverage to investments located in the territory of the country, the U.S. executive directors at the multilateral banks must oppose any new MDB financing for that country, and the United States shall ask the IMF to engage in special consultations aimed at persuading it to eliminate the currency misalignment.¹⁸ The United States would also be required to oppose any change in the governance arrangements of the international financial institutions if this change would increase that country's voting share or representation.¹⁹

Other bills would add additional criteria to the reporting procedure specified in the 1988 Exchange Rates Act. The Rangel bill noted above (H.R. 3306) would amend the 1988 law to strike the words "have material global account surpluses" from the criteria the Secretary of the Treasury must use to determine whether a country is manipulating its currency. It would also add a definition of exchange rate manipulation, taking away any discretion the Secretary might have on that point, and it would require the Secretary to explain the methodology used in the semi-annual reports for determining whether or not a country is manipulating the exchange rate for its currency. Bills introduced by Senator Snowe (S. 984) and Representative Manzullo (H.R. 2208) would insert the same definition of exchange rate manipulation ("protracted large-scale intervention in one direction in the exchange markets") and would require the Secretary to include in the semi-annual reports an explanation why the trade surplus figures that China reports for its world trade differ so greatly (six and one-half times smaller) than the aggregate trade deficits which the United States and other countries report they have with China.

¹⁸ Of the four countries in Asia (Japan, China, South Korea and Taiwan) that are generally considered to have seriously undervalued currencies, only Taiwan and South Korea are eligible for OPIC assistance and only U.S. investors with projects in South Korea have received any OPIC assistance (\$1.5 million) in the past five years. In the multilateral development banks, only China is eligible among the four countries for assistance. China is the largest single borrower from the World Bank, though on a net basis it is paying off its loans faster than it is receiving new disbursements. Since 1991, the United States has opposed all MDB loans to China unless they involve environmental protection or basic human needs. The Grassley bill would require the United States to oppose those types of loans as well. China has not borrowed from the IMF since the People's Republic of China was seated as the representative of China in 1985. Countries with undervalued exchange rates generally accrue large increases in their foreign exchange reserves and thus have no need for IMF loans.

¹⁹ China is one of several countries for which an ad hoc increase in their IMF quota is being considered. (On the latter point, see CRS Report RL33626, *International Monetary Fund: Reforming Country Representation*, by (name redacted).) Because of the size of its vote, the consent of the United States is required for the planned alignment in voting shares to occur. Were the United States required to block that alignment in order to prevent an increase in China's share, many of the other reforms being contemplated for the IMF could not go into effect because sufficient support from other countries would be lacking.

The English bill noted above (H.R. 3283), passed by the House in June 2005, would require the Treasury Secretary to submit a report to the relevant congressional committees (1) defining currency manipulation, (2) describing the actions by foreign countries that would be considered exchange rate manipulation, and (3) describing how the administrative procedures in the 1988 Exchange Rates Act and Section 40 of the Bretton Woods Agreements Act (BWAA) can be clarified in order to provide an improved and more predictable evaluation of potential exchange rate manipulation. It would also require discussion of the procedures used and efforts made by China to implement its announced policy which aims to move the value of its currency towards a market-based representation of its value. The bill would require that these discussions be included in each semi-annual report.

Section 40 of the BWAA requires the Secretary of the Treasury and the U.S. Executive at the IMF to work for the adoption of policies by the Fund which promote stability of exchange rates and avoid the manipulation of exchange rates between major currencies. The Secretary is supposed to seek changes in the Article IV annual consultation procedure that would attempt to ensure that countries with artificially undervalued or overvalued rates of exchange will adopt market-determined exchange rates. The U.S. Executive Director is required to take country performance in this regard into account when deciding how to vote on any proposal for IMF assistance.

The English bill (H.R. 3283) would have required the Secretary of Commerce to report every six months describing the actions taken by foreign countries to manipulate their currencies in order to increase exports or to limit imports from the United States. The Commerce Secretary would have been required to discuss how currency manipulation affects the U.S. manufacturing sector and U.S. monetary policy. The President would have been required to institute negotiations with any country identified as a currency manipulator. If the issue is not resolved within 90 days, the President would have been required to refer the issue to the WTO and other relevant international institutions and to take steps under U.S. law—specifically Section 301 of the Trade Act of 1974—against such a country or countries. Section 301 authorizes the USTR to withdraw trade benefits from countries or to institute special tariffs or duties on their goods if they take actions which are unreasonable or discriminatory and burden or restrict U.S. commerce. The President would also have been required to seek compensation from the country in question equivalent to the damages incurred by U.S. manufacturers or by other U.S. parties adversely affected by foreign currency manipulation.²⁰

A bill introduced by Representative Dingell (H.R. 3157) would amend the Trade Act of 2002 to specify that the principal negotiating objective of the United States with respect to exchange rates

²⁰ This idea resembles a recent proposal by the Treasury Under Secretary Timothy Adams calling for the IMF to play a strong role in exchange rate surveillance by announcing periodically what it thought the appropriate exchange rates for key currencies ought to be and by identifying countries whose exchange rates “might not be in accord with IMF principles.” (U.S. Department of the Treasury. “Remarks by Under Secretary for International Affairs Tim Adams at AEI Seminar Working with the IMF to Strengthen Exchange Rate Surveillance.” February 2, 2006, JS-4002. Available from the Treasury Department website at <http://www.gtreas.gov/press/releases/js4002.html>.) Managing Director Rodrigo de Rato has said that he agrees the Fund should put more emphasis on surveillance but he rejected suggestions it should take the central policing role that Adams had previously proposed. (Rodrigo de Rato. *The IMF's Mid-Term Strategy: New Priorities, New Directions*. Remarks at the Aspen Institute, Rome, Italy, February 9, 2006. Available from the IMF website at <http://www.imf.org/external/np/speeches/2006/020906.htm>.) In particular, de Rato rejected proposals that the Fund should put greater pressure on China or other countries accused of currency manipulation. “There is a trade-off,” he said, “between our role as a confidential advisor in our surveillance work and our role as a transparent judge (Chris Giles and Krishna Guha. “Interview with Rodrigo de Rato.” *Financial Times* (London), January 28, 2006, p. 8.) For a broader discussion of issue of exchange rates and IMF policy, see CRS Report RL33322, *China, the United States and the IMF: Negotiating Exchange Rate Adjustment*, by (name redacted).

is to ensure that government intervention in currency markets should be aimed at stabilizing short-term disruptive market conditions and it should be of limited duration and carried out in consultation with major trading partners. Presumably these negotiations would be held in a multilateral context (most likely the IMF) and not bilaterally with other countries.

The Lieberman bill (S. 377) would have required the International Trade Commission (ITC) to determine whether and by how much foreign countries are manipulating the value of their currencies and to identify all alternative mechanisms for redress through international trade treaties and agreements and international institutions and through U.S. trade law. As noted earlier, the President would have been required to institute action comparable to that required in the Dingell bill and to seek compensation for damages if no agreement to end the currency manipulation is reached with the country in question within 90 days. The Lieberman bill would also have required the Secretary of Defense to report to Congress the effect that foreign currency manipulation has on U.S. security and on critical manufacturing sectors. The USTR and ITC would have been required to report to Congress on steps being taken to significantly improve trade enforcement efforts against unfair trade practices. The Secretaries of State and Commerce would also have been required to report to Congress recommending steps that could be taken to significantly improve trade promotion of U.S. goods and services.

H.R. 2414, introduced by Representative Rogers of Michigan, would require the Secretary of the Treasury to analyze the exchange rate policies of China and China's trade surplus data and to report to Congress the degree to which its currency is undervalued below its appropriate market value. It would also have the United States seek authorization from the World Trade Organization (WTO) for a special tariff and other trade measures to offset the negative effects that China's presumed undervalued currency has on the U.S. economy.

Action Through International Organizations

Besides the Grassley, Rogers, Dingell, English and Lieberman bills noted earlier, other legislation introduced during the 109th Congress would have also required the United States to seek action by the international agencies that would address the economic problems which are allegedly caused by undervalued or manipulated currencies.

Perhaps the most prominent bill of this sort was S. 2317, introduced by Senator Baucus. No specific countries are mentioned and the provisions of the bill would apply to all countries which are found by the IMF to be manipulating the value of their currency to the detriment of the United States and other countries. Section 5 of the bill expressed the sense of Congress that the President should instruct the U.S. Executive Director at the IMF to request that the Managing Director be more aggressive in seeking consultations with countries about their exchange rate policies. These consultations should seek ways of remedying, in a transparent manner, situations where countries' interventions in currency markets have results that are contrary to the Articles of Agreement of the IMF and have negative effects on the currencies of other countries and on the world economy.

All countries have the right to ask the IMF Managing Director to undertake special consultations with another country when the first country believes the second is pursuing exchange rate policies that are not consistent with the rules and principles of the IMF. If the Managing Director believes there may be a problem, he can raise the issue confidentially with the country concerned. If he finds reason to believe that country is manipulating its exchange rate in violation of IMF rules, he must convene a meeting of the IMF Executive Board to discuss the matter. On the other hand, if he finds there is no problem of manipulation, he need only inform the board informally to that

effect. Special consultations of this sort have occurred twice previously (with Korea and Sweden in the early 1990s) as the consequence of complaints respectively by the United States and Germany. However, the Managing Director does not need to hold these meetings if he believes that countries are not manipulating the value of their currency. This has also occurred. In 2006, for example, Managing Director Rato rejected U.S. proposals that the Fund should hold special consultations and put pressure on China to stop it from manipulating its currency.²¹ He said that he did not consider China to be a currency manipulator and he said the IMF had been the first international body to urge China to move from a fixed peg to a more flexible exchange rate system.²²

The Baucus bill also suggests that the President propose that the IMF should issue a semi-annual report on exchange rate policies which examines all large-scale intervention by countries in international currency markets and their effects on exchange rates and present possible remedial steps that would curtail such practices. The bill also expresses the sense of Congress that the President should support further efforts to reform the IMF in order to strengthen its vigilance over exchange rates, reform the Executive Board in order to give large emerging economies—including those in Asia—more votes and influence, and to improve the transparency of the IMF especially as regards country data and information on exchange rate policies.

Senator Bayh has proposed, in his bill S.Res. 270, that the United States should ask the IMF to investigate whether China is manipulating the rate of exchange between the yuan and the U.S. dollar. The bill also proposed that the United States should bring a formal complaint against China to the IMF board of executive directors on grounds that it was not complying with the requirements of Article IV of the IMF charter.

The bylaws of the IMF provide that “The Managing Director shall report to the Executive Board any case in which it appears to him that a member is not fulfilling obligations under the Articles....”²³ Individual countries also have the same right to bring a complaint to the IMF Executive Board. The IMF says that countries have filed complaints of this sort with the Executive Board in the past, though none have been filed to date respecting Article IV. If the Executive Board agrees with the complaint, it may adopt a variety of sanctions including the interim suspension of the country’s voting rights or borrowing privileges or, in an extreme case, a requirement for “compulsory withdraw” (the IMF term for expulsion). None of these would have the effect, however, of requiring a country to change the valuation of its currency if it is willing to bear the burden of the sanctions approved by the IMF board.

On many occasions, the IMF has advised countries to make their foreign exchange procedures more flexible so the market can play a larger role in the valuation of their currency. The IMF made a recommendation of this sort to China in June 2005, a month before China announced its intent to move gradually towards a more flexible and market-oriented foreign exchange regime. Unless the country in question wants a loan, however, the IMF has no way of requiring that

²¹ Treasury Undersecretary Timothy Adams said the IMF had been “asleep at the wheel” and he urged that it confront China about deficiencies in its Exchange rate policies. See Paul Blustein, “IMF Chief Pressured on Trade Imbalances,” *The Washington Post*, September 29, 2005, p. D1.

²² Giles and Guha, op cit note 18, p. 8.

²³ Rule K-1 (adopted in 1946) of the *By-Laws Rules and Regulations of the International Monetary Fund*, Sixtieth Issue May 2006, available from the IMF website at <http://www.imf.org/external/pubs/ft/bl/blcon.htm>.

countries adopt policy changes of this sort or for accelerating the speed by which they put such policy changes into effect.

Major Issues

Throughout history, civilization has sought to create authoritative bodies—bodies capable of judging disputes between individuals or groups and of enforcing their decisions—so that disputes between individuals or groups can be resolved peacefully rather than through self-help or inter-group negotiation or conflict. Self-help can resolve an immediate situation, at least from the point of view of one of the parties, but it can also perpetuate a dispute if the other party responds in a way that creates new incidents that need resolution. Inter-group negotiations can fracture a society into competing elements if a controversy between two groups is resolved on the basis of their current relative power or at someone else's expense. If one group's relative power increases, it may want to reopen the earlier settlements in order to get new terms that better reflect its current strength. The group now being pressured to give up an advantage gained previously may resist such change. Likewise, if a dispute is resolved by taking something away from a weaker third party, the latter may harbor resentment and seek restitution if its strength increases.

Authoritative bodies can promote civil peace if they can settle disputes on the basis of general principles which all can use as guidance for future situations. By contrast, ad hoc agreements between parties are not likely to establish guidelines or create precedents which others can use as the basis for the equitable settlement of their own disputes. When conditions do not favor the establishment of authoritative bodies or agreed methods for resolving disputes, however, individuals, groups and nations have little choice but the use of self-help and negotiations to resolve disagreements that affect their concerns.

No Rules or Authoritative Bodies

If the original provisions of the IMF Articles of Agreement were still in effect and the world still operated on the fixed parity exchange rate system, controversies about exchange rate manipulation could be resolved relatively easily. Countries would need the permission of the IMF Executive Board to change the legal value of their currencies and this would not likely be given if countries wanted to peg them at rates below their normally accepted value. Likewise, if the rules of the WTO allowed export subsidies delivered through exchange rate manipulation to be causes for action, disagreements about exchange rate manipulation and currency issues could be settled through its dispute settlement procedure.²⁴ However, the old exchange rate system no longer exists and exchange rate controversies are not generally seen to be adjudicable through the WTO.

The IMF is responsible for surveillance over the international exchange rate system and the establishment of basic principles, but it has no role in the determination of exchange rates and little authority to make countries change their policies if these do not comply with established rules.

²⁴ On this point, see CRS Report RL33322, *China, the United States and the IMF: Negotiating Exchange Rate Adjustment*, by (name redacted), pp. 43-52. The likelihood—or rather the unlikelihood—that the IMF would play a significant role in adjudicating exchange rate disputes if countries took these controversies to the WTO is also discussed.

The Potential for Abuse

Fixed exchange rate systems may be too inflexible for the modern fast-moving globalized economy. They also limit countries' ability to use monetary policy as a tool for managing their economies. On the other hand, a system of flexible or floating exchange rates without clear and enforceable rules can lead to problems. Some countries may choose to overvalue the exchange rate for their currency in order to artificially lower the cost of imports and thus to raise their domestic standard of living. Alternatively, countries may decide to undervalue their currencies in order to stimulate exports, discourage the inflow of foreign goods by making them artificially expensive, expand their foreign exchange reserves, and reduce unemployment.

In both cases, foreigners bear most of the economic cost of the currency misalignment. In the case of overvalued currencies, however, countries may be forced to devalue their currency and to reduce their people's standard of living if investors decide in large numbers that the government lacks the resources to sustain the higher rate and—as seen in the Asian Financial Crisis of 1997-1998—many decide simultaneously to sell local currency and to buy dollars or other major types of foreign exchange. If everyone is selling and nobody is buying, the value of the local currency compared to foreign currency will fall precipitously and many firms and individuals will be forced into bankruptcy. Countries undergoing such financial crises will likely apply to the IMF for assistance and the IMF will likely suggest reforms aimed at helping the country work its way out of its difficulties and avoiding their recurrence.

In the case of undervalued currencies, there is likely to be no corresponding situation which would force a government to raise the exchange value of its currency. If the government decides that it can control the growing inflationary pressure, suppress the unrealized domestic demand for imports and ignore the dissatisfaction of its trading partners, it can probably sustain a policy of undervaluing its currency for a long time. Because their foreign exchange reserves will expand as long as their currencies are undervalued, countries in this situation will not need to apply to the IMF for loans and they will not need to acquiesce to the IMF's policy conditionality as the price for obtaining that sort of aid.

What Can the United States Do?

The question is what the United States can do if other countries undervalue their currencies in order to artificially expand their exports to the U.S. market. Most economists agree that the undervalued currencies of countries such as Japan, Korea, China, or Taiwan are not the principal cause of the U.S. balance of payments deficit nor the principal reason for the decline in the U.S. manufacturing sector.²⁵ If those countries were to raise the value of their currencies, the U.S. trade deficit and the decline in U.S. manufacturing would not likely diminish so long as the United States continues to import large amounts of capital in the form of foreign investments or foreign loans. Nevertheless, the benefits of trade might be enhanced for everybody and the growing international imbalances in trade and financial flows might be lessened if the dollar and other currencies were priced appropriately.

As the diversity of the legislation before Congress shows, there is no consensus as to the most effective means the United States could use to promote reform in the world exchange rate system

²⁵ See the discussion of this point in the CRS Reports cited in footnote 11. See also CRS Report RL31032, *The U.S. Trade Deficit: Causes, Consequences, and Cures*, by (name redacted).

and to offset the impact that undervalued foreign currencies have on the U.S. economy. Direct action, to offset the undervaluation of a currency through countervailing duties or special tariffs, might have the most immediate impact on the volume and price of imports from countries with such currencies. It might also lead to negotiations or changes in foreign exchange rate policies. On the other hand, direct action on the part of the United States—particularly action that violates the established rules of the world trading system—might induce the other countries to retaliate by reducing their imports from the United States and by reducing or restricting U.S. participation in their economy. It is difficult at this point to calculate the prospects either way or to determine what the relative costs or benefits might be if the United States took direct action to offset the trade benefits that countries realize when they undervalue their currencies.

Direct negotiations with other countries aimed at encouraging them to revalue their currencies is another approach contemplated by current legislation. The main instrument would be changes in current law which would give the Secretary of the Treasury little option but to declare officially that certain foreign countries are manipulating their currencies to the detriment of the United States and to seek formal negotiations. Some bills would couple the bid for negotiations with a requirement that the United States take direct action to restrict imports from the other country through countervailing duties or other measures.

A formal U.S. request for negotiations might induce another country to talk but there is no requirement that it must do so. The result of the negotiations would depend most likely on the relative influence each country brings to the table. It would also depend on its willingness to trade flexibility on trade and currency issues for flexibility on other topics and the relative value it attaches to each concern. In bilateral talks, the United States would be able to pursue its own negotiating agenda but it would likely bear the costs of any settlement even though other countries would benefit from any changes the other country makes in its foreign exchange policies. It would be impossible to change the exchange rate between the U.S. dollar and the other currency without also affecting the rate between that currency and other currencies as well. In multilateral talks, other countries would participate in the process and bear the cost of any trade-offs needed to reach settlement. However, the final result would likely be a consensus of all views and it might not be the outcome that each of them might prefer.

A third approach would be reform of the IMF exchange rate procedures sufficient to strengthen the rules governing currency manipulation and to discourage countries from intervening in currency markets except for short-term actions to stabilize currency prices in destabilizing situations. The major bills of this type call on the United States to seek stronger action by the IMF to exercise surveillance over exchange rates and to persuade countries not to manipulate their currencies. Some also seek changes that would strengthen the enforcement of Article IV and require closer IMF examination of the interventions by countries in international currency markets. The IMF is taking some relevant initiatives and the Administration is encouraging action by the IMF along these lines, but enactment of a legislative directive might encourage U.S. officials to be more vigorous in their efforts to achieve such IMF reforms. Some of the pending legislation would require the United States to oppose (or consider opposing) loans to countries that manipulate their currency. Others would seek to induce countries to stop manipulating by offering them a possibly larger quota in the IMF or by opposing any increase in their share unless they stop their currency manipulation.

Strengthening the IMF's capacity to enforce provisions such as Article IV requires changes in the Fund's procedures and its institutional arrangements, however, and this requires broad support by the membership and not merely greater efforts by the United States. Many countries do not see

the issue of exchange rate manipulation in the same way as does the United States. Many also do not see the issue on such urgent terms. More fundamentally, stronger enforcement of Article IV would require the IMF to exercise greater surveillance over the economic policy of all countries and not just over the policies of some countries which are accused of currency manipulation.

Because the U.S. dollar is the benchmark currency for measuring the valuation of other currencies, for example, the IMF would likely need to determine if the dollar is correctly priced before it could determine whether the exchange value of other currencies is appropriate. It is not clear that U.S. officials or legislators would welcome IMF commentary on U.S. economic policies or that they would readily adopt policy changes the IMF believes necessary in order to bring the value of the U.S. dollar into line with its calculations. Officials from other countries, be they countries with major currencies or countries accused of manipulating their currency, will likely have a similar view about IMF advice or policy recommendations.

It is possible, however, that legislation aimed at strengthening IMF surveillance and enforcement of Article IV could encourage other countries to expand their efforts along the same lines. A new Bretton Woods conference to restructure the IMF or new amendments to change its basic procedures seem unlikely. Nonetheless, a greater sense of urgency on the part of most major IMF member countries might give the IMF more influence and might make initiatives such as the new program for multilateral consultations more effective. What the final result, if any, might look like and whether it might satisfy U.S. expectations cannot be determined at this time.

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