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TPP Issue Analysis: Currency Manipulation

Currency manipulation has cost U.S. workers millions of jobs – and just a few years ago was estimated to be responsible for as much as half of excess unemployment in the United States. It has contributed to stagnant wages for the middle class and to inequality in the United States. Former Treasury Secretary Larry Summers recently asserted that the United States should use the leverage provided by TPP to address "inappropriate producer subsidies – including through manipulated exchange rates."

Further, former Chairman of the Federal Reserve Paul Volcker has reportedly stated that "trade flows are affected more by ten minutes of movement in the currency markets than by ten years of (even successful) negotiations." Hence, a bipartisan coalition of Members of the House and Senate have urged the Administration to include strong and enforceable currency obligations in the Trans-Pacific Partnership (TPP), which includes a number of countries that have manipulated their currencies in the recent past, such as Japan. Other alleged manipulators, such as Korea and Taiwan, have also expressed an interest in joining TPP.

Many believe the current approach to addressing currency manipulation, a mix of consultations and reports, has failed to end currency manipulation. The United States government has consistently consulted with countries that have manipulated their currencies, yet, as the numbers cited above show, millions of American jobs have still been lost. And both the International Monetary Fund (IMF) and the U.S. Department of Treasury (Treasury) report on currency manipulation – but the issue still persists.

Others urge that dialogue has persuaded some countries, such as China, to allow their currencies to appreciate, while countries that have manipulated their currencies in the past, such as Japan, are no longer doing so. They also note that 'strong and enforceable' disciplines to address currency manipulation could have unintended consequences, such as potentially jeopardizing U.S. monetary policy.

This memo describes the outcome on currency manipulation as it relates to TPP and discusses the potential impact of a strong currency manipulation provision on U.S. monetary policy.

I. Will the TPP Declaration Meaningfully Improve Upon the Status Quo?

The text of the TPP does not address currency manipulation. The closest the text comes is in the preamble, stating that the Parties "recognise the important work that our relevant authorities are doing to strengthen macroeconomic cooperation, including on exchange rate issues, in appropriate fora".

Instead of addressing the issue in the text of the TPP Agreement itself, the macroeconomic policy authorities of the TPP countries issued a separate side "Declaration" (attached), not a formal side "agreement".[1] The Declaration is not subject to a dispute settlement mechanism, unlike nearly every provision in TPP.

Secretary Lew made the following statement following the negotiation of the Declaration:

> There is for the first time ever in the context of a trade agreement a joint declaration that commits countries to refrain from practices that could be seen as being unfair currency practices, a commitment to a transparency regime so that we can each see clearly what each other are doing, and an agreement to have a process to hold each other accountable through a process of engagement. I can tell you that in my role here, I have used every opportunity I've had to bring clearly to bear the influence of the United States to have countries change policies that we think are unfair. I think with the joint declaration on currency, it's a way to add to our tool kit — ways that we can hold countries accountable if they step out of line.

It is important to note that currency manipulation was directly addressed in the agreement establishing the World Trade Organization (WTO): Article XV of the General Agreement on Tariffs and Trade (GATT) states that "Members shall not, *by exchange action*, frustrate the intent of the provisions of this Agreement[.]" The GATT also asserts that "[m]ultiple currency

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[1] The parties to international agreements are normally the nations themselves. The parties to the Declaration are not the TPP nations, but their respective macroeconomic policy authorities.

practices can in certain circumstances constitute a subsidy to exports which may be met by countervailing duties…or can constitute a form of dumping."[2] Lastly, the WTO agreement regarding subsidies contains an illustrative list of prohibited export subsidies, which include "currency retention schemes" and "exchange risk programmes."[3]

The U.S. government itself has previously insisted upon the implementation of the obligation in GATT Article XV. In 1993, when the U.S. Department of Treasury designated China as a currency manipulator, the Treasury Department noted that China was in violation of this provision and that "China must bring its exchange rate system into conformity with GATT Article XV" before it would be allowed to join the WTO.[4]

The WTO has an effective enforcement mechanism, which many Members of Congress, including Senator Obama, had urged previous Administrations to use. But some have argued that the GATT provision on currency manipulation is vague, as it was written before countries had adopted a floating exchange rate system.

But other agreements also address currency manipulation. Most importantly, at the end of World War II, around the same time that the GATT was signed, the IMF Articles of Agreement were written and included disciplines on exchange rates. In 1978, after the world moved away from the gold standard,[5] the Articles were amended to explicitly provide that Members shall avoid manipulating exchange rates to gain an unfair competitive advantage.[6]

In 2007, the IMF created what many authorities argue are clear guidelines defining currency manipulation. Whereas the WTO has a strong enforcement mechanism but vague currency obligations, the issue at the IMF is a lack of enforcement. Some have urged that the TPP provides the opportunity to take and merge the best of both the IMF and WTO systems: the binding dispute settlement mechanism at the WTO and the clear provisions at the IMF.

A. Statements and Commitments in the Declaration

The parties to the Declaration "recognize" a number of principles, including that "allowing real exchange rates to adjust in line with economic fundamentals…helps to avoid prolonged external imbalances, and promotes strong, sustainable, and balanced global growth." They also "confirm" that each TPP party is "bound under the Articles of Agreement of the [IMF] to avoid manipulating exchange rates…to gain an unfair competitive advantage." These statements are not written to serve as formal obligations.

The main provision regarding currency manipulation in the TPP Declaration states:

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[2] GATT Ad Article VI, footnote 2 to paragraphs 2 and 3.
[3] Agreement on Subsidies and Countervailing Measures, Annex I: Illustrative List of Export Subsidies, (b) and (j).
[4] Department of the Treasury, Sixth Annual Report to the Congress on International Economic and Exchange Rate Policy, May 1993, p. 25.
[5] The original IMF Articles of Agreement were signed when the gold standard was still in place. Nevertheless, they still contained an obligation to "avoid competitive exchange alterations." When countries moved off of the gold standard, the IMF Articles of Agreement were amended to provide more detail on exchange rate activity.
[6] *See* International Monetary Fund Articles of Agreement, Article IV: Obligations Regarding Exchange Arrangements, Section 1. General obligations of members.

> Each [macroeconomic policy] Authority is to take policy actions to foster an exchange rate system that reflects underlying economic fundamentals, and avoid persistent exchange rate misalignments. Each Authority will refrain from competitive devaluation and will not target its country's exchange rate for competitive purposes.[7]

This language is similar to the basic obligation that every TPP Party has already agreed to at the IMF[8] and many TPP parties have agreed to similar statements as part of the G7[9] or G20.[10] However, the TPP Declaration does not contain any further language that defines currency manipulation in the clear or specific manner that the IMF did in its 2007 guidelines. Thus, it is unclear how the TPP Declaration will improve upon the status quo.

One area of improvement over the status quo is transparency. Certain TPP Parties, such as Singapore, Malaysia, and Vietnam, have agreed to more extensive transparency commitments than they have in the past.[11] If these countries live up to these commitments and provide accurate information regarding their intervention in foreign exchange markets, the TPP will be an improvement in this area. But if these countries do not live up these commitments, the TPP appears to provide no recourse to dispute settlement.

B. Mechanisms concerning Compliance

i. Consultation Requirements

The Declaration's stated objective is to promote market-determined exchange rate regimes "through transparency and dialogue." As noted above, the Declaration is not subject to the enforcement mechanism that nearly every other obligation in TPP is subject to.[12] Instead, the

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[7] Macroeconomic Policy Authorities Declaration, Article I, p. 1. It is not entirely clear whether the use of the term "will" in this and other provisions in the Declaration is intended to constitute formal obligations. International agreements, including the TPP Agreement, typically use the term "shall" to convey such obligations.

[8] In fact, the Declaration acknowledges that all TPP Parties are members of the IMF and that the Declaration "is consistent with" the rights and obligations under the IMF Articles of Agreement. Macroeconomic Policy Authorities Declaration, p. 5, fn. 1. But the term "consistent with" simply makes clear that there is nothing in the Declaration that is *inconsistent* with the IMF Articles of Agreement. The Declaration does not require the TPP parties to honor their IMF commitments.

[9] *See e.g.*, Group of Seven Statement, February 12, 2013 ("We, the G7 Ministers and Governors, reaffirm our longstanding commitment to market determined exchange rates and to consult closely in regard to actions in foreign exchange markets. We reaffirm that our fiscal and monetary policies have been and will remain oriented towards meeting our respective domestic objectives using domestic instruments, and that we will not target exchange rates. We are agreed that excessive volatility and disorderly movements in exchange rates can have adverse implications for economic and financial stability. We will continue to consult closely on exchange markets and cooperate as appropriate.").

[10] *See e.g.*, Group of Twenty Statement, February 16, 2013 ("We will refrain from competitive devaluation. We will not target our exchange rates for competitive purposes, will resist all forms of protectionism and keep our markets open.").

[11] Macroeconomic Policy Authorities Declaration, Article II, p. 2.

[12] Of note, the TPP does contain a provision that would permit a TPP Party to pursue a claim against another TPP Party "considers that a benefit it could reasonably have expected to accrue to it…is being nullified or impaired as a result of the application of a measure of another Party that is not inconsistent with this Agreement." TPP Text, Article 28.3(c). In theory, this mechanism could be used to adjudicate a dispute regarding currency manipulation.

Declaration will create a forum for "macroeconomic policy consultations".[13] Specifically, it contemplates an annual forum where the parties can discuss a wide range of macroeconomic issues.

To determine whether this dialogue and these consultations will meaningfully improve upon the status quo, it is important to recognize that macroeconomic policy authorities already engage in frequent and regular, formal and informal, dialogues at the bilateral, plurilateral, and multilateral levels, including through G20 meetings, G7 meetings, regional meetings, and in IMF discussions. The Treasury Department has noted that its officials already raise concerns with other countries at every opportunity. But, as a former IMF official has noted, "The U.S. Treasury's almost exclusive reliance on 'quiet diplomacy,' the vague pleas for 'greater flexibility of exchange rates…' have sent weak signals…and have produced meager results."[14] While the official reached that conclusion over eight years ago, currency manipulation remains a problem today.

ii. Reporting Requirements

The TPP macroeconomic policy authorities are also required to "prepare and publish reports, communiqués, or other documents regarding the meeting and any conclusions that reflect the collective views of the Group."[15] This report does not appear to be an improvement over the numerous reports that already exist regarding currency manipulation. For instance, the Treasury Department completes semi-annual reports on currency manipulation and the IMF completes country-specific reports on currency manipulation annually.

An improved report could have, for instance, included language requiring the analysis to be conducted by independent experts, required a determination regarding whether a country is manipulating its currency, and required the experts to include recommendations to particular countries regarding appropriate policy responses. Instead, the report described in the TPP declaration will "reflect the collective views of the Group".[16] This would appear to require the support of any TPP country that is manipulating its currency.

II. Would a Strong and Enforceable Currency Manipulation Provision Jeopardize U.S. Monetary Policy?

A chief concern about including strong and enforceable currency disciplines in TPP is that U.S. monetary policy could be successfully challenged by our trading partners, given that our expansionary monetary policy (in the form of 'quantitative easing') may have had the secondary effect of weakening the dollar.

However, given this Administration's refusal to include an enforceable currency manipulation provision in TPP and the past Administration's rejection of petitions calling for a WTO dispute on currency manipulation, there is no reason to believe that an administration would be willing to use this mechanism.

[13] Macroeconomic Policy Authorities Declaration, Article III, p. 2-3.

[14] Morris Goldstein, "A (Lack Of) Progress Report on China's Exchange Rate Policies," Peterson Institute Working Paper WP 07-5, June 2007.

[15] Macroeconomic Policy Authorities Declaration, Article III.2, p. 3.

[16] *Id*.

Secretary Lew recently articulated this concern: "…all of the partners consulted have made clear that they will not support the introduction of enforceable currency provisions in the context of trade agreements, and specifically, the TPP. Our partners fear that a trade agreement with an enforceable currency discipline could constrain the ability of their monetary authorities to conduct appropriate macroeconomic policies, and that is a risk they are unwilling to take…We have a serious concern that in any trade negotiation other countries would insist that an enforceable currency provision be designed so it could be used to challenge legitimate U.S. monetary policy, an outcome we would find unacceptable. Seeking enforceable currency provisions would likely derail the conclusion of the TPP given the deep reservations held by our trading partners."

Others, however, have argued that a provision based on the IMF's currency manipulation guidelines would not define U.S. monetary policy as currency manipulation. Specifically, the IMF guidelines, which have been accepted by all of the TPP parties who are all Members of the IMF, provide that currency manipulation is about government interventions in the foreign exchange markets, not about other policies that may have a secondary impact on foreign exchange rates. The IMF guidelines distinguish between currency manipulation – government intervention in foreign exchange markets – and monetary policy. The following brief review of each factor identified in the IMF guidelines relates to the issue whether an accommodative monetary policy can be described as a form of currency manipulation.

Factor 1: Protracted Large-Scale Intervention, in One Direction, in Currency Markets

The United States intervenes in the currency market less than almost any other country in the world. The United States has only intervened in the currency markets a total of three days since the late 1990s: June 17, 1998 (during the Asian exchange rate/financial crisis); September 22, 2000 (after the euro was introduced and concerns grew over the euro's significant depreciation against the dollar); and March 18, 2011 (in connection with a Japanese earthquake and tsunami). These three interventions over nearly 20 years cannot be described as "protracted" interventions. Compare this record with, for example, China's interventions over the past decade, which have occurred almost daily, and almost always in the same direction, to weaken their currency.

While the United States has a flexible exchange rate (i.e., it lets the market determine its value), it is also important to note that the IMF Guidelines do not prevent other countries from establishing a fixed or managed exchange rate. The Guidelines only provide that the rate cannot be set at a consistently artificially low level (i.e., countries may engage in "protracted, large scale" interventions, so long as all of these interventions are not all in the same "direction").

Factor 2: Excessive Accumulation of Foreign Exchange Reserves

Despite the fact that the United States has the largest or second largest economy in the world, the United States holds fewer foreign exchange reserves than Thailand, Algeria, and Saudi Arabia, among others. Further, China has 25 times as many foreign exchange reserves (nearly $4 trillion) as the United States ($126 billion).

Factor 3: Restrictions on/Incentives for Transactions or Capital Flows for Balance of Payments Purposes

The United States has one of the least restrictive regulatory structures in the world concerning the free flow of capital. In fact, the World Economic Forum ranks the United States first in the world in terms of capital account liberalization and second in the world under a more general 'financial development' index.

Factor 4: Encouragement of Capital Flows through Monetary Policy for Balance of Payments Purposes

This is the only guideline that even mentions monetary policy. And while the United States – and every other country in the world – does have a monetary policy, the purpose of U.S. monetary policy is neither to encourage capital flows nor to achieve a balance in payments. The goals of U.S. monetary policy are spelled out in the Federal Reserve Act, which specifies that the Board of Governors and the Federal Open Market Committee should seek "to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates."

Factor 5: Fundamental Exchange Rate Misalignment

If anything, the U.S. dollar is properly valued or even overvalued, not undervalued, according to the most recent IMF data and estimates. Further, given the continued weakening of the yen and euro, many expect the dollar to further strengthen in value in 2016.

Factor 6: Long and Sustained Current Account Surpluses

The United States has had just one current account surplus since 1981. In fact, the United States has been running large current account and trade deficits for almost four decades. Indeed, those imbalances are a major cause of concern to many economists – and currency manipulation by other countries has contributed substantially to the U.S. trade deficits in recent years.

Factor 7: Large External Sector Vulnerabilities from Private Capital Flows

While the United States does have external sector vulnerabilities (i.e., private and public sector debt owed to foreigners), as reflected in the large current account deficit, much of those vulnerabilities stem from purchases of U.S. debt by foreign governments – not private capital flows. And much of those purchases by foreign governments are the result of foreign government intervention in the currency markets that result in the accumulation of foreign reserves. Thus, if anything, this factor, like Factor 6, tends to suggest that the United States is a casualty of other governments' currency manipulation, not that it is manipulating itself.