The Fund appears to be sleeping at the wheel
>By Morris Goldstein and Michael Mussa
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Frustrated with the lack of meaningful exchange rate adjustment by China and some other Asian economies, the US Treasury has called on the International Monetary Fund to be more ambitious in its surveillance of exchange rates and warned that the "perception that the IMF is asleep at the wheel on its most fundamental responsibility – exchange rate surveillance – is very unhealthy both for the institution and the international monetary system".

We agree – even if the criticism comes from an institution that has itself only recently awakened from a long slumber on these issues. But continued acrimony between the IMF and its largest shareholder would not be helpful – especially when the world economy faces critical challenges in reversing large and rapidly rising payments imbalances.

Consistent with the IMF's responsibility under its articles of agreement "to oversee the international monetary system in order to ensure its effective operation", the Fund has repeatedly emphasised that the massive US external deficit and the corresponding surplus of the rest of the world must start declining. The IMF has rightly focused on many of the policy adjustments important for reducing payments imbalances in a manner that limits risks of financial turmoil and best sustains prospects for global growth. This includes pressing the US for a more responsible fiscal policy.

But the IMF is also uniquely charged to "exercise firm surveillance over the exchange rate policies of its members, and [to] adopt specific principles for the guidance of members with respect to those policies". Regrettably, the Fund has been retreating from this key mandate at a critical juncture. It has endorsed general calls for China and other Asian economies to adopt "more flexible" exchange rate regimes but has failed to emphasise the need for significant exchange rate appreciation to help reduce global imbalances.

China is now the third largest trading economy. Its overall current account surplus has risen from 3 per cent of gross domestic product in 2003 to 4 per cent in 2004; it is likely to exceed 6 per cent in 2005 and may grow more next year. Many other Asian economies also have substantial overall current account surpluses. Massive, sustained, one-way intervention in the foreign exchange market (averaging 12 per cent of Chinese GDP in 2003 and 2004 and rising in 2005) has kept the renminbi from appreciating meaningfully against the dollar in nominal terms and has induced moderate depreciation in China's real effective exchange rate. Many other Asian

economies have also limited the appreciation of their currencies. In contrast, the market-determined exchange rates of European countries and of Australia, Canada and New Zealand have appreciated very substantially against the dollar since early 2002. Reduction of the US external payments deficit from more than 6 per cent of GDP to a sustainable level of about 3 per cent undoubtedly requires substantial real depreciation of the dollar against the trade-weighted average of US trading partners. No significant exchange rate adjustment against Asian currencies means that much larger adjustment will be required against currencies that have already appreciated substantially.

Moreover, large-scale, prolonged, one-way intervention by several Asian countries to resist meaningful appreciation is clearly contrary to the IMF's stated principles for the guidance of members' exchange rate policies. Yet, the IMF has held no special consultations with Asian countries on their exchange rate policies. Nor has it provided explicit and public advice on the extent of necessary policy adjustments. It welcomed the renminbi's tiny appreciation against the dollar in late July without indicating the need for substantial further appreciation.

Against this background, it is simply not credible for Rodrigo de Rato, the Fund's managing director, to claim the IMF has been "well ahead of the curve" in its exchange rate advice to China, that there is "no evidence" that China has been running foul of IMF exchange rate guidelines, and that the IMF should not be "a special pressure group" to induce policy changes.

The key issue is that present exchange rate levels in Asia are not consistent with the need to reduce global payments imbalances in a way that minimises risks of financial disruption and supports sustainable global growth. The IMF has a clear responsibility to address this. More sound bites on the need for "greater flexibility" in currency regimes will not suffice.

The Fund should also treat the US Treasury's call for more ambition in IMF exchange rate surveillance as a good opportunity to give substance to its special consultations tool; to publish its own assessment of exchange rates; to review its guidelines on exchange rate policies; and to demand a meaningful role in discussions of exchange rate surveillance by the Group of Seven leading industrial countries.

If the IMF fails in these duties, others will take up the task. This is apparent in the widespread Congressional support for the Schumer-Graham bill that would impose high US tariffs on Chinese imports to offset the estimated undervaluation of the renminbi.

Down this route lies a potential trade war and international chaos. The only viable alternative is to insist that the IMF does its assigned job as the vigorous, competent, unbiased, international umpire of exchange rate policies.

The authors are senior fellows at the Institute for International Economics

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