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FACT OF THE WEEK (February 2, 2010)

THE INTERNATIONAL MONETARY FUND (IMF) RECORD ON CURRENCY MANIPULATION

From its founding in 1944, the International Monetary Fund (“IMF”) has been charged with promoting exchange stability, maintaining orderly exchange arrangements among its members, and avoiding competitive exchange depreciation. The inclusion of this responsibility in the IMF’s Articles of Agreement reflected the painful experience of the Great Depression in the 1930s. It was understood that market-oriented exchange rates are indispensable to efficient functioning of the international trading system.

Initially, the IMF relied upon a gold-based, par-value system of exchange rates. This structure proved to be insufficiently flexible and ended in the early 1970s after the United States in August 1971 suspended the convertibility of the U.S. dollar into gold. Article IV of the IMF’s Articles of Agreement subsequently was amended in 1976 and formally adopted in 1978 in its present form, permitting each member to choose its own exchange arrangement from the range of hard-peg regimes, floating regimes, and intermediate, soft-peg regimes.

Under revised Article IV, each member undertakes to collaborate with the IMF and other members to assure orderly exchange arrangements and to promote a stable exchange system. As part of this obligation, Article IV.1(iii) states that each member shall avoid manipulating exchange rates or the international monetary system in order to prevent effective balance-of-payments adjustment or to gain an unfair competitive advantage over other members.

Further, revised Article IV.3 provides for the IMF to oversee the international monetary system to ensure its effective operation. For this purpose, the IMF is authorized and instructed by Article IV to exercise “firm surveillance” over the exchange-rate policies of the members and to adopt specific principles for the guidance of members with respect to those policies.

In 1977, the IMF accordingly issued a first decision that set forth principles and procedures for surveillances and thereafter has held surveillances, usually annually, of each member’s exchange-rate policies. In 2007, this first decision was superseded by a second decision that brought forward much of the substance of the 1977 decision. In addition, the second decision, among other things:

(a) included a recommended, non-obligatory principle that a member should avoid exchange-rate policies that result in external instability and defined “external stability” as

achieved when the balance-of-payments position does not, and is not likely to, give rise to disruptive adjustments in exchange rates;

(b) updated the framework for surveillance to note that “fundamental exchange-rate misalignment” (that is, a significant deviation of the real effective exchange rate from its equilibrium level) is an important indicator of external instability;

(c) elaborated that “manipulation” means that a member is engaged in exchange-rate policies for the purpose of securing an undervalued “fundamental exchange-rate misalignment” in order to increase net exports; and

(d) underscored that the IMF’s Managing Director has the authority to engage in ad hoc consultations with a member outside the normal schedule for surveillance.

The IMF has invested considerable effort in its surveillance activities over the last 35 years or so. Yet it clearly lacks the leverage to bring a member into compliance with Article IV that is deemed to be “manipulating” its currency’s rate of exchange with other countries’ currencies. In particular, the IMF’s Articles of Agreement do not provide for binding dispute settlement or vest the IMF with any special power to enforce measures to correct such a finding with respect to members that are not borrowers of the IMF’s funds. Instead, the IMF must rely in these circumstances upon what influence it has in the international community through persuasion, peer pressure, and publicity.

The case of China underscores the shortcomings of the IMF’s system. Particularly since China joined the World Trade Organization in December 2001, the IMF’s Staff and Executive Board have expressed concern that the renminbi has been substantially undervalued and urged China to focus less on exports and more on domestic consumption. The IMF has stopped short of quantifying the extent of the perceived undervaluation and has not made a determination of manipulation.

Not only has China persisted in the undervaluation, but it also has prevented publication by the IMF of those reports for 2007, 2008, and 2009. The IMF responded to China’s stonewalling in mid-August 2008 by clarifying its second decision on surveillance in 2007, observing that progress at times has been hampered by technical difficulties in assessing exchange-rate equilibria and that the frankness called for in some discussions of exchange rates has been a sensitive matter. This reevaluation by the IMF seems to have precluded discussion by the IMF’s Executive Board of the Staff’s reports on China in 2007 and 2008. In late August 2008, the U.S. Treasury Department bluntly assessed the IMF’s record of delays on exchange-rate surveillance, citing China as an example, and urged the IMF to speak out publicly and forcefully about harmful exchange-rate practices by countries. In July 2009, the IMF’s Executive Board released its assessment of China’s 2009 surveillance, encouraging greater exchange-rate flexibility by China and pointing out the methodological difficulties of making exchange-rate assessments.

The bottom line is that the IMF has no means to compel a recalcitrant member to live up to its Article IV obligations, even when the stability of the global monetary system demands it. The IMF is a toothless tiger when it comes to exchange-rate surveillance.

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