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Testing times for the IMF... and for Europe

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A few days ago the International Monetary Fund (IMF) announced the first revision in thirty years of its bilateral surveillance over the member countries' policies (<http://www.imf.org/external/np/sec/pn/2007/pn0769.htm>). In its annual dialogue with governments it now intends to assess 'external stability' (a new, broad concept meaning that the balance of payments does not risk giving rise to disruptive adjustments in exchange rates) and to recommend avoiding policies that result in such external instability. And the Fund will determine whether member countries are engaging in currency manipulation through policies 'causing the exchange rate to move or preventing it from moving', especially 'for the purpose of securing an undervalued exchange rate' in order 'to increase net exports'.

Translation: the US government has requested the IMF to get serious about the exchange rate of the renminbi, to tell the Chinese that time has come to let their currency appreciate and, if Beijing does not bow to pressure, to state officially that its currency is manipulated.

It is not hard to understand why. For several years, the US Treasury has been trying – largely in vain – to persuade Beijing to accept a significant appreciation of the renminbi and the transition to a more flexible exchange rate regime. Meanwhile, Congress has been discussing – but never passed – retaliatory measures, such as the 2005 Schumer-Graham bill requesting a countervailing tariff. In December 2006, Fed Chairman Ben Bernanke famously suggested that exchange rate intervention by the Chinese central bank amounted to an export subsidy. Now Congress is increasingly receptive to suggestions that it should retaliate against what Washington widely regards as Chinese currency manipulation.

For the US, the advantages of IMF involvement are clear. First, Washington is torn between its currency dispute with Beijing and its desire to not to damage what Treasury secretary Henry Paulson has called America's "most important economic relationship". Second, the Fund is not part of the bilateral monetary dispute between the US and China and can therefore be expected to be more authoritative; already, it has served as a venue for consultations on global imbalances with the US, China, Japan, the euro area and Saudi Arabia. Third, the IMF has real clout because a pronouncement that the Chinese currency is manipulated would open the way to the filing of a complaint at the World Trade Organisation, whose provisions state that member countries 'shall not, by exchange action, frustrate the intent of the provisions of the [GATT] Agreement'.

From a global standpoint, there are also advantages in an enhancement of the Fund's surveillance. Even those who believe that current account imbalances should not be a cause for concern must admit that the world economy is approaching dangerous territory. What the standard euphemism calls a 'disorderly adjustment' of those imbalances would involve significant risks to economic growth and trade openness worldwide. It is wise to make sure that the world's premier financial institution is equipped to deal with exchange rate matters at the multilateral level as well as vis-à-vis particular countries.

Finally, for an IMF whose staff remains idle and whose resources are dwindling for lack of financial crises, a new mission is exactly what it is looking for ('new mission' is somewhat of an exaggeration because exchange rate surveillance has always been part of its remit, but a new impetus at least). However, the challenge is not a negligible one, for two reasons.

First, the Fund will need, if not to tell, at least to hint at what an appropriate exchange rate for the Chinese currency would be. This is risky business politically, and there will be a need to persuade the Chinese government that a move is in the country's best interest. But this is also risky technically: estimates of the renminbi equilibrium exchange rate are notoriously imprecise, as recognised in Fund research (<https://www.imf.org/external/pubs/ft/wp/2006/wp06220.pdf>). From a wider perspective, in a world of unfettered capital mobility, a sustainable current account balance is not exactly what it used to be. Several years of controversies over the US deficit have shown economists that traditional models were in need of serious rethinking. This is not to say that one should adopt a Panglossian view of the world, only that equilibrium exchange rate assessments are fraught with difficulties.

Second, the Fund is still looked at with suspicion in Asia. At the time of the 1997-1998 crisis, it was widely perceived in the region as an instrument of the US and the Europeans, and was accused of having a biased perspective on Asia. At the time, the proposal was even made to create an Asian Monetary Fund – an idea that Washington did not lose time killing. As a US- and Europe-dominated institution, the IMF risks being regarded as illegitimate. Already, China's central bank has expressed reservations about the Fund's decision, has asked also to take into account 'internal stability' and called for a strengthening of policy surveillance 'over those members who issue major reserve currencies' – meaning the US. A move by the IMF that would be perceived as biased towards US interests would certainly trigger strong reactions in China and throughout the region.

This is where the Europeans have a direct stake in the debate. From the US point of view, a very straightforward way to convince to the Chinese and other emerging countries that the move is not directed against them would be to increase further their voice on the IMF board. The reform of the voting system is on the agenda of the coming months and everybody knows that the name of the game is to reduce the weight of the Europeans and to increase that of the emerging and developing countries – a move that the European states are desperately trying to delay. The US now has every incentive to side with China against an overrepresented Europe. For Europe, there might thus be some collateral damage in the making.

This should not lead the EU to bury its head in the sand (it is too late anyway). It also has something to gain from an adjustment of the renminbi and from a more legitimate IMF that is able to avoid divergences over exchange rate policy degenerating into trade disputes. It should insist that the US obsession with China is excessive and that while it is right to push for a revaluation of the renminbi, Japan also holds the key to an adjustment of Asian currencies. The yen's weakness was necessary as long as Japan was fighting deflation, but its recovery should now pave the way for its appreciation. Last but not least, it should get serious about a consolidation of European chairs on the IMF board and trade some of the vast nominal power it enjoys for real influence.