

REPORT TO THE COMMITTEES ON APPROPRIATIONS ON CLARIFICATION OF STATUTORY PROVISIONS ADDRESSING CURRENCY MANIPULATION

Introduction

This report was prepared pursuant to Section 221 of Title II of Division H of the Consolidated Appropriations Act, 2005 (Public Law 108-447). This Section states that: “Not later than 60 days after the enactment of this Act, the Secretary of the Treasury shall submit to the Committees on Appropriations a report describing how statutory provisions addressing currency manipulation by America’s trading partners contained in, and relating to, Title 22 U.S.C. 5304, 5305 and 286y can be better clarified administratively to provide for improved and more predictable evaluation, and to enable the problem of currency manipulation to be better understood by the American people and the Congress.”

Title 22 U.S.C. 5304 requires, inter alia, that the Secretary of the Treasury analyze on an annual basis the exchange rate policies of foreign countries, in consultation with the International Monetary Fund, and consider whether countries manipulate the rate of exchange between their currency and the United States dollar for purposes of preventing effective balance of payments adjustment or gaining unfair competitive advantage in international trade. Section 5304 further requires that: “If the Secretary considers that such manipulation is occurring with respect to countries that (1) have material global current account surpluses; and (2) have significant bilateral trade surpluses with the United States, the Secretary of the Treasury shall take action to initiate negotiations with such foreign countries on an expedited basis, in the International Monetary Fund or bilaterally, for the purpose of ensuring that such countries regularly and promptly adjust the rate of exchange between their currencies and the United States dollar to permit effective balance of payment adjustments and to eliminate the unfair advantage.”

Title 22 U.S.C. 5305 requires, inter alia, the Secretary of the Treasury to provide reports on international economic policy, including exchange rate policy. Among other matters, the reports are to contain the results of negotiations conducted pursuant to Section 5304.

Title 22 U.S.C. 286y requires the Secretary of the Treasury, inter alia, to initiate discussions with countries regarding economic dislocations which result from structural exchange rate imbalances; and to instruct the United States Executive Director of the International Monetary Fund to work for adoption of policies in the Fund that promote conditions contributing to the stability of exchange rates and avoid the manipulation of exchange rates between major currencies.

Summary

The assessment of whether an economy is manipulating the rate of exchange between its currency and the U.S. dollar for the purposes of preventing effective balance of payments adjustments or gaining unfair competitive advantage in international trade is inherently difficult. The determination of exchange rates reflects the interplay of macroeconomic and microeconomic forces throughout every corner of the world. Assessments under Section 5304 require a

comprehensive review of significant international economic developments and an evaluation of the factors that underlie those developments. In making such assessments, Treasury is guided by the following considerations:

- Notwithstanding the inherent difficulties in rendering assessments, the authorities of an economy could be said to manipulate the exchange rate if they intentionally act to set the exchange rate at levels, or ranges, to prevent effective balance of payments adjustments or gain unfair competitive advantage in international trade such that for a protracted period the exchange rate differs significantly from the rate that would have prevailed in the absence of action by the authorities. However, such a significant difference could also arise from the interplay of economic forces or other factors.
- Hence, in making assessments, a wide range of economic data and policies must be reviewed. In this light, one must carefully review trading partners' exchange rates, external balances, foreign exchange reserve accumulation, macroeconomic trends, monetary and financial developments, state of institutional development, and financial and exchange restrictions. Developments in any one area do not typically provide sufficient grounds to conclude that exchange rates are being manipulated in terms of Section 5304.
- Although a broad range of economies in all regions of the world are routinely examined, those countries with concurrently large bilateral surpluses with the United States and large global current account surpluses are reviewed more thoroughly.
- Analysts also examine indicators that could be consistent with official action to manipulate currencies for such purposes. Though potentially helpful, these indicators are generally not dispositive in and of themselves. They include, inter alia: (1) measures of undervaluation; (2) protracted large-scale intervention in one direction; (3) rapid foreign exchange reserve accumulation; (4) capital controls and payments restrictions; and (5) trade and current account balances.
- To enable the problem of currency manipulation to be better understood by the American people and Congress, the Treasury must continue its ongoing intensive monitoring of foreign economic policies and performance, provide Congress and the public with continued timely reporting on international economic developments, and maintain its close engagement with Congress.

Manipulation

There are many inherent difficulties in rendering assessments of when a currency is being manipulated to prevent effective balance of payments adjustments or gain unfair competitive advantage in international trade. However, the authorities of an economy could be said to "manipulate" the exchange rate in terms of Section 5304 if they intentionally act to set the exchange rate at levels, or ranges, such that for a protracted period the exchange rate differs significantly from the rate that would have prevailed in the absence of action by the authorities. A significant difference between a market rate and an underlying "equilibrium" rate could also arise from the interplay of economic forces or other factors.

There are many reasons why the authorities might seek to influence the exchange rate. For example, they may wish to counter disorderly market conditions; or use the exchange rate as an anchor for monetary policy; or build up international reserves to reduce vulnerability to possible currency crises. If an economy manipulates its exchange rate in order to prevent effective balance of payments adjustments or achieve an unfair advantage in international trade, however, this can be very harmful to other economies and the global financial system.

In order to render assessments on foreign economic and exchange rate policies, Treasury staff monitors economic and financial developments in countries across the globe on a real-time basis.

The International Monetary Fund also conducts surveillance over members' exchange rate policies as required by the Articles of Agreement. The IMF Executive Board adopted general principles in 1977 that continue to provide guidance with respect to these obligations.¹ Treasury consults regularly with the International Monetary Fund on what constitutes exchange rate "manipulation" as discussed above, both in the context of the reports required under Section 5304 and on an *ad hoc* basis.

Further, the United States has urged the IMF to strengthen its surveillance of exchange rate issues in its regular Article IV consultations. In particular, the IMF has been urged to make candid discussions of exchange rate policy a routine exercise, particularly when a fixed peg is involved. The United States has also emphasized that further work on exit strategies from managed exchange rate regimes (involving direct official intervention or indirect intervention such as through the banking system) is a priority. Engagement with the IMF is continuing on many levels so that the IMF undertakes a thorough, clear, and analytically rigorous assessment of exchange rate issues in its surveillance, even when the country authorities' views diverge with those of IMF staff.

Country Examinations

Although a broad range of economies in all regions of the world are routinely examined, in light of the requirements of Section 5304, those countries with large overall current account surpluses or large bilateral surpluses with the United States are reviewed more thoroughly. The term "material global current account surpluses," used in Section 5304, is taken to mean large current account surpluses, measured as a percent of an economy's GDP. The term "significant bilateral trade surplus," used in Section 5304, is taken to mean a large bilateral trade surplus with the United States, relative to the size of U.S. trade.

In measuring bilateral trade surpluses, the Treasury uses Bureau of Census statistics on trade in goods. Foreign official statistics are typically used in the examination of global current account balances, which includes global trade balances. China's global trade surplus (a major component of the current account surplus) as reported in aggregate by China's trading partners, however, differs markedly from what is reported by Chinese official statistics. Treasury is undertaking an investigation to see how this arises and what, if any, of the difference can be reconciled.

¹ See "Surveillance over Exchange Rate Policies," Decision No. 5392-(77/63), 4/29/1977, as amended (also included as Attachment III).

The discrepancy between the estimate of China's trade surplus reported by Chinese authorities and by China's trading partners has been investigated in a number of studies.² One difficulty that arises is that much trade to and from China travels via Hong Kong. Importing countries usually accurately determine the source of their imports through certificates of origin. But exporters (both Chinese and partner country exporters) often record the destination of their exports as Hong Kong, even though the goods go on to other markets. This explains a significant part of the discrepancy between Chinese and partner country trade estimates of China's trade surplus, since a significant part of the trade between China and partner countries is recorded as trade with Hong Kong. (It is worth noting that the discrepancy between Chinese and partner country trade data is mirrored in partner country data with Hong Kong. In 2003 Hong Kong reported a global trade deficit of \$8 billion, while partner country data showed a \$121 billion surplus with Hong Kong.)

Correction for exports reported to Hong Kong but destined elsewhere, and for the addition of cost, insurance, and freight to exports substantially reduces, but does not completely eliminate, the discrepancy between Chinese and partner country trade data. Treasury considers both Chinese and partner country data in analyzing the size of China's global current account surplus.

Analysis of Foreign Exchange Rate Policies

In making its assessments, Treasury undertakes a careful review of trading partners' exchange rates, external balances, foreign exchange reserve accumulation, macroeconomic trends, monetary and financial developments, state of institutional development, and financial and exchange restrictions. Developments in any one area do not typically provide sufficient grounds to conclude that exchange rates are being manipulated. A combination of factors can lead, and has in the past led, Treasury to find that certain economies were manipulating their currencies consistent with the terms of Section 5304. China, Taiwan, and South Korea were each considered to be manipulating its currency in terms of Section 5304 during different periods in the years 1988 through 1994 (see Attachment II).

Many formal models, as well as a great deal of informal reasoning, have been used over the years to attempt to explain exchange rate determination.³ These efforts have helped enhance understanding of exchange rate trends and issues. But no approach or model has been fully able to describe observed market-determined exchange rate behavior. The results of any analysis of exchange rate behavior can vary substantially depending on the approach used.

² The discrepancy between estimates of China's global trade surplus based on Chinese and partner country statistics was analyzed in the 301 petition submitted by the Fair Currency alliance in April 2004. The global discrepancy is currently being analyzed by Treasury, and also by John Schindler and Dustin Beckett at the Federal Reserve ("How Big is China's Trade Surplus," unpublished draft, 2005). Studies of the US-China bilateral trade balance have been conducted by Fung and Lao (K.C. Fung, Lawrence J. Lau, "New Estimates of the United States - China Bilateral Trade Balances," Institute for International Studies, Stanford University, April 1999) and by Voon and Kueh (J.P. Voon and Y.Y. Kueh, "Country of Origin, China's Value-Added Exports, and Sino-U.S. Trade Balance Reconciliation," paper presented to the Third Sino-American Relations Conference, Hong Kong, November 15-16 1999).

³ Examples include purchasing power parity, the monetary approach, and the portfolio balance approach, as well as numerous formal macroeconomic models.

To assist in the identification of exchange rate manipulation, analysts examine indicators that are consistent with official actions to manipulate currencies for the purposes of preventing effective balance of payments adjustments or gaining unfair competitive advantage in international trade. Though potentially helpful, these indicators are generally not dispositive in and of themselves in determining that a specific economy has manipulated its exchange rate under the terms of Section 5304. In addition to standard macroeconomic and microeconomic analysis, these indicators include, inter alia: (1) measures of undervaluation; (2) protracted large-scale intervention in one direction; (3) rapid foreign exchange reserve accumulation; (4) capital controls and payments restrictions; and (5) trade and current account balances. These indicators are described in detail below.

(1) Measures of Undervaluation

A large “undervaluation” of a market exchange rate may exist relative to an “equilibrium exchange rate,” calculated using a specific model. However, calculating such an “equilibrium” exchange rate is quite difficult given that the given methodological approach may not capture observed market behavior.

Further, even if a currency can be identified as “misaligned” in the sense that it deviates substantially from its “equilibrium exchange rate,” as determined by a specific model, that does not necessarily mean that “manipulation” is occurring. For example, if a country initiated a contractionary fiscal policy and an expansionary monetary policy, which temporarily lowered real interest rates, the model might be incapable of predicting the amount by which the country’s currency would depreciate. In such circumstances, the “misalignment” might reflect problems with the model describing market reaction to the fundamental macroeconomic policy mix, but not “manipulation” of the exchange rate.

Similarly, if there were a large, unexpected surge in private capital outflows from a country, driving down the exchange rate, the exchange rate could appear to be “misaligned” due to inadequate modeling of market behavior. However, this would not be attributable to developments in the current account, and it again would not necessarily imply “manipulation.”

(2) Protracted Large-Scale Intervention in One Direction

Protracted large-scale intervention in one direction also merits attention in any consideration of “manipulation,” insofar as such intervention could reflect an effort by the authorities to maintain a given exchange rate level in the face of market pressure for the purposes of Section 5304.

Intervention can be carried out for a number of purposes. IMF surveillance procedures provide that: “A member should intervene in the exchange market if necessary to counter disorderly conditions, which may be characterized inter alia by disruptive short-term movements in the exchange value of its currency. Members should take into account in their intervention policies the interests of other members, including those of the countries in whose currencies they intervene.”⁴

⁴ IMF, *Surveillance over Exchange Rate Policies*, April 29, 1977.

Evidence shows that the effectiveness of intervention in influencing exchange rate behavior is, at best, short-lived. Intervention can, however, impact domestic inflation. As a result, most countries “sterilize” their intervention so that the impact of intervention on the monetary base is offset. Although short-term sterilized intervention may be effective in offsetting short-term foreign exchange market shocks, there is little evidence that it has long-term effects on the exchange rate.

The ability of governments to marshal sufficient resources for effective intervention is also often limited by the size of the foreign exchange market – for example, according to the latest Bank for International Settlements survey (2004), average daily turnover is \$1.9 trillion in traditional foreign exchange markets (spot transactions, outright forwards, and swaps) and \$1.2 trillion in over-the-counter currency and interest rate derivatives markets.

(3) Rapid Foreign Exchange Reserve Accumulation

When a country’s financial authorities purchase foreign exchange, that country’s reserve holdings typically rise. For example, if a country had a large balance of payments surplus and intervened heavily to absorb capital inflows, its foreign exchange reserves could rise rapidly. There are many reasons why a country might wish to increase its reserves, and there is no universally agreed optimum level of reserves. Some countries – for example, countries with a heavy tourist season – experience large seasonality in their balance of payments, which they might wish to smooth to avoid significant swings in their exchange rate. Other countries may need to buy foreign exchange in order to make payments on external debt or to counter disorderly market conditions.

After the Asian financial crisis, many economists came to believe that emerging markets and developing countries needed to raise their reserves in order to take account of volatility in short-term capital flows. U.S. foreign exchange reserves tend to be quite small, reflecting in large measure the dollar’s predominant role as a reserve currency in the international monetary system.

(4) Capital Controls and Payments Restrictions

Capital controls also warrant attention in making assessments regarding currency manipulation. Capital controls can be applied to inflows (limiting upward pressure on domestic currency) or outflows (limiting downward pressure on the domestic currency). Some countries have used controls on inflows out of concern that large short-term portfolio investment from major financial centers could suddenly reverse – disrupting small domestic capital markets. If controls are placed on outflows, lifting them could result in increased capital outflows that cause the domestic currency to depreciate.

More broadly, capital controls prevent capital from flowing to its most productive uses. They involve significant administrative costs, reduce the pressure on countries to institute needed economic reforms, and can increase the risk to the domestic economy in times of crisis (for example, by limiting sources of funding if there is a shock to domestic credit markets).

Payments restrictions regulate the use of foreign currency to buy goods and services and can be very distortionary. Residents of a country with such restrictions may wish to buy certain foreign goods or services but may be denied the foreign currency necessary to make the purchase even if they are willing to do the transactions at the formal exchange rate. The General Obligations of IMF members severely discourage restrictions on current international transactions⁵.

(5) Trade and Current Account Balances

Many analysts focus on the impact of exchange rates on trade flows, often examining developments in bilateral trade balances and current account balances. Bilateral balances, however, reflect unique patterns of demand or comparative advantage and are therefore highly limited in their ability to explain exchange rate movements. For example, it is quite understandable that the United States would have a large bilateral deficit with a country that is a major oil exporter. At the same time, in a multilateral trading system, a bilateral deficit with one country can be offset by a bilateral surplus with another.

Current account positions reflect a country's balance on trade in goods and services (normally the largest component), plus its balance on income and transfers. Trade balances are heavily affected by cyclical forces – the growth of one economy's income relative to that of its major trading partners. Indeed, a principal cause of the widening of the U.S. current account deficit in recent years has been the strong cyclical performance of the U.S. economy relative to many other major industrial economies. Trade may also be affected by a number of factors that influence costs and prices in one economy relative to its trading partners – for example, exchange rate movements, growth in productivity, and relative monetary conditions. Given the large US current account deficit, it is natural that the counterpart to the deficit is to be found in large surpluses in other countries of the world.

The current account balance is, by accounting definition, equal to the gap between saving and investment in a country.⁶ Saving is equal to public and private saving and is thus affected by fiscal policy and individual saving decisions. Investment is determined by business decisions, which depend on productivity, interest rates, and the relative attractiveness and risk-adjusted returns of economies.

A current account deficit must be financed from abroad, by foreigners acquiring more assets in the deficit country than the deficit country is acquiring abroad. Alternatively stated, a current account deficit is mirrored in capital and financial account inflows (including changes in foreign exchange reserves). Thus, exchange rate determination is strongly affected by global capital flows. Strong inflows of capital into the United States in recent years have been attracted by sound U.S. economic performance, the attractiveness of the U.S. investment climate, and the

⁵ Article VIII, Section 2(a) of the IMF Articles of Agreement states: "Subject to the provisions of Article VII, Section 3(b) and Article XIV, Section 2, no member shall, without the approval of the Fund, impose restrictions on the making of payments and transfers for current international transactions." The IMF does not have authority over the capital account.

⁶ In the first half of 2004, the US current account deficit was \$594 billion (seasonally adjusted, on a national income accounts basis). This deficit equaled the gap between \$2,246 billion in investment and \$1,652 billion in saving. That is, U.S. domestic investment was \$594 billion more than domestic saving with net foreign investment making up the difference.

depth and liquidity of U.S. financial markets. When global tensions arise, there can also be “safe haven” demand for such currencies as the U.S. dollar.

As a share of GDP, current account balances vary widely (see table). The globalization of financial markets has given investors greater freedom in placing their assets and has supported greater dispersion of the size of current account balances and net foreign asset positions.⁷

Different Exchange Rate Regimes

There is considerable diversity in the exchange rate regime choices of countries, ranging from flexible exchange rate systems with little or no intervention to currency unions and full dollarization. Until the early 1970s, the international economy had generally operated with pegged exchange rates – as under the pre-WWII gold standard and the post-WWII Bretton Woods system. Even after the collapse of the Bretton Woods system, European economies continued to maintain relatively fixed exchange rate arrangements among themselves, culminating in the creation of the euro. The IMF Articles of Agreement (Article IV) provide that members have the right to determine their own exchange rate arrangements.⁸

Current Account Balances	
Share of GDP, 2004	
United States	-5.4
Australia	-5.3
Central and Eastern Europe	-4.4
United Kingdom	-2.0
Africa	0.4
India	0.5
Euro area	0.9
Brazil	1.2
China	2.4
Korea	3.1
Japan	3.4
Thailand	3.8
Taiwan	6.9
Middle East	12.7

Source: IMF

Many countries have continued to choose a form of pegged exchange rate regime, particularly countries which are small and open; trade significantly with a country to whom their currency is pegged; have limited financial sector development; lack a significant capacity to implement an independent monetary policy and instead use the exchange rate as a nominal anchor; or believe that exchange-rate based stabilization is an attractive method to address high inflation. Strong exchange rate pegs, such as currency board arrangements and outright dollarization, have also been used by a number of countries in recent years. A country’s macroeconomic policies should be consistent with whatever exchange rate regime is chosen.

Conclusion

The determination of foreign exchange rates is a complex process that involves countless economic decisions, both at the national and global levels. Although there are many plausible reasons that authorities might seek to influence an economy’s exchange rate, there is a legitimate concern that some countries might succeed in manipulating an exchange rate to prevent effective balance of payments adjustments or to achieve an unfair competitive advantage in international trade. The assessment of whether an economy is manipulating the rate of exchange in terms of Section 5304 requires a comprehensive review of significant international economic

⁷ See, for example, “Financial Globalization and Exchange Rates,” Philip Lane and Gian Maria Milesi-Ferretti, IMF Working Paper, January 2005.

⁸ See also “Exchange Rate Regimes in an Increasingly Integrated World Economy,” Occasional Paper 193; Michael Mussa, Paul Masson, et al., International Monetary Fund, 2000.

developments to determine if a country is able to manipulate the rate of exchange for those purposes and succeeds in creating an unfair competitive advantage or preventing effective balance of payments adjustments.

Treasury has broadly used the approach outlined above since it began assessing foreign exchange policy under Section 5304. Treasury has stated, in the past, that it considered certain economies to be manipulating their exchange rates in terms of that Section. It continues to carry out these assessments vigorously and will report to Congress on any economy that it considers to be manipulating its exchange rate in terms of Section 5304 and on the negotiations required with such an economy under that Section. Treasury must continuously monitor country economic developments and global financial markets in every corner of the world on a real-time basis to render its assessments.

ATTACHMENT I

22 USC § 5304. International negotiations on exchange rate and economic policies**(a) Multilateral negotiations**

The President shall seek to confer and negotiate with other countries—

(1) to achieve—

(A) better coordination of macroeconomic policies of the major industrialized nations; and

(B) more appropriate and sustainable levels of trade and current account balances, and exchange rates of the dollar and other currencies consistent with such balances; and

(2) to develop a program for improving existing mechanisms for coordination and improving the functioning of the exchange rate system to provide for long-term exchange rate stability consistent with more appropriate and sustainable current account balances.

(b) Bilateral negotiations

The Secretary of the Treasury shall analyze on an annual basis the exchange rate policies of foreign countries, in consultation with the International Monetary Fund, and consider whether countries manipulate the rate of exchange between their currency and the United States dollar for purposes of preventing effective balance of payments adjustments or gaining unfair competitive advantage in international trade. If the Secretary considers that such manipulation is occurring with respect to countries that

(1) have material global current account surpluses; and

(2) have significant bilateral trade surpluses with the United States, the Secretary of the Treasury shall take action to initiate negotiations with such foreign countries on an expedited basis, in the International Monetary Fund or bilaterally, for the purpose of ensuring that such countries regularly and promptly adjust the rate of exchange between their currencies and the United States dollar to permit effective balance of payments adjustments and to eliminate the unfair advantage. The Secretary shall not be required to initiate negotiations in cases where such negotiations would have a serious detrimental impact on vital national economic and security interests; in such cases, the Secretary shall inform the chairman and the ranking minority member of the Committee on Banking, Housing, and Urban Affairs of the Senate and of the Committee on Banking, Finance and Urban Affairs of the House of Representatives of his determination.

22 USC § 5305. Reporting requirements

(a) Reports required

In furtherance of the purpose of this chapter, the Secretary, after consultation with the Chairman of the Board, shall submit to the Committee on Banking, Finance and Urban Affairs of the House of Representatives and the Committee on Banking, Housing, and Urban Affairs of the Senate, on or before October 15 of each year, a written report on international economic policy, including exchange rate policy. The Secretary shall provide a written update of developments six months after the initial report. In addition, the Secretary shall appear, if requested, before both committees to provide testimony on these reports.

(b) Contents of report

Each report submitted under subsection (a) of this section shall contain—

- (1)** an analysis of currency market developments and the relationship between the United States dollar and the currencies of our major trade competitors;
- (2)** an evaluation of the factors in the United States and other economies that underlie conditions in the currency markets, including developments in bilateral trade and capital flows;
- (3)** a description of currency intervention or other actions undertaken to adjust the actual exchange rate of the dollar;
- (4)** an assessment of the impact of the exchange rate of the United States dollar on—
 - (A)** the ability of the United States to maintain a more appropriate and sustainable balance in its current account and merchandise trade account;
 - (B)** production, employment, and noninflationary growth in the United States;
 - (C)** the international competitive performance of United States industries and the external indebtedness of the United States;
- (5)** recommendations for any changes necessary in United States economic policy to attain a more appropriate and sustainable balance in the current account;
- (6)** the results of negotiations conducted pursuant to section 5304 of this title;
- (7)** key issues in United States policies arising from the most recent consultation requested by the International Monetary Fund under article IV of the Fund's Articles of Agreement; and
- (8)** a report on the size and composition of international capital flows, and the factors contributing to such flows, including, where possible, an assessment of the impact of such flows on exchange rates and trade flows.

22 USC § 286y. Promoting conditions for exchange rate stability

(a) In order to help assure that the resources provided under section [286e-1i](#) of this title are used to support pro-growth policies which will help establish the economic conditions necessary for more appropriate financial and exchange rate alignment and stability, it is the sense of Congress that the Secretary of the Treasury shall—

(1) in consultation with the Secretary of State and the United States Trade Representative, initiate discussions with other countries regarding the economic dislocations which result from structural exchange rate imbalances; and

(2) instruct the United States Executive Director of the Fund to work for adoption of policies in the Fund, both within the framework of article IV (of the Articles of Agreement of the Fund) consultations and with respect to the conditions associated with Fund-supported balance of payments adjustments programs, which promote conditions contributing to the stability of exchange rates and avoid the manipulation of exchange rates between major currencies. Among other initiatives, the Secretary of the Treasury shall propose strengthening the article IV consultation procedures of the Fund to attempt to ensure that countries which are artificially maintaining undervalued or overvalued rates of exchange agree to adopt market determined exchange rates.

(b) In determining his vote on extensions of assistance to any Fund borrower, the United States Executive Director of the Fund shall take into account whether such borrower's policies are consistent with the requirements of article IV of the Articles of Agreement of the Fund.

ATTACHMENT II

**ECONOMIES CONSIDERED TO HAVE MANIPULATED EXCHANGE RATES
AS DESCRIBED IN
TREASURY REPORTS TO CONGRESS ON
INTERNATIONAL ECONOMIC AND EXCHANGE RATE POLICIES**

October 1988 Report:

Korea and Taiwan were considered to be manipulating their exchange rates under the terms of 22 U.S.C. 5304.

The report stated that undervalued exchange rates were a major factor in the increase in the external surpluses of the two countries. The undervaluation was deemed the direct result of currency intervention by the central bank, capital controls, and administrative mechanisms aimed at preventing the exchange rates from reflecting market forces and achieving competitive gain.

With respect to Taiwan the report stated:

Taiwan's underlying economic fundamentals strongly suggest that further appreciation would occur if capital and exchange restrictions were dismantled and market forces were given freer rein. Taiwan has a strong economy with a large global current account surplus, a large bilateral surplus with the United States, its foreign exchange reserves have risen sharply and yet its currency is depreciating. Pursuant to provisions of Section 3004, the United States intends to initiate bilateral negotiations with Taiwan on an expedited basis for the purpose of ensuring that Taiwan regularly and promptly adjusts the rate of exchange between the NT dollar and the U.S. dollar to permit effective balance of payments adjustment and to eliminate the unfair trade advantage.

With respect to Korea, the report stated:

Korea's strong economic fundamentals – 3 consecutive years of double digit real growth, large and growing external surpluses, substantial prepayment of external debt, and reserve accumulation – also point to an undervalued exchange rate. The Korean authorities have used administrative arrangements and strict capital controls to perpetuate the undervaluation of their currency. As with Taiwan, numerous tariff and non-tariff barriers continue to restrict Korean imports and prevent a sizable shift in its external surpluses, despite recent progress of trade liberalization.

...

Given Korea's strong underlying economic fundamentals, further exchange rate appreciation within a framework of liberalized trade, exchange and capital controls, is clearly required. As such, the United States also intends to initiate

bilateral negotiations with Korea on its exchange rate policy to allow for balance of payments adjustment and to eliminate the unfair trade advantage.

April 1989 Report:

Korea and Taiwan were considered to be manipulating their exchange rates under the terms of 22 U.S.C. 5304.

The reported noted progress but that this was insufficient to alter the basic judgments of October 1988.

October 1989 Report:

Korea was considered to be manipulating its exchange rates under the terms of 22 U.S.C. 5304.

The report stated that there continued to be indications, despite positive moves, of exchange rate manipulation by Korea. The assessment was based on exchange rate developments over the previous six months; questions as to whether a recent reduction in Korea's surpluses would continue; the lack of a significant role for market forces in Korea's exchange rate determination system; and the widespread capital and interest rate controls that contributed to the government's ability to directly manipulate their exchange rate.

May 1992 Report:

China and Taiwan were considered to be manipulating their exchange rates under the terms of 22 U.S.C. 5304.

With respect to China, the report stated:

The size and growth of China's external payments surpluses are a source of serious concern. These surpluses result in large part from pervasive administrative controls maintained by the Chinese authorities over the external sector of the economy, including a highly regulated system of foreign exchange allocation and direct controls on imports. At the same time, balance of payments adjustment in China has been hindered by continued devaluation of the administered exchange rate and controls on exchange rates in the nation's foreign exchange swap centers.

...

Given the size of China's external payments surpluses and the level of its foreign exchange reserves, continued devaluation of the administered exchange rate and control of swap center rates must be viewed as an effort by the authorities to frustrate effective balance of payments adjustment.

The report also concluded that Taiwan was manipulating its exchange rate within the meaning of the Act. This was based on the judgment, in the context of Taiwan's continued large bilateral and overall trade surpluses and foreign exchange reserves, that continued official action that directly interfered with the role of market forces in exchange rate determination, such as intervention in the foreign exchange market and imposition of controls on capital inflows, must be viewed as an effort by the authorities to inhibit effective balance of payments adjustment.

December 1992 Report:

China and Taiwan were considered to be manipulating their exchange rates under the terms of 22 U.S.C. 5304.

The report stated that Taiwan continued to manipulate its currency. It pointed, as a basis for this conclusion, to continued large overall trade and current account surpluses; a large and increasing bilateral trade surplus with the US; excessive foreign exchange reserves; and continued official action that directly interfered with the role of market forces in exchange rate determination.

The report also stated that China continued to manipulate its currency. It noted that, given the size of China's external payments surpluses and the level of its foreign exchange reserves, continued use of the administered exchange rate and of regulated swap center rates must be viewed as an effort by the authorities to frustrate effective balance of payments adjustment.

May 1993 Report:

China was considered to be manipulating its exchange rates under the terms of 22 U.S.C. 5304.

The report noted that while China had committed itself to reform its trade regime, for example, in the context of the GATT, similar commitments had not been made with respect to its foreign exchange system. Chinese officials had expressed general support for reform of the system, and the long-term objectives of unifying the dual exchange rates and making the currency convertible. However, they had not indicated the specific nature of the steps they planned to take nor the timing of reform.

While there was some prospect that China's current account surplus might diminish in 1993, its foreign exchange restrictions continued to impede balance of payments adjustment and to contribute to large bilateral trade surpluses. In 1992 and early 1993, no significant changes were made in China's foreign exchange regime, and the authorities continued to maintain limits on access to foreign exchange. Therefore it was Treasury's judgment that China was manipulating its foreign exchange system in a manner that prevents effective balance of payments adjustment within the meaning of the Act.

November 1993 Report:

China was considered to be manipulating its exchange rates under the terms of 22 U.S.C. 5304.

The report expressed support for China's plans to move towards a more market-based economy and reform its foreign exchange system. It noted, nevertheless, that China's foreign exchange system continued to be heavily regulated and the United States was seriously concerned with the level of China's bilateral trade surplus with the United States. Based on China's continued reliance on foreign exchange restrictions, Treasury considered that China continued to manipulate its exchange rate under the meaning of the Act. Treasury urged Chinese authorities to eliminate all restrictions on access to foreign exchange, a step which would facilitate imports and promoted adjustment in China's large bilateral surplus with the United States.

July 1994 Report:

China was considered to be manipulating its exchange rates under the terms of 22 U.S.C. 5304.

Treasury welcomed China's decision to unify its dual exchange rates as of January 1, 1994. Nonetheless, further reforms implemented on April 1, 1994, segmented the foreign exchange market and imposed restrictions that limited foreign-funded enterprises access to foreign exchange. Based on China's continued reliance on foreign exchange restrictions that could limit imports, the report concluded that Treasury considered that China manipulated its exchange system to prevent effective balance of payments adjustment and gain unfair competitive advantage.

ATTACHMENT III

IMF – Exchange Arrangements and Surveillance

SURVEILLANCE OVER EXCHANGE RATE POLICIES

1. The Executive Board has discussed the implementation of Article IV of the proposed Second Amendment of the Articles of Agreement and has approved the attached document entitled "Surveillance over Exchange Rate Policies." The Fund shall act in accordance with this document when the Second Amendment becomes effective. In the period before that date the Fund shall continue to conduct consultations in accordance with present procedures and decisions.

2. The Fund shall review the document entitled "Surveillance over Exchange Rate Policies" at intervals of two years and at such other times as consideration of it is placed on the agenda of the Executive Board.

Decision No. 5392-(77/63)
April 29, 1977,
as amended by Decision Nos. 8564-(87/59), April 1, 1987,
8856-(88/64), April 22, 1988, and 10950-(95/37),
April 10, 1995

Surveillance over Exchange Rate Policies

General Principles

Article IV, Section 3(a) provides that "The Fund shall oversee the international monetary system in order to ensure its effective operation, and shall oversee the compliance of each member with its obligations under Section 1 of this Article." Article IV, Section 3(b) provides that in order to fulfill its functions under 3(a), "The Fund shall exercise firm surveillance over the exchange rate policies of members, and shall adopt specific principles for the guidance of all members with respect to those policies." Article IV, Section 3(b) also provides that "The principles adopted by the Fund shall be consistent with cooperative arrangements by which members maintain the value of their currencies in relation to the value of the currency or currencies of other members, as well as with other exchange arrangements of a member's choice consistent with the purposes of the Fund and Section 1 of this Article. These principles shall respect the domestic social and political policies of members, and in applying these principles the Fund shall pay due regard to the circumstances of members." In addition, Article IV, Section 3(b) requires that "each member shall provide the Fund with the information necessary for such surveillance, and, when requested by the Fund, shall consult with it on the member's exchange rate policies."

The principles and procedures set out below, which apply to all members whatever their exchange arrangements and whatever their balance of payments position, are adopted by the Fund in order to perform its functions under Section 3(b). They are not necessarily comprehensive and are subject to reconsideration in the light of experience. They do not deal

directly with the Fund's responsibilities referred to in Section 3(a), although it is recognized that there is a close relationship between domestic and international economic policies. This relationship is emphasized in Article IV which includes the following provision: "Recognizing ... that a principal objective [of the international monetary system] is the continuing development of the orderly underlying conditions that are necessary for financial and economic stability, each member undertakes to collaborate with the Fund and other members to assure orderly exchange arrangements and to promote a stable system of exchange rates."

Principles for the Guidance of Members' Exchange Rate Policies

A. A 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.

B. A member should intervene in the exchange market if necessary to counter disorderly conditions, which may be characterized inter alia by disruptive short-term movements in the exchange value of its currency.

C. Members should take into account in their intervention policies the interests of other members, including those of the countries in whose currencies they intervene.

Principles of Fund Surveillance over Exchange Rate Policies

1. The surveillance of exchange rate policies shall be adapted to the needs of international adjustment as they develop. The functioning of the international adjustment process shall be kept under review by the Executive Board and Interim Committee and the assessment of its operation shall be taken into account in the implementation of the principles set forth below.

2. In its surveillance of the observance by members of the principles set forth above, the Fund shall consider the following developments as among those which might indicate the need for discussion with a member:

- (i) protracted large-scale intervention in one direction in the exchange market;
- (ii) an unsustainable level of official or quasi-official borrowing, or excessive and prolonged short-term official or quasi-official lending, for balance of payments purposes;
- (iii) (a) the introduction, substantial intensification, or prolonged maintenance, for balance of payments purposes, of restrictions on, or incentives for, current transactions or payments, or
 - (b) the introduction or substantial modification for balance of payments purposes of restrictions on, or incentives for, the inflow or outflow of capital;
- (iv) the pursuit, for balance of payments purposes, of monetary and other domestic financial policies that provide abnormal encouragement or discouragement to capital

flows;

(v) behavior of the exchange rate that appears to be unrelated to underlying economic and financial conditions including factors affecting competitiveness and long-term capital movements; and

(vi) unsustainable flows of private capital.

3. The Fund's appraisal of a member's exchange rate policies shall be based on an evaluation of the developments in the member's balance of payments, including the size and sustainability of capital flows, against the background of its reserve position and its external indebtedness. This appraisal shall be made within the framework of a comprehensive analysis of the general economic situation and economic policy strategy of the member, and shall recognize that domestic as well as external policies can contribute to timely adjustment of the balance of payments. The appraisal shall take into account the extent to which the policies of the member, including its exchange rate policies, serve the objectives of the continuing development of the orderly underlying conditions that are necessary for financial stability, the promotion of sustained sound economic growth, and reasonable levels of employment.

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Procedures for Surveillance

I. Each member shall notify the Fund in appropriate detail within thirty days after the Second Amendment becomes effective of the exchange arrangements it intends to apply in fulfillment of its obligations under Article IV, Section 1. Each member shall also notify the Fund promptly of any changes in its exchange arrangements.

II. Members shall consult with the Fund regularly under Article IV. In principle, the consultations under Article IV shall comprehend the regular consultations under Articles VIII and XIV, and shall take place annually. They shall include consideration of the observance by members of the principles set forth above as well as of a member's obligations under Article IV, Section 1. Not later than three months after the termination of discussions between the member and the staff, the Executive Board shall reach conclusions and thereby complete the consultation under Article IV.

III. Broad developments in exchange rates will be reviewed periodically by the Executive Board, inter alia in discussions of the international adjustment process within the framework of the World Economic Outlook. The Fund will continue to conduct special consultations in preparing for these discussions.

IV. The Managing Director shall maintain close contact with members in connection with their exchange arrangements and exchange policies, and will be prepared to discuss on the initiative of a member important changes that it contemplates in its exchange arrangements or its exchange rate policies.

V. If, in the interval between Article IV consultations, the Managing Director, taking into account any views that may have been expressed by other members, considers that a member's exchange rate policies may not be in accord with the exchange rate principles, he shall raise the matter informally and confidentially with the member, and shall conclude promptly whether there is a question of the observance of the principles. If he concludes that there is such a question, he shall initiate and conduct on a confidential basis a discussion with the member under Article IV, Section 3(b). As soon as possible after the completion of such a discussion, and in any event not later than four months after its initiation, the Managing Director shall report to the Executive Board on the results of the discussion. If, however, the Managing Director is satisfied that the principles are being observed, he shall informally advise all Executive Directors, and the staff shall report on the discussion in the context of the next Article IV consultation; but the Managing Director shall not place the matter on the agenda of the Executive Board unless the member requests that this procedure be followed.

VI. The Executive Board shall review the general implementation of the Fund's surveillance over members' exchange rate policies at intervals of two years and at such other times as consideration of it is placed on the agenda of the Executive Board.