Esprit de Currency

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The IMF and WTO must pull together to iron out exchange rate policy disputes

THE INTERNATIONAL monetary system and the international trading system are usually considered distinct entities that serve different functions. But exchange rate policy and trade policy are highly interrelated. Tensions between the two have been evident throughout history—such as during the Great Depression and the Bretton Woods era—and may become increasingly apparent in the years to come. The membership of the International Monetary Fund (IMF) and the World Trade Organization (WTO) will have to work together to defuse disputes over exchange rate policy—most notably between the United States and China—that could spill over and adversely affect trade relations.

Depression-era protectionism

The Great Depression of the 1930s is a prime example—albeit rarely so recognized—of how exchange rate policies can create difficulties for trade policy. That decade saw a virulent outbreak of protectionist trade policies that contributed to a collapse of world trade. In fact, higher trade barriers accounted for about half of the 25 percent decline in the volume of global trade between 1929 and 1932 and stunted the growth of trade for the remainder of the decade.

Yet countries varied significantly in the extent to which they increased tariffs and imposed import quotas. A key factor in determining a country's trade policy response was not—perhaps surprisingly—the degree to which it suffered from falling output and rising unemployment, but rather its exchange rate policy under the gold standard (Eichengreen and Irwin, 2010; Irwin, 2012). Under the gold standard, a country's monetary policy was largely determined by the amount of gold reserves held by its central bank. With each country defining the value of its domestic currency in terms of gold, countries that operated on the gold standard also had fixed exchange rates with one another.

In the late 1920s, the United States and France began attracting gold from the rest of the world, but their central banks did not expand their money supplies as they accumulated reserves. This constituted a deflation-

ary shock to the world economy that contributed to the Great Depression. Other countries faced the choice of reducing their gold outflows and addressing their balance of payments difficulties either by changing their exchange rate or by imposing import controls. Depending on their commitment to the gold standard, countries chose either to keep the exchange rate fixed and restrict trade or to let the exchange rate go and keep trade open.

For example, countries such as France that opted to stay on the gold standard adopted many more trade restrictions than did other countries. Furthermore, because central banks in countries with a fixed exchange rate had to focus on maintaining exchange rate parity, they were unable to use monetary policy to reverse deflation and relieve the financial distress of the period—thereby prolonging the Great Depression.

By contrast, countries that abandoned the gold standard and allowed their currencies to depreciate—for example, Sweden—not only were able to avoid much of the damaging protectionism of the period, but also were free to use expansionary monetary policies to help end the Depression.

Wrong lessons

Unfortunately, the architects of the post–World War II international economic order did not always draw the right lessons from this period. Instead of recognizing that flexible exchange rates allowed for an independent monetary response to national economic conditions, most economists and policymakers recoiled at what they perceived to be the currency turmoil of the 1930s. Because countries left the gold standard at different times, the exchange rate changes were large and abrupt, jolting world trade and financial markets. Because fixed exchange rates were considered the norm, these changes came to be labeled "competitive devaluations," implying that they were a beggar-my-neighbor policy used by countries to improve their competitive position at the expense of others.

But to call these changes competitive devaluation misrepresents the historical experience. Countries did not deliberately devalue their currencies in the 1930s to give their exports a competitive advantage. Instead, countries fought the exchange market pressure on their currency by raising interest rates and borrowing emergency reserves from other central banks in a valiant effort to prop up their currency's value. Facing a massive loss of gold reserves, most countries were ultimately forced to allow their currency to fall in value or to impose exchange controls to stop the loss of gold and foreign exchange reserves.

For example, the September 1931 decision by the Bank of England to abandon the gold standard and allow the pound to fall in value was not a step that it deliberately chose to give British exporters an advantage in world trade. Rather, the bank resisted the selling pressure on the pound for many weeks, but eventually decided that it was a losing battle. Officials concluded that the fight to keep the pound at gold parity was no longer worth the loss of additional gold and foreign exchange reserves.

Britain's reluctance to allow its currency to fall in value was shared by other countries too. For all practical purposes, the notion that countries engaged in competitive devaluation during the 1930s is simply erroneous.

Yet the most frequently drawn lesson from the period was that fixed exchange rates were necessary to provide monetary stability and avoid chaotic exchange rate movements. Ragnar Nurkse's influential *International Currency Experience*, published in 1944 by the League of Nations, warned that floating exchange rates would be destabilizing and would seriously disrupt international trade. And John Maynard Keynes was skeptical that exchange rate adjustments could resolve payments imbalances, so he proposed quantitative import restrictions to help do the job.

Postwar policy

These perceptions led government officials at the 1944 Bretton Woods conference to establish a system of "fixed but adjustable" exchange rates so that the turmoil of the 1930s would not be repeated. The Bretton Woods agreement acknowledged that countries might have to change the value of their currency in the face of persistent balance of payments problems, so exchange rates were adjustable in principle. But such changes were discouraged and countries were reluctant to change their parity in practice. The IMF was created to provide countries with short-term financing so that they would not have to resort to disruptive exchange rate changes when they encountered balance of payments difficulties. The IMF's Articles of Agreement required that countries "avoid manipulating exchange rates or the international monetary system to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members."

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At the same time, governments wanted to do away with the protectionist measures that blocked the flow of world trade. To prevent a repeat of the damaging protectionism experienced in the 1930s, the United States led about two dozen other countries in establishing the General Agreement on Tariffs and Trade (GATT) in 1947. The GATT set out rules for conducting trade policy, and the participating countries negotiated the first multilateral reductions in tariff barriers after the war.

Thus, postwar policymakers sought to combine fixed exchange rates with trade liberalization, even though these two policies had conflicted in the past when countries were faced with balance of payments difficulties. This created built-in tension between the international monetary system,

represented by the IMF, and the international trading system, represented by the GATT. By discouraging exchange rate changes, the Bretton Woods system pushed countries toward imposing import restrictions to facilitate balance of payments adjustment. Article XII of the GATT concedes that countries may restrict imports on balance of payments grounds, stating that "any contracting party, in order to safeguard its external financial position and its balance of payments, may restrict the quantity or value of merchandise permitted to be imported. . . . [the] import restrictions instituted, maintained or intensified by a contracting party under this Article shall not exceed those necessary: (i) to forestall the imminent threat of, or to stop, a serious decline in its monetary reserves, or (ii) in the case of a contracting party with very low monetary reserves, to achieve a reasonable rate of increase in its reserves."

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Limits on imports

As these texts suggest, the IMF's desire to limit exchange rate changes trumped the GATT's desire to reduce trade barriers. Consequently, countries were reluctant to change the value of their currency during the 1950s and 1960s and they often turned to import restrictions instead. Between 1955 and 1971, nine advanced economies—including Canada, France, Sweden, and the United Kingdom—used import surcharges to address balance of payments problems in the hope of avoiding exchange rate changes. For example, in October 1964, Britain imposed a 15 percent import surcharge to defend the fixed exchange rate. This was reduced to 10 percent in February 1965 and was finally eliminated in November 1966. By contrast, in August 1971, the United States imposed a 10 percent surcharge on imports—dropped four months later—to force an exchange rate change and address the undervaluation of foreign currencies against the dollar.

Although these measures were temporary, lasting from a few months to several years, the import surcharges had significant effects on trade. They usually consisted of a 5 to 15 percent tariff on selected or dutiable imports. By contrast, under the Kennedy Round of GATT negotiations—the only significant tariff reductions negotiated during the Bretton Woods period (1963–67)—the European Economic Community (predecessor of the European Union) reduced its average tariff on nonagricultural dutiable imports by only about 5 percentage points. Of course, the import surcharges were temporary, whereas the Kennedy Round cuts were permanent, but the surcharges still provoked sharp criticism and were a source of friction among trading partners.

Furthermore, the import surcharges proved ineffective in providing a long-term solution to the underlying balance of payments problem. They usually delayed but almost never averted an eventual devaluation. Examples include the French devaluation in 1958, the British devaluation in 1967, and the French devaluation in 1969. Fortunately, since the policies were substitutes for one another, import surcharges were lifted once the exchange rate changes helped improve the country's balance of payments position.

Trading off

Since 1973, most major currencies have operated largely in a floating exchange rate regime in which the foreign exchange market determines the prices of various currencies. But many developing economies have chosen to maintain fixed or pegged exchange rates. The postwar trade policy experience of developing economies under fixed exchange rates was even more problematic than it had been for advanced economies. Although the goal of fixed rates was to provide monetary discipline and curb inflation, they often did so imperfectly, resulting in an overvalued currency. Developing economies then turned to import controls, such as quantitative restrictions and exchange controls, to compensate for the overvaluation and relieve pressure on the balance of payments (Schatz and Tarr, 2002). Although such controls tended to build up over time and succeed in restricting imports, they almost always failed to prevent an eventual devaluation. The devaluation should have permitted the import controls to be removed, but the controls often remained in place for an extended period because they sheltered some domestic producers who now had a stake in perpetuating them.

In the 1990s, transition economies in eastern Europe faced the same trade-offs between their exchange rate policy and their trade policy. The former communist countries of Bulgaria, the Czech Republic, Hungary, Poland, and Romania aimed to stabilize their nominal exchange rates, but failed to contain domestic inflation or improve their productivity. As a result, their currencies became overvalued. Rather than adjust the nominal exchange rate, these countries resorted to import surcharges and other trade restrictions. These policies disrupted their foreign trade without solving the underlying balance of payments problems that arose because of a misaligned exchange rate (Drabek and Brada, 1998).

Currency wars

Today, with the uneven economic recovery after the global financial crisis of 2008–09, there are fears that "currency manipulation" will lead to "currency wars." The main target of such concerns is China, whose accumulation of more than $3 trillion in foreign exchange reserves has led to charges that it is deliberately undervaluing the renminbi. This has led to pressure in the United States and Europe to impose trade sanctions against China for failing to allow its currency to adjust to market forces. Recent empirical studies suggest that currency undervaluation increases the likelihood of WTO disputes (Copelovitch and Pevehouse, 2011). Indeed, somewhat reminiscent of the 1971 U.S. import surcharge, legislation has been proposed in the U.S.

Congress that would force action against countries that manipulate their exchange rate against the dollar to gain an unfair competitive advantage in trade.

Unfortunately, both the IMF and the WTO (which succeeded the GATT as global trade arbiter in 1995) are ill-equipped to deal with such problems. The GATT text requires that it defer to the advice of the IMF with regard to any issue relating to exchange rate arrangements, foreign exchange reserves, the balance of payments, and the like. In 1977, the IMF membership agreed that "protracted large-scale intervention in one direction in exchange markets" might constitute evidence that a country was manipulating its currency. In the past, IMF surveillance on exchange rate matters has been weak because officials have been reluctant to criticize important member countries' exchange rate policy (Mussa, 2008). The most recent IMF staff report on China (IMF, 2010) notes that the renminbi is "substantially below the level that is consistent with medium-term fundamentals" and that "a stronger renminbi is needed." But even if it were to conclude that a violation of its agreements had occurred, the IMF has no means of enforcing its finding or compelling a country to change its policy.

Left unresolved, these tensions over exchange rate policy could give rise to unilateral action.

By contrast, the WTO has an enforcement mechanism—trade retaliation—that comes out of its dispute settlement system. This has led countries to probe the texts of various WTO agreements in search of support for action against others on the basis of exchange rate disputes. Yet the provisions of these agreements offer little hope to countries seeking to take action against the exchange rate policies of others. Although Article XV of the GATT states that countries "shall not, by exchange action, frustrate the intent of the provisions" of the agreement, that is likely a reference to exchange controls, not exchange rate policy. The WTO's agreement on Subsidies and Countervailing Measures prohibits certain types of export subsidies, but government policies that affect the exchange rate are not actionable under this accord. And the WTO provision against the "nullification and impairment" of the trade-liberalizing intent of the agreement is untested when it comes to a case involving exchange rates, but it also appears to be a slender reed on which to base a legal case.

This weakness in the IMF and WTO provisions regarding exchange rates does not mean that the underlying problem goes away. Rather, it means that disputes over exchange rate policies could fester without resolution at the multilateral level. That in turn increases the likelihood of a buildup of domestic political pressures and unilateral action on trade, outside of the existing institutional architecture, to address the situation. For example, as noted earlier, members of the U.S. Congress have again introduced legislation that would require an emergency tariff surcharge on imports from countries found to have "fundamentally misaligned" currencies. In March of this year, U.S. Treasury Secretary Timothy Geithner warned that "asymmetry in exchange rate policies creates a lot of tension," including "protectionist pressures." While China's currency has appreciated in real terms, due to higher domestic inflation, and its current account surplus has fallen, such political pressures have yet to abate, perhaps because of the lackluster U.S. economic recovery. Yet the United States is not alone; many developing countries share a concern that protectionist pressures can arise because of misaligned fixed exchange rates.

Left unresolved, these tensions over exchange rate policy could give rise to unilateral action. This would not only undermine the credibility of the international institutions that have responsibility in this area, but could lead to damaging retaliation that would be difficult to contain and further harm a weakened world economy. The solution is for the international community, in particular the IMF and the WTO, to work out new rules to help defuse current and future disputes over exchange rate policy and clarify the conditions under which trade sanctions might be considered an appropriate remedy. ■

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