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Getting Surplus Countries to Adjust

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The world has witnessed two distinct attempts to build a multilateral mechanism to discipline surplus countries that declined to adjust their surpluses, and several proposals are currently on the table to do the same. On the two previous occasions the major surplus country of the day defeated attempts to create such a mechanism, and today China (not to mention Japan or Germany) exhibits no enthusiasm for the idea. Despite the importance of the issue, there has been remarkably little discussion of these proposals.

The first occasion arose when the International Monetary Fund (IMF) was being created. During the pre–Bretton Woods negotiations, John Maynard Keynes proposed that countries would finance their payments imbalances by building up and running down bancor balances[1] at the putative IMF and that excessive balances in either direction would be penalized through interest payments. Under this scheme, surplus countries would build up large bancor balances on which they would be charged interest. The major surplus country of the day, which did not expect to lose its position, was the United States. It vetoed the proposal but provided an alternative, the scarce currency clause. In the event, the scarce currency clause proved an ineffective discipline.

The second occasion was during the Committee of Twenty negotiations on reforming the international monetary system, when the United States had already come to think of itself as a chronic deficit country.[2] In 1972 the US delegation led by Paul Volcker proposed that all countries should be assigned a "reserve indicator." If their reserves came to exceed (or fall short of) this indicative level by a specified percentage, they would have an obligation to adjust their surplus (or deficit). One acceptable mechanism of adjustment for a surplus country was currency revaluation, although if a country preferred it could expand demand or stimulate long-term capital outflows or increase aid, but it would have an obligation to adopt effective adjustment actions. Germany was the great surplus country of the day, and together with its European partners, vetoed the Volcker Plan.

The division of the burden of adjustment between surplus and deficit countries is an issue that has been with us for at least 70 years.

A recent policy brief by my colleague Morris Goldstein (2010) proposes to use the IMF as the instrument for disciplining surplus countries. Countries showing large and persistent current account surpluses would have to receive a Fund mission, whose purpose would be to judge whether the country had a misaligned exchange rate. Depending on the size and persistence of any misalignment it diagnosed, the negotiations might remain private or be made public for larger misalignments, or for the gravest failures they might involve trade retaliation authorized through the World Trade Organization (WTO).

1. According to the Keynes Plan, countries would have paid their international debts in a synthetic currency called bancor. They would have received an initial endowment giving them the right to spend a certain (but limited) quantity of bancor.

2. In fact the United States still had a current account surplus at that time, but attention was in those days focused on the official settlements balance, in terms of which the United States did indeed have a deficit.

In a recent working paper, my colleague Arvind Subramanian and his coauthor Aaditya Mattoo (2008) have proposed that countries could bring a case for unfair trade through currency undervaluation to the WTO dispute settlement system. The WTO would seek to establish the facts of the matter from the IMF—whether a currency was being systematically undervalued, thus providing an export subsidy to the country's exporters and import protection to its import-competing industries and whether this was the result of a deliberate government policy. But instead of leaving the IMF to mete out punishments to the offending government (a task for which it has not been equipped by history) as suggested by Goldstein, Mattoo and Subramanian propose that the WTO—which wields effective and graduated responses to malpractice—should prescribe the punishment.

On the two previous occasions the major surplus country of the day defeated attempts to create such a mechanism, and today China (not to mention Japan or Germany) exhibits no enthusiasm for the idea.

In a recent op-ed, another colleague of mine, C. Fred Bergsten (2010), has proposed a mechanism that he argues could be used to discipline surplus countries. Rather than having an international organization prescribe disciplines, he proposes to leave the instrument—counter-intervention in the currency markets—in national hands, but with the right of appeal by the aggrieved party to the IMF. Presumably if one feels that his instrument of counter-intervention is practical one could substitute it for trade retaliation, most obviously in the Goldstein proposal.

Even more recently, US Secretary of the Treasury Timothy Geithner, echoing ideas of the Korean G-20 hosts and endorsed by Yi Gang, a vice governor of the People's Bank of China, has proposed that members of the G-20 should commit themselves to not running current account imbalances in excess of 4 percent of GDP.

Other ways of disciplining surplus countries, by limiting or taxing the assets that surplus countries hold, have recently been advanced by Daniel Gros and Gary Hufbauer. While these were not proposed in the context of a comprehensive plan, they are certainly germane to this discussion. They are therefore also considered.

The primary purpose of this policy brief is to compare and contrast these proposals. In the later parts of this brief I also address the question of how the international community could fashion these ideas into a set of proposals for disciplining surplus countries.

TWO PREVIOUS INITIATIVES

The Keynes Plan

In September 1941 Keynes wrote two memoranda for the UK Treasury on postwar currency policy (reproduced in Moggridge 1980, 21–40). One of these was largely backward-looking, analyzing the behavior of the gold standard over the preceding 500 years. He dismissed the classical theory that the gold standard had maintained equilibrium by adjusting relative price levels and argued that the use of money to effect international exchanges had been a success only in two periods: during silver inflation in the 16th century and when international investment had been centered on London in the late 19th century and up to World War I. The loans made during the latter period had been for productive purposes and therefore created new sources of revenue to service them, while the fact that an increased payments surplus of London led to an increase in foreign investment meant that the burden of initiating adjustment fell on the creditor. The key reason that the system had worked was this transfer of the obligation of initiating adjustment from the debtor to the creditor: During most periods adjustment was viewed as compulsory for the debtor and voluntary for the creditor, with the result that (as in the interwar period that he cited) it had not worked satisfactorily. There is no question that the difficulties of the interwar period had made a deep impression on Keynes: He came to the conclusion that a system in which the surplus countries could sterilize reserve accumulation in unlimited amounts was bound to throw the entire burden of adjustment on deficit countries and therefore make the system suffer from a deflationary bias.

This memorandum may not have been among Keynes's great contributions to economic analysis, but it was important in inspiring one of the truly novel proposals contained in the second memorandum, on his International Clearing Union. This memorandum assumed that the postwar world would remain Schachtian[3] in the sense that the international transactions of each country would be cleared through the central bank but very un-Schachtian in what would happen

3. Hjalmar Schacht was the governor of the Reichsbank, the German central bank, for much of the interwar period, including the Nazi years. He developed an elaborate mechanism of bilateral clearing with other European countries that depended upon all foreign payments to and from those countries being routed through the two central banks responsible.

to the net balances. Rather than a network of bilateral agreements, with pressures on deficit countries to sell more or buy less with that particular bilateral partner and on the surplus countries to sell less or buy more bilaterally, tending to lead to a set of bilaterally balanced (and therefore inefficient) trade positions, Keynes envisaged each central bank settling only its net *multilateral* position in credit with the Clearing Union (as actually happened with the European Payments Union). Each country would be assigned a quota with the Clearing Union (expressed in bancor, a unit of account) equal to half the value of its average total visible trade for the last five prewar years. It could borrow a sum equal to its quota by running multilateral deficits or could build up its bancor balance by running multilateral surpluses. But if it departed too far from the bancor balance originally assigned, it would become subject to adjustment pressures.

Specifically, a country whose bancor balance fell by 25 percent would be entitled to depreciate by 5 percent; one whose balance fell by an average of over 50 percent could be obliged to depreciate 5 percent (or to sell the Clearing Union gold and/or to prohibit capital exports). Conversely, a country whose bancor balance increased by 25 percent would be entitled to revalue by 5 percent, and if its bancor balance averaged over 150 percent of quota it could be obliged to revalue by 5 percent (or obliged to release any frozen foreign-owned balances). Countries would pay interest on both borrowings from the Clearing Union and excessive holdings of bancor; specifically, a surplus country would be charged 5 percent interest on the excess over 125 percent of quota and 10 percent on the excess over 150 percent. Any balance in excess of 200 percent would be liable to forfeiture.

Three forms of pressure were therefore to have been exerted on surplus countries.[4] They would have been subject to *payment* (rather than receipt) of interest, if their cumulative surplus got large. If it got very large, they would essentially face seizure and get *no* benefit from the additional exports. And they would have had to adopt adjustment policies that would have been decided for them by a third party. History has tended to regard the first of these pressures, through interest payments, as the decisive one. In fact the other two appear much more onerous, if and when they were in fact brought to bear, but they would have kicked in only if the country made an error or chose to defy the international community, whereas the first was expected to be regularly levied.

The ability to exert pressure for adjustment on surplus countries was an important issue for Britain, which was at that time dominated by Keynesian fears of permanent deflationary pressures emanating from the United States. However, much of the Keynes Plan was regarded as quite unacceptable in Washington: It proposed creating a new international money, it gave no special role to the dollar despite the fact that the dollar was already the world's dominant currency, and it created what Washington envisaged would be an inflationary amount of international liquidity. In a December 1942 revision, the Americans offered to graft onto their alternative plan (the White Plan, which was quite similar to that ultimately adopted) a scarce currency clause intended to deal with the British concern with the absence of pressures on surplus countries. This clause allowed the Fund to declare a currency scarce if an excess demand for it was manifest in the Fund exhausting its supplies, whereupon debtor countries would be entitled to discriminate against payments to the country whose currency had been declared scarce (assumed to be the United States). Since the Fund never exhausted its supplies of dollars or other currencies and alternative means of providing currencies to the Fund were in due course invented (notably through the General Arrangements to Borrow), the scarce currency clause has never been invoked.

The Committee of Twenty

The Committee of Twenty was intended to reform the world monetary system following the demise of the Bretton Woods arrangements in August 1971. It consisted of the finance ministers of the 20 countries then represented on the IMF's Executive Board, but most of the work was done by meetings of their deputies (ministry of finance officials and central bankers). The committee and its deputies met from late 1972 to mid-1974, by which time it had long been apparent that the negotiations were deadlocked. The 1973 oil crisis provided an excuse to declare that it would be necessary to live temporarily with an unreformed system incorporating the big change that had happened against most official wishes—floating exchange rates. The world has lived, if not always happily, with this "system" ever since.

The US proposals for reform of the international monetary system were first presented at the 1972 IMF/World Bank Annual Meetings by Secretary of the Treasury George Shultz, further elaborated by the US deputy, Paul Volcker, at the deputies meeting in November 1972, and a few months later published in the Report of the Council of Economic Advisors. The three basic proposals, of which the first two were heavily interdependent, were reserve indicators, convertibility of the dollar into primary reserve assets, and multicurrency intervention. The proposal of multicurrency intervention was intended to provide for a measure of symmetry, while that of convert-

4. The first and third pressures would have been imposed symmetrically for deficit countries.

ibility was intended to assuage European sensibilities, but the United States emphasized that these could be honored only if there was assurance that other countries would not make excessive demands.

It envisaged the reserve indicator proposal as inter alia providing that necessary reassurance. Each country was to have a reserve indicator, with a norm. Just how this was to be selected was not specified as part of the plan; possibilities outlined were in proportion to IMF quotas and based on past reserve levels, but it was important to the proposal that the sum of those norms should roughly equal the level of reserves in existence. The reserve norms would be surrounded by two warning points and, further removed, by an "outer point" and a "low point."

If a country's reserves moved beyond the warning points there would be a strong presumption that the country should adjust, although the means to be used were left to the discretion of the individual country involved. But if reserves moved toward either the outer point or the low point, the country would be expected to apply measures of "progressive intensity." If reserves actually hit either of these points, the country would become subject to "pressures" if a program of adjustment deemed adequate by the Fund were not in place. Which measures were to constitute the pressures were not spelled out, but possible pressures on surplus countries that were mentioned by the United States were the loss of scheduled allocations of special drawing rights (SDRs), an authorization to impose import surcharges on the offending country's exports, and (again) a tax on excess reserves.

The pressures on surplus countries were not as explicitly defined as in the Keynes Plan, presumably because this was intended to be a negotiating position and the United States would accommodate its partners by giving substance to the ideas in the way that they found most congenial. In practice, negotiations never got to the point where partner countries were required to define their preferences. The principles that the United States sought to establish were nonetheless clear.

CURRENT PROPOSALS

The Goldstein Proposal

Unlike both of the previous occasions, most of the current proposals for disciplining surplus countries were launched in nonofficial papers. In one of these, my colleague Morris Goldstein (2010, 5) proposes that any country that runs a current account surplus greater than (say) 4 percent of GDP over a one-year period should automatically receive an ad hoc consultation by the Fund (meaning the staff) to discuss its exchange rate policy. The Fund (meaning its Executive Board) would summarize its views at the end of the process by issuing a verdict, or ruling, as to whether the member in question is fulfilling its international obligations on exchange rate policy. He writes that in broad terms "the test should be whether the country's real effective exchange rate is seriously misaligned, whether the country's policies—intentionally or not—contribute materially to that misalignment, and whether the misalignment harms significantly the country's trading partners." In some cases the Fund would presumably find that a country either needs no action (perhaps because the imbalance is expected to disappear) or is reacting appropriately, and if the judgment is wrong the Fund would have to wait only 12 months before sending another mission. But in other cases the Executive Board would need to indicate that the country is violating its membership obligations and that it must eliminate its noncompliance in a timely way. Failing such timely elimination of noncompliance, the Board would have to impose penalties.

Morris Goldstein proposes that any country that runs a current account surplus greater than (say) 4 percent of GDP over a one-year period should automatically receive an ad hoc consultation by the Fund to discuss its exchange rate policy.

Penalties should be graduated to the size of the failing. For misalignments of under 10 percent and up to a year's duration, Goldstein envisages only intensive (but private) consultations with the Fund. For misalignments of 10 to 25 percent and a duration of one to two years, the Fund should go public and ask for a specific plan (and the country would not be able to veto publication of the report). For countries with even larger misalignments that refuse to commit credibly to a proposed plan of action to improve the situation, he proposes that the WTO approve trade policy retaliation. In addition, countries in this category should temporarily forfeit their eligibility for new SDR allocations and increases in Fund quotas. There is no discussion of the necessary WTO procedures, such as whether they should be automatic or follow some agreed process.

Note that Goldstein suggests that discussions should focus on the appropriateness of the level of the exchange rate. This leaves unaddressed an important subject that has recently arisen in the European Union, which is whether a creditor country has a responsibility to adjust to other members within a fixed exchange rate area.

The Mattoo-Subramanian Proposal

Mattoo and Subramanian (2008) propose to enlarge the Doha Round negotiations on the future of the WTO in two directions: (1) employ the WTO dispute settlement system to impose penalties when an exchange rate is undervalued and (2) give the WTO jurisdiction over sovereign wealth funds. The former aspect is the one of importance in the present context, but it is important to be clear that Mattoo and Subramanian do not imagine that China would be willing to submit to WTO jurisdiction over its exchange rate policy as a matter of goodwill; they propose a bargain in which China gains an assurance of continued access for its foreign investments (plus market economy status in the United States[5]) in return. Whether it would be judged a bargain of sufficient weight to induce Chinese acceptance of an international obligation to adjust is another question.

In principle the WTO already has jurisdiction over undervalued exchange rates because they act in the same way as a combined export subsidy and import tariff, and Article XV(4) states that "Contracting Parties shall not, by exchange action, frustrate the intent of the provisions of [the WTO] Agreement…." But Mattoo and Subramanian argue that "this is too vague an obligation to provide a basis for effective enforcement" and that "there is no jurisprudence on this provision of the GATT, and it is highly unlikely that WTO dispute settlement panels would be willing to rule against undervalued exchange rates on this tenuous basis" (Mattoo and Subramanian 2008, 6). Similarly, Hufbauer, Wong, and Sheth (2006) examine the probability of the WTO demanding a Chinese revaluation under either Article XV (4) or the Code on Subsidies and Countervailing Measures and conclude that no case on the matter would be likely to succeed on the basis of present obligations.

A decision to start using this power would therefore amount to a policy change that would require further negotiation, even if it did not lead to a formal change in the rules (requiring amendment of the WTO's charter with attendant complications). The proposal of Mattoo and Subramanian is that a country that felt threatened by another country's exchange rate policy could refer its complaint to the WTO. The WTO could then ask the IMF[6] for expert advice on the facts of the situation, just as for many years the GATT asked the Fund for advice on whether a developing country had a balance of payments deficit that might justify the imposition of import restrictions. Specifically, the WTO should ask the IMF two questions: (1) whether an exchange rate is substantially undervalued, and, if so (2) whether the undervaluation is demonstrably attributable to government action. An ability to answer the first question clearly depends upon the ability to declare an exchange rate misaligned with a high measure of confidence. Mattoo and Subramanian remark that this is "probably not [possible], but that could be a strength rather than a weakness because the WTO would regulate only egregious cases of misalignment—where the technical determination is relatively robust and criticism-proof."

Aaditya Mattoo and Arvind Subramanian have proposed that countries could bring a case for unfair trade through currency undervaluation to the WTO dispute settlement system.

Personally I think it absurd to doubt that the world can recognize misalignments of 15 or 20 percent[7] (and there are examples where misalignments have been even larger), but one needs to recognize that there are economists who have asserted that such recognition is impossible, and it will be necessary to confront their testimony in making the case for this proposal.

The other factual question on which the IMF would be asked to rule is whether an undervaluation is due to deliberate government policy. Here again situations can be as clear as daylight, when governments (or central banks or other quasi-government agencies) engage in prolonged one-way intervention in foreign exchange markets or deliberately peg their currencies to those of other countries, and more ambiguous cases in which undervaluation is caused by fiscal, monetary, or trade policies and there is no large, continuous reserve acquisition or official peg. Only where it is concluded from the evidence that the central policy objective is the external one is it envisaged that the WTO should be called on to pressure a country by imposing sanctions through the dispute settlement provisions.

If the WTO found that a member country was guilty of maintaining an undervalued exchange rate, the member(s) who brought the action would gain the right to compensation or, failing that, to impose sanctions on the exports of the country with the undervalued exchange rate. The size of the sanctions would be determined by the WTO. The proposal implicitly assumes that the imposition of a surcharge on

5. This would render it less vulnerable to discretionary antidumping and countervailing trade-restrictive action.

6. Much hangs on exactly what part of the IMF would provide this advice: staff, or staff plus management, or whether an answer has to be approved by the Executive Board, with the danger of political paralysis this implies. The precedent of IMF expert advice on whether a developing country had a payments deficit suggests that the IMF staff, overseen by management, would generally write the opinion but that it would require formal approval by the Executive Board, which has normally in the past been granted on a lapse of time basis.

7. See, for example, Cline and Williamson (2010).

imports from the offending country would be limited to the countries bringing the action, but there would be advantages in requiring all WTO members to impose such sanctions from the standpoints of increasing the potency of the threat and avoiding diversion of trade to third countries. However, imposing such an obligation would break entirely new ground for the WTO and would therefore involve even greater difficulty in obtaining the assent of members.

The Bergsten Proposal: Counter-Intervention

C. Fred Bergsten (2010) has recently proposed that a reserve currency country should be able to engage in counter-intervention to push up the value of a currency that is being deliberately held down to an undervalued rate through intervention. If the counter-intervention was equal to that of the intervention that induced it, the presumption is that the exchange rate would be unchanged; correction of the rate would require larger intervention (or a policy change in the country with the undervalued currency). Thus correction of the rate by the reserve currency country would face the issues of deciding upon the scale of the intervention or the target rate toward which it was aiming. The immediate motivation is clearly to enable the United States to retaliate against China, but this faces an additional difficulty in that the renminbi is not a convertible currency and therefore the United States would not be able to invest any renminbi it acquired.

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Bergsten suggests that a way of overcoming this difficulty would be to purchase proxies like "nondeliverable forward renminbi contracts and renminbi-denominated debt instruments in Hong Kong," though this would limit the potential scope of the counter-intervention to well below the size of Chinese intervention. It would also mean that China would retain in its hands the ability to inflict capital losses upon the United States, since these would be determined by a comparison of actual renminbi rates on the maturity date with the rates prevailing when the securities were purchased. It is, furthermore, not obvious that this would put pressure on China.

There are at least two versions of the proposal presented in Bergsten's op-ed. In the first, a reserve currency country takes the initiative but can be challenged in the IMF; if the IMF takes the side of the surplus country, the reserve currency country has to back off. In the second version, the IMF authorizes a reserve currency country to act. The first version will be discussed in what follows.

The Bergsten proposal seems to assume that the rest of the international community would be happy to go along with giving a special position to the United States.

The Geithner Proposal: Current Account Targets

The proposal that is here attributed to US Secretary of the Treasury Timothy Geithner in fact has a prehistory. As hosts of the then-impending Seoul summit of the G-20, Korean officials had been quietly urging a commitment of the G-20 countries to limit their payments imbalances to a maximum of 4 percent of GDP, a formula that according to one account had been suggested by China. The suggestion was endorsed by Yi Gang (2010), a vice governor of the People's Bank of China and head of the State Administration of Foreign Exchange, in a speech to a seminar at the 2010 IMF/World Bank Annual Meetings in Washington. Hence when Secretary Geithner proposed at the Gyeongju meeting of the G-20 Finance Ministers that each of the G-20 countries should aim at limiting the size of its imbalance below 4 percent of GDP, he appeared to be pushing on an open door (though objections, especially by Germany, subsequently surfaced). He acknowledged that there would need to be exceptions for countries exporting natural resources but urged the others to agree that they would pursue structural, fiscal, and exchange rate policies consistent with a maximum imbalance of 4 percent of GDP. This was presented as an alternative to exchange rate targeting, but that can be questioned.

According to most macroeconomic models, including those that I have used in estimating "fundamental equilibrium exchange rates," achievement of a given target for the current account implies, for a given pressure of demand, a particular exchange rate. Presumably this exchange rate would alter with a sufficiently large change in the structural conditions in the economy, but this merely means that one needs to take the likely structural conditions into account when estimating the exchange rate target. But if it were easier to agree on current account targets than on exchange rate targets, such a change in presentation might be useful. The more fundamental problem

Timothy Geithner has proposed that members of the G-20 should commit to not running current account imbalances in excess of 4 percent of GDP.

is that a current account of a nation includes imbalances with other members of a currency union, which a nation would therefore be called on to curb but without having an exchange rate instrument able to assist in this objective.

Introducing a Reciprocity Requirement: Gros

Daniel Gros (2010) has proposed that the main Western countries invoke the principle of reciprocity and declare that they will henceforth sell public debt only to official institutions from countries in which they have a reciprocal right to purchase public debt. He argues that this would be legal under the IMF Articles because these require only current account convertibility, and not freedom of capital movements. One could imagine that the United States and the European Union might nonetheless be unwilling to initiate a step that could be seen as a reversion toward capital controls, but it would be unfortunate if they were on those grounds to dismiss a potentially promising initiative.

But this proposal does, of course, involve a species of capital controls, and one knows that capital controls are leaky. The first thing is therefore to examine whether the leaks would be likely to jeopardize achieving the objective. Gros argues that this is unlikely since it would require one or more financial institutions to become an intermediary for the Chinese and lie to the US authorities that the beneficial owner of the assets being invested was not from a country in which foreigners cannot buy and hold public debt instruments. It is one thing to agree that it would be unlikely that the Chinese would be able to continue large-scale investments in public debt, but there is also much private debt in the United States. Indeed, Gros himself argues subsequently the potential benefits to the United States of a large move by the Chinese authorities to dump Treasury bills in favor of either US bank deposits or other private US assets.[8] One cannot simultaneously argue that the Chinese would be unable to continue financing a large imbalance by buying private US assets and that it would be good news for the United States if the Chinese dumped Treasury bills in favor of US private assets.

I find Gros's second argument the more persuasive, and accordingly I assume that the Chinese could continue to finance their imbalance by buying private US assets. An effective sanction would have to involve also a prohibition on buying private US assets on a nonreciprocal basis, and the policing of that would be several orders of magnitude more difficult than anything Gros envisaged.

Taxing Asset Accumulation: Hufbauer

Gary Hufbauer (2010) proposes the use of taxation to penalize Chinese accumulation of dollars. He envisages the United States giving notice that it would terminate the US-China Tax Treaty, and then following this up by Congress allowing the Treasury secretary to impose a 30 percent withholding tax on the income accruing to a foreign government that maintains a seriously undervalued currency.

Some of the difficulties with the proposal should be noted. First, at present interest rates are near zero, and 30 percent of near zero is even closer to zero, and therefore not much of a disincentive. Second, the Treasury secretary is called on to impose this disincentive only on the Chinese government, which he would therefore have to name, in a process that one could assume would have the same overtones, only more so, as the current drama in which he has never to this day named the Chinese government as a manipulator. Third, decisions are envisaged as being made by the US government rather than by an international process. Fourth, and arising directly from the foregoing, unless it were on an international scale involving all the potential reserve currencies it would give a big incentive to the emergence of multiple reserve currencies. Fifth, it would involve a change in the US policy of allowing without question untaxed foreign holdings of US government securities[9] and might therefore undermine foreign will to hold dollars. There has to be a question as to whether the United States would be prepared to risk the reserve currency role of the dollar.

COMPARISON OF THE PROPOSALS

Central ideas of both of the two previous attempts to discipline surplus countries envisaged the possibility of charging interest payments on excessively large accumulations of international reserves, along with the ability of the international community to insist on a change in the exchange rate. The Keynes plan envisaged penalizing a country for accumulating excessive bancor balances. A country running a surplus would have had to convert it into bancor and thus make itself potentially subject to the discipline. A central measure envisaged in the

8. Gros assumes that the existing stock of Treasury securities held by China would be grandfathered.

9. Except by countries like Iran, which are declared the target of sanctions.

US Indicators' Proposals (the Volcker Plan) was also payment of interest on the holding of excessive reserves. In this case the reserves would have been compared to an indicator level; a leading candidate for assigning indicators would have been IMF quotas, so at this level the proposal could easily have been very similar to the Keynes Plan. (However, as earlier noted, the Keynes Plan did assume that every country had centralized payments through the central bank, which is very different from the system that has evolved in the postwar decades.)

The idea of fining countries for defying international norms of behavior has never been applied in practice in the monetary realm, although the initial version of the Stability and Growth Pact (before it was gutted for reasons of national expediency by France and Germany) provided for such penalties. The practice has, however, been implemented in the trade field. For example, the United States is currently paying Brazil to avoid retaliation in the cotton case that it has lost in the WTO. There is no apparent reason why similar disciplines should not be applied for inappropriate adjustment policies.

Both Goldstein and Mattoo-Subramanian propose a graduated system of penalties for undervaluation....

The basic difference between the two older approaches and those currently on the table lie in using reserve accumulation as a measure of the need for adjustment: Both the Keynes Plan and the Volcker Plan proposed that countries accumulating excessive reserves should be subject to international pressures. This possibility is not mentioned in any of the current proposals. The Goldstein proposal envisages that the initiating variable should be a current account surplus, which is a joint outcome of the exchange rate and the levels of demand, but the judgment concerns the appropriateness of the exchange rate. Both the Mattoo-Subramanian and the Bergsten proposals judge countries directly on an inappropriate level of the exchange rate, rather than on its outcome or its integral.[10] The technical difficulties reside in the need to reach a decision on whether an exchange rate can be called misaligned. The Geithner proposal was widely welcomed for apparently avoiding an exchange rate judgment, but as already argued this was more apparent than real.

In fact there is a far more fundamental difficulty as well. Members of a currency union do not have an exchange rate between them that can be varied in order to effect adjustment, and yet—unless one believes that Germany has no responsibilities vis-à-vis the Greeces of this world—one needs to identify adjustment obligations in such cases too.

The fundamental point is that basing adjustment obligations on the stock of reserves requires that a surplus result in the accumulation of a well-defined reserve stock. If, for example, a mere accounting change could result in reserves being labeled something else and thus escaping the charge, the discipline would be ineffective. To take an obvious current example, the discipline would be ineffective if a surplus country was entitled to shunt its holdings of reserves into a sovereign wealth fund and in that way escape the charge. But presumably one would not want to prohibit countries from exchanging assets in the ground for paper portfolios (on the model of Norway), so one couldn't simply prohibit sovereign wealth funds. Indeed, unless one wants to prohibit capital movements, one would presumably wish to exempt current account surpluses (deficits) that were matched by capital outflows (inflows), at least if these promise to be a reasonably dependable source of capital. The problem, which was already recognized in the Volcker Plan, then becomes one of establishing which capital flows are acceptable as forms of adjustment, since it would seem utterly perverse to include speculative flows that may be reversed in short order as consistent with balance. Two conceivable ways of making a distinction would be on the basis of sector ownership or maturity: to accept private-sector capital outflows as constituting adjustment or to accept long/medium-term outflows as implying adjustment.[11] The former seems unlikely to be acceptable to many countries in an era when public-sector ownership has found new favor, and the latter bristles with problems. Some of the most stable capital flows have in practice been the build-up of short-term assets, while long-term assets are not necessarily held for a long time. Certainly they would not all be held for the long term if one created an incentive to avoid short-term assets.

The Gros proposal is immune to this difficulty, because the Chinese government also owns the Chinese sovereign wealth fund. Similarly the Hufbauer proposal envisages imposing additional taxes on all assets owned by the Chinese government.

What of the feasibility of the alternative of judging the appropriate level of the exchange rate, as envisaged in both the Goldstein and Mattoo-Subramanian proposals? As it happens I am in the business of producing estimates of equilibrium exchange rates (Cline and Williamson 2010), so I am hardly in a position to argue that this is impossible. But I do not doubt for a moment that there will be economists who argue that this is a misplaced endeavor. However, recall that Mattoo

10. That is, the accumulation through time of the high reserve levels that result, ceteris paribus, from a continuing balance of payments surplus.

11. This was the basis of the old liquidity concept of the balance of payments once used by the United States.

and Subramanian acknowledged the uncertainty in the enterprise and argued that it was only in the case of pretty large misalignments that the WTO would be expected to ask the IMF whether a misalignment exists and that in such cases the determination is relatively robust and criticism-proof. Of course, no approach based on estimating equilibrium exchange rates can be applied within a monetary union.

Both Goldstein and Mattoo-Subramanian propose a graduated system of penalties for undervaluation, thus avoiding the classic problem that the Fund has historically had no way of enforcing the conclusions of its surveillance between remonstration and expulsion. Both envisage that in severe cases the WTO should be asked to authorize the use of trade retaliation as an enforcement device. They differ, however, in their suggestion of who should hold the responsibility. Goldstein proposes to rely on the IMF to initiate a surveillance mission, and to make the substantive decisions, merely using the WTO to do its bidding when the need for enforcement arises. Mattoo and Subramanian propose, in contrast, to base the determination in the WTO, using the traditional mechanism of country complaints to initiate the action and confining the questions addressed to the Fund to specific issues where expertise on exchange rate issues is required, and using the existing dispute settlement mechanism as the disciplining device. Bergsten envisages that the individual reserve currency country would initiate counter-intervention, although the Fund would be able to countermand this decision if it concluded that the facts did not justify it.

The Mattoo-Subramanian proposal contrasts the ability of countries to take the initiative in the WTO with the practice of relying on the management and staff in the case of the IMF.

If one is choosing between these proposals, one needs to judge how suitable the IMF and WTO are for the roles assigned to them. In the IMF there is no tradition of enforcement, which is reflected in the fact that the Fund lacks any mechanism to enforce its views on the surplus countries it has surveilled between expressing its opinion on the one hand and expelling them on the other. (This problem has been discussed by Truman 2009, but his solution of a more robust peer review process to provide the needed discipline is dependent on more internalization of external consequences by all member countries than some of us consider likely.) Countries can, and frequently do, ignore the views that are expressed. Goldstein is acutely aware of this and therefore sees a need to be able to authorize more robust action; hence he proposes to have the Fund get the WTO to authorize the use of trade retaliation, but the question then arises of whether the WTO would automatically have to approve a Fund request. It hardly seems likely to act that way, but Goldstein does not discuss what would be involved in getting a Fund request approved or how the IMF is supposed to react if its request for WTO action is refused.

In contrast, the Mattoo-Subramanian proposal is much more complete. They contrast the ability of countries to take the initiative in the WTO with the practice of relying on the management and staff in the case of the IMF. The latter are likely to be especially reluctant to challenge the policies of members while they are endeavoring to change the Fund's reputation for being hard-nosed. (Even so, they are likely to be more willing to challenge individual countries than the gentlemanly Executive Board.) Mattoo and Subramanian contrast the legitimacy of the IMF, which has been eroded by the reluctance of the European countries to cede power as emerging markets grow, with the fact that in the WTO power grows organically as nations' trade increases.

They give examples of the sorts of questions that the WTO could have posed to the IMF in the case of China, and which would have required factual answers from the Fund:

- What are the estimates of undervaluation suggested by the CGER[12] models?
- What is the preponderance of evidence from studies on China's exchange rate misalignment?
- Is the level of the exchange rate being maintained by intervention by the government or the central bank?

The WTO would then be in a position to declare whether a currency was undervalued as a result of deliberate government policy, and the consequences of a finding of undervaluation would follow well-established precedents.

The Bergsten proposal envisages overcoming the problem of lack of an enforcement capacity in the IMF by having one or more of its members employ an enforcement mechanism (subject to a right of appeal). A critical issue concerns the feasibility of the proposed enforcement mechanism. There are two distinct issues here: whether the proposed enforcement mechanism is feasible (1) against countries with nonconvertible currencies and (2) against those with convertible curren-

12. CGER stands for Consultative Group on Exchange Rates, which is the group of staff members that the Fund has established to make estimates of equilibrium exchange rates.

cies. Consider first the feasibility of action against a country like China with a nonconvertible currency. If the United States purchased sufficient nondeliverable forward contracts, the effect (assuming that China maintained unchanged its pegging policy, or appreciated by less than implicit in the forward contract) would be that when the contracts expired the United States would lose money on them. This hardly seems likely to exert pressure on China to alter its policy. To the extent that the United States purchased renminbi-denominated assets in Hong Kong, the effect would be to push up the price of those assets and reduce their rate of return, but it is not apparent how this would impact the exchange market or therefore the renminbi exchange rate. To do that, one would have to offer to buy renminbi at a higher price than was being offered by the Chinese authorities. (Having got the renminbi, there would be no opportunity of investing them.) The people selling renminbi are the Chinese importers, who could presumably be induced by the Chinese government to refuse this offer. (If not, there would be an opportunity of unlimited profitable arbitrage by the private sector.) In short, I do not see how effective pressure could be brought to bear on a country with an inconvertible currency.

Consider next whether counter-intervention offers an effective pressure against countries with convertible currencies. In this case the country authorized to take action (say, the United States) against the country believed to have an undervalued currency would offer to buy that country's currency at the same rate and in the same amount that the country was selling its currency in exchange for dollars. This would make it impossible for the country with the undervalued currency to manage its own exchange rate, which is the object of the exercise. If this led to a revaluation of the undervalued country's currency, the US Treasury would stand to make a profit. The conclusion is therefore that this would provide a potent tool in the case of a convertible currency.

But that provides the clue as to why this instrument has not been used in the past. It would give the United States the ability to undo the effect of intervention by countries that the United States judged to be undervalued, which would compel those countries to either revalue to a satisfactory rate or to float (provided that it could persuade the IMF). One unwelcome byproduct would be a big new incentive to avoid making currencies convertible. More fundamentally, the Bretton Woods system, and its successor, rest on an implicit bargain between the center country and the rest: The center country agreed to forgo the use of exchange rate policy, in return for use of the center country's currency as the principal reserve asset. (That solved the famous n – 1 problem.) One may take the view that this was a bad bargain for the United States or that there were limits beyond which the United States could not be expected to—and has not—lived with other countries' exchange rate preferences, but it is unlikely that the rest of the world would agree that henceforth the United States will gain the power to insist that other countries revalue or float, even subject to an IMF vote, without a fundamental reconstruction of the international monetary system.

The Geithner proposal was intended for naming and shaming, but it is not well adapted for judging the consistency of present policies. In particular, the focus on the current account outcome means that it would be too long-lagged to be a useful device for securing ex ante consistency. An exchange rate is continuously available, and a current change will have an influence in the future. So if one is concerned with evaluating how countries behaved over some past period, a current account objective provides a good test; but if one wants to test whether current policies are appropriately adapted to securing a particular future outcome, then a current account target provides infinite opportunities for obfuscation. It is always possible to plead that there are special circumstances or that the future is (as it usually is) unusually uncertain. One can welcome the Geithner proposal without thereby believing that it offers an alternative solution to this particular problem.

SYNTHESIS: COMBINING THE GOLDSTEIN AND MATTOO-SUBRAMANIAN PROPOSALS

I have argued that both of the two older proposals assumed a role for reserves that they no longer have and are unlikely to regain. The Bergsten proposal seems to me to assume that the rest of the international community would be happy to go along with giving a special position to the United States. I have just argued that the Geithner proposal is not adapted to this particular role. The Gros proposal would be ineffective because it ignores the possibility of China holding private assets. I in fact think it likely that some version of the Hufbauer proposal will ultimately be implemented by the United States, if China maintains its current policy, but I take it that an ideal policy would work through an international mechanism rather than reliance on national action. That leaves two of the proposals for consideration.

The first point is that it is not clear that the Goldstein and Mattoo-Subramanian proposals have to be considered as alternatives. Why not require that the Fund examine the policies of any country with a surplus above a certain level (presumably relative to GDP) and also allow any member to initiate action in the WTO? The worst that could happen is that resources were wasted on conducting two studies when one would have done (and anyway much of both studies would be done by the same people). In practice one would expect that countries with independent currencies would normally be the subject of a WTO procedure, at least where the spillover effects are strong, but there would still be a mechanism for examining the surpluses of members of monetary unions and there would be a forum to propose the adoption of measures designed to correct their disequilibria. Basing such studies in the IMF might seem objectionable to the members of monetary unions, but one should not object to the alternative of the monetary union itself taking this responsibility, provided that it does not dismiss it as a nonproblem. If a monetary union agrees to do this, the IMF should simply hear charges that the surplus of the monetary area, rather than of the individual countries that comprise it, is excessively large.

Whether the work is undertaken by the IMF or within the monetary union, the charge that a surplus is possible only because of excessive deficits elsewhere in the monetary union cannot be answered by an appraisal of the exchange rate. This would make no sense for a member of a monetary union; for example, it would be quite inappropriate to vary the euro exchange rate to achieve German (or Greek) ends (quite apart from any difficulty there may be in persuading floating exchange rates to float to levels that might achieve policymakers' ends). Insofar as exchange rates are controllable by policymakers, these should look at the collective needs of the monetary area, not those of a particular country.

Policy therefore has to be focused on the level of internal demand, since there is no exchange rate instrument. The question is whether the monetary union has an appropriate level of demand to be consistent with aggregate supply arising from the sum of the supply potential of individual members, any acceptable payments imbalance for the monetary union as a whole, and the continued solvency of all members of the monetary union. It is fine for Germany to program demand to be less than supply if other members of the monetary union are in a position to finance offsetting deficits, or if the monetary union as a whole is generating a surplus that is acceptable to the rest of the world. But if neither is true then Germany's surplus can only be labeled excessive. The logical corollary of a finding of an excessive surplus by a member of a monetary union is a recommendation to increase the level of internal demand *of that country*, rather than a revaluation of the *common* currency. Unlike in a separate monetary area, where increased demand can be offset by appreciation, demand has to be increased even if the likely result is internal inflation. That is the logic of having entered a monetary union (and the rationale for following the principle, adopted in name in Europe although not always practiced, of refusing membership to countries that would require their partners to inflate in order to achieve reasonable external balance). Once countries have entered a monetary union, they have to be willing to subject their internal price levels to the requirements of reasonable external balance, in the way that Germany deflated (too much in retrospect) when it judged its initial euro exchange rate a little overvalued. Conversely, the IMF (or more likely the European Central Bank [ECB]) will have to take on the unfamiliar task of telling certain members—though not the whole monetary union—that they need to be prepared to accept more inflation.

For the vast majority of countries that are not members of currency unions, action could be initiated either by the IMF or by the WTO. In both cases the analysis would focus on the appropriateness of the exchange rate[13] and would therefore be essentially similar. In the case where action is initiated by a country in the WTO, it would be necessary to spell out what is meant by "the IMF." Specifically, if a series of technical questions were posed by the WTO to "the IMF," it would be important that these be answered apolitically, i.e., by the management and staff rather than requiring the endorsement of an Executive Board that remains responsible to national governments. The policy change would require endorsement by the Board, but that is a quite different matter to requiring the Board to hold itself responsible for approving every answer. In contrast, one could hardly imagine the Executive Board surrendering its power if, as in the Goldstein Plan, there were no alternative place where political power could be exercised (like in the WTO).

If the Mattoo-Subramanian proposal is to be implemented, it will probably also require the threat of imposition of additional taxes on Chinese foreign earnings to persuade China to agree to such a proposal.

However, agreeing to institute the Mattoo-Subramanian proposal does depend upon a political willingness to implement the scheme, and one of the parties whose agreement is required is (in practice, if not in theory) the Chinese government. It has to be recognized that, despite the incentives to buy into this scheme, it is possible that China will remain resistant. In that case one has to ask whether there are available incentives to alter

13. This is not to deny that current accounts are also influenced by savings and investment or indeed that ex post the current account is identically equal to the difference between them. But given a figure for the level of income (determined by inflation targeting or a notion of full employment or a Taylor Rule), there is a 1:1 correspondence between the steady-state exchange rate and the current account balance, as originally shown by Meade (1951). The practice of observing that the current account balance is equal to S – I and then believing that one has shown the irrelevance of the exchange rate is a demonstration of economic illiteracy.

Chinese policies that do not depend upon the acquiescence of the Chinese government, which leads one to think of the Hufbauer suggestion: China would not be able to evade the imposition of additional taxation. If the Mattoo-Subramanian proposal is to be implemented, it will probably also require the threat of imposition of additional taxes on Chinese foreign earnings to persuade China to agree to such a proposal.

CONCLUDING REMARKS

It has been argued that both of the past two proposals to hold surplus countries responsible for initiating adjustment suffer from the same problem: the impossibility of devising a suitable test of whether a country needs to adjust on the basis of its reserve holdings in the contemporary world. In many ways the Mattoo-Subramanian proposal represents an attractive alternative: It focuses attention on the exchange rate rather than reserve holdings, it seeks to use the IMF in an area where it undoubtedly has expertise, but it also seeks to exploit the greatest success in international cooperation in recent years, namely the dispute settlement mechanism of the WTO.

This proposal suffers from two limitations, however: It requires agreement by the Chinese government, and it is unable to address the problem created when a member of a monetary union runs an excessive surplus. It is argued that the best chance of addressing the first limitation is by adding a threat of additional taxation of Chinese government-held securities unless China were to agree to the Mattoo-Subramanian proposal (in addition to the incentives they propose, WTO guarantees that their sovereign wealth fund would have right of investment plus US recognition of market economy status for China). The second could be addressed by running the Goldstein proposal (perhaps operated by the ECB rather than the IMF) in parallel to the Mattoo-Subramanian proposal. This could enable the international community to address this problem also, although it would be necessary to tweak the Goldstein proposal so that in this case it was not focused on the exchange rate issue but was prepared to recommend demand expansion even at the cost of faster national, as opposed to eurowide, inflation.

The division of the burden of adjustment between surplus and deficit countries is an issue that has been with us for at least 70 years. It is doubtful if the world can wait another 70 years before the international community addresses it.

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