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Addressing Currency Manipulation Through Trade Agreements

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THE ISSUE

A bipartisan majority in both Houses of Congress is insisting that the United States include a provision in future trade agreements that would bar currency manipulation. A letter from 60 senators to Secretary of the Treasury Jacob Lew and United States Trade Representative (USTR) Michael Froman on September 23, 2013, called for "strong and enforceable foreign currency manipulation disciplines" in the Trans-Pacific Partnership (TPP) while 230 members of the House of Representatives told President Barack Obama on June 6, 2013, that "it is imperative that (the TPP) address currency manipulation…to create a level playing field for American businesses and prevent more US jobs from being shipped overseas." The trade promotion authority (TPA) legislation proposed by congressional trade leaders on January 9, 2014, establishes the avoidance of currency manipulation as a "principal US negotiating objective" in its future trade agreements.

The issue of foreign countries suppressing the value of their currencies to lower the prices of their exports to American consumers, and increase the prices of US imports in their markets, has vexed both US international monetary policy and US trade policy, and the politics surrounding them, for many years. But linking policy toward exchange rates to trade agreements would be historically unprecedented. Currency issues and trade agreements, indeed virtually all trade policy issues, have traditionally been handled under separate negotiations and legal constructs and by different institutions at both the national and international levels. Integrating them would require fundamental changes in the conduct of international economic policy in the United States and around the world.

Transmission of congressional letters does not guarantee that their signers will ultimately oppose TPP legislation if the currency issue is not fully resolved. Neither does the January 9 TPA legislation guarantee that the issue will be fully addressed. However, the bipartisanship and breadth of support for a currency measure is unique in the current political atmosphere and certain to become central to the debate over the TPP, new TPA legislation, and other future trade pacts.

These congressional initiatives derive from a decade or more of growing dissatisfaction with the failure of US policy and current international arrangements to combat widespread currency manipulation and its impact on trade and current account imbalances, which have distorted economic output and employment in many countries. Research conducted with my colleague Joseph Gagnon (Bergsten and Gagnon 2012, elaborated and updated in Gagnon 2013), which was cited in both congressional letters, shows that direct intervention in the currency markets by at least 20 countries has averaged almost $1 trillion annually for several years and shifted trade balances by more than $500 billion per year from deficit to surplus countries. This practice has artificially impeded the ability to export, and accelerated imports, in the United States and other victimized countries in ways that have contributed significantly to their continuing high unemployment.[1] Secretary Lew, in testimony to Congress on this topic

1. If an economy is at full employment, as conventionally assumed in most trade models, changes in current account and trade balances alter the distribution of output and employment between tradable and nontradable goods and services within the economy rather than changing their aggregate levels. Even this effect can be extremely costly as when the large capital inflows to

on December 12, 2013, reiterated that the administration "continues to insist on market-determined exchange rates" but failed to note how widely that principle is violated and how costly the results are for the United States.

Many TPP advocates fear that adding a "currency chapter" would delay and perhaps kill the negotiations. This Policy Brief argues, to the contrary, that it would be anomalous and unacceptable for such a "21st century trade agreement," one that seeks to become the new template for global economic accords, to ignore an issue that clearly has greater impact on trade than any other, especially when the International Monetary Fund (IMF) and other institutions have failed to resolve it for so long. Such a "chapter" would very likely deter future manipulation by several important countries that have employed it in the past. Moreover, the difficulty of negotiating such a chapter is exaggerated. Only one or two current TPP participants are now manipulating. Including clear obligations to avoid currency manipulation in the TPP and other future trade agreements, along with an effective dispute settlement mechanism and sanctions against violators to make sure the obligations are observed, is in fact necessary to *save* TPP and other pacts because Congress is unlikely to approve them otherwise.

A "currency chapter" in the Trans-Pacific Partnership agreement would very likely deter future manipulation by several important countries that have employed it in the past.

China has been the major currency manipulator of the last decade. It has piled up $4 trillion of foreign exchange assets by intervening massively in the currency markets for the past decade, buying dollars at an average pace of close to $1 billion per day to keep its exchange rate substantially undervalued. China has let the renminbi rise by about 40 percent over the past eight years and its external surplus has declined to under 3 percent of GDP, but its intervention rebounded sharply in 2013 and my colleague William R. Cline estimates that its exchange rate would have to rise by 18 percent to eliminate its surplus (Cline 2013b). China is not participating in TPP negotiations so would not be affected in the short run by inclusion of a currency provision in that agreement. It has recently shown considerable interest in the TPP, however, as it will suffer substantial trade diversion from remaining outside (Petri, Plummer, and Zhai 2012), so might become covered in a later expansion of membership.

A number of other Asians, at least two of which (Malaysia and Singapore, perhaps to be joined by Korea) are engaged in TPP negotiations, have also intervened and piled up sizeable reserves relative to any historical norms. Some of them, like China, have also let their exchange rates rise considerably over the last few years but all continue to run large current account surpluses and intervene heavily to keep their currencies from reflecting economic fundamentals. Japan is a major source of the current congressional anxiety, although it has not bought dollars in the currency markets for over two years. Japan has also joined the strong G-7 renewal of its commitment to avoid such activity in February 2013. The country has a history of manipulation, however, and some spokesmen for the incoming Abe government in 2012 indicated their desire for a weaker currency ("oral intervention"), after which the exchange rate fell by 25 to 30 percent.

As the world's largest trading country, the United States is the largest loser from the manipulation of recent years.. Because most of the intervention takes place in dollars, the dollar has been pushed to systemically overvalued levels. Bergsten and Gagnon (2012) estimate that the US current account deficit has averaged $200 billion to $500 billion per year higher as a result of the manipulation (by all countries, not just those prospectively involved in the TPP). This translates into a loss of between one and five million US jobs within the environment of continuing high unemployment and shortage of alternative policy instruments to remedy the problem.

Currency manipulation also adversely affects many other countries, including those with weak economies in the euro area.[2] Brazil, India, Mexico, and other emerging-market countries have been hit and have complained vocally. Many small and poor countries inevitably suffer as well. In light of these large and widespread trade effects, it would seem logical to address currency issues in trade agreements.

the United States generated by the buildup of foreign reserves stemming mainly from manipulation exacerbated the housing bubble that, along with inadequate regulatory responses, contributed to the financial crisis (Bernanke 2010). Many analysts also say this redistribution has contributed to wage stagnation and inequality in the United States. But full employment has obviously not been the case in the United States and many other countries in recent years nor is it likely to be restored in the foreseeable future.

2. Bergsten and Gagnon (2012) estimate that the euro area has been experiencing an aggregate current account position that is $150 billion to $200 billion weaker annually as a result of recent levels of currency manipulation by its trading partners, notably China but also Switzerland and several other neighboring countries. See also Chen, Milesi-Ferretti, and Tressel (2012) and European Commission (2012).

CURRENCY ISSUES AND TRADE AGREEMENTS

Previous trade agreements have avoided the issue for two basic reasons. First, trade agreements aim primarily at expanding the *level* of trade while exchange rates have generally been viewed as primarily affecting trade *balances*. Cline (2013b) demonstrates that a 1 percent weakening (strengthening) of the trade-weighted inflation-adjusted exchange rate of the dollar, the real effective exchange rate (REER), will lead to a reduction (increase) of about $35 billion in the US global current account deficit after a lag of two to three years. In dollar terms, the trade effect is fully realized by an increase in exports (since the higher price and lower volume of imports roughly cancel each other out) so total US trade expands considerably. In real terms, however, the net effect is divided roughly half-and-half between a rise (decline) in exports and a reduction (increase) in imports so there is no net increase in the level of US trade. Cline's research similarly shows that a 1 percent strengthening (weakening) of the REER of the renminbi leads to a lagged reduction (increase) of the global current account surplus of China by about $20 billion.

As the world's largest trading country, the United States is the largest loser from the manipulation of recent years.

In addition, most economists see trade balances as primarily a reflection of saving-investment differences and broader economic "fundamentals" and thus best addressed through monetary, fiscal, and other macroeconomic policies. By contrast, the level and composition of trade are seen as structural and microeconomic, reflecting the resource endowments and comparative productive advantage of national economies. Tariffs, quotas, and other trade policy measures are thus seen as tools to address the level and composition of trade flows.

Timing has also played a major role in this traditional differentiation. Trade imbalances, and the currency misalignments that can produce them, have been seen as transitory developments that will self-correct (by markets, under flexible exchange rates) or be corrected (by governmental policies, under fixed exchange rates) within relatively short periods of time. Trade agreements, by contrast, are intended to alter economic relations between participating nations on a permanent basis.

Problems arise, however, when trade imbalances persist uncorrected by either markets or government policies. The United States, for example, has run sizeable current account deficits for most of the past 30 years. Japan has been a persistent surplus country for at least as long (though its trade balance recently shifted into deficit as a result of its sharp increase in energy imports after the shutdown of its nuclear power plants in the wake of the Fukushima disaster in 2011). China has run sizeable surpluses since the early 2000s. The guidelines for IMF surveillance of countries' exchange rate policies inveigh against "protracted" intervention in the currency markets because it can prolong imbalances beyond their normal short-run horizons.

The World Trade Organization (WTO), with its mandate to guard against restrictive trade policy measures, has been concerned by protectionist policies being justified by trade deficits. Trade agreements are also explicitly or implicitly premised on the principle of reciprocity in reducing tariffs, subsidies, and other barriers and not on making adjustments to trade imbalances.

But because manipulation aims to produce currency undervaluation that reduces the prices of a country's exports and increases the prices of its imports, it is equivalent to a simultaneous export subsidy and import surcharge. It is thus as protectionist as directly applying such measures. When the amounts involved become very large, as they frequently have, they can export unemployment far more than most trade policy devices.

The second, institutional, issue is that currency policy and trade policy are generally managed by different authorities within national governments and by different international organizations. Finance ministries and central banks (which are often independent from governments) are usually responsible for exchange rates, whereas trade or commerce or foreign affairs ministries handle trade policy. At the international level, the IMF is responsible for exchange rates while the WTO covers trade. Turf conflicts between these actors have frequently prevented a coordinated response to issues that linked currency and trade.

The United States has tried to coordinate trade policy and international monetary policy over the years. In 1971, President Richard Nixon imposed a temporary import surcharge to help negotiate devaluation of the dollar, a step taken under pressure from Congress. Again, in 1985, Secretary of the Treasury James A. Baker III, also responding to congressional anxieties about trade deficits, negotiated the Plaza Agreement to weaken the dollar and strengthen the European currencies and Japanese yen. Financial issues became part of trade negotiations in the late 1990s, resulting in the Financial Services Agreement in the new WTO and in subsequent limits on capital controls in some US free trade agreements (FTAs). In these cases, the Treasury Department handled the negotiations, with USTR seeking to assure that policies were consistent with the goal of more open trade.

Lack of coordination is much more common, however. The IMF and GATT/WTO have frequently discussed better coordination and have occasionally set up mechanisms to promote it but without much effect. The IMF staff vetoed inclusion of currency considerations in China's protocol of accession to the WTO on the grounds that such a provision was within the jurisdiction of the Fund rather than the trade organization (Independent Evaluation Office 2009, 59). A failure to get together by the congressional committees that oversee trade matters (House Ways and Means, Senate Finance) and financial issues (House Financial Services, Senate Banking) has impeded currency legislation in the past.

These substantive and institutional considerations have traditionally led the manipulation issue to be addressed by monetary officials and in the IMF rather than by trade officials and trade agreements. The United States has pursued this approach, primarily with respect to China, for most of the past decade. Secretary Lew reiterated his support for that approach in his testimony on December 12, arguing that "we've done it (promoting market-determined exchange rates) through the G-20…(and) in bilateral relations." However, the monetary efforts have made so little progress that they have lost their credibility and Secretary Lew acknowledges that "a trade agreement has to be built on that firm commitment (to market-determined exchange rates)". Thus there is a strong case for incorporating manipulation in future trade agreements as called for by the congressional majorities.

A CURRENCY CHAPTER

Most FTAs, including those negotiated by the United States, have chapters on specific topics. The TPP under negotiation has 29 chapters, and the United States hopes that it will become the template for future agreements. The TPP is in turn based largely on the Korea–United States FTA (KORUS) negotiated in 2005–07. This Policy Brief proposes that currency questions be covered, for the first time, in an additional "chapter" with three components: (1) a statement of objectives, (2) criteria for defining and pursuing those objectives, and (3) policy responses to foster their implementation. These elements should, where possible, conform to existing international agreements, such as the Articles of Agreement of the IMF and the charter of the WTO.

The objectives of the currency chapter could be drawn from the IMF Articles. IMF members are already committed to "avoid manipulating the exchange rate or the international monetary system in order to prevent effective balance of payments adjustment or to gain unfair competitive advantage over other members" (Article IV, Section (iii)). The Fund is supposed to maintain surveillance over exchange rate policies and discuss "protracted large-scale intervention in one direction in the exchange markets" with errant members. The Articles also call on member countries to "take into account in their intervention policies the interests of other members, including those of the countries in whose currencies they intervene." These precepts could provide the foundation for specifying the goals of a currency component of an FTA and could even be incorporated by reference.

The G-7—the United States, Britain, Germany, France, Japan, Italy, and Canada—has also adopted a nonbinding commitment to consult within the group before undertaking intervention activities. The members have largely adhered to that agreement. G-20 communiques have pledged that its members "will not target our exchange rates for competitive purposes," though some of them have obviously ignored that stricture. Such pledges could be incorporated in trade agreements, if binding commitments are not possible, but would fall far short of what is needed.

The methodology for pursuing the agreed objectives should start with commitments to provide data on the relevant variables, per agreed IMF conventions in most cases. These should particularly cover reserve levels, including those outside the official monetary reserves (notably sovereign wealth funds), intervention, and the currency composition of official reserves. Data reconciliation committees could be set up to compare, and try to resolve, differences in the national data series on trade, current account balances (as the United States and Canada did under their original FTA), and other issues.

Determining the existence and extent of currency misalignment, especially as a possible trigger for remedial action, has proven enormously difficult, however, both intellectually and politically. Numerous conceptual approaches to defining and measuring currency "misalignment" have been attempted. The IMF uses three different measures that often produce very different results. Most official discussions, and even many academic efforts, have foundered at this initial level.

Gagnon's (2013) proposal to ignore the determination of "misalignment" per se in favor of more straightforward and objective indicators thus has considerable merit. The goal of the exercise would be simply to prevent a country from running large and persistent external surpluses that result from efforts to depress the value of its exchange rate in the currency markets.[3] Only three variables would need to be identified: current account surpluses, levels of reserves (to determine if

3. See Mattoo and Subramanian (2008) for a similar construct.

they are "excessive"), and amounts of intervention (or changes in reserve levels as a proxy if actual intervention numbers are not available on a timely basis).

A key concept is of course "intervention." Substantial amounts of direct purchases of foreign exchange with local currency should be a central criterion for triggering a currency provision in an FTA. The participating countries should fully disclose their intervention activities, though some reporting could initially remain confidential if necessary in a transition period.

More complex questions surround oral and indirect intervention. Oral intervention—that is, calls for market exchange rates to be adjusted unaccompanied by any new policy—can be obvious or extremely subtle but with powerful effects, at least in the short run. If the new rules limiting direct intervention are credible, however, oral intervention would be less effective because no policy follow-up would be permissible.

Indirect intervention could include a wide range of policies, such as capital controls on inflows and/or outflows and macroprudential financial regulations (and particularly the timing of their installation and removal). It would be extremely difficult to define such measures with sufficient precision, however, because many steps seen as indirect intervention are defended as having much broader purposes. For example, macroeconomic policies, including monetary policies such as quantitative easing (QE) but also fiscal policies, should not be included. Brazil, China, and a few other countries have in the last couple of years accused the United States itself of currency manipulation via the massive bond purchasing policies of the Federal Reserve. They argue that this practice depresses the dollar's value and that Japan, the United Kingdom, and the United States should be targeted with any international sanctions that apply to manipulation.

Like all monetary policy, QE affects the exchange rate (and the exchange rate is indeed one of its several transmission channels because lower interest rates lead to private capital outflows). But direct intervention aims directly at the exchange rate through purchases or sales of foreign currencies. By contrast, QE primarily aims to influence domestic demand and operates via *domestic* monetary instruments (treasuries, mortgage-backed securities, and the like) without affecting foreign currency instruments. All international rules and norms, including those of the IMF and most recently the G-7, explicitly recognize this distinction and exonerate QE policies from any responsibility for "currency manipulation." Some countries may keep raising the issue, but their objections should not deter these new policy initiatives.

Particularly in the case of measures with indirect effects on exchange rates, intent can be an important consideration. Were the steps undertaken to influence exchange rates or were such influences solely a by-product of some other primary purpose? The requirement to demonstrate intent to competitively devalue under current IMF doctrine has provided a loophole enabling countries to justify clearly manipulative actions knowing that no mechanisms exist to override their assertions. This problem reinforces the need for objective indicators such as reserve increases and direct intervention, along with current account surpluses, as triggers for action.

HOW TO DEFINE AND MEASURE "EXCESSIVE" RESERVES AND INTERVENTION

The definition of "reserves" is extremely important, especially if changes in them are a factor in determining the existence of a manipulation problem. The amount of foreign exchange holdings reported by virtually all countries' monetary authorities would of course be the core number. Some countries, however, hold foreign exchange through other governmental or quasi-governmental entities, including sovereign wealth funds (SWFs). These funds are legitimate vehicles enabling countries to set aside a portion of their wealth to protect them from short-term dissipation, to smooth consumption patterns over time, and to permit longer-term investments to maximize earnings without the overriding focus on liquidity (and thus short-term investments) that usually dictates the disposition of monetary reserves (Truman 2010). But SWFs also represent an extension of a country's reserves and provide a ready means to dampen (or totally obviate) any rise in a country's reserve holdings. Hence the foreign assets of SWFs must be included in determining the level, and changes in the level, of a country's reserves for purposes of implementing currency rules in an FTA. The foreign assets of the banking system could also be considered, especially in a country where governmental authorities control that system to a significant extent.

Agreement would have to be reached on several dimensions of these key variables. First, what constitutes an "excessive" level of reserves beyond which a country should avoid further increases? A number of countries in recent years have sought much higher reserve levels than in the past as a form of "self- insurance" against future crises. This has been particularly true in Asia, where profound unhappiness with the region's treatment by the IMF (and the Washington Consensus more broadly) during its crisis in 1997–98 produced a strong resolve to never again become beholden to conditional lending from outside.

The traditional rule of thumb, among both officials and economists, is that a country should hold an amount equal to the value of three months' worth of imports. In light of the

enhanced self-insurance motive and recent practice in many countries, an FTA might permit a considerably higher level of reserves, say six months' equivalent. A more recently suggested criterion is the level of a country's short-term (less than one year) external debt denominated in foreign currencies. Either or both of these variables could be included in a currency chapter as the threshold for determining an "excessive" level.[4] A higher range might be allowed for countries whose exports are dominated by nonrenewable resources such as oil, to provide for their future generations, and for poorer countries that may face higher economic volatility.

The goal is to identify and sanction sizeable and prolonged imbalances run by important countries that have significant economic and systemic effects, to a substantial extent due to their currency intervention, and thus to deter such practices.

Second, what constitutes an "excessive" level of intervention? In principle, any net intervention to prevent appreciation (or generate depreciation) should be banned for a country that is already beyond the agreed ceiling for reserve levels. Some minimal exceptions could be granted, particularly for brief time periods, and offsetting interventions aimed at smoothing market fluctuations should be permitted. But there is no rationale for adding further to reserves that are already fully (or, in many cases, much more than fully) adequate. Doing so cannot be justified as more "self-insurance" and can only be interpreted as aimed at preventing appreciation in order to strengthen the country's price competitiveness.

Third, what constitutes an "excessive" current account surplus? Traditional economic analysis suggests that high-income capital-abundant countries should run current account surpluses and low-income labor-abundant countries should run current account deficits.[5] Countries can of course run surpluses, and even sustain undervalued exchange rates for some time, without intervening primarily due to the interplay of markets and especially private capital movements (as Sweden has done in recent years). But any prolonged surpluses that coincide with extensive intervention seem inappropriate when reserves have already reached an agreed threshold level. Again, some minimal exceptions could be permitted with respect to amounts and/or time periods, and a modest surplus that was clearly due to cyclical factors could be viewed as acceptable.

High degrees of precision are not essential in defining and applying these concepts. The goal is to identify and sanction sizeable and prolonged imbalances run by important countries that have significant economic and systemic effects, to a substantial extent due to their currency intervention, and thus to deter such practices.[6] There is no need to pick up every single deviation from "equilibrium." Pragmatic implementation of the construct should be quite feasible.

HOW ACTION WOULD BE TRIGGERED

There are several more controversial questions relating to remedial steps for countries deemed to be violating currency norms. For example, would there be automatic triggers for consideration of currency issues or would a party to the FTA have to explicitly raise the question of violations of the agreed criteria? Automatic triggers for such purposes have been discussed over the years, dating back to the Committee of Twenty in the IMF that sought to write new rules for the international monetary system after the breakdown of fixed exchange rates in 1971 (Williamson 2011). More recently, proposals were made by Korea and the United States (and, at least initially, by China) for the G-20 summit in 2010. Such triggers could be based on reserve increases or current account surpluses above agreed levels.

Automaticity has the great advantage of obviating the need for an aggrieved country to explicitly initiate the retaliatory process, which it could be reluctant to do for diplomatic or other reasons even when another country is clearly violating the terms of the agreement. However, the 4 percent of GDP level reportedly suggested in the G-20 discussions in 2010, let alone the EU Commission's 6 percent of GDP threshold for surplus countries within the euro area, are far too lax.[7]

4. All countries cited as manipulators by Bergsten and Gagnon (2012) far exceed both thresholds.

5. On that reasoning, *any* surplus in China and other developing countries should be viewed as "excessive" (and any US deficit should be viewed as inappropriate).

6. Some deficit countries are forced to intervene in the foreign exchange markets to keep their currencies from becoming even more overvalued. Such "defensive intervention" to prevent manipulation by surplus countries from worsening the positions of these deficit countries is fully justified. In addition, countries can run current account surpluses and undervalued exchange rates without intervening in the currency markets due to private capital exports (as in the case of Sweden at present) or simply market misperceptions of their equilibrium positions ("market errors").

7. In its periodic calculation of "fundamental equilibrium exchange rates" over the years, economists at the Peterson Institute for International Economics have typically posited normative ceilings of 3 percent of GDP for current ac-

As for the decision-making process through which these concepts would be implemented, there are fairly clear guideposts from traditional practice in both the WTO and existing FTAs:

- The aggrieved country requests consultation with the alleged violator of the rules (unless an automatic trigger is included) and a major effort is made to reach a mutually satisfactory voluntary solution.
- Failing agreement in the consultations within 90 days, or some other tight time limit, a panel of experts[8] is chosen (from a contingent list) to recommend a solution within another tight time limit (another 90 days).
- A country found to have violated the rules and failed to accept the recommended solution within another tight time limit is subject to the penalty phase in which a separate compliance panel (perhaps comprising the same experts) authorizes counter measures.[9]
- That panel monitors the situation, taking into account the expected lagged effects of previous exchange rate changes in eliminating the excessive current account surpluses, and calls for termination of retaliation when the cause of the problem (those surpluses or the manipulation) ceases.

The final question is what enforcement mechanisms could be included to make the agreement work and assure its credibility; the absence of such mechanisms has been a cardinal flaw of the IMF system throughout its existence. Five types of measures are possible: withdrawal of concessions made in the FTA itself, imposition of countervailing duties, import surcharges, monetary penalties (fines), and countervailing currency intervention (CCI). Gradation of each measure is possible. Penalties can be adopted in a first phase and adjusted in accordance with the seriousness or extent of the violation.

The usual technique for withdrawing concessions in an FTA is the "snapback clause," under which tariffs are returned to the pre-FTA level (usually the most favored nation, or MFN, rate) for "breach of the agreement." Snapbacks are typically applied on a product-specific basis, to counter violations in a particular sector, but would have to be installed across the board in the case of currency violations. It would also be possible to apply the snapback concept to concessions other than tariffs, as in the current WTO case where Brazil has been authorized to withdraw some of its commitments regarding intellectual property rights if the United States continues to violate the dispute settlement panel's ruling on its cotton subsidies. The original concessions would be restored when the problem was corrected.

More extensive retaliation can be envisaged, including countervailing duties if currency manipulation is deemed a countervailable subsidy like any other.[10] Given the modest level of most MFN tariffs, in both the United States and many potential FTA partners, import surcharges could be authorized as well. Monetary penalties, such as NAFTA provides for violation of its labor and environmental disciplines and through which the United States is now compensating Brazil for the US violation of WTO agricultural agreements in the cotton sector, could be added to the arsenal of potential measures.

The problem with each of these options, however, is the difficulty of calculating the amount of the currency undervaluation to provide a basis for determining the magnitude of the permitted retaliation. As indicated above, such calculations are fraught with both intellectual uncertainty and great political sensitivity. Hence they should be avoided in fashioning a workable currency provision in trade agreements.[11] The snapback approach avoids that difficulty so should be used as the trade policy response to manipulation under an FTA.

This means, however, that it would be highly desirable to add a monetary policy tool, one that would effectively fight fire with fire. Such an approach would overcome the problem that trade policy remedies like snapbacks only curb imports,[12] whereas currency manipulation also suppresses the aggrieved country's exports (to global markets as well as to the manipulating country itself). An aggrieved country should thus be

count deficits and surpluses (see Cline 2013b for the latest example). However, Cline (2013a) also analyzes an "aggressive rebalancing scenario" in which current account targets are set at zero for China and the United States, and the Institute's in-depth analyses of China (especially Goldstein and Lardy 2008) espoused a similar goal.

8. The IMF could theoretically be asked to render such judgments, as it is in fact required to do with respect to any currency cases that might be brought to the WTO. Under current international jurisprudence and norms, however, regional agreements such as the TPP (or bilateral agreements) cannot utilize the global institutions. The inability of the IMF to reach firm judgments on such issues to date, moreover, does not provide much incentive to give it a central role in the process.

9. Compensation by the offending country is traditionally posited as an alternative to countermeasures in trade agreements. It is difficult to envisage policy measures that would provide adequate compensation for currency manipulation, however, so that concept is not included here.

10. This is the preferred strategy of many of the Brazilian economists who call for action against currency manipulation. See, for example, de Lima-Campos and Gaviria (2012).

11. I had suggested inclusion of these remedies in some of my own earlier writings, including most recently Bergsten (2013).

12. It would be theoretically possible to authorize the aggrieved country to implement export subsidies as well as an import "snapback." This would require budgetary expenditures (perhaps in the form of tax expenditures) by the country, however, and would presumably not be very attractive to it.

authorized to employ CCI for this purpose: purchases of currency of the manipulating country to neutralize the impact of that country's own intervention in the foreign exchange markets (Bergsten 2003, 2010). A clear indication by the United States that it was prepared to act on such authorizations should deter most future manipulation efforts.

CCI would clearly work against countries with convertible currencies and mature financial markets. This means that it would be an effective tool in the TPP context, where all present (Singapore and possibly Malaysia) and past (Japan, potentially Korea) manipulators satisfy these criteria.[13] It has traditionally been thought that CCI could not be fully implemented against extensive intervention by countries with inconvertible currencies whose capital markets are still developing, such as China, but that issue is moot for at least the next several years since China is not participating in the current TPP negotiations and could not possibly join until a later stage in its evolution.[14]

CCI could presumably be carried out by Treasury and the Federal Reserve under current legislative authorities although specific authorization for such a policy was also included (as "remedial currency intervention") in the currency bill passed by the Senate (but not taken up by the House) in 2011. Including such a provision in FTAs would be the most straightforward and effective response, at least for the United States, to currency manipulation. Lodging implementation of this key sanction in finance ministries and central banks should assuage institutional concerns that make it difficult to address the problem through trade agreements. The United States could of course simply start implementing CCI unilaterally against some or all countries that it might determine were manipulating; its doing so might ease congressional concerns and encourage TPP partners to include currency in the agreement as a way to bring it within agreed multilateral rules and procedures.[15]

Finally, transition issues could affect the currency aspect of an FTA. The proposals outlined here assume that the external balances and exchange rates of the participating countries are in approximate equilibrium when the agreement goes into effect. The currency chapter would provide rules and procedures for addressing subsequent changes that created new imbalances. If, to the contrary, significant misalignments exist at the time the agreement becomes effective, side negotiation can provide for an agreed starting point that would not disrupt the agreement at its outset. This should not be a significant problem for the TPP, however, because as noted above only one or two of its initial member countries might run afoul of the proposed manipulation rules.

It might of course prove impossible in the TPP or any other trade pact to agree on binding and comprehensive rules, subject to an effective dispute settlement mechanism (DSM) and consequent sanctions, as proposed here. Compromises may thus be needed on such matters as the ambition of the rules, the degree to which they become legal commitments, the vigor of the DSM, or the severity of the sanctions against offenders. Tradeoffs among those variables are likely in these negotiations.[16]

But it must be remembered why the issue has remained unresolved for so long. The IMF Articles contain legally binding objectives that are largely adequate but contain no enforcement tools. The "dispute settlement mechanism" has proven to be enormously difficult to navigate (Blustein 2013). The WTO charter's vague obligations have failed to trigger its relatively efficient DSM and powerful sanctions. Any effective currency chapter in a trade agreement would have to be sufficiently ambitious on all counts to be credible as a deterrent to currency manipulation. The TPP seeks ambitious outcomes on a wide range of equally contentious issues, and it would be hard to achieve a truly "gold standard 21st century agreement" with another spineless attack on the manipulation problem.

It would be a particularly serious mistake to weaken either the firm obligations to avoid manipulation that are already enshrined in long-standing global agreements or the potency of the available remedies. Hence the most plausible "wiggle room" lies in the ambitiousness of the criteria that would trigger action: The term "excessive," as applied to levels of reserves and intervention as well as current account surpluses, could be set high enough that only the most egregious violators would be caught. The objective of the exercise is in fact to discipline just such extreme behavior rather than every minor violation.

Another possible avenue of compromise relates to the interaction of the obligations binding the participants and the methodology through which they are to be implemented. Countries wishing to limit their risk of exposure will want

13. Vietnam is participating in TPP talks and is sometimes cited as a currency manipulator. However, its current level of foreign exchange reserves is quite low and it has begun to run surpluses only very recently. Hence it would probably not meet the proposed criteria for some time if ever.

14. Congressman Sander Levin (2013) proposes to address that concern by suggesting that "TPP parties agree to take coordinated action to address currency manipulation by non-parties."

15. Adoption of CCI by the United States would also provide it with a tool to implement any future IMF decisions on manipulation issues. C. Randall Henning (2007) points out that, unlike the WTO or the United Nations, the IMF has no national enforcement instruments to rely on to reinforce its rules and recommends that the United States put such instruments in place.

16. A less ambitious but still potentially useful agreement is proposed in Hufbauer and Schott (2012).

to trade off "soft" obligations against "hard" dispute settlement provisions or vice versa.[17] For example, the indicators of violations of the agreed currency obligations could become "presumptions" or even "illustrations" rather than legally binding commitments. The adjudicatory panels could be limited to recommendations to a politically constructed final arbiter rather than binding protocols, as is the case in some existing FTAs. It is perfectly plausible to set up and finely tune a separate DSM for the currency chapter as part of the overall negotiation of the issue.[18]

CONCLUSION

The United States and other participants in the TPP negotiations are aiming to conclude a "21st century trade agreement" designed to serve as a template for future trade and investment arrangements. The United States and the European Union hope that their Transatlantic Trade and Investment Partnership (TTIP) will set the highest possible standards that will then be emulated around the world.

In doing so, the countries that are participating in these negotiations are addressing many technically complex and politically sensitive issues, including the enforcement of intellectual property rights, the role of state-owned enterprises, and the treatment of incoming direct investment in Asian countries. The United States and Europe, for all their compatibility in income levels and basic economic philosophy, have failed for two decades to achieve the kind of "regulatory coherence" or common health standards that they are now seeking.

In both these megaregional initiatives, negotiating countries have not shied away from issues that have previously eluded international consensus and the challenge of setting global rules and institutions to address their differences. It would thus be anomalous if such agreements failed to include the currency topic, which is clearly more important quantitatively than any of the other issues being considered. Currency is politically sensitive in many countries but no more than other items being negotiated. The TPP, TTIP, and any other forthcoming major trade negotiations would in fact be derelict if they failed to address currency—and would therefore probably fail if only because of the US Congress's refusal to ignore the linkages.

The United States and its trading partners have had similar experiences in the past with the addition of new issues to their trade policy agendas. Spurred by domestic political pressures akin to those now generated by currency concerns, the United States began inserting intellectual property rights issues, and then labor and environmental topics, into (primarily multilateral) trade negotiations in the 1980s and especially its first major regional agreement, NAFTA, in the early 1990s. Most of its partners initially opposed the basic concept of linking these issues to trade but subsequently came to appreciate both the merits and the political imperative of doing so. These topics, while still controversial in some quarters, have now become staple components of virtually all trade agreements, including many that do not include the United States.

Some experts have also suggested that adding another major issue to the negotiating agenda for the TPP, which hopes to conclude in the near future, would collapse the negotiations. (This is a lesser concern for TTIP negotiations, which have just started.) But many issues have been added to trade negotiations late in the game. For example, the seminal idea of converting the 1940s era General Agreement on Tariffs and Trade (GATT) into the WTO was added to the Uruguay Round, in 1989, three years after the talks began and only a year before they were scheduled to end in 1990. Midstream agenda adjustments, in terms of both adding and deleting issues, are in fact fairly common in major trade negotiations.

To be sure, the United States will be accused in some quarters of "launching a trade war" if it insists on including the currency issue in trade agreements (or especially if it were to take Nixon-like unilateral action to enhance the prospect for reaching new international accords). The truth is the opposite for at least four reasons.

First, it is the currency manipulators who launched the "trade war" (or, more properly, "currency war") a decade or more ago by violating fundamental rules of the international economic system to massively strengthen their own competitive positions.

Second, the United States has accepted these manipulations by other countries, largely passively, and has in fact run large trade and current account deficits for over 30 years. Washington, for example, has accommodated and indeed enabled the success of the export-oriented growth strategies of a succession of "economic miracle" cases, ranging from Japan in the 1970s and 1980s through the newly industrialized economies (Korea, Taiwan, Singapore, and Hong Kong) in the 1980s and 1990s to China and several other East Asians more recently. By buying dollars, the surplus countries financed the US deficits without too many complaints, to be sure, but the net result was clearly to strengthen their economies and weaken the United States. Any moral high ground in the trade debates of the last half century clearly belongs to the United States.

Third, the United States would not be seeking a generalized depreciation or weakening of the dollar. To the contrary,

17. I am indebted to my colleague Jeffrey Schott for this insight.

18. See chapter 17 of Bergsten, Hufbauer, and Miner (forthcoming 2014). NAFTA has six different DSMs for different parts of the agreement though that is not widely regarded as one of its finer features.

the goal is simply to make sure that other countries let their exchange rates strengthen sufficiently to accurately reflect their external surpluses and other economic fundamentals. No one could rationally accuse the United States of pursuing a beggar-thy-neighbor policy or objectively equate QE with direct currency intervention.

Fourth, and operationally by far most important, continued *failure* to address the currency issue constructively through new international rules and institutional arrangements could impede or even derail the promising opportunity offered by the new megaregional negotiations. It would be highly preferable to undertake such initiatives in multilateral and monetary forums, notably the IMF. It is a great historic misfortune and indeed tragic failure of leadership that the Fund, and the financial leaders around the world who run it, have been unable to address these issues effectively for so long.

The creation of agreed rules and procedures to address currency manipulation could preempt future disputes that would otherwise be highly destructive in both economic and political terms.

But the imminence of major new trade agreements that will reshape the global economic architecture for decades at least cannot be permitted without a fundamental effort to reshape the currency norms as well. It would nevertheless be desirable to ultimately embed any new enforcement instruments that are agreed in FTAs into the global rules and institutions, primarily by amending the Articles of Agreement of the Fund and possibly the charter of the WTO as well (Mattoo and Subramanian 2008).

The most orderly way to proceed is for Congress to address the issue while considering new trade promotion authority to authorize the TPP, TTIP, and other forthcoming trade negotiations. TPA empowers the administration to negotiate new trade agreements and commits Congress to consider them expeditiously and without amendments. The legislation could add the currency topic to the US negotiating agenda and insist that the administration seek enforceable rules against manipulation. TPA has a proven record as a vehicle for engaging Congress in the conduct of US trade policy, and the addition of exchange rates deserves the careful attention that process can provide.

In practical terms, the inclusion of a currency chapter in the TPP along the lines proposed here would primarily deter countries from future misconduct. Only two recent manipulators, Singapore and Malaysia, are currently participating in those negotiations (and Malaysia's intervention practices have moderated over the past year or so). But deterrence of future manipulation would also cover two other TPP countries, Japan and probable next-entrant Korea, which have been significant manipulators in the past. Moreover, China has recently signaled its interest in joining the TPP at a later stage, fearing large trade diversion losses if it stays outside the agreement. If China joins, the world's largest manipulator would come within the proposed disciplines. Conversely, a failure to adopt effective disciplines on currency manipulation almost assures that the practice will continue, as countries demonstrably get away with it, and perhaps even expand as additional countries feel forced to defend themselves against the current manipulators.

Inclusion of a currency clause in the TTIP would also be important because that agreement seeks new global standards across a wide range of topics. The United States and the European Union, especially the euro area, are the major victims of manipulation, as noted above, and are the issuers of the world's two key currencies, which are the vehicles for most manipulation. Hence they should be completely like-minded on the issue and should be readily able to agree on it. Germany, which has a large trade surplus and is widely criticized for it, would not be affected by new currency rules because of course it does not have an exchange rate of its own. Accordingly, it would have no reason to object to a discipline that applied to the euro area as a whole.

The problems involved in incorporating the currency issue in trade agreements, indeed addressing the currency issue more broadly, are formidable. However, the creation of agreed rules and procedures to address it could preempt future disputes that would otherwise be highly destructive in both economic and political terms. Doing so would represent a milestone in relationships among the participating countries. It would fill a major gap in the international economic architecture that has defied agreement for seven decades.

The economic payoff from successfully resolving the currency manipulation issue would be substantial. The aggrieved countries, most notably the United States but also the euro area, would see their external deficits reduced considerably with large numbers of new jobs created over several years, with no costs to their budgets, as the new disciplines were phased in and extended to the full range of manipulating countries. The erstwhile manipulators would of course experience corresponding gradual declines in their external surpluses and would have to steadily expand domestic demand to offset the adverse effects on their growth rates. China and many of the others have already begun to do so as part of the global rebalancing

process consistently espoused by the G-20 since 2008 as essential to create a sustainable basis for global growth and stability.

As for the argument that currency provisions would be nonnegotiable and jeopardize the TPP (or TTIP), the fact is that most TPP countries, from Australia to Mexico, are victimized by manipulation. Japan, despite being charged with manipulation itself, has been adversely affected by manipulation by China and has in fact criticized China for such practices. Instead of viewing congressional insistence on addressing the currency issue as an obstacle to opening the trading system further, policymakers should realize that *not* including the issue is by far the greater threat to successful conclusion and implementation of the TPP and perhaps the TTIP as well.

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