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A FLOP AND A DEBACLE: INSIDE THE IMF'S GLOBAL REBALANCING ACTS

PAUL BLUSTEIN



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57 Erb Street West
Waterloo, Ontario N2L 6C2
Canada
tel +1 519 885 2444 fax +1 519 885 5450
www.cigionline.org

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ABOUT THE AUTHOR

Paul Blustein, senior visiting fellow at CIGI, is an economic journalist who covered the IMF during his career as a newspaper reporter and has written two books that focus heavily on the Fund. The first, which chronicled the emerging markets crises of the late 1990s, was *The Chastening: Inside the Crisis that Rocked the Global Financial System and Humbled the IMF* (PublicAffairs, 2001); the second was *And the Money Kept Rolling In (And Out): Wall Street, the IMF, and the Bankrupting of Argentina* (PublicAffairs, 2005). A graduate of the University of Wisconsin, Blustein also attended Oxford University as a Rhodes Scholar, receiving an M.A. in philosophy, politics and economics. He spent much of his career as a staff writer for *The Washington Post*, including five years as a correspondent in Tokyo, and before that he worked at *The Wall Street Journal* and *Forbes Magazine*. Among the prizes he has won for his work is the Gerald Loeb Award, which recognizes distinguished business and economic journalism. He lives in Kamakura, Japan, and in addition to his CIGI affiliation he is a nonresident fellow in the Global Economy and Development Program at the Brookings Institution.

ACKNOWLEDGEMENTS

Journalists like me don't usually write papers like this. No mass-circulation media organization would likely publish work that chronicles, at such length, the workings of the International Monetary Fund (IMF) on an issue of technical complexity. At the same time, scholars don't usually write papers like this either. They tend to avoid anecdotes and other story-telling devices that are a journalist's stock in trade, and scholars also go about gathering information and data in different ways than we journalists do (often at much higher levels of sophistication than we journalists are capable of). Persuading interviewees to furnish troves of confidential documents is a journalistic skill I have honed over the years; it is not high on the list of practices that think-tank experts or university professors commonly employ.

The idea that I should produce this sort of paper was the inspiration of Tom Bernes, who until May 2012 was CIGI's executive director and now holds the title of distinguished fellow. I was looking for a way to get support for a book I have been researching about the role played by international institutions in the global financial crisis; Tom imaginatively came up with the concept of my writing research papers for CIGI that would delve deeply into certain issues involving those institutions. With help from Eric Helleiner, holder of the CIGI chair in international political economy at the Balsillie School of International Affairs in Waterloo, Ontario, we decided on topics that would be suitable for such papers. (The other paper I have written, which is about the Financial Stability Forum, will be published shortly.) Tom and Eric provided enormously helpful guidance throughout my research process, including a meeting in June 2011 when CIGI generously hosted me for a fruitful discussion of my preliminary findings with colleagues and graduate students. And once I had finished a first draft of this paper, Tom and Eric — together with Jim Haley, who joined CIGI as director of the global economy program in early 2012 — conferred even more extensive assistance in the form of insightful feedback and suggestions for how the paper ought to be improved. Tom, Eric and Jim bear no responsibility for any errors or shortcomings in the paper, of course, and they should be held totally blameless for my policy recommendations, from which they demurred to varying degrees. But their support and encouragement was invaluable, and I am especially grateful for the friendly spirit in which they gave it.

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Paul Blustein

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EXECUTIVE SUMMARY

Cooperation among major countries to shrink global imbalances in trade and capital flows is highly desirable for the sake of promoting a sustainable recovery from the financial crisis that erupted in 2008. The story that unfolds in this paper does not bode well for such cooperation. It is a detailed account of the initiatives, led by the IMF, to address imbalances prior to the 2008 global financial crisis.

The paper is based on interviews with scores of policy makers who were involved in the initiatives, and on thousands of pages of confidential documents that have never been disclosed. It focuses on two undertakings. The first is the Fund's 2007 decision to strengthen its surveillance of exchange rates, which was aimed at prodding countries — China being the most prominent example — to take action when their currencies were seriously under- or overvalued. The second is the multilateral consultations, in which the IMF convened representatives of five major economies to discuss plans for shrinking imbalances.

It is no secret that these initiatives were unsuccessful. But behind the basic, publicly known facts lies a rich tale, recounting a number of episodes that were secret, up until now, as well as new details about key turning points that have been only hazily understood. This chronicle of events explains how and why these efforts went awry; in the process, it helps illuminate the trouble besetting international coordination in general, and the weaknesses of the Fund in particular. The failure of these initiatives is profoundly relevant to the efforts currently underway in the Group of 20 (G20) to deal with imbalances. The story also illustrates in stark terms how the decline in US power, especially relative to China, has eroded Washington's capacity to exercise leadership and work its will in the global economy.

INTRODUCTION

In the wake of the global financial crisis that erupted in 2008, the need for economic cooperation among major powers is more urgent than ever — particularly on the issue of trade and capital flow imbalances. Even those who doubt that global imbalances helped cause the crisis acknowledge the desirability of a well-coordinated plan aimed at shrinking the imbalances that persist today. After all, the countries that have run large trade deficits, such as the United States, the United Kingdom and Spain, are obliged to impose significant austerity measures sooner or later, which means global growth will be in danger unless countries with large surpluses — such as Germany, China and other Asian export powerhouses — take offsetting action by ramping up demand and importing more goods. Let's hope the G20, which is striving to implement such a plan, produces a shining example of how nations that cooperate harmoniously can achieve mutually beneficial

results. And what better global agency to oversee, or at least monitor, such a process than the IMF?

For those who share this view — and I count myself among them — the story that unfolds in this monograph is dispiriting. It is a detailed account of initiatives led by the IMF to address the imbalances in the years prior to the crisis. Based on interviews with scores of policy makers who were involved and thousands of pages of confidential documents — memos, emails, meeting notes and transcripts — that have never been previously disclosed, it focuses on two undertakings. The first is the Fund's 2007 decision to strengthen its surveillance of exchange rates, which was aimed at prodding countries — China being the most prominent example — to take action when their currencies were seriously under- or overvalued. The second is the multilateral consultations, in which the IMF convened representatives of five major economies (the United States, China, the euro zone, Japan and Saudi Arabia) to discuss plans for shrinking imbalances.

News reports and scholarly commentary have long made clear that neither of these initiatives ended well.¹ The IMF's 2007 decision on exchange rates became a major embarrassment for the Fund, because of the inclusion of the term "fundamental misalignment," which the Fund was supposed to apply to currencies judged to be egregiously out of line with underlying economic conditions. This endeavour came to naught when Chinese officials effectively blocked any such judgment on the renminbi by repeatedly staving off the Fund's annual assessment of their economy, the so-called Article IV report. As for the multilateral consultations, when they concluded in April 2007, the plan released by the five participants was derided in the media as essentially a restatement of commitments that the IMF had made already — notwithstanding the Fund's efforts to depict the talks as successful.

But behind these basic, publicly known facts lies a much richer tale that reveals the depths to which these undertakings sank, as well as the heights to which hopes occasionally soared that they might lead to breakthroughs in governance of the global economy. This chronicle of events provides a substantial amount of new evidence to explain how and why these efforts went awry; in the process, it helps illuminate the trouble besetting international coordination in general, and the weaknesses of the Fund in particular. A lengthy retelling is required to do justice to the machinations, which are often suggestive

1 See Scheherazade Daneshkhu (2007). "Big economies renew vow on imbalances," *Financial Times*. April 16; Bob Davis (2009). "An Empowered IMF Faces Pivotal Test," *The Wall Street Journal*. March 31; Alan Beattie (2009). "IMF in discord over renminbi," *Financial Times*, January 26; Edwin M. Truman (2009). "The International Monetary Fund and Regulatory Changes" Working Paper No. 09-16, Peterson Institute for International Economics, Washington, December; Chris Giles (Christian Oliver and Alan Beattie (2010). "Pledges stir uneasy sense of déjà vu" *Financial Times*. November 12.

of the aphorism about sausages and laws: “It is better not to see them being made.”

Each of the IMF’s initiatives took different approaches to the issue of imbalances. The 2007 decision was an exercise in devising rules for the international system, with provisions to clearly identify violators in the hope of inducing compliance. The multilateral consultations, by contrast, were a collaborative exercise, based on the idea of bringing policy makers from several countries together to tackle a common problem — the theory being that they would more likely grasp the value of acting in concert and might find it politically easier to strike a bargain.

Both initiatives, however, ran up against cold, hard facts: First, the governments of sovereign nations — especially big and powerful ones — can’t be compelled to act in the global interest. Indeed, ruling elites sometimes resist taking such action even when their own people would broadly stand to benefit, because they often have political motives for avoiding measures that might incur short-term adjustment costs. Second, international institutions such as the IMF have little leverage over major countries, or even minor ones, other than those to whom they are lending money. If anything, these institutions are often obliged to indulge the wishes of, and avoid offending, their biggest shareholders. Third, with US power on the wane, leadership in the international system is much more diffuse than before, commensurately complicating the task of reaching agreements. Obvious as these facts may seem, a full appreciation of their robustness depends on the in-depth examination of failures such as the two chronicled herein.

The narrative recounts a number of episodes that have been secret up until now, as well as new details about key turning points that have been only hazily understood. One example is the day that the IMF formally approved the 2007 decision regarding exchange rates. The following account of the events of that day serves as an introduction to the conflicts that have plagued international coordination on imbalances.

PREMATURELY UNCORKING THE CHAMPAGNE

On June 15, 2007, a rare phenomenon — excitement — permeated the IMF boardroom, a 60-foot-long, oval-shaped chamber on the twelfth floor of the Fund’s Washington headquarters. Meetings of the executive board, a 24-person body that represents the 187 member countries, are almost invariably dull and stilted. By tradition, the outcome is agreed by consensus, having been negotiated beforehand at informal gatherings, so drama and tension are virtually unknown in these conclaves. Votes are uncommon; the meeting chairperson, who is either the managing director or one of the deputy managing directors, usually ends the

discussion with a summing-up that has been scripted in advance.

A memorable exception was this late-spring meeting, when the board enacted the decision that changed the rules by which the IMF assesses member countries’ exchange rates. News stories at the time² reported that the decision was approved over the objections of the Chinese and a couple of other countries. What wasn’t revealed was how suspenseful the meeting actually was — and how discordant.

A preliminary vote count, which circulated among IMF staffers on the morning of the meeting, underscored the prevailing enormous uncertainty about the final result. Based on the known opinions of executive directors, including written statements submitted for the record in advance, nine chairs holding a bit over half the voting power favoured approval; they represented the Group of Seven (G7) major industrial countries (which usually forged common positions) plus directors representing constituencies of countries led by Switzerland and Australia. But nine developing-country directors holding 25 percent of the votes were opposed, and others were expressing reservations concerning the “hasty adoption” of the decision. The managing director, Rodrigo de Rato, and the staffers who were working on the proposed new rules hoped to win approval, but they did not want to force a vote without overwhelming support; a narrow victory on such a contentious issue would be disastrously divisive. An email sent on the morning of the meeting by senior staffer Carlo Cottarelli warned, “As many of the supporters are unhappy to go ahead without broader consensus, we may not even have 50 percent.”

One director’s support was clearly unobtainable — Ge Huayong, who represented China. The Chinese government had no doubt that these new rules were intended for use against its exchange rate policy, given the inclusion of “fundamental misalignment” as the main new standard by which the IMF would conduct surveillance of countries’ currencies. Chinese officials were, therefore, going to extraordinary lengths to stave off approval of the proposal, arguing that it was being rushed and needed further consideration. A few hours before the start of the IMF board meeting, the People’s Bank of China summoned the Fund’s Beijing representatives and handed them a letter, signed by Governor Zhou Xiaochuan, addressed to de Rato, which he received by email on the morning of the meeting. “The Chinese government expresses her deep concern over the Fund’s intention to call the Board of Directors to vote,” the letter said. “Such action will break the Fund tradition of passing major decisions based

² See Krishna Guha (2007). “IMF set to scrutinize exchange rate policies,” *Financial Times*. June 19 and “China cool to IMF policy shift,” *Montreal Gazette*. June 21.

on broad consensus, and will also impair the cooperative relations between the Fund and its members.”

But de Rato, Spain’s former finance minister, was determined to push the proposal through that day, provided he could reduce the number of “no” votes to a small fraction of the total. He was under intense pressure from the US Treasury, which was as eager to see the renminbi designated as fundamentally misaligned as the Chinese were to avoid it. Moreover, he could legitimately claim that the issue had received lengthy consideration; the board had first met to discuss it almost a year earlier, in the summer of 2006, and Fund staff had written several long papers explaining the rationale and offering various formulations. So, at 11:30 a.m. that Friday morning, he called the board to order.

Among the first to speak was Meg Lundsager, the executive director for the United States. She emphasized that in the process of drafting and re-drafting the proposed decision, the managing director and his staff had “made exceptional efforts to accommodate concerns” raised by some other countries. “We should finish this today,” Lundsager concluded, according to a written record of the meeting. Her stance drew hearty endorsement from several directors including those from Canada, France, Japan and a Finnish director representing the Nordic countries. But it met with strong resistance from a group of developing countries led by Shakour Shaalan, an Egyptian representing a constituency of 13 countries, mostly in the Middle East. Shaalan acknowledged that the “pro” forces had offered many concessions, but so had his group, and they still weren’t fully satisfied. “We have some further work,” he contended, a view supported by directors from major countries such as Brazil and India.

A lunch break that started just before 1:00 p.m. stretched for three hours, as staffers scrambled between offices with hastily written provisions that, they hoped, would appease most of the opponents without watering down the proposed rules so much that it would anger the Americans and their allies. The most important compromise involved moving the words “fundamental misalignment” to a less-prominent part of the text than before; another, which was drafted by Brazilian Executive Director Paulo Nogueira Batista, involved rewriting the preamble to make it clear beyond any doubt that the rules did not impose any new obligations on member countries. When the board reconvened at 4:00 p.m., de Rato read out the proposed amendments, and as one director after another expressed support for the revised version, it became evident that China would be virtually isolated in opposition.

In a desperate bid for time, Ge asked for an adjournment until Monday, to give directors time to consult with their capitals. “There is no reason to rush to conclude at the end of this meeting,” he said. Ordinarily, such a request is granted as a matter of course, but not this time, to the

shock and discomfort of a number of those present, who viewed the episode as adding insult to Beijing’s injury.

De Rato was deeply concerned about the possibility that the fragile coalition now supporting the proposal would fall apart. After conferring briefly with aides, de Rato said he would adjourn the meeting only if all directors agreed. Lundsager immediately stated she would not, arguing that, as members of a resident board, they were supposed to be decision makers, and several others echoed those sentiments, including Japan’s Shigeo Kashiwagi, who noted humorously that since this meeting was his last as an executive director he would like to see the matter finalized. When the roll was called, only Shaalan and a director from Iran joined China’s Ge in voting no.³

That evening, de Rato summoned to his office the coterie of staffers who had worked closely with him on the proposal. To their pleasant surprise, the managing director poured champagne for everyone and toasted their triumph — yet another rarity on a day already full of them.

The cliché about prematurely uncorked champagne applied literally, and with force, in this case. To this day, passions run high among the IMF policy makers and those from the main countries involved in the 2007 decision on exchange rates. Some IMF economists describe it as the worst policy blunder they can recall in their careers — a shameful example of the Fund allowing the United States to bully it. The opposite view, espoused by some US officials and scholars, is that Chinese pressure later stopped the IMF from applying the decision properly. Both of these interpretations, although supported to some extent by the evidence, miss key elements of the story — in particular, a spirited effort to make the Fund adopt a more even-handed, “symmetrical” approach to its dealings with member countries. But even those who defend the decision as well-intentioned acknowledge the dreadful errancy of its eventual course.

A SAGA WITH RELEVANCE

The meeting recounted above is one episode in a saga full of twists and turns that affords a uniquely granular look at the inner workings of the IMF as it struggled with issues central to the global economy’s future. Historical interest, however, is far from the only purpose for exploring the story in such depth.

The failures of the 2007 exchange rate decision and the multilateral consultations are profoundly relevant to the efforts currently underway in the G20 to deal with imbalances. In its Mutual Assessment Process (MAP), the G20 has incorporated both elements of rule making and the “let-us-reason-together” approach. Periodic leaders’ summits and gatherings of finance ministers are

3 Shaalan later requested that his vote be changed to yes.

supposed to help generate pressure for collective action toward lowering imbalances; additional pressure will, presumably, come from the use of “indicators” to help highlight the countries that are making progress toward the goal and those that are not. Thus, a thorough account of the pre-crisis initiatives and scrutiny of what went wrong is essential to informing the public debate about whether the G20 is on a more promising track. Misunderstandings about some aspects of pre-crisis events may well be leading to faulty conclusions about how to do better on the imbalances issue in the future.

Viewed more broadly, this tale is a parable about why international coordination often proves elusive, whether the issue at stake involves macroeconomics, financial regulation, trade, the global environment or security-related matters. Underlying both the 2007 decision and the multilateral consultations were theories about how to improve the workings of the global system that, while hardly uncontroversial, were eminently defensible. Perhaps not everything that could have gone wrong with these initiatives did go wrong, but a lot did, and a retrospective shows how tricky it is to keep even the most reasonable-sounding exercises in multilateral diplomacy from going off-track. The lack of agreed rules to govern the behaviour of nations, the fiendish complexity involved in trying to forge such rules and the reluctance of the international community to enforce the existing rules, especially where powerful countries are concerned — all come into play in the narrative that follows. So do the many problems and complaints about governance that bedevil the IMF and other international institutions, in particular, the degree to which power in these institutions remains stacked in favour of the rich.

The geopolitical dimension also looms large in this story, which illustrates in stark terms how the decline in US power, especially relative to China, has eroded Washington's capacity to exercise leadership and work its will in the global economy.

For much of the past 65 years, the United States effectively set the rules for the international monetary system, taking advantage of a set of institutions and arrangements that reflected America's geopolitical might, and enhanced its autonomy in important respects. Many of the IMF's most important decisions were subject to the dictates of the US Treasury, as witnessed by the dominant role that Clinton administration officials played in overseeing the management of the crises in Asia, Latin America and Russia in the 1990s. Washington was able to keep a firm hand on the IMF given its status as biggest shareholder, its leadership of the G7 and a “gentlemen's agreement” with Europe that divvied up the top management positions at the Fund and the World Bank. Foreign policy benefits accrued to Washington as a result, a prominent example of this being IMF backing for the bailout of South Korea, which was based in part on Seoul's strategic importance.

Economic benefits also accrued, as the primacy of the US dollar — the main unit in which cross-border trade, lending and investing is conducted — gave Washington its famously “exorbitant privilege.” The recognition by investors the world over that US securities markets are a uniquely convenient and even essential place to put their money has provided the United States with greater flexibility than any other country to run trade deficits, budget deficits and low-interest-rate policies, without having to worry much about a sudden withdrawal of capital. Although these “rules of the game” rankled policy makers from other countries, the rules endured — in part because the other nations enjoyed the benefits of the US security umbrella. America's trading partners even went along, to some extent at least, when Washington insisted they bear the major burden of adjustment to accommodate the need for economic rebalancing — the most notable example being the Plaza Accord of 1985, when the world's five largest industrialized countries agreed to cooperate in lowering the dollar's exchange rate, while raising that of the Japanese yen and German deutsche mark.

In the case of the IMF's 2007 decision on exchange rates and the multilateral consultations, American hegemony would prove to be a dissipating force, especially after the outbreak of the financial crisis. As we shall see, the US Treasury did attempt to intimidate the Fund, but ultimately got nowhere. Even when the United States got its way — which it did at the June 15, 2007 meeting of the IMF board — its victories proved short-lived and hollow. One particularly ignominious example was a series of events in August and September 2008, just as the crisis was approaching its full fury. The Fund staff prepared an Article IV report on China that included an accusation of fundamental misalignment. But the report was never released publicly, because after Lehman Brothers went bankrupt on September 15, 2008, the effort to label the renminbi was abandoned, for the obvious reason that picking a fight with Beijing at that particular juncture would have been foolish in the extreme; Washington desperately needed Chinese cooperation in quelling the turmoil.

Before delving into those developments, it is necessary to recount the circumstances that engendered both of the IMF initiatives. Their origins can be traced to the fall of 2005, an unusually tense period between the Fund and its largest shareholder.

BRIGHT IDEAS NEEDED

Among international economic policy makers and experts, the phrase “asleep at the wheel” evokes fond memories for some, bitter ones for others. Whether positive or negative, the impact of this adage was resounding. Responsibility for its use in this situation belonged initially to Robert Kaproth, a fast-rising civil servant in the US Treasury,

tasked in August 2005 by new Treasury Under Secretary for International Affairs Timothy Adams to write his first major speech, on the subject of the IMF. For his debut on the international stage, Adams wanted to say something meaningful and noteworthy, so Kaproth obliged with a draft using the incendiary phrase to chastise the Fund. The harshness of the wording generated consternation among others on Adams's staff, but the under secretary, an earnest 43-year-old with an all-American demeanour, resolved to keep it in. He knew his boss, Treasury Secretary John Snow, was inclined toward much more measured language, especially in public, so Adams decided to deliver the speech without consulting or even informing the amiable Snow about the passage in question.

The speech, delivered on September 23, 2005 at the Institute for International Economics, was a broadside aimed squarely at the IMF's handling of China's foreign exchange regime — although China was not mentioned by name.⁴ By that point, the renminbi had become a major focus of attention in Washington, with American politicians and industry groups up in arms over Beijing's long-standing policy of keeping its currency closely tied to the US dollar. China's current account surplus, which had swelled to 4.5 percent of GDP in 2004, was clearly headed to even greater heights; exports increased at a rate of 33 percent in the first half of 2005 (well over twice the pace for imports), and the country's foreign exchange reserves were also mounting rapidly — to around \$700 billion. Although China had briefly appeared set on a new course in July 2005, when it lifted the value of the renminbi by about two percent and began to allow it to move more flexibly, the rate of appreciation had been tiny in the two months thereafter. As a result, Senators Charles Schumer and Lindsey Graham were threatening to force a vote on legislation they were co-sponsoring that would unilaterally impose a 27.5 percent tariff on Chinese goods, based on estimates by some analysts of the renminbi's undervaluation (Blustein, 2005).

To Adams and his Treasury colleagues, this situation was exactly what the founders of the IMF had in mind when they created the institution to prevent a recurrence of the beggar-thy-neighbour currency wars of the 1930s. Whether or not China's exchange rate policy was depriving millions of Americans of their jobs, as some in Washington were claiming, it struck the Treasury team as a classic malfunctioning of the international monetary system, the rules of which (as spelled out in the IMF's articles) bar countries from “manipulating exchange rates...to gain an unfair competitive advantage.” And Adams, a staunch internationalist in an administration with a penchant

for unilateral action, wanted to see the Fund take up the cudgels. He was acutely aware that Washington's incessant harping and blustering was probably producing a counterproductive effect in Beijing, and if Congress got so carried away as to impose sanctions, the result could be a ruinous tit-for-tat trade war. Multilateralizing the issue, using agreed rules and a re-energized IMF, was both the principled way to go and the most likely to work — on that, Adams was prepared to try to make his mark as a financial diplomat.

The IMF was by no means oblivious to the issue. The missions it had sent to Beijing repeatedly exhorted Chinese officials to loosen the trading band around the renminbi. Led by Steven Dunaway, a Fund veteran in the Asia and Pacific Department, the missions had a tough sell. Their Chinese interlocutors liked to point out that during the Asian crisis, the IMF had been applauding them for doing exactly the opposite — keeping the renminbi fixed against the dollar, to help prevent currencies in the region from plunging out of control. The Chinese were also fond of citing a handful of prominent Western economists, including some Nobel prizewinners, who contended that the renminbi was appropriately valued. To these arguments, Dunaway and his team responded with a host of data showing unmistakable signs of undervaluation — notably, trends that had taken place since early 2002, including a fall in the trade-weighted value of the renminbi, a swelling of the current account surplus from already substantial levels, and rapid increases in labour productivity and competitiveness. Above all, the IMF stressed (as US officials had done) that considerable benefits would accrue to China from a rise in the renminbi, including a stimulation of consumer spending that would make the economy less dangerously dependent on exports and low-return business investment. In its 2005 Article IV report on China, the IMF had publicly declared that evidence “points to increased undervaluation of the renminbi, adding to the urgency of making a move... greater exchange rate flexibility continues to be in China's best interest” (IMF, 2005).

But that language was a far cry from a warning that the Chinese were playing fast and loose with the rules of the system. As Adams noted in his speech, the IMF managing director was empowered to initiate “special consultations” with countries that were suspected of engaging in currency manipulation, with the implicit threat of bringing the matter to the IMF executive board, where the alleged violator could be subject to further naming and shaming. This authority, however, had only been invoked twice — both times in the 1980s — Adams pointed out, and in the absence of stern action by the Fund, aggrieved politicians, such as those in Congress, might resort to bilateral measures. Hence, his conclusion: “The perception that the IMF is asleep at the wheel on its most fundamental responsibility — exchange

4 See Timothy Adams (2005). “The U.S. View on IMF Reform.” Speech presented at the Conference on IMF Reform, Institute for International Economics, Washington, DC, September 23. Available at: www.iie.com/publications/papers/paper.cfm?ResearchID=564 www.iie.com/publications/papers/paper.cfm?ResearchID=564.

rate surveillance — is very unhealthy for the institution and the international monetary system.”

Adams’s remarks landed with a thud in the IMF’s executive suite, where the initial reaction was to push back hard — both in public and private.

About an hour after Adams spoke, de Rato mounted the same dais to deliver a rejoinder. His central point was that the IMF is not the sort of institution that can exercise power by punishing or censuring its members. “The influence of the Fund in the world comes almost entirely from its ability to persuade its members that they should follow its advice,” de Rato said, adding that this applied to a variety of issues besides China’s currency — including, he noted pointedly, the US budget deficit. “If you’re in a room with a friend you don’t need to talk through a megaphone. And I think quiet diplomacy, as some have characterized it, has produced good results, and not just in the area of exchange rates” (de Rato, 2006a).

De Rato took a similarly resolute position when he met on October 7 with Treasury Secretary Snow, who had been unhappy with the tone of Adams’s speech, but was backing up his new under secretary on the substance. According to a memorandum of the meeting, the US representative on the IMF board, Nancy Jacklin, who also attended, made a pitch for the Fund to be “more critical in public” about exchange rate regimes such as China’s. To this, de Rato retorted that if anything, Fund reports on China’s currency policy were “more explicit than in many other cases.” He also dismissed the idea that the Fund should pursue a special consultation with the Chinese, emphasizing this would be “extremely divisive and partisan” on the board. On that score, he was undoubtedly correct; the view in a number of major capitals was that the renminbi exchange rate was not as worrisome — nor as big a factor in global imbalances — as America’s faults — its budget deficit, excessive consumption and low savings rate. The managing director also noted the rarity of such consultations in the past and the difficulty of proving a charge of manipulation, since it required showing that the reason for the manipulation was to gain competitive advantage. (De Rato was inclined to accept China’s official explanation that “economic stability” was the motive for its exchange rate regime, notwithstanding candid admissions by some in Beijing that this essentially meant preserving jobs in the export sector.)

Finally, de Rato warned that to remain effective, the IMF must avoid being “seen as influenced in its action by any one country.” This was a polite way of saying what many at the Fund had been fuming about privately — that the US Treasury wanted them to do its dirty work. Under US law, the Treasury was legally required to identify, and potentially take action against, countries that manipulate their currencies for competitive advantage (terminology that is nearly identical to that in the IMF’s Articles).

Treasury officials had long refrained from labelling China a manipulator, for fear that using such a politically explosive term would validate arguments for protectionist legislation; while acknowledging that the renminbi was obviously manipulated, the Treasury resorted to the same excuse as the Fund — namely, lack of proof that the Chinese were motivated by a desire for competitive advantage. There was, therefore, no denying the accusation that the Fund was being asked to go where the United States feared to tread. But this accusation irked Treasury officials, who believed that responsible multilateralism mandated such a stance.

The gap between the two sides widened further when, behind the scenes, the Treasury tried another ploy, suggesting in mid-November that the United States would exercise its right to formally request the IMF to initiate special consultations with the Chinese. This move came in the form of a draft of the Treasury’s semi-annual report on foreign exchange policies, which was submitted (in accordance with US law) on a confidential basis to top IMF management before its public release. The draft report stated that the United States “calls on the Fund to consult with China and other large emerging Asian economies” about their currency policies. But the IMF made it clear that if such a request was forthcoming, it would be rejected — a scenario US officials were anxious to avoid, as it would expose the lack of support in the international community for their position. The Treasury grudgingly backed down and the language did not appear in the publicly issued version of the department’s report.

Still, no IMF managing director can go too far in defying the United States, and de Rato had a special reason for wanting to patch up his rift with the US authorities. The Fund was in the midst of an existential crisis, trying to sort out what its role should be in a global economy that appeared in no need of an emergency firefighter. With world markets buoyant and massive foreign exchange reserves accumulating in the coffers of governments throughout the developing world, few countries were interested in IMF loans — one result being that the Fund’s interest income was rapidly depleting, to the point where the institution could eventually find itself in urgent need of new financial resources. Also in doubt was the Fund’s influence as an adviser, given smoldering resentment over the role it had played during the crises of the late 1990s in Asia, where it had been perceived as America’s pawn. Topping all of this off were glaring deficiencies in the IMF’s governance, which had kept emerging countries’ voting power on the executive board from growing anywhere near their share of global GDP, while giving disproportionate clout to the old powers of Europe.

To address these problems, de Rato had proposed a “Medium-Term Strategy” for the IMF in September 2005.⁵ But it had drawn a lukewarm reception because of its lack of clarity and vision, and as he was well aware, US support would be critical for this undertaking as it progressed in the months and years ahead. If Washington perceived the Fund as useless, especially on the China issue, the necessary political backing for maintaining the Fund’s viability would wane.

So de Rato began casting around for ways to demonstrate the IMF’s utility to the US government, particularly to Congress. “The MD would like a better idea of what the options are,” wrote Mark Allen, director of the IMF’s Policy Development and Review Department, in an email sent to senior colleagues a few days following de Rato’s meeting with Snow. The email cited a few possibilities: the initiation of a special consultation with China (though that, Allen observed, almost certainly lacked the necessary board support); the drafting of a paper on how China could increase consumption; and the inclusion of a session on exchange rate issues at a conference that the Fund was planning to hold.

“Any other bright ideas?” Allen asked.

There were. Or so they seemed at the time.

THE 2007 DECISION

The phrase “fundamental misalignment” can be traced to the bill-drafting efforts of Stephen Schaefer, a Republican aide on the Senate Finance Committee, in early March 2006. It is curiously reminiscent of the “fundamental disequilibrium” standard that was used in the original IMF articles to refer to balance-of-payments problems serious enough to merit a change in a country’s currency peg. But Schaefer was a specialist in trade law, not an expert in the Bretton Woods system. He had no idea that the IMF would adopt his term, much less that it would become a major bone of international contention within the institution.

Schaefer was searching for the right words to fit legislation that his boss, committee chairman Charles Grassley, planned to introduce with Senator Max Baucus, the committee’s ranking Democrat. The purpose of the bill, which the Bush administration liked in principle, was to put pressure on China regarding its currency, in a more credible way than rival bills that used drastic — and largely empty — threats of punitive tariffs. That meant concocting a substitute for what Treasury Under Secretary Adams called “the scarlet M” — manipulation, the term the Treasury couldn’t bring itself to use. As he wrote and re-wrote bill drafts, Schaefer therefore sought to

come up with a more practical standard for determining whether a country’s exchange rate policy was deserving of censure or possible sanctions. “Material disequilibrium” got into some drafts; “material misalignment” was another candidate. But neither of those were quite right. “Fundamental misalignment” struck him as the best.

At that point, the IMF was also getting started on its own effort to move away from reliance on “the scarlet M.” The charge of “being asleep at the wheel” may have stung, but it also rang true to a number of influential policy makers at the Fund. The problem, they reasoned, was not so much deliberate dereliction of duty as it was terribly outmoded and narrowly drafted rules. The IMF’s guidelines on exchange rate surveillance had last undergone a major overhaul in 1977, when the system of floating currencies was still in its early years, and before massive amounts of private capital had begun flowing across international borders. At a meeting of high-level staff on December 16, 2005, de Rato approved a proposal to study whether replacement of the 1977 decision was in order, documents show.

Proponents of revising the decision offered several compelling arguments. The existing rules, with their focus on manipulation, hamstrung the IMF from taking action because of the legal requirement to discern the motivations of the manipulators. More broadly, the Fund badly needed to clarify what surveillance was supposed to be about, as Article IV reports often glossed over the issue of exchange rates. Mission chiefs were happy to fill their reports with advice on issues that interested them, such as labour markets, demographics and transportation regulation. But the IMF’s central purpose is supposed to be about keeping countries from adopting policies that risk damaging the rest of the world or the international system in general — and exchange rate policies that kept currencies under or overvalued were among the most obvious examples of such policies.⁶

Another major reason for starting work on a new decision was, of course, the hope that it would pacify the United States by demonstrating that the IMF was looking for better ways to deal with the Chinese exchange rate problem. And it wasn’t only American pressure that de Rato had to worry about; the idea that the Fund ought to engage in more “ruthless truth-telling” of the sort John Maynard Keynes had envisioned was coming from many influential quarters in the early months of 2006. Mervyn King, governor of the Bank of England, argued in a speech that the IMF should step up to its role as “arbiter of the international monetary system...not so much the referee brandishing the yellow and red cards of the football

5 See Rodrigo de Rato (2005). “The Managing Director’s Report on the Fund’s Medium-Term Strategy.” September 15. Available at: www.imf.org/external/np/omd/2005/eng/091505.pdf.

6 Another example of policies that might damage other countries is poor financial regulation, of which the United States is now known to have been grievously guilty. But in early 2006, the Fund was oblivious to the problems brewing in the US financial system.

pitch, more the cricket umpire...making it clear when they believe the players are not abiding with the spirit of the game" (King, 2006). His counterpart at the Bank of Canada, David Dodge, delivered a like-minded speech that also invoked the "umpire" analogy as an important function that the IMF was failing to perform.⁷ De Rato's preference for "quiet diplomacy" made him chary of assuming such an aggressive role, but he could see the flaws in the 1977 decision, and by mid-March he was convinced that the revision should go forward, internal documents show. At the IMF-World Bank spring meetings the following month, the ministers who oversee the Fund formally endorsed the idea as one of the key components of de Rato's revised medium-term strategy.⁸

Charged with drafting proposals for the new decision was a small group of staffers, including IMF General Counsel Sean Hagan and legal specialists working for him, but the lead belonged to high-ranking economists in the Policy Development and Review (PDR) Department — sardonically dubbed the "thought police" by some in the Fund, both because of its power and its role as enforcer of institutional orthodoxy. Among the most senior, whose names will come up later in this narrative, were the aforementioned Carlo Cottarelli, along with Tessa van der Willigen and Isabelle Mateos y Lago. The drafters in the Legal and PDR departments had various views of the undertaking; some felt strongly about the importance of making surveillance more focused, while at least one cynic saw the primary purpose as the necessary evil of satisfying the demands of the US Treasury.

Nobody doubted the sincerity of their leader, Mark Allen, an avuncular Englishman who was the director of the PDR Department. He believed that the international monetary system needed better rules for identifying problematic exchange rate regimes such as China's, and that the IMF had a duty to speak up when countries broke those rules; to that extent, he shared the US Treasury's view. At the same time, Allen believed the guidelines needed updating to cover all kinds of situations in which one country's policies might adversely affect others. He cared fervently about symmetry, a principle much beloved by Keynes — that is, making the rules apply both to countries with large surpluses and those with large deficits, to both creditor and debtor nations, to currencies that were pegged as well as those that floated, and to currencies that were overvalued as well as undervalued. Moreover, Allen saw a need for rules that would go beyond exchange rates and cover domestic policies as well, because even though

7 See David Dodge (2006). "The Evolving International Monetary Order and the Need for an Evolving IMF." Lecture to the Woodrow Wilson School of Public and International Affairs, Princeton, March 30.

8 See IMF (2006). "Communiqué of the International Monetary and Financial Committee of the Board of Governors of the International Monetary Fund." April 22. Available at: www.imf.org/external/np/cm/2006/042206.htm.

IMF member countries obviously had the sovereign right to make their own choices regarding, for instance, government spending, taxes and interest rates, sometimes those policies — big budget deficits, as an example — might foment instability abroad.

Skeptics of the undertaking abounded within the IMF staff, to be sure — and unsurprisingly, they were, for the most part, in the area departments whose members staffed the country missions that wrote Article IV reports. Much of their criticism of the effort to revise the 1977 decision focused on the impossibility of drafting rules that would reflect truly objective judgments about currency levels. "There is no consensus in the economics profession on what constitutes an equilibrium exchange rate," protested Ajai Chopra, an economist in the European department, in a March 14, 2006 memo. One of the most perspicacious comments came in another memo written the same day by Tamin Bayoumi of the Western Hemisphere Department, who questioned whether a new decision would make any difference. "[A]ddressing exchange rate manipulation will ultimately depend more on the will of management and member countries to confront such issues," Bayoumi wrote.

The US Treasury was ambivalent at first. In a speech praising de Rato for seeking new methods of dealing with the currency issue, Under Secretary Adams said he recognized that the special consultations mechanism wasn't working because of the "huge stigma" implied in being called a manipulator. "Some of these phrases are used so infrequently, that when you do use them, they become headline news. So we need to...de-stigmatize, so we can use them for useful purposes," he said (Adams, 2006). At the same time, Adams and his colleagues were less than fully convinced of the need for a new decision. The trouble with the IMF, they felt, was not so much antiquated rules as it was fecklessness. According to the notes of a May 18 meeting between Treasury and Fund officials, Mark Sobel, a deputy assistant secretary known for his zealous, and often blunt, advocacy of the Treasury view, said: "The '77 decision isn't all that bad. The problem is in the practice."

Still, the United States soon warmed to the idea of rewriting the decision — with one proviso: The new decision had to incorporate the "fundamental misalignment" language in the Grassley-Baucus bill, which had been introduced on March 28, 2006. In the Treasury's view, this would be an ideal way of multilateralizing the exchange rate issue, thereby ensuring that responsibility for pressuring China would rest with the IMF, where it properly belonged, rather than increasing the risk that the bilateral US-China dispute would get out of hand.

High-minded as this approach may have seemed from the Treasury's perspective, Mark Allen and his team accepted it, with considerable reservations, because the required language created a huge image problem for them as they

worked on drafts of the new decision. In a memo to top IMF management dated June 19, 2006, Allen fretted that “the focus on exchange rate misalignment [in the new decision]...may be seen by many as a concession to the US because this focus is also shared by the Grassley-Baucus bill.”

But the good news, Allen continued, was that the draft decision “also includes features that should please” many other member countries. Specifically, it “applies to all countries, not just [currency] peggers, and therefore applies to the United States and their domestic policies.” This was because the decision would aim to focus IMF surveillance above all on “external stability” — a term Allen and his colleagues coined, which referred to the effect a country’s policies might have on other economies and the global financial system in general. Although this concept aroused considerable criticism within the Fund,⁹ its ingenuity lay in its potential for promoting impartiality. Exchange rate policies were one of the important factors in determining whether a country met the standard of external stability, but the term also encompassed domestic policies that could lead to significant instability across borders. So the US budget deficit might just as readily run afoul of the new decision as China’s currency manipulation possibly could.

Summing up, Allen told the managing director that “the new principle — which we consider to be the right way forward for the Fund — could, ultimately, be acceptable to various stakeholders. It may, however, elicit a great deal of controversy along the way.”

“A great deal of controversy along the way” — that, too, was perspicacious.

OVERPOWERING THE OPPOSITION

It was entirely predictable that the Chinese government would smell a rat right from the start of the initiative to revise the 1977 decision. Its currency regime was obviously a target, in particular, of a proposed new “Principle D,” which read: “A member should avoid exchange rate policies that, while pursued for domestic reasons, lead to external instability, including fundamental exchange rate misalignment” (IMF, 2007a). And Chinese officials had every reason to assume they were uppermost among the candidates for participation in the “ad hoc consultations” with the managing director that were envisioned for

countries with exchange rates judged to be fundamentally misaligned.

More surprising was the wariness of Latin American officials and officials in other parts of the developing world. Although they had much less reason than the Chinese to worry that their currencies would run afoul of the fundamental misalignment standard, they were suspicious about what a revised decision would mean for them. Based on long and bitter experience, they had concluded that when it came to the IMF they were the rule-takers, while the rich rule-makers didn’t have to worry about becoming the targets of severe Fund surveillance. Claims that the new decision would apply equitably, without regard to wealth or power, did not impress the developing countries; it was common knowledge that the IMF’s most important shareholders could, and sometimes did, use their influence to blunt Fund criticism of their most sensitive policies. So, in the summer of 2006, when the executive board began considering whether to revise the 1977 decision, internal IMF documents show the proposal drew support only from directors representing wealthy nations. Their counterparts from developing countries were deeply concerned about the emphasis on domestic policy as a potential source of external instability. That, they feared, could entail new restrictions on the freedom of their governments to conduct domestic policy as they saw fit.

It didn’t help that the papers written by the PDR and the Legal departments to explain and justify the new approach were not only lengthy (typically 20 to 30 pages), but extremely dense, even by IMF board standards. This couldn’t easily be avoided; the papers had to spell out, in fairly rigorous terms, the meaning of concepts such as external stability and fundamental misalignment. The basic definition the staff came up with for fundamental misalignment was relatively understandable for anyone with a modest background in economics: a country’s exchange rate is significantly above or below the level consistent with the country’s equilibrium current account. However, a host of questions naturally sprang from that: Which measure of the exchange rate was referred to? What time frame was implied by “equilibrium”? How large a divergence from the equilibrium level was required to be considered significant? At that point, the papers often resorted to jargon requiring Ph.D.-level expertise, for example, this sentence: “In general, the equilibrium evolution of the NEAP is expected to be consistent with the present and expected values of such fundamentals as productivity differentials, the terms of trade, permanent shifts in factor endowments, demographics, and world interest rates” (IMF, 2007b). (NEAP stands for net external asset position.)

Faced with the prospect that developing-country opposition might kill their initiative in its nascent stage, Allen and his lieutenants embarked on an intense

9 Critics of the proposed focus on external stability regarded it as excessively narrow. Surely, they contended, the Fund’s surveillance responsibilities should be broader; even a poorly performing country, after all, might fulfill the standard of external stability. Allen and his team countered that the term made sense as a guidepost for surveillance because external and domestic stability were often closely related. A low-growth economy was more likely to generate external instability, because its government would be tempted to resort to policies such as inflation or competitive depreciations.

lobbying campaign in the fall of 2006, with high-level support from de Rato, “in the hope that we can peel off a few of these [directors] from what looks like an almost monolithic bloc,” as the PDR Department’s Tessa van der Willigen put it in an email to her colleagues. The irony of the situation vexed them; the developing-country directors were focusing their attacks on the very features of the proposed decision that were supposed to make surveillance more even-handed. One of the most contentious provisions, called “Principle E,” stated that IMF member countries “should seek to avoid monetary, fiscal and financial policies that lead to external instability” (IMF, 2007a). That was precisely the kind of wording Allen had thought could be used against the United States, and the PDR team hoped that by meeting the developing-country directors to elucidate such points, at least some of the opposition would evaporate.

But try as they might — and their lobbying efforts continued throughout the first half of 2007 — they kept finding themselves encumbered by the IMF’s legacy, as witnessed by an email that van der Willigen received from Hector Torres, an executive director from Argentina: “We cannot read the proposal without having in mind the democratic deficit that the governance of this institution has.” On January 26, 2007, Allen and General Counsel Hagan reported in a memo to de Rato that, although all the directors from G7 countries were supportive of revising the 1977 decision, the developing-country directors, who had banded together in a group called the G11, were solidly opposed. The G11’s concerns “center around asymmetries in surveillance,” Allen and Hagan explained. “They fear that a revised decision...would be used to threaten them with accusations of breach of obligation, while the advanced countries would escape.”

All the while, the US Treasury was tightening the screws on IMF management and staff in its pursuit of a new decision that would include the wording the Treasury wanted. Department officials weren’t shy about using the considerable leverage they held over de Rato’s own priorities, as a memo of an October 5, 2006 meeting shows. According to the memo, the Treasury’s Sobel spelled out some unfavourable consequences that would ensue if the revision of the 1977 decision was not handled to the satisfaction of Washington: The IMF would not be able to count on congressional approval of legislation needed for an agreement to change quotas, or shareholdings, in the Fund — and, in the process, one of the key components of the managing director’s Medium-Term Strategy would probably fail. “Mr. Sobel...made it clear that they considered the revision of the 1977 Decision to be a critical part of a package of reforms seen to modernize the IMF, and that it would be difficult to ask Congress to support the quota reform if a new decision were not approved,” the memo said.

Amid all of these conflicting pressures, de Rato and his aides concluded that the time had come to abandon grand theory in favour of good old-fashioned coalition building, as they intensified efforts in the spring of 2007 to bring the issue to the board for final approval. Most important, they jettisoned Principle E from the proposed decision — a bitter pill for true believers like Allen, who cherished it for instilling the decision with symmetry. (They could take comfort by noting the presence of other language aimed at accomplishing the same goal, such as assertions that the decision would apply to countries with all manner of exchange rate regimes.) In addition, language softening some provisions was added elsewhere — for example, phrases emphasizing that the principles were “recommendations” for member countries rather than “obligations,” and that the IMF would give “the benefit of any reasonable doubt” to a country before deeming its currency fundamentally misaligned.

By mid-May, the opposition of a number of developing-country executive directors was starting to weaken, according to emails among Fund staff. Further boosting the cause of revising the 1977 decision was a report issued that month by the IMF’s Independent Evaluation Office assessing the Fund’s conduct of exchange rate surveillance from 1999 to 2005, which contained a long list of damning conclusions. Among them: “The IMF was simply not as effective as it needs to be to fulfill its responsibilities... The rules of the game for exchange rate surveillance are unclear, both for the IMF and member countries... Operational guidance for staff is insufficiently clear (or, in some cases, absent)...Management assigned insufficient focus and attention on conducting effective dialogue with authorities” (Independent Evaluation Office of the IMF, 2007).

Even so, the opponents had one last bombshell to drop. With just over a week to go before the scheduled June 15 board meeting, the G11 presented an alternative proposal for a new decision that removed all references to fundamental misalignment — which, as they well knew, made it totally unacceptable to the United States. The “overarching problem” the members of the G11 had with de Rato’s version was that they remained worried about the potential for the imposition of new IMF obligations regarding their domestic policies, according to a summary of a meeting with them written by PDR’s Isabelle Mateos y Lago. They were also querulous about how the IMF would go about determining currencies fundamentally misaligned. De Rato agreed to negotiate with the G11 in the hope that they were mainly seeking a few more concessions. “The MD really wants the Indians, Mexicans and Brazilians and maybe a few others to agree at the end of the day,” Allen told his colleagues in an email.

Finally, at the board meeting itself, the necessary modifications were thrashed out, the agreement of those countries conferred, and the substantial majority of

votes were cast in favour, as related previously. Given the amount of effort expended in winning approval of the decision, the champagne toast that followed in de Rato's office reflected an understandable sense of accomplishment. Perhaps, though, the celebrants would have refrained from imbibing if they had foreseen how muddled, impotent and spineless their institution would prove to be during the implementation phase in the weeks and months ahead.

THREE BIG TARGETS

Following the announcement of the 2007 decision in an IMF press release de Rato convened a meeting of top staffers on June 22 to pose the all-important question: Which currencies are prime candidates for designation as fundamentally misaligned? Mark Allen was ready with an answer: the Chinese renminbi, the US dollar and the Japanese yen. The managing director shared Allen's view that applying the label to several large countries would reduce the stigma to a tolerable level, making the whole exercise more practical — so he agreed with Allen's list. "We need to apply the decision in as evenhanded a manner as possible," he said, according to notes of the meeting.

Managing Director de Rato's enthusiasm for the new decision also shone through in an "interim guidance note" he approved a few days later, regarding how the staff should apply the decision when writing Article IV reports on member countries. The note, which the IMF did not release publicly, was in essence a call for ruthless truth-telling — a practice the managing director had previously shied away from. "Where staff assess that there is, beyond reasonable doubt, fundamental misalignment, the term 'fundamental misalignment' should be used in the staff report," the note said.

All of this news triggered alarms in the Fund's area departments, many of whose staffers had opposed the decision and were dismayed to see that its implications might be even worse, from their standpoint, than they had thought. Not only might they be expected to apply the decision to the exchange rates of a good number of countries that they covered, they might also have to write reports about those countries using language that struck them as pejorative. The director of the Asia and Pacific Department, David Burton, wrote a memo to top management on July 5 arguing that "a good case can be...made for reserving fundamental misalignment for relatively extreme situations." He denounced the idea of judging exchange rates in a "legalistic" and "mechanistic" way, adding: "We have already gone too far in this direction with the new surveillance decision, and we should avoid going any further if we can."

This reaction was predictable, given that the area departments are much closer to the authorities in IMF member countries than are the "functional" departments

such as PDR and Research. Although the area departments sometimes have unpleasant confrontations with countries under their purview, they have strong incentives to avoid such situations. Mission chiefs generally seek to maintain cordial relations with a country's finance ministry and central bank, partly because they want them to take their advice, and partly because they fear that a clash with authorities — especially in a big country that has clout at the Fund — might cause the finance minister to call the Fund's managing director and complain.

So PDR was girding for confrontations with area departments over how they would surveil countries—and top PDR staffers expected to win a fair share of those battles. This late-June message from Cottarelli to others in PDR conveys the department's attitude: "Colleagues, the meeting we had with management this afternoon showed that the MD supports the use of the term 'fundamental misalignment' in staff reports whenever this is needed. In addition, it is clear that it would be very problematic to single out only China and another couple of countries as having a FM exchange rate...My suggestion would be to be fairly tough in discussing with area departments whether an exchange rate is fundamentally misaligned and to bring the issue to management if there is no agreement."

It was all the more stunning then for PDR when de Rato announced, on June 28, that he would step down as managing director, citing family reasons for quitting with two years left in his five-year term.¹⁰ Considering how much of his legacy de Rato had spent in winning approval of the 2007 decision, the chances seemed dicey at best that his successor would share the same commitment to seeing the decision aggressively implemented.

What was certain was that area departments were going to use every strategem they could think of to prevent their countries from being labelled fundamentally misaligned. Regarding China, for example, the Asia and Pacific Department reasoned that Beijing should be spared from this designation, because of the likelihood that its currency would become properly aligned in the foreseeable future. A July 6 memo by Dan Citrin, that department's deputy director, pointed out to IMF management that "if the current annual pace of appreciation [in the renminbi] of around 5 percent were to continue over the next five years, this would lead to a cumulative 25 to 30 percent appreciation." If that factor was taken into consideration, "it may not be correct to classify China's currency as being fundamentally misaligned," Citrin asserted.

Hoots of derision from PDR greeted this argument—which, as Cottarelli wrote in a July 9 email, "simply confirms that the exchange rate is currently misaligned, and would

10 See IMF (2007). "IMF Managing Director Rodrigo de Rato to Leave Following the 2007 Annual Meetings." Press Release No. 07147. June 28. Available at: www.imf.org/external/np/sec/pr/2007/pr07147.htm.

remain so in the absence of a sizable appreciation. This is the essence of a misalignment that is ‘fundamental.’”

That didn’t matter, at least not right away. The battle of the renminbi was put off until the following year, as Chinese authorities insisted on additional discussions concerning their 2007 Article IV report, which simply lay in abeyance and was never submitted to either IMF management or the board. In the meantime, fights over other currencies were coming to a head — starting with the world’s most important one.

DODGING THE FIRST BULLETS: THE GREENBACK AND THE YEN

On July 10, the US dollar effectively went on trial in the conference room of First Deputy Managing Director John Lipsky. Although it was a discussion among Ph.D. economists rather than a legal proceeding, the “charge” was fundamental misalignment, the “lead prosecutor” was Cottarelli, and the “defence attorneys” were two high-ranking economists from the Western Hemisphere Department, Ranjit Teja and Tamin Bayoumi. Serving as “judge” was Lipsky, thanks to de Rato’s pending departure. This proceeding was never supposed to be made public; a memo written by Cottarelli a few days later provides many of the details.

This was the case that true believers in the 2007 decision had been fantasizing about from the start. A finding of fundamental misalignment in the Article IV report for the United States would not only make it much easier politically to apply the label to China, it would also show that IMF surveillance was becoming dramatically more evenhanded.

US Treasury officials were in high dudgeon upon hearing of the effort to target the dollar — which, in their view, simply confirmed that Fund staff and management were fecklessly dodging their responsibilities. From the US standpoint, the main purpose of the 2007 decision was to toughen exchange rate surveillance and name countries whose practices violated the norms of the system. How would it look in Washington if the very first major country labelled by the Fund was one that had a flexible currency and had made virtually no effort to exercise control over its currency level for over a decade? Why was the IMF sending the signal that it believed all major countries were equally deserving of opprobrium, when the US was allowing its currency to float freely, while only China was engaging in massive currency intervention, exchange controls and accumulation of reserves? Worst of all, how would Congress react?

The fact that Lipsky was arbitrating the inter-departmental dispute did not bode well for the prosecution, as he was widely viewed within the IMF as sharing the Bush administration view that imbalances posed little risk

to the global economy and that, in any case, US policies were not to blame. A year earlier, when he had emerged as the US choice for the number-two post (Washington has traditionally controlled the job), his pending arrival aroused alarm among some at the Fund, notwithstanding his Stanford Ph.D. and long career as a chief economist at blue-chip banks and securities firms. A news article circulated among the staff said, Lipsky “has long argued that the U.S. current account deficit is not the danger many of his peers believe...not only was he a staunch supporter of...Bush’s programme of tax cuts, but he has attributed the U.S. current account deficit to America’s relative economic strength rather than any shortage of savings” (Holland, 2006).¹¹

Still, the members of the prosecution team, which included PDR’s van der Willigen and two senior colleagues from the Legal and Research Departments, believed they had a reasonable case. Although the dollar was indisputably a free-floating currency, the board meeting of June 15 had endorsed language saying that all kinds of currency regimes were covered by the decision. And the degree of misalignment in the greenback appeared significant; with the US current account hovering at a record six percent of GDP in 2006, the Research Department models estimated that the dollar was somewhere between 10 percent and 30 percent overvalued — a fall of that magnitude “would be required to eliminate the misalignment relative to medium-term macroeconomic fundamentals.”

Of all the arguments made at the meeting, one was noteworthy for its wrongheadedness. To justify the dollar’s high exchange rate, Teja and Bayoumi of the Western Hemisphere Department asserted that a fundamental shift in the demand for US assets had taken place, based on the efficiency of the nation’s financial markets. In other words, the dollar shouldn’t be viewed as overvalued, because it had acquired long-term strength stemming from the eagerness of foreign investors to pour money into a country where banks and securities firms were using the world’s most advanced and innovative techniques to invest capital. At the time, of course, nobody could have imagined how staggeringly off-base this argument was.

After two hours of debate, Lipsky issued his verdict — the equivalent of “not guilty,” as Cottarelli’s memo makes clear: “Mr. Lipsky concluded that the dollar should be regarded as “misaligned” but not “fundamentally misaligned,” adding that the main reasons were: “(i) we do not have clear policy recommendations that would address the problem of the dollar misalignment in the near future; and

11 In fairness to Lipsky, he proved correct in playing down the risks that many others feared, such as a collapse in the dollar. And critics, including the IMF’s own Independent Evaluation Office, have justly accused the Fund of having paid excessive attention to those risks while overlooking vulnerabilities in the financial system that would eventually prove far more serious.

(ii) we are not certain the United States are building up an unsustainable external position so we cannot conclude that the misalignment is ‘fundamental beyond reasonable doubt.’”

In rendering his judgment, Lipsky attached considerable importance to the way the 2007 decision was ultimately written — specifically, the omission of Principle E. Without that principle, he reasoned, there was no way he could find the dollar fundamentally misaligned based on US domestic policy. Principle E had been intended to deal with situations such as America’s, by creating balance between peggers and floaters; although the emerging markets’ insistence on eliminating the principle had dumbfounded him, Lipsky figured the IMF couldn’t label a country with no foreign exchange policy.

In any event, the difficulties of applying the term to other currencies began to mount at this point, just as the PDR team had feared. Also mounting was confusion and frustration about the whole undertaking.

The Japanese yen, for example, was spared from being labelled fundamentally misaligned, for essentially the same reasons as those used in the case of the dollar, despite an estimate by the Research Department’s models that the yen was 15 to 30 percent undervalued. This evoked a series of piercing questions from executive directors when the board met on July 27, 2008 to consider Japan’s Article IV report. “If the yen is not fundamentally misaligned, and yet it is misaligned to the extent of 15 to 30 percent, and it is possible conceptually to have such a degree of misalignment in a completely floating and free exchange rate regime, what would trigger a serious thought of analysis to start examining that a particular currency is fundamentally misaligned?” asked Adarsh Kishore, India’s director, according to a transcript of the meeting. From the completely opposite perspective, the Japanese director, Daisuke Kotegawa, voiced perplexity that anyone would even go so far as to call their currency “misaligned” when, according to the staff’s Article IV report, Tokyo’s macroeconomic policies were “broadly appropriate.” Some of those present complained that, even after hearing the staff’s explanation of the fine points, they could no longer figure out what the terms used in the 2007 decision were supposed to mean. “To be very frank, I still have problems also in grasping the notion of fundamental misalignment,” said Willy Kiekens, a Belgian who represents 10 European countries.

The 2007 decision was clearly in trouble — and an even bigger setback was looming, this time involving one of the world’s least important currencies.

THE SCARLET FM

The Maldives rufiyaa, which was pegged against the US dollar, was fundamentally misaligned by pretty much any sensible interpretation of the 2007 decision — on that, Deputy Managing Director Takatoshi Kato agreed with PDR economists. So, on July 30, for the first time, the executive board met to discuss an Article IV report in which the IMF staff, with management’s blessing, applied the label to a country’s currency. However, those who had championed the 2007 decision now had to explain why, after the United States and Japan had avoided being labelled, harsher treatment should be accorded to an island nation whose entire population would fit into three large football stadiums.

“There is no doubt that this is an awkward issue, and we certainly among others regret that Maldives is the first case where we’re having...this debate,” said Michael Kaplan, who was representing the United States at the meeting, according to a transcript.

Representing the staff that day was Mark Allen, who as head of PDR wouldn’t ordinarily attend the annual board review of such a small country. Allen was there because he knew that if the directors rejected the staff assessment, “we run the risk of creating a precedent that will make our life difficult in the future,” as he had put it in a memo a few days earlier.

Allen elucidated the economic reasoning behind the staff report, which was, essentially, that Maldives was running a dangerously high fiscal deficit — about 28 percent of GDP — that, if continued, would lead to a run on the currency, a drain on reserves and the collapse of the fixed exchange rate. He gave a step-by-step account of how the staff had first looked at the “underlying” current account deficit of Maldives (meaning it was stripped of temporary factors), and then found that it deviated significantly from an equilibrium level “consistent with the economy’s structure and fundamentals.” Even though this didn’t necessarily mean that the government was wrong to keep the rufiyaa pegged to the dollar, it did imply that the fiscal policy was “unsustainable,” he said.

Allen then squarely faced the sensitive issue of why such a tiny country was seemingly being singled out. “Maldives is similar to those of the U.S. and Japan in that the root cause of misalignment is domestic policies and not the exchange rate policies,” he said. “But...we are confident that misalignment is significant enough to be termed fundamental.” This differed from the US and Japanese cases, where there were “reasonable doubts”

about whether the misalignments were so large because of uncertainties about issues such as shifts by Japanese investors toward foreign assets.¹² “We believe in the case of Maldives, it is really very, very clear cut,” he concluded.

Precious few directors were convinced. Egypt’s Shalaan, whose constituency included the Maldives, rebutted Allen by assuring his colleagues that the Maldivian authorities understood the need for budgetary prudence and would take action to minimize any risk to their currency. “Not a single member of this institution has had the honor” of being labelled fundamentally misaligned, Shalaan noted. “Surely we do not wish our first assessment of fundamental misalignment to be attached erroneously to this small island economy, that you have all noted is very fragile and vulnerable.” (The country was still recovering from the 2004 tsunami.) Another director used the word “crucifying” to describe the accusation against the Maldives, while several others voiced their skepticism regarding the claim that the island nation’s circumstances were qualitatively different from those of the bigger countries that the board had just considered. “I remember that for Japan and for the U.S.... it was assessed that the currency was overvalued and in the other case undervalued, probably to a large margin,” said Belgium’s Kiekens. “But not fundamental. Here it is fundamental...I wonder whether we can go public with concepts that are not yet clearly explained.”

The precedent that Allen had dreaded had now been set. Only directors from the United States, Germany and the Nordic countries supported his position, so the staff’s finding of fundamental misalignment received no official Fund endorsement. Summing up the majority view, the IMF’s Public Information Notice about the meeting said, “many Directors noted that adequate information was not available to make a determination whether or not the Maldives’ exchange rate is in fundamental misalignment” (IMF, 2007c).

Just a month and a half had passed since the day of the champagne toast in de Rato’s office, and it seemed clear that neither the board nor management nor much of the staff had the stomach to use the 2007 decision as its drafters had originally intended. The “scarlet M” had turned into the “scarlet FM.” The big question that remained was whether it might be applied in the case of the country whose foreign exchange policy had inspired the term.

THE BATTLE OF THE RENMINBI

Frustration over China’s treatment by the IMF was reaching the boiling point among US Treasury officials in the spring of 2008. The Treasury had been obliged to wait

patiently while Dominique Strauss-Kahn, who succeeded de Rato as the managing director in the fall of 2007, settled into the job. Strauss-Kahn was, by all accounts, appalled at the mess he had inherited regarding the 2007 decision, and had been able to defer making hard choices about the toughest cases as he devoted his energy to other tasks — such as a staff downsizing. But by the spring of 2008, pressure for action was building, as a backlog of Article IV reports was accumulating for countries whose currencies were potential candidates for being labelled as fundamentally misaligned, including Malaysia, Latvia, Fiji and the Seychelles — with China looming over them all.

The IMF had not been able to finalize a staff report calling the renminbi fundamentally misaligned, much less convene a board meeting to endorse such a finding. Ever since approval of the 2007 decision, the Chinese had made sure their economy would not be subjected to that type of affront, by asserting they needed further discussions to make their case — and there was no easy way for the Fund to force the issue. To be sure, one of the obligations of IMF members is to submit to regular Article IV surveillance; the managing director can, technically, put any country’s review on the board meeting agenda, which can be changed only if a board majority votes to do so. However, in practice, a single board member can usually arrange a postponement for a long period by claiming the need for time to hold additional consultations. This is due to the diplomatic niceties that govern board conduct, as well as the recognition by each member that he or she may wish to be accorded similar courtesy in the future. In China’s case, one board meeting was “tentatively scheduled for March” 2008, then another “after the spring meetings, perhaps by May,” another “in the second or third week of June,” and yet another “before the August recess,” according to IMF staff emails. But none of these materialized.

On April 25, the Treasury’s Sobel met with IMF staff and conveyed his department’s displeasure “with great conviction,” according to a memo of the encounter penned by van der Willigen, who summed up the Treasury’s message as follows: “Getting the China Article IV done, with an FM finding, is crucial, and it needs to be done sooner rather than later, as the delay has already damaged credibility and may soon do so beyond repair.” This was not just tough talk; the Americans had, once again, greater-than-usual leverage, because the IMF was planning to sell some of its gold stocks to maintain its financial stability — and that, in turn, required passage of legislation in Congress. According to the memo, Sobel’s “top level message was that the Fund needs to give clear signals when a country is offending against the rules of the international monetary system, and that it is impossible to defend the Fund before Congress if it does not do this.” What was more, the same table thumping was evidently occurring at much higher levels, between Strauss-Kahn and Treasury Secretary Henry Paulson. As the memo put it, Sobel “was

12 Allen was voicing the official position of IMF staff and management on this point, even though — as previously noted — he personally held the belief that both the United States and Japan should have been deemed fundamentally misaligned.

clearly very aware that his boss was simultaneously giving a take-no-prisoners message to DSK.”

So IMF management and staff began moving forward in the weeks following, with efforts to label the renminbi as fundamentally misaligned, despite warnings from Chinese officials that such an act would be “totally unacceptable” (a phrase cited repeatedly in IMF emails concerning conversations with the Chinese). On May 16, the Fund threw down the gauntlet in the form of a memo from Deputy Managing Director Kato to China’s Ge, which spelled out how the process of labelling would work:

As we discussed the other day [Kato’s memo said], below is the language that reflects our current assessment of China’s exchange rate and exchange rate policies in accordance with the 2007 surveillance decision....The language envisaged is as follows:

Despite recent appreciation against the U.S. dollar, the renminbi is judged by the staff to be substantially undervalued, indicating a fundamental misalignment in the exchange rate. Moreover, China’s continued tight management of its exchange rate significantly contributes to external instability.

In support of this conclusion, Kato’s memo cited the quadrupling of China’s current account surplus — it had swelled to 11 percent of GDP in 2007 — and the quintupling of official reserves, to US\$1.7 trillion over the previous five years. Kato also expressed hope that a recently postponed IMF mission to Beijing could be rescheduled promptly, with the aim of proceeding toward the finalization of the Article IV report.

A frosty retort was soon forthcoming from Ge. After noting that the renminbi had appreciated 18 percent against the dollar and 12 percent in real effective terms since July 2005, the Chinese executive director wrote back to Kato on May 27, 2008:

In early 2008, South China was hit by a severe snowstorm and just two weeks ago, Sichuan province was struck by a devastating earthquake...Since the reform of the exchange rate regime, a large number of export enterprises experienced bankruptcy and loss of jobs. Even in this difficult situation, the Chinese authorities have continued to implement policy measures to correct the external imbalances, including exchange rate flexibility.

We hope that the Fund will continue to carry out its duty as a trusted advisor to members....Rushed judgment before frank and comprehensive discussions should be avoided.

Meanwhile, the Chinese authorities are preoccupied with earthquake relief and reconstruction, and it is extremely difficult to accommodate a consultation mission at this time.

Behind China’s hard-nosed stance was more than just a desire to defend national dignity. Beijing was also concerned that an IMF finding of fundamental misalignment might lead to economic sanctions against it; documents show that Chinese officials sought advice from the Fund’s legal department on how vulnerable their country might be to sanctions. The Fund has no practical enforcement powers over members unless they are borrowing its money. But if the renminbi were adjudged to be fundamentally misaligned, that could raise the likelihood of China’s trading partners bringing cases against it at the World Trade Organization (WTO), which does have the power to authorize the imposition of various penalties, including punitive tariffs. Although WTO rules on the subject are murky and have never been tested,¹³ they include provisions prohibiting countries from using “exchange action” to “frustrate the intent” of the agreements granting access to their markets, or using some other subterfuge to “nullify or impair” the rights of another country under the WTO treaty. And, in addition to the prospect of a WTO complaint, China had ample reason to worry about increasing its vulnerability to unilateral sanctions by the United States, since the Grassley-Baucus bill used the same standard — fundamental misalignment — as the 2007 decision. The bill had been combined with tougher legislation, and envisioned that countries with fundamentally misaligned currencies might be subject to a variety of punishments, such as reduced protection from anti-dumping complaints.

The Chinese needn’t have gotten overly anxious — a subtle power shift was underway within the IMF. No longer was China isolated; on the contrary, it had gained plenty of

13 The chance that a country (presumably the United States) would bring a currency-manipulation case against China at the WTO has long been a subject of dread for officials at both the WTO and the IMF. The Fund has jurisdiction over the issue, but some US experts and industry groups have pressed for a WTO case on the grounds that the Fund isn’t doing its job. As the IMF Independent Evaluation Office noted in a report, “The possibility of a case of exchange rate manipulation being adjudicated by both the Fund and the WTO could be problematic... [O]ne cannot rule out the possibility of a WTO member bringing a dispute...to the WTO regarding exchange rate manipulation, or the WTO panel arriving at a different judgment than the Fund...[T]here is no guarantee that an exchange rate measure sanctioned by the IMF will be immune from challenge at the WTO; no legal precedent has been set to date.” (Independent Evaluation Office of the IMF, 2009).

new allies. The near-unanimous support on the Board, which had briefly coalesced behind the 2007 decision at the time of its approval, was evaporating amid growing resentment toward the American browbeating of the Fund. Further damaging the US position was mounting evidence of the fragility in its financial sector, the most salient manifestation being the downfall of the investment bank Bear Stearns in mid-March 2008. These developments showed all too clearly whose economy had eluded tough IMF surveillance.

Even European executive directors, who had once solidly backed the 2007 decision, were increasingly favouring the Chinese position. The reason for this was not so much the merits of the arguments regarding the labelling of the renminbi; rather, it was because the Europeans wanted to help protect one of their own — Latvia — from a similar fate.

Like China, Latvia's Article IV report had been repeatedly deferred because of disputes over the 2007 decision — and like the renminbi, the Latvian lat was as clear a case of fundamental misalignment and external instability as the IMF staff could find, although it was a case of overvaluation rather than undervaluation. The exchange rate of the let was fixed against the euro in preparation for entry into the euro zone, which had helped generate super-fast growth and massive inflows of foreign capital, but also the classic symptoms of an overheated, crisis-prone economy, including a real estate bubble that was starting to implode and a current account deficit well above 20 percent of GDP. Based on IMF models, the lat was overvalued to the tune of 17 to 37 percent, which posed a serious danger to its neighbours, because a collapse of the currency regime would almost certainly have knock-on effects throughout the Baltic region and elsewhere in Eastern Europe, where other currencies were also tied to the euro. But the risk of such spillovers was precisely why the Europeans were adamantly resisting the IMF labelling Latvia as fundamentally misaligned, since it could spark the very crisis the Fund feared. Swedish banks, which had lent heavily to Latvians, were particularly exposed to a currency crisis, and Jens Henriksson, the Swede who represented the Nordic countries on the board at the time, was using every available tactic to keep Latvia's Article IV report from being completed, including exercising his authority to block a staff mission to Riga, as Fund email messages show.

Caught in the middle of all these irresistible forces and immovable objects was Strauss-Kahn, who knew that if he brought either the Chinese or Latvian Article IV reviews to the board, he would be unable to win a majority in favour of labelling the currencies as fundamentally misaligned. Yet the US Treasury was unrelenting, as revealed in notes from meetings the managing director held in mid-June 2008 with G7 officials. In one tête-à-tête with Thomas Mirow, state secretary of the German Finance Ministry,

Strauss-Kahn said: "The U.S. wants to label the Chinese. Paulson says that if we don't use the 2007 decision, the Fund is dead...[It's] blackmail. If there is no solution [that suits] the U.S., it could endanger congressional votes" that the Fund badly needed for the sake of its own financial viability. Although Treasury officials understood that sentiment among executive directors was now heavily against labelling China, they still wanted Strauss-Kahn to bring the matter to the board, which would at least throw his personal weight behind a condemnation of the Chinese foreign exchange regime.

The endgame for the 2007 decision was now at hand. Playing for time, the wily Strauss-Kahn devised a scheme, requiring a slight modification of the decision, which he hoped would satisfy Washington while providing at least a modicum of face-saving for Beijing. Under his plan, when the Article IV report of a country such as China was up for Board review, the managing director could notify the Board of his "significant concerns" that the currency was fundamentally misaligned,¹⁴ which could lead the Board to initiate "ad hoc consultations" — but the formal labelling would be postponed for six months, giving the country a chance to adjust its policies. After the Board gave its assent (over US misgivings) to this new approach, it was unveiled for the news media on August 12, 2008.¹⁵

At that point, a showdown on China was scheduled at the Board for September 22 — which, of course, no one knew would come exactly one week after the most catastrophic financial episode in generations. The staff was putting the finishing touches on its 2008 Article IV report for China, which would never see the light of day. Here is the crucial wording from the report's executive summary:

There are significant concerns that the exchange rate may be fundamentally misaligned and exchange rate policies could be a significant contributor to external instability... Accordingly, staff recommends that the executive board initiate an ad hoc consultation with China that would be expected to be concluded within about six months.

The September 22 Board meeting was never held, the Article IV report was buried and the US Treasury lost interest in prodding the IMF to label China. The bankruptcy of Lehman Brothers, and the financial chaos that ensued, shifted the balance of power once again away from the United States and toward China — this time seismically, by several orders of magnitude greater than anything that

14 The "significant concerns" could also apply to other violations of the 2007 decision.

15 See IMF (2008). "Transcript of a Conference Call on the 2007 Surveillance Decision." August 12. Available at: www.imf.org/external/np/tr/2008/tr080812.htm.

had come earlier in the crisis. To understand why, Henry Paulson's book *On the Brink* offers helpful insight, although it never mentions the 2007 decision. In the chapters about events immediately following the Lehman bankruptcy, the former treasury secretary recounts numerous phone calls to Beijing in which he was essentially imploring Chinese leaders to see that it was in their own self-interest to help keep the rest of the US financial system afloat.¹⁶ According to the recollections of one senior official who held major policy making responsibilities:

It was a terribly volatile time. The last thing we wanted in the middle of a crisis was a public row with China over its exchange rate policy. It was never explicit — it wasn't like the Chinese came back and said, "if you do this, we'll do that." It's just — of all the things that US policy makers had to deal with, was this the thing you wanted to make a priority at this point?

Believe me, Hank Paulson thought it was in the best interests of China and the United States for China to move to a market-based exchange rate, but he didn't seriously consider labelling the Chinese as currency manipulators during the global financial crisis — and I don't think he should have. It wasn't a point-in-time decision. I think it was just the pragmatic evaluation that we were focusing on the most important things, and that moving down that path — particularly given that we were in the middle of a crisis — would have likely failed in influencing the Chinese to alter their policy and could easily have backfired and created greater risk at a very precarious time.

China not only emerged unscathed from the 2007 decision, it also turned the tables on Washington by taking pointed note of which country had, in the final analysis, proved to be the most guilty of "external instability." Yi Gang, deputy governor of the People's Bank of China, delivered a speech at the IMF-World Bank annual meeting on October 11 in which he asserted that the crisis "underscores the need for the Fund to maintain a sharp focus on risks in the major developed countries and their potential spillover effects." He accused the IMF of "mis-focused surveillance," and in a little-noticed but barbed rhetorical thrust, called on the Fund to "consider an ad hoc consultation with the United States" (Yi, 2008).

SOUNDING THE RETREAT

So, in the end, the most perverse sort of symmetry and even-handedness prevailed — that is, all countries escaped labelling. This was a sad mockery of the idealism that, in some quarters at least, had once inspired lofty aspirations for the 2007 decision. The Tim Adamses and Mark Allens of the world had genuinely wanted to see the IMF adopt a mission it had never performed during the era following the end of the Bretton Woods fixed-rate system — that of a rule-setter and arbiter capable of speaking out forthrightly and effectively when unbalanced economies and distorted policies threatened the global common weal. Allen's view that this mission had to encompass threats of all sorts, ones involving US domestic policies as well as Chinese currency practices, was in the most hallowed Keynesian tradition. It was also an admirable attempt to turn a Washington-driven scheme into an undertaking that would elevate the Fund's stature as an impartial body capable of letting the chips fall on even its most powerful members.

But vindication belonged to those who reckoned all along that this approach was far too quixotic and vulnerable to the vagaries of international politics. In retrospect, it was obvious that making the US dollar the first target for labelling as fundamentally misaligned was both unwise and impractical, if only because doing so would have completely undermined support for the Fund in the United States. Equally, it was ill-advised to insist that an institution purporting to speak for the international community should use a term plucked from a US Senate bill to criticize China. Instead of "de-stigmatizing" the business of labelling, as Adams had once proposed, the use of "fundamentally misaligned" exacerbated the problem of stigmatization, most explosively in the Chinese case, increasing the political difficulty that the Fund already faced in ruthless truth telling. And trying to apply the term to the US dollar would inevitably have been seen in Washington as going too far in the opposite direction — that is, eliminating the label's stigma entirely, rendering it useless. No matter how sincere their desire to multilateralize, de-stigmatize and apply policy symmetrically, policy makers couldn't translate their dreams into a workable solution.

Humiliating retreat came almost exactly two years after the IMF board's approval of the 2007 decision, when the Fund essentially renounced the use of the term "fundamental misalignment" forevermore. By that time, Mark Allen had retired as head of PDR,¹⁷ and the senior team that Strauss-Kahn had put in place was eager to rid the Fund of the burden imposed by the labelling requirement. There was a general acknowledgement that the 2007 decision still had

¹⁶ See Henry M. Paulson Jr. (2010). *On the Brink: Inside the Race to Stop the Collapse of the Global Financial System*. Business Plus.

¹⁷ The department was renamed the Strategy, Policy and Review Department. Although technically retired, Allen has stayed with the Fund under contract as its resident representative in Warsaw, returning to a job he held near the start of his career.

many desirable attributes — notably, the way in which it had induced IMF staff to devote much more attention than before to exchange rate issues in their Article IV reports. But nobody had faith any longer that the Fund was capable of applying the fundamental misalignment label to countries. The obligation to do so was, technically, only a matter of management guidance, based on the edict issued by de Rato in late June 2007, ordering staffers to use the term in Article IV reports when they were confident that it was justified. So, while the decision itself was left intact, de Rato's order could be revoked on Strauss-Kahn's authority, which he did with alacrity after informing the Board of his intention and hearing no objection.

The formal excision of the decision's discredited appendages took place on June 22, 2009 in "revised operational guidance" for the 2007 decision that the IMF put on its website. "The attempt to apply exchange rate-related 'labels' — for instance, the use of specific terminology such as 'fundamental misalignment'...has proved an impediment to effective implementation of the Decision," the document said, candidly acknowledging that the result had been "damaging [to] the Fund's credibility." So, henceforth, when staffers were preparing Article IV reports, they needn't use the term "fundamentally misaligned," but should instead include "a clear and candid discussion — using plain economics terms — of the exchange rate and the full range of policies that affect external stability." They should do so for both floaters and peggers, and in cases of "egregious" violations of the decision's principles (when, for instance, a country was manipulating its currency for unfair competitive advantage, and its motive was beyond reasonable doubt) staffers were expected to say so in their reports (IMF, 2009).

One final scene was left in this ill-fated drama, and it was emblematic of the elevated geopolitical status with which China emerged in the wake of the crisis.

Having been mollified by the revised guidance to the 2007 decision, China allowed the long-delayed completion of its Article IV report, as the Board finally met to consider it on July 8, 2009. Tellingly, the staff document that the Board was deliberating that day was different from the 2008 one expressing "significant concerns that the exchange rate may be fundamentally misaligned." That one existed only in email inboxes at IMF headquarters; it had never attained official force, and never would. Rather, the report placed before directors was in accord with the IMF's new approach abandoning the use of the fundamental misalignment terminology. This report assessed the renminbi as "substantially undervalued," and even then, the Board declined to go as far as the

staff. Only "some" directors agreed with the assessment of "substantial undervaluation," according to the IMF's public information notice about the meeting.¹⁸

Another episode around that time provided striking evidence of China's heightened clout. At an executive board meeting to discuss the revised guidance for the 2007 decision, the Chinese representative made it clear that bitterness in Beijing over the whole issue was so strong that it was preventing the leadership from approving a badly needed contribution to bolster the IMF's reserves, according to a written account of the meeting. The implication was that Chinese money wouldn't be forthcoming unless the Fund was definitely forsaking aggressive exchange rate surveillance of the 2007 variety. From this, two conclusions can be drawn: first, the United States was not the only superpower capable of using its leverage over IMF finances to get its way on Fund policy. Second, the Chinese (the new heavyweights in the IMF arena) were still seething about the way they had been treated, so regaining their trust in the institution would take considerable time.

Thus ends the story of the 2007 decision, with a whimper (that, from Beijing's perspective, may have been a glorious bang). While the events recounted above were unfolding, the other "bright idea" that the IMF conceived following Adams's asleep-at-the-wheel speech, the multilateral consultations, was proceeding along a parallel track. The multilateral consultations came to a finish more quickly than the 2007 decision, and with much less rancour. But the following account reveals how far short of the IMF's expectations the exercise fell, and how it culminated in a crowning blow to the Fund's hopes.

THE MULTILATERAL CONSULTATIONS

Imagine an experiment in both interpersonal and international relations. Suppose meetings take place among a dozen or so top policy makers from some of the world's largest economies, all of whom ostensibly agree on the following: a major problem threatens the world's prosperity; responsibility for this problem lies largely with the others in the room; and solving the problem requires a collective effort in which all participants take policy actions that would improve their economic prospects, both jointly and individually.

Won't each of the participants, after waiting strategically for the others to move first, begin to offer commitments to change policies? Won't movement by one entice similar commitments from the rest? After all, each participating

18 See IMF (2009). "Transcript of a Press Teleconference Call with International Monetary Fund Officials on China's 2009 Article IV Consultation." July 23. Available at: www.imf.org/external/np/tr/2009/tr072309.htm.

country should be pleased at the prospect of receiving complementary policy action from the others, thereby gaining political cover that would minimize the cost involved in making a contribution toward the mutually beneficial goal. So, won't they all have significant incentives to cooperate?

That, in a nutshell, was the theory behind the multilateral consultations. To see where the idea first surfaced, it is necessary to sift through one of the IMF's most forgettable documents, "The Managing Director's Report on the Fund's Medium-Term Strategy," issued by de Rato on September 15, 2005. In the second paragraph of item number nine of the report is a proposal for the IMF to sponsor "multilateral dialogues" on various issues facing the global economy. "The obvious example" of a topic for such a dialogue, the document said, was that of global imbalances (one of the gravest threats to international financial stability, in the Fund's view, as the US current account deficit was widening that year to a new record of more than \$800 billion).¹⁹

This proposal quickly fizzled, along with much of the rest of de Rato's strategy paper. One of the main drawbacks was that de Rato envisioned the dialogue taking place "at the level of the International Monetary and Financial Committee," which, as a group representing the entire membership is large, notoriously cumbersome and prone to formal speechmaking, rather than give-and-take.

Still, the idea that the Fund ought to play a central, even a leading role in addressing the imbalances appealed to many in the international economic policy community. Moreover, the US Treasury was continuing to demand action on the currency issue, and de Rato and his aides saw considerable merit in broadening the debate beyond the US-China dispute. The question was how?

PIE IN THE SKY, WITH A MISSING INGREDIENT

A number of IMF staffers were in the audience at an American Enterprise Institute conference on February 2, 2006, where they heard an intriguing proposal from Yusuke Horiguchi, a former Fund department head. "Many of you might say that I am talking about a pie in the sky," Horiguchi said in introducing his plan, which involved a novel way of using the special consultation procedure.

Instead of holding special consultations solely with China or any other individual country, Horiguchi suggested the Fund could dispatch "special consultation missions" simultaneously to the United States, China, Japan and the euro zone, to discuss how each could contribute to

¹⁹ See Rodrigo de Rato (2005). "The Managing Director's Report on the Fund's Medium-Term Strategy." September 15. Available at: www.imf.org/external/np/omd/2005/eng/091505.pdf.

shrinking imbalances. The consultations with the Chinese would focus heavily on the renminbi, while talks with the others would focus on actions they could take — curbing the US budget deficit and raising America's savings rate being the most obvious. The findings of these missions would be wrapped together in a "comprehensive action program" for consideration and endorsement by the IMF board, and the Fund staff would issue periodic "scorecards" to show how each economy was performing relative to its expected results — with follow-up consultations "for those economies which are judged not performing."²⁰

Some Fund staffers recall returning to their offices excited and convinced that Horiguchi's idea was the way to go. Although others don't believe his proposal was nearly so seminal, it did share many features with the approach that the Fund eventually adopted.

Whoever deserves credit for its intellectual paternity, the term "multilateral consultation" was appearing in internal drafts of de Rato's newly revised strategy paper by early March 2006. Although the US Treasury wasn't thrilled with the idea — it would have definitely preferred some sort of consultations for China alone — it went along. The following month, de Rato unveiled the idea in a speech, saying, "What is needed is coordinated action...Global imbalances are the problem not of just one country but of many, and we need a multilateral format for consultations to address them" (De Rato, 2006b). On April 22, 2006, the Fund membership bestowed its blessing, at a meeting of its ministerial steering committee.²¹

One key element of Horiguchi's plan, however, wasn't included — the assumption, by the IMF, of the role as arbiter, ready to point fingers at participants that were failing to deliver the necessary adjustments in policy. As noted above, that idea was a central theme of the speeches delivered by the governors of the British and Canadian central banks. But at that juncture, de Rato stuck firmly to his position that taking such an "outsider" stance would conflict with the IMF's ability to engage in private persuasion and foster an environment of compromise. "Should we want to keep governments at a distance at a moment in which we want to get governments inside a multilateral consultation?" he asked rhetorically at a public forum on April 20. He concluded that if the IMF did

²⁰ I am grateful to Mr. Horiguchi for providing a text of his remarks, which were delivered at the American Enterprise Institute conference, "The IMF's Role in Foreign Exchange Surveillance," February 2, 2006. His idea wasn't entirely original; a previous managing director, Michel Camdessus, had convened Latin American ministers some years before for a consultation exercise, although that was not a "special consultation" per se.

²¹ See IMF (2006). "Communiqué of the International Monetary and Financial Committee of the International Monetary Fund." Press Release No. 06/81. April 22. Available at: www.imf.org/external/np/sec/pr/2006/pr0681.htm.

so, “then those people are not going to sit at the table. No way” (De Rato, 2006c).

Small wonder, given how events unfolded over the following year, that many who were involved recall being skeptical from the outset that much would come of the “MC,” the abbreviation often used by IMF staff in emails and correspondence. With the benefit of hindsight, it seems obvious that the talks would never advance beyond the level of finance ministry and central bank deputies, and that plans for a high-profile ministerial would be scrapped for lack of sufficient “deliverables.” But internal IMF documents reflect a strong sense of optimism about the concept, at least in the weeks and months immediately after the membership endorsed it. Though some top staffers warned of the need to keep expectations in check, notes of meetings show that others cited the 1985 Plaza Accord as the type of outcome the talks should aim to achieve.

THE FUND: GUNG-HO

De Rato, for one, was raring to go. In a May 2, 2006 memo to heads of IMF departments, the managing director said “a priority would be to complete” the multilateral consultations by the annual meetings, which were to be held in Singapore on September 19-20. Although he soon concluded that this deadline was unrealistic, schedules prepared by the staff envisioned very rapid progress, starting with visits to participating countries in mid-summer, followed by a meeting of deputies from those countries in August, capped by a meeting of ministers, whom de Rato suggested should “pencil in November.” On June 5, the IMF announced the five economies that would participate, with Saudi Arabia — like China, a non-industrialized country running a big surplus — being added to Horiguchi’s list to help avoid giving the Chinese the impression that they would be ganged up on by the richer-country representatives from the United States, the euro zone and Japan.²²

Also “very gung-ho” (as he described himself in an interview) was Raghuram Rajan, then the IMF economic counsellor. Rajan supervised the drafting of a briefing paper that provides striking revelations about the IMF’s ambitions for the multilateral consultations. This briefing

paper, an internal Fund document, was prepared for a mission of staffers, led by Rajan and another top Fund official, who spent much of July 2006 in Riyadh, Beijing, Tokyo, Frankfurt and Washington in a preliminary bid to persuade the authorities in those capitals of the need for success in the upcoming talks. “The staff’s broad objectives for the next six months are to persuade the five participants to renew and possibly strengthen their commitment to the proposed policy direction” and “to express their intention to make a down payment on those policies in the coming year (including some upfront action if possible),” the paper said.

The paper took care to recognize that the participants would agree only to measures that were in their individual self-interests. It expressed determination to avoid the sorts of mistakes that had plagued previous efforts at international coordination on imbalances, notably those in the 1970s and 1980s involving the G7 and its predecessor, the Group of Five (G5). “A particular problem [in those cases] was that some countries — notably Germany and Japan — were asked to take actions that they considered to be against their conjunctural or long-term interests, resulting in patchy implementation...and/or mutual recrimination later on,” the paper said. “Second, previous episodes were initiated and led by an individual country — the United States — within the G7.” The multilateral consultations would have “important, and potentially positive differences from the past,” the paper continued, because the talks were to be “convened by the Fund under the auspices of the international community,” and the aim was “for countries to accelerate actions that are generally perceived to be in their own long run interest, rather than undertake short run measures that conflict with those interests.”

What, though, was in each country’s interest? There was the rub. The paper spelled out a long list of measures for possible inclusion in a final package, all of which, the Fund contended, would generate significant benefits for the individual economies that adopted them, as well as for the world as a whole. Indeed, most of the proposals were ideas the Fund had recommended in Article IV reports for the countries involved in the multilateral consultations. The problem was that, in most cases, the proposals had “clear political costs,” and would “adversely affect important political constituencies.”

In the United States, for example, the paper proposed “stepping up fiscal adjustment to $\frac{3}{4}$ percentage point of GDP per year,” and it suggested some highly controversial changes in tax policy that would be necessary to achieve this goal, such as introducing a national sales or value-added tax and limiting the deductibility of mortgage interest payments. Although the Treasury was skeptical that cutting the budget deficit would help much on the imbalances front, the IMF argued that it was clearly desirable for the economy’s long-term health; moreover, the paper said,

²² As inevitably happens when such clubs are formed, those left out vented their displeasure — none more vehemently in this case than Gordon Brown, the British Chancellor of the Exchequer, whose chairmanship of the International Monetary and Financial Committee (IMFC) gave him considerable influence over Fund policy. Thundering that Britain’s exclusion was “not acceptable,” Brown told de Rato in a June 2 phone call that he would be “happy to be involved...as the IMFC chair,” according to notes of the conversation. But the managing director retorted, “That would make it six participants, not five,” and he stood his ground, citing the importance of keeping the size of the meetings manageable. The following Monday, the IMF formally announced the plan to conduct five-way talks.

“U.S. leadership is an essential catalyst for joint action.” As for China, the hottest hot-button item on the Fund’s list was agreement on “near term currency appreciation,” by allowing greater flexibility in the exchange rate — a move that, as noted previously, was viewed by the Fund as a long-run economic boon for the Chinese economy, although the top leadership in Beijing feared the backlash that might ensue from large-scale layoffs in the export sector. The euro zone and Japan were expected to boost growth by liberalizing their service, labour and farming sectors (reducing protection of the Japanese rice market, for example) — measures that economists had been urging for years, but had proven politically toxic. The Saudis, who had already been pouring a substantial amount of their recent windfall from higher oil prices into public expenditures, were asked to spend even more, which they were reluctant to do, given criticism that prior spending sprees had proven wasteful. In the hope of arousing a sense of urgency in the five capitals for such a package, “[t]he mission will emphasize that while no one can know for sure how long imbalances can be sustained, the political calendar in the United States suggests that this may be the last chance to make progress until 2009,” the briefing paper said. “To assume that there would be no adverse effects from adjustment of imbalances over the next 2 ½ years — either through rising protectionist pressures, financial or exchange market turbulence, or slowing growth — would appear quite optimistic...”

Naive though Rajan and other adherents of the gung-ho view may have been, they could not have foreseen two consequential developments that materialized just as the multilateral consultations were getting underway. Both involved changes of personnel in very important positions.

At the Treasury, Tim Adams got a new boss, who did not share his multilateralist instincts. Hank Paulson, who was sworn in as Secretary on July 10, 2006, came to Washington with little knowledge of — or interest in — institutions like the IMF. Having risen to the CEO job at Goldman Sachs, partly on the strength of his success in expanding the firm’s business in China, he intended to tackle Sino-US economic problems by going the bilateral route — not by issuing public threats, but by cajoling and persuading, making the most of his deal-making skills and the relationships he had developed over many years in the Chinese leadership. Although, as noted above, he pushed hard for the IMF to approve the 2007 decision and label the renminbi as fundamentally misaligned, Paulson took a dim view of the multilateral consultations. His attention span was congenitally short; he was acutely conscious of the limited time he had to chalk up accomplishments, given the looming end of George W. Bush’s presidency; and he had no patience for the subtle coalition building required to muster a consensus on bodies such as the IMF executive board. To make matters worse, he quickly sized up de Rato as a weak leader, and spent as little time as

possible dealing with him — a marked change from Snow, an economics Ph.D. who had devoted considerable energy to cultivating ties with the managing director.

Separately, John Lipsky’s emergence as the IMF’s next principal deputy managing director became assured once the United States, which has traditionally controlled that post, selected him to replace the retiring Anne Krueger, whose term ended on September 1, 2006. As second-in-command, Lipsky naturally assumed responsibility for chairing the meetings of deputies from the five participating economies in the multilateral consultations. (De Rato anticipated presiding over the ministerial that would follow.) Unsurprisingly, given his views about imbalances, Lipsky’s stewardship of the deputies’ meetings can best be described as laid-back and lacking urgency; he believed an assertive role for the Fund was unrealistic. That came as a let down to some of those involved, who wanted Lipsky to challenge the participants, at least in the privacy of the meeting rooms, to be more forthcoming concerning the policy measures they might adopt.

It is impossible to say how much difference the arrival of Paulson and Lipsky made to the multilateral consultations, because even if entirely different personalities had been in charge, the results of the talks could well have been the same. Whether a more confrontational approach by Lipsky would have worked is especially doubtful, given Paulson’s lack of commitment to the initiative, which became increasingly evident to the other players and had a commensurately dampening effect on the proceedings.

The deputies certainly got off to an inauspicious start.

CROSSING THE RIVER, FEELING THE STONES AND DISENGAGING

A spat over seating arrangements marred the deputies’ first meeting, which took place in the afternoon of September 18, 2006, in Singapore’s Suntec Centre on the sidelines of the Bank-Fund annual meetings (unbeknownst to the news media, which was deliberately kept in the dark). Each of the participating economies was supposed to get two representatives at the table — one from the finance ministry, one from the central bank — but the euro area was accorded three because of its multiplicity of governing bodies. That raised hackles among the other delegations, especially the protocol-conscious Chinese, who complained diplomatically but vociferously to Lipsky.

“As the Chinese say, we are crossing the river by feeling the stones,” Lipsky told the deputies once everyone had gathered, according to a copy of his prepared opening remarks. “But let me emphasize up front that this is your consultation, and not the Fund’s. I see the Fund’s role primarily as a facilitator.”

For those who may have imagined that the deputies' meetings featured tough negotiating over issues such as budget deficits and exchange rates, minutes recorded at the time dispel such illusions. The minutes show the first meeting accomplished little more than agreement on the importance of avoiding finger pointing, with Xavier Musca, director general of the French Treasury, and Hamad Al-Bazai, the Saudi deputy finance minister, being especially emphatic on this point. Another major theme was the assertion by several participants that their governments had already made great strides toward the goals expected of them, and that their current policy trajectory would yield even more beneficial results. Musca, for example, said the structural reforms adopted in recent years by countries in the euro area were "now beginning to bear fruit," and the region was "prepared to continue" on that path. Hiroshi Watanabe, Japan's vice minister of finance, assured the others that Tokyo "would seek to continue the pace of structural reform" that outgoing Prime Minister Junichiro Koizumi had implemented during the previous five years. Hu Xiaolian, deputy governor of the People's Bank of China, said, "countries had made progress implementing policies to reduce global imbalances," which would "adjust gradually" if those countries continued to pursue those policies. (Regarding the currency issue, she offered nothing new beyond a standard line: "For China, it was accepted that greater renminbi flexibility was in the national interest, but it would take time.") When the US's turn came, Tim Adams cautioned the others that it was "important not to apply medicine that was worse than the disease." This was another way of making the Bush administration's long-standing argument that the budget deficit was already much lower than in previous years (it was narrowing to the \$250 billion range in 2006, compared with a record \$412 billion in 2004), and that shrinking it much further in the near term would risk throwing the US economy into recession, with adverse consequences for the rest of the world. At the end of the meeting, "it was agreed that the Chairman would consult bilaterally with participants, after which the Fund staff would prepare a short paper for the next meeting."

Following that uninspiring parley, nearly four months would pass before the deputies could be troubled to meet again — a sign that revealed how expectations for the multilateral consultations were fading. The chief reason for this, by all accounts, was that Adams was constrained from devoting serious attention to the initiative; Paulson was directing his under secretary to put a much higher priority on the Strategic Economic Dialogue, the bilateral US-China talks that Paulson had launched. When Rajan sought to speak to Adams about the multilateral consultations, Adams would often refer the matter to lower-level staffers. The Chinese complained to top Fund officials that the US had been "disengaged" at Singapore, according to an email sent by an IMF staffer, and the longer the talks went on, the more unmistakable the signals

became. At the second meeting, which took place in Paris in early January 2007, "The US remained somewhat detached," wrote David Robinson, an IMF staffer, in a summary assessment. Likewise, after the third meeting a few months later, another staffer, Michael Depler, wrote in a back-to-office report: "Adams was again disengaged — apparently reflecting both his personal circumstances and the U.S. Treasury's lack of enthusiasm for the MC." (By that point, Adams had announced his departure from the department, stemming from his differences with Paulson.)

Still, the second and third deputies' meetings did not pass uneventfully. During this period, the multilateral consultations were dealt the aforementioned crowning blow.

THE DASHING OF HOPES

It was the answer to a question from Lorenzo Bini Smaghi, who represented the European Central Bank, which aroused hopes — at least for a few weeks — that the multilateral consultations would yield a modest result in the form of a promise from one of the participants, namely China.

In response to Bini Smaghi's question, which came in the second deputies' meeting, Deputy Governor Hu of the Peoples Bank of China said that in future, "the Chinese government intended to pay greater attention to the nominal and real effective exchange rate...and not just to the U.S. dollar," according to minutes of the meeting. That was welcome news to the others, because one of the reasons the renminbi had become so undervalued was that it had been closely tied to the dollar, which had depreciated significantly against most other major currencies over the previous four years. If the Chinese were to use a much broader, trade-weighted measure of the exchange rate, the prospects for an appreciation were greater — not immensely so, but somewhat.

Now that Hu had made her statement in the confines of the meeting room, the question was whether the Chinese would commit publicly to this shift in policy. With the aim of securing such a commitment, the IMF incorporated it into a draft statement that was submitted to the deputies at their third and final meeting, which also took place in Paris, on March 13, 2007. The statement contained five boxes — one for each participant — showing their "policy plans," and as Lipsky explained, the statement would be issued to the IMFC and the public once everyone had signed off on it. In each case, those plans were essentially the same as those the respective governments had publicly expressed their intention to pursue; the discussions, after all, had generated almost no commitments to go further. The only exception was the Chinese policy plan, which included the following sentence: "The trend toward greater exchange rate flexibility will continue, with greater attention paid to nominal and real effective exchange rates." Putting the best

possible spin on the overall outcome, the draft statement said, “Participants’ policy plans are less ambitious than recommended by IMF staff, but, *provided they are fully implemented*, would constitute a useful step forward” in shrinking imbalances (emphasis in original).

Then came the dashing of hopes for any promises of actual change in the policies of the five participants. When final drafts of the statement were circulated for approval, the Chinese representatives insisted on a much watered-down version of their policy plan, with wording that was nearly identical to what they had previously been using for months. Precisely why this happened is unclear, but China’s State Council holds the final word when it comes to the renminbi, so presumably the top leadership overruled any move by the deputies toward faster appreciation.

Naturally, this news evoked dismay from the others. “It is regrettable if a voluntary commitment for further flexibility of the exchange rate is not included in the final document,” Japan’s Watanabe wrote in a March 26, 2007 email to Lipsky. “This voluntary commitment by China is potentially the greatest achievement of the multilateral consultation process.” He urged Lipsky to try to persuade Beijing to restore the previous statement, which Lipsky did in a March 28 letter to Hu. “My colleagues and I would respectfully suggest that you and your colleagues consider editing the latest draft to add back the [original] phrase,” Lipsky’s letter said. “In fact, I worry that if this phrase is not included, it will represent a serious disappointment to the other participants.”

The plea failed. None of the participants would be offering “down payments,” “upfront action” or “strengthening of commitments.” They would do nothing more than offer assurances that they would fulfill their previously made pledges. Yet, no hint of “serious disappointment” appeared in the IMF’s public statement at the conclusion of the multilateral consultations, which proclaimed it “a fruitful initiative.” Lipsky’s press conference on the matter was similarly upbeat. “This outcome represents something that is novel and innovative,” he told reporters on April 18, 2007. “For those who might say that there are no dramatic measures — or even immediate changes in policies — contained in the policy plans, it should be recognized that there was consensus that a dramatic response [to the issue of imbalances] was neither warranted nor appropriate. Rather, a medium-term response was seen to be appropriate.” Emphasizing that the key to success was implementation, he touted a calculation by IMF staff that, if all of the participants proceeded with their stated policy plans, global imbalances would shrink by about one to 1.75 percent of GDP over the following four years. “You can’t call this trivial or insubstantial,” he said. “Some people said there’s nothing new and I would say, show me where this has happened before that these participants have made this kind of public statement. I don’t find it anywhere else.

So this is a good start. It’s not the final word. The final word will be six months from now, a year from now, two years from now. Will we have a sense that policies are moving in the right direction and that imbalances are moving in the right direction?” (IMF, 2007d).

Those forward-looking questions became unanswerable when the global financial crisis intervened. Also hard to answer, but well worth pondering, are questions that arise in looking back at the multilateral consultations. Might the exercise have ended differently if the format had been similar to Yusuke Horiguchi’s plan, with the IMF acting more like the “umpire” suggested by the British and Canadian central bank governors? Would Paulson have been less dismissive if he had known that the Fund was going to issue a scorecard to show how far each participant was going in taking the necessary steps to shrink imbalances, and that the next step would be additional consultations for participants that were falling short? Might the Chinese have been more willing to commit themselves on paper to alter their foreign exchange policy if they had known that by doing so, they would be able to avoid being cast as obstructionists and do-nothings like the others? Maybe not — the outcome could well have been the same.

But it is hard to imagine how the outcome could have been much less successful than it was.

CONCLUSIONS

As depressingly familiar as they are already, the fundamental difficulties that often thwart international cooperation should be even more manifest in view of the events recounted above. The myriad shortcomings of the IMF’s efforts to deal with global imbalances prior to the financial crisis help elucidate a number of inconvenient truths, noted in the introductory section of this paper, about the coordination of policies across national borders.

Sovereign governments have mulish proclivities, so corralling them into acting in the global interest requires an extraordinary confluence of events.

Not only must the public interest of each nation be served, but also the short-term political interests of each government and even the personal priorities of key policy makers. Moreover, the bigger a sovereign nation, the scantier the heed it must pay to the exhortations of international institutions like the IMF, and the greater its immunity from any action, including diplomatic embarrassment, that an institution might use to spur cooperation. Those verities could hardly have been starker when, during the multilateral consultations, Treasury Secretary Paulson treated the initiative with disdain, and the Chinese refused to commit in writing to the change in currency policy they were contemplating in April 2007; or when country after country staved off the IMF’s efforts

to apply the “fundamental misalignment” label under the terms of the 2007 decision. Other problems that afflict international cooperation — notably the governance deficiencies of institutions like the Fund — are also evident in the arduous struggle for approval of the 2007 decision and the loss of support it suffered thereafter.

The same goes for the hotly debated topic of US decline. Historians may someday look back on the approval of the 2007 decision, over Beijing’s strong protest, as the last attempt by the world’s old guard to shape the international system without obtaining Chinese assent. The debacle that ensued is a vivid reminder of Washington’s relatively diminished power and the necessity of enlisting Chinese support for any initiative involving governance of the global economy. It is remarkable to contemplate how, less than a decade earlier, Robert Rubin, Larry Summers and Alan Greenspan were widely depicted (with only modest exaggeration) as the IMF’s puppet masters. No Chinese policy makers show any sign of assuming, or even wanting to assume, the kind of influence that trio held. But for the foreseeable future, the successors of Rubin, Summers and Greenspan will have to consider their counterparts in Beijing as indispensable partners in whatever new directions global economic policy making takes. For good or ill, the “rules of the game” have been fundamentally changed; the international monetary system lacks a leader with the strength that Washington once had to impose solutions when problems arose.

It should not be surprising, given such daunting obstacles to international coordination, that efforts to resolve the problem of global imbalances have made little headway in the years following the financial crisis. The G20 got off to a seemingly propitious start at its Pittsburgh summit in September 2009, when it unveiled the “Framework for Strong, Sustainable and Balanced Growth,” which featured a broad agreement that countries with current account surpluses should boost domestic demand, while deficit countries should promote savings and curb fiscal deficits. The novel part of this undertaking was the MAP, which the summiteers touted as holding more promise than earlier strategies to induce countries to adopt policies conducive to shrinking imbalances. This time, they averred, the countries themselves would take charge and subject each other’s policies to peer review, rather than having the IMF direct the process (although the Fund was to play a part by providing technical analyses of the countries’ policies and the compatibility of those policies with global interests). Under the most optimistic scenarios, the G20 would jointly agree on new rules and indicators that would guide the way toward collectively desirable goals. Then, the peer review dynamic would come into play, with policy makers in major capitals taking those goals into consideration, their incentive being to secure favorable assessments — and avoid unfavourable assessments — from their fellow G20 members at summit meetings.

But discord and distractions at the last two summits have punctured the hopes raised at Pittsburgh. When G20 leaders gathered in Seoul in November 2010, the surplus countries — with China and Germany in the lead, and Japan in a supporting role — joined forces to oppose a US initiative that would have set a target for all G20 countries to keep current account surpluses and deficits within four percent of GDP. Much to US officials’ chagrin, they came under fire themselves for “currency manipulation” as a result of the Federal Reserve’s decision to engage in quantitative easing of the US money supply, because although the motive for that move by the Fed was to protect the United States from sliding back into recession, it did contribute to a weakening of the US dollar. At the Cannes summit in November 2011, imbalances barely drew any attention, as Greece’s sovereign debt crisis dominated policy makers’ time and energy.²³

Meanwhile, the issues that prompted the IMF to undertake the 2007 decision and multilateral consultations are as troublesome today as ever — arguably more so.

The need for a rebalancing between surplus and deficit countries became even more pressing with the outbreak of the euro zone crisis. As many commentators have observed, trade balances among countries within the euro zone are seriously out of kilter, even though the zone as a whole is in rough balance with the rest of the world. The healthier surplus nations of northern Europe, notably Germany, must help boost demand in the crisis-plagued periphery by importing more goods. Otherwise, if the countries in crisis try to bring their indebtedness under control by simply slashing spending and raising taxes, they risk a self-reinforcing spiral of recession, falling tax revenue and more austerity — the result being dimmer prospects for ending the continent’s turbulence.

Likewise, shrinking the trans-Pacific trade imbalance continues to be highly desirable for the sake of global growth and stability. A rebalancing of Asian economies toward greater demand from consumers, with less dependence on exports and investment, would improve the chances that the world economy can sustain momentum in coming years, without the fresh setbacks that may arise as the United States navigates a painful but necessary transition toward fiscal responsibility. Overall, recent Bank of Canada projections indicate that leaving global imbalances unresolved “could have severe negative consequences for global economic growth” — specifically, an eight percent loss in global GDP by 2015 relative to a scenario in which countries undertake the actions necessary to decrease their respective deficits and

23 See Daniel Schwanen (2011). “The G20 Battens Down the Hatches.” November 11. CIGI. Available at: www.cigionline.org/publications/2011/11/g20-battens-down-hatches.

surpluses.²⁴ Progress that has already occurred on the Asian rebalancing front should not be minimized; China's global current account surplus shrank to US\$201 billion, or 2.7 percent of GDP, in 2011, and the Chinese export juggernaut may prove less formidable as the nation's industry moves up the value chain. But it is far too early to call China's share of the job "mission accomplished." Projections about its surplus in coming years differ, mainly regarding whether the gap will widen a great deal or just somewhat.

An additional reason to aim for smaller imbalances is to guard against a crisis in the US dollar, the danger of which should not be dismissed too lightly, as Barry Eichengreen has noted: "Admittedly, not a few of us have warned before about the risks posed by global imbalances....That these early warnings were — how to put it politely? — premature does not mean that they were off target. They were derailed by the global financial crisis, which directed attention elsewhere....But simply because these warnings were early and rendered moot for a time by other events does not make them wrong" (Eichengreen, 2011).

As for China's currency manipulation, the problem — and the need for multilateral approaches to deal with it — has by no means vanished, notwithstanding a significant appreciation of the renminbi. Since the removal of its peg to the US dollar in 2005, the Chinese currency has risen by somewhere between 27 and 40 percent against the greenback (depending on what sort of inflation adjustment is used), leading the IMF to change its assessment of the renminbi in June 2012 to "moderately undervalued" (as opposed to "significantly" or "substantially undervalued").²⁵ Even economists at the Peterson Institute for International Economics, who have been among the most outspoken critics of Beijing's currency policy, recently calculated the renminbi's undervaluation at only about three percent.²⁶ But they were careful to note that this was based on new IMF projections of China's future trade surpluses that may prove over-optimistic, and other analysis suggests that the renminbi is still far enough below its equilibrium level to give Chinese manufacturers an unfair competitive edge.²⁷ The political atmosphere in Washington remains charged — all the more so because the

leading Republican candidate for president, Mitt Romney, has publicly vowed to confront China over the currency issue on his first day in the White House. Defusing the resulting tensions in a multilateral setting should therefore be a paramount goal for the international community. Even if China manages to appease its critics by allowing the renminbi to rise a good deal further in the coming months, what would stop Beijing from resorting anew to a cheap currency policy in the future, should circumstances impel it to do so? Indeed, the renminbi abruptly reversed its upward trajectory in May 2012, raising the prospect of just such a scenario.²⁸

Furthermore, the problem is no longer confined to China. One of the lessons emerging markets learned from the crisis is that a gigantic stash of foreign exchange reserves may offer a country the best protection during periods of turmoil. The predictable upshot has been operations by a number of countries to intervene in markets in ways that generate reserves; in some cases, these countries are admittedly contriving to limit the appreciation of their currencies. With some justification, they argue that other countries, notably the United States and United Kingdom, are achieving similar results with their quantitative easing of monetary policy. Although not yet nearly on a par with the 1930s, the resulting "currency wars" are worthy of deep concern.²⁹ However, the world still lacks any viable, enforceable system for preventing a country from pursuing a currency-cheapening policy to the point where it is violating its IMF obligations. Indeed, now that the Fund has retreated from its 2007 decision, restraints on such policies may be weaker than at any time since the breakdown of the Bretton Woods fixed-rate system in the 1970s.

A redoubling of the efforts of the G20 and IMF is therefore in order. Given the bureaucratic exertion that has been required to advance the MAP to its present point, G20 policy makers might be forgiven if they throw up their hands at the idea of embarking on anything much bolder — but they ought to do so. The predicaments their successors are likely to eventually encounter, in a world of continued large imbalances and minimal curbs on currency manipulation, are all too easy to imagine. Careful consideration of the IMF's pre-crisis experience yields some practical guidance. What lessons can be gleaned and what import do they have for international policy making today? The following are the four most instructive take-aways.

Accountability is essential — preferably delivered by an "umpire." International meetings to discuss issues such

24 See Carlos de Resende, Claudia Godbout, René Lalonde, Éric Morin and Nikita Perevalov (2012). "On the Adjustment of the Global Economy." Bank of Canada Review, Spring.

25 See David Lipton (2012). "Press Conference at the Conclusion of the 2012 Article IV Mission to China." Opening Remarks by David Lipton, First Deputy Managing Director of the IMF. June 8. Available at: www.imf.org/external/np/speeches/2012/060812.htm.

26 See William R. Cline and John Williamson (2012). "Estimates of Fundamental Equilibrium Exchange Rates." Policy Brief No. PB12-14. Peterson Institute for International Economics. May.

27 See Arvind Subramanian (2012). "China's Next Generation Should Look to Zhu." *Financial Times*. April 9.

28 See Keith Bradsher (2012). "China Lets Currency Weaken, Risking New Trade Tensions." *The New York Times*. May 31.

29 See Greg Quinn (2011). "Canada's Macklem Says G-20 Reform Delay threatens Global Economic Recovery." Bloomberg News. August.

as global imbalances will not get very far without some process for holding participating countries to account: a process involving a neutral referee offers the best prospects for success. If the multilateral consultations taught a lesson, this is it. The failure of those talks is often attributed to the fact that they were run by the IMF, which allegedly resulted in a lack of “ownership” by the participating countries. But this interpretation, logical as it sounds, turns out to be at odds with the facts. Although the exercise undeniably suffered from an ownership deficit, especially when Paulson’s indifference manifested itself, the IMF took a fairly passive stance, underscored by Lipsky’s statement to the deputies in their first meeting that he saw the Fund’s role purely as a “facilitator.” The problem was not an over-assertive IMF; a much bigger weakness was the lack of any arbiter, along the lines suggested by Horiguchi, to publicly identify the participants that were making the necessary contributions toward the jointly agreed goal and those that weren’t. With such a system in place, the success of such talks will by no means be guaranteed; however, only then would national policy makers be likely to treat the process with the kind of respect that stands a chance of producing meaningful results.

The good news is that the G20 seems to be moving, albeit haltingly, toward a MAP that would reflect this take-away. During the first half of 2011, G20 finance ministers agreed on a set of indicators for identifying member nations with “persistently large imbalances,” plus a follow-up procedure in which countries would be subjected to a special assessment by the IMF and their G20 peers. Due in part to the insistence of the Chinese, the indicators include a variety of data, involving much more than just current account deficits and surpluses; they also include government deficits and private savings, which are the areas where the United States is most vulnerable to criticism.³⁰ The knowledge that their countries’ economic performance will be scrutinized against those benchmarks, and they could be singled out for special attention, will presumably help leaders and their senior policy makers maintain interest in, and respect for, this process. That should raise their consciousness, to some extent at least, about the effects of their policies on the rest of the world. Moreover, the MAP is supposed to continue for years in an ongoing manner, rather than for a finite period, such as the multilateral consultations had.

The odds appear slim, however, that this process will impel major countries to change their policies in meaningful ways. Here is why.

The umpire had better be neutral — and seen to be so — as well as unrestrained in expressing opinions. Any institution or body that assumes the role of arbiter in the international economic arena must be as free of political influence as

possible, especially if it is going to render judgments on complex, consequential questions, such as whether a country is violating international rules. The IMF fell appallingly short of that standard during the implementation phase of the 2007 decision. The dismal legacy of that episode is that the Fund lost whatever credibility it might have had as guardian of the international monetary system against rule violators. Although the Fund is in many ways a much stronger and more vibrant institution today than it was before the financial crisis, the perception that it became a tool of US policy in the controversy over China’s foreign exchange rate seriously undercut its capacity to serve as an effective whistle-blower when countries are flagrantly manipulating their currencies. In an ideal world, the attempt to apply the 2007 decision symmetrically would have prevailed, so the Fund would have emerged with an enhanced image for treating countries with neither fear nor favour. Instead, the ultimate result exposed the degree to which the institution is captive to the whims of its most powerful members. The Fund let the United States and Japan off the hook, then halfheartedly went after China — abandoning its pursuit when Beijing suddenly loomed as a more potent force on the global scene than it had before. How can the Fund be expected to live down that history, unless its governance and the ways it judges such situations are drastically changed?

So, the IMF — in its present form at least — can be ruled out as the kind of unimpeachably objective umpire capable of delivering a stinging rebuke at a G20 summit to a country whose economic or currency policies pose a threat to others. As for the G20, it is the very epitome of a political body, with all sorts of considerations — including diplomatic ones — liable to affect the judgments its individual members are prepared to issue publicly about the economic policies of other members. The supposed efficacy of the Fund’s peer reviews is based on the claim that its members “own” the process and will, therefore, take it much more seriously than the participants in the multilateral consultations did under IMF direction. Yet the notion that the Fund is playing a much different role than it did before is false, as noted above. It strains credulity to conceive of the G20 rendering a verdict so stern, so credible and so concerted as to alter the policy-making calculus in the capital of a major country. The divisions on the currency issue that plagued the Seoul summit may be just a foretaste of what is to come.

Just as before the crisis — and just as in the multilateral consultations — the leading participants in the G20 won’t adjust their policies in ways that benefit the global good, unless they see their own interests being served by doing so. The MAP will not give them sufficient incentive.

Enforcement — especially if it involves the threat of sanctions — could make a substantial difference. Compared with the two previous take-aways, this one is more tenuously related to the events recounted in this paper. It should, however,

³⁰ See Eichengreen (2011).

be recalled that Chinese officials were anxious about the prospect of tariffs being imposed on their country's products as they scrambled to defend themselves against the 2007 decision. That evidence reinforces the belief — if any reinforcement were needed — that authorities in China and other countries are likely to be much more responsive to international coordination initiatives with teeth, than to those that are toothless.

Symmetry is still a principle worth striving to uphold. No system aimed at shrinking imbalances will work if it gives a free pass to any of the biggest and most powerful contributors to the problem. The world needs a process for dealing with major countries that manipulate their currencies for competitive advantage, but domestic policies matter too — perhaps even more than foreign exchange rates. The 2007 decision, despite its many fiascos, established rules that covered both sorts of problems. It remains in the IMF rulebook, even though the practice of labelling countries as fundamentally misaligned does not. The rules enshrined in that decision, with their emphasis on discouraging “external instability,” provide a reasonable framework for binding major countries — if only a reasonable method existed for making those rules stick.

Having expressed so much dissatisfaction with the status quo, I am obliged to end this paper by offering a brief proposal of my own. I do so in full awareness that it may strike some readers as inviting an even gorier replay of the 2007 decision's horror stories, and that it may make Horiguchi's “pie in the sky” idea seem grounded in realpolitik by comparison.

BORROWING A LEAF FROM THE WTO

Undergirding my proposal is the premise that, for all of the IMF's sins, there is no other institution capable of serving as umpire in the realm of international macroeconomic policy. The other major premise, drawn from my second and third take-aways, is that successful cooperation on the imbalances and currency issue will require two things the Fund currently lacks: enforcement power; and sufficient credibility and neutrality to umpire effectively.

The one solution that would endow the Fund with those capacities would entail a radical change in its modus operandi — adoption of a dispute settlement system resembling that used by the WTO. This system is widely recognized as one of the few successful innovations in international governance, and for good reason. By having independent panels of outside experts weigh the evidence and render judgments when countries accuse each other of violating the rules of international trade, the WTO commands impressive respect for its decisions — and compliance with them. Flawed though the system may be

(some of its features are biased in favor of the strong and powerful, and against the weak and small), the fairness and objectivity with which panels are perceived to operate imparts legitimacy to the process that other international institutions can only envy.

The IMF can't use panels for major decisions such as whether to extend emergency aid during a crisis; nothing that extreme is being advocated here. The Fund could, however, establish panels solely for the purpose of deciding when countries are violating the terms of the 2007 decision — in other words, when their policies are contributing to “external instability.” If countries could feel reasonably confident that their policies — and those of others — would be judged by neutral parties according to objective criteria, perhaps they would be more willing to submit to such judgments.

Under such a system, the United States could lodge a complaint against China for its currency policy, and China could lodge a complaint against the United States for its budget deficit and excessive consumption. In other words, the rules would be symmetrical,³¹ but the “judge and jury” would not be the IMF executive board or IMF management. Instead, it would be a group of experts from other countries, whose impartiality and professional credentials would be as close to being above reproach as possible. The board could retain the right to overturn a panel's decision, of course, so as to avoid handing matters over entirely to unelected and unaccountable experts.

In cases where a panel decides that a country is “guilty” of fomenting external instability, enforcement of that decision could come in the form of sanctions against the offender, although these would have to vary based on the nature of the offense. A country with a large current account surplus and heavily undervalued currency could face the prospect that its trading partners would raise tariffs on some of its products.³²

31 To ensure greater symmetry, the Fund could reinstate the provision (Principle E) that was dropped from the 2007 decision because of objections from developing countries.

32 A precedent exists for such sanctions in one of the IMF's original rules, called the “Scarce Currency Clause,” which envisioned the imposition of tariffs on the products of a country if the country was running such a large surplus that its currency was unavailable to the Fund. The Fund's founders assumed it might be used against the United States; indeed, US acceptance of the clause helped foster agreement in the negotiations at the Bretton Woods conference. But it has never been invoked, and is generally regarded today as a historical curiosity. Barry Eichengreen has advanced the admittedly “out of the box” idea that it ought to be resurrected, with the method of application changed to an automatic process so the IMF board would not have the responsibility for taking such a politically explosive decision. Under Eichengreen's proposal, a country that ran a current account surplus in excess of three percent of GDP for three years would be required to transfer resources to the Fund. Barry Eichengreen (2009). “Out of the Box Thoughts about the International Financial Architecture.” IMF Working Paper WP/09/116. May.

Imposing similar punishment on a country with a large and current account deficit would make little sense, since doing so would only aggravate the deficit. Rather, the country would have to accept some other penalty — and perhaps the most sensible one would be a surcharge on the capital requirements for its banks, since its policies would presumably be increasing the risk of a financial crisis.

Handing these decisions over to WTO panels would be a mistake, in my view. Others have proposed having the IMF work jointly with the WTO on disputes over foreign exchange rates, which makes some sense given that deliberate cheapening of a currency can be tantamount to protectionism. But the policies I believe should be subject to this new mechanism are much broader — and much further from the WTO's core competency — than just those affecting foreign exchange rates. They may include fiscal policy and monetary policy; they are, in short, the sorts of policies that Mark Allen and his allies believed should be subject to IMF surveillance for purposes of symmetry. Admittedly, finding expert consensus on macroeconomic issues of this kind may be considerably more difficult than doing so on matters of trade law. But they are surely better left to independent panels than to the IMF management and board.

Securing China's support for such an approach would pose a major challenge, because just as with the 2007 decision, Beijing would understandably fear the prospect of a guilty verdict against its currency regime. To overcome those concerns, the rules could incorporate numerous safeguards and qualifications. The standard of proof for finding a country guilty of contributing to external instability would have to be high and allow for extenuating circumstances. Perhaps more important, the United States and other countries could legally commit themselves to refraining from imposing unilateral sanctions, including those of the Baucus-Grassley sort, regarding alleged violations of currency rules. A similar trade-off helped make the establishment of the WTO possible; the United States had to effectively defang its domestic laws that provided for sanctions against protectionist trading partners, in exchange for a reliable, enforceable multilateral system of resolving disputes.

This proposal would be a very tough sell in Washington as well as in Beijing. Although US policy makers may be somewhat humbler after the financial crisis than before, they would hardly welcome the prospect of submitting American economic policy to the judgment of an international regime with sanction powers. But one way or another, the United States is going to have to deal with the implications of its reduced economic clout — and one of the most important implications is greater reliance on multilateral institutions to create the global conditions that best ensure American prosperity. With the federal budget deficit swollen as a result of the crisis and its ensuing bailouts, and massive spending cuts and tax

increases required to minimize the risk of a sovereign debt crisis, Washington needs global rebalancing to provide offsetting stimulus. That, in turn, for the reasons specified above, will entail robust multilateral cooperation, which is unlikely to materialize in the absence of ambitious rules, tough surveillance and the threat of enforcement. For the American body politic, adjusting to this new reality will take considerable acclimation. Hopefully, political leaders can help the public understand the national interests that are at stake.

Objections to this proposal are easy to imagine, and it is doubtful that I will be able to rebut all of them. If it only helps stimulate some creative thinking, it will have served its purpose. Certainly, it offers no substitute for actions that major countries must take on their own — notably medium-term deficit reduction in the United States and a restoration of confidence in the euro zone, which pose the most enormous challenges for global stability. There are no international rules or sanctions that are going to be able to overcome those challenges.

This proposal is the least important part of this paper, much less so than the historical narrative about what went on behind the scenes concerning the IMF's 2007 decision and multilateral consultations. Others may draw entirely different lessons from that history than I have, and conclude that the most sensible policy implications bear no relationship to the ones advanced here. The crucial point is that when international cooperation goes wrong, the international community should learn from the mistakes that were made, preserving what may have been well-conceived, while continuing to strive to make such undertakings work. For that, accurate and comprehensive information is necessary, and that is the spirit in which this paper was written.

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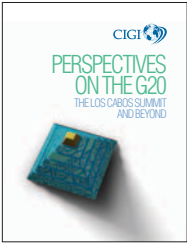
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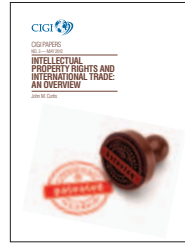
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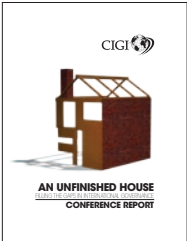
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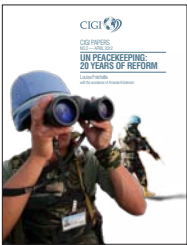
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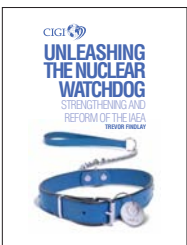
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