U.S House of Representatives
Ways and Means Committee Democrats

TPP Hearing on Currency Manipulation

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Congressman Levin and honorable members of the Ways and Means Committee, thank you for the opportunity to provide my views on the issue of how to deal with currency manipulation in the context of the Trans Pacific Partnership (TPP) trade agreement. This note briefly summarizes my views on the subject.

The TPP is designed as a broad agreement among its members that covers a number of areas including expanded market access, stronger labor and environmental standards, better protection of intellectual property rights, and consistent regulatory frameworks. By its nature, the TPP represents some important compromises. Nevertheless, if ratified and implemented by its members in a manner that respects the principles of the agreement, it has the potential to substantially increase trade flows within the region, benefiting the economies of all 12 members. The agreement could also set minimum thresholds for other trade agreements around the world, especially those that involve existing TPP members.

Exchange rates constitute a key relative price that affect cross-border trade flows. Hence, it is tempting to consider including surveillance of exchange rate management practices among TPP members as part of the agreement. However, given the broad range of macroeconomic and other policies that influence exchange rates, this would amount to expanding the scope of the agreement into ill-defined and possibly counterproductive territory.

One definition of currency manipulation is tied to direct intervention by central banks in foreign exchange markets. The TPP includes an ancillary provision calling on members to disclose the timing and size of their foreign exchange market interventions. Such transparency would certainly be useful in identifying sustained and substantial intervention, which could be interpreted as a signal of a central bank attempting to defy market forces pushing its currency's external value in one direction or another.

However, other macroeconomic measures such as monetary and fiscal policies, as well as policies related to the financial sector and product markets, can also be used to affect the

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exchange rate in lieu of direct exchange market intervention.[2] Even in advanced economies such as the euro zone and Japan, central bankers have made no secret of their desire to weaken their currencies in order to stimulate exports and offset deficient domestic demand. Whether such policies are intended to—or whether in practice they do—work through domestic channels rather than through the external (export) channel is difficult to identify a priori using quantitative metrics.

Emerging markets face additional changes related to exchange rate volatility as their financial markets are underdeveloped, making it harder to absorb and cope with the effects of such volatility. This has led many of these economies to manage their exchange rates, both to avoid what they regard as excessive short-term volatility and to forestall sharp swings away from exchange rate levels that they see as consistent with macroeconomic fundamentals. Markets are also prone to overshooting in one direction or another when there are shifts in economic fundamentals that would normally entail some desirable changes in exchange rates.

This points to another challenge—defining the "appropriate" or equilibrium exchange rate that is consistent with macroeconomic fundamentals. The best that existing empirical models and techniques can do is to generate estimates of suitable levels for medium-term exchange rates. Such estimates have large error bands around them, reflecting the degree of uncertainty inherent in estimates derived using these techniques. The additional step of correcting for short-term business cycle conditions in order to translate such medium-term concepts into evaluating the suitable level of the exchange rate on a real-time basis is fraught with even more conceptual and analytical pitfalls.

In short, it is a seductive but unrealistic notion that an agreement can lay down clear markers for when a country's economic policy interventions are designed solely or expressly to counter market forces and weaken a currency's value in order to gain a competitive advantage in export markets.

This is certainly a worthwhile policy objective from the broader perspective of international financial stability and there are forums such as the IMF through which this should be pursued. But an already ambitious and sprawling trade agreement such as the TPP could end up being hobbled rather than strengthened by trying to include currency issues within its ambit.

Thank you.

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[2] For two lucid pieces laying out some of these and related arguments, see Kemal Derviş, 2015, "Can Trade Agreements Stop Currency Manipulation," *Project Syndicate*, and Jeffrey Frankel, 2015, "The Chimera of Currency Manipulation," *Project Syndicate.*