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Hearing on China's Exchange Rate Policy, Wednesday, March 24, 2010

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These comments are submitted in response to the House Ways and Means Committee's announcement of a Hearing on China's Exchange Rate Policy, dated March 15, 2010. The announcement invited written comments on, among other things, steps that could be taken to address "the immediate and long-term impact of China's exchange rate policy on the U.S. and global economic recoveries and, more specifically, on U.S. job creation." The primary objective of these comments is to explain steps that could be taken to address China's exchange rate policy within the U.S. and international legal framework governing exchange actions and their impact on trade. In particular, the comments demonstrate that the United States does not need to await a formal determination from the IMF that China is manipulating its currency before it can pursue viable claims against China's trade-distorting exchange rate policies at the WTO.

I. Introduction

Economists are in broad agreement that China's exchange rate is substantially undervalued, by as much as 40% according to some estimates. Yet there is equally broad disagreement about what tools, if any, may be available to the United States to address this undervaluation and the severe economic costs it imposes on U.S. firms and workers, as well as the risks it poses to the global economy as a whole. These comments outline legal approaches the United States may wish to consider to achieve a revaluation of the Chinese yuan, consistent with the WTO and IMF obligations of both China and the U.S.

These comments focus on options available for WTO claims regarding the trade effects of China's exchange rate policies. As a preliminary matter, it must be noted that WTO claims provide only one possible avenue for redressing the harmful trade impacts of China's currency practices. The antidumping and countervailing duty laws also provide the U.S. Department of Commerce the authority to remedy exchange rate practices that injure the domestic industry. Stewart and Stewart is co-counsel in a pending countervailing duty investigation before the Department of Commerce where we are urging the Department to investigate exchange rate management as a countervailable subsidy to the coated paper industry in China.[2] The trade remedy laws, when enforced

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[2] The Department decided not to initiate on the original subsidy allegation relating to China's exchange rate management, but petitioners have submitted additional information and argument in a new subsidy

effectively, provide a powerful tool for redressing unfair trade practices such as China's currency practices. Because we believe this tool is already available and the Department of Commerce has been specifically asked to investigate the countervailability of China's practices, these comments instead focus on other tools for addressing the trade effects of China's currency practices.

There is a common perception that the IMF must first formally determine that China is manipulating its currency in violation of Article IV:1(iii) of the IMF Articles of Agreement before a viable WTO claim may be brought regarding the trade effects of China's exchange rate policy. While a number of analysts have argued that China's exchange rate policies meet the legal definition of currency manipulation in Article IV:1(iii),[3] the IMF has been hesitant to make such a formal finding itself and is viewed as being constrained by its political structure from doing so. A closer review of WTO and IMF rules reveals that viable WTO claims against China's trade-distorting exchange rate policies are available even if the IMF refuses to formally determine that China is manipulating its currency in violation of the Fund's Articles of Agreement. In short, there is no need for the U.S. to relinquish its rights at the WTO due to a lack of effective action by the IMF.

II. The Relationship Between IMF and WTO Rights and Obligations

Both China and the U.S. are members of the IMF and WTO, and they thus enjoy certain rights and obligations under both the IMF Articles of Agreement and the WTO Agreements. IMF and WTO members (and GATT Contracting Parties before the WTO was established) have worked to ensure that membership in both organizations does not impose inconsistent obligations.[4] In particular, both organizations have established mutually reinforcing rules addressing the relationship between exchange rate policies and trade.

Under Article IV:1(iii) of the IMF's Articles of Agreement, "… each member shall … avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members."

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allegation to Commerce. The Department has not yet determined whether to initiate an investigation based on the new allegation. *See Certain Coated Paper Suitable For High–Quality Print Graphics Using Sheet–Fed Presses from the People's Republic of China: Preliminary Affirmative Countervailing Duty Determination and Alignment of Final Countervailing Duty Determination with Final Antidumping Duty Determination*, 75 Fed. Reg. 10,774, 10,775.

[3] *See*, *e.g.*, Michael Mussa, "IMF Surveillance over China's Exchange Rate Policy," Paper presented at the Conference on China's Exchange Rate Policy, Peterson Institute for International Economics (Oct. 19, 2007) for a detailed argument that China is in violation of Article IV:1(iii).

[4] *See*, *e.g.*, Deborah E. Seigel, *Legal Aspects of the IMF/WTO Relationship: The Fund's Articles of Agreement and the WTO Agreements*, 96 AM. J. INT'L L. 561 (2002); Jan Wouters and Dominic Coppens, *International Economic Policy-Making: Exploring the Legal Linkages Between the World Trade Organization and the Bretton Woods Institutions*, 3 INT'L ORG. L. REV. 267 (2006).

Article II:3 of the GATT 1994 prohibits a Member from altering its method of converting currencies "so as to impair the value of any of the concessions" it has made in its schedule of concessions. In addition, the WTO Agreement on Subsidies and Countervailing Measures includes in its illustrative list of prohibited export subsidies "Currency retention schemes or any similar practices which involve a bonus on exports." *Ad Note* 2 to Article VI:2 and 3 of GATT 1994 further states:

> Multiple currency practices can in certain circumstances constitute a subsidy to exports which may be met by countervailing duties under paragraph 3 or can constitute a form of dumping by means of a partial depreciation of a country's currency which may be met by action under paragraph 2. By 'multiple currency practices' is meant practices by governments or sanctioned by governments.

In addition, Article XV:4 of the GATT 1994 states: "Contracting parties shall not, by exchange action, frustrate the intent of the provisions of this Agreement, nor, by trade action, the intent of the provisions of the Articles of Agreement of the International Monetary Fund."[5] Article XV:5 also requires the WTO to report to the Fund if it considers that "exchange restrictions on payments and transfers in connection with imports" being applied by a Member are in violation of GATT rules on quantitative restrictions.[6]

WTO rules also require the WTO to defer to the IMF regarding certain matters within the IMF's jurisdiction. Article XV:2 of the GATT 1994 requires the WTO to, *inter alia*, "accept all findings of statistical and other facts presented by the Fund relating to foreign exchange, monetary reserves and balances of payments," and "accept the determination of the Fund as to whether action by a contracting party in exchange matters is in accordance with the Articles of Agreement of the International Monetary Fund." The application of these requirements to WTO dispute settlement panels is further discussed

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[5] The *Ad Note* to Article XV:4 states as follows:

> The word "frustrate" is intended to indicate, for example, that infringements of the letter of any Article of this Agreement by exchange action shall not be regarded as a violation of that Article if, in practice, there is no appreciable departure from the intent of the Article. Thus, a contracting party which, as part of its exchange control operated in accordance with the Articles of Agreement of the International Monetary Fund, requires payment to be received for its exports in its own currency or in the currency of one or more members of the International Monetary Fund will not thereby be deemed to contravene Article XI or Article XIII. Another example would be that of a contracting party which specifies on an import licence the country from which the goods may be imported, for the purpose not of introducing any additional element of discrimination in its import licensing system but of enforcing permissible exchange controls.

[6] Apparently the WTO and GATT before it have never reported to the Fund on a Member's exchange measures under this provision. *See* GENERAL AGREEMENT ON TARIFFS AND TRADE, ANALYTICAL INDEX 403 (6th ed. 1994); WORLD TRADE ORGANIZATION ANALYTICAL INDEX 226 (2nd ed. 2007).

in Section IV, below. Finally, Article XV:9(a) of the GATT 1994 provides: "Nothing in this Agreement shall preclude … the use by a contracting party of exchange controls or exchange restrictions in accordance with the Articles of Agreement of the International Monetary Fund …."

While both institutions seek coherence in international rules governing trade and exchange rate policies, the two institutions have markedly different systems for enforcing these rules. The IMF has no member-to-member dispute settlement system, and enforcement actions must be undertaken by IMF's Executive Board. Due to political constraints on the Board, the IMF generally relies upon dialogue and persuasion to encourage compliance with its obligations rather than outright findings of violation. Indeed, in the more than thirty years since Article IV of the IMF Articles of Agreement was ratified, the IMF Executive Board has never concluded that a member was in violation of the exchange rate policy obligations of the article.[7] In 2007, the IMF Executive Board adopted a new Decision on Bilateral Surveillance of Members' Policies under Article IV, which reaffirmed that "Dialogue and persuasion are key pillars of effective surveillance."[8] Moreover, when assessing whether exchange rates have been manipulated "in order to" prevent balance of payments adjustment or gain an unfair competitive advantage, any representation by a member regarding the purpose of its exchange rate policies will "be given the benefit of any reasonable doubt."[9]

By contrast, a WTO Member may initiate a dispute if it believes another Member is violating its WTO obligations or nullifying or impairing a benefit accruing to the complaining Member. If the dispute is not resolved through consultations, it will be heard by an independent dispute settlement panel and, if appealed from the panel, by the WTO's Appellate Body. If a Member is found to have acted inconsistently with its obligations, the complaining party may be authorized to withdraw concessions if the violation is not remedied. If a Member is found to have nullified or impaired a benefit, the WTO may recommend that the Member concerned "make a mutually satisfactory adjustment," which may include compensation to the complaining Member.[10] The WTO dispute settlement system is designed to operate with less interference from the various political pressures that have hampered more aggressive enforcement action by the IMF.

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[7] *See* Michael Mussa, "IMF Surveillance over China's Exchange Rate Policy," Paper presented at the Conference on China's Exchange Rate Policy, Peterson Institute for International Economics (Oct. 19, 2007) at 40.

[8] *See* International Monetary Fund, Decision on Bilateral Surveillance over Members' Policies (adopted June 15, 2007) at Part I(B)(8). Available on-line at http://www.imf.org/external/np/sec/pn/2007/pm0769.htm .

[9] *Id*. at Annex, para. 3.

[10] *See* Article 26 of the Dispute Settlement Understanding.

III. Defending Exchange Rate Actions from WTO Challenge under Article XV:9(a) of GATT 1994

The U.S. may have several claims that China's exchange rate policies violate WTO rules. If China has altered the method by which it converts its currency in a manner which impairs the value of the tariff concessions contained in its schedule, the measure may violate Article II:3 of the GATT 1994.[11] In addition, the government provision of yuan to exporters in exchange for dollars at an artificially undervalued exchange rate may constitute a prohibited export subsidy under Article 3 of the Agreement on Subsidies and Countervailing Measures. Cases against prohibited export subsidies are relatively straightforward and do not require a showing of the injury or adverse effects of such subsidies. If China is found to maintain a prohibited export subsidy, it would also violate Article 3.2 of the Agreement on Agriculture and China's Protocol of Accession. Certain currency practices that are not contingent on export may nonetheless be actionable at the WTO if it can be established that they are "specific" under Article 2 of the Agreement on Subsidies and Countervailing Measures and cause adverse effects under Articles 5 and 6 of the Agreement.

Alternatively, even if a direct violation of a WTO provision cannot be established, China's exchange rate policies may be subject to a claim under Article XV:4 of the GATT 1994 if they "frustrate" provisions of the WTO agreements, such as the schedule of tariff concessions agreed to by China and enforceable under Article II of the GATT 1994 or the non-discrimination provisions of Articles I and III of the GATT 1994.[12] Finally, even if China's exchange rate policies are found not to directly violate any WTO provisions, they may nullify and impair benefits accruing to the U.S. under the agreements and thus be subject to a dispute settlement claim under Article XXIII of the GATT 1994 and Article 26 of the Dispute Settlement Understanding.[13]

A comprehensive evaluation of the viability of such claims is beyond the scope of these comments. Instead, these comments focus on the potential defenses to such claims, and the procedures the WTO and IMF have established for evaluating such defenses. Any such claims must first be evaluated under Article XV:9(a) of the GATT, which states,

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[11] The provision has been invoked where a country has revalued its currency and thus adjusted bound specific duties so as not to impair the value of its concessions or "afford protection in excess of the amount of protection provided for in the Schedule" of concessions. *See* GENERAL AGREEMENT ON TARIFFS AND TRADE, ANALYTICAL INDEX 83-84 (6th ed. 1994).

[12] *See*, *e.g.*, Panel of Complaints, *Report on The Special Import Taxes Instituted by the Greek Government*, GATT Doc. G/25 (Oct. 31, 1952) at para. 8 ("Even if it were found that the tax did not fall within the ambit of Article III, the further question might arise under Article XV(4) whether the action of the Greek Government constituted frustration by exchange action of the intent of the provisions of Article III of the General Agreement.")

[13] For example, a 1979 GATT Working Party on Specific Duties noted that a claim that a Member who appreciated its currency should be required to reduce duties to preserve the value of its concessions would be available to Members under Article XXIII. *Report of the Working Party on Specific Duties*, GATT Doc. L/4858 (Nov. 2, 1979) at para. 14.

"Nothing in this Agreement shall preclude … the use by a contracting party of exchange controls or exchange restrictions in accordance with the Articles of Agreement of the International Monetary Fund …." As demonstrated below, this provision in no way establishes an absolute bar to all WTO claims regarding exchange actions merely because the IMF has not, at the time of the filing of the dispute, formally declared that such actions violate the IMF Articles of Agreement.

First, it appears clear that Article XV:9(a) may operate as a defense to a claim that an exchange restriction or control that the IMF has approved of under the Articles of Agreement is in direct violation of another WTO provision.[14] However, there is some ambiguity as to the relationship between Article XV:9(a) and the "frustration" claim available under Article XV:4 in the absence of a direct violation of another WTO provision. Some have argued that Article XV:9(a) trumps Article XV:4, and thus that any exchange action that is in accordance with the IMF Articles of Agreement not only cannot be found to directly violate GATT provisions but also cannot be found to "frustrate" any of those provisions under Article XV:4.[15] This view is supported by the negotiating history of Article XV:9(a), as drafters agreed to delete the phrase "Subject to paragraph 4 of this Article" from the beginning of the language now in Article XV:9(a) at the Havana Conference.[16]

The issue was specifically addressed by a Special Group on GATT-IMF relations formed as part of the GATT Review Working Party on Quantitative Restrictions in 1954. The United Kingdom proposed that an interpretative note be added to Article XV:9(a) clarifying that: 1) Article XV:9(a) safeguarded the rights of Members to take IMF-consistent exchange actions "without prejudice" to Article XV:4; 2) Article XV:9(a) should not be interpreted to prevent Members from inviting another Member to discuss the trade aspects of its exchange actions with reference to its GATT obligations; 3) Article XV:9(a) did not prevent parties from reporting exchange restrictions or controls to the IMF under Article XV:5; and 4) Article XV:9(a) did not preclude a party from invoking the nullification and impairment provisions of Article XXIII with regard to another party's exchange actions.[17]

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[14] This appears to be the case whether a violation of a GATT provision or a provision of another WTO Agreement is claimed. For example, the dispute settlement panel in *Dominican Republic – Cigarettes* examined whether the Dominican Republic had a Article XV:9(a) defense to a GATT Article II claim. A 1994 Ministerial Declaration on the Relationship of the World Trade Organization with the International Monetary Fund appears to provide that the exception in Article XV:9(a) also applies to other WTO Agreements in addition to the GATT, unless those agreements explicitly provide otherwise. *See* Siegel, *supra* note 2, at 594.

[15] *See id*. at 591.

[16] *See* GENERAL AGREEMENT ON TARIFFS AND TRADE, ANALYTICAL INDEX 407-408 (6th ed. 1994).

[17] *See Review Working Party I on Quantitative Restrictions: Report of the Special Group on GATT-Fund Relations*, GATT Doc. W.9/234 (Mar. 1, 1955) at Annex II.

The Special Group declined to adopt the interpretative note.[18] As to the first part of the UK proposal, the Special Group "agreed that it would be preferable not to try to lay down general principles about the relationship between paragraphs 4 and 9 but to leave this question over for empirical consideration if and when particular points arose which had a bearing on it."[19] Thus, they declined to resolve one way or the other the question of whether an exchange action consistent with the IMF Articles of Agreement may frustrate a GATT provision under Article XV:4 even if it could not directly violate a GATT provision under Article XV:9(a). However, the Special Group did agree with the position put forward in the second and third parts of the UK proposal, stating its view that nothing in Article XV:9(a) prevented Members from discussing the trade effects of an exchange action with another Member or reporting such actions to the Fund.[20] Finally, the Special Group stated that an interpretative note clarifying that nothing in Article XV:9(a) prevented Members from resorting to nullification and impairment provisions with regard to exchange actions "was unnecessary."[21] Thus, it appears the Special Group agreed that an exchange action in accordance with the IMF Articles of Agreement could be found to nullify or impair benefits accruing to a Member and be subject to the procedures for such non-violative measures provided in Article XXIII.[22]

In sum, it appears that whether a WTO Member may be able to raise Article XV:9(a) as a defense depends on the nature of the WTO claim being brought against it. First, if a claim of a direct violation of a WTO agreement is brought, Article XV:9(a) is available as an affirmative defense if the measure is an "exchange restriction" or "exchange control" that is "in accordance with" the IMF Articles of Agreement. Second, if a "frustration" claim is brought under Article XV:4, it is unresolved whether Article XV:9(a) may be available as a defense, though negotiating history seems to indicate that it should be available. Third, if a nullification or impairment claim is brought against a non-violative measure under Article XXIII, it appears that Article XV:9(a) is likely not available as a defense.

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18 *See id*. at para. 8.

19 *Id*. Subsequent GATT reports on the topic have cited this determination and not departed from it. *See*, *e.g*., Committee on Balance-of-Payments Restrictions, Background Paper by the Secretariat, *Consultation with Italy (Deposit Requirement for Purchases of Foreign Currency)*, GATT Doc. BOP/W/51 (Sept. 25, 1981) at paras. 12-13.

20 *Id*.

21 *Id*.

22 *See also* Committee on Balance-of-Payments Restrictions, Background Paper by the Secretariat, *Consultation with Italy (Deposit Requirement for Purchases of Foreign Currency)*, GATT Doc. BOP/W/51 (Sept. 25, 1981) at para. 13 (characterizing the Special Group as agreeing "that the exemption { in Article XV:9(a) } did not preclude a contracting party from invoking, in relation to an exchange measure, the provisions of Article XXIII on nullification and impairment."). At least one author arguing for a strong reading of Article XV:9(a) nonetheless appears to agree that the exception would not preclude a nullification or impairment claim. *See* Seigel, *supra* note 2, at n. 136.

IV. Determining Consistency with the IMF Articles of Agreement under Article XV:9(a) of GATT 1994

If Article XV:9(a) is raised as a defense in a WTO dispute settlement claim, there are relatively clear rules and procedures regarding how a panel should evaluate the defense. Article XV:2 states that the WTO "shall accept the determination of the Fund as to whether action by a contracting party in exchange matters is in accordance with the Articles of Agreement of the International Monetary Fund." In addition, the Agreement between the International Monetary Fund and World Trade Organization concluded in 1994 states, at paragraph 8, "The Fund shall inform in writing the relevant WTO body (including dispute settlement panels) considering exchange measures within the Fund's jurisdiction whether such measures are consistent with the Articles of Agreement of the Fund."

These procedures were employed by the dispute settlement panel in *Dominican Republic – Cigarettes*. There, the Dominican Republic sought to defend a foreign exchange fee imposed on imported cigarettes under Article XV:9(a).[23] The Panel first noted that any party raising Article XV:9(a) as a defense bore the burden of demonstrating, first, that the challenged measure was an exchange control or exchange restriction, and, second, that the measure was "in accordance with" the IMF Articles of Agreement.[24] The panel further found that it should respect IMF criteria prescribed by the IMF for determining consistency with its Articles of Agreement and apply them in its evaluation.[25] In addition, the panel determined that "it needed to consult with the IMF based on paragraph 2 of Article XV to verify { the Dominican Republic's } argument for a determination by the Panel on whether the measure is justified under Article XV:9(a) of the GATT."[26] The panel requested the views of the Fund, and the IMF replied that the challenged measure did not constitute an "exchange restriction," and thus the issue of its consistency did not arise under paragraph 8 of the Fund-WTO Agreement.[27]

The panel agreed with the IMF, finding that the measure was not an "exchange restriction."[28] The panel then conducted its own analysis of the consistency of the measure with the IMF Articles of Agreement, since the IMF did not consider it to be a measure within the scope of Article XV:9(a) or subject to the agreement to provide a

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[23] *See* Panel Report, *Dominican Republic – Measures Affecting the Importation and Internal Sale of Cigarettes*, WT/DS302/R (Nov. 26, 2004) at para. 7.123.

[24] *Id*. at para. 7.131.

[25] *Id*. at para. 7.132.

[26] *Id*. at para. 7.139.

[27] *See id*. at paras. 7.142 – 7.144, 7.150. The IMF concluded that, because the measure was not an "exchange restriction," it was also not an "exchange control." *See id*.

[28] *See id*. at para. 7.145.

legal determination to the panel.[29] The panel found that the provision of an IMF press release stating that the Dominican Republic had been granted a "waiver" for the measure, absent a copy of the formal waiver decision by the IMF or any clear legal basis for such waiver, was insufficient to establish that the measure was in accordance with the IMF Articles of Agreement.[30] The panel thus found that the measure could not be justified under Article XV:9(a).[31] These findings were not appealed to the Appellate Body.

If a WTO dispute were brought challenging China's exchange rate policies and China sought to justify them under Article XV:9(a), and if the approach of the IMF and the WTO panel were similar to that taken in *Dominican Republic – Cigarettes*, one would expect the IMF and WTO panel to proceed on the following basis:

1) China bears the burden to justify the challenged measures under Article XV:9(a);

2) China must establish both that its challenged exchange rate measures constitute an "exchange restriction" or "exchange control" and that the measures are "in accordance with" the IMF Articles of Agreement;

3) the panel should follow IMF-prescribed criteria in making its evaluation of the measures;

4) the panel must request a determination from the IMF regarding whether the measures fall within the exception in Article XV:9(a);

5) the IMF is required to provide the requested determination to the panel in writing under paragraph 8 of the IMF-WTO Agreement; and

6) China will fail to demonstrate its measures are in accordance with the IMF Articles of Agreement in the absence of a formal IMF determination of consistency with the legal justification therefore under the Articles of Agreement.

V. Conclusion

In sum, the absence of a formal IMF Executive Board decision determining that China has manipulated its currency in violation of Article IV:1(iii) of the IMF Articles of Agreement should not prevent the United States from evaluating whether it has viable WTO claims against China regarding the trade effects of its exchange rate policies. Some claims – such as a nullification and impairment claim, and, arguably, an Article XV:4 claim – may not be subject to the defense in Article XV:9(a) of the GATT 1994. Other claims of direct WTO violations – such as Article II of the GATT 1994 and the

[29] *See id*. at paras. 7.151 – 7.154.

[30] *See id*.

[31] *See id*. at para. 7.155.

prohibited and actionable subsidy provisions of the Agreement on Subsidies and Countervailable Measures – may be subject to a claim by China that is has a defense under Article XV:9(a). However, even if a claim is subject to an Article XV:9(a) defense, China would bear the burden in maintaining the defense, the Fund would be required to provide a legal determination to a WTO panel on the issue, and the absence of a clear and legally justifiable determination that China's policies are in accordance with the Articles of Agreement should cause China's defense to fail.

Economists are in broad agreement that China's exchange rate policies substantially undervalue the yuan, and this undervaluation artificially increases the cost of U.S. exports and decreases the cost of Chinese goods imported into the United States. The result is a massive and persistent U.S. trade deficit with China, elimination of important export opportunities, harsh competition for domestic producers from unfairly low-priced imports, and the loss of production, income, and employment in the United States.

The U.S. has the authority to remedy the harm caused by these practices under its domestic unfair trade laws, and the Department of Commerce should effectively enforce those rules by investigating allegations that currency management constitutes a countervailable subsidy. In addition, the U.S. should actively explore affirmative WTO claims regarding China's exchange rate policies. The WTO and IMF were designed to create a coherent, rules-based system to prevent and redress exactly the type of trade-distorting currency practices that China is currently engaged in. Those rules can and should be employed to their fullest extent to achieve effective relief for U.S. industries, farmers, workers, and communities.