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published in
Griffin's View on International and Comparative law
2008

document version
Peer reviewed version

Link to publication in VU Research Portal

citation for published version (APA)
Denters, H. M. G., & Ciobanasu, I. C. (2008). Manipulation of the Chinese Yuan - May WTO Members Respond? *Griffin's View on International and Comparative law*, *9*(1), 55-70.

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This is a postprint of

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In: (Ed.), (pp. 55-70).

Published version: no link available

Link VU-DARE: http://hdl.handle.net/1871/47427

(Article begins on next page)

MANIPULATION OF THE CHINESE YUAN – MAY WTO MEMBERS RESPOND?

Ioana Ciobănaşu & Erik Denters[*]

Abstract
China has been accused of intentionally undervaluing its currency to gain a competitive trading advantage. The June 2007 Decision of the International Monetary Fund expressly authorizes the Fund to determine whether a country is manipulating the exchange rate of its currency. If the IMF makes a determination, the manipulating member violates its obligations under the IMF Articles. It is argued that this determination could also have legal repercussions under Article XV of GATT (General Agreement on Tariffs and Trade), prohibiting World Trade Organisation members to frustrate GATT provisions through 'exchange action'. The question is raised whether aggrieved members may take this matter to the dispute settlement body provided by the WTO system.

Introduction

A remarkable feature of the current global economy is a significant imbalance in trade flows between the world's economies. Major current account deficits and surpluses result in a major absorption of the savings of one nation by another. In case of the United States the numbers are staggering. With over $800 billion the US has the largest current account deficit ever, making the world's largest economy also the largest debtor.

Where there is a deficit, there must be a surplus somewhere else. The international financial crisis in the late 1990s prompted many emerging economies to fix and manage their exchange rates in order to accumulate large foreign reserves and run current-account surpluses that would provide them the most desired external stability. Their competitiveness would be secured through currency depreciation and rapid productivity gains. The surplus is a feature of many Asian countries and other emerging and oil-rich economies. China has become the largest surplus country in the world. Its trade surplus soared to over $250 billion in 2007[1] and the accumulation of foreign reserves is well known of passing the psychological threshold of $1,5 trillion.

Why is there a concern if these countries are doing so well? As most economists agree, the actual situation is unsustainable in both international financial and domestic political (i.e. trade policy) terms.[2] In a regime of fixed exchange rates, there is always a risk of

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[1] *Ibid.*

[2] C. F. Bergsten, *Currency Misalignments and the US Economy*, Peterson Institute, Testimony before the Subcommittees on Trade, Ways and Means Committee; Commerce, Trade and Consumer Protection, Energy, and Commerce Committee; and Domestic and International Monetary Policy, Trade and Technology, Financial

Electronic copy available at: http://ssrn.com/abstract=1315290

"[…] loss of domestic monetary control and the difficulty of maintaining monetary policy in response to domestic conditions. One sees this very clearly, particularly in the Chinese case where the external constraints exert an important impact on domestic monetary policy. It is noteworthy that much of the speculative bubble in Japan during the late 1980s that had such a catastrophic long run impact on the Japanese economy was driven by liquidity produced by a desire to avoid excessive yen appreciation. Fixed exchange rates with heavy intervention have enormous capacity to create an illusory sense of stability that could be shattered very quickly. That is the lesson of Britain in 1992, of Mexico in 1994, of emerging Asia in 1997, of Russia in 1998, and of Brazil in 1998".[3]

Managed depreciation of a currency in a surplus country creates inflationary pressure and thus hinders global adjustment. The burden of adjustment will shift unevenly onto the countries with a flexible regime of exchange rates.

What is to be done? Last year in spring, during the International Monetary Fund's (hereinafter: IMF or the Fund) Multilateral Consultation on global imbalances, the IMF gave its advice – reduced fiscal and trade deficits in the US, greater domestic demand in China, more flexibility in euro-area economies, greater liberalisation on inward investment in Japan, and more domestic investment in Saudi Arabia. China, along with the euro-area, Japan, Saudi Arabia and US, announced their plans to solve the situation. As the US Treasury's recent semiannual report to the US Congress noted, for China these plans are to "rebalance its economy: boosting domestic demand and consumption-led growth; reforming its financial system; and achieving greater flexibility in its exchange-rate regime. Indeed, rebalancing the pattern of growth is a central economic goal of China's leadership."[4] A substantial increase in the value of the Chinese currency is an essential component of reducing the imbalances. The external deficits financed through a new renminbi-dollar standard are far larger than any deficits associated with the original gold-dollar standard or the original Bretton Woods system.[5]

The collapse of the value of the dollar in the second half of 2007 and, furthermore, its rapid depreciation in the final quarter prompted renewed concern about global imbalances. These imbalances mean that developing countries, by holding US dollars as reserves, are lending money to the US to fuel its current account deficit. That is why it is so likely that China's misalignment will come into focus.[6]

Services Committee of the House of Representatives, May 9, 2007 at http://www.iie.com/publications/papers/paper.cfm?ResearchID=735#_ftnref2.

[3] L. H. Summers, *The U.S. Current Account Deficit and the Global Economy,* delivered at The Per Jacobsson Foundation, Washington D.C., 2004, at http://www.perjacobsson.org/2004/100304.pdf.

[4] S. Johnson & J. Ostry, *The currency traitors* on http://www.taipeitimes.com/News/editorials/archives/2008/02/03/2003400095.

[5] N. Roubini & B. Setser, *Will the Bretton Woods 2 Regime Unravel Soon? The Risk of a Hard Landing in 2005-2006,* presented at the Symposium on the "Revived Bretton Woods System: A New Paradigm for Asian Development?" organized by the Federal Reserve Bank of San Francisco and UC Berkeley, San Francisco, 4 February 2005, at http://www.frbsf.org/economics/conferences/0502/Roubini.pdf.

[6] http://www.brettonwoodsproject.org/art.shtml?x=559969.

Electronic copy available at: http://ssrn.com/abstract=1315290

Discontent over economic behavior of trading partners causes political reactions. Industry and labour unions may call for trade measures or insist on other forms of economic pressure to bring about a change of policies.[7] Politicians may propose sanctions and insist that institutions, nationally and internationally, respond. This article is an attempt to analyze the legal and institutional framework of the current state of affairs. What can be done from within the international institutions that have a mandate to deal with global imbalances? Could the IMF or its members respond to persistent current accounts deficits or surpluses? Could the WTO members respond through its dispute settlement mechanism? These are the questions that we will discuss.

We start from the presumption that China is manipulating its currency. This presumption must be accompanied with a caveat. We are aware of the difficulty[8] of assessing "exchange rate misalignment" as "it is subject to significant measurement uncertainties. Accordingly, the International Monetary Fund will exercise appropriate caution in reaching conclusions about misalignments. Moreover, an exchange rate would only be judged to be fundamentally misaligned if the misalignment was significant."[9]

I. IMF's New Focus on Manipulated Exchange Rates

I.1. Criticism from US/EU Political Circles Incite IMF Focus

To the US increasingly discontentment over the huge trade deficit with China as a consequence of the pegged renminbi,[10] add up also the EU's uneasiness over the Chinese policy. That is so not only because of the same trade deficit (or China's surplus), but also because a falling dollar means the euro is taking the brunt of this heavily managed yuan.[11] This is the paradox: while the Europeans are enduring a trade deficit, the Chinese currency has fallen by at least 5 per cent against the euro;[12] and while the US trade deficit is amounting to over 800bn, the Chinese unit has strengthened by just fewer than 10 per cent against the dollar.

All these issues sparked numerous discussions at the official levels, with questions, recommendations and solutions offered by the parties involved. It was inevitable for the IMF to be asked to deliver its opinion (some would call it "US pressure"). The Fund is the global authority to supervise monetary policies of its members. Indeed, a

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[7] http://www.chinacurrencycoalition.org.
[8] "It is almost impossible to be sure when a currency is misaligned, let alone by how much." 'Misleading misalignments', *The Economist*, June 21, 2007.
[9]. http://www.imf.org/external/np/exr/facts/surv07.htm.
[10] Although allowed to 'float' within limitations since mid-2005. China maintains a crawling peg against a basket of currencies. The composition of the basket is not made public.
[11] Yuan and renminbi both refer to the Chinese currency.
[12] China and Europe, *Economist Intelligence Unit ViewsWire*, Nov 27th 2007: the euro zone finance ministers suggest that the undervaluation of the renminbi against the euro rather than the euro-US dollar or euro-yen rates is their biggest concern. In a statement following a meeting on October 8th, they said, "in emerging economies with large and growing current-account surpluses, especially China, it is desirable that their effective exchange rates move so that necessary adjustments will occur."

purpose of the IMF is the promotion of a stable monetary system and the avoidance of competitive depreciation (IMF Articles of Agreement Article I (iii)). Promotion of a stable system of exchange rates ("systemic stability") is also an objective of the undertaking of members to collaborate with the Fund (Article IV Section 1). These objectives add up to an overarching purpose of the IMF that is "to shorten the duration and lessen the degree of disequilibrium in the international balances of payments of members" (Article I (vi)).

While these objectives focus on monetary issues, the Fund's role cannot be considered in isolation within the global economy. In international economic relations the stability of the monetary system is not an objective *per se*, but merely a condition for advancing prosperity within and among nations. Accordingly, international trade and investments will thrive in a system without volatile exchange rate fluctuations and without substantial and sustained disparities in balances of payments of countries. Therefore the proper role of the IMF is to be subservient to the global trading system.[13] It must create conditions in which the world's economy will thrive. Trading nations expect the IMF to correct behaviour of countries that undermine such conditions. Article IV offers tools to the IMF to address objectionable monetary policies.

I.2. Background of IMF's Articles of Agreement Article IV

For the promotion of a stable exchange rate system, the Fund Articles of Agreement contain *'Obligations Regarding Exchange Arrangements'* (Article IV). These obligations, adopted by amendment in 1978, stipulate that *'orderly exchange arrangements'* are conducive to economic progress and stability of the international monetary system. This Article also states in Section 1(iii) that *"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"*.

Article IV – as it currently applies – was introduced after the breakdown of the so-called Bretton Woods system of fixed[14] but adjustable exchange rates. It allows members to depart from the rigidity of the par value system and adopt more flexible exchange rates regimes.[15] The change caused by the breakdown meant that the exchange rate turned into "a variable clearly within the domain of [the member states'] their economic policies, either to be used as policy instruments or to be the result of policies, or both. Correspondingly, the role of the IMF was changed from that of an umpire to an observer."[16] What is important to stress here that since the breakdown IMF members may opt for any policy on exchange rates, to the extent that exchange

[13] This also follows from the second objective of the IMF: "to facilitate the expansion and balanced growth of international trade (…)".
[14] A fixed exchange rate (or fixed peg arrangement) would be the expression of the value of a domestic currency in another currency (or gold) at a fixed rate. To maintain the fixed peg it would be necessary for monetary authorities to counter market forces and to intervene in the currency markets.
[15] In IMF vocabulary a decision on exchange rate policy is equivalent to 'exchange rates arrangement'.
[16] K. Subramanian, *The IMF's New Mandate* online at http://www.thehindubusinessline.com/2007/10/20/stories/2007102050720800.htm.

rates are orderly. Accordingly, there is no prohibition or obligation to adopt fixed exchange rate, nor is there a prohibition or obligation to adopt exchange rates that are determined by market forces.

The flexibility of the new system was welcomed but some inherent flaws were also recognized. Because the new monetary system also allowed for a free floating of currencies or any *"other exchange arrangement of a member's choice"* it was necessary to introduce safeguards against the abuse of the freedom to choose any exchange rate regime. One way to prevent abuse was giving the Fund the task to exercise *'firm surveillance over the exchange rate policies of members'* (Article IV Section 3 (b)). Thereby, the IMF could urge members to correct disorderly exchange rate policies.

Another safeguard was the obligation to avoid manipulation of the exchange rates, by including the clause that *"each member shall avoid manipulating exchange rates in order to gain an unfair competitive advantage over other members"* (Article IV, Section 1(iii)). This provision holds a duty not to control or influence exchange rates with a specific purpose, i.e. to gain an unfair competitive advantage. This provision conveys an intentional behaviour (manipulate) of monetary authorities of a country to unfairly improve its trading position. Evidence of violation must therefore demonstrate: intentional behaviour, unfair competition and advantage. Hitherto, the Fund has not endeavoured to demonstrate that a country has manipulated the exchange rate of its currency. However, the 2007 Decision on Bilateral Surveillance may arouse the Fund's interest in this matter.

I.3. The June 2007 Decision on Bilateral Surveillance

As explained above, Article IV mandates the Fund's Executive Board to adopt specific principles for the guidance of all members with respect to exchange rate policies.[17] It has done so in 1977 and has adopted new policies in 2007.[18]

The new Decision represents a policy framework guiding the IMF's surveillance over member states' compliance with obligations under Article IV. It is built on the 1977 Decision on Bilateral Surveillance that already encompassed three principles:

- The freedom to adjust exchange rates when it was needed in response to underlying conditions
- The freedom to pursue member's domestic policies and exchange rate necessary for financial stability, and
- Members should pursue responsible exchange rate policies and avoid policies to interfere with the adjustment process or gain undue advantage over others.

[17] Art. IV, Section 3(b).
[18] *Bilateral Surveillance over Members' Policies* Executive Board Decision, June 15, 2007. Public Information Notice (PIN) No. 07/69.

Interestingly, the 2007 decision adds a fourth principle: *"A member should avoid exchange rate policies that result in external instability."*

I.3.1. Manipulation of the Exchange Rates – the Core Issue

The 2007 decision maps out principles and procedures and has the purpose of bringing greater clarity and specificity to what exchange rate policies countries should follow and when the international community has reason to worry. It lays down the rules of the game and updates the principles for the guidance of members' conduct.

Particular importance is given to this new added principle that recommends countries to avoid exchange rate policies that cause external instability. The Fund affirms that this update was needed as *"the most prevalent exchange rate-related problems since 1977 have been the maintenance, for domestic reasons, of overvalued or undervalued exchange rate pegs and, more recently, capital account vulnerabilities often arising from balance sheet imbalances".*[19]

The duty to avoid manipulating exchange rates to gain an unfair competitive advantage over other members underlines the need for fairness. A side document of the 2007 decision[20] considers a number of benchmarks for "unfairness". It concludes that this would preferably be related to "deviations in the exchange rate that result in a sustained *excessive* accumulation of net external assets".[21] This means that an intentional behaviour of monetary authorities leading to an excessive built up of foreign reserves may amount to manipulation.

The 2007 Decision also attaches an annex providing further guidance. It confirms that manipulation is a deliberate policy targeted at the exchange rate. The annex urges the Fund to make an objective assessment of an 'unfair competitive advantage' under two conditions:

> (a) The member is engaged in [these] policies for the purpose of securing fundamental exchange rate misalignment in the form of an *undervalued exchange rate* and
> (b) The purpose of securing such misalignment is *to increase net exports*.

These elements taken together would enable the Fund's Executive Board to assess when manipulation takes place. What action could the IMF take if it concludes that a member has manipulated its exchange rate? The June Decision provides in Part III – *Procedures for Surveillance* – means to monitor the compliance of a member. A member that cannot defy the evidence on manipulation will have the duty to bring its exchange rate policies in accordance with the obligations of the IMF Articles.[22]

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[19] *Ibid.*
[20] Review of the 1977 Decision, Proposal for a New Decision, Companion Paper, Supplement, and Public Information Notice, June 21, 2007.
[21] *Idem*, Companion paper. p.12.
[22] A member that disagrees has no legal means for independent review of the findings of the Fund. It is unfortunate that IMF still does not offer a procedure for settling dispute between the Fund and its member, or

The added fourth principle could be of particular importance for an aggrieved WTO member as it lays down clear-cut obligations with regard to proper and improper behaviour in relation to exchange rates. It gives greater certainty to what should be expected from any member. A prior IMF assessment labelling any state 'a manipulator' could much easier trigger a dispute in the WTO as such a behaviour is prone to violate the provisions of the GATT or one of the other WTO agreements. And even if there would not be a prior IMF finding, a WTO panel may require one.

Could an affected WTO member respond by imposing trade measures following a Fund determination that an IMF member is manipulating? Could it turn to the dispute settlement mechanism available under the WTO? We will consider these issues below. There must be stressed that although this issue is not new, this paper will underline the importance and legal implications of the IMF June Decision in case of a potential dispute in the World Trade Organisation.

II. The Shift Towards the Dispute Settlement Mechanism

II.1. The Institutional Interface between the World Trade Organization (WTO) and the International Monetary Fund (IMF) – Speciality Principle and Cooperation

The inherent relationship between the WTO and IMF follows from the fact that each international trade transaction (WTO jurisdiction) is typically matched by an international payment (IMF jurisdiction). There is no trade transaction without payment, and no payment without a trade transaction. In a sense trade and payments are two sides of one coin and, accordingly, the WTO and the IMF are complementary institutions. Whereas the WTO promotes liberalization by the administration of trade agreements the IMF paves the way for trade liberalization. It does so by policies described above and also by "promoting the removal of restrictions on international payments for current transactions".[23]

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between members. Because 'manipulation' would mean a violation of the obligation of Article IV Section 1 paragraph (iii), hypothetical sanctions such as compulsory withdrawal may be applied. We can only speculate whether the Fund is willing to take such drastic steps. Under Article XXVI sanction are available in the shao of compulsory withdrawal:

"(a) If a member fails to fulfil any of its obligations under this Agreement, the Fund may declare the member ineligible to use the general resources of the Fund. Nothing in this Section shall be deemed to limit the provisions of Article V, Section 5 or Article VI, Section 1.

(b) If, after the expiration of a reasonable period following a declaration of ineligibility under (a) above, the member persists in its failure to fulfil any of its obligations under this Agreement, the Fund may, by a seventy percent majority of the total voting power, suspend the voting rights of the member. During the period of the suspension, the provisions of Schedule L shall apply. The Fund may, by a seventy percent majority of the total voting power, terminate the suspension at any time.

(c) If, after the expiration of a reasonable period following a decision of suspension under (b) above, the member persists in its failure to fulfil any of its obligations under this Agreement, that member may be required to withdraw from membership in the Fund by a decision of the Board of Governors carried by a majority of the Governors having eighty-five percent of the total voting power. (…)"

[23] Payments for current transactions include inter alia 'all payments due in connection with foreign trade'.

The WTO-IMF relationship is also reflected in the institutional arrangements between the institutions. GATT Article XV recognizes the significance of IMF's role in the administration of trade relations by calling upon the WTO to consult fully with the IMF when considering or dealing with problems concerning monetary reserves, balances of payments or foreign exchange arrangements.[24] Thereby, Article XV attempts to delineate jurisdictions and responsibilities: the WTO is not supposed to appraise questions on monetary issues relating to trade.[25] We quote Article XV.

The CONTRACTING PARTIES shall seek co-operation with the International Monetary Fund to the end that the CONTRACTING PARTIES and the Fund may pursue a co-ordinated policy with regard to exchange questions within the jurisdiction of the Fund and questions of quantitative restrictions and other trade measures within the jurisdiction of the CONTRACTING PARTIES.

1. *In all cases in which the CONTRACTING PARTIES are called upon to consider or deal with problems concerning monetary reserves, balances of payments or foreign exchange arrangements, they shall consult fully with the International Monetary Fund. In such consultations, the CONTRACTING PARTIES shall accept all findings of statistical and other facts presented by the Fund relating to foreign exchange, monetary reserves and balances of payments, and 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, or with the terms of a special exchange agreement between that contracting party and the CONTRACTING PARTIES. The CONTRACTING PARTIES in reaching their final decision in cases involving the criteria set forth in paragraph 2 (a) of Article XII or in paragraph 9 of Article XVIII, shall accept the determination of the Fund as to what constitutes a serious decline in the contracting party's monetary reserves, a very low level of its monetary reserves or a reasonable rate of increase in its monetary reserves, and as to the financial aspects of other matters covered in consultation in such cases.*
2. *The CONTRACTING PARTIES shall seek agreement with the Fund regarding procedures for consultation under paragraph 2 of this Article.*
3. *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.*

(…)

9. *Nothing in this Agreement shall preclude:*
    a. *the use by a contracting party of exchange controls or exchange restrictions in accordance with the Articles of Agreement of the International Monetary Fund or with that contracting party's special exchange agreement with the CONTRACTING PARTIES, or*
    b. *the use by a contracting party of restrictions or controls in imports or exports, the sole effect of which, additional to the effects permitted under Articles XI, XII, XIII and XIV, is to make effective such exchange controls or exchange restrictions*[26]

[24] The WTO may want to consult the IMF when a WTO-member imposes trade restrictions because of monetary problems. Such action of a WTO-member would be justifiable under the conditions of Art. XII GATT.
[25] Article XV reflects the principle of speciality as elaborated by the ICJ in 'Legality of the Use by a State of Nuclear Weapons in Armed Conflict'. Advisory Opinion of 8 July 1996, *ICJ Rep*. (1996) p. 75. For a comment see Peter Bekker in 91 AJIL (1997) 134-138.
[26] GATT 1994 Art. XV (pars. 1-4 & 9) as for interest here.

Following an 'ordinary meaning' interpretation[27] the WTO must consult the IMF on monetary matters and shall accept all findings presented by the Fund.[28] There appears little room for the WTO to do anything else than to listen to the Fund. However, in the *India – Quantitative Restrictions* case the Appellate Body (hereinafter AB) did not unequivocally support the indisputability of IMF's findings.[29] It concluded that a careful reading of the Panel report makes clear that the Panel did not simply accept the views of the IMF but "critically assessed" the data and compared those data with data provided by other sources, such as the reports provided by the Bank of India.[30] Thereby the AB hints that there is still some latitude for the WTO to reconsider findings of the IMF on monetary affairs. If this suggestion turns out to be the case, then there would be a clear deviation from the wording of Article XV.

Article XV reflects the common area in which the WTO and the IMF both operate. Trade issues and monetary affairs coalesce. Siegel specifies three categories of interaction in the relationship between WTO and IMF:[31]

- The first category is WTO obligations and Fund conditionality. This category deals with conflicts between obligations arising out of the WTO treaties and IMF adjustment programmes. The question whether a WTO-member may escape from WTO obligations because of conflicting IMF conditions has been dealt with in the Argentine Footwear case.[32]
- The second is the imposition of trade restrictions because of monetary distress. In this category the Fund communicates with the WTO on the question whether a member has serious deficits in its balance of payments or faces a serious decline in its foreign reserves. An 'emergency response' would be the introduction of import restrictions, *prima facie* a violation of the WTO obligation but justifiable under the conditions of the General Agreement on Tariffs and Trade (GATT) Article XII. This was dealt with in India-Quantitative Restrictions.[33]
- The third category deals with exchange restrictions, i.e. restrictions on the making of payments for current transactions. These are payments due in connection with foreign trade primarily including good and services. There are still a number of developing countries which maintain restrictions on such payments and the proper administration by the IMF is of fundamental importance for the liberalisation of trade flows.[34]

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[27] For the rules on treaty interpretation see Art. 31 of the 1969 Vienna Convention of the Law of Treaties.
[28] GATT Art. XV and equivalent in GATS Art. XII.
[29] See also D. Siegel, Legal Aspects of IMF/WTO Relationship: The Fund's Articles Agreement and the WTO Agreements, 96 *AJIL* 3, 561-599. At 583.
[30] AB report, infra note 33, paras. 149-150.
[31] Siegel, p. 572 et seq.
[32] Panel Report, Argentina-Measures Affecting Imports of Footwear, Textiles, Apparel and Other Items, WT/DS56/R (Nov. 25,1997) (adopted Apr. 22,1998), as modified by Appellate Body Report, WT/DS56/AB/R & Corr.1, DSR 1998: 111, 1033.
[33] Panel Report, India-Quantitative Restrictions on Imports of Agricultural, Textile and Industrial Products, WT/DS9O/R (Apr. 6, 1999) (adopted Sept. 22,1999), as modified by Appellate Body Report,WT/DS9O/AB/R,AB-1999-3.
[34] This is discussed below. See also fn. 37.

We would add a fourth category: exchange rate manipulation resulting in unfair competition in trade relations.

II.2. How Would 'Manipulation' Feed the WTO?

The current status of the international economic affairs presented at the beginning of this paper could trigger an assessment from the IMF with regard to China's policy on exchange rates, i.e. to bluntly dub China a 'manipulator'. Subsequently, the assessment would feed the WTO. Hitherto the Fund resisted United States' pressure for such a determination, although the June Decision seems like tailored for PRC's exchange rate policy. That is also why the decision in question sparked criticism from the People's Bank of China.[35] A case of manipulation may end up in a dispute between WTO members.

Three scenarios for a dispute may be discerned, regardless of the presence or timing of a determination by the Fund of manipulation (if ever):

1. An aggrieved WTO member could file a complaint under the WTO dispute settlement procedure. The complainant could build its case around the GATT Article XV paragraph 4 and/or
2. An aggrieved WTO member could file a complaint under the WTO dispute settlement procedure based on the Subsidies and Countervailing Measures Agreement (SCM). In this scenario there is a presumption that the manipulated exchange rate is a *de facto* export subsidy.
3. An aggrieved WTO member could impose across-the-board duties on products imported from a "manipulating" member. In that case the 'manipulating' member may assume a cause of action, because of violation of the most favoured nation clause (GATT Article I).

II.2.1. Legal Case I: Article XV paragraph 4[36]

Article XV paragraph 4 may trigger reactions under two conditions.

1. The manipulation of currency must be an 'exchange action'
2. The manipulation of currency must "frustrate the intent of the provisions of GATT", i.e. trade (this directs one to the GATT Annex I *Note Ad* paragraph 4). The addendum to paragraph 4 specifies that another "specific" provision of the

[35] "China has expressed reservations about the adoption of this Decision as it does not fully reflect the developing countries' opinions." http://www.pbc.gov.cn/english//detail.asp?col=6400&ID=849&keyword=bilateral%20surveillance. (visited Feb. 2008)

[36] It has been asserted by some scholars that an Article XV par. 4 case would have no traction (see Gary C. Hufbauer available at http://www.iie.com/publications/chapters_preview/3942/02iie3942.pdf. The present authors are inclined to assert the opposite as otherwise this provision would be rendered superfluous in its totality.

GATT must be "frustrated" (which could be e.g. Article XVI); the paragraph 4 as such has no standing by itself.

What is the meaning of 'exchange action' and why was the verb 'frustrate' being used? The question also arises what should be understood by 'action'. Does this refer to any policy in this field? We hold that action suggests an active policy of a country that interferes with the objectives of trade liberalisation.

Exchange action
Two interpretations of exchange actions are obvious.

- One is an exchange restriction or exchange control. It is likely that the drafters had these in mind, because of the examples mentioned in the addendum to para. 4. Restrictions may be authorized or unauthorized by the IMF.[37] Article XV para. 9 (GATT) states that exchange restrictions or controls authorized by the IMF are not prohibited under GATT.[38]
- Another meaning of exchange action could be the manipulation of an exchange rate. Once the IMF finds that manipulation has taken place, the WTO may take note of this assessment and may subsequently interpret the manipulation as an exchange action under paragraph 4. This could cause further legal action. An aggrieved member may find that the manipulation is reason for a complaint against the manipulating member. The next step would then be to demonstrate that GATT provisions are frustrated because of the manipulation.
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Frustrate
In an addendum to GATT a clarification on Article XV paragraph 4 is made.

'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.'*

[37] These are the "Restrictions on Current Payments". Cf. Art. VIII & XIV. The latter provision allows for restrictions for a transitional period. There are still 19 IMF members which have authorized restrictions. 166 members have accepted not to apply restrictions. A country which applies for WTO membership must relinquish all restrictions. IMF, *Review of Exchange Arrangements, Restrictions, and Controls*, November 27, 2007, p.
[38] Article XV:4 must be read in tandem with Article XV:9 containing a general exception. Former GATT Director of Legal Services Frieder Roessler also stated that Article XV:4 had to be read "in conjunction" with Article XV:9(a), noting that "Article XV therefore provides no protection against frustrating exchange action approved by the Fund or authorized under its Articles." Frieder Roessler, Selective Balance-of-Payments Adjustment Measures Affecting Trade: The Roles of the GATT and the IMF, 9 *J. WORLD TRADE L.* 643 (1975).

From this note we conclude the following.

- § This note attempts to explain the meaning of 'frustrate' by providing examples. The example under the first indent mentions exchange actions; an example of a trade action that causes frustration of IMF provisions is not given. It is therefore important to underline that the note does not provide an exhaustive explanation or all the sorts of frustrations that exchange and trade actions may cause.

- § The note explains that there are two requirements for a frustration: there must be an exchange action and a "frustrated intent of a provision". Clearly, a "frustrated intent of a provision" is not equivalent to a "violated provision". A provision may be violated, according to an ordinary meaning interpretation, but not frustrated as long as the intention (object and purpose) is upheld.

- § It is also important that para. 4 and the note are applied in the context of Art. XV paragraph 1 and 2. Paragraph 2 clearly delineates the jurisdiction of the IMF vis-à-vis the WTO. According to the speciality principle each institution is supreme in its own field and intrusions must be avoided. This division of labour is also expressed in paragraph 1 of Article XV. Accordingly, the opinion of the IMF on any "action by a contracting party in exchange matters" or "exchange action" is decisive.[39]

Now we have explained the meaning of 'exchange action' and 'frustrate' the core question therefore becomes: does manipulation amount to an 'exchange action' that 'frustrates' the intent of GATT provisions? As with the IMF June 2007 Decision, 'manipulation of exchange rate' has been given extensive explanations.[40] Avoiding manipulation is a specific obligation of the members, as described in the Decision.

Is manipulation an exchange action?
Manipulation of the exchange rate involves policies that are directed at – and actually affect – the level of an exchange rate (movement or the prevention of movement of it). This behaviour may manifest itself in different ways, from excessive market intervention to imposition of capital controls. What is equally important is the *purpose* of adopting such behaviour, i.e. to gain an unfair competitive trading advantage. A member would only be considered to be manipulating exchange rates in order to gain an unfair competitive advantage over other members if the Fund determines both that:

- § the member is engaged in these policies for the purposes of securing fundamental exchange rate misalignment in the form of an undervalued exchange rate, and
- § the purpose of securing such misalignment is to increase net exports[41]

[39] We hold that these expressions in paras. 2 and 4 of Article XV have the same meaning.
[40] *Supra* note 11.
[41] IMF, "Article IV of the Fund's Articles of Agreement: An Overview of the Legal Framework", prepared by the Legal Department in consultation with the Policy Development and Review Department, June 28, 2006; available at http://www.imf.org/external/np/pp/eng/2006/062806.pdf (visited 20 January, 2008)

Manipulation of the exchange rate is an exchange rate policy, i.e. the behaviour adopted to put into operation the chosen exchange arrangement (here, pegging of the currency). Such policiy requires action from monetary authorities. This manipulation not only a breaches an IMF-obligation but also infringes GATT-obligations when the manipulation frustrates the intent of the provisions of GATT 1994.

II.2. Legal Case II: the Subsidies and Countervailing Measures Agreement (SCM)

By definition the manipulation of exchange rates have a profound impact on trade relations. It should be recalled that the IMF only brands a country a manipulator when the country attempts to 'gain an unfair competitive advantage over other members'.

The SCM Agreement prohibits two categories of subsidies - subsidies contingent upon exportation and upon the use of domestic over imported goods - that are specifically designed to affect trade. If a prohibited subsidy is determined, a WTO member may impose countervailing duties if it determines that the subsidy causes injury to the domestic industry.[42]

Scholars have asserted that China's manipulated exchange rate acts, in reality, as a prohibited export subsidy. Benitah[43] explains that a subsidy may be challenged if three criteria are satisfied: the subsidy must be 'specific',[44] it must entail a governmental 'financial contribution'[45] and it must confer a benefit on its recipient. He subsequently

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[42] SCM Agreement Art. 19.1

[43] M. Benitah, ASIL Insights, October 2003, http://www.asil.org/insights/insigh117.htm (February 2008)

[44] Benitah argues: "A program is deemed specific if it is granted selectively, in law or in fact, to an enterprise or group of enterprises. In other words, if it is available for all the sectors of the economy, it is not specific and therefore not an actionable subsidy. A first glance, it may appear that the Chinese fixed exchange rate is not targeted selectively toward a special sector of the Chinese economy, but on the contrary, is available for all sectors of the Chinese economy. Therefore it would not be specific and thus not actionable.

This first impression is misleading if we take into account the fact that the Chinese fixed exchange rate system would most likely be challenged as a prohibited de facto export subsidy, under Article 3 of the WTO Subsidies and Countervailing Measures Agreement ("SCM Agreement"). Article 3 prohibits subsidies contingent, in law or in fact, on export performance. According to the WTO commentary to Article 3, this de facto standard is met when the facts demonstrate that the granting of a subsidy, without having been made legally contingent upon export performance, is in fact tied to actual or anticipated exportation or export earnings. Article 2.3 of the SCM Agreement would then take effect. It stipulates that "Any subsidy falling under the provisions of Article 3 shall be deemed to be specific."

The specificity criterion thus does not seem to be an insurmountable legal obstacle to challenging the Chinese fixed exchange rate as a de facto export subsidy. In other words, if the United States demonstrates that the Chinese fixed exchange rate system is a de facto export subsidy, then automatically the specificity criterion would be satisfied.".

[45] According to Article 1 of the SCM Agreement, there is a financial contribution when "a government provides goods or services other than general infrastructure, or purchases goods. The Panel on US - Softwood Lumber III described the concept of 'financial contribution' under Article 1.1(a)(1) of the SCM Agreement: "Article 1.1(a)(1) SCM Agreement provides that the first element of a subsidy is a 'financial contribution by the government'. Subparagraphs (i) through (iv) then explain that a financial contribution can exist in a wide variety of circumstances including, of course, the direct transfer of funds. But subparagraphs (ii) and (iii) show that a financial contribution will also exist if the government does not collect the revenue which it is entitled to or when it gives something or does something for an enterprise or purchases something from an enterprise or a group of enterprises."

demonstrates that these criteria are met provided that there is ‘a convincing economic demonstration that the Yuan is grossly undervalued’.

A requirement is to demonstrate whether the manipulated exchange rate provides a ‘benefit’ to exporters. To determine a benefit two positions must be compared: a ‘normal position’ and an ‘advantageous position’. Once the normal position is determined, it would be possible to recognize that there is an advantageous position and in fact a subsidy.[46] In Measures Affecting the Export of Civilian Aircraft the AB explained that the normal situation would be an open market:

> “[T]he ordinary meaning of 'benefit' clearly encompasses some form of advantage. ... In order to determine whether a financial contribution (in the sense of Article 1.1(a)(i)) confers a 'benefit', i.e., an advantage, it is necessary to determine whether the financial contribution places the recipient in a more advantageous position than would have been the case but for the financial contribution. In our view, the only logical basis for determining the position the recipient would have been in absent the financial contribution is the market. Accordingly, a financial contribution will only confer a 'benefit', i.e., an advantage, if it is provided on terms that are more advantageous than those that would have been available to the recipient on the market.”

This finding surfaces inconsistent approaches of IMF and WTO towards market liberalisation. As countries operate in the common area of both monetary and trade relations, the WTO determines that an advantageous position created by non-market conditions may amount to an actionable subsidy. In contrast, these market forces are <u>not</u> prevalent in the International Monetary Fund. There is no prohibition to adopt a fixed exchange rate, nor is there an obligation to adopt exchange rates determined by market forces.

Conclusion

There is no smoke without a fire. Within political circles the discussion over the undervalued yuan is a present and more or less flammable issue. It has been asserted that this should be a matter let to be solved through diplomatic means. Notwithstanding the efficiency of diplomacy, in case there will not be a viable result the legal apparatus is the next tool to consider.

Great importance should be attached to the IMF’s June 2007 Decision on Bilateral Surveillance and even more on the new added principle four on ‘manipulation of exchange rates’ and its fairly extensive explanations. This decision shows that the matter is serious and one can speculate that IMF is ready now to point the finger to a ‘manipulator’ i.e. China. If it does so, it could mean two things:

- That IMF could take action within its mandate inside the organization
- An affected WTO member would most likely feel encouraged to take the matter in the dispute settlement mechanism. Even if IMF does not point any finger *a priori*, any afflicted WTO member could bring the ‘manipulator’ in

[46] In our argument the advantageous situation is caused by the currency manipulation.

front of a panel thanks to June Decision, which makes it clearer the kind of behaviour that a state should adopt (and thus is expected to have) vis-à-vis exchange rates.

It is certainly not easy to asses 'manipulation of exchange rates' (as IMF itself recognizes); perhaps even more difficult is to asses how 'manipulation' affects trade and thus infringes the provisions of GATT. Certainly there would not be an easy task to build a case within WTO dispute settlement either on Article XV paragraph 4 or the Subsidies and Countervailing Measures Agreement (SCM), as proposed. What became much easier is the understanding of what 'manipulation of exchange rates' is and this definitely should serve as an impetus for future legal action.

Finally, we conclude that there are systemic inconsistencies between the IMF and the WTO. These inconsistencies lie at the root of the problem discussed above. The IMF allows members to adopt exchange rates policies (short of manipulation) that counter market forces. In contrast, the WTO aims at liberalising trade flows (by removing tariff and non-tariff barriers) whereby market forces prevail. We do not argue that all WTO members must adopt market-based exchange rates in spite of what the IMF Articles of Agreement stipulate. It would be unacceptable that the WTO determine exchange rate policies for countries, as this belongs to the exclusive domain of the IMF. We do believe, however, that IMF-WTO inconsistencies need to be addressed in order to promote fair competition.