

2011

The Need for a Robust Response to Chinese Currency Manipulation - Policy Options for the Obama Administration Including Countervailing Currency Intervention

C. Fred Bergsten

Follow this and additional works at: <http://scholarlycommons.law.hofstra.edu/jibl>

Recommended Citation

Bergsten, C. Fred (2011) "The Need for a Robust Response to Chinese Currency Manipulation - Policy Options for the Obama Administration Including Countervailing Currency Intervention," *Journal of International Business and Law*: Vol. 10: Iss. 2, Article 3. Available at: <http://scholarlycommons.law.hofstra.edu/jibl/vol10/iss2/3>

This Legal Article is brought to you for free and open access by Scholarly Commons at Hofstra Law. It has been accepted for inclusion in Journal of International Business and Law by an authorized administrator of Scholarly Commons at Hofstra Law. For more information, please contact lawcls@hofstra.edu.

THE NEED FOR A ROBUST RESPONSE TO CHINESE CURRENCY MANIPULATION – POLICY OPTIONS FOR THE OBAMA ADMINISTRATION INCLUDING COUNTERVAILING CURRENCY INTERVENTION

By Dr. C. Fred Bergsten¹

The global trade imbalances between the United States and China are at unsustainable levels, making it considerably more difficult to reduce unemployment and achieve a sustainable economic recovery in the United States. One large contributing factor to the global imbalance is the significant undervaluation of China's currency, the Renminbi ("RMB"). For years, the People's Republic of China ("China") has massively intervened in foreign exchange markets to keep the value of the RMB artificially low and thus more competitive against other foreign currencies like the Dollar, the Pound, the Yen, and the Euro. Though the leadership in Beijing has expressed a willingness as of late to let the RMB appreciate against the Dollar, policymakers should recall that China let its exchange rate rise by 20-25 percent between 2005 and 2008.

The Obama Administration should set a goal to persuade the Chinese to let the Renminbi appreciate by a similar amount over the next two to three years. Not only would this appreciation reflect a true market valuation of the RMB, it would reduce China's global current account surplus by \$350-500 billion and the U.S. global current account deficit by \$50-120 billion. A proper valuation of the RMB could have significant positive effects on the U.S. economy including the creation of half a million U.S. jobs at zero cost to the U.S. treasury. To this end, the U.S. should continue to mobilize a multilateral coalition to press China to let its currency rise by 20-25 percent.

Currency realignment is an integral part of the global rebalancing strategy adopted by the G-20 and laid out in detail as part of its new Mutual Assessment Process. Notably however, the efforts of the International Monetary Fund ("IMF") to persuade China to move sufficiently have largely failed. This is in no small part because the IMF has no independent enforcement tools even if it were to take a decisive stand on China's currency undervaluation. Hence, the U.S. and its allies should seek authorization from the World Trade Organization to impose restrictions on imports from China unless it allows its currency to adjust adequately. To lead this effort credibly, the Obama Administration must do what it has repeatedly declined to thus far and designate China a "currency manipulator," which has been the reality for at least seven years. After all, the U.S. can hardly ask the world, through the IMF and the WTO, to indict China if the U.S. is unwilling to do so itself.

¹ Dr. Bergsten has been Director of the Peterson Institute for International Economics since its creation in 1981. He was previously Assistant Secretary of the Treasury for International Affairs (1977-81) and Assistant for International Economic Affairs to the National Security Council (1969-71). His 40 books include *The Long-Term International Economic Position of the United States* (2009), *China's Rise: Challenges and Opportunities* (2008), *China: The Balance Sheet – What the World Needs to Know Now about the Emerging Superpower* (2006), and *The Dilemmas of the Dollar: The Economics and Politics of the United States International Monetary Policy* (2nd edition, 1996). This article is largely based on a statement by Dr. Bergsten before the hearing on China's Exchange Rate Policy before the Committee on Ways and Means in the U.S. House of Representatives on September 15, 2010.

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

In addition to multilateral efforts, the Obama Administration should consider a new strategy of “countervailing currency intervention” (“CCI”) against Chinese purchases of dollars by making offsetting purchases of Chinese RMB should the Chinese refuse to revalue their currency.² China has been intervening at an average of about \$1 billion per day over the past several years, by purchasing dollars with RMB to keep the price of the Dollar up and the price of the RMB down. This massive intervention in the market greatly enhances the price competitiveness of Chinese products in world trade. The U.S. should consider countering this manipulative practice by buying corresponding amounts of RMB with dollars, which the U.S. can create without limit. This is technically challenging, however, since the RMB is not fully convertible, so the American authorities will have to find and buy market proxies such as non-deliverable forward contracts for RMB and RMB-denominated bonds in Hong Kong.

Furthermore, the U.S. should also henceforth treat currencies that are substantially and deliberately undervalued as constituting export subsidies for purposes of calculating and applying countervailing duties (but not antidumping duties). The deliberate and significant undervaluation of a national currency represents a subsidy (and an equivalent import barrier) in economic terms, and I believe the Department of Commerce erred in its recent determination that they are not countervailable under current U.S. law. Congress should adopt legislation that would clarify that currencies that are substantially and deliberately undervalued should be treated as export subsidies subject to U.S. countervailing duties.

This article addresses the urgent need for U.S. policymakers to decisively address the problem of Chinese currency manipulation. The First Part considers the current state of global trade imbalances. It notes that global trade imbalances between the U.S. and China jumped sharply after China re-pegged the RMB to the Dollar and massively intervened in currency markets. Despite Chinese assurances that the RMB will reflect its true market rate, the IMF projects that China’s surplus will rise to historic levels as early as 2015. The Second Part examines the history of exchange rate developments between the U.S. and China, ultimately concluding that China has deliberately manipulated its currency to give it a competitive trade advantage. The Third Part lays out the need for U.S. policymakers to address the problem and proposes several courses of action. An adequate revaluation of the RMB has the potential to cut trade imbalances and create between 300,000 and 700,000 new U.S. jobs. About half of these new jobs would be in manufacturing with wages well above the national average.

However, China is a rational actor and will only revalue its currency if the leadership in Beijing believes that doing so is in the country’s own economic and international self-interest. To convince the Chinese to abandon currency manipulation as a growth strategy, the U.S. can first pursue the matter at the WTO and the IMF, neither of which has been very effective historically. Alternately, the U.S. Congress can pass legislation to authorize the Department of Commerce to find that currency undervaluation is actionable as a subsidy under current U.S. law. Finally, I propose that the U.S. policymakers consider a new option:

² I initially proposed this idea in testimony before the Senate Committee on Banking, Housing and Urban Affairs on January 31, 2007 See *The Treasury Department’s Report to Congress on International Economic and Exchange Rate Policy (IEERP) and the U.S.-China Strategic Economic Dialogue: Hearing Before the S. Comm. On Banking, Housing, & Urban Affairs*, 110th Cong. (2007) (Testimony of Dr. C. Fred Bergsten, Director, Peterson Institute for International Economics); Senators Schumer and Graham have included a version of it in S. 1254 and S. 3134, Currency Exchange Rate Oversight Reform Act of 2009, S. 1254, 111th Cong. (2009); Currency Exchange Rate Oversight Reform Act of 2010, S. 3134, 111th Cong. (2009).

COMPETITIVE CURRENCY INTERVENTION

Countervailing Currency Intervention – the direct purchases of RMB to counter China’s direct purchases of Dollars. There is nothing in either U.S. or international law that would prohibit this proactive approach and it could be used against any nation manipulating its currency to the U.S.’s detriment. Countervailing currency intervention is not without its challenges, though, which will be addressed in greater detail later in the article. The approach is a simple recognition that the time has come for the U.S. to devise and implement effective strategies to adjust the world’s largest international imbalances.

I. THE GLOBAL IMBALANCES

The US deficit and Chinese surplus have both moved substantially, first down and now back up, over the past several years. Both declined sharply in 2009: the U.S. deficit fell from 6 percent of GDP in 2006 to 2.8 percent by the end of 2009,³ and China’s surplus declined from an astounding 11 percent of its GDP in 2007 to 5.8 percent by 2009.⁴

There were two main causes for this improvement. The sharp decline in all world trade, due to the so-called Great Recession, trimmed imbalances as well as overall trade levels because exports and imports both fell by roughly equivalent percentages⁵. This meant that a country that started with an export surplus (China), experienced a drop in that surplus, while a country that started with an import surplus (the United States), experienced a fall in its trade deficit⁶.

The sizable currency adjustments of previous years also had major positive effects. The dollar’s value fell, in a gradual and orderly manner, by a trade-weighted average of about 25 percent from 2002 until early 2007.⁷ The Renminbi (“RMB”), as already noted, was permitted by the Chinese authorities to rise by 20-25 percent from the middle of 2005 to the middle of 2008 (before they re-pegged it to the dollar)⁸. Considering the usual lags of two to three years, these currency corrections made important contributions to the subsequent adjustments in trade imbalances.

Beginning in 2010, however, both the American and Chinese external imbalances have again been climbing sharply⁹. The US deficit in goods and services, which fell to \$25 billion in May 2009, climbed back to \$50 billion in June 2010 and remained above \$40 billion

³ U.S. DEP’T OF THE TREASURY – OFFICE OF INT’L AFFAIRS, REPORT TO CONGRESS ON INTERNATIONAL ECONOMIC AND EXCHANGE RATE POLICIES 11 (2010), available at <http://www.treasury.gov/resource-center/international/exchange-rate-policies/Documents/Foreign%20Exchange%20Report%20July%202010.pdf>. [hereinafter “Treasury Report”].

⁴ William R. Cline, *Policy Brief 10-20: Renminbi Undervaluation, China’s Surplus, and the US Trade Deficit 2010* PETERSON INST. FOR INT’L ECON. (2010), available at <http://www.iie.com/publications/pb/pb10-20.pdf>, [hereinafter “Cline”].

⁵ Richard Baldwin & Daria Taglioni, *The Great Trade Collapse And Trade Imbalances*, Vox, (Nov. 27, 2009) available at, <http://www.voxeu.org/index.php?qN%de/4301>

⁶ *Id.*

⁷ Dr. C. Fred Bergsten, *The Global Crisis and the International Economic Position of the United States*, in THE LONG-TERM INTERNATIONAL ECONOMIC POSITION OF THE UNITED STATES 5 (PETERSON INST. FOR INT’L ECON, C. Fred Bergsten ed., Special Report 2009).

⁸ Treasury Report, *supra* note 3, at 5.

⁹ Neil Irwin, *World Economic Recovery Driven By Global Imbalances*, WASH. POST, July 9, 2010, available at <http://www.washingtonpost.com/wp-dyn/content/article/2010/07/08/AR2010070806177.html?sid=ST2010070806230>.

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

in July, the latest months for which data are available¹⁰. China's surplus, after almost disappearing earlier in 2010¹¹ (for peculiar statistical reasons), soared later in 2010 to monthly averages of approximately \$25 billion between May and August, for which data is available.¹² These reversals are due partly to the recovery of international trade, in response to renewed economic expansion around the world. They are also due partly to the renewed rise in the dollar during the crisis period, as safe-haven investments into the United States, and to the Chinese authorities' termination of appreciation of the RMB.¹³

The outlook unfortunately is for more of the same. The IMF projects that China's surplus will rise back to 8 percent of its GDP by 2015 (after foreseeing even higher levels in some of the earlier drafts of its latest forecast)¹⁴. In light of China's continued rapid economic growth, this number would reach almost \$800 billion and far surpass its previous record high in absolute terms. It could also mean that China's global surplus would exceed the US global deficit in dollar terms.¹⁵

II. EXCHANGE RATE DEVELOPMENTS

This renewed growth of the current account imbalances, under normal market conditions, would produce a renewed rise of the RMB and decline of the dollar. The dollar weakened a bit in late 2010 against most currencies, after strengthening earlier in 2010 due to the flight from risk surrounding the European public debt crisis (as it did for similar reasons during 2008-early 2009 at the depth of the Great Recession), but not by enough to make much difference. The Chinese authorities apparently set the stage for an upward move of the RMB when they announced on June 19, 2010, a return to a more flexible and more market-based exchange rate regime like that they had pursued during 2005-08¹⁶.

The results to date have been very meager, however. As of September 10, 2010 the RMB rose by less than 1 percent.¹⁷ If maintained through 2011, this would amount to an annual rate of only 4 percent. Such appreciation would barely be enough to reflect the annual

¹⁰ U.S. DEPT. OF COMMERCE, BUREAU OF ECONOMIC ANALYSIS, *U.S. International Trade in Goods and Services, 1992 - Present* (July 10, 2010), available at <http://www.bea.gov/interactive.htm>.

¹¹ Treasury Report, *supra* note 3, at 16; V. Phani Kumar, *China's February Trade Surplus Shrinks To \$7.6 Billion*, MARKETWATCH (March 10, 2010), available at <http://www.marketwatch.com/story/chinas-trade-surplus-shrinks-further-in-february-2010-03-09>.

¹² *China's Widening Trade Surplus Adds to Yuan Pressure*, BLOOMBERG NEWS (Aug. 10, 2010), available at <http://www.bloomberg.com/news/2010-08-10/china-s-july-trade-surplus-surges-as-exports-outpace-imports-report-says.html>.

¹³ Cline, *supra* note 4, at 1.

¹⁴ INT'L MONETARY FUND, *World Economic Outlook April 2010, Rebalancing Growth*, (2010), available at <http://www.imf.org/external/pubs/ft/weo/2010/01/pdf/text.pdf>.

¹⁵ I refer throughout this statement solely to the *global* trade and current account positions of the two countries. The bilateral imbalance between them is analytically irrelevant in a multilateral world economy. As China's global surplus approaches the US global deficit in absolute terms and as its share of the US global deficit continues to rise, however, the bilateral number will be an increasingly accurate proxy for the global totals.

¹⁶ *Timeline: China's Reforms of the Yuan Exchange Rate*, REUTERS (June 19, 2010), available at <http://www.reuters.com/article/2010/06/19/us-china-economy-yuan-idUSTRE65113620100619>.

¹⁷ Alan Beattie, *US Union Calls For Action Against China*, FINANCIAL TIMES (Sept. 10, 2010), available at <http://www.ft.com/cms/s/0/393772b4-bc75-11df-a42b-00144feab49a.html#axzz1AfdgxGgJ>.

COMPETITIVE CURRENCY INTERVENTION

rise in productivity growth in China, compared with that of its trading partners, let alone reduce the large undervaluation accumulated over the last half decade.¹⁸

The Peterson Institute's latest calculations suggest that China would have to let the RMB appreciate by about 15 percent on a trade-weighted basis and about 25 percent against the dollar to achieve equilibrium, defined as cutting the Chinese surplus to 3 percent of GDP.¹⁹ These numbers are less than the "25-40 percent" undervaluation that I and others have cited until recently²⁰ because the IMF and most other projections of China's future current account surpluses, though still very high as noted above, have been reduced considerably from their earlier levels so less currency appreciation would be required to reach the current account target. If one believes that China should totally eliminate its surpluses, however, the required adjustment would still be on the order of those earlier numbers. A reasonable goal would be a rise of 20 percent in the trade-weighted average of the RMB even the next couple of years, about the same amount the currency rose during its earlier period of appreciation in 2005-08.

It is obvious that China continues to intervene heavily in the currency markets to keep the RMB from rising much more rapidly. It does not publish intervention numbers and the latest data on its foreign exchange reserves cover only the second quarter, including only the first ten days of the "new policy."²¹ Through that period, however, the data on reserves suggest that intervention has averaged at least \$1 billion daily since 2005.²² This official buying of dollars keeps the price of the dollar artificially high and the price of the RMB artificially low, generating the currency undervaluation that adds substantially to China's international competitive strength. It is immensely ironic that China complains about the international role of the dollar but does far more than anyone else on the planet to further increase that role by adding such massive amounts to its, and thus global, dollar reserves.

Hence, it remains obvious that China is "manipulating" the value of its currency. This clearly violates both the international monetary rules of the International Monetary Fund's ("IMF") Articles of Agreement²³ and the global trading rules of the World Trade Organization ("WTO") Charter.²⁴ The latest report from the U.S. Department of Treasury, while stating clearly that "the RMB is undervalued,"²⁵ nevertheless again failed to label China

¹⁸ Cline, *supra* note 4, at 10-20 (Estimates that the RMB needs to rise by about 2 ½ percent annually to prevent China's rapid productivity growth from generating steady increases in its external surpluses).

¹⁹ William R. Cline & John Williamson, *Policy Brief 10-15: ESTIMATES OF FUNDAMENTAL EQUILIBRIUM EXCHANGE RATES*, MAY 2010, PETERSON INST. FOR INT'L ECON., (June 2010).

²⁰ See my testimony on that topic to this Committee on March 24, 2010; *Correcting the Chinese Exchange Rate: An Action Plan, before the H. Comm. on Ways & Means*, 111th Cong. (2010) (Statement of Dr. C. Fred Bergsten, Peterson Institute for International Economics).

²¹ *Monthly Foreign Exchange Reserves*, STATE ADMIN. OF FOREIGN EXCHANGE, (2010), available at http://www.safe.gov.cn/model_safe_en/tjsj_en/tjsj_detail_en.jsp?ID=3030300000000000,19&id=4.

²² China's total foreign exchange reserves have now reached about \$2.5 trillion. The next largest holder is Japan, at about \$1 trillion. No other country holds reserves in excess of \$500 billion. The headline number for China's reserve increase in the second quarter was only \$10 billion but this included a markdown of \$70 billion in the dollar value of their euro holdings so intervention must have approximated \$80 billion—more than \$1 billion per working day.

²³ International Monetary Fund Agreement, Jul. 22, 1944, 22 U.S.C. 385, 60 Stat. 1401, 2 U.N.T.S. 39 [hereinafter "IMF"].

²⁴ Marrakesh Agreement Establishing the World Trade Organization, Apr. 15, 1994, 1867 U.N.T.S. 154 [hereinafter "WTO"].

²⁵ Treasury Report, *supra* note 3, at 18.

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

a currency “manipulator.”²⁶ One can understand the Treasury’s tactical desire to avoid further antagonizing China on the currency issue, even if disagreeing that doing so would reduce the prospect of its adopting more constructive policies. However, by doing so, the Treasury is violating both the letter and spirit of existing legislation as well as common sense by refusing to designate China a currency manipulator.²⁷

Some critics still argue that currency adjustments would be ineffective in correcting the imbalances.²⁸ To be sure, such adjustments must be considered in the context of complementary economic policies. This notably includes decisive US action to correct its own budget deficit over the next several years and expansion of domestic demand in China, as already undertaken via their huge fiscal and monetary stimulus programs, to offset the negative impact on growth of a declining external surplus. But this proviso is well understood and is imbedded in the G-20’s rebalancing strategy. Moreover, the process demonstrably works: the earlier rise of the RMB during 2005-08 contributed importantly to the subsequent sharp fall in China’s surplus, as noted above, without denting China’s rapid overall growth during the period.²⁹

On the current accounts themselves, The Peterson Institute’s latest studies show that every rise of 1 percent in the trade-weighted average of the RMB will cut China’s global surplus by \$170-250 billion over the succeeding 2-3 years and will cut the US global deficit by \$22 1/2-63 billion over a like period³⁰. Hence, the proposed RMB appreciation of 20 percent could be expected to reduce China’s global surplus by \$350-500 billion and the US global deficit by \$50-120 billion.³¹

III. A PROPOSED ACTION PLAN

Under current conditions of high unemployment, an improvement of \$50-120 billion in the US trade balance would generate 300,000 – 700,000 new US jobs.³² About half of these new jobs would occur in manufacturing and would pay wages well above the national average. The initiatives proposed in this article could achieve this outcome and would have virtually zero budget cost. Hence, RMB correction (and exchange rate adjustment more

²⁶ Roya Wolverson, *Confronting the China-U.S. Economic Imbalance*, COUNCIL ON FOREIGN RELATIONS (Oct. 19, 2010), available at http://www.cfr.org/publication/20758/confronting_the_chinaus_economic_imbalance.html.

²⁷ For the report’s treatment of manipulation in the case of China, see C. Randall Henning, ACCOUNTABILITY AND OVERSIGHT OF US EXCHANGE RATE POLICY 44-52 (Peterson Institute for International Economics June 2008).

²⁸ See, e.g., Interview by Roya Wolverson, Staff Writer CFR.org with Stephen S. Roach, Chairman, Morgan Stanley Asia, *Avoiding a U.S.-China Trade Showdown*, COUNCIL ON FOREIGN RELATIONS (Oct. 22, 2009) available at http://www.cfr.org/publication/20486/avoiding_a_uschina_trade_showdown.html; Robert Staiger & Alan Sykes, 2008, *Currency Manipulation and World Trade* (Dec. 8, 2008), STANFORD UNIVERSITY, available at <http://www.stanford.edu/~rstaiger/china.paper.120808.pdf>; AmCham China, *White Paper on the State of American Business in China*, THE AMERICAN CHAMBER OF COMMERCE IN THE PEOPLE’S REPUBLIC OF CHINA (May 10, 2010), available at <http://www.amchamchina.org/article/6309>.

²⁹ Cline, *supra* note 4, at 1.

³⁰ Mark Drajem, *Bergsten Says Rise in Yuan Value May Lead to Creation of 500,000 U.S. Jobs*, BLOOMBERG (Sept. 15, 2010), available at <http://www.bloomberg.com/news/2010-09-15/bergsten-says-rise-in-yuan-value-may-lead-to-creation-of-500-000-u-s-jobs.html>

³¹ *Id.*

³² *Id.*

COMPETITIVE CURRENCY INTERVENTION

broadly) must be one of the most cost-effective stimulus measures now available to the US government.

The cardinal issue remains, what initiatives should be undertaken to promote the needed Chinese actions. Some of these steps range well beyond the currency issue itself. Most importantly, the US case would be much more credible and effective in achieving its goals if it would take tangible steps to address the imbalances from its own deficit side of the equation. The key step would be an effective program to reduce, and preferably eliminate, the budget deficit over the next three to five years. President Obama's National Export Initiative,³³ to double exports over the next five years, is a laudable goal in this context but has yet to encompass any meaningful content – and will be impossible to achieve without substantial appreciation of the RMB and some other important currencies against the dollar. But it “takes two to tango,” thus, China (and the other large surplus countries, notably Germany and Japan) must also adopt corrective policies to enable the needed adjustment to take place even if the United States were to do everything right.

It is also essential to embed the exchange rate issue in the broader context of rebalancing the world economy, with the United States consuming less and exporting more, while China consumes more and exports less. The G-20 has adopted such a strategy,³⁴ the IMF has laid out the implementation details in its Mutual Assessment Process,³⁵ and the US and Chinese leaders have committed their countries to pursue it.³⁶

Most fundamentally, China will allow its currency to rise only if its authorities believe that doing so makes sense in terms of the country's own economic and international objectives. There is much debate around that issue but most analysts agree that it does. A stronger currency and smaller trade surplus, offset in growth terms by expansion of domestic demand, will rebalance the Chinese economy from capital-intensive investment and exports toward consumption and services. This in turn will promote a more rational allocation of capital, create more jobs, help check inflation, sharply reduce the country's need for energy and other raw materials, and cut pollution.³⁷ Such adjustment will also reduce the risk of international conflict, caused by China's surpluses, and thus promote its broad foreign policy interests along with its economic goal of maintaining open markets for its exports.

³³ *National Export Initiative*, INT'L TRADE ADMIN. (2010) available at <http://trade.gov/nei/nei-introduction-state-of-the-union-012710.asp> (last visited Mar. 18, 2011) (quoting President Barack Obama, State of the Union Address (Jan. 27, 2010, 9:11 p.m.), available at <http://www.whitehouse.gov/the-press-office/remarks-president-state-union-address>).

³⁴ Wendy Dobson, *Rebalancing Global Growth: The G20's Difficult Challenge*, 2 THE GERMAN MARSHALL FUND OF THE UNITED STATES (2010), available at http://www.trilateral.org/download/file/Dobson_rebalancing_Jun10_final.pdf, [hereinafter “Dobson”].

³⁵ *The G-20 Mutual Assessment Process and the Role of the Fund*, INT'L MONETARY FUND (Dec. 2, 2009), available at <http://www.imf.org/external/np/pp/eng/2009/120209a.pdf>.

³⁶ *Leaders' Statement: The Pittsburgh Summit*, THE PITTSBURGH SUMMIT (Sept. 24–25, 2009), available at <http://www.pittsburghsummit.gov/mediacenter/129639.htm>; Dobson, *supra* note 34.

³⁷ Nicholas R. Lardy, *Sustaining Growth in China*, in CHINA'S RISE: CHALLENGES AND OPPORTUNITIES (C. Fred Bergsten ed., et al., 2008), available at http://www.piie.com/publications/chapters_preview/4174/06iiee4174.pdf; Nicholas R. Lardy, *China: Rebalancing Economic Growth*, in THE CHINA BALANCE SHEET 2007 AND BEYOND (C. Fred Bergsten ed., et al., 2007), available at <http://www.piie.com/publications/papers/lardy0507.pdf>.

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

However, the top Chinese authorities have clearly not accepted that diagnosis to date.³⁸ Hence, direct action on the exchange rate will be needed. One clear lesson of the recent past is that China is likely to respond more constructively to multilateral pressure than to bilateral pressure from the United States alone. The timing of its announced policy change in June 2010, albeit of limited practical effort so far, was apparently motivated by the 2010 G-20 summit in Toronto and the need to comply at least nominally with the MAP being presented by the IMF. The sharp criticism it recently received from fellow emerging economies, notably Brazil and India, may have had some impact as well.³⁹ Thus, the United States should seek to mobilize as broad a coalition as possible, in terms of both the number and development level of countries, to support its efforts to achieve effective adjustment by China.

There are two multilateral instruments for pursuing adjustment by China (or any surplus country), the IMF and the WTO, neither of which has been very effective historically.⁴⁰ The IMF has been seized of the currency issue at least since 2005, with very modest results. When the Executive Board finally discussed the Fund staff's latest report on the country's economy (including the exchange rate) after China had delayed that conversation for three years, it could not even muster a majority to agree that the currency was "substantially undervalued" – as the IMF's Managing Director and staff have been saying repeatedly on the basis of their own in-depth analyses for some time.⁴¹ Close observers believe that only five or six of the Fund's 24 Directors, presumably a few (but not even all) of the Europeans as well as the United States and no developing countries, were willing to criticize China even to this very modest (and obvious) extent.⁴² Even if the IMF Board were willing to indict China, it has no power of enforcement and could only "name and shame" – which would be helpful, particularly in promulgating a WTO case (see *infra*), but would certainly not guarantee a constructive response.

Consequently, attention has turned toward the WTO, which can authorize member countries to erect barriers against imports from other members that violate its rules. The issue is whether current WTO rules do in fact effectively prohibit currency manipulation à la China at present. There are two routes to such action:⁴³

- A general indictment of China under Article XV, which proscribes countries from "frustrat[ing] the intent of the provisions of this Agreement, by exchange action,"⁴⁴ prosecution under which would authorize members to retaliate against China; and

³⁸ See, e.g., Michael Wines, *Chinese Leader Defends Currency and Policies*, N.Y. TIMES (Mar. 14, 2010), available at <http://www.nytimes.com/2010/03/15/world/asia/15china.html>.

³⁹ V. Ramakrishnan & Anoop Agrawal, *India, Brazil Back U.S. Position on Yuan Before G-20*, BLOOMBERG BUSINESSWEEK (Apr. 20, 2010), available at <http://www.businessweek.com/news/2010-04-20/india-brazil-backs-u-s-position-on-yuan-before-g-20-meeting.html>.

⁴⁰ John Williamson, *Encouraging Adjustment by Surplus Countries*, PETERSON INST. FOR INT'L ECON. (Jan. 2011), available at <http://www.iie.com/publications/pb/pb11-01.pdf>.

⁴¹ Public Information Notice, *IMF Executive Board Concluded 2010 Article IV Consultation with China* (July 27, 2010), available at <http://www.imf.org/external/np/sec/pn/2010/pn10100.htm>.

⁴² Alan Wheatley & Lesley Wroughton, *IMF Split in China Yuan Exchange Rate Debate*, REUTERS (July 28, 2010), available at <http://www.reuters.com/article/idUSTRE66R4W220100728?pageNumber=1>.

⁴³ See Gary C. Hufbauer, Yee Wong & Ketiki Sheth, *US-CHINA TRADE DISPUTES: RISING STAKES 1* (2006).

⁴⁴ General Agreement on Tariffs and Trade, art. XV Oct. 30, 1947, 6 Stat. A-11, 55 U.N.T.S. 194 [hereinafter "GATT"].

COMPETITIVE CURRENCY INTERVENTION

- Approval of case-by-case action by individual countries that chose to regard China's currency undervaluation as an export subsidy under the Code on Subsidies and Countervailing Duties, which China would have to challenge to overturn.

I recommend that the United States pursue both courses of action if China continues to resist adequate appreciation of the RMB. In both cases, it should seek to move in concert with as many other WTO members as possible. In both cases, it should be noted that the WTO will be guided on the exchange rate issue itself (as opposed to the trade policy responses) by the IMF.

The Article XV action is preferable in principle because it would apply to Chinese exports of all products to all countries. However, the language and legislative history of the provision make it difficult to apply to the current Chinese case (or any other foreseeable currency case). Some observers therefore oppose invoking the article because they fear that a negative ruling would make it harder to challenge currency undervaluations in the future and might also undermine very valuable dispute settlement mechanism of the WTO. I would nevertheless urge its pursuit, including a push from the Congress if necessary to convince the Administration, because doing so would: (1) represent an impressive multilateral effort that; (2) publicize the need for Chinese action much more widely than at present; and (3) highlight the desirability of reform of the WTO itself to handle such cases if the present language does in fact prove to be impotent. All of this would play out over at least a couple of years, because WTO cases take that long to run their course, and would thus desirably keep the spotlight on the issue as long as it remained unresolved.

In the meanwhile, the United States and as many allies as possible should act on their own to treat the RMB undervaluation as an export subsidy – as Federal Reserve Chairman Ben Bernanke has noted publicly that it is⁴⁵ – that must be included in calculating countervailing duties against Chinese products. The Department of Commerce has recently concluded that currency undervaluation is not actionable as a subsidy under current US law⁴⁶ so Congress should pass legislation, along the lines of H.R. 2378 (The Currency Reform for Fair Trade Act of 2009),⁴⁷ to reverse that ruling.⁴⁸ It is not clear whether this approach will pass WTO muster either, but in this case, unlike the Article XV option under which the United States would take China to the WTO and seek authorization for action, the action would already be taken by the United States (and hopefully others) and China would have to take the United States to the WTO in an effort to remove the countervailing duties. This too would

⁴⁵ Doug Palmer & Lucia Mutikani, *China yuan a subsidy, needs to rise—Bernanke*, REUTERS (July 21, 2010), available at <http://www.reuters.com/article/idUSN2118399420100721>.

⁴⁶ See Press Release, *Preliminary Commerce Investigation Finds Chinese Aluminum Imports Unfairly Subsidized*, US DEP'T COMMERCE, INT'L TRADE ADMIN. (Aug. 31, 2010), available at <http://trade.gov/press/press-releases/2010/preliminary-commerce-investigation-finds-chinese-aluminum-imports-unfairly-subsidized-083110.asp>.

⁴⁷ Currency Reform for Fair Trade Act, H.R. 2378, 111th Cong (2010).

⁴⁸ There are a number of technical problems with H.R. 2378 as currently drafted, however. For example, its threshold level of 5 percent for an "actionable undervaluation" is far too low in light of the imprecision of all misalignment calculations; the number should be at least 10 percent. It muddies the waters by calling for parallel treatment of currency *over*valuations, which do not require similar policy action. And it erroneously treats undervalued currencies, which reflect *government* export subsidies, as a source of discriminatory pricing of exports by *private* parties for antidumping purposes.

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

take a considerable period of time, during which the Countervailing Duties (“CVD”) would be in place, and again, depending importantly on how many countries joined the US initiative, would provide a powerful “shot across the bow” to help induce China to let the exchange rate move substantially.

Mobilization of an international coalition should be particularly feasible under the countervailing duty option. Other major importers would fear diversion of subsidized Chinese goods to their markets if the United States acted alone against its products. Hence, they would almost certainly emulate the US action very quickly and should be willing to act on it simultaneously. Chinese awareness of potential action by a large number of its key markets, especially the United States and the European Union as by far the two largest, would presumably provide maximum inducement for China to prevent the planned action by letting its exchange rate move substantially. Other countries might also be willing to join the Article XV action, however, only because the plaintiffs in the case would be authorized under WTO rules to retaliate against the offensive Chinese practice.

IV. A NEW OPTION

There is one, directly monetary measure that the United States should contemplate taking to counter Chinese currency manipulation: direct purchases of RMB to counter China’s direct purchases of dollars. It is absurd, especially from a US national perspective, but also from the standpoint of global financial stability that other countries set the exchange rate of the dollar. This is a consequence of the international role of the dollar, one of several of which lead me to question whether that role remains in the national interest of the United States.⁴⁹

In principle there could be little objection to such “countervailing currency intervention” against manipulation by another country that was keeping its exchange rate substantially undervalued as a result. In practice, the United States could easily adopt such a policy against any currency that is generally convertible, such as the euro, if it too became substantially undervalued (as appeared to be occurring several months ago).

The United States has of course bought foreign currencies on many past occasions, most recently the euro in 2000⁵⁰ and the Japanese yen in 1998⁵¹. Those interventions were taken in close coordination, and via joint market operations, with the issuer of the other currency at its request because they believed (and the US agreed) that it had become too weak. It would be very different for the United States to intervene *against* the desires of another country, especially to *counter* its intervention, but the market techniques would be identical. Moreover, the objective would be to push a specific exchange rate toward equilibrium levels and thus to reverse a misalignment that was distorting global trade and the world economy.

There is a practical problem in the Chinese case. The absence of full convertibility for the RMB, and the existence of widespread Chinese capital controls, make it impossible for the US authorities to enter well-functioning currency markets (as for the euro or yen) to buy RMB because no such markets exist. Hence, the United States would have to identify proxy

⁴⁹ Dr. C. Fred Bergsten, *The Dollar and the Deficits*, FOREIGN AFFAIRS (Nov./Dec. 2009), available at <http://www.foreignaffairs.com/articles/65446/c-fred-bergsten/the-dollar-and-the-deficits>.

⁵⁰ Dr. C. Fred Bergsten, *We can fight fire with fire on the renminbi*, FINANCIAL TIMES (Oct. 3, 2010, 7:43 PM), available at <http://www.ft.com/cms/s/0/070e525c-cf1d-11df-9be2-00144feab49a,s01=1.html#axzz1InAQht2>.

⁵¹ *Id.*

COMPETITIVE CURRENCY INTERVENTION

assets and buy them instead. Candidates would include non-deliverable forward (“NDF”) contracts for RMB and RMB-denominated securities in Hong Kong. The magnitude of such interventions by the United States would be limited by the size of the relevant markets and thus, far less than the daily purchases of dollars by the Chinese authorities. But such an initiative by the United States would clearly indicate the seriousness of its concern over the misalignment of the RMB, provide an unmistakable and indeed dramatic signal to the markets themselves, and add further to the pressure on China to cooperate.

There is nothing in US law or the IMF Articles of Agreement that would prohibit the United States from undertaking such “countervailing currency intervention” today. However, Congress might want to consider amending the relevant portion (Section 3004) of the Omnibus Trade and Competitiveness Act of 1988,⁵² to authorize Treasury to conduct countervailing currency intervention operations whenever it determines that a country is manipulating its exchange rate to gain an unfair competitive advantage. Such an authority would greatly strengthen the hand of the Treasury in conducting the negotiations to remedy an unfair currency practice as called for under the Act. A version of the idea is included in S.1254⁵³ and S.3134,⁵⁴ proposed by Senators Schumer and Graham.

The exchange rate is an inherently international issue because it involves at least the two countries between whose currencies it provides a price. Hence, the use of countervailing currency intervention by the United States, or by any other country, should be subject to review by the International Monetary Fund. Any country that believed it was being unfairly challenged by such a policy should be able to appeal to the IMF, and the countervailing country should be required to desist if its justification for the action was found to be inconsistent with the objectives and rules of that institution. This would parallel the treatment of countervailing duties by the WTO, described above, under which target countries can win disapproval of the countervailing action, if they can demonstrate that their alleged subsidies are in fact not actionable under the rules of the institution.

However, the United States would be in a strong position to defend itself against any such protest from China. . The IMF Guidelines for Exchange Rate Policies call on member countries to “take into account in their intervention policies the interests of other members, including those of the countries in whose currencies they intervene.”⁵⁵ There is no evidence that China has done so *vis-à-vis* the United States despite its massive intervention in dollars. Japan has interestingly just posed a similar question concerning China, complaining that the Chinese are driving up the exchange rate of the yen by buying Japanese bonds, while blocking Japanese purchases of Chinese bonds that might have a counteracting effect.⁵⁶

Countervailing currency intervention would be decidedly superior to countervailing duties to deal with the problem of manipulated exchange rates. Undervalued currencies subsidize all of the exports of the country in question and pose a barrier of equivalent magnitude to

⁵² Omnibus Foreign Trade and Competitiveness Act, Pub. L. 100-418, §3004 (1988).

⁵³ S. 1254, 111th Cong. (2010).

⁵⁴ S. 3134, 111th Cong. (2010).

⁵⁵ Jean-Francois Dauphin, *IMF Clarifies How It Will Monitor Economic Policies*, INT’L MONETARY FUND (Apr. 12, 2008), available at <http://www.imf.org/external/pubs/ft/survey/sof/2008/pol081208a.htm> (emphasis added).

⁵⁶ Toru Fujioka & Kyoko Shimodoi, *Japan Plans to Seek Discussions With China on Bond Purchases*, BLOOMBERG (Sept. 9, 2010), <http://www.bloomberg.com/news/2010-09-09/japan-plans-to-seek-talks-with-china-on-bond-purchases-after-record-buying.html>.

THE JOURNAL OF INTERNATIONAL BUSINESS & LAW

all of its imports. Countervailing duties, however, address only exports of individual products from such a country on a case-by-case basis and do not apply to its imports at all. The currency approach is monetary and comprehensive whereas the trade tool, useful as it is for its intended purpose, involves cross-retaliation and is very selective in its application.

V. CONCLUSION

The time has clearly come, indeed has long since passed, to devise effective strategies to achieve adjustment of the world's largest international imbalances: the US deficit and the Chinese surplus. Continued failure to do so will generate increasing risks of renewed financial crisis, encourage new outbreaks of restrictive trade measures as countries respond to China's blatantly protectionist currency policy, trigger renewed transpacific tensions, and make it more difficult to reduce the US unemployment rate as China exploits demand in other countries to create jobs at home.

The proposed action program entails risks as well. The designation of China as a "currency manipulator" could increase its intransigence rather than promote constructive action. Appealing to the WTO on "exchange action" enters new territory and could jeopardize that valuable institution. Expanding the scope for countervailing duty actions could lead to protectionist abuse of that safeguard device. "Countervailing currency intervention" could trigger temporary instability in financial markets. Furthermore, there is evidence that both the Bush and Obama Administrations' quiet diplomatic efforts are bearing fruit. At the time of writing, the RMB's real rate against the dollar is rising by about 10-12 percent, which if continued would complete the needed correction of 20-30 percent over two to three years. Conditions within China are presumably the most important factor in the Chinese authorities' decision to let the RMB rise significantly as leaders there recognize the need to rebalance their economy away from exports with their underlying investment in capital-intensive industries. However, absent real appreciation over the next few years, the U.S. and its allies must remain vigilant in pressuring the Chinese to properly value the RMB.

The risks of inaction, including to the open system of international trade and finance, are much greater than these and other possible costs of the measures proposed. I strongly recommend that the Congress work closely with the Obama Administration to advance them and, if necessary, insist that the Administration do so.