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IS CHINA'S MANIPULATION OF ITS CURRENCY AN ACTIONABLE VIOLATION OF THE IMF AND/OR THE WTO AGREEMENTS?

*By Elizabeth L. Pettis**

For decades a controversy has been raging in Washington regarding the undervaluation of China's currency. Many economists, politicians and business leaders argue that China has, and continues to, manipulate the value of its currency in order to promote the growth of its exports while protecting its domestic industries from international competition. The basic argument is that this undervaluation keeps the price of Chinese goods low and the prices of goods produced in other countries out of reach of the average Chinese consumer. This undervaluation, it is thus argued, gives Chinese exporters an artificial trading advantage that is unfair, damaging both the US economy and the global trading system.

With the deepening of the Great Recession, the rhetoric of American labor unions, economists and politicians regarding this issue is getting more intense. In March 2010, the Economic Policy Institute (EPI) released a report that found that "China's artificially low currency is a major reason for the lopsided US-China trade balance and that gap eliminated or displaced an estimated 2.4 million US jobs between 2001 and 2008."[1] On September 20, 2010, EPI released another report that predicted the undervaluation of Chinese currency "will cost one-half million US jobs in 2010."[2] Most recently, on October 10, 2010, economist Dr. C. Fred Bergsten, of the Peterson Institute for International Economics, stated that China's currency actions "have unleashed worldwide currency conflicts that threaten to replicate the spiral of competitive devaluations that deepened the Great Depression in the 1930s."[3]

These experts and politicians are now calling for the Obama Administration to act. Among other things, it has been recommended that the Treasury Secretary label China as a currency manipulator under the Omnibus Trade Act of 1988, the Treasury file a complaint with the Executive Board of the International Monetary Fund ("IMF") alleging that China is unfairly manipulating exchange rates in violation of the IMF Agreement, and the Office of the United States Trade Representative ("USTR") file a complaint with the World Trade Organization ("WTO") alleging that China's manipulation of the value of its currency violates the General Agreement on Tariffs and Trade and/or the Agreement on Subsidies and Countervailing Measures.

Both houses of Congress have also taken their own independent steps to address the controversy. On March 17, 2010, Senators Charles Schumer (D – N.Y.) and Lindsey Graham

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[1] Robert E. Scott, *Unfair China Trade Costs Local Jobs*, ECON. POLICY INST. (2010), *available at* http://epi.3cdn.net/91b2eeeffce66c1a10_v5m6beqhi.pdf [hereinafter "Unfair China Trade Costs Local Jobs"].

[2] ROBERT E. SCOTT, *Rising China Trade Deficit Will Cost One-Half Million U.S. Jobs in 2010*, 1 ECON. POLICY INST. (2010), *available at* http://www.epi.org/page/-/pdf/ib283.pdf

[3] Dr. C. Fred Bergsten, Editorial, *Topic A*, WASH. POST, Oct. 10, 2010, at A17.

(R – S.C.), introduced a bill that would, according to Senator Schumer, "make it easier for the Department of the Treasury to cite the Chinese by finding currency misalignment rather than manipulation."[4] Similarly, on October 1, 2010, the House of Representatives passed the Currency Reform for Fair Trade Act (H.R. 2378) which would "direct the Commerce Department to treat Chinese currency undervaluation as a prohibited subsidy" under current US trade law.[5]

On the other side of the debate, some experts argue that the US cannot or should not do anything about China's manipulation of its currency. These experts assert, among other things, that China's currency policy is not in fact prohibited by the IMF or WTO Agreements, does not warrant action because it will not significantly impact the global trading system in the long term, or that unilateral US action will be deemed prohibited by a WTO dispute resolution panel and will divert the world's focus from China's actions and refocus it on the US' habit of taking unilateral action rather than developing international solutions.

This paper will examine US options for challenging China's currency manipulation under the IMF Agreement, Article XV(4) of the GATT or the Subsidies and the Countervailing Measures Agreement ("SCM Agreement"). It will assess the relative strengths and weakness of each option and will conclude by recommending a course of action that may not quickly resolve the problem but will clarify the law on this issue or will clearly identify the form of currency manipulation utilize by China as an issue that must be resolved by agreement among the G-20 and/or the member states of the WTO.

I. BACKGROUND

Experts say that between 1994 and mid-2005, the Chinese government pegged the value of the renminibi ("RMB") at a rate of 8.28 RMB to a US dollar.[6] Between 2005 and 2008, due to pressure from its trading partners and the IMF, China allowed the value of the RMB to appreciate between 20 to 25 percent as compared with the value of the US dollar.[7] This increase in value was facilitated through China's shift to a policy in which it loosely pegged the value of the RMB to a "basket of major currencies" that included the US Dollar, the Euro and the Japanese Yen.[8]

Since the beginning of the economic crisis in 2008, however, China has reverted back to its previous policy of pegging the value of the RMB to the value of the US dollar. Currently, the peg is at an exchange rate of approximately 6.83 RMB to a dollar.[9] China would likely argue that the whole world has benefited from the economic and monetary actions it took in the wake of the collapse of the American housing and financial markets. More precisely, it would argue that the swift recovery of the Chinese economy, due to its exports

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[4] Aaron Lorenzo & Amy Tsui, *Schumer Says Report on Cost of Weak Yuan Justifies Bill to Fight Currency Manipulation*, 27 INT'L TRADE REP. 424 (2010).

[5] Amy Tsui, *Reps. Ryan, Murphy Circulate Draft Letter Asking for Vote on China Currency Measure*, 27 INT'L TRADE REP. 1296 (2010).

[6] Robert W. Staiger & Alan O. Sykes, *Currency "Manipulation" And World Trade: A Caution*, VOX, (Jan. 30, 2009), http://www.voxeu.org/index.php?q=node/2934 [hereinafter "Staiger & Sykes"].

[7] *Correcting the Chinese Exchange Rate: Hearing on China's Exchange Rate Policy Before the H. Comm. On Ways & Means*, 111th Cong. 1 (2010) (testimony of Dr. C. Fred Bergsten, Director, Peterson Inst. For Int'l Econ.).

[8] Staiger & Sykes, *supra* note 6, at 109.

[9] *Id.* at ¶1.

and other economic recovery measures, has helped other nations' recover as well. Most economists agree with this assessment. For example, Mark Zandi, Chief economist at Moody's Economy.com, suggested that "Chinese authorities reasonably halted further appreciation of the RMB" when the global panic hit.[10] But the global economy and the Chinese economy have been stabilized and are now growing again. In fact, the Chinese economic growth has been so impressive that China announces figure earlier this year that show that it is now the world's second largest economy.

The Organization for Economic Co-operation and Development ("OECD"), in its 2010 Economic Survey of China, recommended that the Chinese release the RMB's peg and allow it to continue appreciating.[11] Additionally, on July 27, 2010, the IMF said that the RMB is "undervalued" and is "substantially below the level that is consistent with the level of medium-term fundamentals."[12]

Prior to Toronto summit of the G-20 in June 2010, the Chinese government seemed to be responding to increased international concern about the undervaluation of its currency. China publically announced that it was removing the RMB's peg to the dollar and would widen the band around which its currency could fluctuate.[13] As of September 10, 2010, however, the value of the RMB had risen by less than 1 percent. Economists say that China's currency is presently "undervalued by between 25 and 40 percent"[14] and that "China should allow its currency to appreciate at least by 5 percent per year for the next five years."[15]

Finally, during Chinese President Hu Jintao's state visit to the United States, President Obama reportedly told President Jintao that China's currency is undervalued. Then, speaking alongside President Hu at a White House news conference on January 19, 2011, President Obama said that while some steps have been taken to make the yuan (The yuan is the base unit of the RMB, which translates to "The People's Currency") market-based, progress hasn't come fast enough. China so thereafter announced "more flexibility for the RMB" but what this actually means will have to be determined.[16]

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[10] Mark Zandi, Editorial, *Topic A*, WASH. POST, Oct. 10, 2010, at A17.

[11] Kathleen E. McLaughlin, *OECD Urges China Forward on Currency, Continued Reforms*, 27 INT'L TRADE REP. 229 (2010).

[12] Diana I. Gregg, *International Finance: IMF Says Chinese Currency Undervalued, But Board Members Disagree on How Much*, 27 INT'L TRADE REP. 1186 (2010).

[13] Kathleen E. McLaughlin, Aaron Lorenzo and Amy Tsui, *International Finance: China's Easing of U.S. Dollar Peg Draws Mixed Views on Yuan's Rise in Weeks Ahead*, 27 INT'L TRADE REP. 939 (2010).

[14] *See* Robert E. Scott, Policy Memorandum No. 164, *Currency Manipulation: History Shows That Sanctions Are Needed*, 2010 ECONOMIC POLICY INST. 1, 2, *available at* http://www.epi.org/publications/entry/pm164/; *Correcting the Chinese Exchange Rate: Hearing on China's Exchange Rate Policy Before the H. Comm. On Ways & Means*, 111th Cong. 1 (2010) (Testimony of Dr. C. Fred Bergsten, Director, Peterson Institute for International Economics.) [hereinafter "Bergsten Testimony"].

[15] Robert E. Scott, *Currency Manipulation: History Shows That Sanctions Are Needed*, ECON. POLICY INST. (2010), *available at* http://www.epi.org/publications/entry/pm164 [hereinafter "Robert E. Scott"]; Mark Zandi, Editorial, *Topic A*, WASH. POST, Oct. 10, 2010, at A15; *see also* Bergsten Testimony, *supra* note 14.

[16] Dr. Elliot J. Feldman, *A Comment On Currency Manipulation*, CHINA-US TRADE LAW, Nov. 19, 2010, *available at http://www.chinaustradelawblog.com/2010/11*.

II. HOW CHINA CONTROLS THE VALUE OF THE RMB

China is by no means the only country that manipulates its currency and devaluations of a country's currency are not typically unlawful under international law.[17] In fact, William Cline and John Williamson, of the Peterson Institute for International Economics, estimate that currently the currencies of Hong Kong, Malaysia, Singapore and Taiwan are also undervalued by 25 to 32 percent.[18] It is also estimated that the "Japanese yen is undervalued by approximately 14%."[19]

Additionally, many countries, including the US, have bought currencies and sold its own currency in the foreign exchange markets in order to raise or lower the value of its national currency so as to avert an economic crisis. In fact, on November 3, 2010, the US Federal Reserve announced that it would "purchase $600 billion in long-term US Treasury securities by the end of the second quarter of 2011."[20]

What makes the Chinese currency situation different is that, unlike other governments, "the Chinese government prohibits all dollar-to-renminbi exchanges except those to which it is a party (either directly or through official forex banks)."[21] It also requires authorized exchange transactions to occur at a "government-determined" administered rate rather than at a rate determined by foreign exchange market forces. This arrangement allows the Chinese government to prevent market forces from naturally raising the value of the RMB.

What also makes China's currency regime different is the duration and amount of money involved. It is estimated that China "already has accumulated $2.5 trillion of foreign exchange reserves" since 2001.[22] Over the past several years, China has been intervening in the currency market at an average of about $1 billion per day.[23] Between December 2008 and December 2009 alone, China purchased $453 billion in US treasury bills and other securities in order to maintain its peg on US dollar. No other country has tried or has been able to maintain an exchange-rate distorting policy at this level for this extended a length of time.[24]

National governments and international organizations have attempted to negotiate a solution to this issue with China to no avail. In fact, both the IMF and the OECD have recently identified the undervaluation of the RMB as problematic and have unsuccessfully attempted to persuade the Chinese government to allow its currency to appreciate.

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17 Robert E. Scott, *supra* note 15, at 1, 2.

18 William R Cline & John Williamson, Policy Brief 10-2, *Notes on Equilibrium Exchange Rates: January 2010*, 2010 PETERSON INST. FOR INT'L ECONOMICS 1, *available at* http://www.iie.com/publications/pb/pb10-02.pdf. [hereinafter "Cline & Williamson"].

19 Robert E. Scott, *supra* note 15, at 2.

20 Press Release, FED. RESERVE (Nov. 3, 2010), *available at* http://www.federalreserve.gov/newsevents/press/monetary/20101103a.htm

21 JOHN MAGNUS & TIMOTHY C BRIGHTBILL, *China's Currency Regime Is Legitimately Challengeable As A Subsidy Under ASCM Rules, in* THE US-SINO CURRENCY DISPUTE: NEW INSIGHTS FROM ECONOMICS, POLITICS AND LAW, 147 (Simon Evenett ed., 2010), *available at* http://www.voxeu.org/reports/currency_dispute.pdf.

22 Dr. C. Fred Bergsten, *Correcting the Chinese Exchange Rate: An Action Plan, in* THE US-SINO CURRENCY DISPUTE: NEW INSIGHTS FROM ECONOMICS, POLITICS, AND LAW 9, n. 2 (Simon Evenett ed., 2010), *available at* http://www.voxeu.org/reports/currency_dispute.pdf

23 Bergsten Testimony, *supra* note 14.

24 Unfair China Trade Costs Local Jobs, *supra* note 1, at 2.

III. CHALLENGING CHINA'S CURRENCY MANIPULATION UNDER THE IMF AGREEMENT

The Article IV of the IMF Agreement that is applicable to the Chinese currency manipulation issue. According to Section 1 of Article IV, the IMF was formed to, among other things, "provide a framework that facilitates the exchange of goods, services and capital among countries, sustains sound economic growth, and continues the development of the orderly underlying conditions that are necessary for the financial and economic stability of each member state."[25] This Article also charges the IMF with the responsibility for exercising firm surveillance over each member's exchange rate polices. Therefore, the IMF has an affirmative mandate to handle the dispute over the RMB's valuation.

Article IV, Section 1 also obligates each member state to "collaborate with the Fund and other members to assure the orderly exchange arrangements and to promote a stable system of exchange rates."[26] More specifically, Article IV, Section 1, subsection (iii) states that each member shall "avoid manipulating exchange rates . . . in order . . . to gain an unfair competitive advantage over other members".[27]

From this language, it is clear that there is a two-part test under which the United States must demonstrate that:

1. China has manipulated exchange rates; and

2. China manipulated exchange rates with the intent to gain and unfair competitive advantage.

Unfortunately, Article IV does not define the meaning of the phrase "manipulating exchange rates" nor does any other Article of the Agreement.

The IMF Executive Board's 2007 Decision on Bilateral Surveillance (2007 Decision), however, provides guidance on what may constitute manipulation of exchange rates. In Section 15 of the 2007 Decision, the Board stated that the Fund would view the following developments as possible indications of a member's manipulation of exchange rates:

> (i) protracted large-scale intervention in one direction in the exchange market;
>
> (ii) official or quasi-official borrowing that either is unsustainable or brings unduly high liquidity risks, or excessive and prolonged official or quasi-official accumulation of foreign assets, for balance of payments purposes;
>
> (iii) (a) the introduction, substantial intensification, or prolonged maintenance, for balance of payments purposes, of restrictions on, or incentives for, current transactions or payments, or

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[25] Articles of Agreement of the International Monetary Fund, July 22, 1944, 60 Stat. 1401, 2 U.N.T.S. 39 [hereinafter "IMF"].
[26] *Id.* at § 1.
[27] *Id.* at § 1(iii).

(b) the introduction or substantial modification for balance of payments purposes of restrictions on, or incentives for, the inflow or outflow of capital;

(iv) the pursuit, for balance of payments purposes, of monetary and other financial policies that provide abnormal encouragement or discouragement to capital flows;

(v) fundamental exchange rate misalignment;

(vi) large and prolonged current account deficits or surpluses; and

(vii) large external sector vulnerabilities, including liquidity risks, arising from private capital flows.[28]

Given the fact that China has been taking actions to suppress the value of the RMB since 2001, has purchased more than $2.2 trillion in foreign exchange reserves since 2001 and has maintain a trade surplus with the United States that is in the billions of dollars, the United States should have little difficulty demonstrating that: 1) a protracted large-scale intervention in the exchange market to suppress the value of the RMB was carried out by China; 2) an excessive and prolonged official Chinese accumulation of US dollars, for balance of payments purposes; 3) a fundamental exchange rate misalignment of China's currency; and/or 4) a large and prolonged current account surpluses with regard to trade with the United States.

Additionally, in Section 2 of the Annex of the 2007 Decision, the Board further elaborated on when it believed a member would be acting in violation of Article IV, Section 1, Subsection (iii). It stated the following:

2. A member would only be acting inconsistently with Article IV, Section 1(iii) if the Fund determined both that: (a) the member was manipulating its exchange rate or the international monetary system and (b) such manipulation was being carried out for one of the two purposes specifically identified in Article IV, Section 1(iii).[29]

The Board further explained that:

(a) "Manipulation" of the exchange rate is only carried out through policies that are targeted at—and actually affect—the level of an exchange rate. Moreover, manipulation may cause the exchange rate to move or may prevent such movement.

(b) A member that is manipulating its exchange rate would only be acting inconsistently with Article IV, Section 1(iii) if the Fund were to determine that such manipulation was being undertaken "in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members." In that regard, a member will only be considered to

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[28] *IMF Executive Board Adopts New Decision on Bilateral Surveillance Over Members' Policies*, INT'L MONETARY FUND (June 21, 2007), *available at* http://www,imf.org/external/np/sec/pn/2007/pn0769.htm.
[29] *Id.*

> be manipulating exchange rates in order to gain an unfair competitive advantage over other members if the Fund determines both that: (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.[30]

Again, from the facts it should not be difficult for the United States to demonstrate that China's currency policies are targeted at and actually affect the level of an exchange rate between the US Dollar and the RMB. The circumstances also seem to support the contention that China has intentionally kept the value of the RMB low so as to unfairly ensure the competitiveness of its exports.

Unfortunately, however, the intent requirement of the currency manipulation test is a subjective standard that may be almost impossible for the US to demonstrate because it would be "politically very delicate for the IMF to officially find one of its members in breach of that provision."[31] Additionally, the relevant sections of the 2007 Decision are not binding. Therefore, the IMF is not required to find in the US' favor even if it were to prove the presence of the indicative developments and China's intent.

Finally, and most importantly, the IMF Agreement does not provide for a dispute resolution procedure. Article XXIX of the Agreement provides that the Executive Board may settle "any question of interpretation of the provisions of the Agreement arising between any member and the Fund or between any members of the Fund".[32] However, even if the Executive Board found that China was manipulating the exchange rate in violation of Article IV, the IMF lacks a mechanism by which to enforce a decision made regarding the matter.

IV. CHALLENGING CHINA'S CURRENCY MANIPULATION UNDER THE GATT

There are several provisions in the GATT that concern the relationship between monetary issues and trade. The text of Article XV of the GATT, however, seems to directly address China's conduct. Article XV, Section 4 of the GATT states the following:

> 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.[33]

From a plain language reading of Section 4, it seems clear that a Member state is prohibited from undermining its obligations under the GATT through exchange actions. Therefore, it appears that the United States' would simply have to prove the following to a dispute resolution body of the WTO:

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[30] *Id.*

[31] Claus D. Zimmerman, *Congress Continues to Attack Currency Manipulation as China Defuses G-20 Pressure For Now: the International Law Issues*, AM. SOC'Y INT'L L. INSIGHT, June 30, 2010.

[32] IMF, *supra* note 25, at art. XXIX.

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

1. China's manipulation of exchange rates is an exchange action under Article XV; and

2. This manipulation frustrates the intention of the provisions of the GATT.

Unfortunately, Article XV does not define the terms "exchange action" or "frustrate". Additionally, a WTO dispute resolution panel has never interpreted Section 4 of Article XV.[34] Therefore, there is no precedent to guide such an inquiry and the United States will be required to put forth an explanation of the intent of the drafters of the agreement. In short, it will have to define these terms in a manner that is in accordance with customary rules of interpretation of public international law.

"It is well settled in WTO case law that the principles codified in Articles 31 and 32 of the Vienna Convention on the Law of Treaties (the "Vienna Convention") are such customary rules" of interpretation of public international law.[35] Article 31 outlines the general rule of interpretation and instructs as follows:

> 1. A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose.
>
> 2. The context for the purpose of the interpretation of a treaty shall comprise, in addition to the text, including its preamble and annexes:
>
> (a) any agreement relating to the treaty which was made between all the parties in connection with the conclusion of the treaty;
>
> (b) any instrument which was made by one or more parties in connection with the conclusion of the treaty and accepted by the other parties as an instrument related to the treaty.
>
> 3. There shall be taken into account, together with the context:
>
> (a) any subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions;
>
> (b) any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation;
>
> (c) any relevant rules of international law applicable in the relations between the parties.

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[34] Jorge Miranda, *Currency Undervaluation as a Violation of GATT Article XV(4)*, *in* THE US-SINO CURRENCY DISPUTE: NEW INSIGHTS FROM ECONOMICS, POLITICS AND LAW 115, 118 (Simon Everett ed., 2010) [hereinafter "Jorge Miranda"].

[35] *Id.* at 118.

4. A special meaning shall be given to a term if it is established that the parties so intended.[36]

Article 32 of the Vienna Convention then goes on to outlines supplementary means of interpretation and states the following:

Recourse may be had to supplementary means of interpretation, including the preparatory work of the treaty and the circumstances of its conclusion, in order to confirm the meaning resulting from the application of article 31, or to determine the meaning when the interpretation according to article 31:

(a) leaves the meaning ambiguous or obscure; or

(b) leads to a result which is manifestly absurd or unreasonable.[37]

In light of the relevant language of Articles 31 and 32 of the Vienna Convention, the United States must simply put forth an interpretation of the terms "exchange action" and "frustrate" based upon the ordinary meaning of the terms used, their context, and the object and purpose of Article XV.

Webster's New World College Dictionary assigns a variety of meanings to the word "exchange". The most relevant definitions, however, state that an exchange is "a transfer of a sum of money of one country for the equivalent in the money of another country" or "the difference in value between currencies."[38] Similarly, Webster's Dictionary assigns a variety of meanings to the word "action". The most relevant definitions state that an action is "an act or thing done" or "the effect produced by something".[39]

In accordance with the ordinary meaning of the root words, the United States should argue that the term in context means "the effect produced by transferring a sum of money of one country for the equivalent in the money of another country" and/or "an action that affects the difference in value between currencies."[40] Given that the intent of the GATT was to liberalize trade among member states, it seems clear that it should not be difficult for the United States to demonstrate that China's continued interventions related to the suppression of the RMB's value are actions that affect the difference in value between the US dollar and the RMB, and thereby the difference in cost of US and Chinese goods.

Webster's New World College Dictionary assigns a variety of meanings to the word "frustrate". The most relevant definitions stating that the verb "frustrate" means "to cause to have no affect", "to counteract" or "to nullify."[41]

Unlike, with the term "exchange rate" the term "frustrate" references an Ad Note that must also be consider when interpreting Section 4. The Ad Note reads as follows:

> The word "frustrate" is intended to indicate, for example, that infringements of the letter of any Article of this Agreement by exchange action shall not be regarded as a violation of that Article if, in practice, there is no appreciable departure from the intent of the Article. Thus, a contracting party which, as part of its exchange control operated in accordance with the

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[36] Vienna Convention on the Law of Treaties art. 31, May 23, 1969 (entered into force Jan. 27, 1980).

[37] *Id.* at art. 32.

[38] WEBSTER'S NEW WORLD COLLEGE DICTIONARY 495 (4d. 2000).

[39] *Id.* at 14.

[40] *Id.* at 14 and 32.

[41] *Id.* at 571.

> 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 license 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.[42]

This Ad Note seems to clearly instruct that not all violations of an Article of the GATT would frustrate the intent of the Articles of the GATT within the meaning of Section 4 of Article XV. Additionally, some commentators have suggested that this Ad Note may operate as an additional condition or hurdle to establishing a violation of the Article.

If the Ad Note should be read to be an instruction that a violation of Section 4 would be triggered whenever the intent of at least one of the GATT Articles is frustrated through "exchange action", then the United States would have to demonstrate that China's exchange actions violate another provision of the GATT beside Section 4 of Article XV.

An argument that the United States could reasonably make to overcome the hurdle established by the Ad Note is that China's exchange rate actions frustrate the intent of Article II of the GATT. Article II of the GATT address schedules of concessions. Section 1 of Article II states the following:

> Each contracting party shall accord to the commerce of the other contracting parties treatment no less favorable than that provided for in the appropriate Part of the appropriate Schedule annexed to this Agreement.[43]

Additionally, WTO case law has further held that these tariff schedules are an integral part of Article II. For example, in the *European Communities – Custom Classification of Certain Computer Equipment* case, the Appellate Body of the WTO held that:

> Tariff concessions provided for in a Member's schedule . . . are reciprocal and result from a mutually-advantageous negotiation between importing and exporting Members. A Schedule is made an integral part of the GATT 1994 by Article II:7 of the GATT 1994. Therefore, the concessions provided for in that Schedule are part of the terms of the treaty.[44]

The United States must therefore characterize the intent of Article II as either preventing duties from exceeding the concessions agreed to by the member state, or the broader notion that it is providing member states greater access to other member states' markets.

Applying the above analysis, it seems that the United States could make a strong argument that China's currency manipulation is an exchange action within the meaning of Section 4. It should also be able to convincingly demonstrate that these exchange actions are

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[42] GATT, *supra* note 33, at sec. 4, ad note 4.
[43] *Id.* at art. II, sec. 1.
[44] Appellate Body Report, *European Communities – Custom Classification of Certain Computer Equipment*, WT/DS62/AB/R (Jun. 22, 1998).

frustrating the intent of the tariff schedule China agreed to when it acceded to the WTO in 2001. The United States will need to demonstrate this by showing that China's intentional undervaluation of the RMB makes US products 25% to 40% more expensive than they would otherwise be in the Chinese market and that the undervaluation has nullified the reduction of tariffs on US goods that China had agreed to in its negotiated tariff schedule.

Given the fact that neither the WTO nor the GATT dispute resolution bodies have interpreted Article XV, there is no way to evaluate the likelihood of success for this approach. It must also be taken into consideration that China is still a developing country. China could plausibly argue that it is taking these exchange actions not to frustrate the intent of Article II but to make it attractive to foreign investors and to ensure it is able to compete with other countries in its region like Malaysia, South Korea and Taiwan. It could also argue that the reinstatement of the peg was a necessary tool used to correct the damage done to the Chinese economy by the global recession; therefore, it was not implemented to frustrate the intent of the GATT.

Section 2 of Article XV must also be considered when evaluating the applicability of Section 4. Section 2 states the following:

> 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.[45]

This provision requires the WTO to consult with the IMF on problems concerning foreign exchange arrangements and requires it to accept the IMF's determinations in exchange matters.

The WTO-IMF cooperation agreement further states that "the Fund shall inform the relevant WTO body considering exchange measures within the Fund's jurisdiction whether such measures are consistent with the Articles of Agreement of the Fund."[46] Therefore, if the IMF determines that China's exchange rate policy is compatible with the IMF Agreement, a WTO dispute resolution panel would be prohibited from finding that China's exchange actions frustrate the intent of Article II of the GATT.

As previously stated, there are also legitimate arguments that can be made that the exchange actions taken by China violate Article IV of the IMF Agreement. Therefore, given the political nature of the IMF's position, the outcome of this approach could also be determined not based on the law but on politics.

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[45] GATT, *supra* note 33, at sec. 2.

[46] Agreement Regarding World Trade Organization-International Monetary Fund Cooperation, Dec 9, 1996.

Challenging China's Currency Manipulation under the SCM Agreement

Among economists there is broad consensus that the undervaluation of the RMB meets the definition of a subsidy. Again, this undervaluation of the RMB makes Chinese products more competitive than they would otherwise be. There is much not consensus, however, about whether the undervaluation meets the narrower legal definition of a subsidy.

The SCM Agreement of the WTO directly addresses the subject of subsidies. Article 1.1 of the Agreement contains the legal definition of the term "subsidy". It provides that:

> For the purpose of this [SCM] Agreement, a subsidy shall be deemed to exist if:
>
> (a)(1) there is a *financial contribution* by a government or any public body within the territory of a Member (referred to in this Agreement as "government"), . . . and
>
> (b) a *benefit* is thereby conferred.[47]

In the *Brazil – Aircraft* case, a Dispute Resolution Panel of the WTO examined each element of this definition and stated that:

> Article 1.1 of the SCM Agreement sets out a general definition of a subsidy. It provides that a subsidy is deemed to exist, inter alia, if there is 'a financial contribution by a government' and 'a benefit is thereby conferred.[48]

The WTO Appellate Body subsequently upheld the Panel's holding and stated "it considers a 'financial contribution' and a 'benefit' as two separate legal elements which together determine whether a subsidy exists".[49] Therefore, in order to establish that China's exchange rate policy is a legal subsidy, the United States must demonstrate that the policy includes both a financial contribution and a benefit.

Financial Contribution

Article 1.1, subparagraph a (1) in the Agreement on Subsidies and Countervailing Measures contains the following examples of a "financial contribution". It states that a financial contribution can be found where:

> (i) a government practice involves a direct transfer of funds (e.g. grants, loans, and equity infusion), potential direct transfers of funds or liabilities (e.g. loan guarantees);

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[47] Agreement on Subsidies and Countervailing Measures, 1994 WL 761483 (G.A.T.T.) [hereinafter "ASCM"], art. 1.1.

[48] Appellate Body Report, *Brazil – Export Financing Programme for Aircraft*, WT/DS46/AB/R (Aug. 2, 1999).

[49] Appellate Body Report, *Canada – Measures Affecting the Export of Civilian Aircraft*, WT/DS70/AB/R (Aug. 20, 1999).

> (ii) government revenue that is otherwise due is foregone or not collected (e.g. fiscal incentives such as tax credits)1;
>
> (iii) a government provides goods or services other than general infrastructure, or purchases goods;
>
> (iv) a government makes payments to a funding mechanism, or entrusts or directs a private body to carry out one or more of the type of functions illustrated in (i) to (iii) above which would normally be vested in the government and the practice, in no real sense, differs from practices normally followed by governments;[50]

In the *US - Softwood Lumber III* case, the Panel described the concept of "financial contribution" under Article 1.1(a)(1) of the SCM Agreement and stated that:

> Subparagraphs (i) through (iv) 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. Subparagraph (iv) ensures that government directed transfers affected through a private entity do not thereby cease to be government transfers. In other words, Article 1.1(a)(1) SCM Agreement provides that a financial contribution can exist not only when there is an act or an omission involving the transfer of money, but also in case goods or certain services are provided by the government."[51]

At first glance, it seems clear that the Chinese undervaluation of the RMB is not an act or an omission involving the transfer of money. However, the United States could argue that the conversion of foreign currency by the Chinese government at a fixed rate could be classified as the equivalent to a service or as a transfer of money after the fact.

Given the facts about China's exchange rate policy, the United States can demonstrate that there is a direct transaction between the government and the Chinese exporter who is converting dollars after selling its products abroad. If the exporter were able to exchange the resulting dollars for RMB on the open market, the entity facilitating the exchange would charge the exporter a fee for its services. However, under China's regime, the service occurs at the government's window and the government does not charge the exporter for its services.

The US could also argue that the government is directly transferring funds to the exporter after its products are sold. As part of the exchange transaction, the Chinese government is arguably giving the exporter 25% to 40% more RMB than the US dollars exchanged are worth. This fact could possibly be characterized as a transfer of money from the government the exporter.

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[50] ASCM, *supra* note 47, at 229.

[51] Panel Report, *United States – Preliminary Determinations with Respect to Certain Softwood Lumber From Canada*, WT/DS236/R (Sep. 27, 2002), ¶ 7.24.

Benefit

In the *Canada-Aircraft* case, the Appellate Body quoted approvingly the Panel's focus on the recipient of the subsidy in its interpretation of the term "benefit" under Article 1.1(b):

> "[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."[52]

Given the facts about China's exchange rate policy, the United States should have little difficulty demonstrating that Chinese exporters have received something of value (cash) from the Chinese government and are better off than they would have been if they had exchange US dollars for RMB on the open foreign exchange market.

The US' argument cannot end here however, because not all subsidies are prohibited under the SCM Agreement. Article 3 outlines those subsidies that are *per se* prohibited under the Agreement. It states as follows:

> 3.1 Except as provided in the Agreement on Agriculture, the following subsidies, within the meaning of Article 1, shall be prohibited:
> (a) subsidies contingent, in law or in fact, whether solely or as one of several other conditions, upon export performance . . .
> (b) subsidies contingent, whether solely or as one of several other conditions, upon the use of domestic over imported goods.
> 3.2 A Member shall neither grant nor maintain subsidies referred to in paragraph.[53]

Footnote 4 of Article 3 further explains, "this 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. The mere fact that a subsidy is granted to enterprises which export shall not for that reason alone be considered to be an export subsidy within the meaning of this provision."[54]

While at first glance it seems that the Chinese subsidy, in the form of currency undervaluation, does not appear to be contingent on exports because all individual and entities exchanging US dollars for RMB receive this better rate of return, the US could make a strong

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[52] Appellate Body Report, *Canada – Measures Affecting the Export of Civilian Aircraft*, 149, WT/DS70/AB/R (Aug. 2, 1999).
[53] ASCM, *supra* note 47, at 231.
[54] *Id.*

argument that the subsidy is in fact export contingent based upon WTO Appellate Body decisions in which the US was the defendant.

In the *United States-Tax Treatment* case, the Appellate Body held that the US' extraterritorial income tax regime constituted a countervailable subsidy despite the fact that the tax exemption was available for goods produced in the US and for goods produced outside of the US because it overwhelmingly benefited US exporters.[55] Additionally, in the *United States-Upland Cotton* case, the Appellate Body upheld a panel ruling that a US subsidy was export contingent even though it was also available to domestic users of cotton.[56]

With regard to China's currency regime, the facts demonstrate that at least 70% of the subsidy goes to Chinese companies who can receive it only by exporting. Therefore, despite the fact that tourists and foreign investors can take advantage of the subsidy, the US could put forth a strong argument that the subsidy is in fact export contingent and is therefore prohibited under Article 3 of the SCM Agreement.

Rather than arguing that China's currency regime is a prohibited subsidy under Article 3, the United States could also argue that it is an actionable subsidy under Article 7 of the SCM Agreement. Articles 7.1 and 7.2 of the Agreement state the following:

> 7.1 Except as provided in Article 13 of the Agreement on Agriculture, whenever a Member has reason to believe that any subsidy referred to in Article 1, granted or maintained by another Member, *results in injury to its domestic industry, nullification or impairment or serious prejudice*, such Member may request consultations with such other Member.
>
> 7.2 A request for consultations under paragraph 1 shall include a statement of available evidence with regard to (a) the existence and nature of the subsidy in question, and (b) the injury caused to the domestic industry, or the nullification or impairment, or serious prejudice19 caused to the interests of the Member requesting consultations.[57]

Given the magnitude of the US-China trade imbalance and the job loss statistics outline by various economists, it should not be difficult for the US to show that China's currency regime has resulted in injury to the US economy.

CONCLUSION

Challenging China's currency manipulation under the IMF and WTO Agreements will not be easy for the United States and will take several years to bear any potential fruit. Nevertheless, it is possible for the US to prevail in a claim or claims brought under one or all of the agreements. Any resulting IMF Executive Board and/or WTO panel decisions would, at any rate, give the US, and other WTO members, guidance regarding all the unanswered questions regarding currency manipulation that can then be applied to similar situations that may arise in the future.

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[55] Appellate Body Report, *United States – Tax Treatment for Foreign Sales Corporations*, E-2, WT/DS108/AB/R (Jan. 14, 2002).

[56] Appellate Body Report, *United States – Subsidies on Upland Cotton*, 101, WT/DS267/AB/R (Mar. 3, 2005).

[57] ASCM, *supra* note 47, at 235-236. .

If the IMF and/or the WTO rule against the US, then the US, the Group of 20 and the WTO members will be on notice that this is an unresolved area of the law that requires either an amendment to the IMF Agreement, the GATT, and/or the SCM Agreement or multilateral consensus on this issue. This issue could then be addressed in a subsequent meeting of the G-20 or a subsequent round of the WTO.

Most importantly, given the fact that the EU, Brazil, India, Canada and other countries are also complaining about the negative effects of the undervaluation of the RMB, it would be most prudent for the US to first rally the support of these countries, and others, before it takes any action. In fact, it is now crucial in light of the Federal Reserve's November announcement regarding its plan to purchase US Treasury securities.[58] More specifically, this announcement caused many countries, including Brazil, Germany, India, South Korea and Japan to accuse the US of manipulating its currency as well. Therefore, it is essential for the US to refute any accusations that it is being hypocritical. The US needs to do this by discussing the matter with other governments and emphasizing the difference in quality, quantity, intent and duration of the intended US monetary actions.

In the end, this multilateral approach would also help the US strengthen its claims, by demonstrating injury has been caused not just to the US but to the WTO trading regime as a whole. The US could also mitigate the burden associated with such an undertaking by soliciting the help of other WTO members that have the skills and funds to assist with what will be a very complicated, expensive and protracted dispute. Finally, utilizing a multilateral approach could help the US keep the world's focus on China's conduct rather than refocusing it on the US' conduct and its tendency to go it alone rather than find a multilateral solution.

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[58] Press Release, FEDERAL RESERVE, Nov. 3, 2010, *available at http://www.federalreserve.gov/newsevents/press/monetary/20101103a.htm*