Trade and Currency: *Linkages and Key Issues*

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Trade and Currency....the international mood?

Trade and Currency: Linkages?

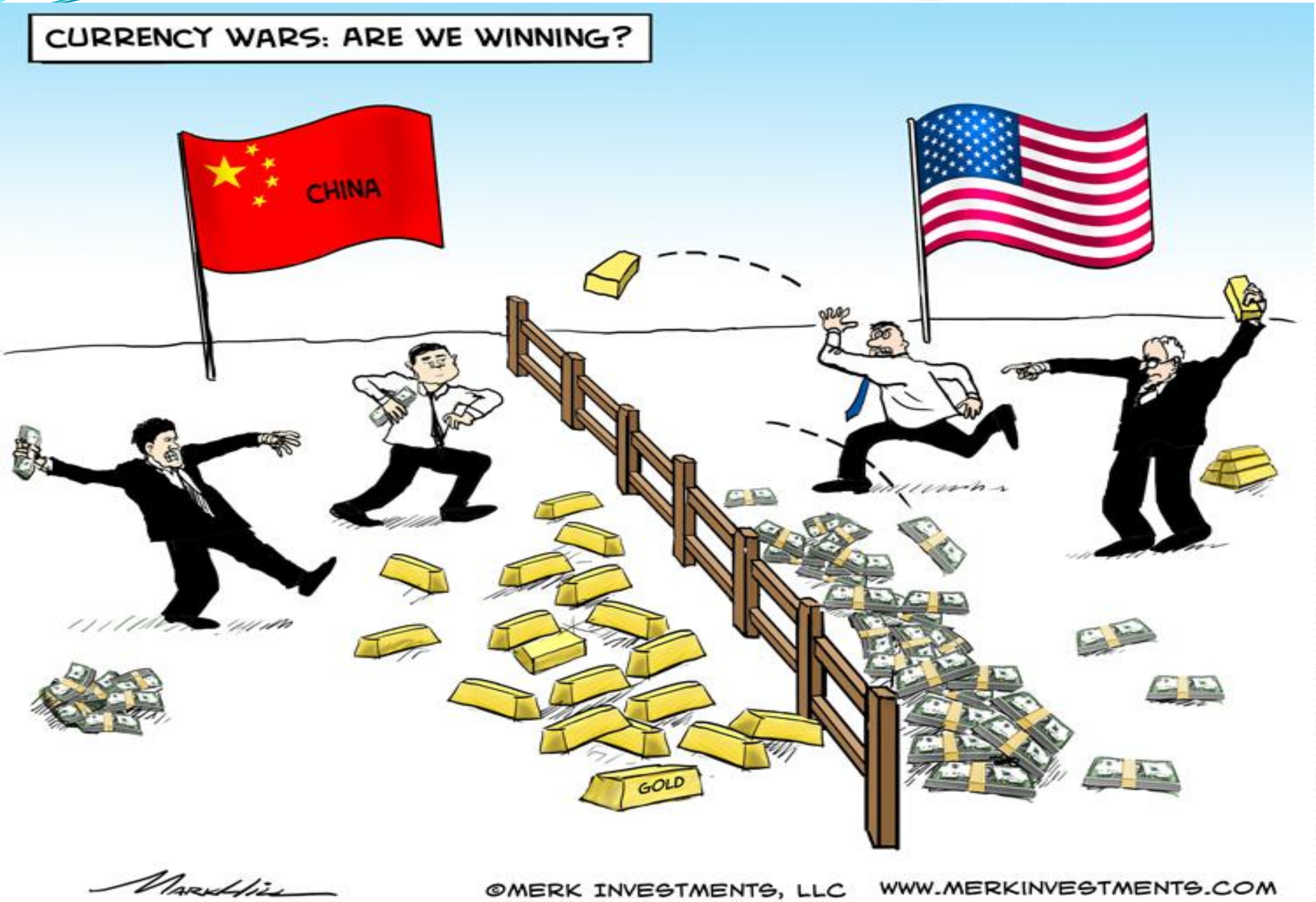
- It is now proven that monetary policy and international trade are inextricably linked
- Interventions of central banks in foreign exchange markets may stimulate exports and retard imports or vice versa – depending upon the direction of the intervention.
- Such interventions or so called currency manipulation or misalignment has impact on international trade.
- Whether there is currency misalignment – based on complex econometric models and analysis.

What is currency manipulation?

- Currency misalignment or manipulation has not been clearly defined in any of the international agreements dealing with trade and currency issues.
- It is understood to occur when a government buys or sells foreign currency to push the exchange rate of its currency away from its **equilibrium value** or to prevent the exchange rate from moving toward its equilibrium value
- **China's case**: Of late, there has been allegations against certain countries, especially China (made by the U.S.)of intentionally lowering the value of its currency against foreign currency
- Main intention to increase competitiveness and increase exports

What is currency manipulation?

- While most economists are in agreement that China's currency is undervalued, economists are less certain as to the effect of the undervaluation.
- Despite the equivocal data, critics of China's regime claim that the undervaluation leads to cheaper, and therefore increased exported goods, while at the same time raising the price of imported goods.
- For this reason, U.S. Lawmakers perpetually raise the issue and periodically initiate legislation, which would deem China a "currency manipulator" and thus trigger retaliatory measures. The core complaint is that Chinese exporters receive an unfair advantage due to the undervalued exchange rate.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Currency Manipulation: Where does it fit?

- Aspects of currency or exchange rates issues covered by both, the:
  - **International Monetary Fund**
  - **World Trade Organization**

Key Issue: Debate and uncertainty as to which is the most appropriate forum to tackle the issue of currency manipulation.

International Monetary Fund

- The Articles of Agreement of the International Monetary Fund or the **IMF Agreement** was drafted with the intention of maintaining a vigil over international monetary law and its practices across the globe.
- Amongst its most important objectives was that of monitoring the impact of competitive misalignment and its effect on interests of other countries during the Great Depression.
- **Article IV** of the IMF Agreement gives the organization, direct authority to maintain surveillance over each member's exchange rate policies.

IMF Agreement

- Article IV further establishes specific obligations for member states requiring the members to engage in capacity building with the IMF to promote a stable system of exchange rates. **Article IV, Section 1 (iii)** specifically imposes an obligation on member states to ***avoid manipulation of exchange rates <u>in order to</u> gain an unfair competitive advantage over other members*.**
- While the IMF Agreement nowhere defines what constitutes 'manipulation', the **2007 Executive Board decision on Bilateral Surveillance** throws some light on the issue.

2007 Executive Board Decision on Bilateral Surveillance

- Identified the following **as indicators 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
- (b) the introduction or substantial modification for balance of payments purposes of restrictions on, or incentives for, the inflow or outflow of capital;

2007 Executive Board Decision on Bilateral Surveillance

- (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 shall be indicators of a member's manipulation of exchange rates

2007 Executive Board Decision on Bilateral Surveillance

- Further, in the 2007 decision the Executive Board under Section 2 of the Annex stated that a member would be in violation of 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).*

Criticism of the Executive Board's Decision

- The underlying problem with this interpretation is that even if a member's currency exchange practice fits into one aforementioned indicators, it only violates Article IV, Section 1(iii) if it devalues its currency with a '*forbidden intent*', i.e. when the **intentional misalignment occurred with the intention to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members**.

- The Executive Board also stated in its 2007 decision that an assessment of any member's representation on the issue has to be based on *all available evidence*. It goes further in stating that such representation shall be accompanied with a *benefit of reasonable doubt* against the member. This subjective standard of determination of intent is not readily demonstrable and would be "politically very delicate for the IMF to officially find one of its members in breach of that provision" (Zimmerman, 2010)

Limited authority of the IMF

- Where the IMF falls short as a regulatory institution in such matters is the **absence of dispute settlement procedure.**
- Even though **Article VIII Section 3** establishes a general obligation on Members not to engage in discriminatory currency practices, the Chapeau uses the term '**Avoidance of discriminatory practices**' downplaying its enforceability.
- Further, **Article XXIX** only stipulates that the <u>Executive Board may settle any issue of interpretation that arises with respect to the provisions of the Agreement</u>. This restricts the authority of IMF to enforce any decision it makes as they themselves are **not binding on any member**.

Limited authority of the IMF

- Some solutions proposed, but these are also not devoid of problem:
- One such suggestion contemplates - **changes to the IMF's Articles of Agreement** to give the fund more authority over international exchange and more authority to require that countries comply with its rules .
- The problem with this solution is that an amendment to the IMF agreement would require 85% majority vote of the member countries.
- Many members may not be willing to vote in favor of such a change as they feel that the current exchange rate system is working reasonably well and very few countries would want to IMF to have such authority over their exchange rate policies.

Currency Issues at the WTO

- Currency/Exchange Rate has interface with, *inter alia* the following provisions under the WTO Agreements:
- **General Agreement on Tariff and Trade, 1994**
  - Article II:6
  - Article XV
- **Agreement on Subsidies and Countervailing Measures**

Article II, GATT, 1994

- Article II of the GATT, 1994 deals with the **Schedules of Concessions,** which contains the bound and applied rates of duties for products for each Member.
- Article II.1 (b) prevents members from imposing other duties and charges or ordinary customs duties in excess to bound tariffs in their Schedules. In other words, countries have to keep their applied tariffs in an equal or lower level than their bound tariffs.
- Scholars like Vera Thornstenson argue that by devaluating their currencies, China and even the US grant a less favorable treatment to imported products than the one determined on their Schedules, since, with the combination of tariffs and exchange rate misalignments, the barriers imposed to products imported from other contracting parties surpass the threshold negotiated at the GATT/WTO. This could mean a violation of GATT Article II.

Article II, GATT, 1994

- Nevertheless, it is important to emphasize that not all misalignments are violating Article II. Only the ones affecting the level of market access negotiated by members can be raised at the WTO.
- GATT established, on Article II:6, a threshold of 20% as a minimum rate devaluation to allow the renegotiation of specific bound tariffs.
- This negotiation has occurred 9 times during GATT era, between 1950 and 1975, allowing the raise of bound specific tariffs of Benelux, Finland (3 times), Israel, Uruguay (twice), Greece and Turkey.

Article II:6, GATT, 1994

- 6. (*a*) The **specific duties and charges included in the Schedules** relating to contracting parties members of the International Monetary Fund, and **margins of preference in specific duties and charges** maintained by such contracting parties, **are *expressed in the appropriate currency at the par value accepted or provisionally recognized by the Fund* at the date of this Agreement**. Accordingly, **in case this par value is reduced consistently with the Articles of Agreement of the International Monetary Fund by more than twenty per centum, such specific duties and charges and margins of preference may be adjusted to take account of such reduction**; *provided* that the CONTRACTING PARTIES (*i.e.*, the contracting parties acting jointly as provided for in Article XXV) concur that such adjustments will not impair the value of the concessions provided for in the appropriate Schedule or elsewhere in this Agreement, due account being taken of all factors which may influence the need for, or urgency of, such adjustments.

Article II:6, GATT, 1994

- Article II(6) states that the specific duties and charges included in the Schedules of Concessions relating to the contracting party members of the IMF, and the margins of preference in these specific duties and charges are expressed in the appropriate currency at par value accepted or provisionally recognised by the IMF at the date of the GATT, 1994.
- Thus, in case this **par value is reduced consistently** with the Articles of Agreement of the IMF by **more than twenty per centum**, such specific duties and charges and margins of preference may be **adjusted to take account of such reduction**.

Article II:6, GATT 1994

- On January 29th 1980, the Working Party of GATT released the "***Guidelines for Decisions under Article II:6(a) of the General Agreement*** (L/4938, 27S/28-29).
- This document reaffirmed the importance of maintaining the mechanism in order to neutralize the effect of exchange rate devaluation on specific tariffs of contracting parties and kept the threshold of 20% of exchange rate misalignment as a base for the renegotiation.
- It noted that the rules for the adjustment of bound specific duties in Article II:6(a) of the General Agreement were drafted on the assumption that the members of the International Monetary Fund maintain par values for their currencies. However, under the Articles of Agreement of the Fund, as amended on 1 April 1978, Fund members were no longer obliged to maintain par values but had the right to adopt exchange arrangements of their choice.
- Some Fund members had introduced floating exchange rates, and others maintained the exchange rate against one other currency, a basket of currencies or an international unit of account.
- The Working Party concluded that the right to adjust specific duties in the present monetary situation could not be called into question but that the modalities for the application of Article II:6(a) needed to be adjusted to take into account the changes in the international monetary system.

Article II:6, GATT 1994

- Thus, the provisions of Article II.6(a) and its related guidelines seem to indicate that:
  - (i) there is a recognition that significant currency fluctuations can have a direct impact on the value of concessions provided for in Member's Schedules and
  - (ii) currency fluctuations may represent, under certain conditions, a justification to adjust tariff commitments.

Currency at the WTO

- Other provisions:
  - Article XV of GATT, 1994
  - Agreement on Subsidies and Countervailing Measures

Brazil’s Proposal

- Currency manipulation issue at the WTO gained momentum in November 2012, when **Brazil** made a submission titled **Exchange-Rate Misalignment and Trade Remedies: A Conceptual Note by Brazil** to the Working Group on Trade, Debt and Finance. It stated that:

- “Existing provisions related to exchange-rate movements in the WTO agreements as well as the three Agreements providing for trade remedies at the WTO were created to deal with situations unrelated to the dynamics of exchange-rate movements in today's volatile international monetary system. The WTO seems to be systemically ill-equipped to cope with the challenges posed by the macro and microeconomic effects of exchange rates on trade. Members may wish, against this background, to consider the need for exchange-rate trade remedies and to start some analytical work to that effect.”


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Thank You