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China's Policy of Substantially Undervaluing the Renminbi:
A Challenge for the International Monetary and Trading System

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I. INTRODUCTION

The international community is no stranger to enforced undervaluation of currencies by some countries. These experiences, it can reasonably be said, have generally been unpleasant, have generated considerable controversy, and, when extreme enough, have put substantial strain on trade and investment across national boundaries, even to the point of creating dangerous, destructive imbalances and situations. The problem in the first place is that there are self-serving gains, at least for a time, that a country will realize from engaging in this practice, albeit at the expense of its trading partners, particularly increases in exports and foreign direct investment, curtailment of imports, and consequently greater foreign exchange reserves, larger corporate profits, and more employment than would be the case if the country allowed its currency to reflect the market's fundamentals of supply and demand.

This paper explores some of the recent history of this phenomenon and the international efforts that have been made, beginning in World War II, to understand and discourage measures that can be described by various names such as competitive currency depreciation, exchange-rate undervaluation, and currency manipulation. What emerges from this review is the somewhat curious picture of a global system that is relatively tolerant of competitive currency depreciation despite the considerable damage that can result and that, on occasion, has resulted from such behavior.

The basic thesis of this paper is that competitive currency depreciation is a hybrid in nature – a national monetary measure that has a direct impact on international trade and investment – and that regulatory efforts in this area accordingly should include international oversight that takes this duality into account more fully than has been the case to date. During and after World War II, the drafters of both the Articles of Agreement of the International Monetary Fund (“IMF”) and the General Agreement on Tariffs and Trade (“GATT”) recognized that no international trading system can function and prosper without a stable international exchange system. The critical importance of this interrelationship was one of the central lessons drawn from the stagnant economic conditions that prevailed globally between the two World Wars, due in no small part to a number of countries’ enforced undervaluation of their currencies.

In establishing the IMF and implementing the GATT in the mid- and latter 1940s, the international community took the first steps of putting in place an international framework for dealing with competitive currency depreciation. This framework has been expanded upon to a degree since then, but – in the absence for many years of rampant competitive currency depreciation – has been little utilized and so remains largely untested, especially as to how the IMF and the World Trade Organization (“WTO”) might collaborate to identify and address particularly pronounced instances of exchange-rate undervaluation.

As Justice Oliver Wendell Holmes, Jr., wrote, all life is an experiment,¹ and what can be seen as the unfinished work of the IMF and the WTO as to competitive currency depreciation illustrates the point. Over the last decade or so, a number of countries, most notably the People’s

¹ Abrams v. United States, 250 U.S. 616, 630 (1919) (Holmes, J., dissenting).

Republic of China (“China”), have succumbed to the temptations noted above that are offered by exchange-rate undervaluation. This activity by the Chinese government and others has occurred on such a protracted and large scale that the issue of how best to deal with competitive currency depreciation has come to the fore once again and assumed a renewed urgency. It is hoped that this paper will shed light on what adjustments might most effectively be implemented to hold competitive currency depreciation in check and to avoid a weakening of international trade and investment like that in the 1930s between the two World Wars.

II. THE HISTORICAL BACKDROP

A. Exchange-Rate Undervaluation Between World War I and World War II

As Professor Andreas Lowenfeld has remarked, an international legal regime governing the conduct of states in regard to monetary affairs did not exist until the end of World War II, whereas trade agreements by then had existed for many centuries.² This disparity or uneven development perhaps is attributable to a longstanding, widely held view that the conduct of monetary affairs more than international trade is a matter that properly falls within the sovereign prerogative of each nation to oversee. In any event, the lack of an international legal regime for monetary affairs had far-reaching consequences starting at the time of World War I. In Professor Lowenfeld’s words,

For about 35 years prior to the outbreak of World War I, the major western countries – the United Kingdom, France, Germany, and the United States – all tied their currencies to gold, so that the rates of exchange among the franc, the mark, the pound, and the dollar were essentially fixed. Many other states in effect tied into what was known as the gold standard by linking their currencies to one of the key currencies and keeping their reserves either in gold or in one of those currencies. No international legal obligation required adherence to the gold standard, and it collapsed almost overnight at the start of World War I. But though the era of the gold standard was neither as long nor as smooth as it seemed in retrospect, the period before World War I brought to the minds of the planners of the post-World War II economy memories of fixed exchange rates, great expansion of trade, and the growth of transnational investment on a scale the world had not previously seen.

By contrast, the period between World War I and World War II seemed like a nightmare. The pound floated against the dollar from 1919 to 1925, while the dollar remained tied to gold. Then Britain returned to gold as well, pretty clearly at an overvalued rate. The French franc floated – generally down – for

² Andreas F. Lowenfeld, *International Economic Law* 500 and 500 n.1 (2003).

most of the 1920s, then was linked to gold, first de facto and then de jure, accompanied by a variety of exchange controls. Both the franc and the pound, it seems, were sustained by large capital exports from the United States; when these ceased at the close of the decade, Great Britain suspended gold payments, France did not. The United States abandoned the gold standard as one of the first acts of the Roosevelt presidency, and rejected a proposed dollar-franc-pound stabilization proposal at the London International and Monetary Conference of 1933, which broke up in disarray. As trade contracted sharply and unemployment increased worldwide, each of the major countries tried to use competitive devaluations, multiple exchange rates, trade restrictions, subsidies, and controls of various kinds to divert economic distress abroad.³

With so many countries taking these monetary actions that had such widespread and negative repercussions, it is not surprising that statutory provisions and remedies were used by a number of countries under their domestic laws to address at the national level the impact of these various currency practices on international trade. In effect, these national laws represented countries' initial, uncoordinated attempts to fill the vacuum caused by the absence of an international legal regime for exchange matters. These individual national efforts underscored a generally perceived need to curb competitive currency depreciation and also revealed a certain international consensus that additional duties on imports from a country with an undervalued currency could serve as a viable means to that end. The review following illustrates by way of a brief survey how competitive currency depreciation was considered in the time between the two World Wars as either a countervailable subsidy or a type of dumping.

1. **Treatment by the United States of Exchange-Rate Undervaluation As a Subsidy**

In F.W. Woolworth Co. v. United States, 28 CCPA 239 (1940) (“Woolworth”), the U.S. Court of Customs and Patent Appeals was presented with a situation in which Woolworth had imported into the United States in August 1936 some china tableware from Germany and had paid its German supplier in reichsmarks. At the time, the Exchange Control Board and the Foreign Exchange Bureau of Germany’s government distinguished between and established different rates of exchange for free-exchange (or free) reichsmarks and registered reichsmarks. Under German law, the value of free reichsmarks was arbitrarily set at \$0.4033/free reichsmark, which was the declared gold value of the standard gold reichsmark, but the value of registered reichsmarks was set at a much lower rate of about \$0.21/registered reichsmark. As allowed and controlled by the German government, Woolworth bought both some free reichsmarks and some registered reichsmarks, with the latter purchased by Woolworth – under conditions established by the Reichsbank (the federal bank of the German government) – from the Chase National Bank in New York City and deposited in Woolworth’s account in the Deutsche Bank of Germany at an average cost to Woolworth of just \$0.2142/registered reichsmark. Woolworth then sought and

³ Id. at 500-501 (footnote omitted).

received a permit from the Reichsbank and its corporation, the Treuhand-Gesellschaft, to apply some of the registered reichsmarks against the German china tableware being bought by Woolworth. See Woolworth, 28 CCPA at 244-245.

In buying the china tableware for 2,716.25 reichsmarks (the equivalent of \$1,095.46 in U.S. currency at the declared exchange rate of \$0.4033/free reichsmark), Woolworth paid 271.625 free reichsmarks (10 percent of the total cost in reichsmarks) that Woolworth had purchased at a cost of \$0.4033/free reichsmark, or \$109.54, and the 90-percent balance of 2,444.625 registered reichsmarks at an average cost to Woolworth of \$0.2142/registered reichsmark or \$523.64. The total cost to Woolworth for the 2,716.25 reichsmarks in U.S. dollars was consequently \$633.18 (\$109.54 + \$523.64) or an average of \$0.2331/reichsmark. After rounding, Woolworth thus paid approximately \$461.41 less for the combination of free and registered reichsmarks than if the china tableware had been bought only with free reichsmarks (\$1095.46 - \$633.18). See Woolworth, 28 CCPA at 245-246.

Also importantly, (a) had the export transaction been consummated entirely in free reichsmarks, the German seller would have been entitled to an export subsidy directly from the German government, see Woolworth, 28 CCPA at 247; (b) the German seller knew beforehand that he was to be paid by a combination of fully valued free reichsmarks and depreciated registered reichsmarks and priced the china tableware accordingly at a higher price in marks than if payment was to have been completely in free reichsmarks, see Woolworth, 28 CCPA at 247; and (c) once paid by Woolworth, the previously depreciated registered reichsmarks were worth the same to the German seller as the fully valued free reichsmarks. See Woolworth, 28 CCPA at 246.

Under these circumstances, upon importation of the china tableware into the United States, U.S. Customs suspended liquidation of the entry and required a deposit of estimated countervailing duties of \$461.41 under section 303 of the Tariff Act of 1930. These steps were taken pursuant to a decision issued by the Secretary of the Treasury, Henry Morgenthau, on June 4, 1936. See Woolworth, 28 CCPA at 246-247.

Affirming the Customs Court's decision in F.W. Woolworth Co. v. United States, 3 Customs Court Reports 236 (1939), which had upheld assessment of countervailing duties, the Court of Customs and Patent Appeals observed,

It is not possible to escape the conclusion from the record that the German Government by various devices and through different authorized governmental agencies was seeking to aid its manufacturers in invading foreign markets with their goods to compete in such markets with domestic producers. To this end various devices and practices were resorted to by and with the authority, encouragement, and aid of the German Government. Among such was the control of the registered marks and the limitations placed upon their use.

As has been said, concededly a bounty would have followed the payment of the total purchase price in free marks. It

seems clear that, since the registered marks which were used became immediately worth the same to the manufacturer as free marks, the identical ultimate result in dollars and cents was obtained. In the one instance a direct bounty would have been paid; in the other the result was reached indirectly.

Woolworth, 28 CCPA at 248.

At least in the instance of Woolworth, therefore, the U.S. Department of the Treasury, as the administering authority at the time of the U.S. countervail law, was found to have acted lawfully in collecting countervailing duties on imports of china tableware that had been subsidized by the German government's reliance upon multiple exchange rates and, in particular, upon a depreciated rate of exchange when exports from Germany were involved.⁴

⁴ In this connection, the subsequent case of United States v. Hammond Lead Products, 58 CCPA 130, cert. denied, 404 U.S. 1005 (1971) ("Hammond Lead"), also should be mentioned. A majority of the Court of Customs and Patent Appeals ultimately held there on jurisdictional grounds as a matter of statutory construction that the assessment of countervailing duties could only be made with the acquiescence of the Treasury Department under section 303 of the Tariff Act of 1930 and could not take place under section 516(b) of that Act as the result of an American manufacturer's protest to the courts of a decision by the Secretary of the Treasury as to the classification or rate of duty for imported merchandise like that produced or sold at wholesale by the American manufacturer. The Court noted that this question was a novel and momentous one, ". . . fraught with consequences as to the control of the executive branch over the foreign relations and foreign policy of the United States." Hammond Lead, 58 CCPA at 134. Perhaps for this reason, and as a way of punctuating the majority's view that control of the countervailing duty statute should rest with the executive branch, the Court went on to state in dictum that

{n}othing, at least in the short range, stimulates exports more than a devaluation of the currency. After devaluation, the exporter gets more home currency for each article he exports, and with it can purchase more goods and services at home, and he obtains these benefits largely at the expense of the producer for the home market who now gets paid in devalued currency. Yet we do not assess countervailing duties against countries because they devalue their currencies. Why not? The only valid reason is that these devaluations have been encouraged by our government, in the effort it has expended since Bretton Woods for a worldwide system of freely convertible currencies.

Hammond Lead, 58 CCPA at 138. It is submitted that, in addition to being dictum that was not needed for resolution of the issue before the Court, this passage does not seem to have taken into account the Court's decision in Woolworth, 28 CCPA at 248 (even though that case is cited generally at 58 CCPA at 135), that a devalued currency affecting exports was properly found by the Treasury Secretary to be a countervailable bounty or grant. Moreover, as discussed further below, the accuracy of the Court's claim about devaluations being consistent with the purpose of

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2. Other Countries' Treatment of Exchange-Rate Undervaluation As Actionable Dumping

The other and more common way in which countries reacted between World War I and World War II to counteract competitive currency depreciation's negative influence on international trade was by means of antidumping duties. During 1933 as Congress was weighing possible amendments to the U.S. antidumping duty law, the United States Federal Trade Commission ("FTC") conducted a study on this subject, which study was published in early 1934 as a Senate Document.⁵ The FTC's Report contains a detailed section devoted to "exchange dumping," as opposed to other kinds of dumping, and gives a picture of the considerable extent to which currency undervaluation was actionable under the antidumping laws of a series of countries other than the United States.⁶

Almost all countries that have passed antidumping legislation, with the exception of the United States, have included provisions to prevent exchange dumping or the importation of goods from foreign countries with depreciated currency. In some cases this is the only form of dumping for which duties are imposed, and in a number of countries it has been the most important part of the antidumping administration.

The exchange situation after the World War {World War I}, and especially depreciation of currency in Germany, served as immediate cause for a number of laws and regulations, including those in Great Britain and the Colonies, Belgium and Spain. The lowering of currency values during the recent depression period led to further steps in Europe and in Argentina, and renewed activity in Canada.

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Bretton Woods and encouraged by the United States is open to question. As already remarked, competitive currency depreciation was seen very logically in a negative light at Bretton Woods.

⁵ Antidumping Legislation and Other Import Regulations in the United States and Foreign Countries – Report Prepared for the Federal Trade Commission by the Export Trade Section of the Commission Relative to Antidumping Legislation and Other Import Regulations in the United States and Foreign Countries, S. Doc. No. 112, 73d Cong., 2d Sess. (Jan. 11, 1934) ("the FTC's Report").

⁶ Whether the impact of currency undervaluation on international trade is better addressed as a countervailable subsidy or as actionable dumping (or as neither) is a question that remains unsettled to this day. In the latter 1930s, as shown, the United States opted for the subsidy approach, while a number of other nations chose the dumping approach. Whether both countervailing and antidumping duties should be employed to offset currency undervaluation also is a debated proposition, but this methodology does not appear to have been adopted by any country to date.

The laws vary, some provide for duties equal to the currency depreciation, but the later measures have sought to equalize costs of production. If the currency of a country is low and prices and wages have not risen, the workers are paid amounts equivalent to the lower currency price, and costs of production are therefore low. But if the rise in internal prices and wages has kept pace with the depreciation of currency, then the cost of production is not low and there is less need for special duties.

The FTC's Report, S. Doc. No. 112, 73d Cong., 2d Sess. at 9-10 (parenthetical material added).

After this introduction, the FTC's Report gives an overview of the treatment of exchange dumping in the antidumping laws of Great Britain, Canada, Australia, New Zealand, South Africa, Spain, Belgium, France, Germany, Yugoslavia, Czechoslovakia, and Argentina.⁷ The FTC subsequently added Italy to the list of countries that countered exchange dumping with additional duties⁸ and noted that Cuba was contemplating doing so.⁹

In addition to the fact that so many countries that were major international traders at that time made provision in their trade laws to offset exchange dumping due to depreciated currencies by means of additional duties, it is interesting and worthwhile to consider some of the ways that currency undervaluation was determined and measured in the first place. What is striking in this regard is not only the range of the means selected for doing so, but also the different procedures' relative degrees of precision or, perhaps more aptly put, transparency. Thus, for example –

- Under Great Britain's act of 1921, additional duties for exchange dumping were imposed on imports if the exporting country's currency was depreciated by 33 $\frac{1}{3}$ percent or more of the par value of the exchange.¹⁰

- In the case of Canada's 1922 act, circulars issued in 1922 designated Germany, Austria, Hungary, Russia, Czechoslovakia, and the Kingdom of the Serbs, Croats, and Slovenes as countries with undervalued currencies – apparently without any accompanying calculations – and set the amount of special duties as the difference between (a) the imported product's lower price in Canada due to the exporting country's undervaluation of its currency and (b) the price prevailing for similar goods either in the United Kingdom (the mother country) or, if there was

⁷ The FTC's Report, S. Doc. No. 112, 73d Cong., 2d Sess. at 10-13. Also cited by the FTC as responses to currency undervaluation in lieu of antidumping duties were import licensing of certain products by Switzerland and the Netherlands and import prohibitions on luxury articles by Norway and Denmark. See The FTC's Report, S. Doc. No. 112, 73d Cong., 2d Sess. at 12.

⁸ Annual Report of the Federal Trade Commission for the Fiscal Year Ended June 30, 1934, at 114 (1934) ("the FTC's Fiscal Year 1934 Report").

⁹ Annual Report of the Federal Trade Commission for the Fiscal Year Ended June 30, 1935, at 113 (1935).

¹⁰ The FTC's Report, S. Doc. No. 112, 73d Cong., 2d Sess. at 10.

no manufacture or production in the United Kingdom, with reference to the price for similar goods that would be paid in any European country with a “normal currency.”¹¹

- Under Australia’s law of 1921, after inquiry and report by the Tariff Board that the currency of the exporting country was depreciated less than one-twelfth of its normal par value as compared with the pound sterling, a further duty would be charged equal to the difference between (a) the landed cost of the import into Australia adjusted to include the normal tariff and an amount for profit computed by the Australian authorities and (b) the Australian wholesale price of similar goods of Australian origin.¹²

- New Zealand’s law of 1921 treated another country’s currency as depreciated if the commercial or banking value of that currency in relation to New Zealand’s currency was less than the value of the other country’s currency in accordance with the mintage rate of exchange. The amount of depreciation and a corresponding “special duty” could be determined either by reference to any invoice or other verified evidence of the value of the goods imported into New Zealand or in any other manner directed by New Zealand’s administering officials.¹³

- South Africa’s Act of 1925 originally called for an exchange dumping duty equal to the difference between (a) the export price of goods imported into South Africa from a country with a depreciated currency and (b) the export price of similar, undumped goods imported into South Africa from a country whose currency in relation to South Africa’s currency was not depreciated by more than 5 percent. In 1931, South Africa’s 1925 act was amended so that whether the exporting country’s currency was considered depreciated was resolved by the South African authorities in relation to the value of South Africa’s currency. Once the extent of any such depreciation was computed, the exchange dumping duty was figured as the difference between (a) the f.o.b. cost at the foreign port of the goods imported into South Africa expressed in South Africa’s currency and (b) that cost in the exporting country’s currency converted into South Africa’s currency at the rate of exchange found by the South African authorities not to be depreciated. The amount of the exchange dumping duty was capped so as not to exceed one-half of the value of the imported goods.¹⁴

- Under Spain’s law of 1921 and Belgium’s law as early as 1920, exchange dumping duties were established through systems of “coefficients” that varied by tariff class and group and that were expressed as percentages. The FTC’s report does not explain how these “coefficients” and their percentages were computed. These percentages were applied against the difference between (a) the par rate and (b) a monthly average rate of exchange between the exporting country’s currency and Spain’s (or Belgium’s) currency. The resulting figure was the percentage by which the regular duty was to be increased.¹⁵

¹¹ Id.

¹² Id. at 11.

¹³ Id.

¹⁴ Id.

¹⁵ Id. at 12.

- France introduced in early 1931 an “exchange compensation surtax” to counter the effect on imports’ prices of foreign currencies’ depreciation from their legal par. In a decree in December 1931, France revised its initial methodology so that the focus of the exchange surtaxes was on offsetting the effect of currency depreciation on the manufacturing costs of foreign products. This goal was achieved by calculating the difference between (a) the product’s present price in the exporting country expressed in gold and (b) the price in force in the exporting country with its currency depreciated. Under this 1931 decree, the French government applied its “exchange compensation surtax” against products from twenty-four countries at rates from 7 to 25 percent.¹⁶
- In January 1932, not long after the French decree in December 1931, Germany issued an emergency decree of its own that authorized an “equalization surtax” on goods imported into Germany from countries with currencies below gold parity.¹⁷
- In brief fashion, the FTC also mentioned the authority in Yugoslavia’s 1921 act and in Czechoslovakia’s 1927 act to levy exchange dumping duties and an Argentine decree in August 1931 listing the rate of exchange as a factor to be taken into account in meeting competition harmful to production in Argentina.¹⁸

At least two observations can be made from the foregoing review. First (expressed in Justice Holmes’ frame of reference), during the time between the two World Wars there was a great deal of experimentation by a significant number of countries with their respective domestic laws – accompanied by considerable inconsistency between and among those laws – as to how exchange dumping should be defined and calculated. Almost surely because competitive currency depreciation was being practiced on an unprecedented scale and was generating such widespread damage to international trade, many important trading nations felt an imperative to take corrective action against undervalued imports into their territories at the same time that a good number of them were undervaluing their own currencies to aid their exports. Governments were flailing about and complicating an already terribly chaotic situation in which virtually everyone was complicit. Second, the FTC’s descriptions of these countries’ laws in its 1934 report suggest that exactly how countries arrived at the conclusion that another country’s currency was depreciated was left in large part to the discretion of the importing country’s authorities and that the methodologies underlying the findings of currency undervaluation frequently were largely unclear and unspecified.

With these national initiatives in mind and evidence of the Great Depression and the two World Wars still painfully present and vividly remembered, the drafters of the IMF’s Articles of Agreement and the General Agreement on Tariffs and Trade commenced their task of creating an international monetary and trading order.

¹⁶ Id. at 12-13.

¹⁷ Id. at 13.

¹⁸ Id.

B. Efforts Commencing in World War II to Build an International Framework for Dealing With Exchange-Rate Undervaluation

1. A Sense of Urgency Prompted by the Great Depression and the Second World War

From the outset of the drafting of the IMF's Articles of Agreement and the General Agreement on Tariffs and Trade during and immediately after World War II, the international community was acutely aware that competitive currency depreciation and high tariff and non-tariff barriers can have devastating effects on national economies and international trade and investment. Searing memories of the Great Depression in the 1930s and of Japan's aggressive push for a Greater East Asia Co-Prosperity Sphere as a way of securing raw materials for Japanese industries were fresh in the minds of those persons who were involved in crafting the post-war international monetary and trading system. Among the principal lessons drawn from these terrible experiences was the recognition that orderly exchange arrangements are integral to the facilitation of desirable international trade and investment.

The interdependent nature of monetary matters and international trade and investment were perhaps best captured by Harry Dexter White, the primary architect for the United States of the International Monetary Fund along with John Maynard Keynes for Great Britain. Writing in the latter stages of World War II, White observed that the lowering of barriers to international trade, ". . . cannot be done until there is assurance of orderly exchange rates and freedom in exchange transactions for trade purposes. A depreciation in exchange rates is an alternative method of increasing tariff rates; and exchange restriction is an alternative method of applying import quotas."¹⁹ Expanding on this critical bond between international trade and stable and strong exchange rates, as opposed to rigid and brittle exchange rates, White remarked,

The world needs assurance that whatever changes are made in exchange rates will be made solely for the purpose of correcting a balance of payments which cannot be satisfactorily adjusted in any other way. The world needs assurance that exchange depreciation will not be used as a device for obtaining competitive advantage in international trade; for such exchange depreciation is never a real remedy. It inevitably leads to counter measures, and the ultimate effect is to reduce the aggregate volume of trade. This is precisely what happened in the period of the 1930's when competitive exchange depreciation brought wider use of import quotas, exchange controls and similar restrictive devices.²⁰

¹⁹ H.D. White, "The Monetary Fund: Some Criticisms Examined," 23 Foreign Affairs 195, 208 (1944-45).

²⁰ Id. at 199.

Along the same lines, and emphasizing that change from the old order was indispensable, Lord Keynes remarked in his "Proposals for an International Currency (or Clearing) Union," dated February 11, 1942, "It has been suggested that so ambitious a proposal is open to criticism on the ground that it requires from the members of the Currency Union a greater surrender of their sovereign rights than they will readily concede. But, in the present version of the plan, no greater surrender is required than in any commercial treaty. . . . Surely it is an advantage, rather than a disadvantage, of the scheme that it invites the member States and groups to abandon that licence to promote indiscipline, disorder and bad-neighbourliness which, to the general disadvantage, they have been free to exercise hitherto."²¹ In his subsequent "Proposals for an International Clearing Union," in April 1943, Lord Keynes stated, "We need an orderly and agreed method of determining the relative exchange values of national currency units, so that unilateral action and competitive exchange depreciations are prevented."²² And in another observation around this time Lord Keynes added, "It is quite true that in some quarters the feeling might prevail that freedom to manipulate the value of currency is an important instrument of government. But clearly, if this view is pressed, it stands in the way of all currency agreements whatever."²³

While the foregoing comments were made at a time when the world was still on the gold standard and international flows of private capital were restricted, the interrelationship of which Harry Dexter White and John Maynard Keynes spoke remains just as vital today as then and, if anything, is more essential due to the phenomenal expansion of international trade and investment that has taken place since the end of World War II.²⁴ Unless exchange rates reflect

²¹ J. Keith Horsefield (ed.), "The International Monetary Fund, 1945-1965: Twenty Years of International Monetary Cooperation, Vol. III: Documents," at 13-14, ¶¶ 49, 50, and 52 (IMF, 1969).

²² J. Keith Horsefield (ed.), "The International Monetary Fund, 1945-1965: Twenty Years of International Monetary Cooperation, Vol. III: Documents," at 20 (IMF, 1969).

²³ Quoted in Sir Joseph Gold, "Exchange Rates in International Law and Organization," at 27 (ABA 1988).

²⁴ Robert Solomon, for many years the top international economist at the U.S. Federal Reserve Board until his retirement in 1976, eloquently and succinctly put this notion as follows:

A well-functioning monetary system will facilitate international trade and investment and smooth adaptation to change. A monetary system that functions poorly may not only discourage the development of trade and investment among nations but subject their economies to disruptive shocks when necessary adjustments to change are prevented or delayed – much as an earthquake is said to represent a sudden release of subsurface tensions that build up as edges of geological plates first lock and then slip as they shift in relation to each other. So the international monetary system matters because it affects the ways in which nations impinge on each other and in which they manage their economic interdependence.

(...continued)

the market's fundamentals of supply and demand, mutually acceptable reductions in tariff and non-tariff barriers will likely not be negotiated successfully or, if agreed to by the parties, will be undercut and negated to the extent that governmental actions insulate the setting of exchange rates from market forces and result in currencies that are fundamentally misaligned. Messrs. White and Keynes and their colleagues were on the mark in concluding that orderly, market-oriented exchange rates and a certain ceding of national sovereignty over monetary measures are of paramount importance to the efficient functioning of the international trading system.

2. **International Monetary Reform**

a. **Focus on Orderly Exchange Arrangements and the Bretton Woods' Par-Value System**

From its very beginnings, the IMF's charter has expressed that one of the IMF's purposes is "[t]o promote exchange stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation."²⁵ As Harry Dexter White elaborated on this goal,

Stability of exchange rates is not, however, identical with rigidly fixed rates that cannot be changed under any circumstances. The difference between stability and rigidity in exchange rates is the difference between strength and brittleness. It is the difference between an orderly adjustment, if conditions warrant it, and eventual breakdown and painful adjustment. The assumption that rigidly fixed exchange rates are always advantageous is no longer held to be axiomatic. It is true that if countries permit wide fluctuations of exchange rates in response to temporary changes in their balance of payments, the level of international trade and international investment will be adversely affected. But when the economic position of a country shifts because major factors have affected the world's demand for its exports, the proper remedy *may* be an adjustment in exchange rates.²⁶

In the IMF's original Articles of Agreement, therefore, Article IV headed "Par Values of Currencies," in its Section 4 on "Obligations regarding exchange stability" read,

- a. Each member undertakes to collaborate with the Fund to promote exchange stability, to maintain orderly exchange

(...continued)

Robert Solomon, "The International Monetary System, 1945-1976," at 7 (1977) (footnote omitted).

²⁵ Article I(iii) of the IMF's Articles of Agreement.

²⁶ H.D. White, "The Monetary Fund: Some Criticisms Examined," 23 Foreign Affairs 195, 199 (1944-45) (emphasis in the original).

arrangements with other members, and to avoid competitive exchange alterations.

- b. Each member undertakes, through appropriate measures consistent with this Agreement, to permit within its territories exchange transactions between its currency and the currencies of other members only within the limits prescribed under Section 3 of this Article [on foreign exchange dealings based on parity]. A member whose monetary authorities, for the settlement of international transactions, in fact freely buy and sell gold within the limits prescribed by the Fund under Section 2 of this Article [on gold purchases based on par values] shall be deemed to be fulfilling this undertaking.²⁷

With the best of intentions by the negotiators, there was created at Bretton Woods, New Hampshire, in 1944 a par-value system of exchange rates to be overseen by a newly established International Monetary Fund. The hope was that this arrangement would encourage the expansion of international trade by promoting stable and orderly exchange rates and fair currency standards.²⁸

Under the Bretton Woods system, each member undertook to maintain the par value of its currency, that is, a central value in terms of gold, the ultimate standard of value of the system. In practice, the United States came to play a unique role in managing this system. That was not only because it retained gold convertibility for dollars held by foreign central banks and had initially (with Britain) half the total votes, but also because of the overwhelming strength of the dollar. In the immediate aftermath of the war, the crippled economies of Europe and Japan needed vast imports and could export very little. The United States had emerged from the war with an immense productive capacity and national wealth, including its reserves of monetary gold. * * * Thus the dollar became the world's principal reserve asset and the United States could create international money by expanding its short-term liabilities to the rest of the world. The stability of the monetary system came to depend on the management of the United States' monetary policy and, by implication, her economy.²⁹

²⁷ The IMF's original Articles of Agreement are available at www.imf.org/origins/original1.html.

²⁸ Fred M. Vinson, "After the Savannah Conference," 24 *Foreign Affairs* 622, 623 (1945-46).

²⁹ "North-South: A Program for Survival, The Report of the Independent Commission on International Development Issues Under the Chairmanship of Willy Brandt," at 202-203 (1980).

Even though the pre-war reliance by the international community on gold was continued, the par-value system was a radical departure from the principle that each country had unlimited authority over its currency's exchange rate.³⁰ Moreover, as set forth in Article IV, Section 5 of the IMF's original Articles of Agreement,³¹ a member was allowed to propose a change in the par value of its currency only to correct "a fundamental disequilibrium," a concept that is not defined by the Articles of Agreement and that has never been officially defined by the IMF,³² and only after consultation with the IMF.³³ The subject of how the IMF should treat proposals to revalue was very controversial, with the United States favoring exchange stability and the IMF's authority over members and with Britain emphasizing exchange elasticity and members' rights against the IMF.³⁴ The actual experience with changes in par value to the end of the 1950s has been described as follows:

Par value changes had not been frequent. The general devaluation of 1949, initiated by Britain and followed in varying degrees by other countries, was looked upon as exceptional, representing a one-shot adjustment to postwar conditions and, in fact, was strongly encouraged by the United States. After that, Canada decided in 1950 to let its currency float, and France devalued in two steps in 1957-58. No other industrial country changed its par value. Par value changes and multiple currency practices occurred much more often among developing countries, in cases where inflation was rapid or where the terms of trade moved adversely.³⁵

³⁰ Sir Joseph Gold, "Exchange Rates in International Law and Organization," at 28 (ABA 1988).

³¹ The IMF's original Articles of Agreement are available at www.imf.org/origins/original1.html.

³² Robert Solomon, "The International Monetary System, 1945-1976," at 12 (1977).

³³ One other variation of the par-value system worth mentioning is the "scarce-currency" clause in Article VII of the IMF's original Articles of Agreement. Under this provision, if a member ran excessive trade surpluses and its currency became undervalued, the IMF could formally declare that member's currency to be scarce, in which event other members were authorized, after consultation with the IMF, to impose temporarily limitations on the freedom-of-exchange operations in the scarce currency. Article VII was borne of concern that the United States' preeminent position as the world's supplier and economic power in the early post-war period would lead to its accumulation of enormous amounts of foreign reserves and a shortage of U.S. dollars for other countries, but Article VII was not functional, was never invoked, and was abolished. See Statement of C. Fred Bergsten, "China's WTO Compliance and Industrial Subsidies," at 89 (Hearing Before the U.S.-China Economic and Security Review Commission, Apr. 4, 2006); and Robert Solomon, "The International Monetary System, 1945-1976," at 13 (1977).

³⁴ Sir Joseph Gold, "Exchange Rates in International Law and Organization," at 31 (ABA 1988).

³⁵ Robert Solomon, "The International Monetary System, 1945-1976," at 30 (1977).

For approximately twenty-five years after World War II, bolstered by the Bretton Woods system, rapid and yet relatively stable economic expansion was achieved around the world. During this timeframe, Japan and European countries gradually regained their economic health and strength, multinational corporations made great strides, and restoration of currency convertibility and growth of domestic liquidity in industrialized countries increased the volume of funds that could be transferred internationally.³⁶

By 1968, however, it was apparent to U.S. officials as well as to others that there was need for more flexibility in exchange rates than the par-value system was allowing.³⁷ The United States' balance-of-payments deficit and inflation were rising, and with the United States unable to change its own exchange rate, the only alternative was to seek revaluation of the U.S. dollar relative to other currencies. Countries like Germany, Japan, and Italy had very large trade surpluses. France was in deficit and confronted by the major political question of whether to devalue the franc. A widespread view was taking root that a way was needed for countries routinely and in a de-politicized procedure, without endangering the prestige of their governments, to be able to make "small and frequent" changes in their exchange rates.³⁸ As part of this process and as a first step toward the "banalization" and dethroning of gold as the IMF's ultimate standard of value,³⁹ the IMF's Articles of Agreement were amended in July 1969 (the "First Amendment") to introduce the Special Drawing Right ("SDR") as the IMF's unit of account and also as an unconditional line of credit for participating members.⁴⁰

b. End of the Bretton Woods' Par-Value System in 1971, the International Monetary Fund's 1977 Surveillance Decision, and 1978's Second Amendment to the International Monetary Fund's Articles of Agreement

³⁶ "North-South: A Program for Survival, The Report of the Independent Commission on International Development Issues Under the Chairmanship of Willy Brandt," at 203 (1980).

³⁷ While the par-value system was not truly a system of "fixed" exchange rates, exchange-rate adjustments were not undertaken lightly, and temporary and cyclical imbalances were addressed by means of reserves or borrowing from the IMF and were to be corrected by policies other than exchange-rate adjustment. Robert Solomon, "The International Monetary System, 1945-1976," at 12 (1977).

³⁸ Id. at 168.

³⁹ Id. at 313.

⁴⁰ James M. Broughton, "The International Monetary Fund, 1979-1989: Silent Revolution," at xvii-xviii (IMF, 2001). Since July 1969, the IMF's lending commitments accordingly have been specified in SDRs, and disbursements have been made either in SDRs or in convertible currencies. The SDR initially was defined as the equivalent of the gold value of one U.S. dollar, but in 1974 was redefined as a basket of sixteen currencies, and in 1981 this basket was reduced to five currencies. Id.

On August 15, 1971, after several years of growing speculative selling of U.S. dollars, increasing demand by private parties for gold, and a steep decline in the United States' gold reserves, the United States suspended the convertibility of the U.S. dollar into gold and so terminated the Bretton Woods' par-value system.⁴¹ Thereafter, an attempt was made in the Smithsonian Agreement of December 18, 1971, to establish an orderly structure of fixed exchange rates, although without reliance upon the IMF's exchange-rate provisions of the par-value system, as a stopgap until the Articles of Agreement could be amended.⁴² In the spring of 1972, the "Committee of Twenty" (with nine developing countries among its members) was established by the IMF to address reform of the international monetary system. At the insistence of the United States, the Committee of Twenty's mandate included related matters to ensure that arrangements regarding trade and investment would be consistent with the aims of monetary reform.⁴³ In March 1973, as the Committee of Twenty continued its deliberations, the Smithsonian Agreement's temporary structure collapsed under an onslaught of speculative movements of funds that two devaluations of the U.S. dollar were not able to deter.⁴⁴

The Committee of Twenty completed its work in June 1974 by issuing an Outline of Reform that, among other things, suggested the creation of an Interim Committee of the IMF's Board of Governors to carry forward the work of reform. This Interim Committee was duly established by the Board of Governors in October 1974 at the IMF's annual meeting. Between October 1974 and January 1976, the Interim Committee and the Executive Board of the IMF addressed several major subjects, among them the exchange-rate regime, and the IMF's Executive Board also completed an extensive revision of the IMF's Articles of Agreement.⁴⁵ After considerable diplomatic and legal activity and analysis, the Interim Committee agreed on the text of the amended Articles of Agreement (the "Second Amendment"), in a meeting held in January 1976 in Jamaica.⁴⁶

As relevant, the so-called Jamaica Agreement accepted the *fait accompli* that had emerged after the breakdown of the Bretton Woods' system in August 1971 and permitted members to accept the exchange arrangements of their choice while giving the IMF the role of carrying out surveillance of members' exchange-rate policies and adopting specific principles to guide members in regard to those policies.⁴⁷ Over time, the IMF's members have opted for a range of different exchange arrangements from hard-peg regimes to floating regimes to

⁴¹ See "North-South: A Program for Survival, The Report of the Independent Commission on International Development Issues Under the Chairmanship of Willy Brandt," at 204-205 (1980).

⁴² Sir Joseph Gold, "Exchange Rates in International Law and Organization," at 62 (ABA 1988).

⁴³ See Robert Solomon, "The International Monetary System, 1945-1976," at 224 (1977).

⁴⁴ Sir Joseph Gold, "Exchange Rates in International Law and Organization," at 62 (ABA 1988).

⁴⁵ Robert Solomon, "The International Monetary System, 1945-1976," at 302-303 (1977).

⁴⁶ *Id.* at 307-312.

⁴⁷ See "North-South: A Program for Survival, The Report of the Independent Commission on International Development Issues Under the Chairmanship of Willy Brandt," at 205-206 (1980).

intermediate, soft-peg regimes (that is, conventional fixed pegs, crawling pegs, and crawling bands).⁴⁸

In particular, Article IV of the amended Articles of Agreement now referred to “Obligations Regarding Exchange Arrangements” – rather than to “Obligations regarding exchange stability” – and otherwise extensively revamped and superseded the original Article IV to reflect the shift from the par-value system.⁴⁹ Article IV’s Section 1 on “General obligations of members” and Section 3 on “Surveillance over exchange arrangements” are the heart of the current Article IV for present purposes and are worth quoting here in toto.

Article IV. Obligations Regarding Exchange Arrangements

Section 1. *General obligations of members*

Recognizing that the essential purpose of the international monetary system is to provide a framework that facilitates the exchange of goods, services, and capital among countries, and that sustains sound economic growth, and that a principal objective is the continuing development of the orderly underlying conditions that are necessary for financial and economic stability, each member undertakes to collaborate with the Fund and other members to assure orderly exchange arrangements and to promote a stable system of exchange rates. In particular, each member shall:

- (i) endeavor to direct its economic and financial policies toward the objective of fostering orderly economic growth with reasonable price stability, with due regard to its circumstances;
- (ii) seek to promote stability by fostering orderly underlying economic and financial conditions and a monetary system that does not tend to produce erratic disruptions;
- (iii) avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members; and
- (iv) follow exchange policies compatible with the undertakings under this Section.

* * *

⁴⁸ Bubula, Andrea and Inci Otker-Robe, “The Evolution of Exchange Rate Regimes Since 1990: Evidence from De Facto Policies,” at 14 (IMF Working Paper WP/02/155, Sept. 2002).

⁴⁹ See James M. Broughton, “The International Monetary Fund, 1979-1989: Silent Revolution,” at 123-124 (IMF, 2001).

Section 3. *Surveillance over exchange arrangements*

(a) The Fund shall oversee the international monetary system in order to ensure its effective operation, and shall oversee the compliance of each member with its obligations under Section 1 of this Article.

(b) In order to fulfill its functions under (a) above, the Fund shall exercise firm surveillance over the exchange rate policies of members, and shall adopt specific principles for the guidance of all members with respect to those policies. Each member shall provide the Fund with the information necessary for such surveillance, and, when requested by the Fund, shall consult with it on the member's exchange rate policies. The principles adopted by the Fund shall be consistent with cooperative arrangements by which members maintain the value of their currencies in relation to the value of the currency or currencies of other members, as well as with other exchange arrangements of a member's choice consistent with the purposes of the Fund and Section 1 of this Article. These principles shall respect the domestic social and political policies of members, and in applying these principles the Fund shall pay due regard to the circumstances of the members.⁵⁰

While it was not until April 1, 1978, that the Second Amendment and so revised Article IV were accepted by the number of members having the requisite proportion of total voting power,⁵¹ the IMF issued on April 29, 1977, the specific principles and procedures called for in Section 3 of Article IV (the "1977 Decision").⁵² The 1977 Decision subsequently was augmented by the "1979 Decision on Surveillance: Ad Hoc Consultations" (essentially enabling the IMF's Managing Director to undertake *ad hoc* consultations with a member at anytime, in addition to the member's regularly scheduled consultations, if the circumstances of the member's exchange arrangement or exchange-rate policies warranted in the Managing Director's judgment) and the "1988 Decision to Eliminate Annual Procedural Reviews" (stipulating that the IMF's Executive Board shall review the general implementation of the IMF's surveillance over members' exchange-rate policies at intervals of two years and at such other times as consideration of it is placed on the Executive Board's agenda).⁵³

⁵⁰ *Id.*

⁵¹ Margaret Garritsen de Vries, "The International Monetary Fund, 1972-1978: Cooperation on Trial, Vol. II: Narrative and Analysis," at 769 (IMF, 1985).

⁵² "1977 Decision on Principles and Procedures," Decision No. 5392-(77/63) (IMF, Apr. 29, 1977), available at James M. Broughton, "The International Monetary Fund, 1979-1989: Silent Revolution," at 125 (IMF, 2001).

⁵³ "1979 Decision on Surveillance: Ad Hoc Consultations," Decision No. 6026-(79/13) (IMF, Jan. 22, 1979); and "1988 Decision to Eliminate Annual Procedural Reviews," Decision No.

(...continued)

Since its inception, surveillance has been considered “a central pillar” of the IMF’s activities and responsibilities, the principles and procedures of which have evolved through experience.⁵⁴ A critical point to be kept in mind is that the IMF’s Articles of Agreement do not vest the IMF with any special powers to enforce its conclusions and findings from surveillance with respect to members that are not borrowers of the IMF’s monies. Instead, the IMF must rely in these circumstances upon what influence it has in the international community through persuasion, peer pressure, and publicity.⁵⁵ A further complication in the conduct of surveillance has been an ongoing debate over what the objective of exchange-rate policy should be for the IMF’s members individually and as a whole: should exchange rates be “an instrument for external adjustment, a nominal anchor for financial stability, or a real anchor for maintaining international competitiveness?”⁵⁶

In its 1977 Decision, the IMF cited three main principles of guidance for members’ exchange policies: (1) the avoidance of exchange-rate manipulation or manipulation of the international monetary system in order to prevent effective balance-of-payments adjustment or to gain an unfair competitive advantage over other members; (b) reliance upon intervention in the exchange market by a member if necessary to counter disorderly conditions characterized by disruptive short-term movements in the exchange value of the member’s currency; and (c) consideration by a member, in the implementation of its intervention policies, of the interests of other members, including those members in whose currencies the member intervenes.⁵⁷

The 1977 Decision also identified certain principles of surveillance, notably illustrative developments that might indicate the need for further discussion with a member, as follows: (a) protracted, large-scale intervention in one direction in the exchange market; (b) an unsustainable level of official or quasi-official borrowing, or excessive and prolonged short-term or quasi-official lending, for balance-of-payments purposes; (c) the introduction, substantial intensification, or prolonged maintenance, for balance-of-payments purposes, or restrictions on, or incentives for, current transactions or payments; (d) the introduction or substantial modification for balance-of-payments purposes or restrictions on, or incentives for, the inflow or outflow of capital; (e) the pursuit, for balance-of-payments purposes, of monetary and other domestic financial policies that provide abnormal encouragement or discouragement of capital flows; (f) behavior of an exchange rate that appears to be unrelated to underlying economic and

(...continued)

8856-(88/64) (IMF, Apr. 22, 1988), available at James M. Broughton, “The International Monetary Fund, 1979-1989: Silent Revolution,” at 128-131 (IMF, 2001).

⁵⁴ See James M. Broughton, “The International Monetary Fund, 1979-1989: Silent Revolution,” at 67 (IMF, 2001).

⁵⁵ Id. at 67-69.

⁵⁶ Id. at 70.

⁵⁷ Id. at 125-126.

financial policies that provide abnormal encouragement or discouragement to capital flows; and (g) unsustainable flows of private capital.⁵⁸

c. **China, the International Monetary Fund's 2007 Surveillance Decision, and Reports by the U.S. Department of the Treasury**

Not surprisingly, as China has grown in international importance economically and financially, the IMF in its surveillances has devoted increasing attention to China. In 1987, China notified the IMF that China was employing a “managed-float” exchange regime. In April 1999, following China’s pegging of the renminbi to the U.S. dollar in 1994 (discussed in Section IV.B.3 below) and the IMF’s shift in early 1999 from a “*de-jure*” to a “*de-facto*” classification system, the IMF changed China’s 1987 classification to a “conventional-fixed-peg” exchange regime.⁵⁹ Further, as international frustration has grown in the last several years especially with China’s large-scale interventions in the exchange markets, burgeoning trade and current-account surpluses, and massive and increasing foreign-exchange reserves (discussed in Section IV below), the IMF has taken the occasion of its surveillances of China to urge that there be greater flexibility and appreciation allowed in the renminbi’s value, but has not found intentional “manipulation” by China of the renminbi.⁶⁰ The Chinese government has responded by taking what can reasonably be described as modest steps that have left the renminbi still substantially undervalued (also discussed in Section IV below).

Apparently reacting at least in part to the Chinese government’s ongoing insistence on undervaluing the renminbi, on June 15, 2007, the IMF’s Executive Board adopted a new “Decision on Bilateral Surveillance over Members’ Policies” (the “2007 Decision”) completing a year-long review of the 1977 Decision.⁶¹ Although formally repealing and replacing the 1977 Decision, this 2007 Decision carried forward with only minor changes much of the substance of the 1977 Decision, notably the 1977 Decision’s principles for guidance of members’ policies and principles of surveillance. At the same time, however, the 2007 Decision added as a fourth, recommended (not obligatory) principle of guidance that a member should avoid exchange-rate policies that result in external instability⁶² and also added as new principles and factors to be weighed by the IMF in surveillances (a) fundamental exchange-rate misalignment, (b) large and

⁵⁸ Id. at 126.

⁵⁹ Congressional China Currency Action Coalition, “Petition for Relief Under Section 301(a) of the Trade Act of 1974,” at Exhibit 1, page 5 (May 17, 2007).

⁶⁰ See, e.g., “People’s Republic of China: 2004 Article IV Consultation,” IMF Country Report No. 04/351 (Nov. 2004); “People’s Republic of China: 2005 Article IV Consultation,” IMF Country Report No. 05/411 (Nov. 2005); and “People’s Republic of China: 2006 Article IV Consultation,” IMF Country Report No. 06/394 (Oct. 2006), available at www.imf.org.

⁶¹ “Decision on Bilateral Surveillance over Members’ Policies” (IMF, June 15, 2007), available at www.imf.org/external/np/sec/pn/2007/pn0769.htm.

⁶² “Decision on Bilateral Surveillance over Members’ Policies,” at 9, Part II, ¶ 14 (IMF, June 15, 2007), available at www.imf.org/external/np/sec/pn/2007/pn0769.htm.

prolonged current-account deficits or surpluses, and (c) large external-sector vulnerabilities, including liquidity risks, arising from private capital flows.⁶³

In its public release, the IMF characterized the 2007 Decision as a comprehensive statement on bilateral surveillance that underscores the collaborative nature of surveillance, the importance of dialogue and persuasion, and the need for candor and evenhandedness.⁶⁴ As for “external stability” as an organizing principle for bilateral surveillance, the 2007 Decision describes this concept as referring to “a balance of payments position that does not, and is not likely to, give rise to disruptive exchange rate movements,”⁶⁵ and the IMF’s accompanying public release elaborates that “external instability” encompasses both the current account of the balance of payments (and so issues of exchange-rate misalignment) and the capital account of the balance of payments.⁶⁶

⁶³ “Decision on Bilateral Surveillance over Members’ Policies,” at 10, Part II, ¶ 15 (IMF, June 15, 2007), available at www.imf.org/external/np/sec/pn/2007/pn0769.htm.

⁶⁴ “Decision on Bilateral Surveillance over Members’ Policies,” at 2 (IMF, June 15, 2007), available at www.imf.org/external/np/sec/pn/2007/pn0769.htm.

⁶⁵ “Decision on Bilateral Surveillance over Members’ Policies,” at 6, Part I.A, ¶ 4 (IMF, June 15, 2007), available at www.imf.org/external/np/sec/pn/2007/pn0769.htm. Further as to “external stability,” the 2007 Decision remarks,

In the conduct of their domestic economic and financial policies, members are considered by the Fund to be promoting external stability when they are promoting domestic stability – that is, when they (i) endeavor to direct their domestic economic and financial policies toward the objective of fostering orderly economic growth with reasonable price stability, with due regard to their circumstances, and (ii) seek to promote stability by fostering orderly underlying economic and financial conditions and a monetary system that does not tend to produce erratic disruptions.

Id. at 7, Part I.A, ¶ 6.

⁶⁶ “Decision on Bilateral Surveillance over Members’ Policies,” at 2 (IMF, June 15, 2007), available at www.imf.org/external/np/sec/pn/2007/pn0769.htm. “Fundamental exchange-rate misalignment” (as an important indicator of “external instability”) arises when the real effective exchange rate deviates from its equilibrium level, that is, the level consistent with a current account (stripped of cyclical and other temporary factors) in line with economic fundamentals. Recognizing that the concept of misalignment is clear, but subject to uncertainties in measurement, the IMF has said that it will exercise appropriate caution in reaching conclusions about misalignment and that an exchange rate will only be deemed to be fundamentally misaligned if the misalignment is “significant” (which term the IMF has not specified). See, e.g., “IMF Surveillance – The 2007 Decision on Bilateral Surveillance,” at 2-3 (IMF, June 2007), available at www.imf.org/external/np/exr/facts/surv07.htm.

Also very importantly, the 2007 Decision provides more insight than the IMF has given previously into how the IMF views “manipulation.” In particular,

(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 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.”⁶⁷

Lastly, the provision in the 2007 Decision for ad hoc consultation should be highlighted.⁶⁸ As observed earlier, the notion of ad hoc consultation was incorporated in the 1977 Decision, such that the IMF’s Managing Director could undertake discussions with a member outside the normal schedule for surveillance if the Managing Director felt that the circumstances of the member’s exchange arrangement or exchange-rate policies so warranted. Similarly, paragraph 20(a) of the 2007 Decision specifies that the Managing Director at anytime can initiate informally and confidentially a discussion with a member whose exchange-rate policies or currency’s exchange-rate behavior is likely to be affected by important economic or

⁶⁷ “Decision on Bilateral Surveillance over Members’ Policies,” at 12-13, Annex, ¶ 2 (IMF, June 15, 2007), available at www.imf.org/external/np/sec/pn/2007/pn0769.htm. In an earlier paper by the IMF’s Legal Department in combination with the IMF’s Policy Development and Review Department, the points were made (a) that the determination of whether a member intends to manipulate the exchange rate of its currency is made independently by the IMF and is not based exclusively on the member’s representations of its motives and (b) that the IMF will give to the member the opportunity to explain the motivation behind its actions, but will take into account “all available and relevant information regarding the member’s exchange rate policy” and will itself decide whether the member’s representation is correct and whether or not “manipulation” is present. This general approach is the same as that followed by the Fund in resolving whether a measure by a member has been introduced legitimately or not for balance-of-payments purposes. See Sean Hagan, “Article IV of the Fund’s Articles of Agreement: An Overview of the Legal Framework,” at 2, 15 (IMF, June 28, 2006).

⁶⁸ “Decision on Bilateral Surveillance over Members’ Policies,” at 11, Part III, ¶ 20 (IMF, June 15, 2007), available at www.imf.org/external/np/sec/pn/2007/pn0769.htm.

financial developments. If the IMF's Executive Board considers it appropriate after reviewing the Managing Director's analysis, an ad hoc consultation under Article IV shall be conducted.⁶⁹

Since issuing the 2007 Decision in June 2007, the IMF appears to have been wrestling with how to apply the 2007 Decision's precepts generally and, almost certainly and more specifically, as to China.⁷⁰ The IMF's experience over the last year with implementing the 2007 Decision seems to have given rise to two principal, broad difficulties, both of which, perhaps not surprisingly, center on how most accurately and fairly from member to member the 2007 Decision's key concepts of "fundamental exchange-rate misalignment" and "external stability" should be assessed.⁷¹ In an announcement on August 12, 2008, clarifying how economic policies will be monitored under the 2007 Decision, the IMF noted that progress has at times been hampered by technical difficulties in evaluating exchange-rate equilibria and that frankness called for in some discussions of exchange rates has been a sensitive matter.⁷²

While it is not clear exactly what will unfold in the time ahead, it appears that more frequent use by the IMF of ad hoc consultations is a real possibility. Earlier involvement by the IMF's Executive Board than in the normal surveillance process is being seen as a positive way of opening surveillance to consideration by the international community, enhancing the nature of the discussions, and helping to ensure evenhandedness. Importantly as well, the IMF has stressed that initiation of an ad hoc consultation will not prejudice the outcome and will not mean that the underlying concerns about a member's exchange rate will only or best be resolved by a change in the nominal exchange rate of that member's currency.⁷³

Amidst speculation and informal word that China's normal Article IV surveillance delayed since late 2007 might be sent to the IMF's Executive Board by the end of September 2008, it appears that consideration of an ad hoc consultation of China might occur at that time.⁷⁴ Peer pressure would thus be brought further into play as a means to move China toward changing

⁶⁹ Id.

⁷⁰ For the first time in some years, the IMF last year did not issue an annual surveillance report as to China toward the end of the year. If timely, this report likely would have been issued in October or November 2007.

⁷¹ See, e.g., Allen, Mark and Sean Hagan, "Guidance on Operational Aspects of the 2007 Surveillance Decision" (IMF, Aug. 4, 2008).

⁷² "IMF Clarifies How It Will Monitor Economic Policies," at 1 (IMF, Aug. 12, 2008), available at www.imf.org/external/pubs/ft/survey/so/2008/POL081208A.htm.

⁷³ Id. at 2-3.

⁷⁴ Inside U.S.-China Trade, "IMF Director May Give Greater Role to Members In Currency Reviews" (Aug. 20, 2008), available at www.chinatradeextra.com/secure/CTE/ch_dsply_nl_txt.asp?f=wto2002.ask&dh=121444237&q=.

policies, but if any information deemed by China to be sensitive were not removed by the IMF from its Article IV Consultation Country Report, China could block the report as a whole.⁷⁵

In the meantime, on August 28, 2008, the U.S. Department of the Treasury issued a “Report to Congress on Implementation of the International Monetary Fund’s 2007 Decision on Bilateral Surveillance Over Members’ Policies.”⁷⁶ In a blunt assessment, this report takes a dim view of the IMF’s past record on exchange-rate surveillance⁷⁷ and expresses frustration with the IMF’s implementation of the 2007 Decision thus far, describing the results as “mixed” and asserting that “. . . difficult cases have been repeatedly and unnecessarily delayed for considerable periods due to debates about the meaning of the 2007 Decision. For example, the scheduled 2007 Article IV review for China has yet to be completed.”⁷⁸ Looking forward, the report states,

. . . given the Fund’s reluctance in the past to undertake “special consultations”, the challenge before the Fund now is to vigorously use the proposed new “ad hoc consultations” approach to fulfill the IMF’s systemic responsibilities and to implement the full extent of the 2007 decision. Meeting this challenge will be a critical factor in judging the Fund’s efforts to modernize and reform itself and to maintain its relevance and legitimacy.⁷⁹

According to the report, “While the consensus-based nature of the IMF is critical for its cooperative character, when the Fund’s powers of persuasion and candor have not resulted in meaningful change after a prolonged period, it is imperative that the Fund speak out forcefully and publicly about harmful country exchange rate practices.”⁸⁰

⁷⁵ Id.

⁷⁶ U.S. Department of the Treasury, “Report to Congress on Implementation of the International Monetary Fund’s 2007 Decision on Bilateral Surveillance Over Members’ Policies” (Aug. 28, 2008) (“2008 Treasury Report”), available at www.treas.gov/press/releases/hp1122.htm.

⁷⁷ In its words, “Over time, it became clear that the Fund had drifted away from its core responsibility on exchange rate surveillance. Further, the Fund had failed to engage rigorously on exchange rates, despite having an explicit mandate and procedures to do so.” “2008 Treasury Report,” at 6.

⁷⁸ “2008 Treasury Report,” at 10.

⁷⁹ Id. at 11.

⁸⁰ Id. at 10. This criticism might also be applied to the policy of the U.S. Department of the Treasury itself in recent years. The agency certainly has raised with China both bilaterally and multilaterally the issue of the renminbi’s “continuing substantial undervaluation.” Even though no meaningful change by China has resulted, the agency in its semi-annual determinations sent to Congress has not cited China under 22 U.S.C. § 5304 for “manipulation” of the renminbi on the basis that it cannot ascertain any intent by the Chinese government, contrary to Article IV.1(iii), to prevent effective balance-of-payments adjustment or to gain an unfair competitive

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As the 2008 Treasury Report indicates, nearly 65 years after its founding, the IMF still very much has – and is trying to address as well as it can under its charter – major issues with effectively overseeing the exchange-rate arrangements and policies of its members and is fully cognizant that international trade and investment suffer to the degree that countries' exchange rates are fundamentally misaligned.

3. The Structuring of International Trading Rules

a. Early Developments and Fundamental Principles

Even as work was progressing on the monetary side of matters during World War II and the Bretton Woods system came to be in mid-1944, efforts were underway on the trade side of matters. This trade work, however, did not move ahead as quickly due to the demands and turmoil of the war and the sheer size and daunting nature of the task of devising a set of rules to govern international trade on a global scale, something never before undertaken.

In one sense, the efforts to structure an international legal framework to regulate trade across national boundaries did not fare as well as the monetary efforts; whereas the IMF and the World Bank were in place and beginning to function by World War II's end, the International Trade Organization (“ITO”) that was envisioned as the institution that would direct global trade rules never became operational, chiefly due to opposition in the late 1940s by the U.S. Congress, which was less liberal on trade issues and less internationally oriented than the U.S. Executive Branch.⁸¹ Nevertheless, after extensive preparatory drafting by representatives from various countries in London in the autumn of 1946, in Lake Success, New York, in early 1947, and in Geneva from April through October 1947, the General Agreement on Tariffs and Trade emerged.

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advantage over other members of the IMF by means of the undervaluation. See, e.g., U.S. Department of the Treasury, “Report to Congress on International Economic and Exchange Rate Policies,” at 2, 27-29 (May 15, 2008), available at www.treasury.gov/offices/international-affairs/economic-exchange-rates/. These more recent, negative judgments on “manipulation” by the agency are in contrast to its affirmative findings of the renminbi’s “manipulation” by China in 1992-1994 before China ended its policy of dual-exchange rates and when China’s trade balances, foreign reserves, and other benchmarks were just small fractions of what the levels of these indicia are presently. See, e.g., U.S. Government Accountability Office, “International Trade: Treasury Assessments Have Not Found Currency Manipulation, but Concerns about Exchange Rates Continue,” at 13-14 (GAO-05-351, Apr. 2005); and China Currency Coalition, “Historical Comparison of Determinations by the Treasury Department Regarding China’s Currency Manipulation,” available at www.chinacurrencycoalition.org/legislation.html.

⁸¹ See Jackson, John H., William J. Davey, and Alan O. Sykes, “Legal Problems of International Economic Relations,” at 217-222 (5th ed. 2008). The events of the negotiations and friction between the United States and Great Britain over specific tariff and preference concessions and congressional distrust of multilateralism are recounted very thoroughly in Richard N. Gardner, “Sterling-Dollar Diplomacy: The Origins and the Prospects of Our International Economic Order,” at 348-380 (1969).

The activity on the GATT in Geneva took place simultaneously with tariff negotiations and work on the ITO's charter, and the GATT originally was intended to be a subsidiary agreement of the ITO and not an organization.⁸² In order that the substance of the GATT could be accepted and implemented as soon as possible under their various domestic laws without waiting for the ITO's charter to enter into force, the United States and other countries agreed in late October 1947 to apply the GATT provisionally, effective January 1, 1948.⁸³ The GATT both served as a mechanism for the Contracting Parties to modify their tariff concessions in light of economic and political conditions and also provided a set of commercial policy principles to guard against the value of the tariff concessions being eroded by other, non-tariff restrictions. These rules of the GATT for the most part were a shortened version of the principles already incorporated in the ITO's charter.⁸⁴

⁸² See Jackson, John H., William J. Davey, and Alan O. Sykes, "Legal Problems of International Economic Relations," at 218-219 (5th ed. 2008).

⁸³ *Id.* at 219. "Protocol of Provisional Application of the General Agreement on Tariffs and Trade," Oct. 30, 1947, 61 Stat. pts. 5, 6, TIAS No. 1700, 55 UNTS 308. This provisional status left the GATT in an ambiguous legal posture that was not fully rectified until the World Trade Organization was established as a full-fledged international institution effective January 1, 1995, but did not prevent the development and funding by the Contracting Parties of a highly-dedicated and skilled staff in Geneva to assist the Contracting Parties in the administration and enforcement of the GATT. See, e.g., Olivier Long, "Law and Its Limitations in the GATT Multilateral Trade System," at 43-64 (1987) (Mr. Long was Director-General of the GATT from 1968 until 1980).

⁸⁴ Richard N. Gardner, "Sterling-Dollar Diplomacy: The Origins and the Prospects of Our International Economic Order," at 361 (2d ed. 1969). Herbert Feis, Economic Advisor for International Affairs at the U.S. Department of State in the Hoover and Roosevelt administrations, broadly summarized these "basic economic conceptions" with reference to the ITO's charter in the following manner:

. . . (1) that governments should reduce all types of restriction imposed on imports and exports; (2) that each should abstain from actions which would cause products produced within their territories to be offered in foreign markets at prices out of correspondence with domestic prices; (3) that each should permit products from every foreign land to compete within its markets on equal terms, and thereby leave the origin of imports to be settled by universal competition; (4) that each should accord all foreign buyers equal opportunity to secure its products on the same terms; (5) that each should abstain from bilateral agreements for the exchange of goods that would or might lessen the opportunity of others to compete for the trade.

Herbert Feis, "The Conflict Over Trade Ideologies," 25 Foreign Affairs 217 (1946-47).

b. **Recognition by the General Agreement on Tariffs and Trade of the Need for Orderly Exchange Arrangements to Facilitate International Trade**

Given the inextricably intertwined relationship between exchange measures and trade measures, it is difficult to conceive of any step that a country might take that would have anywhere nearly as great an impact on international trade and investment as does a country's enforced undervaluation of its currency over a protracted period of time. At a single stroke, a country that embarks on such a policy undercuts as a practical matter the major axioms on which the GATT is structured.⁸⁵

Thus, when a country's exchange-rate regime undervalues a currency and that country imposes ad valorem tariffs on imports, that country's tariff concessions and bindings under Article II of the GATT are impaired as the amount of the assessed and collected duties expressed in the undervalued currency rises above the amount of the duties that would apply if the country's currency were realistically valued by market forces. Similarly, observance of the requirement in Article III of the GATT – that imported products be treated no less favorably in the importing country's home market than domestic products are treated – is weakened when a government's enforced undervaluation of its currency inflates the price (denominated in the undervalued currency) of imported products in its territory, thereby acting as an internal tax to the extent of that undervaluation on the imported products, but not on domestic products. Further, at odds with the general ban in Article XI of the GATT against restricting or prohibiting imports, undervaluation means that the competitiveness and volume of imported products are reduced either partially or completely due to the added import duties and inflated prices in the imported country's market. A currency's undervaluation can even diminish the standard in Article I of the GATT that a member state shall accord equal treatment to products imported from all of its trading partners. This situation can arise when an undervaluing country's currency is effectively pegged to a second country's currency. If a third country's currency loses strength against the first two countries' currencies, companies in the third country that export to the undervaluing country will have an edge over companies in the second country that seek to export to the undervaluing country, simply because the undervaluing country's enforced undervaluation makes the products of the second country more expensive than the products of the third country in the undervaluing country's market.

Very importantly, the authors of the GATT were as attuned as the drafters of the IMF's Articles of Agreement to the precept that stable exchange arrangements and policies are critical to balanced, sustainable international trade and investment. In the words of Professor John Jackson, "It was well recognized at the time of drafting GATT that currency par value manipulation and exchange controls could be used to protect domestic markets against

⁸⁵ A discussion on some of the ways in which exchange measures can affect trade is found in John Jackson, "World Trade and the Law of GATT," at 479-482 (1969).

imports.”⁸⁶ The text of the GATT, from 1947 through today, manifests this awareness in a number of places.

i. Article XV of the GATT

Article XV of the GATT deals with exchange arrangements and in Article XV:4 stipulates that a member state will not, by exchange action, “frustrate” the intent of the GATT’s provisions and will not, by trade action, “frustrate” the intent of the IMF’s Articles of Agreement.⁸⁷ Further, Article XV:9(a) of the GATT directs that nothing in the GATT shall preclude the use by a member state of exchange controls or exchange restrictions that are in accordance with the IMF’s Articles of Agreement.⁸⁸ Lastly, in part, Article XV:2 of the GATT

⁸⁶ John Jackson, “World Trade and the Law of GATT,” at 479 (1969) (commenting that the legislative history of the act authorizing participation in GATT by the United States records strong congressional complaints against foreign use of these devices).

⁸⁷ The GATT’s Interpretative Note Ad Article XV, ¶ 4, amplifies a bit on the meaning of “frustrate” as follows:

The word “frustrate” is intended to indicate, for example, that infringements of the letter of any Article of this Agreement by exchange action shall not be regarded as a violation of that Article if, in practice, there is no appreciable departure from the intent of the Article. Thus, a contracting party which, as part of its exchange control operated in accordance with the Articles of Agreement of the International Monetary Fund, requires payment to be received for its exports in its own currency or in the currency of one or more members of the International Monetary Fund will not thereby be deemed to contravene Article XI or Article XIII. Another example would be that of a contracting party which specifies on an import 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.

⁸⁸ With reference to how Article XV:4 and Article XV:9(a) of the GATT are to be read in conjunction with each other, there is little GATT or WTO jurisprudence, and one well-respected scholar has written,

Exchange controls with effects equivalent to trade controls not permitted under the General Agreement frustrate the purposes of that Agreement. However, Article XV:4 has to be read in conjunction with Article XV:9(a) which exempts from *all* obligations under the General Agreement the use of exchange controls in accordance with the Fund Agreement. Whether the exemption of Fund-authorized exchange actions also relieves contracting parties of their obligation not to frustrate the General Agreement’s intent through exchange actions was discussed in

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1954. The CONTRACTING PARTIES concluded that this question should be left “over for empirical consideration if and when particular points arose which had a bearing on it.” It is therefore still an open legal issue whether exchange controls frustrating the intent of the General Agreement, but imposed in conformity with the Fund Agreement, are at variance with the provisions of the General Agreement or not.

Frieder Roessler, “The Legal Structure, Functions & Limits of the World Trade Order, A Collection of Essays,” at 162-163 in Ch. 7, “The Relationship Between the World Trade Order and the International Monetary System” (2000) (emphasis in the original, footnote omitted). As far as is known, the question still remains undecided as to whether IMF-consistent exchange controls that frustrate the intent of the GATT will be found at variance with the GATT or not.

The reference by Frieder Roessler to the discussion in 1954 is to ¶ 8 of the “Report of the Special Sub-Group on Relations Between the GATT and the International Monetary Fund,” BISD, 3d Supp., 195, 198 (1955) (“Report of the Special Sub-Group”). At ¶¶ 9-11, the Special Sub-Group also stressed the need for addressing two problems in order to establish more effective machinery between the IMF and the GATT as called for by GATT Article XV: (a) ensuring that governments who were members of both bodies should themselves pursue a coordinated policy in relation to the IMF and the GATT, “. . . taking full account, in particular, of the implications of exchange measures. . . ” for countries’ obligations under the GATT; and (b) developing liaison between the IMF and the GATT. *Id.* The Working Party agreed on the importance of these two recommendations by the Special Sub-Group. “Working Party, Reports Relating to the Review of the Agreement,” BISD, 3d Supp., 170, 195, ¶ 93 (1955).

The Report of the Special Sub-Group and its endorsement just noted by the Working Party took place not too long after a dispute settlement brought by France against Greece in “Special Import Taxes Instituted by Greece,” BISD, 1st Supp., 48 (1953). In this case, the Greek government levied a “contribution” on imports that Greece described as “. . . a charge imposed on foreign exchange allocated for the importation of goods from abroad equivalent to a multiple currency practice,” and that Greece saw “. . . as indispensable to cover the constantly widening gap between the official exchange rates of the drachma in relation to foreign currency and the effective purchasing power of the drachma.” *Id.* at 49, ¶ 2. The GATT panel framed the primary issue as being whether, as France contended, this measure was an unacceptable, discriminatory internal tax or charge on imported products contrary to Article III:2 of the GATT, *id.* at 49, ¶ 5, or, as Greece contended, was a tax on foreign exchange allocated for the payment of imports and consistent with the IMF’s Articles of Agreement. *Id.* at 50, ¶ 7. The GATT panel ultimately felt that it did not have enough information about the tax to determine if it fell within Article III of the GATT as an internal tax or charge or within Article II of the GATT as an additional import charge and requested the parties to submit additional material. *Id.* at 50, ¶ 9. In doing so, however, the GATT panel reasoned (a) that if Greece were correct that its system was a tax on foreign exchange, the IMF would have the task of determining whether that system was an acceptable multiple currency practice under the IMF’s Articles of Agreement, (b) if the IMF

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states that the WTO will consult fully with the IMF on problems before the WTO that concern monetary reserves, balances of payments, or foreign-exchange arrangements, shall accept all findings of statistical and other facts presented by the IMF relating to foreign exchange, monetary reserves, and balances of payments, and shall accept the IMF's determination as to whether action by a member state in exchange matters is in accordance with the IMF's Articles of Agreement.

More than any other provision of the GATT, Article XV attempts to lay out an international legal scheme to harmonize the many situations in which monetary and trade actions intersect and affect one another, but does so in very broad terms whose precise meaning to this day is not as clear as might be wished.

ii. Articles XII and XVIII:B of the GATT

Article XII of the GATT (with respect to developed countries) and Article XVIII:B of the GATT (with respect to developing countries) permit resort by a member to restrictions on imports under certain conditions to protect their reserve positions and, as far as developing countries are concerned, additionally to ensure adequate reserves for implementing their programs of economic development. Quantitative restrictions on imports that a country could not afford were seen by John Maynard Keynes and others in the mid-1940s as a common-sense way of supporting currency convertibility and exchange-rate stability.⁸⁹ After having been employed in the GATT's early years as a legal cover for import restrictions during the time of readjustment following World War II, the balance-of-payments ("BOP") exception has come

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were to rule affirmatively on that question, Greece's tax system would fall outside the scope of the GATT's Article III and (c) that, in those circumstances, the further issue might arise under Article XV:4 of the GATT whether the Greek government's action constituted frustration by exchange action of the intent of the provisions of Article III of the GATT. *Id.* at 50, ¶¶ 7 and 8, and at 51, ¶ 12. While a further report by the GATT panel proved unnecessary when Greece devalued the drachma by 50 percent in 1953, *see, e.g.*, Raj Bhala, "Modern GATT Law, A Treatise on the General Agreement on Tariffs and Trade," at 1175 (2005), the report was formally adopted by the Contracting Parties on November 3, 1952. "Special Import Taxes Instituted by Greece," BISD, 1st Supp., 48 (1953).

In light of the Report of the Special Sub-Group and the GATT panel's report in France's dispute settlement against Greece, it seems fair to conclude with Friedrich Roessler that the issue of whether Article XV:4 takes precedence over Article XV:9(a) of the GATT remains unresolved.

⁸⁹ Frieder Roessler, "The Legal Structure, Functions & Limits of the World Trade Order, A Collection of Essays," at 165-167 in Ch. 7, "The Relationship Between the World Trade Order and the International Monetary System" (2000). Interestingly, by the late 1970s, economic theory had shifted to the point where trade measures generally were considered by the GATT's contracting parties to be an inefficient means to maintain or restore balance-of-payments equilibrium. *Id.* at 167.

into disfavor as an effective economic tool and rarely has been invoked since the termination and replacement of the par-value system with more flexible exchange arrangements in the 1970's.⁹⁰

Under Articles XII:2 and XVIII:9 of the GATT a member desirous of restricting imports on BOP grounds need only show either that it is confronted by "a serious decline in its monetary reserves" or has "very low monetary reserves." Whether either of these situations exists is a decision that very logically involves the IMF and brings into play the IMF's monetary expertise. Significantly, however, even though Article XV:2 of the GATT in relevant part states that the Contracting Parties of the GATT (now the WTO's Member States) ". . . shall accept all findings of statistical and other facts presented by the Fund relating to foreign exchange, monetary reserves and balances of payments, . . .," in India – Quantitative Restrictions on Imports of Agricultural, Textile and Industrial Products, WT/DS90/AB/R, adopted 22 Sept. 1999, the WTO's Appellate Body upheld the panel's exercise of independent judgment on whether India's BOP import restrictions were valid under Article XVIII:9 of the GATT. The Appellate Body took this course and approved the panel's approach (with the panel ultimately accepting the IMF's statistical and other factual findings) on the strength of Article 11 of the WTO's Dispute Settlement Understanding, which reads in part, ". . . a panel should make an objective assessment of the matter before it, including an objective assessment of the facts of the case and the applicability of and conformity with the relevant covered agreements." In particular, the Appellate Body observed that,

. . . the Panel submitted to the IMF a number of questions regarding India's balance-of-payments situation. The Panel gave considerable weight to the views expressed by the IMF in its reply to these questions. However, nothing in the Panel Report supports India's argument that the Panel delegated to the IMF its judicial function to make an objective assessment of the matter. A careful reading of the Panel Report makes clear that the Panel did not simply accept the views of the IMF. The Panel critically assessed these views and also considered other data and opinions in reaching its conclusions.

In that respect, we note that, on the issue of whether India's balance-of-payments restrictions were justified under Article XVIII:9, we note that in paragraphs 5.170 to 5.184 of its Report, the Panel took into account evidence adduced by both the United States and India, including information from the report of the Reserve Bank of India. As to whether India's balance-of-payments restrictions were justified under Article XVIII:11 and the Note *Ad* Article XVIII:11, the Panel reached its conclusion after weighing all the evidence and considering the arguments of the parties. With respect to the proviso to Article XVIII:11, the Panel based its conclusion primarily on the fact that India failed to supply convincing evidence that the removal of its balance-of-payments

⁹⁰ Id. at 164-165.

restrictions would entail a change in its development policy. Moreover, it is clear from the Panel's analysis in paragraphs 5.211 and 5.220 of its Report that it critically assessed the views of the IMF on this issue.

We conclude that the Panel made an objective assessment of the matter before it. Therefore, we do not agree with India that the Panel acted inconsistently with Article 11 of the DSU.

The question whether Article XV:2 of the GATT 1994 requires panels to consult with the IMF and to consider *as dispositive* specific determinations of the IMF was debated at length by the parties before the Panel. However, the Panel did not consider it necessary, for the purposes of this dispute, to decide this issue. As this finding of the Panel is not appealed, we abstain from taking any position on it.⁹¹

This dispute settlement at the WTO on India's BOP restrictions illustrates the divergent opinions and complications that can arise over how the IMF and the WTO are to proceed even when it is evident that the substantive issue being debated under the GATT concerns monetary measures' statistical and factual findings that are accepted by all parties as clearly falling within the IMF's area of responsibility.

iii. Article II of the GATT

The text of Article II of the GATT, dealing with schedules of tariff concessions, is yet another instance in which the links between monetary measures and trade measures were recognized by the GATT's authors. More specifically, Article II:3 stipulates that no member shall alter its method of converting currencies so as to impair the value of any of its tariff concessions, and Article II:6(a) of the GATT elaborates that the bound specific duties and charges of a member that also is a member of the IMF may be adjusted to take account of a reduction in the par value of that member's currency as long as (1) the par value is reduced consistently with the IMF's Articles of Agreement by more than twenty per cent and (2) the GATT's Contracting Parties (now the WTO's Member States), acting jointly under Article XXV of the GATT, concur that such adjustments will not impair the value of the Member State's tariff

⁹¹ India – Quantitative Restrictions on Imports of Agricultural, Textile and Industrial Products, WT/DS90/AB/R, adopted 22 Sept. 1999, ¶¶ 149-152 (footnotes omitted; emphasis in the original). The United States expressed the view before the panel that the panel must accept as dispositive the IMF's determinations on the matters of fact specified in Article XV:2, in particular, whether the facts of India's balance-of-payments and reserve situation placed India within the criteria listed in Articles XVIII:9(a) and (b). A discussion of this dispute settlement appears in Deborah E. Siegel, "Legal Aspects of the IMF/WTO Relationship: The Fund's Articles of Agreement and the WTO Agreements," 96 A.J.I.L. 561, 576-584 (2002).

concessions, “due account being taken of all factors which may influence the need for, or urgency of, such adjustments.”

In May 1978, a Working Party was formed under the GATT to examine how Article II:6(a) of the GATT should be applied in light of the Second Amendment to the IMF’s Articles of Agreement effective April 1, 1978, that the IMF’s members were no longer obliged to maintain par values for their currencies and could adopt exchange arrangements of their choice, including floating exchange rates and exchange rates fixed against another currency, a basket of currencies, or an international unit of account.

As the Working Party explained, Article II:6(a) was drafted on the assumption that members of the IMF would maintain par values for their currencies. Concluding that a member’s right to adjust specific duties could not be called into question in the present monetary situation after the Second Amendment, the Working Party considered whether and how the modalities for the application of Article II:6(a) could be adjusted to take into account the changes in the international monetary system, when the importing country’s currency in which the specific duties were defined experienced either depreciation or appreciation. See Specific Duties: Report of the Working Party, BISD, 27th Supp., 149, 150-156 (1979-1980) (“Specific Duties”). In its study, the Working Party was aided by advice and reports requested by the Working Party from the IMF. Id. at 149, ¶ 4.

The Working Party’s report (L/4858) and recommended guidelines (L/4938) were adopted by the Contracting Parties on January 29, 1980. Id. at 149; and Guidelines for Decisions Under Article II:6(a) of the General Agreement,” BISD, 27th Supp., 28-29 (1979-1980) (“Guidelines”). In accordance with Article IV.1 of the IMF’s Articles of Agreement as to the avoidance of manipulating exchange rates and with Article XV:2 of the GATT, it was agreed that the IMF should provide factual information regarding changes in members’ exchange rates, calculations of the extent of depreciation, and statistics used in the calculations and information on the sources of those statistics. Specific Duties, BISD, 27th Supp., at 155, ¶ 17; and Guidelines, BISD, 27th Supp., at 28-29.

iv. Article VIII of the GATT

Article VIII of the GATT concerns fees and formalities connected with importation and exportation of goods. Interpretative Note 1 Ad Article VIII elaborates,

While Article VIII does not cover the use of multiple rates of exchange as such, paragraphs 1 and 4 condemn the use of exchange taxes or fees as a device for implementing multiple currency practices; if, however, a contracting party is using multiple currency exchange fees for balance of payments reasons with the approval of the International Monetary Fund, the provisions of paragraph 9(a) of Article XV fully safeguard its position.

At least in this instance, it appears that the drafters of the GATT envisioned that an exchange action taken by a member and endorsed by the IMF would not frustrate the GATT's intent and would not, more exactly, trigger a violation of Article VIII of the GATT.

v. **Article VI of the GATT**

One more example should be identified of how the GATT was written to take into account the effects of exchange arrangements and exchange-rate policies. The GATT's Interpretative Note 2 Ad Article VI, ¶¶ 2 and 3, explains,

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

GATT's Interpretative Note 2 Ad Article VI, ¶¶ 2 and 3 (bracketed material added). This recognition by the GATT that countervailing or antidumping duties can be imposed by national authorities to offset injurious imports that have been unfairly advantaged by way of an exporting country's enforced undervaluation of its currency is not surprising given that the global community was wracked by competitive currency depreciation between World Wars I and II, as related in Section II.A above.

C. **The Groundwork for Coordination Between the International Monetary Fund and the World Trade Organization**

Perhaps not surprisingly, relations between the IMF and the GATT/WTO are complicated, and whether and how one institution will deal with the other institution and what the outcome will be in a given situation can be difficult to predict. One experienced scholar as of 2000 evaluated the situation in the following way:

The aim of GATT's drafters – namely, that the CONTRACTING PARTIES seek a co-operative arrangement with the Fund assuring not only that trade questions within the jurisdiction of the GATT are co-ordinated with the Fund, but also that exchange matters under the authority of the Fund are co-ordinated with the GATT – has thus not been achieved. There are cordial and intellectually fruitful relations between the staffs of the Fund and the GATT and an extensive exchange of information between them, but there is

nothing that could be described as policy coordination between the governing bodies of the two institutions.⁹²

That policy coordination by the governing bodies of the IMF and the WTO with each other is not as much in evidence as would be wished is both very frustrating, because the interplay between exchange action and trade action is so prevalent and because it often is difficult to discern whether a particular measure is an exchange action or a trade action,⁹³ and also puzzling, because there would seem to be enough international law in place and general concurrence on the subject so that one could be forgiven for thinking that the mandate, motive, and means are all present to effect a close working relationship between the two institutions.⁹⁴

Even with these provisions, however, and even with a broad consensus that the IMF's Articles of Agreement and the WTO's GATT and related agreements share the joint interest of avoiding conflicts and ensuring that members common to both organizations are subject to consistent rulings,⁹⁵ it is difficult to escape the impression that there still is room for enhancement and more consistency of the two organizations' cooperation with each other. Along with the Indian BOP dispute settlement noted earlier, two other dispute settlements are worth mentioning in this regard.

⁹² Frieder Roessler, "The Legal Structure, Functions & Limits of the World Trade Order, A Collection of Essays," at 177-178 in Ch. 7, "The Relationship Between the World Trade Order and the International Monetary System" (2000).

⁹³ In answering this question, for example, should the analysis turn on the purpose of an action, the effect of an action, or the technique of an action (that is, the way in which a measure is formulated and made to operate)? Frieder Roessler, "Selective Balance-of-Payments Adjustment Measures Affecting Trade: The Roles of the GATT and the IMF," 9 J. World Trade L. 622, 641-642 (1975).

⁹⁴ In addition to Article XV and the other Articles of the GATT noted in Section II.B.3, there are (a) Article X of the IMF's Articles of Agreement (stating that the IMF "shall cooperate" within the Articles of Agreement's terms with public international organizations having specialized responsibilities in related fields), (b) Article III:5 of the Agreement Establishing the World Trade Organization (directing the WTO, "as appropriate," to cooperate with the IMF and the World Bank in the interest of a greater coherence in global economic policy-making), (c) a Ministerial Declaration at the Uruguay Round on the Contribution of the World Trade Organization to Achieving Greater Coherence in Global Economic Policymaking (amplifying on Article III:5 of the Agreement Establishing the World Trade Organization), (d) a Ministerial Declaration at the Uruguay Round on the Relationship of the World Trade Organization with the International Monetary Fund (reaffirming the relationship of the WTO with the IMF in areas covered by the WTO's multilateral agreements on trade in goods), and (e) an Agreement Between the International Monetary Fund and the World Trade Organization, Dec. 9, 1996 (spelling out in considerable detail procedures for the WTO and the IMF to strengthen and give formality to the WTO's cooperative relationship with the IMF while fully maintaining their respective independence and different roles) ("the 1996 Agreement").

⁹⁵ See Deborah E. Siegel, "Legal Aspects of the IMF/WTO Relationship: The Fund's Articles of Agreement and the WTO Agreements," 96 A.J.I.L. 561, 584-85 (2002).

In Argentina – Measures Affecting Imports of Footwear, Textiles, Apparel and Other Items, WT/DS56/AB/R, adopted 22 Apr. 1998, the focus was a statistical tax that Argentina imposed on imports to finance statistical services to importers, exporters, and the general public. This tax was found by the panel to be inconsistent with Article VIII of the GATT, which deals with fees and formalities connected with importing and exporting, because the statistical services tax exceeded the approximate costs of the services rendered and was a measure designated for fiscal purposes. Before the WTO’s Appellate Body, Argentina argued that the panel had not made an objective assessment of the facts of the case under Article 11 of the WTO’s Dispute Settlement Understanding, advancing for this purpose a “Memorandum of Understanding” between Argentina and the IMF that Argentina urged the Panel had failed to consider and that included an alleged “undertaking” or “obligation” on Argentina’s part to collect a specified amount in the form of a statistical tax. Although the panel had not consulted with the IMF, the Appellate Body rejected this contention by Argentina, agreeing with the panel’s “implicit finding” that Argentina failed to demonstrate that it had a legally binding commitment to the IMF that would somehow supersede Argentina’s obligations under Article VIII of the GATT.⁹⁶ The Appellate Body also found that the 1996 Agreement provides specific means for the IMF and the WTO to cooperate administratively, but does not modify, add to, or diminish the rights and obligations of the WTO’s members under the WTO’s agreement and does not modify members’ commitments to the IMF.⁹⁷ The Appellate Body accordingly concluded that Argentina had violated its obligations under Article VIII of the GATT 1994.⁹⁸

One last dispute settlement at the WTO should be noted, Dominican Republic– Measures Affecting the Importation and Internal Sale of Cigarettes, WT/DS302/R, adopted 19 May 2005, which involved a foreign exchange fee that the Dominican Republic imposed on all imports. In this case, the panel asked the IMF for guidance on the precise legal nature and status of the foreign exchange fee’s measure in the standby arrangement between the IMF and the Dominican Republic and whether this measure constituted an “exchange restriction”⁹⁹ In its response to the panel the IMF’s General Counsel advised that the Dominican Republic’s foreign exchange fee was not a multiple-currency practice, an exchange restriction, or an exchange-control measure. The panel agreed with the IMF’s opinion and consequently found that the Dominican Republic’s measure was an impermissible “other duty or charge” in excess of the Dominican Republic’s

⁹⁶ Argentina – Measures Affecting Imports of Footwear, Textiles, Apparel and Other Items, WT/DS56/AB/R, adopted 22 Apr. 1998, ¶ 69.

⁹⁷ Id. at ¶¶ 70-72.

⁹⁸ This outcome by the Appellate Body was negatively criticized in Deborah E. Siegel, “Legal Aspects of the IMF/WTO Relationship: The Fund’s Articles of Agreement and the WTO Agreements,” 96 A.J.I.L. 561, 572-576 (2002).

⁹⁹ Dominican Republic– Measures Affecting the Importation and Internal Sale of Cigarettes, WT/DS302/R, adopted 19 May 2005, ¶ 7.139. In doing so, the panel cited paragraph 8 of the 1996 Agreement quoting, “The Fund shall inform in writing the relevant WTO body (including dispute settlement panels) considering exchange measures within the Fund’s jurisdiction whether such measures are consistent with the Articles of Agreement of the Fund.” Id. at ¶ 7.140.

tariff bindings under Article II:1(b) of the GATT, not an exchange restriction in accordance with the IMF's Articles of Agreement, and so could not be justified under Article XV:9(a) of the GATT.¹⁰⁰

At least in this dispute settlement, there seems to have been effective cooperation by the WTO and the IMF, although the issue was fairly straightforward, and the answer arrived at was consistent both with the IMF's reading of its Articles of Agreement and with the relevant provision of the WTO's GATT in the panel's view and as adopted by the WTO's Dispute Settlement Body (that is, the WTO's Member States acting as a whole).

D. Summary

As the foregoing, selective histories of the IMF's Articles of Agreement and the WTO's covered agreements indicate, there has been a conscious awareness by the international community from the origins of the IMF and the GATT forward to the present that stable monetary arrangements and trade rules are integral parts of a sustainable international trading regime. At the same time, however, as the experiences and dispute settlements discussed above in Section II.B indicate, the working of these two components in tandem is a difficult undertaking, and the IMF and the WTO appear very much to be in the process of learning how best to deal together with monetary matters that have effects on trade, most notably undervalued fundamental exchange-rate misalignment or "manipulation."

III. CONTEMPORARY VIEWS OF EXCHANGE-RATE UNDERVALUATION

A. The Importance of an Equilibrium Exchange Rate

Contemporary economic theory has built upon the global community's painfully gained experience in the 20th century to arrive at a solid, and generally agreed-upon, foundation for defining currency misalignment using the concept of an equilibrium exchange rate. An equilibrium exchange rate is a calculable benchmark rate under which trade by a nation with its trading partners and domestic growth within that nation are sustainable. While the level of the equilibrium exchange rate for any given currency with other currencies changes over time in response to dynamic conditions, a long-term departure from an equilibrium exchange rate can lead to macroeconomic instability both for a nation whose currency diverges from that equilibrium and for its trading partners as well. This proposition is confirmed by the experiences of countries such as Chile, Argentina, and Turkey, each of which has had damaging consequences flow from extended overvaluation of its exchange rate.

On the other hand, recent scholarship has suggested that at least some of the economic success of countries such as China, Japan, Uganda, and South Korea is attributable to the sustained undervaluation of their exchange rates. The examples of these countries challenge the

¹⁰⁰ Dominican Republic– Measures Affecting the Importation and Internal Sale of Cigarettes, WT/DS302/R, adopted 19 May 2005, ¶¶ 7.144-7.145, and 7.155. No appeal was taken from the panel's report.

simple equation that departure from equilibrium equals disaster and indicate that undervaluation can bring about short- to medium-term economic expansion for the nation that undervalues its currency. Nevertheless, there also are several ways in which undervaluation of an exchange rate can hurt macroeconomic stability and growth. In addition, even when undervaluation contributes for a while to gains in a country's economy, increases in that country's gross domestic product ("GDP") come at the expense of growth in the country's institutions and market infrastructure. Thus, on balance, economic theory explains that the long-term undervaluation of a country's exchange rate with its trading partners comes at a high cost not only to the trading partners of the country that undervalues its currency, but also to the country that engages and persists in that undervaluation.

For various reasons, most economic models of the direct effects of currency undervaluation on growth, domestic consumption, and trade are models of bilateral trade. What follows next is a discussion of the theory of these direct effects that accordingly focuses on the real exchange rate ("RER"), which is the rate at which a basket of goods in one country can be exchanged for an identical basket of goods in another country. At the same time, it is important to keep in mind that the preferred measure of the exchange of goods between a country and its trading partners for policy applications and economic studies of undervaluation is the real effective exchange rate ("REER"). The REER measures the trade-weighted, average rate at which a basket of goods in one country can be exchanged for an identical basket of goods in the markets of that country's major trading partners and reflects all of that country's bilateral foreign-exchange relationships, while the RER measures bilaterally the foreign-exchange relationships between a country and each of its major trading partners in turn. Put otherwise, the REER equals the trade-weighted average of the RERs of the given country's trading partners with that country.

B. Nominal Exchange Rates and Real Exchange Rates

When the sale of a good is conducted across national boundaries and involves the different currencies of two countries, the importer must buy the currency of the exporter's country with the currency of the importer's country in order to make the purchase of the item. This procedure occurs because the prices of goods normally are given in units of the seller's national currency. This cost to purchase with one country's currency some amount of another country's currency, that is, the price at which the currency of one country can be exchanged for the currency of another country, is called the nominal exchange rate.

However, the nominal exchange rate does not fully describe the exchange between currencies, inasmuch as the nominal exchange rate of two currencies does not capture or express the buying power of either country's currency in its home market or in its trading partner's market. For example, one U.S. dollar might be sufficient to purchase 0.7 Euros. The same dollar also could be adequate to purchase a candy bar in the United States, but the nominal monetary equivalent of 0.7 Euros might not be enough to buy the same candy bar in Europe. Another measure, therefore, termed the real exchange rate, quantifies the comparative buying power between two currencies. The RER between one country's currency and a given trading partner's currency is defined as the weighted-average price of goods produced and sold in one country's market divided by the weighted-average price of the identical goods produced and sold

in the market of a trading partner of the first country, with both of these weighted-average prices denominated in the currency of the trading partner. Thus, a high RER means that the prices of goods produced and sold in the one country are more expensive relative to the prices of identical goods produced and sold in the trading partner's country. Given that the RER is a bilateral measure, if Country A's RER with Country B is high, Country B's RER with Country A must be low. The RER is the measure of bilateral exchange preferred by economists.

A country's real exchange rate is said to be misaligned if there is a deviation of the actual RER with respect to some benchmark level, called an equilibrium RER.¹⁰¹ An equilibrium RER is defined so that, when a country's RER is at the benchmark level, that RER simultaneously facilitates the country's path toward continuing economic health domestically – through high levels of employment and output – and also encourages a sustainable position as either a net creditor or a net debtor to world markets.¹⁰² When a RER is below its equilibrium level, it is said to be undervalued. Similarly, when a RER is above its equilibrium level, it is deemed to be overvalued. The equilibrium RER is determined by the fundamentals of an economy, including the country's per capita income and current account balance.¹⁰³ An undervalued RER occurs when the price levels of goods produced and sold domestically in Country A are lower, relative to the prices of identical goods produced in Country B (Country A's trading partner) and sold in Country A, than the fundamentals of Country A's economy imply they should be. Economic theory holds that in the absence of state intervention or market failure, free-market forces will bring every country's RER in line with its equilibrium value.¹⁰⁴

C. Ways in Which Undervaluation Hurts the Macroeconomy and Growth

Economic theory suggests several ways in which an undervalued RER hurts macroeconomic stability and growth. First, by definition, undervaluation causes foreign goods' prices denominated in the undervaluing country's currency to be relatively more expensive than would be the case if the undervaluing country's currency were not undervalued. This pricing differential acts as the equivalent of an import tariff. Thus, the imported goods are put at a competitive disadvantage vis-à-vis goods produced in the undervaluing nation.

Second, and conversely, each trading partner of an undervaluing country experiences price reductions on goods produced by the undervaluing country and imported by the trading partner, relative to the trading partner's domestically produced goods (because any undervaluation by a country results in a partial overvaluation for its trading partners). In this

¹⁰¹ Aguirre, Alvaro, and Cesar Calderon, "Real Exchange Rate Misalignments and Economic Performance," at 3 (Central Bank of Chile, Economic Research Division, Apr. 2005).

¹⁰² Razin, Ofair, and Susan M. Collins, "Real Exchange Rate Misalignments and Growth," at 1 (Georgetown University 1997).

¹⁰³ Isard, Peter, Hamid Faruquee, G. Russell Kincaid, and Martin Fetherston, "Methodology for Current Account and Exchange Rate Assessments," at 29, Occasional Paper 209 (IMF, 2001).

¹⁰⁴ David Tarr, "Trade Deficits, Trade Policy, and The Value of the Dollar," Appendix at i-iv (paper prepared for the conference, "Trade Policy: Free or Fair?") (Nov. 1985).

way, an undervaluing country's exporter receives the equivalent of a subsidy on its exported goods, because the exporter can charge lower prices expressed in the currency of the undervaluing country's trading partner without having to decrease the exporter's costs.

The aggregate effect of undervaluation on imports and exports is a shift in investment toward export-oriented industries in undervaluing countries and a possible shift away from export-sector production in their trading partners. The latter effect stems from the fact that producers in countries that do not undervalue have reduced incentives and ability to compete in foreign markets with producers that are subsidized by the undervalued currency of the undervaluing country.¹⁰⁵

Third, undervaluation by a country of its currency increases political pressure by its trading partners for the protection of native industries against imports from an undervaluing country. The trading partners' import-competing industries often call for protective counter-tariffs to combat the competitive advantage that undervaluation gives to their foreign competitors. Tariffs can lead to decreased levels of trade, reduced international competition, and losses of growth and welfare for both the undervaluing country's importers and its trading partners' domestic producers.¹⁰⁶

Fourth, in the undervaluing country, the relatively higher prices imposed on imported goods by undervaluation are felt as a loss of total purchasing power by citizens of these countries, because they can buy fewer foreign goods. This handicap in turn slows growth of the undervaluing country's domestic industries that are not export-oriented or that are dependant upon foreign-made inputs.

Fifth, should undervaluation cause trade to become too unidirectional, that is, in the event that an undervaluing country purchases substantially fewer goods from abroad than its trading partners purchase from the undervaluing country, the result will be a deficit in the current accounts of the trading partners and a surplus for the undervaluing country.¹⁰⁷ To finance such deficits, the trading partners must issue debt. Should the market for debt become tighter, the trading partners will pay more interest on the debt to attract capital. This added cost of capital, in turn, increases the possibility of default by the trading partners.

Sixth, undervaluation of a currency distorts the free-market allocation of goods.¹⁰⁸ Industries in an undervaluing country that are protected by undervaluation have a competitive advantage that is not the result of their achieving the lowest cost structure or the highest demand

¹⁰⁵ Shatz, Howard and David Tarr, "Exchange Rate Overvaluation and Trade Protection: Lessons From Experience," at 3 (Sept. 2000).

¹⁰⁶ Id.

¹⁰⁷ Dani Rodrick, "The Real Exchange Rate and Growth: Theory and Evidence," at 33 (July 2007).

¹⁰⁸ Aguirre, Alvaro, and Cesar Calderon, "Real Exchange Rate Misalignments and Economic Performance," at 5 (Central Bank of Chile, Economic Research Division, Apr. 2005).

for their products. Similarly, a trading partner's industries that seek to export to customers in an undervaluing country are disadvantaged by the undervaluation. As a result, consumers in both the undervaluing country and in its trading partner make their purchases based on distorted market signals, and free-market allocation of goods is unlikely to be achieved.¹⁰⁹

Seventh, and lastly, undervaluation requires an inflexible monetary policy by the undervaluing country. In order to maintain an undervalued real exchange rate and to avoid appreciation of its currency, the undervaluing country must keep its interest rates low.^{110, 111} Low interest rates, in turn, risk inflation in the stock market and the housing market of the undervaluing country by artificially injecting large quantities of low-cost money into the economy.¹¹²

D. Undervaluation as a Second-Best Solution for Developing Countries to Strengthen Their Export Sectors

Departure from an equilibrium exchange rate should by definition take a country off the optimal path for economic growth and macroeconomic stability. Nevertheless, several economists have shown empirically that undervaluation of a developing country's currency relative to its trading partners' currencies can boost the developing country's economic growth for some significant amount of time, which varies case by case, by encouraging investment in exports. Importantly, this relationship is not present for richer countries.¹¹³

Undervaluation by a developing nation of its currency, however, only partially and temporarily compensates for, and does not correct, institutional and market weakness in the developing country. Undervaluation brings economic harm to the undervaluing country and also harms the undervaluing country's trading partners. The first and best solution to

¹⁰⁹ Allocation of goods by the free market generally achieves the highest level of consumer welfare.

¹¹⁰ Some contend in this regard that a stronger exchange rate in China would assist China's government to shift the balance of growth away from investment and exports toward domestic consumption. *The Economist*, "Lost in Translation" (May 17, 2007).

¹¹¹ Higher-than-average interest rates attract investment from both foreign and domestic investors. To invest, foreigners must first purchase the undervaluing country's domestic currency and in this way increase the demand for that domestic currency. Such an increase in demand leads to a corresponding increase in the price that the foreign investor is willing to pay for the domestic currency expressed in the foreign investor's currency. Thus, higher interest rates in the undervaluing country can be expected to lead to an increase in the nominal exchange rate of the undervaluing country's currency. An increase in the nominal exchange rate puts upward pressure on the RER between the two countries unless there is a compensating shift in the relative price levels of goods in either the undervaluing country or in its trading partner.

¹¹² *The Economist*, "Lost in Translation" (May 17, 2007).

¹¹³ Dani Rodrick, "The Real Exchange Rate and Growth: Theory and Evidence," at 2 (July 2007).

underinvestment in a developing country's export sector is to fix the weak institutions. This approach allows market signals to direct the proper level of investment to all sectors of the developing country's economy without harming trading partners.

Many developing countries have legal and financial institutions that are too weak to enforce contracts, prevent bribery, or avoid expropriation of property. These countries also suffer from weak credit markets and other market failures. The trade sector is harmed disproportionately, relative to other parts of the economy, by the absence of strong institutions and the presence of market failures. Thus, investment in the production of traded goods becomes relatively less profitable when institutional quality is poor and when weak credit markets and other market failures are present. These shortcomings are likely to affect the capital-intensive tradables sector and cause underinvestment in goods for export. Given the important role that exports often play in an economy, underinvestment in goods for export brings down the developing country's aggregate productivity and innovation and thereby significantly slows the developing country's growth.¹¹⁴

In these circumstances, the danger is that a developing country will decide to subsidize its trade sector through undervaluation of its currency and in this manner to spur greater foreign direct investment and encourage growth through exports. In effect, undervaluation compensates – for a time – for the adverse influence of a developing country's institutional weaknesses and market imperfections. Undervaluation does not, however, correct those systemic problems. Perpetuation of institutional weaknesses impedes a developing country's path toward optimal growth through market forces due in part to undervaluation's market-distorting consequences for the undervaluing country's domestic economy. Undervaluation also can hurt the trading partners whose purchases of the undervalued products from the developing country fuel that country's growth. The best solution to achieve a sustainable balance comes when the developing country avoids undervaluing its currency and instead directly strengthens its institutions and corrects its market imperfections.

E. Summary

There is consensus among economists and within the international community today that a sustained fundamental misalignment of an exchange rate can lead to dramatic corrections.¹¹⁵ When a country's exchange rate has been fundamentally misaligned for a protracted period of time, market forces can be expected eventually to cause such an exchange rate to move abruptly to its equilibrium, risking harmful effects to the domestic growth of that country as well as macroeconomic instability for the global community.¹¹⁶ Even when a country's economy appears to be boosted for a while by the fundamental misalignment, as with some developing countries, this growth weakly and only partially offsets growth lost due to the developing

¹¹⁴ Rodrick, at 21-26.

¹¹⁵ Isard, Peter, Hamid Faruqee, G. Russell Kincaid, and Martin Fetherston, "Methodology for Current Account and Exchange Rate Assessments," at 1, Occasional Paper 209 (IMF, 2001).

¹¹⁶ Id. The IMF monitors and consults with its members to guard against such destabilizing swings.

country's flawed institutions and market imperfections. The most prudent course for such an undervaluing country is to strengthen its institutions in the first place so as to allow market forces to allocate investment efficiently.

IV. CHINA'S EXCHANGE-RATE POLICIES AND PRACTICES AND THEIR RAMIFICATIONS FOR THE INTERESTS, ECONOMY, AND SMALL BUSINESSES OF THE UNITED STATES

A. Background

China has gone through roughly four exchange-rate phases since the country began to turn away from Mao Zedong's policies of economic isolation at the end of the 1970s.

First, during the years from 1978 to 1988 there was a growing recognition by China's government that the rigid economic regime of Mao had not worked well in some respects. This acknowledgement spurred the first stirrings of modifications to that regime, including the central government's creation of the first "swap centers" for foreign-exchange dealings, even as all of China's international trade continued to be transacted at a fixed, state-determined foreign-exchange rate.

Second, the change begun in China's economic system from 1978 to 1988 accelerated and broadened somewhat between 1988 and 1993 as exchange-rate policy took a more pronounced, government-approved, "experimental," market-oriented turn. In selected regions, and only to a limited extent, Chinese buyers and sellers of foreign exchange were allowed to determine rates of exchange at the previously organized "swap centers." Governmental intervention took place from time to time for the purpose of stabilizing prices in the "swap centers."

Third, in 1994 the Chinese government unified the official and the market-determined rates into one rate and characterized the movements of that unified rate as a "managed float." However, in practice, from 1994 to July 2005 this management amounted to a de facto peg of the renminbi to the U.S. dollar.

Fourth, and finally, China's latest exchange-rate phase started with a modest 2.1-percent revaluation of the renminbi against the dollar on July 21, 2005, and has continued until the present. Since July 2005 China's government has expanded the number of participants in the foreign-exchange market, but has allowed only a limited appreciation of the renminbi relative to the dollar.

Comparison of the growth of China's economy with the concurrent history of China's exchange-rate policy highlights a stark contrast. Changes to China's economy triggered by the Chinese government's selective adoption of free-market principles and the opening up of China's economy to international trade have brought the country rapid (and largely beneficial) economic growth. As businesses have been given a wide array of governmental subsidies and more control than previously over decisions on production, labor, and wages, Chinese industry has flourished. Yet, with regard to exchange-rate policy, the Chinese government has shown an ongoing

willingness and determination to subvert free-market principles by maintaining control over the currency market for the renminbi.

China's refusal to enable the market to value the renminbi has undercut China's capital markets, misallocated resources, lowered returns on China's foreign-exchange reserves, hampered reform of China's weakened banking sector, fueled speculative investing, and perpetuated extensive restrictions on capital. Unless China's government allows the relative value of the renminbi to be determined by market forces, its exchange-rate policy risks stalling or hobbling further economic growth for China in addition to causing dangerous imbalances for the global economy and the United States.

B. China's Distrust of Market Forces to Value the Renminbi

1. Adjustment After Mao: 1978 to 1988

At the time of Mao Zedong's death in 1976, China was practically a closed economy with very limited trade and little economic interaction with the rest of the world.¹¹⁷ Over the years since the coming to power of the Chinese Communists in 1949, Mao's government had put in place policies designed to create self-sufficient, autonomous regions within China.¹¹⁸ Allocation of capital and decisions on production were directed by the central government in accordance with a national plan. Similarly, China's government pursued a policy of centralized control and unified management of foreign exchange.¹¹⁹ A few state-run companies, called foreign trade corporations ("FTCs"), carried out all of China's international trade in order to facilitate the set goals of the national plan.¹²⁰ All foreign-exchange transactions were carried out by the Bank of China ("BOC"), a division of the People's Bank of China ("PBC"), at a fixed rate determined by the central government.¹²¹ The FTCs were required to surrender to the BOC their foreign exchange receipts acquired through international trade.¹²² To guard against retention by the

¹¹⁷ Min Zhao, "External Liberalization and Evolution of China's Exchange System: An Empirical Approach," at 3 (The World Bank Beijing Office, May 2006).

¹¹⁸ Jaggi, Gautam, Mary Rundle, Daniel Rosen, and Yuichi Takahashi, "China's Economic Reforms: Chronology and Statistics," at 3 (Institute for International Economics Working Paper 96-5, 1996).

¹¹⁹ See, e.g., China's State Council, "Provisional Regulations for Foreign Exchange Control of the People's Republic of China," Art. 1 (Dec. 18, 1980).

¹²⁰ Min Zhao, "External Liberalization and Evolution of China's Exchange System: An Empirical Approach," at 4 (The World Bank Beijing Office, May 2006).

¹²¹ During the late 1970s and much of the 1980s China's state-determined, fixed exchange rate was set so that the renminbi was relatively strong against foreign currencies. However, the renminbi frequently was devalued by the Chinese government in response to economic developments and the opening up of the economy. Tao Wang, "China: Sources of Real Exchange Rate Fluctuations," at 4 (IMF Working Paper WP/04/18, Feb. 2004).

¹²² Min Zhao, "External Liberalization and Evolution of China's Exchange System: An Empirical Approach," at 4 (The World Bank Beijing Office, May 2006).

FTCs of any foreign exchange, Chinese banks handling the transactions were required by law to examine foreign-exchange receipts and expenditures against import and export licenses or against the customs declarations for imports and exports.¹²³

By the late 1970s, there was growing discontent with Mao's version of socialism, especially within rural areas. The central government's policies of regional self-sufficiency and political isolationism had resulted in significant differentials in income by region, slow economic growth compared to that of neighboring countries, and shortfalls in agricultural harvests. After Mao's death in 1976, this discontent gave the government a mandate to reform China's economic system.¹²⁴ In December 1978, China's Communist Party formally recognized "the backwardness of the economy in responding to the needs of the people" as a principal concern for China.¹²⁵ The central government set about addressing the inefficiencies of its system.

Under Deng Xiaoping, China began to emphasize more localized initiatives in place of the monolithic approach that had characterized the Mao era. China's size and diversity, as well as the decentralization in decision-making that was introduced early in the reform process, allowed the Chinese government to adopt a small-scale, "laboratory approach" to reform. Within this framework, a market-oriented measure would be instituted in a selected region and then, if success followed, would be implemented on a wider scale. Some of these experiments began with the central government designating one area as a pilot region. In other cases, municipal authorities would initiate a project that subsequently might be recognized by the central government and treated as an experimental project of national significance.¹²⁶ These localized actions were possible because the mobility of labor and capital were highly restricted during the first years of reform in China. Thus, projects in one area – even if successful in that area – could be conducted without spillover into any other area or areas of the country unless the central government approved of that transfer.¹²⁷

As a first step toward reform, in 1979 the Chinese authorities established the State Administration of Foreign Exchange ("SAFE") as part of the BOC,¹²⁸ allowed more firms to conduct foreign trade, and permitted a select group of these firms to retain part of their foreign-

¹²³ See, e.g., China's State Council, Provisional Regulations for Foreign Exchange Control of the People's Republic of China, Art. 10 (Dec. 18, 1980).

¹²⁴ Jaggi, Gautam, Mary Rundle, Daniel Rosen, and Yuichi Takahashi, "China's Economic Reforms: Chronology and Statistics," at 2-3 (Institute for International Economics Working Paper 96-5, 1996).

¹²⁵ Laurens, Bernard, Hassanali Mehran, Marc Quintyn, and Tom Nordman, "Monetary and Exchange System Reforms in China: An Experiment in Gradualism," at 1 (IMF, Sept. 1996).

¹²⁶ Id. at 8.

¹²⁷ Id.

¹²⁸ Congressional China Currency Action Coalition, "Petition for Relief Under Section 301(a) of the Trade Act of 1974," at Exhibit 1, page 19 n.13 (May 17, 2007). SAFE was made part of the PBC in 1982. Id.

exchange earnings to be used only in international trade as an incentive to export.¹²⁹ These retained foreign-exchange earnings had to be surrendered to the central government, converted into renminbi at the official exchange rate, and deposited into an account with the BOC, which account the FTC was then able to draw on in carrying out further international transactions.¹³⁰ The balance of the FTC's foreign-exchange earnings was simply remitted to the central government to be spent as the central government saw fit. At the onset of these experiments, there were extensive restrictions on what goods could and could not be exported or imported.

On a parallel track, in order to encourage foreign investment in China, in 1980 special economic zones ("SEZs") were established in certain coastal cities. These SEZs were given the freedom to offer special advantages to foreign companies, such as tax breaks, in order to attract foreign direct investment ("FDI") and encourage the establishment of new businesses.^{131, 132} The success of the SEZs led to increasing levels of international trade, FDI, and economic prosperity in China. By the mid-1980s, the Chinese government was authorizing more areas of the country to become SEZs. This expansion helped to decentralize the administration of China's international trade.

In 1981, the official exchange rate controlled by the Chinese government was 1.54 renminbi/U.S. dollar. This rate appeared to overvalue the renminbi significantly and to be the cause of serious unprofitability for China's exporting sector. Rather than proceed with direct subsidization of the Chinese exporters' losses, the Chinese government implemented dual exchange rates by adding a secondary rate known as the Internal Settlement Rate or "ISR" at 2.80 renminbi/U.S. dollar. This ISR was restricted to use in foreign-trade-related transactions.¹³³

In 1984, under pressure and criticism from the IMF of this dual-exchange-rate system, China abolished the ISR and reinstated direct subsidies to Chinese exports to offset exchange-related losses.¹³⁴ In addition, with exporters permitted to retain some of their foreign-exchange earnings within China's domestic economy, the Chinese government opened a number of foreign-exchange "swap centers" in selected cities in 1986.¹³⁵ At these centers, foreign-funded

¹²⁹ Local governments also were allowed to retain foreign exchange. Min Zhao, "External Liberalization and Evolution of China's Exchange System: An Empirical Approach," at 10 (The World Bank Beijing Office, May 2006).

¹³⁰ Id.

¹³¹ Id. at 6.

¹³² The aim of these SEZs was to use foreign capital to fill the savings-investment gap that existed in China at the time and to attract foreign capital to promote export growth and import substitution. Id. at 7.

¹³³ Congressional China Currency Action Coalition, "Petition for Relief Under Section 301(a) of the Trade Act of 1974," at Exhibit 1, page 18 n.11 (May 17, 2007).

¹³⁴ Id.

¹³⁵ Min Zhao, "External Liberalization and Evolution of China's Exchange System: An Empirical Approach," at 5 (The World Bank Beijing Office, May 2006).

enterprises could buy and sell foreign exchange. The exchange rate for these transactions, however, was a fixed rate set by China's central government.¹³⁶

2. Experimentation and Dual Exchange-Rates: 1988 to 1993

The emergence of China's "swap centers" marked the start of a second exchange-rate phase and facilitated international trade in specific, mainly coastal regions from their creation in 1986 into the early 1990s. Their services were available only to a group of companies chosen by the Chinese government. In an important development in 1988, the central government ended its control of exchange rates at the "swap centers" and allowed designated Chinese exporters and importers to negotiate foreign-exchange rates between and among themselves.¹³⁷ As noted above, governmental intervention occurred periodically in efforts to stabilize exchange rates.¹³⁸ Thus, after having ended its dual-rate system with the ISR in 1984, by just a few short years later from 1988 through 1993 China again had a dual-exchange-rate system in which the official, fixed-exchange rate used for trading in China outside the chosen coastal regions coexisted with more market-determined rates in the "swap centers."¹³⁹ This arrangement led to two complications.

First, with the exchange rates arrived at by the "swap centers" the renminbi depreciated rapidly throughout the early 1990s, while the renminbi under the official exchange rate in the rest of China depreciated more slowly and to a lesser magnitude. These trends indicated that the renminbi at the official fixed rate was becoming increasingly overvalued.¹⁴⁰ Continuing liberalization by the Chinese government for domestic companies to run their businesses led China's economy to overheat in 1992 and 1993. With the weakening of the renminbi in the "swap centers" and expanding exports, Chinese businesses took in growing amounts of foreign currencies that were converted into more renminbi than the economy could absorb, and inflation in China rose significantly. In order to reduce exports and inflation, toward the end of 1993 the PBC intervened in the "swap centers" and strengthened the renminbi relative to other countries' currencies.¹⁴¹

¹³⁶ Jaggi, Gautam, Mary Rundle, Daniel Rosen, and Yuichi Takahashi, "China's Economic Reforms: Chronology and Statistics," at 23 (Institute for International Economics Working Paper 96-5, 1996).

¹³⁷ Id.

¹³⁸ Laurens, Bernard, Hassanali Mehran, Marc Quintyn, and Tom Nordman, "Monetary and Exchange System Reforms in China: An Experiment in Gradualism," at 56 (IMF, Sept. 1996).

¹³⁹ Tao Wang, "China: Sources of Real Exchange Rate Fluctuations," at 4 (IMF Working Paper WP/04/18, Feb. 2004).

¹⁴⁰ Id.

¹⁴¹ Min Zhao, "External Liberalization and Evolution of China's Exchange System: An Empirical Approach," at 14 (The World Bank Beijing Office, May 2006).

Second, due to the geographic distances and isolation of the “swap centers” from one another, exchange rates at the different “swap centers” began to diverge. In April 1993, the Chinese government reacted by issuing a regulation that explicitly encouraged traders at the various “swap centers” to deal with one another and through such arbitrage and competition to reach a market-driven, unifying rate among the “swap centers.” It quickly became clear, however, that this initiative was inadequate to overcome the differences of the “swap centers” and their foreign-exchange rates with one another.

3. Exchange-Rate Unification: 1994 to 2005

As the foregoing account suggests, after Mao’s death in 1976 China became – slowly at first – increasingly active in international trade. This shift brought to the fore for the Chinese government the question of how to proceed with respect to foreign exchange. Prior to 1994, the central government at different times exhibited a wariness toward market-driven exchange rates and a tendency to intervene in the currency markets whenever the renminbi’s rate in the “swap centers” did not meet with the Chinese government’s approval.

The lessons that China drew from its experience between 1978 and 1993 were made clear when the central government put in effect on January 1, 1994, several major decisions that reinforced the Chinese central government’s control over foreign exchange: (1) the role of China’s “swap centers” was curtailed and largely taken over by state-owned, national foreign-exchange banks;¹⁴² (2) China’s dual-exchange-rate system was terminated; and (3) China’s official exchange rate and the exchange rates of the “swap centers” were combined by China’s government into a unified exchange rate of 8.70 renminbi/U.S. dollar. The foreign-exchange-retention scheme also was ended temporarily in 1994, and domestic companies were again for a

¹⁴² See Zimmerman, James M., “China Law Deskbook,” at 446 n.189 (2005). As explained by Zimmerman in pertinent part,

Since the restructuring of China’s foreign exchange system at the beginning of 1994, swap centers have been open only for use by foreign investment enterprises (FIE), such as joint ventures, so there must be sufficient foreign investment enterprises with currency to sell for trades to take place. Chinese entities other than FIEs can enter into foreign exchange transactions at designated foreign exchange banks, which differ from swap centers in that the bank itself is the counter-party for the transaction. As part of the 1994 reforms, the swap centers are now run by the foreign exchange banks, and the Chinese government has stated that it plans to abolish swap centers because all entities have been allowed access to the foreign exchange banks. During the transition period, however, the swap centers continued to operate.

Id. In other words, the “swap centers” starting in 1994 lost their separate identities and became part of China’s foreign-exchange-trading system under the Chinese government’s direction and oversight.

while obligated to surrender all of their export earnings to the Chinese government.¹⁴³ The new, unified exchange rate was described by China as a single and managed floating exchange rate regime based on supply and demand.¹⁴⁴

Within a few years thereafter, despite intervention in the exchange markets by the Chinese central government to purchase U.S. dollars with renminbi, the renminbi had appreciated relative to the U.S. dollar to a rate of 8.30 renminbi/U.S. dollar, and China's foreign-exchange reserves had jumped from U.S. \$26 billion to U.S. \$78 billion.¹⁴⁵ Beginning in 1997, the renminbi was *de facto* pegged (fixed) by China in nominal terms to the U.S. dollar at a rate of 8.28 renminbi/U.S. dollar.^{146, 147}

With the outbreak of the Asian Financial Crisis in 1997, other Asian countries depreciated their currencies, but China maintained its fixed-exchange rate of 8.28 renminbi/U.S. dollar.¹⁴⁸ Having emerged from this severe turmoil with China's economy relatively unscathed, Chinese governmental officials concluded that the renminbi's peg to the U.S. dollar was one of the reasons why China's economy had fared reasonably well,¹⁴⁹ and so China left this policy in place and continued to enforce its currency's nominal peg relative to the U.S. dollar. While the renminbi's exchange rate was officially determined through trading on China's (now centralized)

¹⁴³ *Id.* at 88; and Congressional China Currency Action Coalition, "Petition for Relief Under Section 301(a) of the Trade Act of 1974," at Exhibit 1, pages 18-19 (May 17, 2007).

¹⁴⁴ Jianhuai Shi, "Are Currency Appreciations Contractionary in China?" at 7 (17th Annual East Asian Seminar on Economics, June 22-24, 2006). This description also was employed by China in its negotiations to join the World Trade Organization, *see, e.g.*, "Report of the Working Party on the Accession of China," at 6, ¶ 31 (WT/ACC/CHN/49, Oct. 1, 2001), even though the IMF in April 1999 had formally recognized that China's foreign-exchange regime was a conventional, pegged arrangement, not a managed float. Congressional China Currency Action Coalition, "Petition for Relief Under Section 301(a) of the Trade Act of 1974," at Exhibit 1, page 20 (May 17, 2007).

¹⁴⁵ Congressional China Currency Action Coalition, "Petition for Relief Under Section 301(a) of the Trade Act of 1974," at Exhibit 1, page 20 (May 17, 2007); and "Trade Policy Review: Report by the Secretariat – People's Republic of China," at 12, ¶ 15 (WT/TPR/S/161, Feb. 28, 2006).

¹⁴⁶ Tao Wang, "China: Sources of Real Exchange Rate Fluctuations," at 4 (IMF Working Paper WP/04/18, Feb. 2004).

¹⁴⁷ "The exchange rates for other foreign currencies were based on the rates of RMB against the US dollar and cross-exchange rates of other foreign currency on the international market." "Report of the Working Party on the Accession of China," at 6, ¶ 31 (WT/ACC/CHN/49, Oct. 1, 2001).

¹⁴⁸ Jianhuai Shi, "Are Currency Appreciations Contractionary in China?" at 7 (17th Annual East Asian Seminar on Economics, June 22-24, 2006).

¹⁴⁹ Morrison, Wayne M. and Marc Labonte, "China's Currency: Economic Issues and Options for U.S. Trade Policy," at 7 (Cong. Research Service, Jan. 9, 2008).

foreign-exchange market, the number of participants in this market was limited by China's government to a few participants. This restrictiveness kept the foreign-exchange market thin and underdeveloped, with the result that the central government, acting "anonymously," could intervene in the exchange market and keep the renminbi's exchange rate at the targeted value of 8.28 renminbi/ U.S. dollar.¹⁵⁰

In practice, the achievement of this desired rate typically meant that China's governmental authorities purchased with renminbi printed by China the U.S. dollars and other foreign currencies that were being earned by exports from China in order to keep the renminbi from appreciating. To avoid or minimize inflation caused by the substantial and growing amounts of renminbi being injected in this manner into the Chinese domestic economy, the central government then issued bonds to borrow those renminbi as part of a practice often called "sterilization" that is discussed further below in Section IV.C.

With the passage of time, pressure on the renminbi to appreciate grew dramatically.¹⁵¹ In the mid- to late 1990s, improvements in productivity and the quality of Chinese goods led to increased demand and foreign direct investment in China. With the accession of China to the World Trade Organization in December 2001, these trends became more pronounced and intensified the pressure on the renminbi to appreciate. Compounding the problem, foreign investors found ways around the Chinese government's capital controls and were able to purchase renminbi in expectation of its appreciation. Despite these speculative inflows and the influx into China of earnings from exports and funds from FDI, however, the renminbi's *de facto* peg to the U.S. dollar remained in place until July 21, 2005, when China announced a one-time 2.1-percent revaluation of the renminbi to a rate of 8.11 renminbi/U.S. dollar¹⁵² In taking this measure, China appears to have been moved by the international community's widening chorus of exhortations that the renminbi be allowed by the Chinese central government to strengthen.

4. Revaluation: July 2005 to the Present

With the renminbi's revaluation relative to the U.S. dollar in July 2005, China stressed that it was terminating the renminbi's peg to the U.S. dollar and that the renminbi's value would henceforth reflect a weighted basket of currencies, the contents and weightings of which were not explicitly made public and remain unclear to the present. In addition, the number of participants in China authorized to trade the renminbi was increased.¹⁵³ Under China's new exchange-rate policy, designated traders such as banks and large enterprises in China are to buy and sell renminbi on the central currency exchange. China's central government through its

¹⁵⁰ Goodfriend, Marvin and Eswar Prasad, "A Framework for Independent Monetary Policy in China," at 22-23 (IMF Working Paper WP/06/111, May 2006).

¹⁵¹ *Id.* at 25.

¹⁵² Barboza, David and Joseph Kahn, "China Says It Will No Longer Peg Its Currency to the U.S. Dollar" (N.Y. Times, July 21, 2005).

¹⁵³ "People's Republic of China, 2006 Article IV Consultation - Staff Report," at 16 (IMF, Oct. 2006).

financial arm, the PBC, is no longer a direct participant in the market, but is now a client of the traders. However, the PBC's size and governmental influence mean that China's political leadership retains control over the renminbi's rates of exchange.¹⁵⁴

At first, the Chinese government restricted the daily movement of the renminbi to a narrow band of no more than 0.3% higher or lower relative to the U.S. dollar. In May 2007 the range of trading was increased to +/- 0.5%. In contrast to the previous *de facto* peg, following the revaluation in July 2005 the renminbi has slowly appreciated in nominal terms relative to the U.S. dollar and, as of early September 2008, had reached a level of approximately 6.8 renminbi/U.S. dollar. Yet, this modest nominal strengthening of the renminbi points toward a disproportionately heavy weighting of the U.S. dollar in China's basket of currencies. The U.S. dollar has rapidly depreciated against many other currencies, but not by as much *vis-à-vis* the renminbi, even as the pressure on the renminbi to appreciate has grown due to China's burgeoning exports and rising inflows into China of foreign currencies.¹⁵⁵ Moreover, on a trade-weighted, fundamental-equilibrium-exchange-rate basis, recent estimates conclude the renminbi remains undervalued relative to the U.S. dollar by about 30 percent.¹⁵⁶ The Chinese government insists that its control of the pace of liberalization of China's exchange-rate system is warranted in light of China's history of poverty, colonial subjugation, and civil wars.¹⁵⁷

C. Measures Employed by China in Lieu of Market Forces to Control the Renminbi's Rate of Exchange Vis-à-Vis Foreign Currencies and the Rate of Inflation in China

As just discussed, after various, sometimes inconsistent efforts during the approximately three decades of the post-Mao era, the Chinese government since the mid-1990s has had an established exchange-rate policy under which China's national authorities very deliberately have set the relative value of the renminbi by means of governmental measures rather than through the workings of the market. Based upon the Chinese government's actions and evident resolve, there seems little chance at this juncture that China's leaders will revise this stance at anytime in the foreseeable future, barring some dramatic change in conditions or events. Aside from the questions of why and with what effect China has taken this fundamental decision, therefore, there is the matter of how China actually accomplishes – essentially by governmental fiat – the task of overriding the market's forces and determining the renminbi's worth relative to other countries' currencies. An evaluation of the mechanics, so to speak, and the extensive

¹⁵⁴ Id.

¹⁵⁵ Morrison, Wayne M. and Marc Labonte, "China's Currency: Economic Issues and Options for U.S. Trade Policy," at 10 (Cong. Research Service, Jan. 9, 2008).

¹⁵⁶ "Estimation of the Fundamental Misalignment of the Chinese Renminbi" (The China Currency Coalition, July 2008), available at www.chinacurrencycoalition.org; and Cline, William R. and John Williamson, "New Estimates of Fundamental Equilibrium Exchange Rates," Policy Brief Number PB08-7 (Peterson Institute for International Economics, July 2008).

¹⁵⁷ Steven R. Weisman, "China and U.S. Clash at Trade Talks" (International Herald Tribune, Dec. 14, 2006), available at <http://www.iht.com/articles/2006/12/14/business/trade.php>.

arrangements relied upon by China to undervalue the renminbi is instructive in its own right and as a way of gaining insight into this practice for purposes of more fully appreciating the monetary-trade interrelationship and hybrid nature of currency undervaluation.

1. China's Basic Regulation on Foreign Exchange

China's basic regulation on the management of foreign exchange dates from 1996, has been amended twice since then (in January 1997 and, more recently, in August 2008), and is administered by the People's Bank of China and the State Administration of Foreign Exchange.¹⁵⁸ These FOREX Rules are sweeping in their reach and lay down the framework and essential guidelines by which the Chinese government monitors and controls the flow of currency into, out of, and within China. In practice, this oversight means that the Chinese central government can insulate the renminbi to a great degree from the market's pressures and undervalue the renminbi relative to the values of the currencies of China's trading partners. As the articles next highlighted illustrate, the current version of the FOREX Rules continues to vest extensive powers in the People's Bank of China and the State Administration of Foreign Exchange.

- Article 7 - All foreign-exchange transactions or changes in foreign-exchange accounts must be reported to the foreign-exchange administration.
- Article 8 - All foreign currencies are prohibited from circulating within China. The prices of Chinese goods cannot be quoted in foreign currency unless the government states otherwise.
- Article 9 - The Chinese government holds the power to decide when and how foreign currency earned by domestic companies operating overseas may be repatriated.
- Article 11 - In the event or the possible event of a "serious disequilibrium" in China's balance of payments with China's trading partners or a "severe crisis" of the national economy, the government may impose currency safeguards, controls, or other necessary measures.
- Article 12 - Financial institutions engaging in foreign-exchange transactions must examine foreign-exchange receipts and expenditures against import and export licenses or against the customs declarations for imports and exports.
- Article 19 - All bonds or guarantees issued outside China must be approved by the government.

¹⁵⁸ State Council of the People's Republic of China, "Rules of the People's Republic of China on Foreign Exchange Control (Jan. 29, 1996, amended Jan. 4, 1997, and Aug. 5, 2008), current version [available at www.pbc.gov.cn/english/showaccdoc.asp?col=6400&id=1088](http://www.pbc.gov.cn/english/showaccdoc.asp?col=6400&id=1088) ("FOREX Rules"). As part of this revision to the FOREX Rules, the PBC also announced the formation of a new Foreign Exchange Department within the PBC that expands and builds upon the previous Exchange Rate Policy Division of the PBC's Monetary Policy Department.

- Article 20 - Lending by Chinese non-banking institutions to institutions or individuals outside China must be approved by the Chinese government.
- Article 32 - The foreign-exchange administration may intervene in the Chinese foreign-exchange market to reduce the volatility of this market.
- Article 33 - The foreign-exchange administration may inspect the records of any foreign-exchange operation in China or any operation suspected of illegal foreign-exchange operations in China.

With these extraordinary powers, China's government clearly is in a position to seal off foreign currencies – as much or as little as it chooses at any given time – from the Chinese domestic market. This segregation allows the Chinese government to intervene effectively in the foreign-exchange markets to undervalue the renminbi.

2. The Chinese Government's Intervention in the Exchange Markets to Control the Renminbi's Relative Value

As observed above, China officially ended its de facto peg of the renminbi to the U.S. dollar on July 21, 2005, but has continued to manage the renminbi's foreign-exchange rate by means of persistent and heavy interventions in foreign-exchange markets and through controls on capital movements and currency holdings.¹⁵⁹ These direct interventions require the Chinese government to print enormous amounts of renminbi in order to be able to buy on domestic foreign-exchange markets the huge numbers of U.S. dollars and other foreign currencies that are obtained from China's exports and FDI in China.¹⁶⁰ These interventions increase both the supply of renminbi and the demand for U.S. dollars, thus strengthening the U.S. dollar's value relative to the renminbi's value. Put another way, China's currency interventions result in a weakening of the renminbi against the U.S. dollar.

China's policy of protracted, large-scale intervention in the exchange markets has had two principal consequences. First, China has been accumulating massive foreign reserves due to the Chinese government's purchases of the increasing numbers of U.S. dollars that have been entering China each year. As of May 2008, as discussed further below in Section IV.D., it is estimated that China's foreign reserves were approximately \$1.8 trillion.¹⁶¹ Second, in order to earn interest on China's accumulation of foreign reserves, China purchases low-risk, dollar-denominated assets. Historically, the Chinese government has mostly used its foreign reserves to

¹⁵⁹ U.S. Department of the Treasury, "Report to Congress on International Economic and Exchange Rate Policies," at 32 (Dec. 2007).

¹⁶⁰ Id.

¹⁶¹ See, e.g., The London Telegraph, "Beijing Swells Dollar Reserves Through Stealth" (Aug. 26, 2008). Official reserves increased by \$462 billion in 2007 and by \$154 billion in the first quarter of 2008. U.S. Department of the Treasury, "Report to Congress on International Economic and Exchange Rate Policies," at 2 (May 2008).

purchase U.S. Treasury securities.¹⁶² The Chinese government's accumulation of large foreign-exchange reserves held in U.S. Treasury bonds entails an opportunity cost for China, because these funds could be invested elsewhere, such as in infrastructural development in China or in investments with higher rates of return.¹⁶³

3. Inflation and "Sterilization" in China as Consequences of the Chinese Government's Intervention in the Exchange Markets

China's intervention in the exchange markets increases the quantity of renminbi that is in circulation and available for spending in China. This growth in the supply of renminbi, without a coincident expansion in the availability of goods or productivity-enhancing investments, leads to inflation. In an attempt to hold inflation in check, the Chinese government resorts to several methods that collectively are referred to typically as "sterilization." These measures by the Chinese government include (a) the issuance of renminbi-denominated debt in the form of bonds; (b) a requirement that Chinese banks maintain increasing amounts of currency reserves; and (c) "window guidance" by which Chinese banks are strongly encouraged to slow their pace of lending to borrowers in China.

a. "Sterilization" Bonds

The Chinese government's issuance of renminbi-denominated debt is critical to China's ability to limit inflation. When these bonds are purchased by banks and private investors in China, the newly printed renminbi are taken out of circulation. China's cost to issue "sterilization" bonds continues to rise. In its efforts to limit inflation, the Chinese government must ensure that there is a domestic market in China for its bonds to support the "sterilization" process. However, sustaining the market for "sterilization" bonds becomes a delicate and more expensive balancing act over time. As the Chinese government issues more bonds to Chinese banks and to private Chinese investors in order to "sterilize" the Chinese government's purchases of foreign currencies, the increase in the supply of bonds forces the Chinese government to pay greater yields to the Chinese investors.¹⁶⁴ Increasing the return on the bonds increases the cost of "sterilization" in renminbi, because more renminbi are needed for future payments by the Chinese government to the investors.¹⁶⁵

¹⁶² There is also the possibility that the Chinese government has bought securities of Fannie Mae and Freddie Mac. Morrison, Wayne M. and Marc Labonte, "China's Currency: Economic Issues and Options for U.S. Trade Policy," at 9 (Cong. Research Service, Jan. 9, 2008).

¹⁶³ Morrison, Wayne M. and Marc Labonte, "China's Currency: Economic Issues and Options for U.S. Trade Policy," at 28 (Cong. Research Service, Jan. 9, 2008).

¹⁶⁴ Thus, for example, the yields on the Chinese government's bonds issued in 2007 increased from 2.5 percent to 3.3 percent. U.S. Department of the Treasury, "Report to Congress on International Economic and Exchange Rate Policies," at 32 (May 2008).

¹⁶⁵ In addition, if interest rates rise to high enough levels, the Chinese government runs the risk that the bonds will attract illegal foreign investment, contrary to Article 7 of the FOREX Rules noted earlier. If not offset by some other means, these inflows in foreign investment would (...continued)

b. Reserve Requirements for Chinese Banks

As a second technique to minimize inflation attributable to the Chinese government's intervention in the exchange markets, the People's Bank of China and the State Administration of Foreign Exchange restrict the growth of the money supply by increasing the renminbi-denominated reserve requirements for banks in China.^{166, 167} The decrease in the amount of renminbi that consequently is available for lending slows the speed of consumption and investment in China and thereby eases inflationary pressures.¹⁶⁸

c. "Window Guidance"

As a more direct measure to minimize inflation, since 2003 the Chinese government has provided "window guidance" to Chinese banks on a monthly basis.¹⁶⁹ "Window guidance" describes requests by Chinese governmental officials that representatives of commercial banks in China avoid excessive expansion of credit while at the same time not dampening China's

(...continued)

strengthen the renminbi. As foreign investors converted their currencies into renminbi to buy renminbi-denominated bonds, the increased demand would push up the renminbi's value against the foreign currencies. Such a strengthening of the renminbi, of course, would undercut the Chinese government's purpose of undervaluing the renminbi by interventions in the exchange markets. See, e.g., The Economist, "Lost in Translation" (May 17, 2007).

¹⁶⁶ U.S. Department of the Treasury, "Report to Congress on International Economic and Exchange Rate Policies," at 33 (May 2008).

¹⁶⁷ There were six reserve increases in the first half of 2007 alone. *Id.*

¹⁶⁸ A recent study by HSBC reportedly has concluded that banks in China also have been required over the last year to hold extra reserves in U.S. dollars rather than in renminbi. The London Telegraph, "Beijing Swells Dollar Reserves Through Stealth" (Aug. 26, 2008), available at <http://www.telegraph.co.uk/money/main.jhtml?xml=/money/2008/08/26/ccchina126.xml>. If so, while details are sparse, it is possible that mandatory extra holdings in U.S. dollars force the Chinese banks to bid up the renminbi-denominated value of the U.S. dollar. Moreover, given that the renminbi used by the Chinese banks already are in circulation in China, the Chinese government does not have to print additional renminbi for the Chinese banks to purchase these additional U.S. dollars. The impact of these two related steps together is that the supply of renminbi circulating in China should be significantly less overall than if the U.S. dollar reserves were not required of the Chinese banks and if the Chinese government was itself purchasing the U.S. dollars with newly-printed renminbi. Once again, inflationary pressures on the renminbi would be reduced.

¹⁶⁹ U.S. Department of the Treasury, "Report to Congress on International Economic and Exchange Rate Policies," at 33 (May 2008).

economic momentum.¹⁷⁰ How closely or not the Chinese government's advice is heeded by commercial banks in China is difficult to ascertain.

4. Summary

As seen in China's FOREX rules, China's ability to set the relative value of its currency derives from China's system of capital controls. These FOREX Rules insulate the renminbi for the most part from economic pressures to appreciate and thereby allow the Chinese government to intervene in the exchange markets effectively. By having intervened for years and years in the exchange markets and having bought on a very large scale U.S. dollars and other foreign currencies in exchange for renminbi, the Chinese government has prevented the renminbi from reaching its equilibrium level on a trade-weighted basis relative to the currencies of other nations, not least the U.S. dollar. Moreover, this intervention by the Chinese government has contributed substantially to excessive, renminbi-denominated liquidity in China and a serious problem with inflation that could become worse. In an effort to keep inflation at bay as much as possible, the Chinese government has relied upon "sterilization" bonds, increasingly strict reserve requirements for Chinese banks, and "window guidance" to Chinese banks. When all is said and done, therefore, it is abundantly evident that China has taken for a long time, and continues to take, extraordinary measures that enforce the renminbi's undervaluation on a trade-weighted basis relative to other countries' currencies, including the U.S. dollar.

D. The Extent of the Renminbi's Undervaluation

As seen, the Chinese government devotes considerable time, effort, and resources to measures designed to undervalue the renminbi. Given this focus by China, it is not surprising that the renminbi has been and remains, in fact, significantly undervalued relative to the currencies of its trading partners. As the U.S. Department of the Treasury has observed, "Exchange rate analysis is inherently complex."¹⁷¹ Even so, there are widely recognized and accepted indicators of undervaluation and methodologies that reasonably quantify the degree of a currency's undervaluation. In particular, there are core indicators and methodologies that are subscribed to by both the IMF and the U.S. Department of the Treasury and that confirm the renminbi's undervaluation.

Thus, both the U.S. Department of the Treasury and the IMF consider the following indicators in evaluating whether a country's currency is undervalued: (1) capital controls and restrictions on payments; (2) protracted, large-scale intervention in one direction in the exchange

¹⁷⁰ See "Trade Policy Review: Report by the Secretariat – People's Republic of China," at 13, ¶ 17 (WT/TPR/S/161, Feb. 28, 2006).

¹⁷¹ U.S. Department of the Treasury, "Report to Congress on Implementation of the International Monetary Fund's 2007 Decision on Bilateral Surveillance Over Members' Policies," at 1 (August 2008).

markets; (3) rapid accumulation of foreign-exchange reserves; (4) large, sustained trade and current-account balances; and (5) econometric estimates of any undervaluation.^{172, 173}

In terms of applying these core indicators to China's circumstances, the picture that emerges is quite unequivocal that the renminbi is markedly undervalued.

First, as to capital controls and restrictions on payments, China's far-reaching FOREX Rules are noted above in Section IV.C.1. As mentioned there, the Chinese government's capital controls essentially exclude foreign currencies from being used in the Chinese domestic market (Article 8) and preclude renminbi from being exchanged for foreign currencies unless approved by the Chinese authorities responsible for foreign exchange (Article 12). This segregation of currencies is critical to the ability of China to control the renminbi's value. Moreover, the sweeping nature and breadth of the FOREX Rules have necessitated extensive implementing regulations that cover a wide variety of topics and situations ranging from a stipulation that a Chinese individual may purchase the foreign-exchange equivalent of no more than U.S.\$50,000 per year¹⁷⁴ to the condition that a foreign firm may own no more than 33 percent of the equity of a domestic Chinese investment bank.¹⁷⁵

Second, the Chinese government's interventions in the exchange markets have been protracted, on a large scale, and in one direction. China's authorities consistently have been purchasing large quantities of U.S. dollars and other foreign currencies since at least 2001,¹⁷⁶ and

¹⁷² U.S. Department of the Treasury, "Report to the Committees on Appropriations on Clarification of Statutory Provisions Addressing Currency Manipulation" (March 11, 2005), available at http://www.ustreas.gov/press/releases/js2308.htm#_ftnref6; and IMF, "Bilateral Surveillance Over Members' Policies: Executive Board Decision," Public Information Notice (PIN) No. 07/69 (June 21, 2007), available at <http://www.imf.org/external/np/sec/pn/2007/pn0769.htm#decision>.

¹⁷³ Both the U.S. Department of the Treasury and the IMF acknowledge a sixth factor, that of the intent of the country that has the undervalued currency and, more specifically, whether the country has "manipulated" its currency with the intent of preventing effective balance-of-payments adjustment or of gaining an unfair competitive advantage over other countries. See *id.*; and Article IV.1(iii) of the IMF's Articles of Agreement. A currency, in other words, can be undervalued but not "manipulated" in the sense just described. This section addresses only undervaluation and so does not further discuss "manipulation" and the factor of intent.

¹⁷⁴ State Administration of Foreign Exchange, "The Circular of the State Administration of Foreign Exchange Concerning the Printing and Distribution of the Detailed Rules for Implementing the Measures for the Administration of Personal Foreign Exchange," at Art. 2 (Jan. 5, 2007).

¹⁷⁵ U.S. Foreign and Commercial Service, "Doing Business in China: A Country Commercial Guide," at 119 (Feb. 27, 2008).

¹⁷⁶ "Trade Policy Review: Report by the Secretariat – People's Republic of China," at 12, ¶ 15 and Chart I.1 (WT/TPR/S/161, Feb. 28, 2006).

the U.S. Department of the Treasury has expressed its agreement that persistent and heavy interventions by China in the exchange markets have played an important role in the PBC's ability to achieve strict management of the renminbi's value versus the U.S. dollar.¹⁷⁷ Indeed, one observer estimated in early 2007 that the Chinese government had been buying in the exchange markets \$15 - \$20 billion per month for several years in order to maintain a low value for the renminbi relative to the value of the U.S. dollar.¹⁷⁸ Given that China's foreign-exchange reserves have grown substantially in 2007 and 2008 to date, it is probable that China's purchases of U.S. dollars in the exchange markets have increased considerably during that period compared with the pace in the prior years. The Chinese government's consistent purchasing of U.S. dollars constitutes intervention in one direction in the exchange markets.

Third, China has rapidly accumulated huge quantities of foreign reserves. China's foreign-exchange reserves rose from approximately \$700 billion as of the second quarter of 2005 to nearly \$1.8 trillion as of May 2008.¹⁷⁹ In the first five months of 2008, China's reported reserves increased by \$269 billion, 20 percent more than the foreign reserves accumulated by China in the same period of 2007.^{180, 181} To put matters in perspective, it has been estimated that China at this juncture is accumulating foreign reserves at the remarkable rate of \$100 million per hour, and the speed of accumulation shows no sign of slowing down.¹⁸²

¹⁷⁷ U.S. Department of the Treasury, "Report to Congress on International Economic and Exchange Rate Policies," at 32 (Dec. 2007).

¹⁷⁸ C. Fred Bergsten, "The Chinese Exchange Rate and the U.S. Economy," at 1 (Jan. 31, 2007).

¹⁷⁹ IAS Group Ltd., "Appreciation of the Renminbi: What's Happened – and What Hasn't," at 7 (July 2008).

¹⁸⁰ The Economist, "Hot and Bothered" (June 26, 2008), available at http://www.economist.com/finance/displaystory.cfm?story_id=11639442. While perhaps \$170 billion of the \$265 billion represent "hot money" or foreign exchange from investors outside China speculating on a significant revaluation of the renminbi in the relatively short-term, *id.*, these speculative inflows represent added demand for the renminbi. If China's government, therefore, would simply allow the market to work, the renminbi's relative value would increase.

¹⁸¹ China's reported foreign reserves appear to understate the true amount of China's accumulated foreign reserves for two reasons. First, China's reported foreign-exchange reserves do not include foreign reserves that are transferred by China's central government to China's sovereign wealth fund, the China Investment Corporation. The World Bank, "China Quarterly Update," at 6 (June 2008). Second, as commented in footnote 168 above, it has recently come to light that the Chinese government requires investment banks in China to hold substantial quantities of U.S. dollars as reserves. It seems likely that these U.S. dollars are not included in China's reported foreign reserves, but properly should be reported.

¹⁸² See The Economist Intelligence Unit Views Wire, "An Embarrassment of Riches" (June 10, 2008), available at http://www.economist.com/agenda/displaystory.cfm?story_id=11526752.

Fourth, China has large, sustained trade and current-account balances that have grown for over a decade.¹⁸³ China's global trade surplus rose from \$9 billion in 1990 to \$178 billion in 2006.¹⁸⁴ China's current-account surplus grew over the span of 1995 to 2006 from 0.2 percent to 9 percent of China's GDP.¹⁸⁵ Relying upon the Chinese government's official import and export data, the IMF has reported that this trend continued in 2007 when China's current-account balance reached a record high surplus of \$315 billion.¹⁸⁶ According to the World Bank, China's current-account surplus has risen even further in 2008.¹⁸⁷

Fifth, and finally, econometric estimates show that the renminbi is strikingly undervalued both on a bilateral basis with the U.S. dollar and on a multilateral basis relative to the currencies of China's major trading partners. More specifically, as noted earlier, two recent studies – one by the China Currency Coalition and the other by the Peterson Institute for International Economics – have each found that the renminbi is approximately 30 percent undervalued relative to the U.S. dollar on a real-exchange-rate basis as of February 2008.¹⁸⁸ Each study derives its bilateral renminbi-U.S. dollar exchange rate from calculations of the renminbi's trade-weighted, real-effective-exchange-rate with the currencies of China's trading partners.¹⁸⁹ Relying upon

¹⁸³ Elwell, Craig, Mark Labonte, and Wayne Morrison, "Is China a Threat to the U.S. Economy?" at 31 (Cong. Research Service, Jan. 23, 2007). It also should be noted that, in recent years, China's official trade data have shown current account surpluses that are significantly smaller than those based on the trade data of China's trading partners. This skewing takes place because the Chinese government's official data regularly have understated China's reported exports and overstated China's reported imports. These discrepancies persist even after adjustment for trade routed through Hong Kong and adjustment for the inclusion of transport costs in import-value data. Therefore, official Chinese current-account data appear to understate the size of China's current-account surplus. See Magrath, Patrick J., Matthew M. Kemper, and Yan Chun Liu, China's Global Trade Balance Discrepancy: Hong Kong Entrepot Effects and Round-Tripping Chinese Capital (Sept. 2008).

¹⁸⁴ Id. at 6.

¹⁸⁵ Morrison, Wayne M. and Marc Labonte, "China's Currency: Economic Issues and Options for U.S. Trade Policy," at 9-10 (Cong. Research Service, Jan. 9, 2008).

¹⁸⁶ "The International Financial Statistics," at 304 (IMF, Aug. 2008). Again, for the reasons noted in footnote 183, it is believed that the \$315 billion figure taken from the Chinese government's official import and export data is an understatement of China's current-account balance in 2007.

¹⁸⁷ The World Bank, "China Quarterly Update," at 13 (June 2008).

¹⁸⁸ "Estimation of the Fundamental Misalignment of the Chinese Renminbi," at 2 (The China Currency Coalition, July 2008), available at www.chinacurrencycoalition.org; and Cline, William R. and John Williamson, "New Estimates of Fundamental Equilibrium Exchange Rates," at 9, Policy Brief Number PB08-7 (Peterson Institute for International Economics, July 2008).

¹⁸⁹ Id.

somewhat different methodologies, the China Currency Coalition has reckoned that the renminbi's REER is 11.8 percent undervalued, whereas the Peterson Institute for International Economics has found that the renminbi's REER is 18.4 percent undervalued.¹⁹⁰

To recapitulate, then, the five relevant indicators of undervaluation that the U.S. Department of the Treasury and the IMF employ in their analyses of currencies' exchange rates all point toward significant undervaluation of China's renminbi.

E. Ways in Which the Persistent Undervaluation of China's Currency Has Been Detrimentially Affecting the United States and China and Is Likely to Continue Doing So

1. Introduction

China's persistent undervaluation of the renminbi has harmed the U.S.'s manufacturing sector and China's financial and banking sectors. More particularly, the renminbi's undervaluation (1) distorts in China's favor pricing in the import-export markets between the United States and China, (2) adversely affects U.S. trade and current-account deficits with China, (3) increases the vulnerability of the United States to economic shocks, and (4) runs the risk that the United States might react to China's governmentally-skewed international trade by curtailing truly market-driven and beneficial international trade.

China's economy and physical environment also are being damaged as a consequence of the Chinese government's undervaluation of the renminbi. China's monetary policies aimed at lowering the relative value of China's currency are retarding the development of China's banking and financial system. China's undervalued currency is contributing as well unsustainably to excessive production of goods in China while at the same time decreasing the buying power of consumers in China.

¹⁹⁰ While measurement of a currency's equilibrium value relative to other currencies is a demanding task, therefore, careful reliance upon accepted methodologies and public data that are officially maintained by governments and international institutions does yield very reasonable and dependable evaluations of a currency's undervaluation in relation to other currencies. The two methodologies that are the most widely accepted by economists for this purpose are the macroeconomic-balance approach and the reduced-form-real-exchange-rate approach. Indeed, the IMF considers these two methodologies to be reliable for its currency-surveillance operations. See Lee, Jaewoo, Gian Maria Milesi-Ferretti, and Lucia Ricci, "Methodology for CGER Exchange Rate Assessments" (IMF 2006).

The China Currency Coalition's study accordingly used publicly available data compiled by the World Bank and the IMF and took the straight average of the results of the macroeconomic-balance approach and the reduced-form-real-exchange-rate approach to measure the renminbi's undervaluation. Similarly, the Peterson Institute's study incorporated a variation of the macroeconomic-balance approach.

In short, China's policy of competitive currency depreciation is causing serious harm and is doing no one any lasting good. On the other hand, if China were willing to trust market forces to set the renminbi's relative value, that decision would help the United States to make the transition to a sustainable trade position and would begin to undo the damage that China has inflicted on its own economy and people. Should the undervaluation of the renminbi continue, the grave consequences already sustained by the United States and China likely will seriously worsen.

2. Direct Harm to the U.S. Economy

China's undervaluation of its currency relative to the U.S. dollar acts as an implicit subsidy to Chinese exports to the United States.¹⁹¹ Because U.S. manufacturers do not receive a similar subsidy, they are put at a competitive disadvantage in the U.S. market against Chinese manufacturers who export to the United States.¹⁹² Similarly, the artificially low value of the renminbi relative to the U.S. dollar makes goods manufactured in the United States more expensive compared to Chinese goods in the Chinese market. The relative increase in price for U.S. manufacturers exporting to China acts as an import tariff on U.S. goods going into China.¹⁹³

3. Indirect Harm to the U.S. Economy

The competitive advantages just noted for Chinese producers, gained by the undervaluation of the renminbi relative to the U.S. dollar, have led to several deleterious effects on the U.S. economy. First, China's advantages have contributed to the large and growing U.S. trade deficit with China.¹⁹⁴ The U.S.'s bilateral trade deficit with China contributes to the growth of the U.S.'s global trade deficit, which in turn leads to an increase of the U.S. global current-account deficit.^{195, 196} The demands placed on the U.S. economy by the continual growth

¹⁹¹ Ben S. Bernanke, "The Chinese Economy: Progress and Challenges," Speech Given at the Chinese Academy of Social Sciences (Beijing, China, Dec. 15, 2005), available at <http://www.federalreserve.gov/newsevents/speech/bernanke20061215a.htm>.

¹⁹² See Section II.C. for more detail on the underlying economic theory.

¹⁹³ Id.

¹⁹⁴ Id.

¹⁹⁵ Current Account Balance = Trade Balance + Grants Received or Given + Investment Income + Remittances by Domestic Workers to Foreign Countries. The direct relationship between the Trade Balance and the Current Account means that any increase in the U.S. trade deficit contributes to an increase in the U.S. current-account deficit.

¹⁹⁶ Some economists argue that China's contribution to the U.S.'s trade and current-account deficits comes not through undervaluation, but only as the result of too much saving by China and too much spending by the United States. While the two countries' different rates of saving are germane, an explanation of China's contribution to the U.S. current-account deficit that excludes undervaluation is incomplete. Undervaluation gives Chinese manufacturers a price advantage and gives an incentive and the ability, therefore, to U.S. consumers to buy more
(...continued)

of the U.S. current-account deficit (growth which is in no small part due to China's undervaluation of the renminbi) are becoming unmanageable for the United States.¹⁹⁷ In 2007, the U.S. had to pay \$8 billion in principal and interest every day to finance the U.S. current-account deficit and foreign direct investments made by U.S. persons in foreign countries.¹⁹⁸ As the deficit grows, the amount needed to finance the deficit also grows. At some point, investors in U.S. debt probably will question the U.S.'s ability to finance its debt, which could lead to a reassessment of the creditworthiness of the United States. At that point, investors either will not invest in U.S. debt or will demand a higher rate of return as a risk premium, raising the U.S.'s cost of capital and U.S. debt even more.

In either case, higher returns on U.S. debt would contribute to higher interest rates offered by U.S. lending institutions. The increase in interest rates would slow interest-sensitive investments in the U.S. in production facilities, capital equipment, and housing, which are key to the health of the U.S. economy. In short, if the renminbi continues to be undervalued significantly relative to the U.S. dollar, the consequence almost surely will be increasingly detrimental to the U.S. economy.

Second, in the medium run, the renminbi's undervaluation undermines U.S. exporters and U.S. producers that must try to compete with low-priced imports from China.^{199, 200} U.S.

(...continued)

Chinese goods than if the renminbi were realistically valued by the market. By the same token, the renminbi's undervaluation means as a practical matter that Chinese consumers generally cannot afford to buy as many manufactured goods from the United States and other countries as they could if the renminbi were properly valued. In addition, by contributing to the weakness of China's banking and financial system and that system's low rates of return (which are kept low by the Chinese government in order to enforce the renminbi's undervaluation), the renminbi's undervaluation also makes investing funds in that system by China's companies unattractive. Instead, therefore, Chinese companies tend to reinvest those funds in their own companies' operations. Thus, the U.S. trade and current-account deficits are increased directly by the renminbi's undervaluation.

¹⁹⁷ Ahearne, Alan and William Cline, Kyung Tae Lee, Yung Chul Park, Jean Pisani-Ferry, and John Williamson, "Global Imbalances: Time For Action," at 4, Policy Brief Number PB 07-4 (Peterson Institute for International Economics, Mar. 2007).

¹⁹⁸ C. Fred Bergsten, "The Chinese Exchange Rate and the U.S. Economy" (Jan. 31, 2007), available at <http://www.iie.com/publications/papers/paper.cfm?ResearchID=706>.

¹⁹⁹ Elwell, Craig, Mark Labonte, and Wayne Morrison, "Is China a Threat to the U.S. Economy?" at 41 (Cong. Research Service, Jan. 23, 2007). Some commentators have suggested that U.S. and Chinese manufacturers do not compete directly, contending that Chinese manufacturers produce goods that are labor-intensive while U.S. production is more technology-intensive. Yet, China is quickly moving up the technology ladder, so that even industries like the automobile industry that are not currently competing directly with China soon will be.

²⁰⁰ Some economists argue that China maintains a trade advantage over the U.S. due to low salaries of China's work force. However, profit (and therefore trade advantage) is decided not (...continued)

producers have been forced to close down factories and lay off workers.^{201, 202} Layoffs are particularly harsh on smaller towns. Unlike layoffs in larger, more economically diverse cities, the closing of one medium-sized factory in a small town can be devastating as the effects ripple through that town's economy,²⁰³ resulting in dramatic job losses, shuttered factories, and the near devastation of some rural economies.²⁰⁴ The effect of the renminbi's undervaluation goes far beyond rural towns. On a nationwide basis, manufacturing workers account for a disproportional share of workers who have lost their jobs.²⁰⁵ Workers from the manufacturing sector displaced by trade, historically, have had difficulty finding comparable employment elsewhere.²⁰⁶

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by the lowest hourly rates, but by the lowest unit labor cost, that is, the lowest cost per item produced per unit of time. In most cases unit labor costs in low-wage countries like China are at least a substantial percentage of U.S. unit labor costs and in some cases actually exceed the U.S. level. In addition, if China's relatively greater costs of infrastructure, materials, and energy are considered, then China quite possibly does not have an absolute cost advantage over the U.S. producers. Unfortunately, a lack of data from China in these respects prevents confirmation of this point. Elwell, Craig, Mark Labonte and Wayne Morrison, "Is China a Threat to the U.S. Economy?" at 31 (Cong. Research Service, Jan. 23, 2007.)

²⁰¹ Manufactured goods make up about 80 percent of international trade but only 18 percent of U.S. GDP, so factors that affect international trade probably will be more strongly felt in the manufacturing sector than in the wider U.S. economy. Elwell, Craig, Mark Labonte and Wayne Morrison, "Is China a Threat to the U.S. Economy?" at 27 (Cong. Research Service, Jan. 23, 2007.)

²⁰² It has been argued that, even without China's currency policies, there would still be an ongoing loss of U.S. jobs to international producers outside China, particularly companies in other Asian countries. This argument ignores, however, China's influence on the relative values of other Asian countries' currencies. While this impact is not easy to measure, the sheer size of China's population and economy and the renminbi's substantial undervaluation have pressured other Asian countries especially to undervalue their own currencies in an attempt to remain competitive with China. See U.S. Department of the Treasury, "Report to Congress on International Economic and Exchange Rate Policies," at 2 (May 2008); and Cline, William R. and John Williamson, "New Estimates of Fundamental Equilibrium Exchange Rates," Policy Brief Number PB08-7 (Peterson Institute for International Economics, July 2008). Furthermore, the Congressional Budget Office estimates that two-thirds of China's market share in the United States of manufactured goods represents additional production by China and not a loss of U.S. market share by other Asian producers. Congressional Budget Office, "How Changes in the Value of the Chinese Currency Affect U.S. Imports," at 2 (July 2008).

²⁰³ U.S.-China Economic and Security Review Commission, "2007 Report to Congress," at 70 (Nov. 2007.)

²⁰⁴ Id. at 63.

²⁰⁵ Bureau of Labor Statistics, "Displaced Worker Summary: Worker Displacement 2003-2005," (Aug. 17, 2006).

²⁰⁶ Id.

This loss of jobs jeopardizes the U.S. ability to maintain a base of skilled workers in critical manufacturing fields. As American companies have shut down or moved operations abroad, often to China, the jobs lost have included positions in highly specialized areas.²⁰⁷ Skills for some of these jobs are so advanced that it has taken workers years and even generations to acquire those skills through concentrated training and on-the-job apprenticeship. Lay-offs in U.S. manufacturing attributable to off-shoring have resulted in fewer Americans being trained in these fields.²⁰⁸ If the United States, therefore, for whatever reason, were to have the opportunity or need to manufacture in the United States any products requiring specialized knowledge and skills that have been lost, the United States would be in a very awkward, possibly dangerous position and could be caught short.

Third, and lastly, international trade based upon comparative advantage is broadly recognized as being beneficial for all concerned. Unfair trade practices, on the other hand, such as China's undervaluation of the renminbi, do not rest upon any comparative advantage and consequently distort international trade ultimately to no one's advantage. Overvaluation of the U.S. dollar and U.S. trade deficits historically have triggered resistance by the U.S. public to open trade policies. China's undervaluation of the renminbi runs the considerable risk of generating the same sort of reaction.²⁰⁹

4. Harm to China's Economy and Environment

China's economy is also detrimentally affected by the Chinese government's enforced undervaluation of the renminbi relative to the currencies of its trading partners. This policy has left its economy, in the words of China's Premier, Wen Jiabao, unstable, unbalanced, uncoordinated, and unsustainable.²¹⁰ By *unstable*, Premier Wen was referring to excess investment and liquidity and to China's sharply widening current-account surplus. By *unbalanced*, he was alluding to China's economic disparities between China's urban and rural cities and also between China's more wealthy Eastern region and China's less developed Western region. By *uncoordinated*, Premier Wen was drawing attention to the divergence of China's booming manufacturing sector from China's undeveloped services sector and also to the disparities between excess investment and deficient consumption in China. And by *unsustainable*, he was referring to the environmental degradation and overuse of natural

²⁰⁷ For example, these professions include toolmaking, shipbuilding, and aircraft production. U.S.-China Economic and Security Review Commission, "2007 Report to Congress," at 53 (Nov. 2007.)

²⁰⁸ Id.

²⁰⁹ C. Fred Bergsten, "The Chinese Exchange Rate and the U.S. Economy" (Jan. 31, 2007), available at <http://www.iie.com/publications/papers/paper.cfm?ResearchID=706>.

²¹⁰ Stephen S. Roach, Testimony Given at the Senate Finance Committee's Hearing on "Risks and Reforms: The Role of Currency in the U.S.-China Relationship" (Mar. 28, 2007).

resources that has accompanied China's rapid growth.²¹¹ Premier Wen's analysis is insightful and correct.

China's exchange-rate policy has helped to cripple its banking sector, leading to excess liquidity and overinvestment in China's stock and housing markets. As Section IV.C. explained, at the heart of the Chinese government's control of the relative value of the renminbi is its intervention in the exchange markets and its "sterilization" of the renminbi printed to facilitate the intervention. To limit the cost of "sterilization" and to discourage inflows into China of foreign currencies by speculators, the Chinese government sets a low rate of return on "sterilization" bonds. Historically, the Chinese government has invested its U.S. dollar reserves in U.S. government securities. "Sterilization" has two consequences.

First, China could derive more benefit from the U.S. dollars invested in U.S. government securities if these funds were invested in Chinese infrastructural projects or in investments with higher rates of return. Infrastructural projects could allow the rural and western regions of China to share more equitably in China's income growth. Investment in financial instruments other than U.S. Treasury bonds could speed the growth of China's national savings.²¹² China's current reserve investment strategy entails a significant opportunity cost for the country.

Second, "sterilization" bonds substitute for other assets that might be held by banks and private investors. This substitution interferes with growth and development of private financial markets by crowding out other private investment opportunities for the banks.²¹³

In addition to the rising costs of "sterilization" bonds, it appears that perhaps not all of the renminbi being printed by the Chinese government to purchase the inflows into China of foreign currencies are being "sterilized." Inflation is becoming more of a problem, due in part to China's undervaluation policy.²¹⁴ Inflation in China was estimated to have risen above 8 percent during the first quarter of 2008.²¹⁵ The heart of the problem is the excessive liquidity that China is now experiencing in its financial system. Housing prices have increased in many cities in China due to the rising demand for housing encouraged by the excess liquidity. Without attractive interest rates for savings accounts by individuals and businesses in China, money also has flowed into China's stock market, fueling stock-market bubbles.^{216, 217}

²¹¹ Id.

²¹² Some financial instruments are stocks, bonds, and CDs.

²¹³ Ben S. Bernanke, "The Chinese Economy: Progress and Challenges," Speech Given at the Chinese Academy of Social Sciences (Beijing, China, Dec. 15, 2006), available at <http://www.federalreserve.gov/newsevents/speech/bernanke20061215a.htm>.

²¹⁴ U.S. Department of the Treasury, "Report to Congress on International Economic and Exchange Rate Policies," at 29 (May 2008).

²¹⁵ U.S. Department of the Treasury, "Report to Congress on International Economic and Exchange Rate Policies," at 2 (May 2008).

²¹⁶ Asian Development Bank, "Asian Development Outlook 2008," 132-33 (2008).

In reaction to China's growing inflation difficulties, the Chinese government curbs the independence of the People's Bank of China in order to limit the growth of China's money supply in several ways. These curbs limit the PBC's ability to allocate capital efficiently according to market signals, which stifles the growth of the banking sector. First, instead of allowing banks to set their own interest rates to attract depositors, the Chinese government has standardized interest rates for deposits at low levels across Chinese banks so that the interest rates will not be attractive to foreign investors and will not encourage additional speculative inflows that need to be sterilized.^{218, 219} "Window guidance"²²⁰ is another response of the Chinese government to inflation by which the Chinese government influences banks' choices directly, when these banks would be better served by reacting to free-market signals.

Over the long run, such practices by the Chinese government as asking banks to buy low-yield bonds, setting higher reserve requirements, and encouraging banks to curtail credit growth could have a distorting effect on Chinese banks' balance sheets and the overall economy.²²¹

Similarly, China's currency policy has redirected China's economy away from domestic consumption and toward export-oriented manufacturing. The undervalued renminbi's subsidization of exports from China strongly encourages Chinese companies to be export-oriented and likely acts as an inducement for investment by foreign and Chinese interests in these Chinese export oriented companies. Given that Chinese companies have limited investment options for their profits, due to China's hobbled banking and financial sectors, a large percentage of Chinese companies' profits are reinvested in the companies or saved. This plowing back of these corporate funds further fuels a cycle of excess capacity and excess saving in China. As far as individual Chinese persons are concerned, the impact of China's undervalued REER is experienced as an increase in the relative prices of non-Chinese goods. In this way, the buying power of Chinese citizens is reduced by China's undervalued REER.²²² Lack of buying power probably contributes to China's low level of domestic consumption. In combination, as Premier Wen suggested, the effects of the renminbi's undervaluation on Chinese companies and consumers leave China's economy in an uncoordinated state of excess manufacturing capacity and suppressed consumption.

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²¹⁷ The Economist, "Lost In Translation" (May 17, 2007).

²¹⁸ There are strong capital controls preventing Chinese citizens from investing outside China. For more information on capital controls see Sections IV.C. and IV.D.

²¹⁹ Foreign investment inflows into banks would strengthen the renminbi, which would negate the purpose of "sterilization."

²²⁰ See Section IV.C.2 for a definition of "window guidance."

²²¹ See Moskow, Michael H. and Cathy Lemieux, "China Up Close: Understanding the Chinese Economy and Financial System," at 2, Chicago Fed Letter Number 247 (Federal Reserve Bank of Chicago, Feb. 2008.)

²²² See Section III.C. for a more detailed explanation of currency undervaluation's effects on the buying power of Chinese consumers.

China's export-oriented, manufacturing-heavy economy also poses environmental consequences for China. The export sector emits more pollution than do other sectors.²²³ The rapid growth in China's export sector without adequate environmental safeguards has led to a correspondingly rapid growth of pollution in China. The World Bank reports that "[t]wo decades of phenomenal growth have taken a serious toll on the rural natural resource base and urban environment."²²⁴ Twenty of the top 30 most polluted cities in the world are located in China.²²⁵ China's current production mix, which has been influenced by undervaluation, is environmentally unsustainable.

5. Conclusion

China's longstanding undervaluation of its currency has put the economies of the United States and of China on a dangerous path. The renminbi's undervaluation has contributed to unsustainable trade and current-account deficits in the United States and to unbalanced and unstable growth in China. To some degree, other Asian countries have imitated China by undervaluing their currencies as well, which has magnified the negative effects of China's currency policy and thereby reduced the effectiveness of many countries' exchange rates in correcting their trade and current-account imbalances. The sooner, therefore, that China can bring itself with firm encouragement from the rest of the world to allow the renminbi to be revalued by market forces, the better the conditions and climate for international trade and investment will be for everyone.

F. Summary

China's foreign-exchange policies have gone through roughly four phases over the past 30 years as China gradually has opened its economy to international trade. Since 1994, China's foreign-exchange policies have limited the movement of China's currency against the U.S. dollar through direct, large-scale interventions in the exchange markets. These interventions by China have resulted in a measurable and substantial undervaluation of the renminbi versus the U.S. dollar and versus the currencies of many other trading partners of China. At huge cost, China's persistent undervaluation of its currency has harmed, and continues to harm, the U.S. manufacturing sector, China's financial and banking sectors, and China's environment. As turned to in the next section, therefore, it is submitted the international community needs to act in

²²³ Stephen S. Roach, Testimony Given at the Senate Finance Committee's Hearing on "Risks and Reforms: The Role of Currency in the U.S.-China Relationship" (Mar. 28, 2007).

²²⁴ The World Bank, "Country Brief, available at <http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/EASTASIAPACIFICEXT/CHINAEXTN/0,,contentMDK:20610209~pagePK:1497618~piPK:217854~theSitePK:318950,00.html>.

²²⁵ The World Bank, "China: Quick Facts," available at <http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/EASTASIAPACIFICEXT/CHINAEXTN/0,,contentMDK:20680895~pagePK:1497618~piPK:217854~theSitePK:318950,00.html>

concert in reliance upon thoughtful international legal precepts to steer China and other countries that undervalue their currencies away from this extremely debilitating practice.

V. **THE NEED FOR EFFECTIVE DETERRENCE BY THE INTERNATIONAL COMMUNITY OF EXCHANGE-RATE UNDERVALUATION**

A. **Collaboration Between the International Monetary Fund and the World Trade Organization**

China's decision not to trust the market and instead to enforce by means of governmental measures the substantial undervaluation of its renminbi poses a tremendous challenge to the IMF and the WTO. If China did not have as large an economy as it has and if China's influence were not as far-reaching as it is, even to the point where some other major trading countries appear to have been undervaluing their currencies in the hope of remaining competitive with China,²²⁶ the problem would not be as pressing. But the international monetary and trading system can ill-afford to allow undervaluation on this enormous scale by any country or countries to continue unchecked. The economic imbalances to which this undervaluation is contributing within the United States, within China, and globally are alarmingly great, and the potential consequences and suffering are cause for grave concern and concerted, purposeful action.

If the IMF and the WTO are to enjoy success in this endeavor, consistent with their charters, their chances will be much enhanced if they do all within their powers to complement each other's strengths and minimize each other's weaknesses by joining their resources, expertise, and powers and by pulling together. This approach reflects the tie between monetary measures and trade measures. While it is hoped that the IMF's 2007 Decision and ad hoc consultations in the surveillance process will sway China to relent in the renminbi's enforced undervaluation, it is reasonable to anticipate that the IMF's surveillance alone will not suffice, especially as China has so much at stake in regard to increasing the standard of living for the hundreds and hundreds of millions of persons in China who live in or near poverty and in regard to becoming a global economic and military power.

What must be kept uppermost in mind is that without a free market in currencies the global community cannot claim the benefits of free trade.²²⁷ What also is worth recalling is the pithy statement of Justice Holmes, that all life is an experiment. When Harry Dexter White and John Maynard Keynes created the International Monetary Fund and the drafters of the GATT shaped its set of international trading rules by dint of hard work and keen intelligence, they were all reacting to a horrendous situation and were experimenting in order to prevent, or at least lessen the chance of, such turmoil and plague ever recurring. While the situation today is quite different in many respects to the situation that prevailed in the mid-1940s, what the present era

²²⁶ See Cline, William R. and John Williamson, "New Estimates of Fundamental Equilibrium Exchange Rates," at 9, Policy Brief Number PB08-7 (Peterson Institute for International Economics, July 2008).

²²⁷ Ralph E. Gomory, Testimony Before the U.S. House of Representatives, Committee on Science and Technology, Subcommittee on Investigations and Oversight, at 8 (May 22, 2008).

shares with that time is a considerable danger that global economic conditions will continue to deteriorate with distressing and not always foreseen or controllable consequences unless there is some reform of the current system.

Exactly what steps that reform might entail are not clear, but greater collaboration between the IMF and the WTO should certainly be an element. Article XV of the GATT is the keystone of the IMF-WTO relationship, and yet its history has left its meaning unclear and open to not unreasonable differences of opinion and uncertainty. It is suggested that one approach to assist in rectifying this lack of clarity be an acknowledgement by the IMF and the WTO, and examples to illustrate, that there will be times and circumstances when approval by the IMF of an exchange action will not excuse that measure from being found inconsistent with the member's obligations under the GATT and the WTO's other covered agreements. While the goal of consistent rulings by the IMF and the WTO is generally sensible and desirable, that purpose should give way at a minimum when exchange action significantly jeopardizes the benefits of free trade.

B. Recourse to Remedies Available Under the World Trade Organization's Provisions Against a Currency's Persistent Undervaluation

Along the lines just urged, a prime instance of an exchange action putting seriously at risk balanced, sustainable trade across national boundaries is a country's protracted large-scale intervention in the exchange markets and other measures that undervalue that country's currency. Whether or not the country that has such a policy intends thereby to prevent effective balance-of-payments adjustment or to gain an unfair competitive advantage over other members is critical in a decision by the IMF on "manipulation" under Article IV:1(iii) of its Articles of Agreement, but is not relevant under the WTO's agreements, either Article VI of the GATT, the Agreement on Subsidies and Countervailing Measures ("the SCM Agreement"), or the Antidumping Agreement, which are concerned only with the effects of trade actions.

In these circumstances, therefore, one route that responsibly can be taken as a matter of international law is for national authorities to entertain countervailing duties to offset injurious imports at low prices due to the enforced undervaluation of the exporting member's currency, whether or not that member's currency is "manipulated."^{228, 229} With its powers of dispute

²²⁸ This approach appears to be recognized in Deborah E. Siegel, "Legal Aspects of the IMF/WTO Relationship: The Fund's Articles of Agreement and the WTO Agreements," 96 A.J.I.L. 561, 593 (2002).

²²⁹ A strong case can be made that undervalued exchange-rate misalignment is a countervailable, prohibited export subsidy. Under Articles 1, 2, and 3 of the SCM Agreement, a measure must satisfy three criteria in order to be considered a prohibited export subsidy. In essence, there must be a governmental financial contribution (Article 1.1(a)(1)), a benefit must thereby be conferred (Article 1.1(b)), and such a subsidy must be specific by virtue of being contingent in law or in fact upon export performance (Articles 1.2, 2.3, and 3.1(a)). The renminbi's enforced undervaluation by the Chinese government meets each of these criteria.

(...continued)

settlement, which the IMF does not have, the WTO would be in a position to enforce the assessment and collection of countervailing or antidumping duties in that situation. In combination with the IMF's moral suasion and surveillances under Article IV of its Articles of Agreement, this extra remedy under the WTO's agreements might tip the balance within the exporting country's government in favor of those against a policy of undervalued exchange-rate misalignment²³⁰ and also might serve to relieve pressure in the market somewhat gradually, no small factor to be weighed when a country has been undervaluing its currency as long and as much as China has been undervaluing the renminbi.

VI. CONCLUSION

It is hoped that this paper will add constructively to consideration of how the international community will face up to competitive currency depreciation as a governmental policy by some countries. Ultimately no one gains and everyone loses from this practice. That was the lesson learned after World Wars I and II and the Great Depression and ideally will not need to be learned anywhere nearly as painfully again.

(...continued)

First, in a typical export transaction, having been paid for goods sold to a customer in the United States, as seen earlier the exporter in China must transfer the U.S. dollars received to the Chinese government in return for renminbi at the undervalued exchange rate in effect.

In this sequence of events, the Chinese government provides a financial contribution of funds to the exporter by means of the service of converting U.S. dollars into renminbi.

Second, a benefit is conferred by this governmental financial contribution that is equal to the difference between what the renminbi would be worth if its value were set by the market and its artificially low value as the result of its undervaluation by the Chinese government. With the renminbi undervalued by approximately thirty percent, therefore, for each U.S. dollar earned by the sale of goods to the United States the Chinese exporter will receive thirty percent more renminbi and so is "better off" and benefits from the undervaluation.

Third, and lastly, this subsidy is contingent upon export performance. Only after the exporter has been paid in U.S. dollars for the goods that have been exported to the United States is the exporter required to convert those proceeds into renminbi.

²³⁰ As remarked above, until recently China allowed the renminbi to strengthen nominally against the U.S. dollar after the revaluation in July 2005, but in August 2008 ceased doing so. A report in early September 2008 commented on how the People's Bank of China and China's Ministry of Finance have been engaged in a vigorous debate over China's currency policy, with the former urging that the renminbi be strengthened and the latter advocating enforced undervaluation of the renminbi. See Keith Bradsher, "Main Bank of China Is in Need of Capital," New York Times (Sept. 4, 2008). A trade remedy by way of either countervailing duties or antidumping duties might reinforce the PBC's position that there is more to be gained by China from a policy of enabling the market to value the renminbi than not.