PREDATORY CURRENCY MISALIGNMENTS: A CREDIBLE THREAT TO THE INTERNATIONAL TRADE ORDER

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Currency misalignments (CMs), as expressed by the difference between an actual exchange rate and its estimated equilibrium rate, can be caused by market fluctuations and other factors that normally influence markets or by government intervention or both. Misalignments have become commonplace from the end of the gold standard and the introduction of floating exchange rates in the early 1970s.

Although for the general public CMs may be an abstract notion, they certainly are not science fiction. The best evidence is the International Monetary Fund's (IMF) estimates of exchange rate misalignments,[2] the official authoritative source on the subject, which shows 14 countries with overvalued currencies, 9 with undervalued and 5 with both positive and negative misalignments during the period. Misalignments are defined in the IMF report as the estimated differences between real effective exchange rate and that consistent with economic fundamentals and desirable policies. Fundação Getúlio Vargas (FGV) of Brazil looks at fundamentals through a net foreign asset approach to calculate CMs. In comparison with the IMF's, given the distinction in methodologies, FGV's model leads to different results, as expected, but both agree on direction of CMs for most countries.[3] The Peterson Institute of International Economics (PIIE) calculates the "fundamental equilibrium exchange rate" (FEER), defined as the exchange rate that is expected to be indefinitely sustainable on the basis of existing policies. Cline and Williamson, from the PIIE, explain it as "the currency exchange rate

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[2] IMF, Pilot External Sector Report, July 2, 2012.
[3] Notable differences between FGV and IMF numbers are related to Japan (FGV=undervalued, IMF=overvalued), France (uv, ov), Italy (uv, ov), U.S. (uv, ov).

which is expected to generate a current account surplus or deficit that matches the country's underlying capital flow over the cycle, assuming that the country is pursuing internal balance as well as it can and that it is not restricting trade for balance-of-payments reasons."[4] Surjit Bhalla, in his book "Devaluing to Prosperity"[5], calculates CMs using an "exponential model", which results in an S-shaped evolution of real exchange rate with respect to income. There are obviously differences in the measurement of CMs, but definitely no lack of models to measure them.

Are all CMs bad from an economic point of view? If we use the analogy of an electrocardiogram (EKG), misalignments generated solely by market factors would look like a normal, healthy EKG. Like a doctor, we should be concerned with deviations from that norm and at which point the health of the patient is at greater risk. Government intervention, on the other hand, may be just what the doctor ordered for correcting economic imbalances, as long as once the problem is corrected the medicine, i.e. the intervention, stops. The IMF, for example, for many years prescribed devaluation policies as medicine for countries with balance of payments and other economic illnesses. I believe that these types of corrective economic policies are legitimate choices that should continue to be available to governments without condemnation or penalties. The common characteristic in both instances - market fluctuations and corrective interventions - is their TEMPORARY nature and, thus, not a serious cause of anxiety.

However, PERSISTENT government intervention raises concerns of its own. If it is used to sustain a significant (not negligible), longer-term undervaluation, that is not there to correct an economic imbalance and cannot be justified by the devaluing country's economic fundamentals, there is only one explanation: the currency is being manipulated to generate more reserves and gain unfair advantage over trade partners. In other words, if all pertinent economic indicators are positive in a particular country, this country's currency, under normal market conditions, would most likely tend to appreciate overtime, not stay undervalued for a long period. In this case, one could say that the aim

[4] Cline and Williamson, "Updated Estimates of Fundamental Equilibrium Exchange Rates", PIIE (November 2012).
[5] Bhalla, Surjit S., *Devaluing to Prosperity*, PIIE, August 2012.

of the government's manipulation is to improve its balance of trade (BOT) by both creating an artificial advantage for its exports and increasing barriers to its imports at the same time. Going back to our analogy, when all pertinent economic indicators are positive and the patient is healthy, its currency exchange rate performance over a period of time should resemble a normal EKG. If it does not, it is due to intervention, in this case, designed to boost economic performance, much like doping an athlete to win a race. This is PREDATORY MISALIGNMENT and it should be condemned as an unfair or illegal practice as much as doping.

Section 3004 of the Omnibus Trade and Competitiveness Act of 1988 requires the U.S. Treasury to determine if any country with global current account and significant bilateral trade surpluses with the U.S. is found to be manipulating the rate of exchange between their currency and the dollar for the purposes of preventing effective balance of payments adjustments or gaining unfair competitive advantage in international trade. If the U.S. Treasury concludes in the affirmative, which it never does, expedited negotiations, through the IMF or bilaterally, are to be initiated. J. Gagnon, from the PIIE, defines extreme manipulators as countries that have foreign exchange reserves that are greater than the value of six months of goods and services imports; have an average current account balance (as a percent of GDP) between 2001 and 2011 that is greater than zero and have increased their reserve stocks relative to their GDP over the past 10 years.[6]

The negative effects of Predatory Currency Misalignments (PCMs) on trade have been demonstrated in at least two excellent research studies. One is by FGV of Brazil,[7] which tariffied the impact of CMs on the tariff schedules of several countries. For the sake of explanation we will divide them in two categories: non-undervalued-currency (NUC) countries and undervalued currency (UC) countries. FGV demonstrates that import tariff protection levels in NUC countries, duly negotiated at the World Trade Organization (WTO), are eroded to the point of becoming negative (providing a subsidy to imports). In such circumstances, NUC countries face an additional threat – the

[6] Gagnon, Joseph E., "Combating Widespread Currency Manipulation", PIIE Policy Brief, July 2012.
[7]

likelihood that the protection of their on-going trade remedies (antidumping, antisubsidy and safeguards) disappear together with their tariff protection. In UC countries, the FGV study found that import tariff protection levels are increased and may go up even beyond the limits of WTO bound rates.

If that's the case, why do countries bother to negotiate tariffs at the WTO for a long period of time when all can be wiped out with a single devaluation? Looking from another angle, countries today can go ahead and agree with relatively low tariff bound rates at multilateral (or bilateral or regional) negotiations, devalue later and pay no penalties for violating their tariff commitments with the WTO (or bilateral or regional trade partners). It makes sense, therefore, to have specific provisions at the WTO (and in bilateral and regional agreements) to deal with the negative effects of PCMs. Exchange rates, on the other hand, play critical functions in the areas of monetary stability, and trade and competitiveness, both of which are being seriously distorted by PCMs.

Another paper by Mattoo, Mishra and Subramanian looks into the "spillover effect"[8]. It suggests that, on average, a 10 percent appreciation of China's real exchange rate boosts a developing country's exports of a typical 4-digit Harmonized System (HS) product category to third markets by about 1.5 to 2 percent. By preventing appreciation that would otherwise occur, China has tilted the playing field against exporters in other developing countries. And, given the existence of PCMs from other UC countries, China is probably not alone here.

If PCMs can increase the tariff protection level of manipulators beyond WTO bound levels and, at the same time, decrease that level of protection of trade partners, including rendering moot any trade remedy margin that trade partners may have in place, PCMs are "frustrating" the intent of the provisions of the GATT. According to Article XV(4) of GATT 1994, "Contracting parties shall not, by exchange action, frustrate[9] the

[8] Mattoo, Aaditya; Mishra, Prachi; Subramanian, Arvind, "Spillover Effects of Exchange Rates: A Study of the Reminbi", IMF Working Paper, March 2012.
[9] *Ad* Article XV (Paragraph 4): 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

intent of the provisions of this Agreement, nor, by trade action, the intent of the provisions of the Articles of Agreement of the International Monetary Fund." 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.[10] The effects of PCMs are undoubtedly violations with clear, "appreciable departure from the intent of the article."

If there is "frustration", what can affected WTO members do? One obvious option is to request a Panel to the DSB under Article XV. At this time, however, given the high sensitivity of the issue, such a case would be politically charged and, having in mind the different interpretations with regard to the role of the IMF, the risk of an unfavorable decision that could potentially "legalize" the practice of PCMs is too big.

Another option is negotiation, either bilateral or multilateral or plurilateral. A bilateral approach will not bring a worldwide solution – the problem is global. At the multilateral level, Brazil is pushing for a solution at the World Trade Organization (WTO). As proposed in September of 2011, the Brazilian initiative was comprised of three steps. The first was a review of the literature available on the subject, which was done by the WTO Secretariat on October 2011 (Staff Working Paper ERSD-2011-17). Second, a two-day seminar to discuss the subject of currency misalignments and trade, which was held in Geneva in March 2012. The focus of the latter, however, was more on "stock taking" rather than on "what can be done", which given the political sensitivities was not unexpected. It was supposed to be an open meeting, with broad participation, which unfortunately was not, reportedly at the request of China and the U.S. Third, a

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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.

[10] Id.

discussion of proposals at the WTO's Working Group on Trade, Debt and Finance to tackle the problem, which took place in November 2012. A paper with Brazilian suggestions was presented in that meeting[11] , but no conclusion was reached. The best result out of that meeting is that the discussion will continue, with the IMF invited to participate in the next gathering. Discussions at the G-20, on the other hand, have not produced concrete results. However, if the problem is the negative effect (of PCMs) on trade, the solution must be reached at the WTO, not the G-20.

I agree with the pursuit of a multilaterally negotiated solution as the best option, because only through a multilateral agreement a permanent solution to the negative effects of PCMs can be sustained. However, as demonstrated by the difficulties in the Doha Round of negotiations, any consensus on a negotiated solution in the WTO for the PCM problem is bound to be a long-term proposition, especially if it requires a new agreement or changes in existing rules. If this is so, what are governments and affected industries to do in the meantime? Right now, in the absence of a clear guideline from the WTO on how to deal with this problem, NUC countries are making use of defensive measures which are undesirable from an economic or trade perspective.

Under these circumstances, I have been suggesting that the best way to achieve a multilateral solution is a complementary second track approach to take care of short and medium term situations and, if well designed and implemented, ultimately aid in a negotiated solution at the WTO. It calls for plurilateral action through coordinated use of trade remedies, specifically countervailing duties (CVDs). Why not safeguards or antidumping? Well because safeguards are across-the-board measures that do not discriminate between countries, affecting NUC and UC countries alike, which is not the purpose here. The objective is to compensate NUC countries for the negative effects of PCMs. Antidumping, on the other hand, would allow us to select products, industries and countries, but is not the adequate defense instrument since PCMs are unquestionably subsidies in economic terms and can be shown to be prohibited export subsidies under the Agreement on Subsidies and Countervailing Measures (ASCM).

[11] WT/WGTDF/W/68 – "Exchange rate misalignment and trade remedies : a conceptual note by Brazil"

A coalition of the injured, composed of influential NUC and some UC countries with negligible levels of undervaluation, which are being harmed by PCMs, should be formed. Such a coalition would include countries like Brazil, Canada, EU, India, Japan, the United States and others, that together could effectively apply pressure on manipulators to engage in constructive negotiations for a multilateral solution. To that end, each member of the coalition would initiate, in coordination with the others, several CVD cases against major products from manipulating countries. The legal arguments are laid out in detail in the article I co-authored with Juan Gaviria, "A Case for Currency Misalignments as Countervailable Subsidies" (Journal of World Trade, 46:5,2012). It advocates that PCMs (not every CM) can be treated as prohibited subsidies under the ASCM and be subject of a petition to domestic investigating authorities. PCMs are prohibited subsidies because they are contingent upon exports – the benefit only accrues to exporters if there is exportation. An injury test and a causal relationship between the injury and the subsidized imports would be required to impose a CVD. This would have the triple benefit of limiting the amount of petitions that would qualify to receive a remedy, providing relief only to those that need it and requiring a definition of what constitutes "persistent" (1 year of PCM data or more?)[12] in terms of showing injury from PCMs before a countervailing duty can be imposed.

If respondent countries wish to do so, they can initiate a dispute settlement procedure at the WTO/DSB. But, they will have to bear the burden of proof. More importantly, the restrictive effects of a CVD investigation on imports from manipulating countries will be felt from the beginning of the investigating process, when petitions are filed. Intensity of these effects will increase as the case goes forward and last as long as necessary for an agreement to be reached at the multilateral level or, alternatively, until the PCM practice is terminated.

[12] In injury examinations a minimum requirement in national trade regulations of 1 to 3 years of data is not uncommon. As an example, a 3-year period could include 2 years of imports with no CMs + 1 year with PCM.

There are benefits in following this two-track approach: first, well prepared CVD cases can put pressure on negotiators to expedite a consensus solution at the WTO; second, even the threat of CVD cases may remove negotiating obstacles, if not, the restrictive effects of the CVDs will; third, CVD cases can aid in providing ideas for a negotiated solution at the WTO; and fourth, if it is reviewed by a WTO panel, it narrows the focus of the analysis to technical issues while reducing the opportunities for political influence (quite the opposite would happen in an Article XV case). In addition, coalition governments will have in CVD investigations a ready legal instrument to compensate injured domestic industries, under due process, which is a better alternative than “ad hoc” unilateral defensive measures that could end-up being challenged at the WTO.