Trade Negotiators Need to Address Exchange Rate Manipulation

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Deliberate manipulation of foreign exchange rates by a number of countries is one of the most egregious of all unfair trade practices today. By maintaining an artificially low exchange rate, a country in effect imposes an extra charge on imports (equivalent to a tariff) and also gains an unfair trade advantage in the U.S. and third country markets. While this practice has long been recognized as unfair, international trade rules have no effective provisions to address this issue.

Recommendations

1. A number of countries that manipulate their exchange rates are in the Asia-Pacific region and accordingly it is critical that the negotiations for a Trans-Pacific Partnership address this issue if this agreement is to be a real template for future agreements. Unfortunately this issue is not currently on the table for these negotiations; however, negotiators will be meeting in early March and this issue should be addressed at that time.

2. In his 2013 State of the Union address, President Obama said the U.S. and the European Union will launch negotiations for a Trans-Atlantic Free Trade Area (TAFTA). This issue needs to be on the agenda for those negotiations.

3. Brazil has proposed that the World Trade Organization begin a serious work program to address the relationship between exchange rates and international trade. The U.S. should vigorously support this Brazilian initiative.

4. When Congress next considers Trade Promotion Authority, which specifies objectives for trade negotiations and requires Congress to consider such agreements on a “fast track”, one of the key objectives should be a requirement that effective international rules on currency manipulation be developed.

The Issue

In economic theory an “undervalued exchange rate is *both* an import tax and an export subsidy and is hence the most mercantilist policy imaginable.”[1] However, exchange rate manipulation is a complex issue for trade negotiators to address.

While some countries pursue an undervalued currency as a deliberate tool to gain a trade advantage at their partners’ expense, there are several legitimate reasons why a country might deliberately devalue its currency and it is sometimes difficult to sort out legitimate policy initiatives from “beggar thy neighbor” practices. Some countries, such as Israel, might have foreign policy concerns that would lead them to build up holdings of foreign exchange by undervaluing their currency. Others, such as Brazil, may be running unsustainable trade deficits and seek to bring their trade account back into balance by depreciating their currency. And still

William Krist’s book “Globalization and America’s Trade Agreements” is expected to be published in the fall of 2013.

others might maintain an undervalued currency to avoid being at a competitive disadvantage vis-à-vis trade competitors that have devalued their own currency to gain an artificial advantage.

Almost all developed countries allow their currency to "float", which means that the exchange rate of their currency is in theory determined by market forces. Under these conditions, economic theory indicates that if a country is running a trade surplus its currency would appreciate, making its exports more expensive on world markets and imports less expensive in its domestic market, which should bring its trade account back into balance. Conversely, if it is running a deficit as the U.S. has over the past forty years its currency should depreciate making its exports cheaper and its imports more expensive.

However, some countries "manage" their exchange rates and may peg the exchange rate of their currency to another currency, typically the dollar or the euro. One of the main tools to accomplish this is for their central bank to sell their currency in exchange for the targeted currency. A major objective of devaluing the exchange rate is often to create jobs and expand production. However, this comes at their trade partners' expense, which lose jobs and sometimes even whole industries. A good estimate for the impact of currency manipulation on the U.S. economy is that it increases our trade deficit by $200 to $500 billion annually and causes a loss of 1 to 5 million jobs.[2]

Some argue that consumers may benefit in the short term by cheaper prices of imports from countries with artificially low exchange rates; however, this benefit is not as large as the loss to producers and to global efficiency. The fact is that currency manipulation undermines the whole rational for trade liberalization, which is to promote trade based on comparative advantage, not artificial government distortions.

International Rules on Currency Manipulation

GATT/WTO Article XV states that "Contracting Parties shall not, by exchange action, frustrate the intent of the provisions of this Agreement, nor, by trade action, the intent of the provisions of the Articles of Agreement of the International Monetary Fund." If there are problems, the WTO is to seek cooperation with the IMF "to pursue a co-ordinated policy with regard to exchange questions within the jurisdiction of the Fund." The WTO is then required to "accept all findings of statistical and other facts presented by the Fund relating to foreign exchange, monetary reserves and balances of payments, and shall accept the determination of the Fund as to whether action by a contracting party in exchange matters is in accordance with" the IMF rules.[3]

The IMF does have rules on exchange rate manipulation, but unfortunately the IMF has proven to be very weak in its willingness to address foreign exchange issues. In fact, the IMF has never concluded that a member was out of compliance with its obligations in this regard. Even if the IMF did conclude that a country was manipulating its exchange rate to take unfair advantage of the trade system, it has no leverage to deal with this issue.[4]

Although the IMF does not have leverage to force countries to stop manipulating their currencies, there are some important rules on this issue; unfortunately, however, these rules are

frequently not observed. For example, IMF guidelines call on countries to be transparent in their interventions in the currency market and to notify other countries when they intervene in their currencies.

Because the founders of the post war institutions envisioned that the IMF would address this issue, WTO rules are inadequate to deal with the problem of deliberate currency manipulation. There have never been any WTO dispute settlement cases regarding the Article XV prohibition on exchange rate manipulation. And the subsidies/countervailing duty code is of limited use since it defines prohibited subsidies as being industry specific, not across the board as is the impact of currency manipulation.

Problems caused by misaligned currency rates have periodically risen to the fore since the GATT went into effect in 1947. In 1971 the U.S. believed that some other nations were pegging their currencies below the market value of the dollar to gain a trade advantage. President Nixon imposed an import surcharge, which was only removed after Germany, Japan and others revalued their currencies. And then the problem resurfaced again in the mid-1980s, particularly with regard to Japan and some European currencies. At that time Congress threatened to impose an across the board import surcharge, which led Japan to agree to revalue the yen by some 80 percent and the Europeans to allow their currencies to appreciate by some 50 percent in the so-called Plaza Accord of 1985. While the immediate problem was addressed in both of these occasions, the huge gap in the effectiveness of the trade rules was not addressed.

In view of this enormous gap, Brazil is proposing that the World Trade Organization (WTO) undertake a work program to consider the relationship of exchange rates and international trade. In Brazil's view, the "WTO could and should . . . deal with the effects of [currency] fluctuations and misalignments."[5] Among other things, this work program should "define methodologies to assess currency misalignments".

Agreeing on general principles to identify unfair currency manipulation will be difficult. In an outstanding analysis by C. Fred Bergsten and Joseph E. Gagnon of the Peterson Institute, four criteria are listed that may identify a country that is unfairly manipulating its currency: (1) the country's foreign exchange reserves must exceed six months of goods and services imports, (2) foreign exchange reserves must have grown more rapidly than GDP, (3) the country's current account must have been in surplus on average since 2001, and (4) per capita gross national income must be at least $3,000.[6] While these criteria are a good starting point for consideration, it will take some time to gain an international consensus as to what constitutes unfair currency manipulation.

The Currency Manipulators

The Bergsten report lists eight countries as the most significant currency manipulators: China, Denmark, Hong Kong, Korea, Malaysia, Singapore, Switzerland and Taiwan. It also notes that Japan "has been an occasional manipulator in the past but has not intervened recently."[7] (This report was published in December 2012; since that time, Japan's recently elected Prime Minister Abe has instituted an aggressive devaluation of the yen.)

Because of its size, China is the focus of concern by most analysts today. In its semi-annual report on exchange rates released Nov. 27, 2012, the U.S. Treasury noted that China's currency is "undervalued by between 5 and 10 percent on a real effective basis, as of July 2012." While a considerable improvement from the extent of Chinese undervaluation of the past decade, this still represents a significant trade distortion. The report also notes that "China's official foreign exchange reserves remain exceptionally high compared to those of other economies", and it says that it is important that the Chinese government move toward greater disclosure of its activities in the currency market."

Ironically, the immediate problem with China's currency regime might have been resolved when China joined the WTO. According to the IMF's Independent Evaluation Office, the draft protocol on China's accession to the WTO would have required that China bring its foreign exchange regime into conformity with the obligations of the IMF. Unfortunately, the IMF staff forced deletion of this provision on the grounds that such a provision was the IMF's jurisdiction, not the WTO's.[8]

South Korea is another major country that does not publish intervention data, according to the Treasury report.

Exchange Rate Manipulation and the Trans-Pacific Partnership Negotiations

As noted, two countries participating in the Trans Pacific Partnership negotiations – Malaysia and Singapore - have undervalued exchange rates. Additionally, it is hoped that at some point in the future China, Japan and South Korea will join the TPP, and these are major countries that are or have manipulated their exchange rates. Consequently, the TPP negotiations have to address the issue of exchange rate manipulation.

While the issue of exchange rate manipulation needs to be addressed multilaterally in the WTO and the IMF, progress can be made in the TPP. First off, all countries participating in the TPP negotiations have already committed not to manipulate their currencies for trade advantage as part of their WTO membership. Furthermore, as members of the IMF, they have committed to transparency in their actions to affect their exchange rate and to notify their trade partners if they intervene in their currencies. These commitments can be reaffirmed and strengthened in the TPP by making them subject to the agreement's dispute settlement mechanism.

Gaining agreement in the TPP on what constitutes unfair currency manipulation and what should be done about it will be more difficult, given the objective of concluding these negotiations in 2013. For example, according to Bergsten, Malaysia and Singapore "tend to follow China closely in managing their own exchange rates."[9] These countries might be hesitant to agree to prohibit trade distortive currency manipulation as long as China or other major trade competitors manipulate their currencies. However, as much progress as possible should be made in the TPP negotiations, and if agreement cannot be reached, TPP participants could agree to continue work on this issue with a view to developing effective rules and procedures.

While these rules are being developed, China, Japan, South Korea or other major countries that may wish to join the Trans-Pacific Partnership should only be admitted if they are clearly committed to not manipulate their exchange rates to gain a commercial advantage.

Sources

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[1] Aaditya Mattoo and Arvind Subramanian. *Exchange Rates - From Currency Undervaluation and Sovereign Wealth Funds: A New Role for the World Trade Organization. (*Washington DC: The World Bank, Development Research Group, July 2008), 3.

[2] Bergsten, C. Fred and Joseph E. Gagnon. "Currency Manipulation, the US Economy, and the Global Economic Order." Washington, DC: Peterson Institute for International Economics, December 2012, p. 1.

[3] The World Trade Or

[4] The IMF does have enormous leverage over countries that run into severe balance of payments problems caused by deficits through its lending programs, but this leverage does not work vis-à-vis surplus countries.

[5] "The Relationship between Exchange Rates and International Trade". World Trade Organization, WT/WGTDF/W/68, November 5, 2012, p. 2.

[6] Bergsten, C. Fred and Joseph E. Gagnon. "Currency Manipulation, the US Economy, and the Global Economic Order." Washington, DC: Peterson Institute for International Economics, December 2012, p. 5.

[7] Ibid. Page 2.

[8] This incident is reported in the IMF's Independent Evaluation Office, *IMF Involvement in International Trade Policy Issues*, page 59.

[9] Bergsten, C. Fred and Joseph E. Gagnon. "Currency Manipulation, the US Economy, and the Global Economic Order." Washington, DC: Peterson Institute for International Economics, December 2012, p. 6.