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# The China Currency Issue: Why the World Trade Organization Would Fail to Provide the United States with an Effective Remedy

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# The China Currency Issue;

## Why the World Trade Organization Would Fail to Provide the United States with an Effective Remedy

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Marcus Sohlberg

### ABSTRACT

*A critical issue in the global trading system that came to the forefront in 2010 concerns exchange rates. Having suffered to various degrees through the worst economic and financial downturn since the Great Depression, many large trading nations have sought to achieve economic recovery through export-led growth. In order to boost international competitiveness, many have engaged in competitive devaluations, i.e. interventions in currency markets to devalue domestic currency. According to Brazilian Finance Minister Guido Mantega this situation has escalated into a “global currency war”.*

*This paper focuses on China’s practice of maintaining an artificially undervalued currency, and addresses the question of whether the United States could challenge this practice in the dispute settlement system of the World Trade Organization (WTO). The answer is one of interpretation, but there is at least a tenuous legal basis pursuant to which the United States could bring a formal complaint. The rationale for WTO involvement is that an artificially undervalued exchange rate is a protectionist trade policy because it is a combination of an import tariff and an export subsidy in the country where it is maintained.*

*However, even if there is a legal foundation by which the United States could lodge a formal complaint, it is the contention of this paper that WTO litigation would be unsuitable. Drawing from the experience of past WTO case law, there is reason to believe that the WTO Dispute Settlement Body would fail to provide the United States with an effective remedy, seeing that the China currency issue is not a mere trade disagreement. Rather, it involves the exercise of a sovereign prerogative that delves into complex issues of social and economic structures in China. Therefore an adverse ruling compelling China to refrain from its current practice is unlikely to be complied with. Moreover, a case like this could also set a dangerous precedent for expansive interpretation of vague WTO provisions, and considerably broaden the trade organization's authority into peripheral trade-related areas.*

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## **Introduction**

Why has not the United States filed a formal complaint with the World Trade Organization (WTO) against China for obtaining an unfair trade advantage by virtue of maintaining a significantly undervalued currency? After all, if one of the most critical issues to the global trading system, and an alleged reason for the weak US economy, is not litigated in the WTO, what does that tell us about the WTO dispute settlement system and the WTO at large?

The rationale for WTO involvement is that an artificially undervalued exchange rate is a protectionist trade policy because it is a combination of an import tariff and an export subsidy in the country where it is maintained.<sup>1</sup> Thus, is the fact that the United States has not brought a WTO challenge indicative of the multilateral trade organization's demise from effectively adjudicating trade disputes between its member states? This paper responds to the question in the negative. It is argued that the China currency issue cannot conclusively be said to fall within the competence of the WTO and should therefore not be resolved by way of dispute settlement. Litigation in the WTO of the issue is both unsuitable as well as it would be fruitless, seeing that the dispute settlement procedure would fail to provide an effective remedy.

Part I of this paper provides the context in which the China currency issue has arisen, and explains why it is one of the most critical international trade issues as of late. Part II examines the relationship between exchange rates and international trade, and explains how the WTO fits into this picture. Part III offers an appraisal how the United States could challenge China's exchange rate policy in the WTO. Finally, Part IV

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<sup>1</sup> Arvind Subramanian, *New PPP-based Estimates of Renminbi Undervaluation and Policy Implications*, Peterson Institute of International Economics, Policy Brief 10-08, p. 6

attempts to show potential adverse consequences of bringing a WTO case, and how, ultimately, the WTO fails to provide an effective remedy to the issue.

## **Part I**

### **Origins of the Dispute**

The China currency issue is not a newfound issue for lawmakers in the United States. Senator Charles Schumer (Democrat – New York), backed by Senator Lindsey Graham (Republican – South Carolina), introduced the first proposal for unilateral legislative action against the undervalued Chinese Renminbi<sup>2</sup> (RMB) in 2003. A whole host of unsuccessful congressional bills followed suit until September 29, 2010, when the House of Representatives approved the “Currency Reform for Fair Trade Act” (H.R. 2378). The running theme of these bills is to instruct the U.S. Department of Commerce to invoke trade remedies, in the form of countervailing duties, against Chinese imports in the event the RMB is not revalued.<sup>3</sup> In other words, the legislation treats China’s artificially lower-valued currency as an export subsidy and authorizes countervailing duties to offset the amount of undervaluation. Broad political and industry pressure have been the underlying forces of the legislative initiative; seeing that a seemingly insurmountable unemployment rate and trade deficit is maintained in the United States.

With the effects of the financial and economic crisis still reverberating around the world, many governments have decided that economic recovery shall be achieved through export-led growth. President Obama has endorsed this line of thought by

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<sup>2</sup> China’s currency is interchangeably referred to as “Yuan” or “Renminbi”. The more formal term “Renminbi” will be used in this paper; see Matt Phillips, *Yuan or Renminbi: What’s the Right Word for China’s Currency?* WALL STREET JOURNAL (Jun. 21, 2010)

<sup>3</sup> Gary Clyde Hufbauer & Claire Brunel, *The U.S. Congress and the Chinese Renminbi*, p. 222, in Morris Goldstein & Nicolas R. Lardy (eds.), *Debating China’s Exchange Rate Policy* (2008)

promising to double U.S. exports over the next five years through, *inter alia*, government trade promotion initiatives such as the National Export Initiative.<sup>4</sup> One major obstacle for the United States in attaining this goal is that many leading trading partners around the globe are intervening in currency markets to drive down the price of their currencies in order to boost export competitiveness, so called “competitive devaluation”. The value of a country’s currency has, therefore, become an increasingly important consideration in the fierce competition for world market shares. Brazilian Finance Minister, Mr. Guido Mantega, has famously referred to these tactics as a “global currency war”.<sup>5</sup>

The fact that governments are engaging in competitive devaluations to determine the value of their currencies, instead of having free floating market-determined exchange rates that reflect underlying economic fundamentals, is not a new tool of economic statecraft. For decades, it has been utilized by governments to affect their exporting-industries’ competitiveness and generate domestic employment opportunities. Even the United States, now on the receiving end of the currency exchange interventions, has deployed tactics to achieve desired exchange rate movements in the dollar.<sup>6</sup> Arguably the latest of such tactics took place in 2010, by virtue of the U.S. Federal Reserve’s extensive cash injections into the U.S. economy, by way of so called quantitative easing, which contributed to a substantial easing of the dollar against other world currencies.<sup>7</sup>

As alluded to above, China is not the sole culprit in the “global currency war”. In fact, several big trading nations and oil-exporting countries act proactively in driving the

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<sup>4</sup> United States Trade Representative, *President Obama Lays Out Export Initiative To Create Jobs* (Jan. 28, 2010)

<sup>5</sup> Jonathan Wheatley, *Brazil in “Currency War” Alert*, FINANCIAL TIMES (Sept. 29, 2010)

<sup>6</sup> U.S. Federal Reserve of New York, *U.S. Foreign Exchange Intervention*

<sup>7</sup> William Cline & John Williamson, *Currency Wars?* Peterson Institute for International Economics, November 2010, Policy Brief 10-26, p. 2

price of their currencies down.<sup>8</sup> If China had merely been a medium-sized economic power, its currency policy would most likely not have been the center of the United States' attention. But when China in fact is the world's second largest economy, the world's largest exporter, and the world's largest manufacturer, it occupies a systemically significant role in the world economy. Its mercantilist currency policy, therefore, is one that the United States cannot afford to sit back and passively accept.<sup>9</sup> Hence reference to the issue as the "China currency issue".

## Part II

### Currency Exchange Rates and International Trade

Although complex to assess, there exist a clear linkage between currency exchange rates and international trade. Strong currency stimulus in one country has the potential of enhancing export opportunities for trading partners, because it increases private purchasing power and consumption of domestic consumers while making national exports more expensive. Conversely, a weak national exchange rate acts so as to encourage a country's exports while discouraging the inflow of imports.<sup>10</sup>

In the case of China, it has been suggested that the undervaluation of the RMB is more than 20% in real effective terms and about 40% relative to the dollar.<sup>11</sup> The continuous success of the People's Bank of China (China's central bank) in maintaining an artificially undervalued RMB has the effect of stimulating Chinese exports by

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<sup>8</sup> For instance, Malaysia, Thailand, South Korea, Taiwan, and Japan, *see* Peter Garnham, *Currency Race that Everyone is Trying to Lose*, FINANCIAL TIMES (Oct. 12, 2010); and oil-exporting countries, such as the United Arab Emirates, Kuwait, Saudi Arabia, Venezuela, *see* Aaditya Mattoo & Arvind Subramanian, *infra* note 40, pp. 1, 24

<sup>9</sup> Gideon Rachman, *China Can No Longer Plead Poverty*, FINANCIAL TIMES (Oct. 27, 2010)

<sup>10</sup> Robert W. Staiger & Alan O. Sykes, *Currency Manipulation and World Trade*, NBER Working Paper 14600 (December 2008), p. 1

<sup>11</sup> William Cline & John Williamson, *2009 Estimates of Fundamental Equilibrium Exchange Rates*, Peterson Institute for International Economics, Policy Brief 09-10



conferring an unfair price advantage to national exporters *vis-à-vis* foreign competitors. While it, conversely, has the effect of weakening the purchasing power of Chinese households, which effectively reduces consumption and importation of foreign goods. In effect, it is a combination of an export subsidy and an import tariff.

This asymmetry between export/import trade flows is a major contributing factor to China's global current account surplus that amounts to US\$270 billion of which the trade surplus, for November 2010, accounted for US\$22.9 billion.<sup>12</sup> As professor Christoph Herrmann, Professor at University of Oldenburg, Germany, explains:<sup>13</sup>

*From the perspective of exchange rate theory, it is obvious that the [RMB] is manifestly undervalued. Without the interventions of the People's Bank of China, the massive capital inflow and the record trade surplus could not persist at the same time, neither theoretically nor practically. A floating exchange rate would appreciate until the point where the balance of payments would be equalized, with the current account balance and the capital and financial account balance outweighing each other.*

The fact that one country is running a current account surplus naturally requires one or more countries to maintain deficits. In the case of China's surplus, the United States finds itself on the receiving end. It is currently the world's largest debtor, suffering from a soaring current account deficit of US\$466 billion.<sup>14</sup> The trade deficit, alone, was US\$38.7 billion in October 2010, which is a direct consequence of the disparity between surging Chinese imports and weak U.S. exports.<sup>15</sup> In a United States where there is high unemployment and slow economic growth, there is a strong body of opinion that think

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<sup>12</sup> Financial Times, *Imbalances Cloud 20/20 Vision*, Nov. 10, 2010, p. 9; Alan Rappeport, *Exports Shrink US Trade Gap*, FINANCIAL TIMES (Dec. 10, 2010)

<sup>13</sup> Christoph Herrmann, *Don Yuan: China's "Selfish" Exchange Rate Policy and International Economic Law*, p. 33, in C. Herrmann and J.P. Terhechte (eds.), *European Yearbook of International Economic Law* (2010)

<sup>14</sup> Geoff Dyer, *China's Trade Surplus Jumps in October*, FINANCIAL TIMES (Nov. 10, 2010)

<sup>15</sup> United States Department of Commerce, *U.S. Commerce Secretary Gary Locke Statement on October 2010 U.S. International Trade in Goods and Services Report* (Dec. 10, 2010)

China's exchange rate regime, in addition to warranting unilateral legislative action, is in violation of WTO law.<sup>16</sup>

### **The Bretton Woods Institutions**

The Bretton Woods Institutions were precisely created to address issues of global economic imbalances, or externalities, created as a consequence of countries pursuing unilateral trade policy objectives.<sup>17</sup> The International Monetary Fund (IMF or the Fund), for instance, is mandated to address trade imbalances caused by fundamentally misaligned or manipulated exchange rates through its surveillance powers.<sup>18</sup> To this end, the IMF is concerned with the impacts of exchange rate policies on trade imbalances.<sup>19</sup> By contrast, the WTO, which developed through the 1947 General Agreement on Tariffs and Trade (GATT), has as its overall function to reduce and eliminate measures that restrain or distort the volume of international trade.<sup>20</sup> Arguably, exchange rate manipulation that has an adverse effect on international trade volumes falls within the competence of the organization, as evidenced by GATT Article XV(4).

Although there is a possible overlap between the jurisdictions of the two organizations, in that both can be said to be concerned with the effects of member states' exchange rate policies, two points bear emphasis. First, determining whether a state's exchange rate is in violation of an IMF or a WTO obligation evolves around different sets of facts and considerations. A finding, therefore, that an exchange rate is "fundamentally misaligned" or "manipulated" under IMF Article IV:1(iii) do not automatically establish

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<sup>16</sup> See witness statements and testimonies for the United States House Ways and Means Committee *Hearing on China's Exchange Rate Policy* (Mar. 24, 2010)

<sup>17</sup> Robert W. Staiger & Alan O. Sykes, *supra* note 10, p. 5

<sup>18</sup> Art. IV IMF Rules

<sup>19</sup> Robert W. Staiger & Alan O. Sykes, *supra* note 10, p. 5

<sup>20</sup> *Id.* p. 6

a violation of GATT Article XV(4), or vice versa.<sup>21</sup> Second, unlike the IMF, the WTO has a formal dispute settlement mechanism, conferred with exclusive competence to adjudicate issues relating to member states' WTO commitments. Thus, taking into consideration that every adverse WTO recommendation is coupled with a remedy (compensation or multilaterally approved retaliatory action),<sup>22</sup> the WTO is by far the most appealing forum in which to challenge China's exchange rate policy.

### **Part III**

#### **Challenging the China Currency Issue in the WTO**

As alluded to above, the dispute settlement procedure in the WTO provides for one of the most effective dispute settlement procedures and enforcement mechanism in international law. By virtue of Article XXIII of the Dispute Settlement Understanding (DSU), the WTO enjoys exclusive jurisdiction to determine whether a member state measure is consistent with WTO law.<sup>23</sup> An adverse recommendation of the Dispute Settlement Body (DSB) normally results in the member state withdrawing the measure concerned. In exceptional cases, the prevailing member is entitled to monetary compensation or may be authorized to retaliate by suspending the application of concessions or other obligations against the non-complying member state.<sup>24</sup>

The United States has three conceivable legal bases in the WTO Agreements, pursuant to which it can challenge the undervalued Chinese currency. The RMB can arguably be held to violate WTO law on the basis that: (a) it is a WTO illegal export

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<sup>21</sup> Robert W. Staiger & Alan O. Sykes, *supra* note 10, pp. 7, 8

<sup>22</sup> Art. 22.2 DSU

<sup>23</sup> *United States - Section 301-310 of the Trade Act of 1974*, WT/DS152/R, adopted December 22, 1999, para. 7.95 (Panel Report)

<sup>24</sup> Art. 3.7 DSU

subsidy;<sup>25</sup> (b) it undermines the intent of the WTO;<sup>26</sup> or (c) it is an exchange action that frustrates the intent of the GATT.<sup>27</sup>

**a. Export Subsidization**

The purpose of the Agreement on Subsidies and Countervailing Measures (SCM Agreement) is to impose a multilateral discipline on the premise that some forms of government intervention distort international trade, or have the potential to distort international trade.<sup>28</sup> The question is whether China’s practice of intervening in currency markets to drive down the price of the RMB to enhance its export competitiveness constitutes the proscribed act.

In order for there to be a subsidy, Article 1.1 SCM Agreement requires that the governmental action either provides a “financial contribution” or “any income or price support” which confers a “benefit” to the recipient. Furthermore, the SCM Agreement requires that the benefit is *specific* so as to confer an advantage to a certain enterprise or industry.<sup>29</sup> It is, thus, a two-prong test qualified by the requirement of specificity that determines whether a measure meets the internationally agreed definition of a subsidy in the WTO treaty.<sup>30</sup>

***i. Governmental Financial Contribution***

The concept of a governmental financial contribution connotes a clear transfer of economic resources to a national recipient. Article 1.1 SCM Agreement sets out an exhaustive list identifying specific forms of governmental financial contributions that are

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<sup>25</sup> Arts. 1-3 WTO Agreement on Subsidies and Countervailing Measures

<sup>26</sup> A so called “non-violation complaint” pursuant to Article XXIII GATT

<sup>27</sup> Art. XV(4) GATT

<sup>28</sup> *Canada – Measures Affecting the Export of Civilian Aircraft*, WT/DS70/R, adopted August 20, 1999, para 9.119 (Panel Report)

<sup>29</sup> Art. 2 SCM Agreement

<sup>30</sup> *Canada - Aircraft*, *supra* note 28, para 156

deemed to distort international trade.<sup>31</sup> Given the strict confines within which the term operates, it is possible that a governmental financial contribution that is not among the enumerated items in the provision is not held to be a WTO subsidy even though it provides an economic benefit to a national industry.<sup>32</sup>

Former Chairman of the WTO Appellate Body James Bacchus argues that the act of the People's Bank of China of selling units of RMB and obtaining, mainly, U.S. dollars in an attempt to control the value of its exchange rate can be seen as an exercise of China's *general* regulatory powers.<sup>33</sup> It is characterized by China's participation in the exchange markets, which does not generally involve a direct financial contribution to national exporters. It can be argued in the alternative, however, that when China intervenes and drives down the value of the RMB it impedes the inflow of imports and thus "foregoes tariff revenue otherwise due", which is also recognized as a financial contribution in the SCM Agreement.<sup>34</sup> Moreover, in the instances where Chinese exporters engage directly with the People's Bank of China to exchange foreign currency for RMB, a "direct transfer of funds" would most likely take place.<sup>35</sup>

## *ii. Advantage*

According to Article 1 SCM Agreement, an advantage exists where the subsidy provides value to the recipient. The fact that Chinese exporters can trade units of foreign currency for RMBs at a discount of approximately 20-40%, equal the undervaluation,

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<sup>31</sup> *United States – Measures Treating Export Restraints as Subsidies*, WT/DS194/R, adopted August 23, 2001 (Panel Report)

<sup>32</sup> Robert W. Staiger & Alan O. Sykes, *supra* note 10, p. 32

<sup>33</sup> James Bacchus, *A Survey of Views Regarding Whether Exchange-Rate Misalignment Is a Countervailable, Prohibited Export Subsidy Under the Agreements of the World Trade Organization* (April 2007), p. 2

<sup>34</sup> Art. 1.1(a)(1)(ii) SCM Agreement

<sup>35</sup> Robert W. Staiger & Alan O. Sykes, *supra* note 10, p. 32 ft. 65

may be deemed as providing an advantage to the exporter. However, there is no conclusive way of measuring the exact value of the advantage because there is no currency-exchange market where the RMB is openly traded. In other words, the value of the RMB is not determined by market forces of supply and demand, but rather by the exclusive discretion of China. John Magnus, President of TradeWins LLC, Washington D.C, argues that China's currency regime can be seen as an exchange-risk program that appears to shield Chinese exporters from the expense of hedging against foreign-exchange losses or from purchasing guarantees to guard against exchange-rate fluctuation. Arguably, this service comes at no cost to the exporter, and could be characterized as an advantage valued at the amount equal to the cost of entering into an off-setting forex position on any given day.<sup>36</sup>

### *iii. Specificity*

The specificity requirement is intended to operate as a tool to limit the number of governmental actions that can become subject to the WTO subsidy rules.<sup>37</sup> Article 2.3 SCM Agreement states that the specificity requirement is met if the subsidy can be characterized as an "export subsidy" – i.e. a subsidy contingent upon export performance. China's practice of intervening in currency exchange markets does not directly confer an advantage to Chinese companies or industries contingent upon their export performance. It is true that exporting firms tend to be the biggest beneficiaries of an undervalued exchange rate, but it cannot conclusively be determined that the undervalued RMB is an export subsidy merely because Chinese exporting firms *tend* to benefit the most. On the

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<sup>36</sup> ChinaCurrencyCoalition.com, *A Survey of Views Regarding Whether Exchange-Rate Misalignment Is a Countervailable, Prohibited Export Subsidy Under the Agreements of the World Trade Organization* (April 2007), pp. 6, 7

<sup>37</sup> Luca Rubini, *The Definition of Subsidy and State Aid* (2009), p. 359

contrary, the effects of the lower-valued RMB are felt throughout the whole Chinese economy, which is short of satisfying the specificity requirement.

**b. Non-Violation Complaint**

The United States could bring a “non-violation” complaint, pursuant to GATT Article XXIII, arguing that China’s exchange rate practice is not necessarily a violation of a WTO commitment *per se*, but is prohibited because it undermines the intent of the trade agreements. The benefit that otherwise would accrue to the United States derives from the concession agreement China has reciprocally negotiated *vis-à-vis* the other WTO member states. These agreements set out the specific bound tariff rates for goods that are applied upon importation to a member state. Arguably, China is in violation of its agreed tariff rates by maintaining an undervalued currency given that it impedes the volume of imports due to the severely weakened purchasing power of Chinese consumers. The *de facto* increase in tariffs, across-the-board for all imports, equals the extent of the undervaluation, i.e. 20-40%. However, the evidentiary problem as to the exact amount of undervaluation is an obvious obstacle for bringing a successful complaint forward. Furthermore, a non-violation complaint suggests that a member state has adopted a new policy action that undermines its WTO commitments. There is a formidable challenge for any WTO member to argue that China’s exchange rate practice is one that it did not exercise when it acceded the organization in 2001. Exchange rate policies are also peculiar in the sense that no WTO member can legitimately expect another member to maintain basically the same exchange rate policy that was in place when it joined the multilateral organization, seeing that monetary policies are prone to change to meet

national economic concerns.<sup>38</sup> In other words, exchange rate policies are by nature ill suited to form the basis of a non-violation complaint.

**c. Exchange Action Frustrating the Intent of GATT**

GATT Article XV addresses currency exchange measures that undermine a member state's commitments under the GATT. The obligation most relevant for our purposes is found in Article XV paragraph 4, which provides:<sup>39</sup>

*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.*

Article XV(4) shall be read in combination with the addenda to the paragraph, which in relevant part provides:

*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.*

The meaning and exact scope of Article XV(4) are fraught with uncertainties because there is no jurisprudence on the provision since it has never been interpreted in neither GATT nor WTO litigation. The scope of the article and the intention of the GATT draftsmen have instead been extensively debated among scholars, whose views do not necessarily converge. Aaditya Mattoo, Research Manager at the World Bank, and Arvind Subramanian, Senior Research Staff at Peterson Institute for International Economics, argue that Article XV(4) is too vague an obligation to provide a basis for effective

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<sup>38</sup> Dukgeun Ahn, *Is the Contemporary Chinese Exchange Rate Regime "WTO-legal"?* (2010), p. 4

<sup>39</sup> In the event of a challenge, the WTO is required to *consult* with the IMF and *accept* all findings presented by the Fund.



enforcement against the Chinese currency misalignment and suggest that new rules have to be adopted to this end.<sup>40</sup> Stanford University Professors Robert W. Staiger and Alan O. Sykes also seriously question the viability of such a challenge. Moreover, they also find a claim asserting the undervalued RMB as comparable to an illegal export subsidy or illegal import tariff to be non-viable.<sup>41</sup> However, arguing in the contrary, Jorge O. Miranda, King & Spalding, concludes that Article XV(4) does provide a sufficient legal basis for a challenge to be brought forwards and, more importantly, argues that the prospect of a favorable outcome is reasonably attainable.<sup>42</sup>

When interpreting the WTO Agreements, WTO panels and the Appellate Body must apply “the customary rules of interpretation of public international law”.<sup>43</sup> The customary rules have been settled in WTO case law to be codified in the Vienna Convention on the Law of Treaties, Articles 31 and 32.<sup>44</sup> The effect of these treaty interpretative rules, for our purposes, is that Article XV(4) shall be interpreted based on its ordinary meaning, context, and object and purpose, as well as with the aid of supplementary means, such as the preparatory works of the GATT, if the ordinary meaning of the provision remains ambiguous or obscure.<sup>45</sup> Applying the treaty interpretative rules the question is whether China’s management of the value of the RMB qualifies as an exchange action that frustrates, to an appreciable extent, the intent of the

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<sup>40</sup> Aaditya Mattoo & Arvind Subramanian, *Currency Undervaluation and Sovereign Wealth Funds: A New Role for the World Trade Organization*, World Bank Policy Research Working Paper 4668 (2008), p. 4

<sup>41</sup> Robert W. Staiger & Alan O. Sykes, *supra* note 10

<sup>42</sup> Jorge O. Miranda, *Currency Undervaluation as a Violation of GATT Article VX(4)*, p. 115, in Simon J Evenett (ed.), *The U.S.-Sino Currency Dispute: New Insights from Economics, Politics, and Law* (2010)

<sup>43</sup> Art. 3.2 DSU

<sup>44</sup> *United States – Standards for Reformulated and Conventional Gasoline*, WT/DS2/AB/R, adopted April 29, 1996, p. 17 (Appellate Body Report)

<sup>45</sup> Jorge O. Miranda, *supra* note 42, p. 119

GATT?

*i. Exchange Action*<sup>46</sup>

Since Article XV(4) only refers to “exchange action” and not “exchange-rate policies” or “exchange-rate management” *per se*, the interpretative challenge is whether these terms nevertheless fall within the meaning of “exchange action”. First, the ordinary meaning of “action” does not conclusively settle whether “policies” or “management” are included or excluded in the term. Second, the context of the provision suggests that the GATT draftsmen intended for the term to be given a broader meaning, because in neighboring provisions they have utilized much narrower terms, such as “exchange controls” and “multiple exchange rates”. Third, the object and purpose of Article XV can reasonably be said to prevent member states from impeding or hindering in any way the free flow of international trade by virtue of exchange rate practices. Furthermore, Professor John H. Jackson, with reference to the preparatory works of the GATT, suggests that “exchange-rate policies” were something the GATT draftsmen did indeed intend to fall within the broader term of “exchange action”.<sup>47</sup> It is therefore conceivable that China’s monetary practice satisfy the first legal requirement.

*ii. Frustrates*

The ordinary meaning of the verb “to frustrate”, with reference to the *Shorter Oxford English Dictionary*, includes “prevent”, “counteract” or “make ineffectual”. In other words, the exchange action has to impede or otherwise make ineffectual the intent of the GATT. As such, the undervalued RMB restricts trade volumes seeing that it has

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<sup>46</sup> This section relies on the article of Jorge O. Miranda, *supra* note 42, pp. 119, 120, which in material part coincides with my interpretation of GATT Article XV(4).

<sup>47</sup> John H. Jackson, *World Trade Law and the Law of GATT* (1969), p. 479

similar effects as an import tariff and export subsidy.

### *iii. The Intent of the GATT*

The exchange action, also, has to frustrate the intent of the GATT, which most reasonably ought to be interpreted as frustrating a provision of the GATT as opposed to the agreement as a whole. A member state's concession agreement forms part of the GATT by virtue of Article II(7) and, as argued above, the fact that China maintains an undervalued exchange rate is equivalent to an import tariff and, therefore, in violation of one of its commitments under the GATT.

In conclusion, the interpretation of Article XV(4) set forth above lends itself for a finding that China's exchange rate practice is an "exchange action" in violation of WTO law, because it makes ineffectual (frustrates) the bound tariff rates China has negotiated *vis-à-vis* other member states (intent of GATT). However, a word of caution is warranted. The fact that the DSB has not adopted an official interpretation of Article XV(4) does mean that there is great uncertainty as to its scope. Hence, the interpretation set forth is but a mere qualitative guess. Furthermore, the fact that there are inherent uncertainties and evidentiary problems with respect to bringing a challenge against China's exchange rate practice under all three legal bases in the WTO Agreements ought to make the United States government to hesitate before lodging a formal complaint. The uncertainties and evidentiary obstacles serves as strong evidence that matters of exchange rate policies are not *sensu stricto* within the competence of the WTO. Moreover, the fact that no member states' exchange rate practices have ever been challenged in either GATT or WTO litigation is, *a fortiori*, another piece of evidence that ought to deter the United States from bringing a formal complaint.

## Part IV

The viability of bringing a successful challenge in the WTO against China's exchange rate practice is, at best, only reasonably attainable for the United States. Notwithstanding the vagueness and evidentiary obstacles in bringing a case, there are additional factors that make WTO litigation unsuitable. This part of the paper attempts to illuminate some of these. They are not set out in any hierarchical order of importance.

### “One of Those Big Trade Cases”

The WTO dispute settlement system has, rightfully so, been acknowledged and accredited for providing an effective mechanism for the resolution of international trade disputes. Since its inception in 1995, the DSB has adopted approximately 166 panel reports and 96 appellate body reports, covering a broad range of topics in international trade.<sup>48</sup> It is not equally clear, however, whether the WTO can be deemed to have had the same success in adjudicating the so called “big trade cases”. To this subjectively categorized group belong disputes such as *EC – Bananas*,<sup>49</sup> *EC - Hormones*<sup>50</sup> and the still ongoing *Boeing/Airbus*<sup>51</sup> cases. These disputes stand out because they did not exclusively concern differences on mere trade issues, rather the disagreements delved into complex issues that went deep into social and economic structures of the member states involved. The common denominator of these disputes, in other words, is the considerably high political and economic stakes at play that made WTO litigation both unsuitable and ineffective.

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<sup>48</sup> WorldTradeLaw.net, <http://www.worldtradelaw.net/reports/wtoab/abreports.asp> (accessed Nov. 23, 2010)

<sup>49</sup> *European Communities – Regime for the Importation, Sale and Distribution of Bananas* (DS27)

<sup>50</sup> *European Communities – Measures Concerning Meat and Meat Products* (DS26, DS48)

<sup>51</sup> *European Communities – Measures Affecting Trade in Large Civil Aircraft* (DS316) & *United States of America - Measures Affecting Trade in Large Civil Aircraft* (DS317)

In *EC - Hormones*, the United States challenged measures of the EC that banned the importation of beef from animals produced with hormones to stimulate growth. The EC argued that the measures were justified because they were based on a sound scientific basis, as required by the WTO Sanitary and Phytosanitary Agreement (SPS Agreement), showing an identifiable risk to human health from the use of hormones for growth purposes in beef cattle.<sup>52</sup> The argument of the EC was tenuous, but sought to protect widely held societal values in the EC that disapproved of such practices. On appeal, the appellate body found in favor of the United States, holding the EC measures out to be inconsistent with the SPS Agreement.<sup>53</sup> However, it is not surprising that the EC, due to the domestic political constraints, did not lift the ban and allowed for the importation of hormone-treated beef. Instead, it accepted the adverse ruling authorizing the United States to impose retaliatory tariffs amounting to US\$116.8 million a year, equal the level of damage to U.S. producers. The case evidences that in some instances deep-seated societal values and political considerations will trump the legal obligations imposed on member states by the global trading system.

In a similar vein, the China currency issue is more than a mere trade issue. Arguably, it is a completely different animal. National monetary policies are the prerogative of a sovereign state. A state has the inherent and exclusive power to freely control and manage the value of its currency. In adherence to the doctrine of comity, no other state shall sit in judgment of that power. Thus, even though China's exchange rate policy inevitably has trade volume implications, it is above all an exercise of a sovereign prerogative that is beyond reach of the rules and dispute settlement system of the WTO.

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<sup>52</sup> *EC – Hormones*, WT/DS26/R/USA, adopted February 13, 1998, para III.4 (Panel Report)

<sup>53</sup> *EC – Measures Concerning Meat and Meat Products (Hormones)*, WT/DS48/AB/R, DSR 1998:III, 699, para 253(1) (Appellate Body Report)

To have the issue adjudicated pursuant to the trade rules would not only produce an unsatisfactorily outcome but it would also pose serious risks and consequences to the future success of the dispute settlement system.

For instance, such a case could set a dangerous precedent for expansive interpretation of vague WTO provisions, and considerably broaden the trade organization's authority through judicial activism.<sup>54</sup> How far would the trade regime extend its reach into other controversial areas with undeniable trade implications such as labor, environment, competition, and investment? Although the question is beyond the scope of this paper, suffice it to say there is a correlation between the success of the WTO dispute settlement system and the narrow scope of trade issues it is, and has, concerned itself with. Delineating how far the trade regime shall delve into these peripheral and politically charged areas should not be left with the dispute settlement system to decide. With reference to the doctrine of separation of powers, the decision should be vested with the WTO General Council (the executive) or decided in WTO trade negotiation rounds (the legislator), but not the judiciary.<sup>55</sup> It is important to emphasize that the WTO treaty recognizes that there are limits to what the dispute settlement system can deliver. In Article 3.7 DSU, WTO members are encouraged to exercise judgment as to whether bringing a formal complaint would be fruitful. Taking account of the considerations aforementioned, it is not unwarranted to suggest that the WTO dispute settlement system is not a suitable forum for the China currency issue.

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<sup>54</sup> Marc Busch & Philip Levy, *The Case Against a China Currency Case*, THE AMERICAN (Oct. 7, 2010)

<sup>55</sup> Claude Barfield, *Overreach at the WTO*, VOX.EU.ORG (Sept. 30, 2010)

## **Not an Effective Remedy**

If the United States would nevertheless forego the appeal of the WTO to exercise judgment, as prescribed in Article 3.7 DSU, and submit a formal complaint there are concerns that a recommendation by the DSB would not provide an effective remedy to the China currency issue.

As a preliminary matter, it is by no means certain that the outcome of a case would yield a win for the United States. The viability of a challenge has been examined at some length above. However, one final point is warranted. The fact that the United States may not prevail carries the profound risk of handing a mightily big victory to the Chinese; which in effect would vindicate its exchange rate practice. An unfavorable outcome for the United States would, therefore, result in a significant loss of leverage and make it a great deal more difficult to successfully address the issue thereafter.

Second, in view of the subject matter of the issue it is likely that a dispute would be a long, drawn-out proceeding that ultimately would fail to provide an effective remedy to an immediate problem. Notwithstanding that Article 20 DSU foresees a maximum duration of nine to twelve months for the DSB to adopt a report, experience from the so called “big trade cases” suggest that the actual duration of a WTO proceeding would be considerably longer. For example, in *EC - Bananas* it took the DSB five years to adopt the final recommendation, in *EC - Hormones* the time period was three years, while in the first *Boeing/Airbus* dispute the DSB adopted the panel report more than five years after the United States’ request to establish a panel. Moreover, the panel report in *Boeing/Airbus* was appealed and is currently under Appellate Body review, which will further add to the longevity of the dispute.

In regards to the China currency issue, there is nothing suggesting that it would be resolved within the short time frame foreseen by Article 20 DSU. Rather a proceeding is more likely to be protracted with years of appeals and attracting other WTO members either as co-complainants or interested third parties.<sup>56</sup> The fact that a WTO proceeding, therefore, would most likely last for several years is yet another reason why WTO litigation is not the best option for the United States, seeing that the forum will fail to provide an effective remedy to an immediate problem that needs to be redressed sooner rather than later.

Third, it is also by no means certain that China would comply with an adverse WTO recommendation. Notwithstanding that compliance with DSB recommendations have been a particular strength of the WTO dispute settlement system,<sup>57</sup> compliance is a political calculation taking into consideration the political and economic importance of the particular issue at stake.<sup>58</sup> Therefore, there is greater risk of member state noncompliance in cases where political and economic stakes are particularly high. In the case of China, the lower-valued exchange rate generates substantial employment opportunities to its vast population, which serves the grander goal of the Chinese Communist Party namely: political stability. The fact that China's export competitiveness is an emanation of the higher societal goal of limiting social unrest with China's political system makes a revaluation of the RMB inconceivable.

Fourth, in the event China would be in noncompliance with a DSB recommendation, the question is whether the United States' right to employ retaliatory

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<sup>56</sup> Marc Busch & Philip Levy, *The Case Against a China Currency Case*, *supra* note 54

<sup>57</sup> Approximately 3% of all complaints have exhausted the whole dispute settlement procedure without settlement: *see* Carlos Frederico Coelho, *Compliance and the WTO*, *infra* note 58

<sup>58</sup> Carlos Frederico Coelho, *Compliance and the WTO: Bridging the gap between international law and international relations* (2008), p. 8



tariffs, as prescribed in Article 22.4 DSU, would provide an effective remedy.<sup>59</sup> Although the impositions of retaliatory tariffs on Chinese imports would go some way in providing a remedy, it would not be effective. The United States has on several occasions been authorized to implement retaliatory tariff measures, including against the (now) European Union in *EC - Bananas* and *EC – Hormones* respectively. In the former, retaliatory tariffs amounting to US\$191.4 million a year has been applied since 1999 without ever successfully obtaining the European Union’s full compliance with the DSB recommendation.<sup>60</sup> In the latter case, the United States and the European Union have as of 2009 reached a provisional agreement on a way forward in the *EC – Hormones* dispute. Under the agreement, the United States will maintain current retaliatory measures of US\$116.8 million a year until 2013, during which period of time the EU will agree to provide additional duty-free access to the EU market for beef *not* treated with growth-promoting hormones.<sup>61</sup> In other words, even though the EU has agreed to concede greater market access to U.S. beef exports it will still be noncompliant with the DSB recommendation since the ban on hormone-treated beef subsists.

Based on the foregoing, the fact of the matter is that retaliation is not always an effective means to obtain counterparty compliance - at least not when the counterparty is a large economic power. It is apparent that retaliation would equally be without teeth against China in inducing a revaluation of the RMB, given that pecuniary retaliation would not carry much force on the world’s second largest economy and the country with

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<sup>59</sup> In relevant part Article 22.4 DSU provides: “*the level of suspension of concessions... shall be equivalent to the level of the nullification or impairment.*”

<sup>60</sup> On May 31, 2010, the United States and the European Union reached an agreement designed to settle the Bananas dispute; *see* United States Trade Representative, *Agreement on Trade in Bananas between the United States of America and the European Union*

<sup>61</sup> United States Trade Representative, *United States and European Union Reach Provisional Agreement in Beef Dispute*, Press Release (May 2009)

the world's deepest currency reserves. There are of course additional consequences flowing from having an adverse DSB recommendation made against China. It could serve the United States with a powerful negotiation instrument, as well as it could have harmful effects on China's reputation, affecting relations with its trading partners.<sup>62</sup> However, the question remains whether these effects are tantamount to an effective remedy to United States' immediate problem? I think not.

### **Is There a Better Option?**

There are a number of options available for the United States to try and force China to revalue its currency. Apart from WTO litigation two others have been briefly mentioned in this paper, namely unilateral trade legislation, currently in the form of a House of Representatives' bill, authorizing countervailing import duties against the export subsidies created by the undervalued RMB and, second, IMF *ad hoc consultation*. Moreover, the United States can seek to have the Group of 20 (G-20) or the WTO adopting guidelines/rules compelling states with persistent current account surpluses to adjust or, alternatively, implementing restrictions on exchange rate management.<sup>63</sup> The United States can also engage in so called "remedial intervention", as foreseen by Senate bill 3134, whereby the United States would proactively intervene in currency markets to offset China's intervention on any given day.<sup>64</sup> Finally, the U.S. Treasury can designate China as a "currency manipulator" in its bi-annual report to Congress on foreign

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<sup>62</sup> Carlos Frederico Coelho, *Compliance and the WTO*, *supra* note 58

<sup>63</sup> Note the omission of the IMF, partly because the Fund already has rules towards this end and partly because of its inadequate leverage to enforce change in member state policies, *see* Aaditya Mattoo & Arvind Subramanian, *supra* note 40

<sup>64</sup> s. 106 "Currency Exchange Rate Oversight Reform Act of 2010" (S.3134), sponsored by Senator Charles Schumer (Democrat – New York). The bill was referred to the Committee on Finance on March 17, 2010.

exchange practices.<sup>65</sup>

Whether these additional options are more suitable than WTO litigation to have China revalue the RMB is open to discussion, seeing that each comes with clear advantages and disadvantages. Whatever option the United States chooses to employ, it is imperative that it is multilateral in nature in order to have the greatest effects. China is far more likely to respond to the criticism of a coalition of countries as opposed to bilateral pressure from the United States alone.<sup>66</sup> Notwithstanding that a multilateral solution to the issue does not seem attainable in the short-term, in fact the G-20 stalemate might even have intensified the feud over currencies,<sup>67</sup> the unilateral methods of trade legislation, i.e. remedial intervention and designation of China as currency manipulator, would run the risk of seriously aggravating the situation by seeing the escalation of beggar-thy-neighbor policies and the ultimate risk of an all out bilateral trade war.

## **Conclusion**

It has been argued in this paper that there is, at least, a reasonable chance for the United States to bring a successful challenge against China's undervalued RMB in the dispute settlement system of the WTO. It has equally been shown that such route would most likely fail to provide an effective remedy to an immediate problem. This is not to say, however, that a favorable outcome would be without any benefit to the United States. A successful challenge could be of considerable leverage in bilateral negotiations, which is a forum more likely to produce a sustainable settlement of the issue as opposed to

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<sup>65</sup> Report on International Economic and Exchange Rate Policies (s. 3004 Omnibus Trade and Competitiveness Act 1988)

<sup>66</sup> C. Fred Bergsten, *Correcting the Chinese Exchange Rate*, Congressional Testimony (Sept. 15, 2010)

<sup>67</sup> C. Fred Bergsten, *Obama has to Tell Beijing some Hard Truths*, FINANCIAL TIMES (Nov. 29, 2010)

embarking upon the adversarial route and WTO litigation.

In answering the question that was posed in the beginning of this paper, whether the fact that the United States has not lodged a formal complaint with the WTO dispute settlement system is evidence of the trade organization's demise from effectively resolving member state disputes, the answer is in the negative. The global trade regime, as embodied by the WTO, has always only concerned itself with a narrow category of measures that affect international trade volumes. The competence of the trade organization is ultimately what the member states have agreed to in treaty. The DSB has, painfully at times, sought to honor the intention of the member states by adopting a strict textual interpretation of the WTO Agreements when adjudicating disputes. Since neither exchange rate policies nor exchange rate management are explicitly referred to in the WTO Agreements, it is evidence that the matter shall not, without further clarification of the member states, fall within the jurisdiction of the DSB. If a challenge, nevertheless, would be brought forward pursuant to tenuous legal bases in the WTO Agreements it would come at the risk of being unsatisfactorily resolved. Moreover, taking into consideration that the issue also involves considerably high political and economic stakes, compliance with a DSB recommendation becomes, *a fortiori*, even less likely.

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