

Is China a “Currency Manipulator”? The Legitimacy of China’s Exchange Regime Under the Current International Legal Framework

BRYAN MERCURIO* & CELINE SZE NING LEUNG**

Abstract

While most economists are in agreement that China’s currency is undervalued, economists are less certain as to the effect of the undervaluation. Despite the equivocal data, critics of China’s regime claim that the undervaluation leads to cheaper, and therefore increased exported goods, while at the same time raising the price of imported goods. For this reason, U.S. lawmakers perpetually raise the issue and periodically initiate legislation, which would deem China a “currency manipulator” and thus trigger retaliatory measures. Lawyers are less certain whether there can be a multilateral solution to the perceived problem.

With the existing legal literature consisting mostly of industry-funded research, the time is ripe to undertake a large-scale legal analysis of China’s exchange regime under the existing international legal framework. This article undertakes such an analysis and in particular, evaluates the legitimacy of China’s exchange regime under applicable international law, that being the Articles of Agreement of the International Monetary Fund (IMF) and both the General Agreement on Tariffs and Trade and the Agreement on Subsidies and Countervailing Measures of the World Trade Organization (WTO). We conclude that while China clearly manipulates its currency, its measures are not inconsistent with the IMF Articles or the applicable WTO agreements. The article concludes by noting that modification of either the IMF Articles or applicable WTO agreements is the only multilateral option available to those determined to more strongly sanction “currency manipulation.”

* Professor, Chinese University of Hong Kong, Faculty of Law; Fellow, Tim Fischer Centre for Global Trade and Finance.

** Clifford Chance, Hong Kong. Ms Leung is a Hang Seng Scholar and was awarded the Hong Kong Schools Alumni Federation Scholarship (together with the Hang Seng Bank (Overseas) Scholarship) to study at Princeton University. She graduated from Princeton University with a B.A. in Economics, Certificate in Finance, and received her J.D. from the Chinese University of Hong Kong.

I. Introduction

China's exchange regime¹ has long been the subject of international criticism. Among the complainants are the United States, Japan, and the European Union,² with the United States being the most vocal critic. Most U.S. criticisms assert that China's currency is undervalued, thereby making Chinese exports into the United States cheaper while at the same time increasing the price of American exports to China.³ These price differences, the critics claim, harm U.S. production, particularly in the manufacturing sector. The core complaint is that Chinese exporters receive an unfair advantage due to the undervalued exchange rate.⁴ Such criticism recently culminated in U.S. Treasury Secretary Timothy Geithner accusing China of "manipulating" its currency.⁵ In doing so, Geithner

1. This article uses the term "exchange regime" interchangeably with "exchange arrangement" to mean the general exchange rate framework or system which a country adopts (e.g. floating exchange rate system or managed float). This definition is based on the IMF Legal Department definition for "exchange arrangement"—the exchange system's broad classification or framework. See Int'l Monetary Fund [IMF], *Article IV of the Fund's Articles of Agreement: An Overview of the Legal Framework*, June 28, 2006, <http://www.imf.org/external/np/pp/eng/2006/062806.pdf> [hereinafter Article IV Overview]. For more detailed information on exchange rates and regimes, see JOSEPH GOLD, *EXCHANGE RATES IN INTERNATIONAL LAW AND ORGANIZATION* (American Bar Association Section of International Law and Practice 1988).

2. See, e.g., RONALD I. MCKINNON, *EXCHANGE RATES UNDER THE EAST ASIAN DOLLAR STANDARD* 138 (The MIT Press 2005); M. Ulrich Killion, *China's Foreign Currency Regime: The Kagan Thesis and Legalification of the WTO Agreement*, 14 MINN. J. GLOBAL TRADE 43, 44 (2004); *That Chinese "Juggernaut"—Should Europe Really Worry About its Trade Deficit with China?* (Euro. Ctr. for Int'l Pol. Econ. [ECIPE], Briefing Paper No. 2/2008, 2008); *Trade Disputes Between China and the EU* (E. Asian Inst. [EAI], Background Brief No. 416, 2008), <http://www.eai.nus.edu.sg/BB416.pdf>.

3. The U.S. trade deficit with China was \$266 billion in 2008. See Wayne M. Morrison & Marc Labonte, *China's Currency: A Summary of the Economic Issues*, RS21625, Congressional Research Service Report for Congress (Apr. 13, 2009), <http://www.fas.org/spp/crs/row/RS21625.pdf>. For criticisms of China's policies, see, e.g., China Currency Coalition, *Petition for Relief Under Section 301 (a) of the Trade Act of 1974, as Amended* (Sept. 9, 2004), <http://www.chinacurrencycoalition.org/petition.html>; C. Fred Bergsten, Peterson Inst. for Int'l Econ., *The Dollar and the Renminbi*, Statement Before the Hearing on U.S. Economic Relations with China (May 23, 2007), <http://www.piie.com/publications/papers/paper.cfm?ResearchID=747>; Peter Morici, *Currency Manipulation and Free Trade* (Dec. 2004), http://www.rhsmith.umd.edu/faculty/pmorici/Morici_Paper_on_Currency_Manipulation.pdf; Lael Brainard, *Global Views: Currency Exchange Rate Oversight Reform Act of 2007*, BROOKINGS, June 14, 2007, http://www.brookings.edu/opinions/2007/0614globaleconomics_brainard.aspx

4. Of course, critics ignore U.S. benefits, such as those to U.S. firms and consumers (in the form of both cheaper goods and increased and cheaper credit) and to U.S. enterprises manufacturing in China. Critics also ignore the detriments of an undervalued exchange rate to China, including the increased costs of importing necessary inputs. See Morrison & Labonte, *supra* note 3, at 3-5 (finding no medium or long-term effect on aggregate U.S. employment).

5. Geithner made the accusation in writing to the Senate Finance Committee immediately prior to the Committee's vote to recommend his confirmation as Treasury Secretary. See *Hearing on Confirmation of Mr. Timothy F. Geithner to be Secretary of the U.S. Department of Treasury*, United States S. Comm. on Fin. (Jan. 21, 2009), <http://finance.senate.gov/sitepages/leg/LEG%202009/012209%20TFG%20Questions.pdf> [Hereinafter *Geithner Confirmation Hearing*]. ("Geithner Confirmation Hearing"). For background and more information see Jackie Chalmes, *Geithner Hints at Harder Line on China Trade*, N.Y. TIMES, Jan. 23, 2009, available at http://nytimes.com/2009/01/23/business/worldbusiness/23treasury.html?_r=1. It must be noted that Geithner did not assert that China's was manipulating its currency in order to gain an unfair trade advantage. Under U.S. law, if a country is found to be manipulating its currency's exchange rate with the U.S. dollar "for purposes of preventing effective balance of payments adjustments or gaining unfair competitive advantage in international trade," the Treasury secretary must "initiate negotiations with such foreign countries on an expedited basis, in the International Monetary Fund or bilaterally, for the purpose of ensuring that such

also declared that his accusations had presidential backing: "President Obama—backed by the conclusions of a broad range of economists—believes that China is manipulating its currency."⁶

While the Obama Administration, and even Geithner himself, have subsequently renounced the direct and unambiguous accusation of currency manipulation,⁷ the U.S. reversal is no doubt influenced by the severity of the current financial crisis, the considerable weaknesses of the U.S. economy, and American dependence on Chinese credit (through the purchase of U.S. Treasury bonds) to sustain its current account deficit.⁸ U.S. legislators, however, do not share the Administration's diplomatic (and pragmatic) considerations and have pressed ahead with plans to unilaterally counter China's "currency manipulation."⁹

Despite what appears to be a temporary reprieve from the Administration, the issue of whether China manipulates its currency is bound to resurface at some time in the future.

countries regularly and promptly adjust the rate of exchange between their currencies and the United States dollar." *Id.* The Act, however, contains an out clause which allows the secretary some discretion: "[the secretary] shall not be required to initiate negotiations in cases where such negotiations would have a serious detrimental impact on vital national economic and security interests". See Omnibus Trade and Competitiveness Act of 1988, 22 U.S.C.A. § 5304 (2009).

6. Geithner Confirmation Hearing, *supra* note 5.

7. In April 2009, a mere three months after Geithner's accusation of currency manipulation, the Administration's semi-annual Treasury report to Congress on international currency practices (as required under Section 3004(b) of the 1988 Act) declined to label China a currency manipulator (such a label would have triggered the provisions in the 1988 Act outlined in footnote 5). See U.S. DEP'T OF THE TREASURY, OFFICE OF INT'L AFFAIRS, REPORT TO CONG. ON INT'L ECON. AND EXCH. RATE POLICIES (Apr. 15, 2009), available at <http://www.treas.gov/offices/international-affairs/economic-exchange-rates/>.

8. On the weakness of the U.S. economy, see *Surviving the Slump*, ECONOMIST, May 30, 2009, available at http://www.acruent.com/Documents/Articles/Economist_Trading_Down_0509.pdf. For statistics on the U.S.-China trading relationship, see OFFICE OF THE U.S. TRADE REPRESENTATIVE, EXECUTIVE OFFICE OF THE PRESIDENT, <http://www.ustr.gov/countries-regions/china> (last visited August 6, 2009). On the U.S. administration's desire for China to continue purchasing U.S. Treasuries (as well as the underlying weakness in the U.S. economy), see Axel Merk, *Geithner & China on U.S. Treasury Bonds Sales Trip: Who Are You Fooling?* (June 2, 2009), <http://www.marketoracle.co.uk/Article11046.html>; Indira A.R. Lakshmanan, *Clinton Urges China to Keep Buying U.S. Treasury Securities*, BLOOMBERG.COM, Feb. 22, 2009, <http://www.bloomberg.com/apps/news?pid=20601070&sid=apSqGtcNsqSY&refer=politics>.

9. See, e.g., the statements and actions of the U.S. Congress and its representatives. The bipartisan supported "Currency Reform for Fair Trade Act" allows for the use of anti-dumping and countervailing duties to counter currency manipulation. Republican Representative Tim Murphy says of the legislation: "The time has come for Congress to stand up for American workers and not allow China to run roughshod over the American economy. With this legislation we will finally force China to stop cheating and level the playing field for America's manufacturers." See *U.S. Lawmakers Target China Currency Policy*, THE SYDNEY MORNING HERALD, May 14, 2009, available at <http://news.smh.com.au/breaking-news-world/us-lawmakers-target-china-currency-policy-20090514-b408.html>. See also, the earlier Schumer-Graham Bill (which also called for countervailing duties to counter undervaluation) and the Grassley-Baucus Bill (which called for greater IMF and U.S. cooperation and oversight into currency misalignment); see also Press Release from Senator Charles E. Schumer, *Schumer-Graham Announce Bipartisan Bill to Level Playing Field on China Trade* (Feb. 3, 2005), http://schumer.senate.gov/new_website/record.cfm?id=260875&. (Senator Schumer stated: "The Chinese actions endanger American and world commitment to free trade and weaken the support in Congress for free trade. This legislation is a tough-love effort to get the Chinese to stop playing games with their currency in order to level the playing field for American companies trying to compete with goods and service coming from China."); Criton M. Zoakos, *Introducing "Grassley-Baucus,"* THE INT'L ECON., Spring 2006, at 26. For criticism of legislative efforts, see Daniel Griswold, *Protectionism No Fix for China's Currency*, CATO INST., June 25, 2005, http://www.cato.org/pub_display.php?pub_id=3946.

For this reason, it remains necessary to undertake a legal analysis of China's exchange regime under the existing international legal framework.¹⁰ This article undertakes such an analysis and in particular, evaluates the legitimacy of China's exchange regime under applicable international law, that being the Articles of Agreement of the International Monetary Fund (IMF Articles) and both the General Agreement on Tariffs and Trade (GATT) and the Agreement on Subsidies and Countervailing Measures (SCM Agreement) of the World Trade Organization (WTO).

Section II overviews the recent modifications to China's exchange arrangement and other relevant issues relating to the Renminbi (RMB).¹¹ Section III analyzes the regime under the IMF Articles and the WTO agreements and concludes that China's exchange regime does not violate any of the current applicable international laws. Section IV concludes by noting that modification of either the IMF Articles or applicable WTO agreements is the only multilateral option available to those determined to more strongly sanction "currency manipulation."

II. China's Exchange Regime

China's present foreign exchange regime is a result of a process that began shortly after China embarked on its path of liberalization in 1978; since that time, the country has adopted various exchange rates¹² and foreign exchange control policies.¹³ Section A overviews China's post-liberalization changes to its exchange regime, while Section B discusses China's measures to control the RMB exchange rate. Section C then examines the movement of the RMB exchange rate and the resulting controversies.

A. CHINA'S EXCHANGE REGIME: AN OVERVIEW

As part of the policy shift embracing trade liberalization, China began to devalue its currency in the early-1980s to reflect a more realistic value of the RMB.¹⁴ Since that time,

10. Indeed, Subramanian and Mattoo call the undervaluation of major currencies leads to "one of the most pressing contemporary problems—global imbalances" Arvind Subramanian & Aaditya Mattoo, *Currency Undervaluation and Sovereign Wealth Funds: A New Role for the World Trade Organization 2* (Ctr. for Global Dev., Working Paper No. 142, 2008). It should also be noted that China is not the only country accused of undervaluing its currency. In fact, in the oil-boom years of 2001-July 2007, the currencies of United Arab Emirates, Kuwait, Saudi Arabia, Bahrain, and Venezuela all depreciated by approximately twenty percent against the U.S. dollar. *Id.*

11. The Chinese currency is referred to as the renminbi (RMB) (literally translated as "the people's currency") or the yuan (which technically is a unit of measurement used when counting). For consistency and ease of reference, we exclusively use the term RMB.

12. Exchange rate policy refers to the country's response to particular market fluctuations. It is therefore narrower in scope when compared with exchange arrangement. Indeed exchange rate policy can be regarded as a policy which the country adopts in realization of its exchange arrangement. For more detailed information, see Article IV Overview, *supra* note 1, at 4.

13. Foreign exchange control policy refers to the policy a country uses to regulate foreign exchange receipts and payment; that is, the currency's convertibility. See DOING BUSINESS WITH CHINA 110 (Jonathan Reuvid & Li Yong eds., Global Market Briefing 4th ed. 2003).

14. BARRY NAUGHTON, THE CHINESE ECONOMY: TRANSITIONS AND GROWTH 383 (2007). For China's policies from 1949 onwards, see Larry L. Drumm, *Changing Money: Foreign Exchange Reform in the People's Republic of China*, 18 HASTINGS INT'L & COMP. L. REV. 359, 362-63 (1995).

China has modified its exchange regime several times.¹⁵ What remains unchanged is that the People’s Bank of China (PBC)—as the central bank of China—is the sole issuer and controller of the RMB.¹⁶

1. 1994-2005: From a Peg Within a Small Band To a De Facto Peg

China began modifying its exchange regime in earnest in 1986, when the government introduced a dual-exchange rate regime under which exporters sold their earnings in a regulated market separate from the inner China market (and thus allowing those exporters to receive more RMB for a unit of foreign exchange than the inner market).¹⁷ In 1994, China merged the dual-currency system and instituted a market-based managed floating system.¹⁸ Every day, the PBC determined and announced the RMB exchange rate within a 0.3% band around which the banks trade the RMB.¹⁹ This system remained in place until the 1995 Asian financial crisis, when the PBC abandoned it in favor of a *de facto* peg against the U.S. dollar.²⁰

2. 2005: From a De Facto Peg to a Crawling Peg

In July 2005, China replaced the *de facto* peg with a short-lived crawling peg. In addition to adopting the crawling peg, the PBC allowed a one-time revaluation of the RMB from 8.28 to 8.11 RMB/US\$ (i.e. 0.121 US\$/RMB to 0.123 US\$/RMB) (an appreciation of 2.1%).²¹ Furthermore, the PBC linked the RMB exchange rate to a basket of currencies.²² Under the new crawling peg, the RMB floated within a daily 0.3% band (later

15. See Min Zhao, *External Liberalization and the Evolution of China’s Exchange System: An Empirical Approach*, at 10-18 (World Bank, China Office Research Paper No. 4, 2007), http://www-wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2007/12/19/000020953_20071219140301/Rendered/PDF/418560CHA0Liberalization0WP401PUBLIC1.pdf [hereinafter External Liberalization].

16. See People’s Bank of China, (adopted at the Third Session of the Eighth National People’s Congress on March 18, 1995, promulgated by Order No. 46 of the President of the People’s Republic of China on March 18, 1995 and amended in accordance with the Decision on Amending the Law of the People’s Republic of China on the People’s Bank of China adopted at the 6th Meeting of the Standing Committee of the Tenth National People’s Congress on December 27, 2003), available at <http://www.china.org.cn/english/DAT/214826.htm> [Hereinafter P.R.C.]. See also Xinchun Sofia Lou, *Challenging China’s Fixed Exchange Rate Regime: An Analysis of U.S. Options*, 28 HASTINGS INT’L & COMP. L. REV. 455, 457-58 (2005); Derek Scissors, *Deng Undone*, FOREIGN AFFAIRS, May-June 2009, at 24-39.

17. NAUGHTON, *supra* note 14.

18. External Liberalization, *supra* note 15, at 16.

19. Lou, *supra* note 16.

20. See External Liberalization, *supra* note 15, at 18. The *de facto* peg to the U.S. dollar has been subject to heavy criticism in the U.S. See, e.g., Morici, *supra* note 3, at 5; Barry P. Bosworth, *Valuing the Renminbi* (The Brookings Inst., Feb. 9, 2004), http://www.brookings.edu/papers/2004/0209macroeconomics_bosworth.aspx; John Cairns, *China—They Haven’t Just Repegged*, IDEAGLOBAL, July 27, 2005, http://www.ideaglobal.com/products/info/view_pdf.asp?id=%7BDB72DA59-3DE6-4417-A522-2810CA619BAC%7D; Virginie Couderc & Cecile Couharde, *Real Equilibrium Exchange Rate in China* 6 (Centre D’Etudes Prospectives et D’Informations Internationales, Working Paper No. 2005-01, 2005), available at <http://ideas.repec.org/p/cii/cepidt/2005-01.html>; DOLLAR ADJUSTMENT: HOW FAR? AGAINST WHAT? 207 (C. Fred Bergsten & John Williams eds., 2004).

21. The People’s Bank of China, Public Announcement of the People’s Bank of China on Reforming the RMB Exchange Rate Regime (July 21, 2005), available at <http://www.pbc.gov.cn/english/detail.asp?col=6400&ID=542> [Hereinafter PBC]; *Id.*; Morrison & Labonte, *supra* note 3, at 1.

22. PBC, *supra* note 21; Morrison & Labonte, *supra* note 3, at 1.

amended to 0.5%) which took as the central parity the previous working day's RMB exchange rate.²³

3. 2005 and Onwards: From a Crawling Peg to a Managed Float

The PBC, however, repealed the crawling peg after only seven days in favor of a managed float.²⁴ Under the managed float, the PBC determines the RMB exchange rate in view of the exchange rates of a basket of currencies (consisting of the U.S. dollar, the yen, the Euro, and a couple other currencies).²⁵ The managed float remains in operation and the PBC retains the right to decide the timing and manner of any future RMB revaluation.²⁶

B. CHINA'S POLICIES TO CONTROL THE RMB EXCHANGE RATE

China relies on two methods for maintaining the RMB exchange rate within the set target. First, the PBC employs both domestic and international monetary measures—such as through increasing the RMB supply by issuing RMB and decreasing foreign exchange supply by purchasing foreign currency—in order to accumulate a large amount of foreign reserves and at the same time counter the appreciative pressure on the RMB.²⁷ Second, China employs strict capital controls to ensure that the adjustment of RMB supply effectively maintains a specified level of RMB exchange.²⁸ Despite these controls, the RMB has been fully convertible “for purposes of trade in goods and services” since China adopted Article VIII of the IMF Articles in 1996.²⁹

Under the Administrative Rules of the People's Republic of China on Foreign Exchange Control in 1996 (1996 Rules), China-based organizations were required to remit any foreign exchange earnings back to China and deposit such earnings in authorized

23. PBC, *supra* note 21; Morrison & Labonte, *supra* note 3, at 1.

24. The PBC adopted a crawling peg on July 21, 2005, and abandoned it in favor of a managed float on July 27, 2005. J. JONATHAN E. SANFORD, CHINA'S CURRENCY: BRIEF OVERVIEW OF U.S. OPTIONS, RS22338, CRS Report, at CRS-4 (2005), available at <http://fpc.state.gov/documents/organization/57797.pdf>.

25. *Id.* Morrison and Labonte define China's managed float in which “market forces are determining the general direction of the [currency's] movement, but the government is retarding its rate of appreciation through market intervention.” Morrison & Labonte, *supra* note 3, at 1.

26. See P.R.C., *supra* note 16.

27. See generally Morrison & Labonte, *supra* note 3, at 4. Mussa also suggests that China steers and controls the exchange rate heavily by purchasing foreign currency; in fact, Mussa claims that China counteracted appreciative pressure on the RMB by purchasing as much as US\$1 trillion worth of foreign currency between 2002 and 2007. See Michael Mussa, *IMF Surveillance Over China's Exchange Rate Policy*, 3 (Peterson Inst. for Int'l Econ., Oct. 19, 2007), available at <http://www.iie.com/publications/papers/mussa1007.pdf>.

28. Paul V. Sharobeem, *Biting the Hand That Feeds Us: A Critical Analysis of U.S. Policy Trends Concerning Chinese Currency Manipulation*, 19 FLA. J. INT'L L. 697, 698 (2007). Before 1994, China controlled all cross-border flow of the RMB and foreign currency through mandatory plans and directives. The PBC was the sole trader of the RMB, to which foreign exchange receipts must be traded. The PBC also made all foreign exchange payments. See DOING BUSINESS WITH CHINA, *supra* note 13.

29. See Press Release, Int'l Monetary Fund, People's Republic of China Accepts Article VIII Obligations, No. 96/58 (Dec. 4, 1996), available at <http://www.imf.org/external/np/sec/pr/1996/pr9658.htm>. Enterprises may exchange the RMB for foreign currencies subject to examination to ensure the underlying transactions are genuine and legally valid. See Christopher H. Stephens, *Policy Collisions—China's Banking Reforms Require Dramatic Changes Affecting Many Policies and Sectors*, 120 BANKING L. J. 34, 39-40 (2003).

foreign exchange banks.³⁰ Thus, in this regard, both enterprises and individuals were subject to the rules that govern the conversion of RMB into foreign currencies.³¹

The 1996 Rules were modified by State Council Order No. 532 in August 2008, through the introduction of the Administrative Rules of the People's Republic of China on Foreign Exchange Control (2008 Rules),³² which aims to achieve balanced regulation on "the inflow and outflow of foreign exchange."³³ The 2008 Rules relax some of the regulations on RMB outflow and broaden the channels through which capital can be transferred abroad. For example, subject to certain terms and conditions, China-based organizations or individuals are no longer required to remit their foreign earnings to China.³⁴

At the same time, the 2008 Rules tighten the regulations on RMB inflow by strengthening the supervision of the underlying transactions to prevent the inflow of "hot money."³⁵ Furthermore, foreign exchange remitted into China under capital account remains subject to stringent controls; for example, use of the exchange and RMB proceeds are restricted and exchange inflow is subject to regulatory authority approval.³⁶ The supervising authority is also entitled to supervise and examine the use of foreign exchange entering into China under such channels.³⁷ Therefore, although the RMB is fully convertible under the current account, strict capital controls remain in place.

C. RMB VALUATION

1. RMB Exchange Rate Movement

Figure 1 shows the nominal RMB exchange rate over the period from 1970 to 2008 while figure 2 illustrates the nominal and real exchange rates of the RMB between 1986 and 2008 with the exchange rate expressed in terms of U.S. dollars per RMB in both figures. The higher the exchange rate, the more valuable the RMB is in terms of U.S. dollars. Therefore, a decreasing exchange rate indicates a depreciation of the RMB, while an increasing exchange rate signals an appreciation of the RMB. Figure 3 demonstrates the nominal exchange rate index and the real effective exchange rate index of the RMB

30. For analysis, see Lou, *supra* note 16, at 458.

31. See *id.*

32. The 2008 Rules were promulgated as the No. 193 order of the State Council of the People's Republic of China on Jan.29, 1996, and were amended according to the Decision of the State Council on Amending the Foreign Exchange Control Regulations of the People's Republic of China on Jan.14, 1997. They were re-amended and passed in the 20th executive meeting of the State Council on Aug.1, 2008. See generally Foreign Exchange Control Regulations of the People's Republic of China (Amended in 2008) available at <http://tradeinservices.mofcom.gov.cn/en/tb/2008-08-05/58193.shtml> [hereinafter Amended Foreign Exchange Control Regulations].

33. Amended Foreign Exchange Control Regulations, *supra* note 32, arts. 1, 6, and 11; For analysis, see King & Wood, *Revolution in the Foreign Exchange Control System—a Brief Analysis on the New Administrative Rules on Foreign Exchanges* (Aug. 15, 2008), available at <http://www.kingandwood.com/en/article/revolution-in-chinas-foreign-exchange-control-10-china-bulletin-2009>.

34. Amended Foreign Exchange Control Regulations, *supra* note 32, at art. 9; see also King & Wood, *supra* note 32.

35. Amended Foreign Exchange Control Regulations, *supra* note 32, at arts. 7, 12 and 15; see also, King & Wood, *supra* note 33.

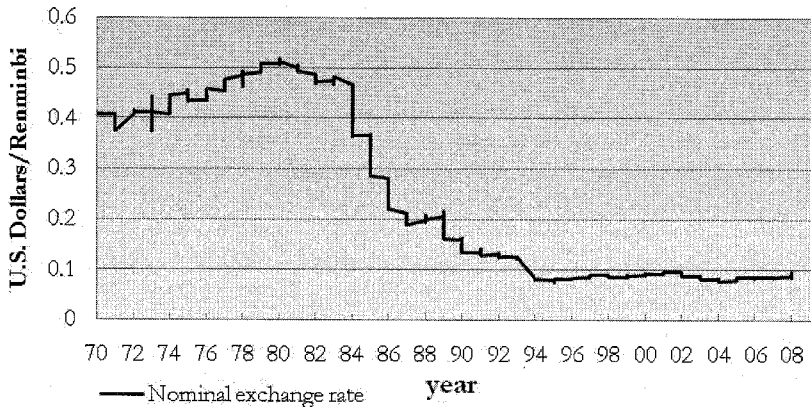
36. Amended Foreign Exchange Control Regulations, *supra* note 32, arts. 21-23; see also *id.* arts. 16-20 (relating to transactions under the current account).

37. *Id.* arts. 33-37.

between 1979 and 2008, with the index in the year 2000 as 100. The exchange rate index reflects the value of the RMB in terms of a basket of currencies. A falling index number represents a depreciation of the RMB while a rising index number represents an appreciation.

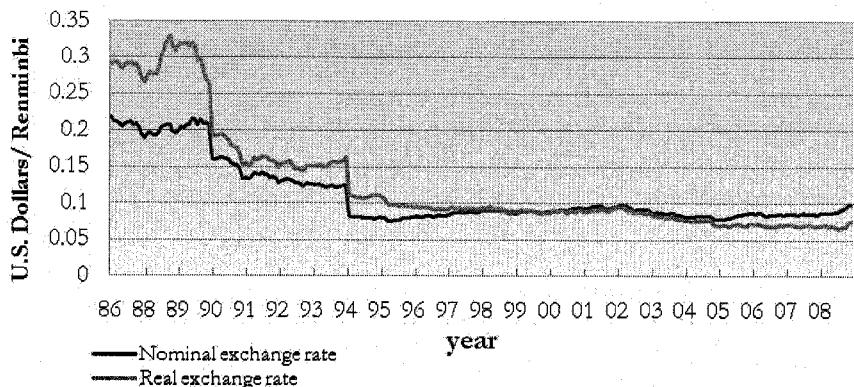
All three figures demonstrate that the RMB's value in terms of foreign currencies dramatically decreased through the 1980s to 1994. After 1994, however, the exchange rate became relatively stable. Moreover, the RMB's nominal exchange rate shows a slight appreciative trend since 2006.

Figure 1: The Nominal Exchange Rates of the RMB Between 1970 and 2008



Sources: constructed by C. Leung using the monthly nominal exchange rates obtained from the database of the International Monetary Fund.

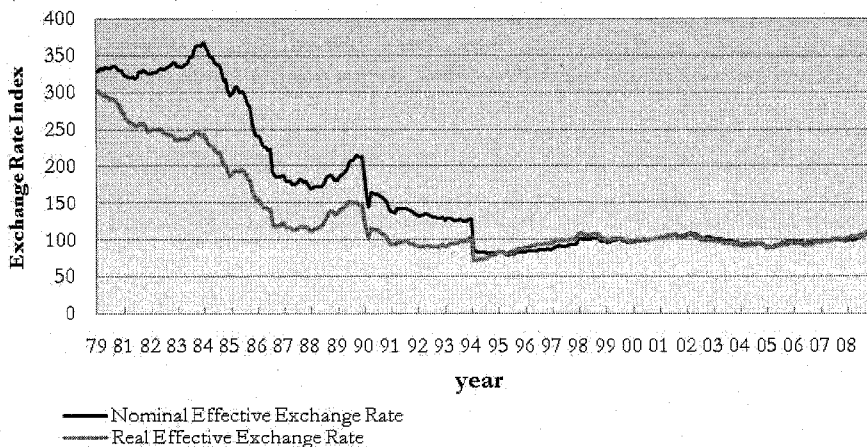
Figure 2: The Nominal and Real Effective Exchange Rates of the RMB Between 1986 and 2008



Sources: constructed by C. Leung using (1) the nominal exchange rate obtained from the database of the International Monetary Fund; (2) the U.S. consumer price index obtained from the database of the International Monetary Fund; and (3) China consumer price index obtained from the database of the China Data

Notes: (i) The exchange rate index is a geometric average of exchange rates for the RMB of certain countries selected by the IMF.
 (ii) The real effective exchange rate adjusts the nominal effective exchange rate for the price movements in China and the selected countries.³⁸

Figure 3: The RMB’s Nominal and Real Effective Exchange Rate Indices (Year 2000=100) Between December 1979 and 2008



Sources: constructed by C. Leung using the nominal and real effective exchange rate indices obtained from the database of the International Monetary Fund.

2. RMB Misalignment

Despite not formally announcing an RMB revaluation, China has allowed the nominal value of the RMB to appreciate against the U.S. dollar by 3.1% in 2006, 5.8% in 2007, and 7.2% in 2008;³⁹ in total, the RMB has appreciated 18.7% from July 21, 2005, to April 13, 2009.⁴⁰ It should be noted, however, that many other currencies have appreciated more substantially against the U.S. dollar in this timeframe. Consequently, some have argued that the relative lower appreciation of the RMB against the U.S. dollar is an effective depreciation of the RMB.⁴¹

Several prominent economists contend that the RMB remains undervalued.⁴² The extent of undervaluation against the U.S. dollar generally ranges from fifteen percent to sixty percent, depending upon the organization or economist conducting the research and

38. IMF, “International Financial Statistics: Exchange Rates and Exchange Rate Arrangements” available at <http://www.imfstatistics.org/imf/IFSExcha.htm>.

39. These figures are calculated by C. Leung using data obtained from the IMF database.

40. Morrison & Labonte, *supra* note 3, at 1.

41. See Mussa, *supra* note 27, at 3.

42. See, e.g., Morrison & Labonte, *supra* note 3; Dani Rodrik, The Real Exchange Rate and Economic Growth, WALL ST. J., Sept. 2008, available at <http://online.wsj.com/public/resources/documents/rodrick.pdf>; Yin-Wong Cheung, Menzie Chinn & Eiji Fujii, *The Overvaluation of Renminbi Undervaluation*, 26(5) J. OF INT’L MONEY AND FIN. 762 (2007); Jeffrey A. Fankel & Shang-Jin Wei, *Assessing China’s Exchange Rate Regime*, 22 ECON. POL’Y 575-627 (2007); Andrew Stoeckel & Warwick J. McKibbin, *Chinese Currency Revalu-*

the calculation method utilized,⁴³ while the undervaluation against the Euro is estimated at approximately twenty-five percent.⁴⁴ On the other hand, IMF research allows for the possibility that the RMB is not undervalued.⁴⁵

Thus, despite a constant stream of commentators labeling the Chinese currency undervalued, a consensus has not emerged as to the extent of RMB undervaluation.⁴⁶ The reason for the continuing uncertainty is clear: estimators adopt different economic functions and methodologies to obtain the estimates. Different estimation methods are subject to different assumptions and measurement uncertainties.⁴⁷ Consequently, no estimation method can authoritatively conclude that the RMB is misaligned (not to mention precisely stating the extent of misalignment).

ation, ECON. SCENARIOS (Ctr. for Int'l Econ. & McKibben Software Group Pty Ltd., 2005), available at http://www.brookings.edu/~media/Files/rc/articles/2005/06globaleconomics_mckibbin/20050610.pdf.

43. See, e.g., Morrison & Labonte, *supra* note 3; Rodrik, *supra* note 42, at 1; Cheung, *supra* note 42, at 76; Fankel, *supra* note 42, at 575-627; Stoeckel, *supra* note 42.

44. See David Lague, *China Rejects Europe's Call for Currency to Rise Faster*, N.Y. TIMES, Nov. 28, 2007, available at <http://www.nytimes.com/2007/11/28/business/worldbusiness/28yuan.html?scp=5&sq=currency,%20china&st=cse>.

45. *But see* Mussa, *supra* note 27, at 4, 114 (citing a paper prepared by the IMF Asian and Pacific Department (APD) estimating that the present undervaluation of the yuan is somewhere between zero and thirty-five percent). On the other hand, Dominique Strauss-Kahn, the managing director of the IMF, recently stated that it was "common knowledge" that the RMB is undervalued. *Burger-thy-neighbour policies*, ECONOMIST, Feb. 5, 2009, available at http://www.economist.com/finance/displaystory.cfm?story_id=13059709. Strauss-Kahn also said the RMB was "significantly undervalued" in April 2009. Lesley Wroughton, *IMF says China currency significantly undervalued*, REUTERS, Apr. 16, 2009, available at <http://www.reuters.com/article/usDollarRpt/idUSWAT01129420090416>; see also Steven Dunaway, Deputy Director, Asia and Pacific Department, *IMF Surveillance Over China's Exchange Rate: Comments on a Paper by Michael Mussa*, Presentation at the Peterson Inst. Conference on China's Exchange Rate Policy (Oct. 19, 2007), available at <http://www.petersoninstitute.org/publications/papers/dunaway-on-mussa1007.pdf>. For others doubting the undervaluation of the RMB, see *Burger-thy-neighbour Policies*, ECONOMIST, Feb. 5, 2009, available at http://www.economist.com/finance/displaystory.cfm?story_id=13059709; Yin Wong Cheung, Menzie Chinn & Eiji Fujii, *China's Current Account and Exchange Rate*, (Nat'l Bureau of Econ. Research, Working Paper No. 14673, 2009) (concluding that the RMB was only ten percent undervalued in 2006—given the RMB's appreciation since 2006 the RMB may no longer be undervalued according to the Cheung, Chinn and Fujii thesis); see generally Jiawen Yang & Isabella Bajeux-Besnainon, *Is the Chinese Currency Undervalued?*, 2 INT'L RES. J. OF FIN. & ECON. 106 (2006).

46. See Sharobeem, *supra* note 28, at 704, 718 (citing Ernest Preeg of the Manufacturer's Alliance estimating the undervaluation to be between fifteen and twenty-five percent; Goldman Sachs Economic Research Group estimating undervaluation at 9.5 to 15%); The Economist is estimating a fifty-eight percent undervaluation (albeit using the Big Mac Index); and certain U.S. senators estimating undervaluation by 27.5% on average).

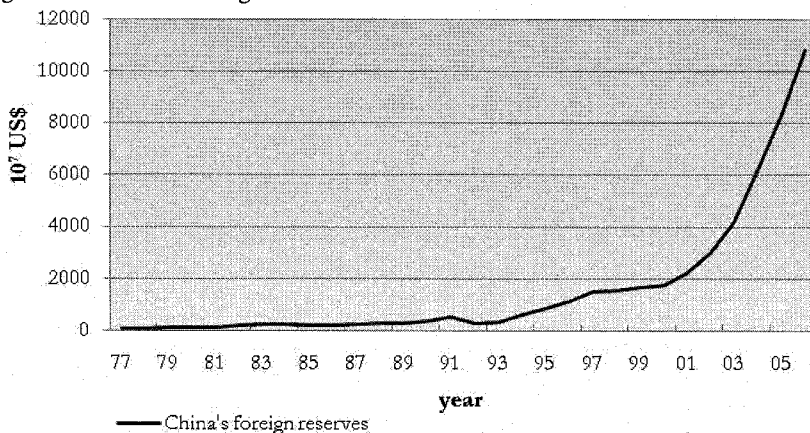
47. For this reason, although it is widely known that IMF staff have privately stated to China that its currency is misaligned, due to the "limitations in current methodologies used for quantitative real exchange rate assessments" and "questions regarding the robustness of . . . the wide range of estimates of the undervaluation of the Chinese currency" IMF staff have "refrained from providing specific quantitative estimates of real exchange rate misalignment". Int'l Monetary Fund, *Treatment of Exchange Rate Issues in Bilateral Surveillance—A Stocktaking*, (Aug. 30, 2006), available at <http://www.imf.org/external/np/pp/eng/2006/083006.pdf>; see also Ionna Ciobănu & Erik Denters, *Manipulation of The Chinese Yuan—May WTO Members Respond?*, 9 GRIFFIN'S VIEW ON INT'L AND COMP. LAW 56 n.1 (2008), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1315290.

3. *China's Exchange Regime: The Criticisms*

Regardless of the true value of the RMB, the RMB exchange rate constitutes one of the most fiercely debated issues involving China and its trading partners. What lies behind this pressure on China to revalue its currency?

The main reason why the international community is concerned with China's exchange regime is China's continued accumulation of foreign reserves and expansion of its trade surplus.⁴⁸ Figure 4 shows China's foreign reserves between 1977 and 2006. Two trends emerge: first, China's foreign reserves have steadily increased since 1994; and second, the rate of the increase has risen since 2001. Figure 5 illustrates China's current account balance between 1970 and 2007. It shows that China has maintained a trade surplus since 1994 and that the surplus increased dramatically between 2004 and 2007.

Figure 4: China's Foreign Reserves Between 1977 and 2006

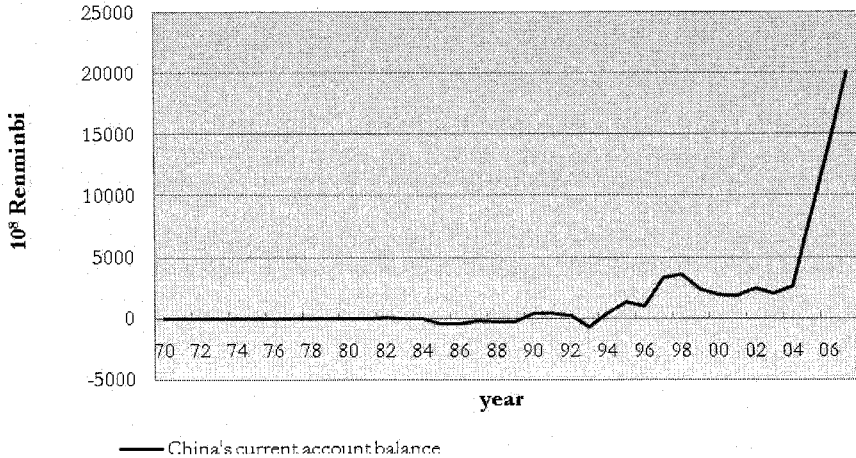


Sources: constructed by C. Leung using China's foreign reserves data obtained from the database of Global Development Finance.

Such an exponentially increasing trade surplus is likely the main factor in the United States' dissentient sentiments and general uneasiness with China's trade policies. Over the past few years, the United States has become increasingly exasperated by its increasing trade deficit with China in the face of a significant rise in the U.S. unemployment rate and corresponding shrinkage of the domestic manufacturing industry.⁴⁹ Figure 6 shows the U.S. imports and exports to and from China between 1972 and 2008. Although both are increasing, the growth rate of exports is greater than that of imports. This growth can be

48. See generally L. Josh Bivens & Robert E. Scott, *China Manipulates Its Currency—A Response is Needed* (Econ. Pol'y Inst., Sept. 25, 2006), available at <http://www.epi.org/publications/entry/pm116/>; Morrison & Labonte, *supra* note 3, at 1 (quoting China's foreign exchange reserves at \$1.95 trillion as of March, 2009, up from \$403 billion in 2003 and China's trade surplus with the world at \$297 billion in 2008).

49. See, e.g., Jeannine Aversa, *Rising Unemployment Spares No State in December*, ASSOC. PRESS, Jan. 27, 2009, available at http://www.blz.com/news/2009/01/27/Indiana_South_Carolina_unemployment_rate_5251.html. For exact statistics, see U.S. Bureau of Labor Statistics, <http://www.bls.gov/>. For statistics on manufacturing, see <http://www.bls.gov/iag/tgs/iag31-33.htm>.

Figure 5: China's Current Account Balance Between 1970 and 2007

Sources: constructed by C. Leung using the yearly imports and exports data obtained from the database of China Data.

seen in figure 7, which illustrates the United States' current account with China and reveals that the U.S. trade deficit with China has been growing at an increasing rate. In fact, not only is China's contribution to the U.S. trade deficit increasing, but it is also the most significant factor in the United States' growing deficits with Asia and the world (i.e. its overall trade deficit). This trend can be seen from figures 8 and 9, which show China's contribution to the United States' current account deficit with Asia and the world, respectively.

III. China's Exchange Rate Policy: Is It Consistent with the International Legal Framework?

A. INTERNATIONAL LAW

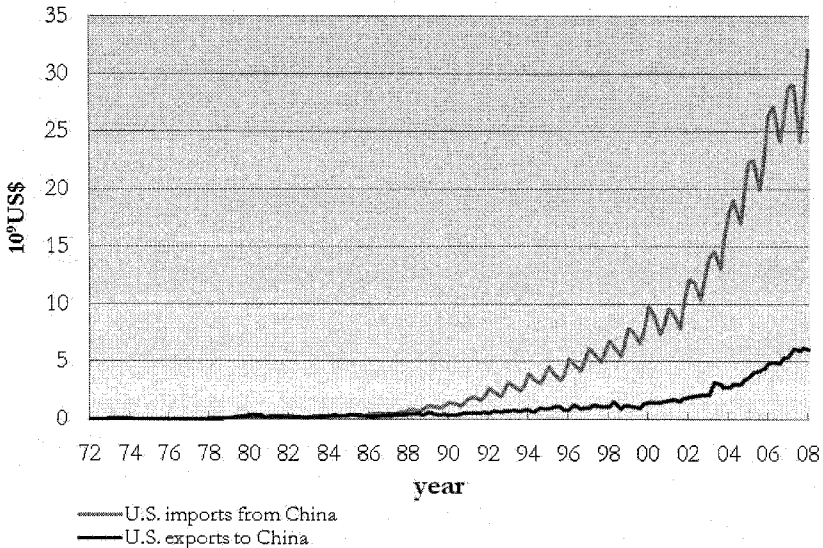
General international law recognizes a state's freedom to issue currency and inherent sovereignty to determine the value of that currency.⁵⁰ As an inherently sovereign act, exchange control or currency regulation is a domestic measure, which is encompassed in a state's domestic jurisdiction.⁵¹ China (and indeed, any country) is free to impose whatever exchange rate policy to the exclusion of any state scrutiny. Indeed, this situation is what the Chinese authorities have traditionally maintained when pressured to revalue the RMB.⁵²

50. ASIF H. QURESHI & ANDREAS ZIEGLER, *INTERNATIONAL ECONOMIC LAW* 156 (London, Sweet & Maxwell 2007).

51. See Charles Proctor, *USA v China and the Revaluation of the Renminbi: Exchange Rate Pegs and International Law*, *EUR. BUS. L. REV.* 1333, 1336 (2006).

52. See Mure Dickie, *Currency Reform Seen as a Question of Sovereignty*, *FIN. TIMES*, July 22, 2005, available at http://www.ft.com/cms/s/0/f4e386c2-fa4e-11d9-b092-00000e2511c8.html?nclink_check=1; Mussa, *supra* note 27, at 8.

Figure 6: The U.S. Exports and Imports to and from China Between 1972 and 2008



Sources: constructed by C. Leung using the quarterly U.S. imports and exports data obtained from the database of Organisation for Economic Co-operation and Development.

Several economists, however, disagree with these sentiments. For instance, Mussa calls the argument “nonsense” based on what he sees as the “logical absurdity” of the national sovereignty argument.⁵³ Mussa’s argument is that because the exchange rate is the value of one currency against another currency, it is logically impossible for two countries to maintain conflicting exchange rates with respect to the other’s currency, and therefore it is “nonsense” to suggest each of them has a sovereign right to determine its exchange rate.⁵⁴

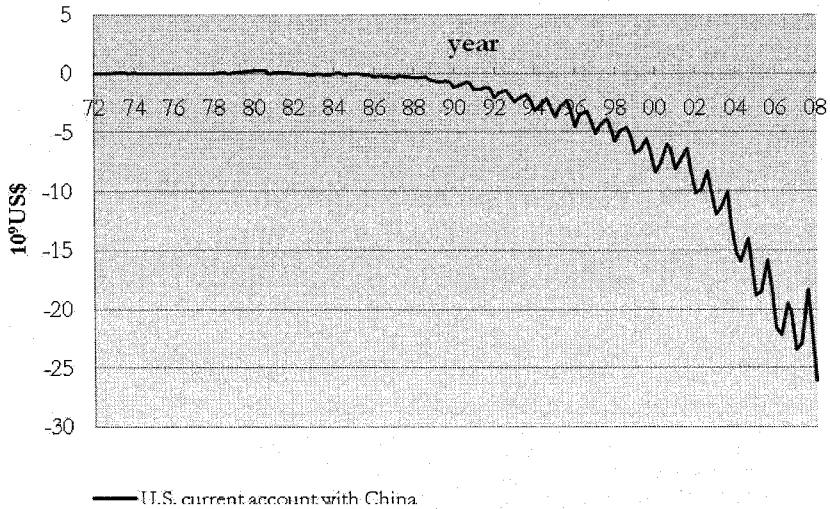
In our view, however, Mussa confuses the “right” with the “manifestation” of the right. The mere fact that a person’s right conflicts with another’s right does not necessarily deprive both persons of their respective rights.⁵⁵ Similar logic applies to rights of nations. The impossibility for both nations to achieve their respective desirable exchange rate may imply either that the countries at issue do not exchange currency or that both countries compromise to agree on an exchange rate. Such practical limitations by themselves, however, are insufficient to negate the existence of the state’s fundamental right to determine its currency.

Given its inherent sovereign right to determine its currency, China’s exchange rate policy infringes on no general international law. China can therefore adopt whatever ex-

53. Mussa, *supra* note 27, at 8.

54. *Id.*

55. An example can be found in family law. Although only one parent would obtain the right of custody to a divorcing couple’s only child, this fact does not deprive both parents of their right to be the child’s custodian. See ATHENA NGA CHEE LIU, *FAMILY LAW FOR THE HONG KONG SAR* 217-235 (Hong Kong, Hong Kong University Press 1999).

Figure 7: The U.S. Current Account with China Between 1972 and 2008

Sources: constructed by C. Leung using the quarterly U.S. imports and exports data obtained from the database of Organisation for Economic Co-operation and Development.

change rate regime it deems to be in its best interests regardless of the impact on other nations. China is a signatory, however, to a number of international agreements that modify its traditional position in relation to exchange rate policy. The following two sections examine the legitimacy of China's exchange rate under the IMF Articles and the WTO, respectively.

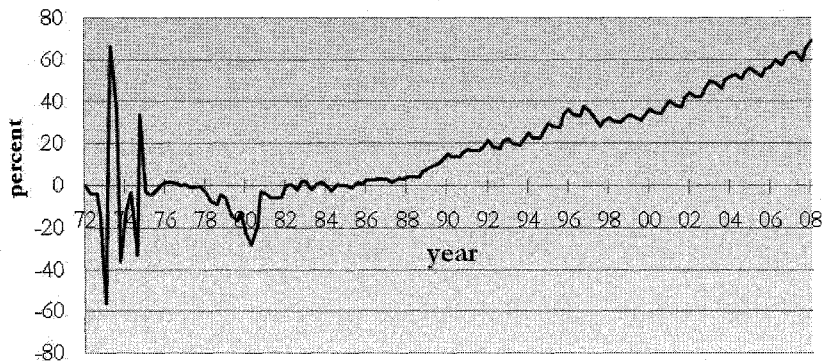
B. INTERNATIONAL MONETARY FUND

Drafted at Bretton Woods in recognition that the exchange rates and currency value of one country can drastically affect the interests of other countries, the IMF Articles are now the most important element of international monetary law and practices.⁵⁶ Together with the other 185 members of the IMF, China must comply with the IMF Articles.⁵⁷

56. The IMF was established in large part to prevent the competitive devaluations so common in the Great Depression. As originally negotiated, the IMF Articles obliged members to maintain a system of fixed exchange rates based upon gold (the so-called 'gold standard' or 'par value' system). This system lasted until 1971, when U.S. President Richard Nixon announced that the United States would allow the market to determine the comparative value of currency. For information on the founding and development of the IMF, see J. KEITH HORSEFIELD & MARGARET GARRITSEN DE VRIES, *THE INTERNATIONAL MONETARY FUND 1945-1965* vol. 1 89-118 (1969). For more on the role of the IMF, see Martin A. Weiss, *The Global Financial Crisis: The Role of the IMF*, Congressional Research Service Report for Congress 1 (Feb. 4, 2009), available at <http://openers.com/document/RS22976>; see also JOSEPH GOLD, *LEGAL AND INSTITUTIONAL ASPECTS OF THE INTERNATIONAL MONETARY SYSTEM: SELECTED ESSAYS* (1984); JOSEPH GOLD, *INTERPRETATION: THE IMF AND INTERNATIONAL LAW* (1996).

57. IMF Members' Quotas and Voting Power & IMF Board of Governors, (2009), available at <http://www.imf.org/external/np/sec/memdir/members.htm#total>. China has been a member of the IMF since its establishment in 1945. See *At a Glance—China and the IMF*, Sept. 1, 2004, available at <http://www.imf.org/external/country/chn/tr/g glance.htm>.

Figure 8: China’s Contribution to the U.S. Current Account Balance with Asia



— China’s contribution to the current account balance of the U.S. with Asia

Sources: constructed by C. Leung using the quarterly U.S. imports and exports data obtained from the database of Organisation for Economic Co-operation and Development.

Notes: the U.S. runs a current account deficit with Asia throughout the whole period except for the third session in 1975. Therefore a positive percentage represents China’s contribution to the U.S. trade deficit except for the third session in 1975.

This section analyzes the legality of China’s exchange rate policies with the IMF Articles.⁵⁸ The section proceeds in four parts, discussing: (1) the exchange arrangement obligations required under Article IV; (2) whether China’s exchange rate regime is an unlawful exchange arrangement; (3) whether China’s exchange rate policy is compatible with the undertakings listed in Article IV(1); and (4) whether China’s exchange rate regime complies with the foreign exchange transaction obligations under Article VIII.⁵⁹

1. Exchange Arrangement Obligations

In 1978, the Second Amendment—which marked the end of the par value system—incorporated the current version of Article IV into the IMF Articles.⁶⁰ The amended version of Article IV reflects a shift in objective from achieving a stable exchange rate to achieving a stable exchange rate system.⁶¹

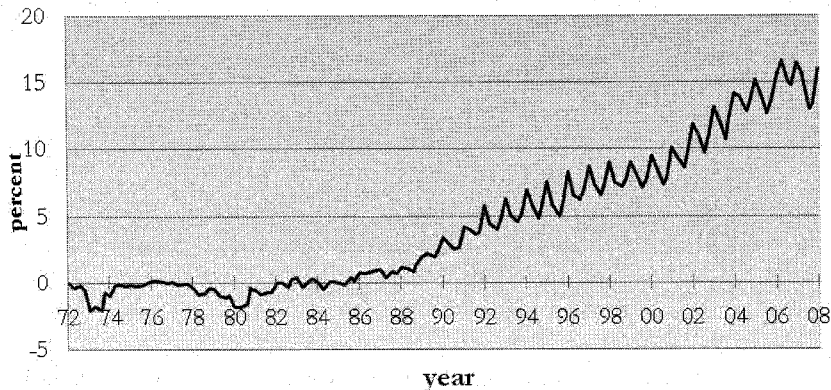
58. It should also be noted at this point that the IMF has never demonstrated that a country has manipulated its exchange rate so as to breach the IMF Articles.

59. This section is limited to evaluating the compatibility of China’s exchange rate regime under the IMF Articles. It does not discuss the procedural and enforcement problems associated with the IMF. For a discussion of those matters, see Robert W. Staiger & Alan O. Sykes, ‘Currency Manipulation’ and World Trade 27–28 (Stanford L. School, Working Paper No. 363, 2008) available at <http://ssrn.com/abstract=1151942> (stating the IMF’s “emphasis on non-confrontational consensus building” and “the absence of credible sanctions for disregarding IMF advice” contribute to the conclusion that the IMF “[cannot] do much to influence the behavior of a member such as China”). See also Subramanian and Mattoo, *supra* note 10, at 5–8.

60. IMF Article IV Overview, *supra* note 1, at 1.

61. *Id.* at 2; See also Raj Bhala, *Virtues, the Chinese Yuan, and the American Trade Empire*, 38 HONG KONG L. J. 183, 222 (2008) [hereinafter *Virtues and Trade*]. For a brief but useful description of how the end of the par value system and corresponding amendment dramatically shifted the role of the IMF, see K. Subramanian,

Figure 9: China's Contribution to the U.S. Current Account Balance with the World



— China's contribution to the current account balance of the U.S. with the world

Sources: constructed by C. Leung using the U.S. imports and exports data obtained from the database of Organisation for Economic Co-operation and Development.

Notes: the U.S. runs a current account deficit with the world throughout the whole period except for the third session in 1975. Therefore a positive percentage represents China's contribution to the U.S. trade deficit, whilst a negative percentage indicates that the U.S. ran a trade account surplus with China during that period.

a. Article IV(1)

Article IV(1) describes the general obligations of members with regards to their exchange arrangements. Section 1 can be regarded as consisting of three parts, namely the (1) preamble, (2) general obligations, and (3) four specific obligations.⁶²

The preamble to Article IV(1) provides: "(1) the purpose of the international monetary system is to provide a framework that (a) facilitates the exchange of goods, services and capital among countries and (b) sustains sound economic growth;" and (2) the international monetary system's "principle objective is the continuing development of the orderly underlying conditions that are necessary for financial and economic stability."⁶³ Although the preamble contains no direct obligations, it serves to assist the interpretation of member obligations under Section 1.⁶⁴

The IMF's New Mandate, HINDU BUSINESS LINE, Oct. 20, 2007, available at <http://www.thehindubusinessline.com/2007/10/20/stories/2007102050720800.htm>.

62. IMF Article IV Overview, *supra* note 1, at 7.

63. Articles of Agreement of the IMF, available at <http://www.imf.org/external/pubs/ft/aa/aa04.htm> (last visited Aug. 8, 2009). This premise rests upon the assumption that members' observance of the Article IV's obligations enhances the effective functioning of the international monetary system, which in turn facilitates trade and promotes financial and economic stability. See IMF Article IV Overview, *supra* note 1, at 8. Thus, the primary goal is not the upholding of a specified system, but the achievement of broader economic benefits. Any rules governing members' monetary policy are means to an end rather than an end in itself. The rules regulating monetary conduct are means to achieve the broader economic objective. See Proctor, *supra* note 51, at 1338.

64. IMF Article IV Overview, *supra* note 1, at 8.

Thus, each IMF member undertakes general obligations to collaborate with the IMF and other members to "(1) assure orderly exchange arrangements and (2) promote a stable system of exchange rates."⁶⁵ Although it is relatively clear that the collaboration concerns the two aspects mentioned above, the obligation to collaborate remains vague as to the degree of collaboration necessary to satisfy the general obligations.⁶⁶

Article IV(1) sets out the specific member obligations:

- (i) Endeavour 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 rate policies compatible with the undertakings under this Section.⁶⁷

b. Article IV(2)

Article IV(2), entitled "general exchange arrangements" contains three main provisions. Section 2(a) requires members to notify the IMF of its choice and any change in such choice of the exchange arrangement which the member intends to apply "in fulfillment of [the member's] obligations under [Article IV(1)]."⁶⁸ Section 2(b) addresses the possible form of exchange arrangement under the international monetary system that prevailed at the time of drafting the Second Amendment. The possible exchange arrangements are:

- (i) the maintenance by a member of a value for its currency in terms of the special drawing right or another denominator, other than gold, selected by the member; or
- (ii) cooperative arrangements by which members maintain the value of their currencies in relation to the value of the currency or currencies of other members; or (iii) other exchange arrangements of a member's choice.⁶⁹

Section 2(c) provides for a mechanism under which the IMF may make further provisions with respect to members' exchange arrangements upon the concurrence of eighty-five percent of the majority of the voting power.⁷⁰ This provision, however, cannot restrict a member's freedom to choose their exchange arrangements so long as such arrangements are consistent with the IMF's purposes and the obligations under Article IV(1).

65. *Id.*

66. See *Mussa*, *supra* note 27, at 9.

67. Articles of Agreement of the IMF, *supra* note 63.

68. *Id.*

69. *Id.*

70. *Id.*

c. Article IV(3)

Article IV(3) provides an oversight function to the Fund. The provision first states that 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 [Article IV].”⁷¹ The provision then provides that such oversight shall be affected through “firm surveillance over the exchange rate policies of members” and through the adoption of “specific principles for the guidance of all members with respect to those policies.”⁷²

The oversight described above is referred to as “bilateral surveillance.” In practice, bilateral surveillance involves an IMF staff assessment of a member’s policies (which could include the finding that a fundamental misalignment exists) followed by consultations between the IMF and the member.⁷³ In order to conduct the bilateral surveillance, members are obligated under Article IV(3)(b) to “provide the Fund with the information necessary for such surveillance, and, when requested by the Fund, [to] consult with it on the member’s exchange rate policies.”⁷⁴

Another key factor in the surveillance function is the Executive Board’s 1977 Decision, “Surveillance over Exchange Rate Policies” (as amended),⁷⁵ that sets out the “principles and procedures” applying to all members “whatever their exchange rate arrangements and whatever their balance of payments position.”⁷⁶ In terms of guidance for exchange policies, the principles merely reiterate the aims of IMF Article IV by stating:

- A. A member shall 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.
- B. A member should intervene in the exchange market if necessary to counter disorderly conditions, which may be characterized inter alia by disruptive short-term movements in the exchange value of its currency.
- C. Members should take into account in their intervention policies the interests of other members, including those of the countries in whose currencies they intervene.⁷⁷

The 2007 Decision on Bilateral Surveillance (Decision) repeats the first three principles and adds a fourth:

- D. A member should avoid exchange rate policies that result in external instability.⁷⁸

71. *Id.*

72. *Id.*

73. See IMF, Treatment of Exchange Rate Issues in Bilateral Surveillance—A Stocktaking (Aug. 30, 2006), available at www.imf.org/external/np/pp/eng/2006/083006.pdf.

74. Articles of Agreement of the IMF, *supra* note 63.

75. Surveillance over Exchange Rate Policies, Decision No. 5392-(77/63), Apr. 29, 1977 (as amended by Decision Nos. 8564-(87/59), Apr. 1, 1987, 856-(88/64), Apr. 22, 1988, and 10950-(95/37), Apr. 10, 1995), available at [http://www.imf.org/external/pubs/ft/sd/index.asp?decision=5392-\(77/63\)](http://www.imf.org/external/pubs/ft/sd/index.asp?decision=5392-(77/63)) [hereinafter Surveillance over Exchange Rate Policies, Decision No. 5392-(77/63)].

76. *Id.*

77. *Id.*

78. See Press Release, IMF, IMF Executive Board Adopts New Decision on Bilateral Surveillance Over Members’ Policies (June 21, 2007), available at <http://www.imf.org/external/np/sec/pn/2007/pn0769.htm>.

Another aspect of the Decision worth noting is Part 2, entitled "Principles for the Guidance of Members' Policies Under Article IV, Section 1," provides that the Fund "shall consider the following developments as among those which would indicate the need for discussion with a member. . . (i) protracted large-scale intervention in one direction in the exchange market."⁷⁹ Interestingly, the Decision substitutes the word "would" for the word "might" that existed in the 1977-1995 version.⁸⁰ An important limitation of the Decision, however, is that while it creates a duty to consult with and listen to the Fund, it cannot create any legal obligation that does not exist in the IMF Articles.

2. *Is China's Peg as an Exchange Arrangement in Itself Unlawful?*

Exchange arrangement refers to the method a member adopts to determine the value of its currency.⁸¹ Considering that Article IV(2)(b)(i) states that "exchange arrangement may include . . . the maintenance by a member of a value for its currency in terms of the special drawing right or another denominator, other than gold, selected by the member," it is reasonable to conclude that Article IV permits pegging to a specific currency or a basket of currencies.⁸² On its face, Article IV(2)(b)(i) expressly prohibits pegging to gold but allows members to maintain currency value by reference to "another denominator."⁸³ Because Section (b)(i) does not qualify the term "another denominator" (other than gold), value can presumably take the form of other currencies.

Even if Article IV(2)(b)(i) fails to provide the basis for the legitimacy of a peg, Article IV(2)(b)(iii) expressly recognizes "other exchange arrangements of a member's choice" as an accepted form of exchange arrangements.⁸⁴ Article IV(2)(b)(iii) therefore seems to confirm a member's freedom to choose its exchange rate regime.⁸⁵ This freedom is subject only to the procedural requirements to inform the IMF of its choice and the requirement that the arrangement should fulfill the members' obligations under Article IV(1).⁸⁶ The relevancy of Article IV(1) is evident from Section 2(a) which qualifies the exchange arrangement with the phrase "in fulfillment of [the member's] obligations under Section 1 of [Article IV]."⁸⁷

Based upon a textual interpretation of Article IV(2), China's current managed flow that pegs the RMB against a basket of currency is not in itself unlawful under the IMF Articles, subject to the requirement that the managed flow complies with China's obligations under Article IV(1). Observance of the obligations set out in Section 1 should be the only re-

79. *Id.* China criticized the adoption of this fourth principle. See Chee Yoke Ling & Celine Tan, *China Criticizes IMF Decision on Exchange-Rate Surveillance*, THIRD WORLD NETWORK, July 3, 2007, available at <http://www.twinside.org.sg/title2/finance/twinfofinance070701.htm>.

80. See Surveillance over Exchange Rate Policies, Decision No. 5392-(77/63), *supra* note 75.

81. IMF Article IV Overview, *supra* note 1, at 1.

82. Articles of Agreement of the IMF, *supra* note 63.

83. See Proctor, *supra* note 51, at 1339.

84. Articles of Agreement of the IMF, *supra* note 63.

85. See IMF Article IV Overview, *supra* note 1, at 4; Mussa, *supra* note 6, at 9.

86. See IMF Article IV Overview, *supra* note 1, at 1; see also, Mussa, *supra* note 2727, at 9; Proctor, *supra* note 51, at 1339.

87. See also IMF Article IV Overview, *supra* note 1, at § 2(c), which (subject to an eighty-five percent majority of the total voting power) empowers the Fund to make provision for general exchange arrangements "without limiting the right of members to have exchange arrangements of their choice consistent with the purposes of the Fund and the obligations under Section 1 of this Article."

striction on the member's freedom to choose an exchange arrangement. A member should not be deprived of such freedom simply because most other members (or indeed, most of its trading partners) have adopted some particular form of exchange arrangement. Therefore, although most of China's major trading partners have adopted a floating exchange rate regime, these trading partners cannot deprive China of its freedom simply because the global trend favors a floating exchange arrangement (or indeed for any reason).

3. *Does China's Exchange Arrangement Violate Article IV(1)?*

Having established that China's current exchange arrangement is not per se inconsistent with Article IV of the IMF Articles, we must now determine whether China's exchange arrangement fulfills its obligations under Article IV(1). In this regard, much of the criticism directed towards China's exchange rate regime revolves around Article IV(1)(iii).⁸⁸ The relevant question under Article IV(1)(iii) is whether China's exchange rate policy is compatible with the undertakings listed in Section 1.

a. Compliance with Article IV(1)(iii)

While much of Article IV(1) is hortatory in nature, Article IV(1)(iii) provides positive duties to member states: members shall "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."⁸⁹

Article IV(1)(iii) thus implies that the only impermissible type of manipulation of exchange rate or the international monetary system under the provision is the one that purports to "prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members."⁹⁰ Under such an interpretation, a member would not violate Article IV if it manipulated its exchange rate in furtherance of its obligations under Article IV, or indeed for other purposes so long as the purposes are consistent with their Article IV obligations (i.e. the manipulation is not instituted or maintained in order to "prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members").⁹¹

China's compliance with Article IV(1)(iii) therefore depends on the answers to the following two questions: (1) does China manipulate its exchange rate or the international monetary system, and (2) if so, is the "manipulation" done in order to "prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members."⁹² Unfortunately, the articles do not define the terms "manipulation" or "unfair competitive advantage" and therefore the meaning of both terms are in dispute.

88. See, e.g., *Mussa*, *supra* note 27, at 10.

89. IMF Article IV Overview, *supra* note 1, at 3.

90. *Id.*

91. *Id.*

92. Articles of Agreement of the IMF, *supra* note 63, at art. IV.

i. Manipulation

The question of whether China manipulates its currency is subject to much discussion and debate.⁹³ Some take a narrow approach to the question and argue that the word "manipulate" implies change, and hence China could not have "manipulated" its currency because the value of its currency remains virtually unchanged.⁹⁴ Others suggest that currency manipulation can be evidenced by the setting of an exchange rate that is too low, which necessitates a "protracted large-scale intervention in one direction" in the exchange market.⁹⁵ Advocates of the latter approach contend that China manipulates its currency through its accumulation of enormous foreign reserves,⁹⁶ which they claim evidences a protracted, large scale, and one-way intervention to prevent appreciation. Such an intervention to counteract appreciation, however, at most suggests a high possibility of exchange rate misalignment; the mere finding of exchange rate misalignment is insufficient to establish that a country has manipulated its currency.⁹⁷ Moreover, it would be grossly unfair to conclude that a country has manipulated its currency based solely on the amount of its foreign reserves.⁹⁸

According to the IMF Legal Department, there are many different ways through which a member can be seen as "manipulating" its exchange rate under Section 1(iii), including excess intervention in exchange markets or through the imposition of capital controls (regardless of whether the official intervention results in movement of the exchange rate).⁹⁹ Manipulation can therefore occur through a set of monetary, fiscal, or trade policies that influence the exchange rate.¹⁰⁰

Indeed, under such a definition, the scope of exchange rate manipulation is so wide that virtually every country can be said to be manipulating its exchange rates.¹⁰¹ With manipu-

93. See Lou, *supra* note 16, at 477 (stating that the lack of precedence on Article IV renders the criteria of "manipulation" unclear).

94. See Mussa, *supra* note 27, at 11. Such contention, however, is untenable following the IMF Legal Department's determination that manipulation may either promote or prevent exchange rate movement. See IMF Article IV Overview, *supra* note 1, at 15.

95. M.R. Venkatesh, *Yuan: the Hero Turns Villain*, THE HINDU BUS. LINE, Oct. 1, 2004, available at <http://www.thehindubusinessline.com/2004/10/01/stories/2004100101960800.htm> (inferring from the IMF Decision on Surveillance in 1977 over Exchange Rate Policies which indicated that a "protracted large-scale intervention in one direction in the exchange market" identifies the circumstances under which the IMF needs to speak with the authorities in order to find out their motivation Surveillance over Exchange Rate Policies, Decision No. 5392-(77/63), *supra* note 75, at ¶ 15(i); IMF Article IV Overview, *supra* note 1, at 16.

96. Bivens & Scott, *supra* note 48.

97. *Id.*

98. See generally *Debating China's Exchange Rate Policy* in PETERSON INST. INT'L. ECON. 39 (Morris Goldstein & Nicholas Lardy eds., 2008) (discussing a similar view).

99. IMF Article IV Overview, *supra* note 1, at 15. See also *Debating China's Exchange*, *supra* note 98, at 40 (explaining that others are of the opinion that manipulation can assume the form of any set of macroeconomic policies).

100. Mussa, *supra* note 27, at 12. See also Bivens & Scott, *supra* note 48; Albert Keidel, Morris Goldstein & Desmond Lachman, *Debate on China's RMB: Is it Seriously Under-Valued and Unfairly Manipulated* (Dec. 8, 2005), available at <http://www.carnegieendowment.org/files/Transcript3.pdf> (Keidel argues that the RMB is not unfairly manipulated because it is not seriously undervalued, whilst Goldstein maintains the opposite positions).

101. Mussa, *supra* note 27, at 13.

lation defined in such broad terms, China undoubtedly manipulates its exchange rate because it has implemented policies that affect the exchange rate.¹⁰²

With the framework set out by the IMF Legal Department virtually unworkable, the IMF Executive Board intervened to narrow the scope of manipulation under Section 1(iii) to mean manipulation that both (1) targets at the level of an exchange rate, and (2) has an effect on such level in the sense that the level moves or remains unchanged.¹⁰³ Mussa criticizes this interpretation as being too confined. According to Mussa, the IMF should deem measures that display the following two features as manipulation: (1) the measure affects the exchange rate or balance of payment, and (2) the measure's domestic objectives could have been achieved by some other measure that did not affect the exchange rate or the balance of payment.¹⁰⁴ Under such an approach, it would be easier to establish that countries—including China—use their exchange regime to manipulate currency. While Mussa's proposal may have merit, it lacks textual support. Mussa's proposal would require an amendment to the IMF Articles as they do not presently require countries to exhaust all other means before resorting to exchange arrangement to achieve its domestic goals. Simply stated, at present the exchange arrangement is legitimate, provided that it is compatible with the IMF Articles.

It is therefore clear that China's regime must, at this time, only be assessed under the current IMF Articles and the definition of currency manipulation as set out by the IMF Executive Board. In this regard, establishing that China's exchange regime targets at the level of the exchange rate may not be difficult given that China maintains a currency peg. As to the actual effect on the level of exchange rate, the RMB's strikingly stable exchange rate following the adoption of a currency peg also makes it difficult to contend that China's exchange regime does not affect the exchange rate level. Thus, under Article IV(1)(iii), when analyzed under the definition set out by the Executive Board, China either manipulates its exchange rate and/or the international monetary system.

ii. *With Forbidden Intent*

Even upon a finding of manipulation of the exchange rate, a member only violates Section 1(iii) if it is shown to have manipulated its currency with forbidden intent; that is, whether the manipulation occurred to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members.¹⁰⁵

Much like with the phrase "currency manipulation," the definitions of "unfair competitive advantage" and "forbidden intent" are contentiously debated. For instance, some take

102. The manipulation of the international monetary system is an aggregated form of exchange rate manipulation. Therefore, having found that China has likely manipulated its exchange rate, it is unnecessary for the current discussion to determine whether China has manipulated the international monetary system.

103. IMF, Executive Board Decision, *Bilateral Surveillance over Member's Policies*, annex ¶ 2(a), (June 15, 2007), available at <http://www.imf.org/external/np/sec/pn/2007/pn0769.htm#decision> (defining manipulation as "policies that are targeted at—and actually affect—the level of an exchange rate") [hereinafter *IMF Bilateral Surveillance*]; See *IMF Bilateral Surveillance*, at ¶ 2(b) ("[A] member will only be considered to be manipulating exchange rates in order to gain an unfair 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 . . .").

104. Mussa, *supra* note 27, at 13.

105. Mussa, *supra* note 27, at 13.

a very narrow approach and argue that the requisite intention is satisfied only if the member confesses to have engaged in manipulating its exchange rate for a forbidden purpose.¹⁰⁶ Under this interpretation, China would not be deemed to have the requisite forbidden intent because the Chinese government has consistently maintained that the purpose of its exchange regime is to enable the country to experience stable growth and to protect the economy from instability flowing from its underdeveloped banking and financial system.¹⁰⁷ China has never professed or even hinted that it intends to use its exchange regime to gain unfair advantage over other members or to prevent the adjustment of balance of payment.

The IMF Executive Board, however, rejects this narrow approach. In fact, the Executive Board has indicated that the Fund will make an independent assessment as to the correctness of the member's representation. The Executive Board Decision of June 21, 2007 makes this clear: ". . . the Fund [must] make an objective assessment of whether a member is observing its obligations under Article IV, Section 1 (iii), *based on all available evidence, including consultation with the member concerned.*"¹⁰⁸ The Executive Board also stated that, "Any representation made by the member regarding the purpose of its policies will be given the *benefit of any reasonable doubt.*"¹⁰⁹ Thus, the Executive Board approach seems sensible, and for practical and political reasons, the IMF should refrain from taking action in the face of ambiguous or unclear evidence regarding a member's intention in implementing the scrutinized action.

Applying such an approach, it is difficult to envision China being found to violate Article IV(1)(iii).¹¹⁰ In fact, it seems almost impossible to prove that China manipulates its currency in order to achieve an unfair advantage that is "for the purpose" of creating fundamental misalignment in the form of an undervalued exchange rate and in order to secure an increase in exports, especially because intent must not only be proven as to both factors and remembering that a member is to be given "the benefit of reasonable doubt" in both determinations.

106. *Id.* at 11.

107. See, e.g., LEONG H. LIEW & HARRY X. WU, *THE MAKING OF CHINA'S EXCHANGE RATE POLICY: FROM PLAN TO WTO ENTRY* 212 (Edward Elgar, 2007) ("[E]xchange rate matters are considered in terms of their impact upon not just the national economy but also domestic social stability, which has long been among the most crucial of national priorities"). *Id.*; Matthew R. Leviton, *Is it a Subsidy? An Evaluation of China's Currency Regime and its Compliance with the WTO*, 23 *UCLA PAC. BASIN L.J.* 243, 260 (2006) (stating China's position can be substantiated by the fact that economists believe China adopted the fixed exchange rate in 1994 to control the inflation resulting from 1980s' expansive economic development and furthermore that China's policies demonstrate its concern not only about the national economy but also about internal social instability); Morrison & Labonte, *supra* note 3, at 2 (stating Chinese officials arguments as fostering economic stability and social stability, ensuring private enterprise stability in the face of significant market-oriented reforms, and protecting an underdeveloped and debt-laden banking system from speculative pressures).

108. IMF Bilateral Surveillance, *supra* note 90, at ¶ 3 (emphasis added).

109. *Id.*

110. *Contra* Proctor, *supra* note 51, at 1344 (arguing that due to changing economic conditions, the peg has become "plainly inappropriate", as demonstrated by China's "one-way" intervention (buying U.S. dollars). This position, however, appears to ignore the textual wording of Article IV (1)(iii) and (2) as well as the objectives as set out by Article IV(1). It therefore does not seem that such a position is sustainable in light of the customary rules of treaty interpretation, as set out in the Vienna Convention on the Law of Treaties (1969), art. 31.

To date, the IMF has never found China to be in breach of the provision against currency manipulation.¹¹¹ For that matter, even the U.S. Treasury has conceded that it cannot find any conclusive evidence of China's intent concerning its exchange rate regime.¹¹² Moreover, several recent incidents also support the proposition that China does not have the forbidden intention in maintaining its exchange regime. For instance, China's insistence on exchange rate stability despite the associated uncompetitive export position during the Asian financial crisis supports the proposition that it does not maintain its exchange regime to gain unfair advantage over other members.¹¹³ If China did manipulate its currency for the purpose of gaining advantage over other exporting countries, it would have allowed its currency to devalue during the Asian financial crisis.¹¹⁴ China's refusal to devalue its currency demonstrates that it acted consistently with its professed intention to ensure the economic stability of China. Finally, evidentiary data suggests that China tends to use fiscal subsidies rather than exchange rate manipulation in order to promote exports.¹¹⁵

Some commentators, however, argue that manipulation that has the effect of preventing effective balance of payment should be found to violate Section 1(iii).¹¹⁶ This argument is untenable due to the wording of Section 1(iii) where the inclusion of the phrase "in order to" suggests the requirement of intent.¹¹⁷ The focus of the provision is therefore on the intention rather than the impact of the impugned arrangement. If the focus of the IMF Articles were meant to be on the effect of the exchange arrangement, the drafters could have substituted "with the result of" in place of "for the purpose of."

That being said, China's exchange rate "manipulation" would not necessarily contravene Article IV(1)(iii) even under an "effect theory." In fact, whether China gains an unfair advantage over other members from its exchange regime depends upon the definition of "unfair advantage." Reading the section in light of the background under which the amended Article IV was drafted, "unfair advantage" refers to the advantage gained from competitive depreciation.¹¹⁸ Some commentators thus interpret "unfair advantage" as the unjustifiably over-flourishing of exports or over-shrinking imports in light of either Adam Smith's principle of absolute advantage or David Ricardo's principle of comparative advantage.¹¹⁹

While it is difficult to simulate the "just" share of China's exports and import in the imaginary world of Smith and Ricardo, the mere fact that China has adopted a currency peg does not necessarily mean that its exports and imports must deviate from what the Smith or Ricardo models envisage to an extent amounting to an "unfair disadvantage."

111. See Mussa, *supra* note 27, at 11; Lou, *supra* note 16, at 477.

112. Mussa, *supra* note 27, at 11.

113. LIEW & WU, *supra* note 107, at 212; Lou, *supra* note 16, at 478; It should also be noted that China's exchange rate stability was "widely praised as a positive factor in helping to mitigate the economic consequences" of the Asian financial crisis; Proctor, *supra* note 51, at 1335.

114. Lou, *supra* note 16, at 478.

115. LIEW & WU, *supra* note 107, at 92.

116. See, e.g., Proctor, *supra* note 51, at 1342 n. 41.

117. Mussa, *supra* note 27, at 12.

118. Virtues and Trade, *supra* note 61, at 222-23 (stating that the Second Amendment incorporates the current Article IV into the IMF Articles in order to cure the problem of beggar-thy-neighbour competitive devaluation policies (in order to increase exports) which were prevalent at that time).

119. *Id.* at 222.

For example, the U.S. trade deficit with China might be perfectly explainable by the comparative advantage theory.¹²⁰ Moreover, a RMB revaluation will likely bring about minimal impact on the U.S. trade deficit for two interconnected reasons. First, more than half of China's exports are produced by foreign-owned enterprises,¹²¹ thus any advantage gained by China through the cheaper exports is shared with foreign enterprises (no matter how "unfair advantage" is defined). Second, China's export-oriented economy essentially acts as a mere production platform because it relies upon the importation of necessary inputs, materials, and components—in fact, China runs trade deficits with most East Asian countries—and thus any revaluation will likely trigger the relocation of factories currently in China to another country (or simply redirect trade from China to another country that has a comparative advantage over the United States.), rather than a shift of world demand in favor of the U.S. good.¹²²

Second, China's exchange rate has not evidentially prevented the adjustment of the balance of payments. Market forces may contribute to the disequilibrium of the balance of payment because the market is imperfect even when left undisturbed by the government.¹²³ The absence of absolute correlation or causation between a fixed exchange rate arrangement and a favorable balance of payments is evident from the Japanese experience: Japan's trade surplus did not significantly deteriorate after the revaluation of the Japanese currency in the 1990s.¹²⁴ Thus, any failed adjustment of the balance of payment is not necessarily the result of China's exchange rate manipulation.

Third, even if China's exchange regime might have delayed the balance of payment adjustment, it would be inaccurate to assert that the regime prevents any adjustment. The statistics clearly demonstrate that China's exchange regime is gradually evolving to facilitate moderate RMB appreciation.¹²⁵ Moreover, the promotion of equilibrium of balance of payments is an explicit consideration of the exchange regime.¹²⁶

120. Morrison & Labonte, *supra* note 3, at 1 (the effect of the RMB's recent appreciation is unclear. For instance, while Chinese exports to China grew by 5.1% in 2008 and 11.7% in 2007, American exports to China grew by 9.5% in 2008 and 18.1% in 2007).

121. See Morrison & Labonte, *supra* note 3, at 5; Xiaolian Hu, *China's Approach to Reform*, 44 FIN. & DEV. 36, 37 (2007), available at <http://www.imf.org/EXTERNAL/PUBS/FT/FANDD/2007/09/xiaolian.htm>; Neil C. Hughes, *A Trade War with China*, FOREIGN AFF., July-Aug. 2005, at 94, available at <http://www.foreignaffairs.com/articles/60825/neil-c-hughes/a-trade-war-with-china?>; Lague, *supra* note 44; Invest in China Investment Statistics, http://www.fdi.gov.cn/pub/FDI_EN/Statistics/FDIStatistics/default.htm (search by each respective year for "Express on Imports and Exports by FIEs") (last visited Aug. 08, 2009) (citing data from the Chinese Ministry of Commerce. Foreign-invested enterprises accounted for 54.42% of total exports from China between January and April 2009. Their exports amounted to 55.34%, 57.10%, 58.24% and 58.29% of China's total exports in 2008, 2007, 2006, and 2005 respectively).

122. See generally JOHN L. MANZELLA, GRASPING GLOBALIZATION: ITS IMPACT AND YOUR CORPORATE RESPONSE 7-32 (2005); Morrison & Labonte, *supra* note 3, at 5.

123. Mussa, *supra* note 27, at 37; see generally, *Yuan step at a time*, ECONOMIST, Jan. 20, 2005, available at [http://s05.middlebury.edu/ECON0340A/Yuan step at a time.pdf](http://s05.middlebury.edu/ECON0340A/Yuan%20step%20at%20a%20time.pdf) (stating that a large trade surplus does not necessarily indicate an undervalued currency).

124. Lague, *supra* note 44.

125. JONATHAN REUVID, THE HANDBOOK OF COUNTRY RISK 2008-2009: A GUIDE TO INTERNATIONAL BUSINESS AND TRADE 236 (GMB Publishing 2008).

126. See Regulations of the People's Republic of China on Foreign Exchange Control (Promulgated as the No.193 order of St. Council on Jan. 29, 1996, amended by St. Council on Jan. 14, 1997, effective Aug. 1, 2008) 2008 STANDING COMM. NAT'L PEOPLE'S CONG. GAZ. 211 (P.R.C.). See also Virtues and Trade, *supra* note 61, at 204.

Fourth, no country, including China, has a positive duty under the IMF Articles to actively correct the balance of payment disequilibrium. Therefore, the mere disequilibrium of the balance of payment is not in itself evidence of China's breach of the IMF Articles. Furthermore, the equilibrium of balance of payments does not necessarily equate to the equalization of exports and imports. The equilibrium is determined by the demand and supply of imports and exports. The balance of payments merely reflects the citizens' choice of a combination of imported and exported goods. Therefore, the fact that the balance of payments is negative or positive by itself does not evidence disequilibrium in the balance of payments.¹²⁷

b. Compliance with Article IV(1) as a Whole

Section 1(i) and Section 1(ii) require China to make its best efforts to (1) direct its economic and financial policies toward the objective of fostering orderly economic growth with reasonable price stability, with due regard to its circumstances; and (2) promote stability by fostering (i) orderly underlying economic and financial conditions; and (ii) a monetary system that does not tend to produce erratic disruptions.

The use of prefatory words such as "endeavor to" and "seek to" indicates that these subsections only impose a very limited legal obligation on members.¹²⁸ Arguably, the words are even hortatory in nature or even a mere declaration of intent.¹²⁹ Given the wording, China satisfies these obligations provided its exchange regime purports to pursue the provisions of the subsections.¹³⁰

China's exchange regime assumes an important role in stabilizing the disruptions that trade liberalization would otherwise bring to the country's underdeveloped financial system.¹³¹ The regime imposes capital and currency controls in order to limit currency speculation and stabilize the banking system.¹³² These controls have significantly contributed to the absence of a banking or currency crisis in China, despite many uncurd problems within the financial system.¹³³ The regime thus enables the economy to grow steadily and stably, which in turn assists economic growth and inflation avoidance.¹³⁴ Therefore, if

127. See, e.g., Yajie Wang, Hui Xiofeng & Abdol S. Soofi, *Estimating Renminbi (RMB) Equilibrium Exchange Rate*, 29 J. POL'Y MODELING 417 (2007).

128. See Robert M. Barnett, *Exchange Rate Arrangements In The International Monetary Fund: The Fund as Lawgiver, Adviser, and Enforcer*, 7 TEMP. INT'L & COMP. L.J. 77, 79 (1993) (It is generally agreed Subsections (i) and (ii) only impose an obligation of a "soft" nature). It is generally agreed Subsections (i) and (ii) only impose an obligation of a "soft" nature. *Id.*; See also, Ross Leckow, *The IMF and Crisis Prevention-The Legal Framework for Surveillance*, 17 KAN. J.L. & PUB. POL'Y 285, 289 (2008) (stating that the Subsections only require members to make their best efforts to satisfy the subsection).

129. Proctor, *supra* note 51, at 1338.

130. It should be noted, however, that it does not follow from the Subsections' soft nature that Subsections (i) and (ii) are irrelevant to China's obligation under the IMF Articles. As Article IV(1)(iv) indicates, China's exchange regime should entail exchange rate policies which follow China's Section 1 undertakings. Therefore, even if the China's regime as a whole is not obliged to actively pursue what Sections 1(i) and (ii) provides, the exchange rate policies should not contravene the Section 1 undertakings even if the policies do not have to actively facilitate the achievement of the undertakings.

131. Virtues and Trade, *supra* note 61, at 234.

132. BJORN LOMBORG, *GLOBAL CRISES, GLOBAL SOLUTIONS* 251 (Cambridge University Press 2004).

133. *Id.*; see Leckow, *supra* note 128, at 289 (claiming Chinese banks remain weak and troubled by the strong growth of credit and non-performing loans).

134. Leviton, *supra* note 107, at 260.

China's exchange regime amounts to economic or financial policy, then China satisfies the obligation contained in Section 1(i) to direct its economic and financial policy to secure orderly economic growth with reasonable price stability, having due regard to China's circumstances.

Furthermore, the exchange regime facilitates economic stability, which is particularly important for the institutional reform transforming the economy towards a market-based economy. The reform advances the legal and regulatory framework, improves the banking and financial system, and upgrades institutional capacity and capability.¹³⁵ In other words, the reform aims to foster the underlying economic and financial conditions. In facilitating the necessary stability for the reform implementation, China's exchange regime also contributes to the development of these underlying economic and financial conditions. In this sense, China fulfills its Section 1(ii) obligation.

Indeed, China's exchange regime is not only in line with the country's Section 1 undertakings; it is also consistent with the general premise encompassed in the preamble to Section 1. As explained in Section B(1) of this article, the preamble reveals that the ultimate aim of Section 1 is the achievement of the broader economic benefit which takes the form of financial and economic stability.¹³⁶ Therefore, if China's discontinuance of the current exchange regime would disrupt financial and economic stability, China's maintenance of the regime would be consistent with the aim of Section 1. In this regard, some economists predict that a sudden and large revaluation of the RMB would impose an unbearable risk on China's immature and fragile financial system.¹³⁷ It would also incur risk of social instability because a large RMB revaluation could result in high and sudden unemployment.¹³⁸ China's exchange regime, which slowly and moderately revalues the RMB, thus furthers the general aim of Section 1 as reflected in the preamble.

4. *Does China's Exchange Regime Comply with its Obligations Relating to Foreign Exchange Transactions Under Article VIII?*

Article VIII of the IMF Articles sets out permissible restrictions on foreign exchange transactions;¹³⁹ in particular, Article VIII(2)(a) prohibits members from imposing restrictions on the making of payments and transfers for current international transactions, un-

135. *Id.*

136. Section 1 envisages this broad economic benefit to be realized by the enhancement of effective functioning of the international monetary system through the members' compliance with their Section 1 undertakings.

137. Debating China's Exchange, *supra* note 98, at 72.

138. This, in turn, could threaten political stability. See Morrison & Labonte, *supra* note 3, at 2; Debating China's Exchange, *supra* note 98, at 71 (claiming that a properly valued RMB would reduce China's current account surplus between six and twelve percent of GDP, an amount currently equal to \$150-\$300 billion).

139. Section 2 prohibits restrictions on current payments; Section 3 prohibits discriminatory currency practices; and Section 4 provides for the convertibility of foreign-held balances resulting from current account transaction. Articles of Agreement of the International Monetary Fund, Art. VIII, July 22, 1944, available at <http://www.imf.org/external/pubs/ft/aa/aa08.htm>. See generally ANNAMARIA VITERBO, DISPUTE SETTLEMENT OVER EXCHANGE MEASURES AFFECTING TRADE AND INVESTMENTS: THE OVERLAPPING JURISDICTIONS OF THE IMF, WTO, AND THE ICSID (2008), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=115467.

less the IMF approves otherwise.¹⁴⁰ This provision is subject to Articles VII(3)(b) and XIV(2), which provide for circumstances under which members may deviate from their Article VIII(2)(a) obligations.¹⁴¹

Article VIII(2) places only limited restrictions on members' monetary sovereignty.¹⁴² More specifically, the Section (2)(a) obligation concerns only the transactions of a "current" nature and does not extend to capital account transactions.¹⁴³ Restrictions on capital transactions are permitted so long as payments for current account are not restricted or unduly delayed.¹⁴⁴ There is no indication that China's current account payment is unduly delayed by the country's capital controls. Therefore, although China maintains tight restrictions on its capital account,¹⁴⁵ the controls almost certainly would not render China's exchange regime in breach of Article VIII.

As noted in Section II(B), the RMB is fully convertible under the currency accounts, with payments for goods and services subject only to examination to ensure the legality and genuineness of the underlying transactions.¹⁴⁶ Because a requirement to report all exchange transactions to a government body for statistical purposes does not in itself violate the IMF Articles, a mere examination of a transaction following such reporting to ascertain the authenticity of the underlying transactions does not amount to a violation. This permission is particularly given so that no restrictions are placed on the underlying transaction except the requirement that the transaction must be genuine. A forbiddance on payment in the name of a fraudulent transaction does not violate Article VIII.

Furthermore, the IMF has defined exchange restrictions according to a technical criterion that disregards the economic effect or underlying purpose of the restrictions.¹⁴⁷ Therefore, China's exchange regime cannot violate Article VIII simply by virtue of the regime's associated impact.

As to the exchange control, the scope of impermissible exchange control under Article VIII(2)(a) is narrow by definition. Exchange control regulations amount to an impermissible exchange restriction under Article VIII(2)(a) only if the measure (1) unduly delays the payments in transactions which involve foreign currencies; (2) caps the availability of foreign currencies; and (3) adopts a procedure which is unreasonable or imposes on the party a disproportionate burden.¹⁴⁸ Because China's exchange controls are not accused of

140. Articles of Agreement, *supra* note 139. Unlike the current Article IV, Article VIII has not been amended since Bretton Woods.

141. Article VII(3)(b) provides that IMF approval can be given by a declaration that the member's currency is scarce, whilst Article XIV(2) provides that a member may upon notification to the IMF, maintain its current foreign exchange restriction as a transitional arrangement, even if the restriction is inconsistent with Article VIII(2)(a). In order to maintain a current foreign exchange restriction under Article XIV(2), the member is only required to continuously evaluate its needs to maintain such transitional arrangement.

142. CLAUS D. ZIMMERMANN, JURISDICTIONAL COMPETITION BETWEEN THE IMF AND THE WTO AND ITS IMPACT ON THE PREVENTION OF MONETARY PROTECTIONISM 10 (2008), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1151802.

143. Examples of capital account transactions include loans, equity investments, and inward and outward direct foreign investment. Indeed, Article VI(3) expressly permits restrictions on capital movement.

144. VITERBO, *supra* note 139, at 10.

145. External Liberalization, *supra* note 15.

146. *Id.* at 458.

147. ZIMMERMANN, *supra* note 142, at 11.

148. VITERBO, *supra* note 139, at 10 (examples of disproportionate burden include an out-of-proportion increase in cost of acquiring more foreign currencies).

exhibiting these features, the issue will not be analyzed further, and it is safe to assume that its exchange control does not amount to an impermissible restriction under Article VIII.

C. WORLD TRADE ORGANIZATION

As a member of the WTO,¹⁴⁹ China's substantive and procedural laws and regulations must comply with all of its WTO obligations and commitments.¹⁵⁰ For the purposes of China's currency policy, Article XV of the GATT and the SCM Agreement are particularly relevant. This section proceeds in two parts: subsection (1) evaluates China's compliance with any applicable obligations existing under the GATT, while subsection (2) examines China's compliance with the relevant provisions of the SCM Agreement.

1. GATT¹⁵¹

Article XV of the GATT recognizes the link between trade and exchange rate policies (such that an exchange action can potentially influence trade issues, whilst trade action can affect exchange issues). In this context, Article XV(4) provides that members shall not (1) "frustrate" the intent of the provisions of the GATT by an "exchange action"; or (2) "frustrate" the intent of the IMF Articles by "trade action."¹⁵²

a. Exchange Action Versus Trade Action

The categorization of China's exchange regime as either an exchange action or a trade action directly impacts upon the restraints imposed by Article XV. For example, if the regime is regarded as an exchange action and not a trade action, China does not infringe Article XV even if the regime frustrates the intent of the IMF Articles' provisions. It is also theoretically possible for China's exchange arrangement to amount to both an exchange action and a trade action (in which case China would breach Article XV if it frustrates either the intent of the GATT or that of the IMF Articles).¹⁵³

149. China acceded to the WTO in 2001 following 15 years negotiating entry. See Protocol of Accession of the People's Republic of China, WT/L/432 (Nov. 23, 2001). For details of China's commitments, see also CHING CHEONG & CHING HUNG-YEE, HANDBOOK ON CHINA'S WTO ACCESSION AND ITS IMPACTS (World Scientific 2003) (detailing China's commitments to the WTO). See generally SIMON LESTER & BRYAN MERCURIO, WORLD TRADE LAW 97-101 (Hart Publishing 2008) (explaining the process of Accession in the WTO).

150. See generally Protocol of Accession, *supra* note 149.

151. This section will limit its analysis to Article XV, which is generally regarded as the most feasible argument used in discussions involving currency manipulation. While some have attempted to use Article I (most favoured nation) and/or a nonviolation (Article XXIII) claim against China, such claims are clearly inappropriate and will not be discussed. For discussion, see Proctor, *supra* note 51, at 1345-47 (discussing the inapplicability of a claim based on Article I); See also Staiger & Sykes, *supra* note 59, at 33-34 (concluding that a nonviolation claim would be difficult to prove given that China initiated and maintained a currency peg prior to its accession to the WTO in 2001). For the difficulty in making out a nonviolation claim, see also Japan-Film, WT/DS44/R, adopted Apr. 22, 1998.

152. Articles of Agreement, *supra* note 139, at art. XV(4) (providing 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.").

153. Virtues and Trade, *supra* note 61, at 221. Staiger and Sykes make the point that the IMF Articles are concerned with the impact of exchange rate policies on *trade imbalances*, the GATT/WTO is concerned with

In evaluating this issue, it is important to remember that trade action and exchange action are distinct from each other.¹⁵⁴ Exchange action relates to the currency and capital, and concerns matters such as currency convertibility or capital movement.¹⁵⁵ On the other hand, trade action concerns the domestic or cross-border flow of goods and services.¹⁵⁶ An exchange action and a trade action may both similarly impact the balance of payment or the level of foreign reserves;¹⁵⁷ the two actions, however, have different aims and remain distinct from each other.

In our opinion, it is more appropriate to categorize China's exchange regime as an exchange action because the regime involves a currency peg, thereby requiring policies that manage capital movement and regulate currency convertibility. Although some commentators contend that the regime is a trade action, in that the regime contributes to the relatively low price of Chinese exports and the relatively high price of foreign imports (which in turn affect the flow of goods from China),¹⁵⁸ such a characterization misinterprets the objectives of Article XV. If the drafters had intended for any action that has a trade "effect" to be deemed a "trade action," then the relevant section would likely have been rephrased to something along the lines of "action which affects trade," as opposed to using the more specific language of "trade action." The use of the more specific term of "trade action" should not be ignored or discounted: a country will frustrate the intent of the IMF Articles only by trade action, as opposed to by an action that has the effect of a trade action.

b. Does China's Exchange Regime Frustrate the Intent of the GATT?

Having concluded that China's exchange regime is an exchange action, it must now be determined whether China has by this exchange action frustrated the intent of the GATT. Unfortunately, Article XV provides very limited guidance as to what would be a permitted form of an exchange rate arrangement,¹⁵⁹ elaborating neither on the "intent of the GATT" nor the meaning of "frustrate."¹⁶⁰

i. *The Meaning of Frustrate*

The Interpretative Note of GATT Article XV(4) indicates that the word "frustrate" denotes the frustration of the spirit of the relevant agreements and articles:

the impact on *trade volumes*. See Staiger and Sykes, *supra* note 59, at 5-6; For discussion on the relationship between the IMF and WTO, see Deborah E. Siegel, *Legal Aspects of the IMF/WTO Relationship: The Fund's Articles of Agreement and the WTO Agreement*, 96 AM. J. INT'L. L. 561 (2002).

154. *The European Political Community*, 29 BRIT. Y.B. INT'L. L. 383, 422 n.3 (1952).

155. *Id.*

156. *Id.*

157. For example, an import quota, which is a trade action, may positively affect the level of foreign reserve to the same extent as an exchange action which upholds an undervalued exchange rate. Similarly, the import quota may improve the balance of payment to the same extent as maintenance of an undervalued exchange rate.

158. *Virtues and Trade*, *supra* note 61, at 221-23.

159. Chris Brown, *China's GATT Bid: Why All The Fuss About Currency Controls?*, 3 PAC. RIM L. & POL'Y J. 57, 80 (1994).

160. *Id.* Article XV(4) has never previously been challenged in dispute settlement, which further complicates applying the Article to China's exchange regime.

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 XIII¹⁶¹

Therefore, a mere infringement of a particular GATT or IMF provision does not in itself frustrate the intent, for the purposes of Article XV(4). The intent is not frustrated so long as the infringement preserves the spirit of the agreement or the article.¹⁶²

The interpretive note, however, does not entirely clarify the situation as it merely explains the object of frustration without actually resolving the meaning of "frustrate." Because the GATT is an agreement between members, principles in contract law may shed light on the meaning of "frustrate." A contract can be "frustrated" by the occurrence of events or circumstances that render the performance of the contract virtually impossible.¹⁶³ The frustration in turn discharges parties of their obligations under the contract.¹⁶⁴ Contract law's concept of frustration, however, only partially assists the interpretation of "frustrate" under the GATT. This divergence is mainly because the GATT and the contract law differ in their object of frustration. Under contract law, it is the contract that is frustrated when the contract's performance is rendered impossible by some unforeseen event. By contrast, the GATT prohibits the frustration of intent, rather than the frustration of performance of an action. Therefore, the extent to which the meaning of frustration under contract law can be applied to the GATT is uncertain. This uncertainty renders unclear how to translate the frustration threshold of rendering the contract's performance "virtually impossible" into the context of the GATT.

A possible counterpart to the GATT, and the idea of the "performance of the intent of GATT" can be taken from the notion in contract law of the "performance of the contract." Article XV of the GATT can be interpreted to prohibit China's exchange regime from rendering impossible the realization of the intent of the GATT. If this situation were the case, the frustration threshold would be difficult to satisfy, as China's exchange regime would not frustrate the "intent" of the GATT even if it only leaves some possibility of the "intent" being realized.

The *Black's Law Dictionary* meaning of "frustrate," however, reveals that to frustrate the GATT's intent can merely mean hindering the intent's attainment, without going to the extreme of rendering impossible or preventing totally the GATT's intent.¹⁶⁵ Therefore, to "frustrate" the GATT's intent assumes a spectrum of meanings that range from

161. General Agreement on Tariffs and Trade, Interp. Note to XV(4), Oct. 30, 1947, 61 Stat. A-11, 55 U.N.T.S. 194 (emphasis added).

162. RAJ BHALA, *MODERN GATT LAW: A TREATISE ON THE GENERAL AGREEMENT ON TARIFFS AND TRADE* 1172 (2005).

163. STEPHEN HALL, *LAW OF CONTRACT IN HONG KONG: CASES AND COMMENTARY* 699 (2008).

164. *Id.*

165. *BLACK'S LAW DICTIONARY* 679 (B. Garner 7th ed. 1999) (frustration means "The prevention or hindering of the attainment of a goal.").

“preventing totally” or “rendering impossible” the attainment of the intent, to merely “hindering” the achievement of the intent.

ii. *The Compatibility of China’s Exchange Regime with the Intent of the GATT*

Many commentators believe that it is “highly unlikely,”¹⁶⁶ if not impossible,¹⁶⁷ to enforce rights and obligations under Article XV(4). For instance, Subramanian and Mattoo state that Article XV(4) provides “too vague an obligation to provide a basis for effective enforcement,”¹⁶⁸ and furthermore question whether (even if such a claim is actionable) a panel would, with no existing jurisprudence on the issues, make a ruling against an undervalued exchange rate.¹⁶⁹ Hufbauer, Wong, and Sheth agree with Subramanian and Mattoo, and go even further by suggesting that the Addenda to the interpretation of Article XV(4) provides that another “specific GATT article needs to be frustrated in an important way before the strictures of Article XV(4) can be invoked.”¹⁷⁰ With no jurisprudence on the issue and the uncertainty of whether the article is even actionable (and if so, under what circumstances and conditions), it is highly improbable that a panel will ever find an exchange regime incompatible with the intent of the GATT.

Even if we assume, however, that an action under Article XV(4) is justiciable (with no other conditions) and discount the possibility of panel discomfort in being the first to rule on the issue, it is still unlikely that China’s exchange regime would be found to frustrate the intent of the GATT. This situation is the case even when the most liberal definition of frustrate—merely “hindering” the achievement of the intent of the GATT.

If “frustrate” is to take the meaning of merely hindering, then China’s exchange regime—as an exchange action—would arguably frustrate the intent of the GATT and hence infringes Article XV(4) if the GATT/WTO is viewed as an agreement/organization that exists solely to liberalize trade through the reduction and removal of barriers to trade. If such an assumption is correct, then China’s exchange regime arguably frustrates the intent of the GATT/WTO, China’s currency peg resembles an export subsidy and an import tax, and therefore could constitute a barrier to trade.¹⁷¹ Furthermore, the capital controls could also be seen to be delaying (or, at the very least, possibly delaying) the realization of trade liberalization in goods and services.¹⁷² But is this explanation the correct understanding of the “intent” of GATT?

On the one hand, such a view could potentially find support from the historical background against which the GATT was drafted, when countries invariably resorted to vari-

166. See Subramanian and Mattoo, *supra* note 10, at 4.

167. See GARY C. HUFBAUER ET AL., *U.S.-CHINA TRADE DISPUTES: RISING TIDE, RISING STAKES* 19 (2006).

168. Subramanian and Mattoo, *supra* note 10, at 4.

169. *Id.*

170. HUFBAUER et al., *supra* note 167, at 19 (emphasis added).

171. BHALA, *supra* note 162, at 1169; see also Subramanian and Mattoo, *supra* note 10, at 4 (calling exchange rate undervaluation “both an import tax and an export subsidy and. . . hence the most mercantilist policy imaginable,” while also recognizing that exchange rate policy is currently largely outside the framework of GATT and the SCM Agreement).

172. MOHAMED EL-ERIAN, *WHEN MARKETS COLLIDE: INVESTMENT STRATEGIES FOR THE AGE OF GLOBAL ECONOMIC CHANGE* 151-192 (2008).

ous exchange actions to boost exports and discourage imports.¹⁷³ Under such circumstances, it is possible that the drafters inserted Article XV into the GATT to prevent similar exchange actions from undermining trade liberalization.¹⁷⁴ Because China's exchange regime arguably resembles the then-prevalent practice of deliberately maintaining an undervalued currency, it follows that China's exchange regime would frustrate the intent of the GATT.

The view that the intent of the GATT is solely to liberalize trade, however, is an incomplete and arguably inaccurate proposition. In this regard, the preamble to the GATT sheds light on a fuller view on the intent of the agreement. The preamble reads as follows:

Recognizing that their relations in the field of trade and economic endeavor should be conducted with a view to raising standards of living, ensuring full employment and a large and steadily growing volume of real income and effective demand, developing the full use of the resources of the world and expanding the production and exchange of goods. . . . Being desirous of contributing to these objectives by entering into reciprocal and mutually advantageous arrangements directed to the substantial reduction of tariffs and other barriers to trade and to the elimination of discriminatory treatment in international commerce¹⁷⁵

The preamble reveals that the contracting parties of the GATT (now WTO Members) agreed to the GATT under a common consideration to conduct trade and economic relations in such a manner so as to achieve the goals of "raising standards of living, ensuring full employment and a large and steadily growing volume of real income and effective demand, developing the full use of the resources of the world, and expanding the production and exchange of goods."¹⁷⁶ The contracting parties agreed to achieve these goals by entering into reciprocal and mutually beneficial agreements, which aim to reduce tariffs and remove other barriers to trade.

Under such a reading, tariff reductions and the removal of trade barriers are merely the means to achieve the goal of increasing economic welfare. One may infer from the stated goals of "developing the full use of the resources of the world and expanding the production and exchange of goods" that the GATT purports to liberalize trade. But, equally one can maintain that such a view is too far-stretched, and that trade liberalization is merely a way to achieve goals encompassed in the preamble.¹⁷⁷ It follows that even if China's ex-

173. BHALA, *supra* note 162, at 1169. These actions included manipulating currency devaluation, adopting a dual exchange rate and instituting a license system for exchanging foreign currency.

174. *Id.*

175. General Agreement on Tariffs and Trade, Preamble, Oct. 30, 1947, 61 Stat. A-11, 55 U.N.T.S. 194.

176. *Id.*

177. That is, the goals of "raising standards of living, ensuring full employment and a large and steadily growing volume of real income and effective demand, developing the full use of the resources of the world and expanding the production and exchange of goods." *Id.*

change regime undermines trade liberalization,¹⁷⁸ it only undermines a means to achieve the intent of the GATT but not the intent itself.¹⁷⁹

Unfortunately, neither the GATT nor any of the other relevant WTO agreements clearly sets out its “intent.” Regrettably, trade scholarship does not adequately address the issue either.¹⁸⁰ Perhaps even more regrettable is the fact that the members themselves now do not even appear to agree on the purpose, aims, and objectives of the WTO as a whole.¹⁸¹ It is therefore unlikely that they would come to an agreement now as to the meaning of the “intent” of the GATT.

With that in mind, even if it is accepted that trade liberalization is one of many intents of the GATT, it does not necessarily follow that the regime has frustrated the intent of the GATT. In fact, it could be argued that China’s exchange regime is an arrangement that furthers the intent of the GATT. As Section III(B)(3) of this article noted, China’s exchange regime assists the implementation of institutional reform which facilitates China’s trade liberalization.¹⁸² In this regard, China’s exchange regime is directly compatible with the GATT’s purported intent to liberalize trade. Furthermore, a revaluation of the RMB that could potentially bring disastrous economic consequences and social upheaval (both in China and elsewhere, given China’s increasing importance to the world economy), would seem to be contrary to enhancing the welfare of the world.¹⁸³ Viewed in such a light, revaluation could even be seen to infringe the intent of the GATT.

Based on the above examination, even when analyzed under the most liberal definition of “frustrate,” China almost certainly does not infringe Article XV(4) because its exchange regime cannot be proven to be an exchange action that frustrates the intent of the GATT.

c. Does China’s Exchange Regime Frustrate the Intent of the IMF Articles?

As detailed in Section (a) of this article, China’s exchange regime should be regarded as an exchange action as opposed to a trade action. Therefore, any Article XV(4) complaint

178. Of course, the term “trade liberalization” is not defined in the GATT (nor in any other WTO agreement) and its meaning is subject to interpretation. For instance, does it mean a reduction of any trade barriers (regardless of the size of the reduction or barrier), complete anti-protectionism or harmonization of laws and barriers? Trade scholarship has not adequately addressed or definitively resolved the issue.

179. It is not even clear whether devaluation has any effect on trade volume or magnitude. See Staiger and Sykes, *supra* note 59, at 11-25. See also Steven Dunaway et al., *How Robust are Estimates of Equilibrium Real Exchange Rates: The Case of China* (IMF, working paper 06/220, Oct. 2006).

180. For an interesting discussion, see Steve Charnovitz, *Triangulating the World Trade Organization*, 96 AM. J. INT’L L. 28 (2002).

181. For discussion, see Bryan Mercurio, *The WTO and its Institutional Impediments*, 8 MELB. J. INT’L L. 198 (2007).

182. See *supra* Part III, at § B(3)(b). China’s exchange regime intends to minimize the economic and social instability brought by the institutional reform whose aim is to facilitate China’s trade liberalization. China’s exchange regime therefore contributes to the smooth implementation of a reform which is significant, if not vital, to successful trade liberalization in China.

183. See *supra* Part III, at § B(3)(b). Indeed, some economic research demonstrates the ability to use exchange rate policy can be used as a tool for economic development. See, e.g., Rodrik, *supra* note 42, at 1; BHALA, *supra* note 162, at 1174. This is not to suggest that exchange rates cannot create negative externalities. Moreover, Subramanian and Mattoo suggest that appropriate levels of exchange rate among China and undervalued oil-exporting nations could have increased world trade by roughly \$500 billion. Subramanian & Mattoo, *supra* note 10, at 2-3.

must prove that the regime frustrates the intent of the GATT.¹⁸⁴ Assuming, arguendo, that the exchange regime amounts to a trade action, China's regime does not necessarily frustrate the intent of the IMF Articles.¹⁸⁵

The IMF Articles do not expressly state their purpose, but Article I does set out the purposes of the IMF, which perhaps hint at the purposes of the articles.¹⁸⁶ Article I provides:

- (i) To promote international monetary cooperation through a permanent institution which provides the machinery for consultation and collaboration on international monetary problems.
- (ii) To facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy.
- (iii) To promote exchange stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation.
- (iv) To assist in the establishment of a multilateral system of payments in respect of current transactions between members and in the elimination of foreign exchange restrictions which hamper the growth of world trade.
- (v) To give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity.
- (vi) In accordance with the above, to shorten the duration and lessen the degree of disequilibrium in the international balances of payments of members.

The Fund shall be guided in all its policies and decisions by the purposes set forth in this Article.¹⁸⁷

The IMF Articles can be read as purporting to eliminate foreign exchange restrictions that suppress world trade growth.¹⁸⁸ More specifically, the articles have been said to en-

184. It must be noted that argument under this provision suffers from the same ambiguity problem with the meaning of "frustrate" as that in relation to the frustration of the intent of GATT.

185. For the purposes of completing the analysis, we assume that Article XV(4) can be violated even if it is deemed lawful (or, perhaps more appropriately, not deemed unlawful) under Article IV of the IMF Articles. Such an assumption may be incorrect—meaning in order to have a violation of Article XV(4) of GATT there first needs to be a violation of Article IV of the IMF Articles. We only note that Article XV(4) is a very brief provision, and it would be unusual, if not extremely odd, for a provision relating to monetary and exchange issues to be inconsistent with the WTO while at the same time being consistent with the relevant provision in the IMF Articles. It would seem more likely that if drafters wanted such a result, the provision would have been more carefully and specifically drafted to accomplish this purpose. For further discussion, see Proctor, *supra* note 51, at 1348-49 (expressing skepticism that there can be a breach of the WTO obligation without a breach of the relevant provision in the IMF Articles).

186. Sharobeem, *supra* note 28, at 725.

187. IMF, Articles of Agreement, art. I, Dec. 27, 1945, 60 Stat. 1401, 2 U.N.T.S. 39.

188. The European Political Community, *supra* note 154, at 422 n.3.

compass two principal purposes: (1) to promote the international monetary cooperation, and (2) to promote exchange stability.¹⁸⁹

In relation to the purpose of promoting exchange stability, the IMF Legal Department maintains that the Second Amendment modified Article IV's objective to promote the stability of the exchange rate system, as opposed to the stability of the exchange rate.¹⁹⁰ One must note, however, the members' reluctance to concurrently amend the wording of Article I.¹⁹¹ This vagueness could have been intentional, and members might have intended that the purposes of the IMF remain promoting exchange stability while at the same time shifting the core of Article IV to focus on the stability of exchange rate system due to the elimination of the par value system. Therefore, the purpose of the IMF Articles can be taken as: (1) the removal of foreign exchange restrictions, which negatively affect world trade growth; (2) the promotion of the international monetary cooperation; and (3) the promotion of exchange stability.

China's exchange regime is consistent with these three purposes, and therefore does not frustrate the intent of the IMF Articles. With regards to the first purpose, it is undeniable that China's exchange regime involves foreign exchange restrictions and is therefore inconsistent with the goal of removing foreign exchange restrictions per se. The foreign exchange restrictions that China's exchange regime imposes, however, do not necessarily adversely impact world trade growth. By contrast, the regime's foreign exchange restrictions help shape a healthier financial and monetary system within China, which ultimately facilitates the world trade growth.¹⁹² As to the second purpose, although China's regime might not actively promote international monetary cooperation, there is no evidence suggesting that the regime hinders such cooperation. With regard to the third purpose, the regime by design promotes exchange stability. The inherent nature of China's exchange regime means that it is unlikely that the regime would undermine the promotion of exchange stability—the essence of the regime is to link the RMB with a basket of currency, which in itself promotes exchange stability.

d. Article XV(9) Immunity

Parts (b) and (c) demonstrate that China's exchange regime does not frustrate the intent of either the GATT or the IMF Article, and is therefore consistent with Article XV(4). Nevertheless, even if China's exchange arrangement is found to be inconsistent with its Article IV obligations, Article XV(9)(a) offers China potential immunity from the infringement. Article XV(9)(a) reads:

Nothing in this Agreement shall preclude: (a) the use by a contracting party of exchange controls or exchange restrictions in accordance with the Articles of Agree-

189. Allan T. Marks, *Exchange Control Regulations Within the Meaning of the Bretton Woods Agreement: A Comparison of Judicial Interpretation in the United States and Europe*, 8 INT'L TAX & BUS. LAW. 104 (1990).

190. IMF Article IV Overview, *supra* note 1, at 12. The IMF Articles envisage the IMF to promote international monetary cooperation by providing a forum for consultation and collaboration on international monetary problems, promoting exchange stability, maintaining orderly exchange arrangements among members, and avoiding competitive exchange depreciation.

191. IMF Article IV Overview, *supra* note 1, at 12 n.15.

192. See *supra* Part III, at § B (3)(b);

ment of the International Monetary Fund or with that contracting party's special exchange agreement with the CONTRACTING PARTIES.¹⁹³

Article XV(9)(a) therefore provides that the IMF Articles should prevail over the GATT if the two agreements conflict with regard to an exchange restriction.¹⁹⁴ Although the scope of this immunity is not well defined or elaborated upon, Article XV(9)(a) arguably offers an IMF member complete immunity against any accusation that it has breached Article XV(4)¹⁹⁵ as "[n]othing in this Agreement" should be interpreted as nothing in the GATT, including Article XV(4).¹⁹⁶ It follows that if China's exchange regime complies with the IMF Articles, Article XV(4) cannot preclude China's use of its exchange regime even if the regime breaches the Article.¹⁹⁷ Of course, Article XV(9)(a) does not preclude the regime from breaching Article XV(4) if the regime breaches any IMF Articles; Article XV(9)(a) merely shields the regime from any potential GATT inconsistency if it is compliant with the IMF Articles.

2. SCM Agreement

The SCM Agreement does not define a subsidy in terms of economic effect; instead, a measure considered a subsidy only if it falls within the criteria set out in Article 1. Moreover, not all subsidies are prohibited; instead, subsidies are prohibited only when they fall within the additional requirements of the SCM Agreement.

a. Prohibited Subsidies Under the SCM Agreement

According to the SCM Agreement, a subsidy is actionable (that is, it can be challenged under the Agreement) if it involves the government or a public body within the territory giving (1) a *financial contribution* (or a form of income or price support in the sense of GATT Article XVI)¹⁹⁸ which confers a *benefit*¹⁹⁹ and is *specific*.²⁰⁰ The three criteria are cumulative.

Article 1.1 lists several types of government (or the public body) measures that fall within the meaning of the SCM Agreement, if:

193. IMF, Articles of Agreement, art. XV(9)(a), Dec. 27, 1945, 60 Stat. 1401, 2 U.N.T.S. 39.

194. BHALA, *supra* note 162, at 1171.

195. *Id.* In fact the immunity extends to cover breaches of any Articles of the GATT. Therefore, provided that China's exchange regime complies with IMF, which Section 2 of this essay shows that it does, it is shielded from any potential GATT suit.

196. BHALA, *supra* note 162, at 1171. For useful discussion on Article IV(9) as applied in WTO jurisprudence, See Panel Report, *Dominican Republic—Measures Affecting the Importation and Internal Sale of Cigarettes*, ¶¶ 7.106-122, WT/DS302/R (Nov. 26, 2004) (issue not subject to the appeal).

197. Article XI of GATS provides even stronger language to this effect, stating: "... nothing in this Agreement shall affect the rights and obligations of the members of the International Monetary Fund under the Articles of Agreement of the Fund, including the use of exchange actions which are in conformity with the Articles of Agreement." General Agreement on Trade and Services, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Article XI, Payments and Transfers—Results of the Uruguay Round, 33 I.L.M. 1125 (1994) [hereinafter GATS];

198. Agreement on Subsidies and Countervailing Measures, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Article 1.1(a)(1)-(2), Definition of a Subsidy—Results of the Uruguay Round, 33 I.L.M. 1125 (1994) [hereinafter SCM Agreement].

199. *Id.* art. 1.1(b).

200. *Id.* art. 1.2.

- (1) its practice involves a direct transfer of funds, or a potential direct transfers of funds or liabilities;²⁰¹
- (2) it forgoes or not collects a government revenue which is otherwise due;²⁰²
- (3) it purchases goods or provides goods or services other than general infrastructure;²⁰³ or
- (4) it pays a funding mechanism, or entrusts or directs a private body to carry out the practices mentioned in (1) to (3), in a manner which resemble that normally carried out by the government.²⁰⁴

A subsidy satisfies the specificity requirement of Article 2 if the authority or the law expressly limits the availability of the subsidy to an enterprise or a group of certain enterprises.²⁰⁵ On the other hand, a subsidy does not meet the specificity requirement if it is available for all sectors.

A subsidy will also satisfy the specificity requirement if it is considered to be a prohibited subsidy under Article 3.²⁰⁶ Article 3 is satisfied if the subsidy is contingent (in law or in fact) on export performance.²⁰⁷ Export performance can be either the sole or one of several conditions on which the subsidy is contingent upon.²⁰⁸

b. Does China's Exchange Regime Comply with Article 1?

i. *Conferring a Benefit by Financial Contribution, a Form of Income or Price Support*

While it is generally agreed that China's exchange regime does not involve income or price support within the meaning of the GATT Article XVI,²⁰⁹ the question of whether the regime entails the government making a "financial contribution" is more contentious. Critics of China's exchange regime contend that China makes a financial contribution to the Chinese exporters in the form of undervalued currency.²¹⁰

In our opinion, however, China's exchange regime cannot be said to entail a "financial contribution" within the definition of Article 1.1.²¹¹ First, it must be noted that Article 1.1 is not an "effects" test, and therefore it is not the case that all government actions that

201. *Id.* art. 1.1(a)(1)(i).

202. *Id.* art. 1.1(a)(1)(ii).

203. *Id.* art. 1.1(a)(1)(iii).

204. *Id.* art. 1.1(a)(1)(iv).

205. *Id.* art. 2.1(a). The SCM Agreement defines "certain enterprises" as "an enterprise or industry or group of enterprises or industries" *id.*: Article 2.1.

206. *Id.* art. 2.3.

207. *Id.* art. 3.1(a).

208. *Id.* art. 3.1(b).

209. Killion, *supra* note 2, at 55-56.

210. *See, e.g.,* Leviton, *supra* note 107, at 256.

211. It should be noted that the Panel found the list of possible "financial contributions" to be exhaustive, and therefore government measures falling outside the scope of the list cannot be deemed to be subsidies. Panel Report, *United States—Measures Treating Export Restraints as Subsidies*, ¶ 8.69, WT/DS194/R (June 29, 2001) [hereinafter Export Restraints Panel Report]. Most commentators agree that Article 1.1 sets out an exclusive, exhaustive list of what constitutes a financial contribution. *See A Survey of Views Regarding Whether Exchange-Rate Misalignment is a Countervailable, Prohibited Export Subsidy Under the Agreements of the World Trade Organization (WTO)*, Apr. 2007, http://www.faircurrency.org/presscenter/survey_of_views0407.pdf (views of James L. Bacchus and Ira Shapiro, Counsel for the National Association of Manufacturers).

benefit an exporter (in this case) will be deemed to be a financial contribution.²¹² Second, China’s exchange regime involves no direct transfer of assets from the government to exporters.²¹³ The regime therefore does not entail a financial contribution as defined in Article 1.1(i) or (ii).²¹⁴ At most, the government can be said to have directed the PBC or the relevant authorities to (1) purchase U.S. Treasury bonds with a view to sterilize the PBC’s interference in the exchange market, (2) issue or buy back the RMB, or (3) buy or sell other currencies. Third, the claim that China’s exchange regime, through the maintenance of an undervalued currency and thus the elimination of the necessity for hedging, constitutes a governmental service under Article 1.1(a)(1)(iii)²¹⁵ does not withstand scrutiny. Neither a financial instrument nor currency can properly be categorized as “goods or services,” the purchase or provision of which is considered as a form of financial contribution under Article 1.1(iii).²¹⁶ The Panel in *United States—Measures Treating Export Restraints as Subsidies* reached a similar conclusion:

The negotiating history confirms that items (i)-(iii) [of Article 1.1(a)(1)] . . . limit these kinds of [government] measures to the transfer of economic resources from a government to a private entity. Under subparagraphs (i)-(iii), the government acting on its own behalf is effecting that transfer by directly providing something of value—either money, goods, or services—to a private entity.²¹⁷

China’s exchange rate policy may indeed benefit exporters, but the benefit is not obtained from an explicit transfer of capital, goods, or services from the government to private businesses in order to promote exports.²¹⁸ In fact, China’s exchange rate regime does not involve the transfer of public assets to private exporters. Instead, the regime simply controls exchange rate fluctuations through the purchase or sale of currencies. Thus, the contention that China’s exchange rate regime is a “governmental service” is overly expansive and unsupported by the text of Article 1.1 and WTO jurisprudence.²¹⁹

212. See Export Restraints Panel Report, *supra* note 211, at ¶ 8.62 (“It does not follow. . . that every government intervention that might in economic theory be deemed a subsidy with the potential to distort trade is a subsidy within the meaning of the SCM Agreement. Such an approach would mean that the ‘financial contribution’ requirement would effectively be replaced by a requirement that the government action in question be commonly understood to be a subsidy that distorts trade.”). See also *id.*, at ¶¶ 8.65–.68.

213. Interestingly, the “Currency Reform for Fair Trade Act” labels an undervalued currency to be a “direct transfer of funds”. See Tariff Act of 1930, 19 U.S.C. § 1654. See also Survey of Views, *supra* note 192 (views of David Hartquist, Terence P. Stewart, Wiley Rein and Fielding and John Magnus).

214. See Survey of Views, *supra* note 192 (views of Bacchus and Shapiro).

215. China Currency Coalition, *The Section 301 Petition*, at 49 (Sept. 9, 2004).

216. See Survey of Views, *supra* note 211 (views of Bacchus and Shapiro; Gary Hufbauer).

217. *Export Restraints Panel Report*, ¶ 8.65, WT/DS194/R (June 29, 2001).

218. Benetah questions whether “it is possible that the provision or the conversion of foreign currency at a fixed rate could be perceived as equivalent to a service given by the Chinese government or by bodies entrusted by it.” Marc Benetah, *China’s Fixed Exchange Rate for the Yuan: Could the United States Challenge It in the WTO as a Subsidy*, ASIL INSIGHTS, (October 2003), available at <http://www.asil.org/insigh117.cfm>. Even challenged as a de facto export subsidy, however, China’s exchange regime does not appear to fit into the Illustrative List of prohibited subsidies annexed to the SCM Agreement. Benetah agrees, noting “it does not seem that the United States could successfully invoke” any of the items mentioned on the prohibited list. *Id.*

219. Staiger and Sykes briefly analyze an alternative argument based on the premise that the government makes a “financial contribution” as a result of its exchange rate intervention by forgoing revenue otherwise due. See Staiger and Sykes, *supra* note 59, at 32. This argument would likely fail for a number of reasons, including the fact that the revenue foregone would not be owed to the government by the exporter. The

ii. Benefit

Even assuming, arguendo, that China has made a financial contribution, it is nevertheless difficult to establish a benefit to Chinese exporters.²²⁰ On this point, critics make two arguments in support of the contention that Chinese exporters receive a “benefit:” (1) the undervalued currency lowers labor costs for Chinese exporters, enabling their products to be more competitive compared with the U.S. products, and thereby conferring a benefit on the Chinese exporters in the form of price advantage which they could not otherwise obtain in the open market;²²¹ and (2) China’s exchange regime confers a benefit on Chinese exporters in the sense that the exporters do not need to hedge against currency fluctuations.²²² Critics assert that both cases provide cost advantages to exporters, and that those cost advantages constitute a benefit under Article 1.1(b) because the exporters would be unable to attain the same advantage on the open market.²²³ This argument thus hinges upon the demonstration that the RMB is substantially undervalued.²²⁴

Even then, however, whether there is a benefit to exporters is ambiguous for at least two reasons. First, an increase in sales volume at lower unit prices does not necessarily lead to an increase in profit.²²⁵ Therefore, it is difficult to state with certainty that exporters have benefited from the undervalued RMB. Second, while the stable currency arrangements might save hedging costs, it does not necessarily follow that the exporters gain additional profits in real terms if regime-initiated price fluctuation is taken into account.²²⁶

iii. Specificity

Even if China’s exchange regime involves a “financial contribution” that confers a “benefit” on exporters, China’s exchange regime does not expressly or in effect limit the bene-

argument would also likely fail as conclusive economic data demonstrating the rise and fall of tariff revenue and the elasticity of demand of imports would be extremely difficult to procure.

220. In the view of Staiger and Sykes, the real effects of currency misalignment decrease over time (even to zero) and thus currency misalignment would certainly offer no benefit to exporters. See *id.* at 1-25, 32.

221. *Id.*

222. Leviton, *supra* note 107, at 264.

223. WTO jurisprudence typically equates “benefit” with whether the recipient has received a “financial contribution” on terms more favorable than the “market”. See Report of the WTO Appellate Body, *Canada—Measures Affecting the Export of Civilian Aircraft*, WT/DS70/AB/R, ¶ 157, (1999). For the view that China’s exchange rate is a “benefit”, see Survey of Views, *supra* note 211 (views of Bacchus Shapiro; Gary Hufbauer).

224. As illustrated throughout this article, such clear-cut economic analysis is currently unavailable. Additionally, Denters argues that so long as China’s exchange regime is compliant with the IMF Articles, the WTO could not be deemed to be a prohibited export subsidy. See Eric Denters, *Manipulation of Exchange Rates in International Law: The Chinese Yuan*, ASIL INSIGHTS (Nov. 2003), available at <http://www.asil.org/insigh118.cfm>.

225. See, e.g., WALTER NICHOLSON, *MICROECONOMIC THEORY: BASIC PRINCIPLES AND EXTENSIONS* 249-50 (Mason, Ohio, Thomson/South-Western 2005) (showings that profit maximization does not necessarily occur at a point where a larger volume of products are sold at a lower price. Rather the profit is maximized at a point where the marginal revenue equals to the marginal cost).

226. This is due to the fact that exporters will have to hedge against inflation risks and interest rate risk which associate with the fixed exchange rate regime. See, e.g., STEPHEN D. WILLIAMSON, *MACROECONOMICS* 516-21 (Boston, Pearson Addison Wesley 2005) (showing how domestic price level and interest rate are respectively susceptible to the change in foreign price level or interest rate under a fixed exchange regime).

fits to an enterprise or certain enterprises; instead, the subsidy is available to all sectors of the economy. This situation is the case as according to Article 2.1(b), under which a measure is not specific if the enterprises are automatically eligible upon satisfying some objective criteria.²²⁷ To export is an objective criterion. Upon satisfying this objective criterion, the exporter is automatically eligible for a certain magnitude of "benefit" flowing from the undervalued currency. The magnitude of the benefit is determined objectively by the amount of goods exported. Therefore, *prima facie*, China's exchange regime fails to satisfy the specificity requirement. Hufbauer and Wong agree, stating:

An undervalued exchange rate is probably the least specific of any benefit that a government might confer. WTO case law in other subsidy disputes runs strongly against the proposition that an undervalued exchange rate qualifies as a specific benefit. Public policy measures that are generally applicable to broad swaths of the economy are not viewed by the WTO as actionable subsidies; rather, for trade policy purposes, the focus is on sector-specific benefits.²²⁸

Subramanian and Mattoo summarize the situation more strongly and succinctly, stating: WTO rules on export subsidies exclude exchange rates from their scope because of the notion of specificity.²²⁹

iv. Contingent on Export Performance

The specificity requirement can alternatively be satisfied by reason that the subsidy is contingent on export performance.²³⁰ This alternative path to satisfying the specificity requirement is currently the preferred argument for critics of the Chinese regime. In essence, critics maintain that China's exchange regime satisfies the specificity requirement as it is contingent on anticipated export performance.²³¹ More specifically, critics argue that the exchange is contingent upon export performance, as it is only after the exporter is paid in U.S. dollars that proceeds of the sale are converted into RMB at the undervalued rate of exchange.²³²

227. SCM Agreement, *supra* note 198, at art. 2.1(b).

228. Gary C. Hufbauer et al., *China Bashing 2004 International Economics Policy Briefs Number PB04-5 8*, (Sept. 2004), available at <http://www.iie.com/publications/pb/pb04-5.pdf>.

229. Subramanian and Mattoo, *supra* note 10, at 4. This is not to say that Subramanian and Mattoo believe that exchange rates should remain outside the scope of the SCM Agreement, stating "This is like having disarmament negotiations on howitzers are haggled over while nuclear weapons remain beyond the scope of negotiations." *Id.*

230. SCM Agreement, *supra* note 198, at art. 2.1(b).

231. See, e.g., China Currency Coalition, at 62-66 (arguing that China's currency policy is contingent in fact upon export performance), available at <http://www.chinacurrencycoalition.org/petition.html>. For half-hearted counter-argument, See Staiger and Sykes, *supra* note 59, at 31 (stating "A respectable argument might be made, however, that an undervalued exchange rate tends to favor exporting firms if it has any real effects at all (assuming that prices have not adjusted to offset it). Even if not formally contingent on export performance, therefore, any export stimulus resulting from an undervalued exchange rate is plausibly characterized as an export subsidy). It should be noted that Staiger and Sykes agree that China's policies do not violate its WTO commitments and further cast doubt as to any actual trade volume effect caused by misalignment. See *id.* at 1-25. See, Benetah, *supra* note 218 (stating: "The specificity criterion [] does not seem to be an insurmountable legal obstacle to challenging the Chinese fixed exchange rate as a de facto export subsidy").

232. See Survey of Views, *supra* note 211 (views of David A. Hartquist).

Contingency on export performance can exist in law or in fact.²³³ Because China's legislative framework does not mandate that the benefit is contingent upon the exportation of goods, it cannot be said to require contingency on export performance in law.

At the outset, it must be noted that the "undervalued" rate of exchange is not only available to exporters but is available to any person holding U.S. dollars; exporters do not receive a more favorable rate of exchange than any other person in China.²³⁴ Moreover, when evaluating the facts and circumstances surrounding China's exchange rate policy (assuming, arguendo, the exchange rate policies meet the financial contribution requirement of Article 1), it is clear that the policy depends on a plethora of non-export related economic factors. Thus, while export performance may be one consideration of the Chinese government, its exchange regime is based on an aggregate of much broader initiatives. For instance, the maintenance of stable currency has allowed for stable growth, curbed inflation, and prevented currency speculation from playing havoc with the economy. The stability of the currency has also been important to many other aspects of China's economy, including foreign investment and infrastructure construction. Finally, it is difficult to evaluate the relationship between China's exchange rate regime and the country's export performance, and cannot be said at this time that China expected or anticipated an increase in export earnings when it adopted its exchange rate regime as illustrated in the preceding sections. China's exchange rate regime promotes economic stability, and any conditionality upon export performance may merely be incidental rather than intentional. In any event, proving any conditionality between exchange rates and conditionality may be difficult as there is only a slight and narrow relationship of conditionality between exchange rate policy and export performance. For these reasons, China's exchange rate regime cannot be said to be contingent upon export performance or tied to actual or anticipated exportation or export earnings.

IV. Concluding Analysis

Any currency value pegged to a currency or maintained against a basket of currencies is controlled by the government. This situation is perhaps even more the case when the weighting of the basket of currencies is not publicly disclosed. It is not hard, therefore to conclude that the Chinese authorities influence and control the exchange regime. This conclusion is almost beyond reasonable doubt. This article, however, moves beyond the mere rhetoric and analyses whether China's exchange regime infringes its obligations under general international law, the IMF Articles, or any WTO agreement (the relevant agreements being the GATT and SCM Agreement). In each case, we reach the conclusion that China does not violate its international obligations. This conclusion is reached despite the fact that "undervalued exchange rates are the classic example of beggar-thy-neighbour policies that both the IMF and WTO were set up to prevent."²³⁵

233. SCM Agreement, *supra* note 198, at art. 3.1.

234. See also Survey of Views, *supra* note 211 (views of James L. Bacchus and Ira Shapiro; Jonathon Sanford). But see views of Terence P. Stewart; Wiley Rein & Fielding; and John Magnus (all arguing that conditions other than export contingency may not necessarily undercut the de facto export-contingent nature of a subsidy). *Id.* See also Appellate Body report, *US-Foreign Sales Corporation*, WT/DS108/AB/R, Feb. 24, 2000.

235. Subramanian & Mattoo, *supra* note 10, at 4.

Under general international law, there simply are not any limitations or obligations upon countries when adopting their exchange rate policies. Thus, states have the freedom to issue currency and inherent sovereignty to determine the value of the currency. Doing so may certainly affect other country's rights, but it does not negate the sovereignty of a nation to adopt its own exchange rate policies.

China's exchange regime is also compliant with its obligations under the IMF Articles. More specifically, China's exchange arrangement (that is, linking the RMB to a basket of currencies) is not inconsistent with Article IV(2), and cannot be proven to violate the more specific provisions of Article IV(1). Most notably, based upon existing evidence, it is not possible to conclude that China manipulates its currency for the purpose of gaining an unfair advantage over other members. Finally, China's regime is consistent with Article VIII as it cannot be shown that its capital controls unduly delays its current account payment.

China's compliance is largely attributable to the nature of the current international system of exchange rate regulation. Simply stated, the current system of exchange rate regulation is one of soft law.²³⁶ Furthermore, the IMF Articles are so vaguely and broadly worded that it is unlikely that any nation will ever be deemed to be acting inconsistently with the IMF Articles. This vagueness is likely not the result of drafting error, but rather intentional because the regulatory norms established by the IMF amount to external regulation of matters which are traditionally viewed as strictly domestic issues. Also, the drafting was done at a time when countries were particularly opposed to ceding any sovereignty over to an international organization.²³⁷ While the Executive Board Decision of 2007 may signal a shift towards stronger operational oversight, it remains to be seen whether such a shift is possible given the politics behind the system, structure and workings of bilateral surveillance (not to mention the lack of a real enforcement mechanism or effective sanctions). Thus, as presently drafted, China is in compliance with the IMF Articles. If IMF members consider that a tighter regulation should be placed on the members, members should invoke Article IV(2)(c) and amend the regulatory regime.

China's exchange regime is also compliant with its WTO obligations. When viewed as an exchange action, China's regime cannot be said to frustrate the intent of GATT in contravention of Article XV given its role in raising living standards and employment not in China and beyond. When viewed as a trade action, China's regime cannot be said to be inconsistent with the intent of the IMF Articles given that it is consistent with the purposes of Article I of the IMF Articles.

Similarly, China's regime cannot be found to be inconsistent with its obligations under the SCM Agreement. Simply stated, the SCM Agreement narrowly defines a prohibited subsidy and we conclude that China's regime cannot be deemed to be a "financial contribution" which (1) confers a "benefit" and is (2) either "specific" or a "contingent on export performance."²³⁸ Although opinions differ, we strongly believe that if the drafters had

236. QURESHI & ZIEGLER, *supra* note 50, at 157.

237. *Id.* See also LESTER ET AL., *supra* note 149, at 66-68 (detailing the failure of the International trade Organization, which includes a resistance to ceding sovereignty to an international organization so quickly after the war).

238. Even if China's exchange rate regime was found to be in violation of the SCM Agreement, China could claim that its measures fall under the Article 27 exception, which recognizes that subsidies can operate to encourage economic growth and therefore exempts developing countries from the prohibition under Article

wanted currency undervaluation to be a prohibited export subsidy they would have explicitly included it in the texts of the SCM Agreement.²³⁹ In our view, the likely reason for the exclusion of currency undervaluation from the ambit of the SCM Agreement is because the WTO was meant to complement, rather than usurp, the IMF. If WTO members now demand more rigorous WTO scrutiny on countries' exchange rate regime, it may do so by amending the GATT or the SCM Agreement.²⁴⁰

With China's exchange regime compliant with the IMF Articles and the relevant provisions of the WTO, the only other option available to the international community (barring amendment of the IMF Articles or relevant WTO agreement) is to negotiate a new agreement or treaty to prohibit, manage, or counter the effects of controlled exchange rate regimes. Until that time, however, China's exchange regime remains in compliance with the international legal regime.

3.1(a) for a period of eight years following entry into the WTO. As a developing country, China would qualify for this exception and having entered the WTO on December 11, 2001, it would still be covered by the exception. Furthermore, the exemption can be extended if, in the view of the Committee, determine that an extension of this period is justified after examining all the relevant economic financial and development needs of the Member in question. In the past, China could have also claimed an exception under Article 28, which allows for prohibited subsidy programs established before accession to the WTO to remain in place for up to three years following accession, and Article 29, which permits countries transforming from centrally-planned to market economies to use programs and measures necessary for that transformation for up to seven years following accession. If China were eligible under these exceptions, they both have expired.

239. See also HUFBAUER ET AL., *supra* note 167, at 22-24.

240. Even Hufbauer concludes the chance of Member succeeding in a WTO dispute on this issue is "at best modest." *Id.* at 16-24.