Challenging Chinese Currency Manipulation as a Subsidy under the WTO Subsidies and Countervailing Measures Agreement

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By Elizabeth L. Pettis, Esquire

For decades a controversy has been raging in Washington regarding the undervaluation of China’s currency. Many economists, politicians and business people argue that China has, and continues, to manipulate the value of its currency in order to promote the growth of its exports while protecting its domestic industries from international competition. The basic argument is that this undervaluation keeps the price of Chinese goods low and the prices of goods produced in other countries out of reach of the average Chinese consumer. This undervaluation, it is thus argued, gives Chinese exporters an artificial trading advantage that is unfair, damaging to the US economy and damaging to the global trading system.

With the deepening of the Great Recession, the rhetoric of American labor unions, economists and politicians regarding this issue is getting more intense. In March 2010, the Economic Policy Institute (EPI) released a report that found that “China’s artificially low currency is a major reason for the lopsided US-China trade balance and that gap eliminated or displaced an estimated 2.4 million US jobs between 2001 and 2008.”¹ On September 20, 2010, EPI released another report that predicted that the undervaluation of Chinese currency “will cost one-half million US jobs in 2010.”² Most recently, on October 10, 2010, Economist C. Fred Bergsten, of the Peterson

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Institute for Economics, stated that China’s currency actions “have unleashed worldwide currency conflicts that threaten to replicate the spiral of competitive devaluations that deepened the Great Depression in the 1930s.”

These experts and politicians are now calling for the Obama Administration to act. Among other things, it has been recommended that the Treasury Secretary label China as a currency manipulator under the Omnibus Trade Act of 1988, the Treasury file a complaint with the Executive Board of the International Monetary Fund (IMF) alleging that China is unfairly manipulating exchange rates in violation of the IMF Agreement and the Office of the United States Trade Representative (USTR) file a complaint with the World Trade Organization (WTO) alleging that China’s manipulation of the value of its currency violates the General Agreement on Tariffs and Trade and/or the Agreement on Subsidies and Countervailing Measures.

Both houses of Congress have also taken their own independent steps to address the controversy. On March 17, 2010, Senators Charles Schumer (D – N.Y.) and Lindsey Graham (R – S.C.), introduced a bill that would, according to Senator Schumer, “make it easier for the Department of the Treasury to cite the Chinese by finding currency misalignment rather than manipulation.” Similarly, on October 1, 2010, the House of Representatives passed the Currency Reform for Fair Trade Act

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(H.R. 2378) which would “direct the Commerce Department to treat Chinese currency undervaluation as a prohibited subsidy” under current US trade law.\(^5\)

On the other side of the debate, some US experts argue that the US cannot or should not do anything about China’s manipulation of its currency. This camp asserts, among other things, that China’s currency policy is not in fact prohibited by the IMF or WTO Agreements, does not warrant action because it will not significantly impact the global trading system in the long term, or that unilateral US action will be deemed prohibited by a WTO dispute resolution panel and will divert the world’s focus from China’s actions and refocus it on the US’ habit of taking unilateral action rather than developing international solutions.

This paper will examine the US option for challenging China’s currency manipulation under the Subsidies and Countervailing Measures Agreement (SCM Agreement). It will assess the relative strengths and weakness of this option and will conclude by recommending a course of action that may not quickly resolve the problem but will clarify the law on this issue or will clearly identify the form of currency manipulation utilize by China as an issue that must be resolved by agreement among the G-20 and/or the member states of the WTO.

**Background**

Experts say that from 1994 up until mid-2005, the Chinese government pegged the value of the renminibi (RMB) at a rate of 8.28 RMB to a US dollar.\(^6\) Between 2005

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and 2008, due to pressure from its trading partners and the IMF, China allowed the value of the RMB to appreciate between 20 to 25 percent as compared with the value of the US dollar. This increase in value was facilitated through China’s shift to a policy in which it loosely pegged the value of the RMB to a basket of major currencies that included the US Dollar, the Euro and the Japanese Yen.

Since the being of the economic crisis in 2008, however, China has reverted back to the policy of pegging the value of the RMB to the value of the US dollar. Currently, the peg is at a rate of approximately 6.83 RMB to a dollar. China has argued that the whole world has benefited from the economic and monetary actions it took in the wake of the collapse of the American housing and financial markets. More precisely, it argues that the swift recovery of the Chinese economy, due to its exports and other economic recovery measures, has helped other nations’ recover as well. Most economists agree with China’s assertions. For example, Mark Zandi, Chief economist at Moody’s Economy.com, suggested that Chinese authorities reasonably halted further appreciation of the RMB when the global panic hit. But the global economy and the Chinese economy have been stabilized and are now growing again. In fact, the Chinese economic growth has been so impressive that China announces figure earlier this year that show that it is now the world’s second largest economy.

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7 Fred C. Bergsten, Correcting the Chinese Exchange Rate, Written testimony before the Committee on Ways and Means of the US House of Representatives, September 15, 2010.

8 Staiger & Sykes, supra, at 109.
The Organization for Economic Co-operation and Development (OECD), in its 2010 Economic Survey of China, recommended that the Chinese release the peg on the RMB and allow it to continue appreciate. Additionally, on July 27, 2010, the IMF said that Chinese currency is “undervalued” and is “substantially below the level that is consistent with the level of medium-term fundamentals.”

Prior to Toronto summit of the G-20 in June 2010, the Chinese government seemed to be responding to increased international concern about the undervaluation of its currency. China publically announced that it was removing the RMB’s peg to the dollar and would widen the band around which its currency could fluctuate. As of September 10, 2010, however, the value of the RMB had risen by less than 1 percent. Economists say that China’s currency is presently undervalued by between 25 and 40 percent and that China should allow its currency to appreciate at least by 5 percent per year for the next five years.

How China Controls the Value of the RMB

China is by no means the only country that manipulates its currency and devaluations of a country’s currency are not typically unlawful under international law. In fact, William Cline and John Williamson, of the Institute for International Economics, “estimates that currently the currencies of Hong Kong, Malaysia, Singapore and Taiwan...”

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are also undervalued by 25 to 32 percent."\textsuperscript{11} It is also estimated that the “Japanese yen is undervalued by approximately 14%.”\textsuperscript{12}

Additionally, many countries, including the US, have bought currencies and sold its own currency in the foreign exchange markets in order to raise or lower the value of its national currency so as to avert an economic crisis. In fact, on November 3, 2010, the US Federal Reserve announced that it would “purchase $600 billion in long-term US Treasury securities by the end of the second quarter of 2011”.

What makes the Chinese currency situation different is that, unlike other governments, “the Chinese government prohibits all exchanges of its currency except those to which it is a party (either directly or through official forex banks).”\textsuperscript{13} It also requires authorized exchange transactions to occur at a “government-determined” administered rate rather than at a rate determined by foreign exchange market forces. This arrangement allows the Chinese government to prevent market forces from naturally raising the value of the RMB.

What also makes China’s currency regime different is the duration and amount of money involved. It is estimated that “China has purchased more than $2.2 trillion in foreign exchange reserves since 2001.”\textsuperscript{14} Over the past several years, “China has been


\textsuperscript{14} \textit{Id.}
intervening in the currency market at an average of about $1 billion per day.”¹⁵ Between December 2008 and December 2009 alone, China had to purchase $453 billion in US treasury bills and other securities in order to maintain its peg on US dollar. No other country has tried or has been able to maintain an exchange-rate distorting policy at this level for this extended a length of time.

National governments and international organization have attempted to negotiate a solution to this issue with China to no avail. In fact, both the IMF and the OECD have recently identified the undervaluation of the RMB as problematic and have unsuccessfully attempted to persuade the Chinese government to allow its currency to appreciate.

**Challenging China’s Currency Manipulation under the SCM Agreement**

Among economists there is broad consensus that the undervaluation of the RMB meets the definition of a subsidy. Again, this undervaluation of the RMB makes Chinese products more competitive than they would otherwise be. There is much not consensus, however, about whether the undervaluation meets the narrower legal definition of a subsidy.

The Subsidies and Countervailing Measures Agreement (SCM Agreement) of the WTO directly address the subject of subsidies. Article 1.1 of the Agreement contains the legal definition of the term “subsidy”. It provides that:

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For the purpose of this [SCM] Agreement, a subsidy shall be deemed to exist if:

(a)(1) there is a financial contribution by a government or any public body within the territory of a Member (referred to in this Agreement as "government"), . . . and

(b) a benefit is thereby conferred.\textsuperscript{16}

In the Brazil – Aircraft case, a Dispute Resolution Panel of the WTO examined each element of this definition and stated that:

Article 1.1 of the SCM Agreement sets out a general definition of a subsidy. It provides that a subsidy is deemed to exist, inter alia, if there is ‘a financial contribution by a government’ and ‘a benefit is thereby conferred.’\textsuperscript{17}

The WTO Appellate Body subsequently upheld the Panel’s holding and stated that “it considers a ‘financial contribution’ and a ‘benefit’ as two separate legal elements which together determine whether a subsidy exists”. Therefore, in order to establish that China’s exchange rate policy is a legal subsidy, the United States must demonstrate that the policy includes both a financial contribution and a benefit.

Financial Contribution

Paragraph Article 1.1, subparagraph a (1) contains the following examples of a “financial contribution”. It states that a financial contribution can be found where:

\textsuperscript{16} Agreement on Subsidies and Countervailing Measures, Jan. 1, 1995, art. 1.1.

\textsuperscript{17} Brazil-Aircraft case, WTO/DS46.
(i) a government practice involves a direct transfer of funds (e.g. grants, loans, and equity infusion), potential direct transfers of funds or liabilities (e.g. loan guarantees);

(ii) government revenue that is otherwise due is foregone or not collected (e.g. fiscal incentives such as tax credits)\(^1\);

(iii) a government provides goods or services other than general infrastructure, or purchases goods;

(iv) a government makes payments to a funding mechanism, or entrusts or directs a private body to carry out one or more of the type of functions illustrated in (i) to (iii) above which would normally be vested in the government and the practice, in no real sense, differs from practices normally followed by governments;\(^18\)

In the *US - Softwood Lumber III* case, the Panel described the concept of “financial contribution” under Article 1.1(a)(1) of the SCM Agreement and stated that:

Subparagraphs (i) through (iv) explain that a financial contribution can exist in a wide variety of circumstances including, of course, the direct transfer of funds. But subparagraphs (ii) and (iii) show that a financial contribution will also exist if the government does not collect the revenue which it is entitled to or when it gives something or does something for an enterprise or purchases something from an enterprise or a group of enterprises. Subparagraph (iv) ensures that government directed transfers affected through a private entity do not thereby cease to be government transfers. In other words, Article 1.1(a)(1) SCM Agreement provides that a financial contribution can exist not only when there is an act or an omission involving the transfer of money, but also in case goods or certain services are provided by the government.\(^19\)

At first glance, it seems clear that the Chinese undervaluation of the RMB is not an act or an omission involving the transfer of money. However, the United

\(^{18}\) Agreement on Subsidies and Countervailing Measures, Jan. 1, 1995, art. 1.1.

\(^{19}\) *US-Softwood Lumber III* case, WTO/DS257
States could argue that the conversion of foreign currency by the Chinese government at a fixed rate could be classified as the equivalent to a service or as a transfer of money after the fact.

Given the facts about China’s exchange rate policy, the United States can demonstrate that there is a direct transaction between the government and the Chinese exporter who is converting dollars after selling its products abroad. If the exporter were able to exchange the resulting dollars for RMB on the open market, the entity facilitating the exchange would charge the exporter a fee for its services. However, under China’s regime, the service occurs at the government’s window and the government does not charge the exporter for its services.

The US could also argue that the government is directly transferring funds to the exporter after its products are sold. As part of the exchange transaction, the Chinese government is arguably giving the exporter 25% to 40% more RMB than the US dollars exchanged are worth. This fact could possibly be characterized as a transfer of money from the government the exporter.

Benefit

In Canada-Aircraft case, the Appellate Body quoted approvingly the Panel’s focus on the recipient of the subsidy in its interpretation of the term “benefit” under Article 1.1(b):

“[T]he ordinary meaning of ‘benefit’ clearly encompasses some form of advantage…. In order to determine whether a financial contribution (in the sense of Article 1.1(a)(i)) confers a ‘benefit’, i.e., an advantage, it is necessary to determine whether the financial contribution places the
recipient in a more advantageous position than would have been the case but for the financial contribution. In our view, the only logical basis for determining the position the recipient would have been in absent the financial contribution is the market. Accordingly, a financial contribution will only confer a ‘benefit’, i.e., an advantage, if it is provided on terms that are more advantageous than those that would have been available to the recipient on the market.”

Given the facts about China’s exchange rate policy, the United States should have little difficulty demonstrating that Chinese exporters have received something of value (cash) from the Chinese government and are better off than they would have been if they had exchange US dollars for RMB on the open foreign exchange market.

The US’ argument cannot end here however, because not all subsidies are prohibited under the SCM Agreement. Article 3 outlines those subsidies that are per se prohibited under the Agreement. It states as follows:

3.1 Except as provided in the Agreement on Agriculture, the following subsidies, within the meaning of Article 1, shall be prohibited:

(a) subsidies contingent, in law or in fact, whether solely or as one of several other conditions, upon export performance . . .

(b) subsidies contingent, whether solely or as one of several other conditions, upon the use of domestic over imported goods.

3.2 A Member shall neither grant nor maintain subsidies referred to in paragraph.21

Footnote 4 of Article 3 further explains that “this standard is met when the facts demonstrate that the granting of a subsidy, without having been made legally contingent upon export performance, is in fact tied to actual or anticipated

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20 Canada-Aircraft case, WTO/DS70.

21 Agreement on Subsidies and Countervailing Measures, art. 3.
exportation or export earnings. The mere fact that a subsidy is granted to enterprises which export shall not for that reason alone be considered to be an export subsidy within the meaning of this provision."\textsuperscript{22}

While at first glance it seems that the Chinese subsidy, in the form of currency undervaluation, does not appear to be contingent on exports because all individual and entities exchanging US dollars for RMB receive this better rate of return, the US could make a strong argument that the subsidy is in fact export contingent based upon WTO Appellate Body decisions in which the US was the defendant.

In the \textit{United States-Tax Treatment} case, the Appellate Body held that the US’ extraterritorial income tax regime constituted a countervailable subsidy despite the fact that the tax exemption was available for goods produced in the US and for goods produced outside of the US because it overwhelmingly benefited US exporters.\textsuperscript{23} Additionally, in the \textit{United States-Upland Cotton} case, the Appellate Body upheld a panel ruling that a US subsidy was export contingent even though it was also available to domestic users of cotton.\textsuperscript{24}

With regard to China’s currency regime, the facts demonstrate that at least 70% of the subsidy goes to Chinese companies who can receive it only by exporting. Therefore, despite the fact that tourists and foreign investors can take

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\textsuperscript{22} \textit{Id.} at footnote 4.
\textsuperscript{23} \textit{United States-Tax Treatment}, WTO/DS108.
\textsuperscript{24} \textit{United States-Upland Cotton}, WTO/DS267.
\end{flushleft}
advantage of the subsidy, the US could put forth a strong argument that the subsidy is in fact export contingent and is therefore prohibited under Article 3 of the SCM Agreement.

Rather than arguing that China’s currency regime is a prohibited subsidy under Article 3, the United States could also argue that it is an actionable subsidy under Article 7 of the SCM Agreement. Articles 7.1 and 7.2 of the Agreement state the following:

7.1 Except as provided in Article 13 of the Agreement on Agriculture, whenever a Member has reason to believe that any subsidy referred to in Article 1, granted or maintained by another Member, results in injury to its domestic industry, nullification or impairment or serious prejudice, such Member may request consultations with such other Member.

7.2 A request for consultations under paragraph 1 shall include a statement of available evidence with regard to (a) the existence and nature of the subsidy in question, and (b) the injury caused to the domestic industry, or the nullification or impairment, or serious prejudice caused to the interests of the Member requesting consultations.25

Given the magnitude of the US-China trade imbalance and the job loss statistics outline by various economists, it should not be difficult for the US to show that China’s currency regime has resulted in injury to the US economy.

Conclusion

Challenging China’s currency manipulation under the SCM Agreement will not be easy for the United States and will take several years to bear any potential fruit. Nevertheless, it is possible for the US to prevail. Any resulting IMF Executive Board and/or WTO panel decisions would, at any rate, give the US,

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25 Agreement on Subsidies and Countervailing Measures, art. 7.1 & 7.2.
and other WTO members, guidance regarding all the unanswered questions regarding currency manipulation that can then be applied to similar situations that may arise in the future.

If the WTO rules against the US, then US, the Group of 20 and the WTO members will be on notice that this is an unresolved area of the law that requires either an amendment to the IMF Agreement, the GATT, and/or the SCM Agreement or multilateral consensus on this issue. This issue could then be addressed in a subsequent meeting of the G-20 or a subsequent round of the WTO.

Most importantly, given the fact that the EU, Brazil, India, Canada and other countries are also complaining about the negative effects of the undervaluation of the RMB, it would be most prudent for the US to first rally the support of these countries, and others, before it takes any action. In fact, it is now crucial in light of the Federal Reserve’s November announcement regarding its plan to purchase US Treasury securities. More specifically, this announcement caused many countries, including Brazil, Germany, India, South Korea and Japan to accused the US of manipulating its currency as well. Therefore, it is essential for the US to refute any accusations that it is being hypocritical. The US needs to do this by discussing the matter with other governments and emphasizing to them the difference in quality, quantity, intent and duration of the intended US monetary actions.
In the end, this multilateral approach would also help the US strengthen its claims by demonstrating injury has been caused not just to the US but to the WTO trading regime as a whole. The US could also mitigate the burden associated with such an undertaking by soliciting the help of other WTO members that have the skills and funds to assist with what will be a very complicated, expensive and protracted dispute. Finally, utilizing a multilateral approach could help the US keep the world’s focus on China’s conduct rather than refocusing it on the US’ conduct and its tendency to go it alone rather than find a multilateral solution.