Challenging Chinese Currency Manipulation under the IMF Agreement

Elizabeth L Pettis, American University Washington College of Law

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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 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.\(^3\)

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. Additionally, 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.”\(^4\)

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 and/or does not warrant action because it will not significantly impact the global trading system in the long term.

This paper will examine the option to challenge China’s currency manipulation under the IMF 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

\(^3\) *What to do about China’s currency?*, Washington Post, October 10, 2010, at A15.

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. Between 2005 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.

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6 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.

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.

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.

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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 are also undervalued by 25 to 32 percent.”\(^{10}\) It is also estimated that the “Japanese yen is undervalued by approximately 14%.”\(^{11}\)

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).”\(^{12}\) 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.

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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.”\(^\text{13}\) Over the past several years, “China has been intervening in the currency market at an average of about $1 billion per day.”\(^\text{14}\) 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 IMF Agreement**

The Article of the IMF Agreement that is applicable to the Chinese currency manipulation issue is Article IV. According to Section 1 of Article IV, the IMF was formed to, among other things, “provide a framework that facilitates the exchange of

\(^{13}\) Id.

\(^{14}\) Fred C. Bergsten, *Correcting the Chinese Exchange Rate*, written testimony submitted to the US House Ways and Means Committee, hearing held September 15, 2010.
goods, services and capital among countries, sustains sound economic growth, and continues the development of the orderly underlying conditions that are necessary for the financial and economic stability of each member state."\textsuperscript{15} This Article also charges the IMF with the responsibility for exercising firm surveillance over each member’s exchange rate polices. Therefore, the IMF seems to be the international organization with the direct authority to handle the dispute over the valuation of the RMB.

Article IV, Section 1 also obligates each member state to “collaborate with the Fund and other members to assure the orderly exchange arrangements and to promote a stable system of exchange rates.”\textsuperscript{16} More specifically, Article IV, Section 1, subsection (iii) states that each member “shall avoid manipulating exchange rates . . . in order . . . to gain an unfair competitive advantage over other members”.\textsuperscript{17}

From this language, it is clear that there is a two-part test under which the United States must demonstrate that:

1) China has manipulated exchange rates; and

2) China manipulated exchange rates with the intent to gain an unfair competitive advantage.

Unfortunately, Article IV does not define the meaning of the phrase “manipulating exchange rates” nor does any other Article of the Agreement.

\textsuperscript{15} International Monetary Fund Agreement, Jul. 22, 1944, art. IV, 22 U.S.C. 385.

\textsuperscript{16} Id.

\textsuperscript{17} Id.
The IMF Executive Board’s 2007 Decision on Bilateral Surveillance (2007 Decision), however, provides guidance on what may constitute manipulation of exchange rates. In Section 15 of the 2007 Decision, the Board stated that the Fund would view the following developments as possible indications of a member’s manipulation of exchange rates:

(i) protracted large-scale intervention in one direction in the exchange market;

(ii) official or quasi-official borrowing that either is unsustainable or brings unduly high liquidity risks, or excessive and prolonged official or quasi-official accumulation of foreign assets, for balance of payments purposes;

(iii) (a) the introduction, substantial intensification, or prolonged maintenance, for balance of payments purposes, of restrictions on, or incentives for, current transactions or payments, or

(b) the introduction or substantial modification for balance of payments purposes of restrictions on, or incentives for, the inflow or outflow of capital;

(iv) the pursuit, for balance of payments purposes, of monetary and other financial policies that provide abnormal encouragement or discouragement to capital flows;

(v) fundamental exchange rate misalignment;

(vi) large and prolonged current account deficits or surpluses; and

(vii) large external sector vulnerabilities, including liquidity risks, arising from private capital flows.\(^\text{18}\)

Given the fact that China has been taking actions to suppress the value of the RMB since 2001, has purchased more than $2.2 trillion in foreign exchange reserves since 2001 and has maintain a trade surplus with the United States that is in the billions

of dollars, the United States should have little difficulty demonstrating that: 1) a protracted large-scale intervention in the exchange market to suppress the value of the RMB was carried out by China; 2) an excessive and prolonged official Chinese accumulation of US dollars, for balance of payments purposes; 3) a fundamental exchange rate misalignment of China’s currency; and/or 4) a large and prolonged current account surpluses with regard to trade with the United States.

Additionally, in Section 2 of the Annex of the 2007 Decision the Board further elaborated on when it believed a member would be acting in violation of Article IV, Section 1, Subsection (iii). It stated the following:

2. A member would only be acting inconsistently with Article IV, Section 1(iii) if the Fund determined both that: (a) the member was manipulating its exchange rate or the international monetary system and (b) such manipulation was being carried out for one of the two purposes specifically identified in Article IV, Section 1(iii).

The Board further explained that:

(a) "Manipulation" of the exchange rate is only carried out through policies that are targeted at—and actually affect—the level of an exchange rate. Moreover, manipulation may cause the exchange rate to move or may prevent such movement.

(b) A member that is manipulating its exchange rate would only be acting inconsistently with Article IV, Section 1(iii) if the Fund were to determine that such manipulation was being undertaken "in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members." In that regard, a member will only be considered to be manipulating exchange rates in order to gain an unfair competitive 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

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19 Id.
undervalued exchange rate and (B) the purpose of securing such misalignment is to increase net exports.\textsuperscript{20}

Again, from the facts it should not be terribly difficult for the United States to demonstrate that China’s currency policies are targeted at and actually affect the level of an exchange rate between the US Dollar and the RMB. The circumstances also seem to support the contention that China has intentionally kept the value of the RMB low so as to unfairly ensure the competitiveness of its exports.

Unfortunately, however, the intent requirement of the currency manipulation test is a subjective standard that may be almost impossible for the US to demonstrate because it would be “politically very delicate for the IMF to officially find one of its members in breach of that provision.”\textsuperscript{21} Additionally, the relevant sections of the 2007 Decision are not binding. Therefore, the IMF is not required to find in the US’ favor even if it were to prove the presence of the indicative developments and China’s intent.

Finally, and most importantly, The IMF Agreement does not provide for a dispute resolution procedure. Article XXIX of the Agreement provides that the Executive Board may settle “any question of interpretation of the provisions of the Agreement arising between any member and the Fund or between any members of the Fund”.\textsuperscript{22} However, even if the Executive Board found that China was manipulating the exchange rate in

\textsuperscript{20} Id.


\textsuperscript{22} International Monetary Fund Agreement, Jul. 22,1944, art. XXIX, 22 U.S.C. 385..
violation of Article IV, the IMF lacks a mechanism by which to enforce a decision made regarding the matter.

**Conclusion**

Challenging China’s currency manipulation under the IMF Agreement will not be easy for the United States and will take several years to bare any potential fruit. Nevertheless, it is possible for the US to prevail in a claim or claims brought under the agreement. Any resulting IMF Executive Board decision, at any rate, give the US, 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 IMF Executive Board 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 IMF 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.