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## ASIL Insights

Manipulation of Exchange Rates in International Law: The Chinese Yuan

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### *Introduction*

In recent testimonies before the US Congress, scholars and representatives of the small business community have argued that China deliberately undervalues its currency, the Yuan, in order to gain a competitive advantage towards its major trading partners. [1] China is being accused of manipulating the exchange rate by buying and selling Yuan on the international capital markets for a fixed price. Thereby it effectively discourages a free market value for the Yuan.

In addition, a bipartisan group of senators urged the Congress to adopt legislation that allows for "appropriate action" if the negotiations with China regarding its undervalued currency and currency manipulation are not successful. The bill would authorize an *ad valorem* duty of 27.5 percent on all imported Chinese products. [2] *security* The bill bases the US authority to impose charges on Article XXI of the GATT 1994. This provision stems from GATT 1947, and is incorporated by reference in GATT 1994. It allows trade measures to protect "essential security interests" relating to fissionable materials or arms trafficking. Restrictions may also be permitted in time of war or other international emergency. The bill says that protecting the manufacturing sector in the United States is "essential to the interests of the United States." It does not allege that US essential interests are at stake.

### *IMF Jurisdiction over Exchange Rate Policies*

In a recent Insight Professor Marc Benitah suggested that the WTO Subsidies and Countervailing Measures Agreement could be explored for a possible finding that the undervalued Yuan results in a *de facto* subsidy to Chinese exporters. Other legal avenues such as Article XV, paragraph 4 of GATT have also been suggested. This provision stipulates that parties shall not frustrate GATT by the use of "exchange action" (which is to be distinguished from "exchange rate action," as will be demonstrated below).

Whatever justifications are brought forward, first there must be a determination that the manipulated exchange rate is undervalued and, second, that as a result competition is unfair. Not surprisingly, Chinese monetary authorities have responded negatively to the allegation of manipulation. Like in any international dispute, the question is who should exercise authority and give binding judgment to the parties concerned.

It is tempting to conclude that the WTO has this authority because there is opportunity for direct access to a dispute settlement procedure in the event negotiations between the US and China break down. It seems also logical to approach the WTO because the consequences of exchange rate manipulation are felt in trade relations. However, attempts to invoke the WTO agreements to challenge exchange rate policies disregard the key role of the International Monetary Fund (IMF). Article XV, paragraph 2 of GATT provides: [3]

In all cases in which the CONTRACTING PARTIES are called upon to consider or deal with problems concerning monetary reserves, balances of payments or foreign exchange arrangements, they shall consult fully with the International Monetary Fund. In such consultations, the CONTRACTING PARTIES shall accept all findings of statistical and other facts presented by the Fund relating to foreign exchange, monetary reserves and balances of payments, and shall accept the determination of the Fund as to whether action by a contracting party in exchange matters is in accordance with the Articles of Agreement of the International Monetary Fund, or with the terms of a special exchange agreement between that contracting party and the CONTRACTING PARTIES.

Consequently, the WTO must consult with the IMF on problems concerning foreign exchange

arrangements and must accept facts presented by the IMF on foreign exchange and IMF determinations in exchange matters. IMF authority in this area cannot be challenged. IMF members have accepted that the IMF is the crux of the international monetary system and serves as "the center for the collection and exchange of information on monetary and financial problems." [4]

The implementation of IMF-WTO cooperation is further clarified in an agreement between both institutions. [5] Paragraph 8 of that agreement states in part: "The Fund shall inform in writing the relevant WTO body (including dispute settlement panels) considering exchange measures within the Fund's jurisdiction whether such measures are consistent with the Articles of Agreement of the Fund."

In light of GATT Article XV, paragraph 2, and the IMF-WTO agreement, if the IMF determines that China's exchange rate policy is compatible with the IMF Articles of Agreement (IMF Agreement), it would not be open to the WTO, including its dispute settlement bodies, to conclude that the Yuan is being manipulated or that it is grossly overvalued. As a result, the Chinese policy regarding the Yuan would not amount to an export subsidy because it would not be regarded as conferring a "benefit" on its recipient.

#### *Exchange Policies v. Exchange Rate Policies*

Understanding the object of IMF-WTO cooperation is not simple. Article XV GATT refers to "foreign exchange," "exchange matters" and "exchange action," whereas the IMF-WTO agreement refers to "exchange measures." The IMF Articles of Agreement mention "exchange rates," "exchange rate arrangements," "exchange policies" and "exchange rate policies."

The inconsistent wording notwithstanding, two policies must be clearly distinguished. The IMF oversees these policies.

(i) "Exchange policies" or "exchange measures" refer to the obligation of IMF members not to restrict the exchange of local currency into the currency of another member. Thus China must accept that Chinese importers of foreign goods (or services) have the right to exchange Yuan for dollars or euros (whatever is required to meet contractual obligations). This is also called "convertibility." It is important to note that in the IMF Articles this right only refers to current transactions (transactions primarily related to trade in goods or services). The IMF does not oversee the liberalization of capital movements. The obligation to liberalize current payments is reflected in Article VIII of the IMF Agreement, but it is subject to acceptance by each IMF member. China accepted the obligation in 1996. It has been accepted by 165 out of 184 IMF members. Hence "exchange action" (as mentioned in GATT Article XV, paragraph 4) refers to the liberalization of payments. In a sense the WTO and the IMF are two sides of one coin: the WTO liberalizes trade whereas the IMF liberalizes payments.

(ii) "Exchange rate policies" or "exchange rate arrangements" refer to the determination of the value of the local currency expressed in a foreign currency. Under Article IV, Section 2 of the IMF Agreement a country may freely choose the exchange rate policy of its currency. Countries may opt for a fixed peg, crawling peg or may decide to let the currency float. Choosing the latter option means that international markets determine the exchange rate. Other options such as a joint currency (euro) are also possible. Together with 33 other members, China has decided to fix its currency against a foreign currency, usually the dollar, euro or a composite currency. This is not illegitimate or unlawful under the IMF Agreement. In the past many industrialized countries have maintained a similar policy.

#### *Manipulation and Unfair Competition*

As explained above, China has accepted convertibility of the Yuan for the purpose of current transactions. In addition, under the IMF Agreement China may maintain an exchange rate regime for its currency as it deems fit. China only has to communicate its exchange rate policy to the IMF. *Prima facie* China's monetary policies are compatible with its obligations under the IMF.

However, an IMF member shall not "manipulate 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" (IMF Agreement Article IV, Section 1(iii)).

This provision requires a clear understanding of the behavior of states ("manipulation") and the intended consequences of such behavior ("to prevent effective balance of payments adjustment" or "to gain an unfair competitive advantage"). Manipulation conveys the sense of improper behavior with the objective to create a situation that is unjustified. It is unclear, however, which results are unjustified. What is meant by "effective balance of payment adjustment"? Does it mean adjustment of balance of payments that are in deficit or surplus? There is no evidence that a large surplus or deficit in the balance of payments is unlawful under the IMF Agreement.

Indeed, an "unfair competitive advantage" could be the result of exchange rate manipulation, but keeping the Yuan pegged to the dollar is not necessary manipulation. The problem is also that "unfairness" is

subject to selective perceptions. [6] Tough competition is not necessarily unfair. Finally, it should not be forgotten that China still is a developing country. China could manipulate its currency not to have an unfair competitive advantage in trade but to be attractive for investors; by doing so it ensures that it is able to compete with other countries like Malaysia, South Korea and the Chinese province Taiwan. [7]

How could the US draw the IMF into an assessment that China manipulates the Yuan and thereby competes unfairly? The IMF Agreement does not provide for a mandatory dispute settlement procedure as the WTO does. IMF Agreement Article XXIX provides, however, that the Executive Board may settle "any question of interpretation of the provisions of this Agreement arising between any member and the Fund or between any members of the Fund (.)." This provision is not intended to settle disputes between members as a WTO dispute settlement panel might resolve a trade dispute, but it can result in an authoritative interpretation that deems Chinese monetary policies unlawful. Article XXIX has been used by the US in the late 1940s to gain what was lost at the negotiations in Bretton Woods in 1944. [8] A number of interpretations have been made under this procedure, but the last was given in 1959.

Any settlement of the dispute over China's exchange rate for the Yuan is more likely to come from diplomacy than from legal challenge.

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[1] House Committee on Small Business, 'Foreign Currency Manipulation and its Effects on Small Manufacturers and Exporters', June 25, 2003. At: <http://www.house.gov/smbiz/hearings/108th/2003/030625>.

[2] Bill S 1586 was proposed on September, 5 2003, 108th Congress, 1<sup>st</sup> session.

[3] Emphasis added. According to GATT 1994 'Contracting Parties' should be read as WTO.

[4] Article VIII, Section 5(c) IMF Articles.

[5] Agreement was adopted in 1996. Text appears as: [http://www.imf.org/external/pubs/ft/sd/index.asp?decision=11381-\(96/105\)\\_2](http://www.imf.org/external/pubs/ft/sd/index.asp?decision=11381-(96/105)_2).

[6] See also Joseph Gold, *Exchange Rates in International Law and Organization*, American Bar Association, 1988, 108-112.

[7] Foreign Direct Investment is crucial for China's development. See the report of the IMF Economic Forum, 'For China, 'Foreign Direct Investment Translates Into Higher Productivity Growth', *IMF Survey*, May 27, 2002

[8] See Erik Denters, *Law and Policy of IMF Conditionality*, Kluwer Law International, 1996, 78-9.

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