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The Revaluation Debate

Between 1995 and 2005, China fixed the renminbi at about 8.28 to the dollar.[1] In July 2005, under considerable foreign pressure, China ended the peg by moving toward a managed exchange rate with a "central parity" based on a currency basket,[2] allowing the renminbi to move up or down within a narrow band of 2.1 percent. The basket effectively revalued the renminbi to a rate of 8.20 to the dollar. Within the prescribed band, daily fluctuations against the dollar are limited to 0.3 percent.[3] Under this system, the renminbi gradually appreciated to around 8.10 to the dollar toward the end of 2005. In May 2006 the Chinese authorities changed the

1. Small variations were allowed on both sides of the official rate of 8.28 renminbi to the dollar.

2. China looked to Singapore in designing its own currency reform. Since 1981, Singapore has used a managed float exchange rate regime: The Singapore dollar is pegged to a basket of currencies with a heavy (but unknown) dollar weighting. Like the People's Bank of China, the Singapore Monetary Authority reveals little information about the exact mix of its currency basket, which can be changed from time to time depending on trade flows and other considerations. See Mary Kissel, "China Studies Currency Basket," *Asian Wall Street Journal,* May 23, 2005.

3. While the exact composition of the currency basket remains a matter of speculation, the governor of the People's Bank of China, Zhou Xiaochun, mentioned that the currency basket reflects a combination of China's trade patterns and sources of foreign direct investment (FDI). Zhou said the basket is dominated by the dollar, yen, and euro but also includes currencies of Singapore, the United Kingdom, Malaysia, Russia, Australia, Thailand, and Canada. In September 2005 China made marginal changes to allow the renminbi to fluctuate by 3 percent against nondollar currencies compared with 1.5 percent previously. See "Patching the Basket—The Yuan," *The Economist,* October 1, 2005.

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"central parity"—a figure that is announced daily—to 7.99 to the dollar. This change allowed the renminbi to appreciate above the psychologically important level of 8.00 to the dollar.

However, both the old renminbi rate of 8.28 to the dollar and the new rate of around 8.00 are widely seen as undervalued for three reasons: China has sharply increased its current account surplus, which topped $100 billion in 2005;[4] it has accumulated huge foreign exchange reserves, reaching $819 billion in December 2005; and for several years foreign direct investment (FDI) has poured into China, totaling some $60 billion in 2004,[5] augmented by a tide of hot money. A strong argument can be made that the Chinese economy was overheating in 2004, 2005, and the first half of 2006, with an annual growth rate of over 9 percent and a boom in real estate prices. According to this argument, significant revaluation could usefully complement China's domestic policy measures to slow the economy by dampening exports and encouraging imports. Experts disagree considerably about the extent to which the renminbi should be revalued, but whether it is undervalued by 10, 25, or 40 percent, in 2005 the renminbi exchange rate became the lightning rod for US-China trade relations.[6]

Meanwhile, both inside and outside China, views are converging that future demand growth should concentrate on consumption rather than investment or net exports (Bergsten et al. 2006; supplement charts from Nicholas Lardy). Investment, including that in new houses and apartments, now accounts for—remarkably—around 50 percent of GDP. Net exports are around 7 percent of GDP, also a very high level. Household consumption is around 40 percent of GDP, a very low figure, especially compared with the very high figure of 70 percent for the United States. Alongside other policy tools, such as expanded consumer credit, higher interest rates, lower personal taxes, and larger public expenditures, revaluation could help shift the composition of Chinese demand growth toward public and private household consumption.

4. Based on unofficial figures, China's current account surplus increased from 3 percent of GDP in 2003, to 4 percent of GDP in 2004, to 7 percent in 2005. See Morris Goldstein and Nicholas Lardy, "China's Revaluation Shows Size Really Matters," *Financial Times*, July 22, 2005. For another critical view, see Morici (2006).

5. FDI in China is far greater than investment in other developing countries, such as India with $4 billion and Russia with $1 billion. See UNCTAD's *World Investment Report* 2005 and OECD, *Trends and Recent Developments in Foreign Direct Investment*, June 2004. Also see Michael R. Sesit, "China Overtakes US as Magnet for Foreign Direct Investment," *Wall Street Journal*, June 28, 2004, A2.

6. See appendix table A.3 for an outline of the numerous proposals to revalue the renminbi exchange rate.

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Section 301 Petition

Early in 2004 the National Association of Manufacturers (NAM) and other members of the Fair Currency Alliance (FCA) mounted a campaign to force the revaluation of the renminbi. On January 21, 2004, President George W. Bush reiterated that "countries like China have got to deal with their currency." Eight days later, the FCA hired a Washington law firm (Collier Shannon Scott) to prepare a draft Section 301 petition to challenge the Chinese exchange rate.[7]

While privately pressuring China to revalue throughout 2004, in April 2004 the Bush administration dismissed the substance of the draft Section 301 petition even before it was filed.[8] Subsequently, the FCA mobilized support for congressional bills that echo the original 301 petition.[9] Pressure from Capitol Hill in the run-up to congressional elections in November 2006 could persuade the Bush administration to take sterner measures.

Key Players

In its May 2005 report to Congress, the Treasury openly criticized China. Treasury Secretary John Snow argued that China's "rigid currency regime has become highly distortionary."[10] In November 2005, however, the Treasury's official semiannual report to Congress backed away from branding China a "currency manipulator," a legal label that—if invoked—would essentially invite Congress to enact punitive legislation against China. In the report Snow conceded that the Chinese "rigid exchange rate" creates

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7. Section 301 of the Trade Act of 1974 enables the president to take measures against "unjustified and unreasonable" foreign barriers. Following the Marrakesh Agreement that established the WTO, the USTR has channeled meritorious Section 301 petitions into the WTO dispute settlement mechanism.

8. At the time, US Treasury Secretary John Snow contended that "persistent engagement" would be more effective than a trade petition. See US Treasury, press release, "US-China Trade Relationship," April 28, 2004.

9. The FCA has since been renamed the China Currency Coalition (CCC) and claims the support of about 35 senators and congressmen. In April 2005 the CCC endorsed the congressional bill known as the Chinese Currency Act of 2005 (HR 1498). See China Currency Coalition, press release, "Legislation Clarifying U.S. Trade Laws Targets Injury Caused By China's Exchange-Rate Manipulation," April 7, 2005, available at www.chinacurrencycoalition.org (accessed November 2005).

10. The Chinese central bank uses renminbi to purchase US dollars in the currency market and then sterilizes part of the addition to renminbi base money by selling renminbi bonds. See "US Treasury Chief Presses China on Currency, Financial Reforms," Agence France Presse, October 12, 2005.

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"distortions and risks," but he endorsed the "initial steps by China to increase exchange rate flexibility."[11] To underline the administration's decision that financial diplomacy would prove more effective than punitive sanctions in persuading China to revalue the renminbi, in May and October 2005 Snow made two appointments to Beijing: Ambassador Olin Wethington as US currency emissary and David Loevinger as financial attaché. Their continuing mission is to advocate a flexible rate and liberalized capital flows.[12] The Treasury's efforts have produced modest results. In January 2006 China launched over-the-counter trading of the renminbi, which allows the market to play a role in determining the exchange rate.[13] In April 2006, prior to President Hu Jintao's visit to the United States, the Chinese government announced that individuals could invest as much as $20,000 in foreign assets and that Chinese companies could have a freer hand in making overseas investment. Such moves on the capital account would not normally strengthen the renminbi, but they do give greater play to market forces, the Treasury's stated goal. Moreover, as mentioned earlier, in May 2006 the People's Bank changed the "central parity" to just under 8.00 to dollar, another slight appreciation and a psychologically important level.

At the beginning of the currency campaign, Federal Reserve Chairman Alan Greenspan advised against a floating exchange rate or ending capital controls.[14] Greenspan emphasized the precarious nature of the Chinese banking system, which carries a huge volume of nonperforming loans

11. See US Treasury, press release, "Statement of Treasury Secretary John W. Snow on the Report to Congress on International Economic and Exchange Rate Policies," November 28, 2005.

12. See US Treasury, press release, "Treasury Secretary Snow Appoints Olin L. Wethington as Special Envoy on China," May 19, 2005. In the run-up to President Bush's meeting, Snow claimed that negotiations between the Treasury and the Chinese government resulted in modest but significant financial-sector reforms. Specifically, the establishment of Chinese foreign exchange trading systems created platforms for a meaningful foreign exchange trading system under a system of floating rates. As Snow pointed out, "to conduct foreign exchange trading … we forget that if you're pegged, you've got to learn how to trade." With the help of US financial experts, Shanghai firms in particular took initiatives to establish forward, derivative, and hedge markets. See "John Snow: Full Transcript," *Financial Times,* November 4, 2005.

13. The new method for determining the renminbi exchange rate announces the "central parity" rate against the US dollar on a daily basis using some sort of weighted average price of market-maker quotes. As a result, the trading band will allow the market to play a more substantial role in determining the renminbi rate, although the People's Bank still calls the shots. See Wang, Wang, and Goodman (2006).

14. See Alan Greenspan, State of the Banking Industry, Testimony before the Senate Committee on Banking, Housing, and Urban Affairs, Washington, April 20, 2004.

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(NPLs) on its collective balance sheet.[15] Ending capital controls, Greenspan argued, could trigger an outward flood of capital to more secure foreign banks. This in turn might destabilize the Chinese economy and drag down world growth. However, by June 2005 Greenspan aligned his position with Snow's statements, conceding that China's large purchases of dollars "pose threats to China's financial stability."[16] In effect, Greenspan acknowledged the primacy of the Treasury in setting US exchange rate policy. The new Federal Reserve Board chairman, Ben Bernanke, will likely support the administration's currency campaign in 2006.

Meanwhile, Capitol Hill added to executive branch voices calling for Chinese currency revaluation. Some 20 out of 25 China bills introduced between 2003 and 2005 alleged an unfair Chinese trade advantage from the undervalued renminbi (appendix table A.2). In February 2005 Senators Charles Schumer (D-NY) and Lindsey Graham (R-SC) introduced a bill to impose a "temporary across the board tariff" of 27.5 percent on all Chinese exports to the United States.[17] After Schumer and Graham visited China in March 2006, they were impressed by Chinese government efforts and agreed to postpone a vote on the bill, but no later than September 2006. Another prominent bill to pressure the Chinese government to revalue the renminbi surfaced in March 2006, when Senators Charles Grassley (R-IA) and Max Baucus (D-MT) proposed milder measures against countries identified as having "currency misalignments." Sanctions included denial of market economy status (relevant to antidumping cases) and mandatory US opposition to a larger voice in the International Monetary Fund (IMF) and the World Bank.

By April 2006, when President Hu Jintao visited the United States, administration and congressional measures had fostered a slightly more

15. According to some estimates, 40 percent of the recent increase in Chinese bank loans, some $259 billion, are nonperforming. See Nicholas Lardy's estimates in Goldstein and Lardy (2005). In May 2006 Ernst & Young published a report saying that nonperforming loans (NPLs) amount to an astounding $911 billion, but the report was quickly retracted under pressure from the Chinese government. Most nonofficial commentators put the NPL range at $300 billion to $500 billion in 2006, whereas the government has published an estimate of $164 billion. See "A Muffled Report," *The Economist*, May 20, 2006, 78.

16. Greenspan recognized that a flexible Chinese exchange rate, determined by the market rather than by "administrative edict," would take many years before it reached a "satisfactory degree of soundness and flexibility." See Alan Greenspan, China, Testimony before the Senate Committee on Finance, June 23, 2005.

17. Under the Schumer-Graham bill, the tariff can be averted by a presidential certification that China is not amassing foreign exchange reserves to prevent exchange rate appreciation. Moreover, if the president determines that China has acted in "good faith" toward revaluing the currency, he can delay imposing the tariff for 180 days.

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flexible renminbi regime but not a substantial appreciation of the currency. It might be worth recalling a previous intersection between trade policy and currency values. In August 1971 President Richard Nixon met with his top advisers at Camp David and agreed on a four-part plan to address the worsening US balance of payments, which had swung from a surplus of 2.2 percent of GDP in 1970 to a deficit of 1.2 percent in 1971. The plan proposed a 90-day freeze on wages and prices, an investment tax credit of 10 percent, an import surcharge of 10 percent, and "closing the gold window."[18] The result of this package was the Smithsonian Agreement of December 1971, which initially realigned the fixed exchange rates of Bretton Woods vintage and ultimately led to a system of floating rates (Solomon 1982). Circumstances in that era were vastly different from those today, but the episode suggests that by breaking enough crockery in the arena of trade, the United States can force other countries to alter their exchange rate systems.[19]

The Legal Case, Part I: GATT Article XV(4)

If the United States gives up on financial diplomacy and resorts to legal action, the FCA draft Section 301 petition prepared in 2004 previews the claims that might be advanced in the WTO. In April 2006 the China Currency Coalition (CCC), the successor to the FCA, issued a statement that supplements the earlier petition.

The core of the case is that China's exchange rate policy, which allegedly undervalues the renminbi by 40 percent, allows Chinese firms to export goods to the United States at artificially low prices, resulting in US job losses.[20] The FCA and the CCC contend that the undervalued Chinese renminbi violates Article XV(4) of the General Agreement on Tariffs and Trade (GATT), which states, "Contracting parties shall not, by exchange action, frustrate the intent of the provisions of the Agreement."[21] The lob-

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18. This phrase meant that the US Treasury would no longer sell gold to foreign central banks, in exchange for dollars, at the rate fixed by President Franklin Roosevelt in the 1930s, namely $35 per troy ounce.

19. In the 1980s, as the dollar became more overvalued, the Reagan administration used selective import protection to quell demands from the US industrial community and then engineered a large decline in the dollar via the Plaza Accord. See Hufbauer and Elliott (1994) and Solomon (1999).

20. See Collier Shannon Scott, press release, "Former USTR Official to Lead China FX Challenge," January 29, 2004; Fair Currency Alliance, press release, "China's Erroneous Numbers: First Report from FCA," June 10, 2004; China Currency Coalition, press release, "China's Record Foreign Currency Reserves No Surprise to U.S. Coalition," January 18, 2006.

21. The text of GATT is available at www.wto.org.

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bies also contend that the undervalued renminbi amounts to a prohibited export subsidy that violates Articles 1, 2, and 3 of the WTO Agreement on Subsidies and Countervailing Measures (the SCM agreement), along with parallel articles in the WTO Agreement on Agriculture.

These claims raise two questions. First, are the claims sufficiently strong that, at least for tactical purposes, the United States Trade Representative (USTR) and the Treasury could bring a plausible case to the WTO? Second, if a case is launched and pursued through decisions by a WTO panel and the WTO Appellate Body—probably a two-year process—what are the chances of a US legal victory?

In our view, the Article XV(4) case, if brought, would have no traction. By contrast, an SCM case passes the plausibility test. Both cases might advance the US goal of giving market forces a greater role in determining the Chinese exchange rate, but if either case were pursued to the bitter end, entailing hundreds of hours of legal argument and thousands of pages of legal briefs, we think the claims advanced by the FCA and CCC would be rejected by the WTO Dispute Settlement Body. We first consider GATT Article XV(4), then the SCM agreement.

Article XV(4)

Neither a fixed exchange rate (the Chinese system prior to July 2005) nor a tightly managed float (the Chinese system since then) can be deemed a per se violation of GATT Article XV(4). Both systems are widely used and condoned by the IMF Articles.[22] GATT Article XV(9)(a) states that "nothing in this Agreement shall preclude . . . the use by a contracting party of exchange controls or exchange restrictions in accordance with the Articles of Agreement of the [IMF]." Insofar as GATT and the WTO are concerned, this language appears to scream "keep out of the exchange rate sandbox."

However, the legal case with respect to Article XV(4) hinges on the argument that in practice, China's exchange rate regime "frustrates the intent of the provisions" of GATT. Uninformed observers may ascribe to GATT and the WTO the intent to ensure bilateral trade balances, and current China bashers often cite as an "offense" the huge bilateral imbalance between the United States and China, now exceeding $200 billion annually according to US statistics.[23] The history of GATT, however, is replete

22. Former USTR Robert Zoellick admitted that there was no WTO obligation against a fixed exchange rate, pointing out that "the United States had a fixed exchange rate until 1971." See Edward Alden, "Zoellick Snubs Calls for WTO Criticism," *Financial Times*, February 26, 2004.

23. Even President Bush, a devout free trader, gave comfort to the bilateral balance argument when he commented that the $200 billion imbalance leaves many Americans "wondering where's the equity in trade" (*Financial Times*, April 11, 2006, 1).

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with evidence that its goal is not to ensure bilateral trade balances. Among economists, triangular trade is a virtue, not a vice, because it enables each country in the multilateral system to specialize in what it produces best. Triangular trade flourishes when bilateral imbalances are condoned. When GATT was formed, the United States worked to limit discriminatory quota and tariff schemes, instituted for balance of payments reasons, that confined trade to bilateral channels.[24]

A better claim, at least on economic grounds, is that the WTO *should* seek balanced trade among its members on a *multilateral* basis. But even this claim runs into objections. First, the preamble to GATT-1947 (adopted *in toto* by GATT-1994) states that

> relations in the field of trade and economic endeavour 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. (WTO 1999)

It can certainly be argued that balanced multilateral trade promotes "rising standards of living," "full employment," the "full use of resources," and helps expand "the production and exchange of goods." But the language does not explicitly commend balanced trade on a multilateral basis. Perhaps that was an omission, but if so, it is repeated in the preamble to the Marrakesh Agreement Establishing the World Trade Organization, which states that

> relations in the field of trade and economic development 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, and expanding the production of and trade in goods and services, while allowing the optimal use of the world's resources in accordance with the objective of sustainable development, seeking both to protect and preserve the environment and to enhance the means for doing so in a manner consistent with their respective needs and concerns at different levels of economic development. (WTO 1999)

As a general rule, interpretations of trade obligations by GATT panels prior to the WTO, and by the WTO Appellate Body since 1994, have not extended member obligations beyond the explicit requirements of the text. It seems unlikely to us that the Appellate Body would read an obligation of balanced multilateral trade into the WTO preamble.

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24. The exceptions to multilateralism in Article I, *General Most-Favoured-Nation Treatment;* Article XII, *Restrictions to Safeguard the Balance of Payments;* and Article XIV, *Exceptions to the Rule of Non-discrimination* were all tightly drafted, at US insistence, to minimize bilateral preferences. See Jackson (1969).

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A second objection, more technical but perhaps more fatal, is that the General Agreement on Trade in Services (GATS) has no language on exchange rates parallel to Article XV(4). So, from a legal standpoint, proponents cannot consider GATT and GATS together to argue for a general objective to achieve multilateral balance in *goods and services.* As an economic proposition, multilateral balance in merchandise trade alone makes no sense; multilateral balance only makes sense if the balance includes both goods and services. Some countries, including China, are large net importers of services and large net exporters of merchandise. Other countries, such as the United States, are the reverse, large net exporters of services and large net importers of merchandise. Yet Article XV(4) of GATT-1947 applies only to frustration of the Agreement's provisions *with respect to trade in goods.* With this limitation, Article XV(4) cannot be read as a GATT prescription for multilateral balance in *goods and services.* The only basis for such a prescription is the WTO preamble, cited above, which does not explicitly commend multilateral balance.

Still more technical but equally fatal is the textual language and addenda to Article XV(4). The language of Article XV(4) commits contracting parties not to use exchange rate action to "frustrate* the intent of the *provisions* of this Agreement" (emphasis added). The asterisk refers to the addenda to Article XV(4), which state that another *specific* GATT article needs to be frustrated in an important way before the strictures of Article XV(4) can be invoked. Try as they may, proponents of multilateral balance will find no GATT article that states such an objective.

In fact, as Jackson's (1969) definitive text reveals, insofar as payments disequilibria are concerned, GATT articles are confined to situations in which a country experiences balance of payments difficulties, not situations in which a country has a large balance of payments surplus. GATT-1947 Article XVIII authorizes a contracting party that "can only support low standards of living and is in an early stage of development" to override its trade obligations with temporary balance of payments measures. Other contracting parties, such as countries in the Organization for Economic Cooperation and Development (OECD), including the United States, must apply for a prior dispensation from the contracting parties as a whole before imposing balance of payments restrictions.[25] Under GATT-1947, trade measures to

25. The limitations on balance of payments measures reflect that, when GATT was drafted after World War II, the United States itself had every prospect of large balance of payments surpluses with war-wracked Europe and Japan. Because of the textual limitations, the Nixon tariff surcharge of 1971 was inconsistent with GATT, though never tested. However, in defense of the Schumer-Graham legislation, the United States might claim balance of payments difficulties if the bill imposed a tariff surcharge on *all* imports, not only imports from China. But the claim would need the prior concurrence of other WTO members, an unlikely prospect. The claim would break new legal ground, since prior experience with the balance of payments exception has involved countries that, unlike the United States, were unable to attract vast amounts of capital to purchase assets denominated in their own currencies.

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restore equilibrium to a country's balance of payments were textually confined to quotas, though tariff surcharges were sometimes used, and surcharges were explicitly authorized by the Understanding on the Balance of Payments Provisions of the General Agreement on Tariffs and Trade 1994.

From a WTO legal standpoint, therefore, China's multilateral trade balances are irrelevant to its obligations under Article XV(4). However, as part of its defense, China would surely argue that it has not *run* an exceptionally large surplus in traded goods and business services—the subject matter of the WTO. Considerable statistical dispute surrounds the size of China's current account surplus. In a dispute proceeding, we think that the WTO would place the greatest weight on IMF figures. Between 2000 and 2004, according to the IMF, China's current account surplus for goods and services totaled $180 billion. Over the same period, Japan's current account surplus was $313 billion, and Germany's was $363 billion. China does not particularly stand out among these economic peers. Moreover, if the policy argument drifts into the realm of current account surplus relative to GDP, China's 6 or 7 percent surplus looks positively innocent compared with those of Japan, Singapore, Hong Kong, the Gulf States, and other WTO members that run persistent double-digit current account surpluses as a percent of GDP.

If critics make an issue of the rapid rise in China's foreign exchange reserves—from $169 billion at the end of 2000 to $819 billion at the end of 2005 (IMF's *International Financial Statistics* 2005)—China can retort that the reserves have been bolstered by substantial inward flows of FDI and portfolio capital.[26] Such financial flows are simply outside the purview of the WTO. An excursion into China's motives for acquiring large foreign exchange reserves, which may reach $1 trillion by the end of 2006 (Bergsten et al. 2006), would take the WTO even further from its institutional purview.

To summarize these various objections, we think the WTO Appellate Body would be most unlikely to condemn China's exchange rate policy under Article XV(4). The question is not whether the United States would lose, but whether its arguments would be summarily dismissed.

SCM Agreement

The FCA draft petition and the CCC statement offer another legal leg for the WTO case. They argue that the undervalued renminbi acts as a "prohibited export subsidy" that violates Articles 1, 2, and 3 of the WTO's SCM agreement. Under the WTO, a "prohibited export subsidy" must sat-

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26. Morgan Stanley economist Andy Xie (2005a) estimates that hot money inflows total as much as $350 billion. According to IMF economists Eswar Prasad and Shang-Jin Wei (2005), more than 87 percent of the increase in China's foreign exchange reserves from 1988–2000 to 2001–04 was explained by hot money. Prasad and Wei reject the mercantilist explanation that China uses a mercantilist policy—a deliberately undervalued currency—to accumulate foreign exchange reserves.

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isfy three criteria: The subsidy must be "contingent . . . upon export performance," it must entail governmental "financial contribution," and it must provide "benefit" to the recipient (see WTO Article 3 in WTO 1999; see also Benitah 2003).

Taking these tests in reverse order, an undervalued exchange rate, if it exists, surely benefits exporting firms. While "benefit" is not precisely defined, the context of the WTO SCM Agreement, along with decided cases, establishes that a prohibited subsidy must provide value to the recipient, whatever it may cost the government.[27] An undervalued exchange rate definitely provides value to exporting firms. The difficulty is proving that the Chinese renminbi is "undervalued." The USTR and Treasury can recruit distinguished scholars to supply expert testimony that the renminbi is seriously undervalued. But the battle of economic expertise is not one-sided: China can draw on its own stable of distinguished scholars, including two Nobel laureates (Robert Mundell and Joseph Stiglitz), a recognized Stanford professor (Ronald McKinnon), and several Wall Street financial experts, to supply opposing expert testimony. Our guess is that the WTO Dispute Settlement Body would turn to the International Monetary Fund (IMF) for an authoritative statement, given the historical division of labor between the IMF and GATT. If the IMF is not willing to declare definitively that the renminbi is undervalued by a certain amount, we think that would be the end of the case. If the IMF is willing to make such a declaration, the WTO dispute proceeding could turn to other issues.

The next issue is whether an undervalued exchange rate entails a "financial contribution" by the Chinese government. In previous WTO cases, policies deemed to provide a "financial contribution" have included giving grants, making loans at below-market rates, providing tax breaks, concessionary terms for exploiting natural resources, and providing transport at especially cheap rates for exported goods (see WTO Article 1 in WTO 1999). A similar budget cost or targeted concession cannot be easily associated with an undervalued exchange rate. To be sure, the United States can argue that importers are paying too much renminbi for their purchases—in other words, that the undervalued rate takes money from importers and gives it to exporters, so that the policy operates like a tax on imports and a subsidy on exports.[28] The United States can also

27. Decided cases (especially in the export credit field) look at the benefit to the recipient firm rather than the cost to the government.

28. John Magnus argues that a financial contribution exists because the Chinese central bank performs the service of converting dollars to renminbi. See his testimony on Chinese Subsidies and US Responses before the US-China Economic and Security Review Commission, Hearing on China's World Trade Organization Compliance, Washington, April 5, 2006. We think this interpretation would not be accepted by the WTO Appellate Body, if only because it would lead to the conclusion that all central banks that operate in the foreign exchange market are thereby providing a financial contribution to their exporters. Such a bold conclusion would, in our opinion, need support from verbatim SCM language to prevail.

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argue that the Chinese central bank will lose money on its dollar assets when the exchange rate is "inevitably" revalued.

China can offer responses to these arguments. First, for WTO purposes, it does not suffice to use an on-budget subsidy analogy to condemn an off-budget public policy such as an undervalued exchange rate. Citing WTO precedents, China can claim that a "financial contribution" equates to an observable budget cost or targeted concession as traditionally measured. Nowhere in the history of public accounts has a budget cost been ascribed to an undervalued exchange rate. In a real sense, of course, an undervalued exchange rate is "targeted" at all exports, but China can argue that if the drafters of the SCM Agreement had meant to encompass an undervalued exchange rate, they would have said so in as many words.

A second Chinese response is that WTO Panel or Appellate Body acceptance of the US argument would project the WTO squarely into turf historically occupied by the IMF. In the future, if a WTO member country were to become unhappy with the exchange rate of another member, it could launch a WTO case. Finance ministers would vigorously object to this intrusion into their policy domain. Equally important, WTO adjudication of exchange rate values would breach the historic division between the IMF and GATT. In our view, the Chinese arguments would persuade the WTO Dispute Settlement Body to rule against the claim of "financial contribution."[29]

Even if we are wrong, the US case faces yet another hurdle: demonstrating that the benefits conferred by the "financial contribution" of an undervalued exchange rate are "contingent, in law or in fact,* whether solely or as one of several other conditions, upon export performance, including those illustrated in Annex I." To a casual reader, it might seem obvious that the benefits of an undervalued exchange rate are "contingent upon export performance." A firm does not benefit from an undervalued exchange rate if it does not export anything. However, a closer reading throws considerable doubt on the assumed "contingency." The asterisk in the quoted text refers to footnote 4 in the SCM Agreement, which states, among other points, "The mere fact that a subsidy is granted to enterprises that export shall not for that reason alone be considered to be an export subsidy with the meaning of this provision." This footnote can be interpreted to mean that a favorable exchange rate with no other strings attached is no more a prohibited export subsidy than any other beneficial economic "climate," such as a concessionary tax rate that applies to all new plant and equipment investment by foreign firms.

29. Alternatively, as John Magnus has contended in correspondence with the authors, these hypothetical Chinese arguments would persuade the WTO Dispute Settlement Body to find that the undervalued exchange rate does not confer a "benefit" in the sense of the SCM Agreement.

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Moreover, the Illustrative List of Export Subsidies, which appears as Annex I to the SCM Agreement, does not support the contingency argument. The genesis of this list was a 1960 GATT Working Party Report (GATT Secretariat 1961), and the list itself was codified in the Tokyo Round Code on Subsidies and Countervailing Duties (Hufbauer and Erb 1984). The SCM Agreement repeats, almost verbatim, the illustrative list in the Tokyo Round Code. It only mentions exchange rate practices by stating that, among prohibited export subsidies are "currency retention schemes or any similar practices that involve a bonus on exports." However, currency retention schemes are a feature of *overvalued,* not undervalued, exchange rate regimes; they permit exporters to retain a certain amount of foreign exchange earned, either to purchase imported inputs or to sell at a premium to other importers.[30] Other than that single reference, all other practices enumerated in the illustrative list refer to tax, expenditure, transport concessions, and credit practices that are specifically tied to export performance. While the list is "illustrative" and not exhaustive, China can argue, as above, that if GATT and WTO members had intended to cover such an important subject as allegedly undervalued exchange rates, they would have written an explicit statement in the text of the SCM agreement or in its illustrative list.[31]

Perhaps recognizing the weakness of its legal case, the CCC has promoted a piece of legislation, the Ryan-Hunter bill (HR 1498), which would *unilaterally* declare that an undervalued currency—the renminbi or any other—amounts to a prohibited export subsidy, subject to countervailing duties. This proposal has shades of the infamous Byrd Amendment,[32] which refunded antidumping and countervailing duties to petitioning US firms and which President Clinton reluctantly signed into law in 2000. Even at the time of enactment, trade experts widely recognized that the Byrd Amendment conflicted with WTO provisions (Ikenson 2004b). However, it took three years of legal wrangling for the WTO to declare the amendment illegal, and only in 2005 did Congress repeal it, effective in October 2007.

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30. Currency retention schemes and multiple exchange rate regimes have been questioned for their subsidy implications by the US Department of Commerce and in GATT (see Hufbauer and Erb 1984). But China maintains a unified exchange rate, and there is no precedent for a GATT or WTO export subsidy case against an allegedly undervalued, but unified, exchange rate.

31. In his testimony to Congress, John Magnus argues that the export contingency test could be met despite the absence of specificity, based on the expansive holding in the extraterritorial income exclusion case (WTO 2002). However, faced with the prospect of extending that holding to exchange rates, the WTO Appellate Body might well "discover" a limiting principle.

32. Formally known as the Continued Dumping and Subsidy Offset Act of 2000.

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We conclude that the chances of a US legal victory in the WTO are at best modest. But we also recognize that litigation can, in certain circumstances, promote productive negotiation, even though the litigation rests on a novel legal theory. This may be one of those circumstances.

The Legal Case, Part 2: IMF Article IV

A second pillar in the FCA's draft petition is that China violated Article IV of the IMF. Article IV Section 1 (iii) states that each IMF member should "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."

To enforce this prescription against competitive undervaluation, IMF Article IV Section 3 states that the IMF should "exercise firm surveillance over the exchange rate policies of members, and shall adopt specific principles for the guidance of all members with respect to those policies." A 1977 Fund Executive Board paper lists indicators for questioning exchange rate policies, including "protracted, large-scale intervention in one direction in the exchange market" (Goldstein 2004). Under the principles of IMF Article IV and the 1977 paper, it can be argued that China violated IMF conditions by maintaining fixed exchange rates for a long period of time, intervening on a large scale and in "one direction in the exchange market."[33] Citing these provisions, Goldstein contends that the IMF should either publicize that China "engaged in currency manipulation or that the renminbi is undervalued" (Goldstein 2005a, 9).

Other economists, such as Nobel laureate Robert Mundell (2004), point out that the IMF has never required a major country with an inconvertible currency to revalue.[34] China expert and former Treasury official Albert Keidel argues that official IMF guidelines, which permit China to intervene in exchange markets "to counter disorderly conditions," provide cover for China's exchange rate policies. Keidel, along with Ronald McKinnon and some Wall Street observers, contends that China's primary interest is to ensure domestic stability rather than to advance a mercantilist trade strategy (Keidel 2005).

Mundell also questions whether a revaluation could run counter to IMF Article IV Section 1. Under Article IV Section 1 (ii), member countries should "seek to promote stability by fostering orderly underlying eco-

33. Goldstein (2005a) observes that the reticence of the Fund and the United States to question Japan when it requested authorization to intervene in exchange markets weakens the case against China. For further analysis of China and its IMF obligations, see Goldstein (2005a).

34. Mundell (2004) contends that a revaluation would delay convertibility indefinitely.

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nomic and financial conditions and a monetary system that does not tend to produce erratic disruptions." Mundell contends that a currency appreciation would increase Chinese unemployment by raising the dollar cost of wages.[35] With existing underemployment in China estimated at 200 million persons, he believes that a revaluation could create economic and financial instability, which violates Article IV Section 1 (iii).[36]

Morris Goldstein's counterassertion to Mundell (and others) has several parts (Goldstein 2005a, 2005b). First, under alternative definitions of equilibrium exchange rates—what he calls the *underlying balance approach* and the *global payments approach*—Goldstein finds that the renminbi is undervalued by 15 to 40 percent. Second, he contends that renminbi revaluation would help put China on a path to sustainable growth, with a larger component of domestic consumption in GDP. Revaluation would also improve China's financial stability, lowering inflows of hot money, and decreasing speculative investment in real estate projects. Finally, Goldstein argues that if the IMF fails to chastise China for currency manipulation, other IMF member countries can and will rationalize their own currency policies, however manipulative, on the basis of seeking full employment.

A related IMF issue is whether China's renminbi policy meets the requirements of IMF Article IV Section 4, which states that member-country exchange rate policies should be evaluated in the context of "the underlying stability of the world economy." Specifically, the IMF "should take into account price movements and rates of expansion in the economies of members." Again, Section 4 provides a peg for criticizing China, but a peg without much prior use.

Yet as the chorus of voices calling for IMF action on renminbi revaluation has grown, the IMF leadership has taken only a few small steps. In the context of Article IV consultations with China in April 2005, the IMF concluded that China needed to undertake "greater exchange rate flexibility," presumably beyond the 2.1 percent revaluation orchestrated in July 2005. For the IMF the rising Chinese current account surplus indicated that the renminbi was undervalued. In November 2005 the IMF

35. Economist Richard Cooper agrees with Mundell's view that a large renminbi revaluation remains a high-risk strategy for China. Cooper believes that the Chinese government's prime concern is to dampen investment in specific economic sectors without raising unemployment in urban areas. Urban unemployment could threaten to incite political unrest, which has already erupted sporadically in rural areas. See Cooper (2005).

36. Stephen Roach of Morgan Stanley underscores another of Mundell's concerns: the fear that dismantling the renminbi peg could destabilize world financial markets. Andy Xie of Morgan Stanley contends that China cannot "tolerate substantial currency volatility," given his estimate of 300 million surplus workers. See Mundell (2004); Stephen S. Roach, Getting China Right, Statement before the US-China Economic and Security Review Commission, Washington, September 25, 2003; and Xie (2005b).

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underscored its earlier support for a flexible exchange rate by noting that Chinese banking liquidity remains too high and investment rates are unsustainable.[37]

Although top IMF leaders, such as the managing director and the first deputy director Anne Krueger, have voiced mild frustration over China's exchange rate policies, without strong leadership from the managing director, the likelihood remains very small that the IMF's Executive Board will chastise China for breaching its IMF obligations. In its more than 50-year history, the IMF has never criticized or suspended a member country for breaching Article IV. To publish a formal criticism of a member country's exchange rate policies over the opposition of that member, a 70 percent majority of the IMF's Executive Board must approve. To suspend a member country for violating Article IV requires a supermajority of 85 percent.[38] Neither formal criticism nor suspension appears to be a meaningful threat in the China case.

Instead soft rhetoric is the IMF's tool of choice: In the most recent IMF Article IV consultations with China, the IMF directors "recommended that the authorities allow the exchange rate to move more quickly toward a level that better reflects underlying market forces."[39] Soft rhetoric continues to be Treasury's tool of choice as well. In its May 2006 report to Congress on international currencies, Treasury merely stressed its "strong disappointment" that China has not allowed the renminbi to rise faster and further against the dollar.[40]

Deliberations in the IMF's boardroom and the Treasury's semiannual report, however, comprise only part of larger negotiations over the renminbi. Additional pressure will emanate from bilateral talks between the United States, the European Union, Japan, and China, from G-8 finance minister meetings; and of course from debates in Congress.

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37. The IMF listed reasons why a renminbi revaluation would be useful for China's own long-term interests, helping to reduce speculative and distorted investment and to raise domestic consumption. See IMF Article IV Consultations with the People's Republic of China, July 8, 2005.

38. IMF Article XXVI enumerates reasons for the IMF to impose "compulsory withdrawal" of any member country. In a small number of cases, usually with political overtones, Article XXVI has been invoked for violations of Article VIII (the requirement to provide economic information). Articles XXVI and VIII have no application to current Chinese circumstances.

39. See IMF Article IV Consultations with the People's Republic of China, September 12, 2005. At the IMF's meeting of 184 members in April 2006, the managing director and his staff were assigned a larger role in "multilateral surveillance" of exchange rates. How the new powers are used remains to be seen, but IMF leadership is nervous about offending China, lest it provoke Beijing into accelerating the creation of a rival Asian monetary facility.

40. See the *Wall Street Journal,* May 11, 2006.

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Evaluation

Over the last few years, the pegged renminbi has helped to boost Chinese exports to the US market and contributed to a growing US trade deficit on a multilateral basis. A revalued renminbi, especially if coordinated with the appreciation of other Asian currencies against the dollar (Cline 2005b), will help stabilize and may even reverse the growing US deficit. An optimistic estimate of Asian currency appreciation (including China) over the next two years is around 20 percent, about the same amount that the euro, the yen, and a few other floating currencies appreciated between November 2002 and October 2004. Assuming that the revaluation is accompanied by an improved balance between saving and investment in the United States,[41] an outside estimate of the induced improvement in the US trade balance is around $120 billion (table 2.1). A more realistic estimate may be between $60 billion to $80 billion per year (Bergsten et al. 2006).[42]

Even the more realistic figure is a step in the right direction, but the White House and Congress will need to take other steps as well. The federal budget deficit needs to be slashed by raising taxes and cutting spending. As part of a larger package, in 2006 and 2007, the Treasury needs to raise the pressure on China to revalue the renminbi, using the language and tools of financial diplomacy. The merits of a high-profile WTO case are questionable; the better tactic is to press for renminbi revaluation in the IMF's boardroom.[43] A reasonable target for the renminbi would be an appreciation of 10 percent in central parity by the end of 2006, coupled with greater flexibility in the renminbi band. By the end of 2007, the target should be an appreciation of 20 percent.

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41. Lawrence Summers, among many other commentators, emphasized that larger US national savings, both at the household and government levels, as well as exchange rate adjustments, are necessary to reduce the US current account deficit. See Lawrence Summers, The United States and the Global Adjustment Process, Third Annual Stavros S. Nierchos Lecture, Institute for International Economics, Washington, March 23.

42. According to US Federal Reserve economists, Jaime Marquez and John Schindler, a 10 percent appreciation lowers China's export share of world trade by one-half of a percentage point in the long run ($52 billion in 2005 trade value terms). The same appreciation is estimated to lower China's import share of world trade by a tenth of a percentage point ($11 billion in 2005 trade value terms). The reason China's imports decrease, rather than increase, with an appreciated renminbi is that about half of China's imports are used as inputs for assembled exports. The Marquez and Schindler coefficients imply that China's bilateral trade surplus with the United States would drop by about $14 billion with a 10 percent appreciation of the renminbi. See Marquez and Schindler (2006).

43. In her confirmation testimony on May 22, 2006, USTR Susan Schwab commented, "In our view, initiating a WTO case on [the renminbi value] would put China in the position of defending, rather than reforming, its currency regime," The Ttalk Quote Book, Global Business Dialogue, Inc., May 23, 2006, available at www.ttalk.biz.

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Table 2.1 Current and prospective US bilateral trade with Asian partners, 2005

Country	**Current merchandise trade** (billions of dollars)			**Hypothetical currency appreciation versus dollar[a]** (percent)
	US exports	**US imports**	**Trade balance**	
China	38	223	–185	22
Hong Kong	15	8	7	36
Korea	25	40	–15	7
Malaysia	10	31	–21	30
Philippines	6	8	–2	22
Singapore	19	14	5	40
Taiwan	20	32	–12	19
Thailand	7	18	–11	17
Total	139	374	–235	22
Calculated change in US trade balance with listed Asian countries combined[b]				117

a. The hypothetical appreciation against the US dollar is one-half the figure shown in Cline (2005a, table 6.2) as "Remaining real appreciation to reach optimal amount." The figure in the total row is the trade-weighted average.

b. The calculated change in the US trade balance is based on Cline (2005a, table 3.5). According to Cline's calculation, after five years, a 10 percent average trade-weighted appreciation of *all* foreign currencies against the dollar will improve the US current account balance by 1.57 percent of US GDP. The listed Asian countries account for about 22 percent of US merchandise trade (imports plus exports). Hence, a 10 percent average appreciation in just the Asian currencies is estimated to cause (after five years) a 0.35 percent improvement in the US current account balance expressed as a percent of GDP (1.57 percent * 0.22 = 0.35 percent). By extension, a 22 percent average appreciation would be estimated to cause an improvement equal to 0.77 percent of GDP (0.35 percent * 2.2 = 0.77 percent). In 2004 US GDP was $11.7 trillion. Assuming 5 percent annual nominal growth, in 2010 US GDP may reach $15.2 trillion. A current account improvement equal to 0.77 percent of GDP would therefore equal $117 billion in 2010, some five years after the hypothetical average Asian appreciation of 22 percent.

Sources: USITC Dataweb, 2006; Cline (2005a).

Even if the renminbi were revalued, however, several trade issues would still create friction between the United States and China. One of the more bitter arenas of contention is the textile and clothing sector, as China finds itself to be quite competitive while the United States experiences painful job losses. The situation has become more acute with the expiration of the Multi-Fiber Arrangement, which has broader implications for both countries regarding their trade strategies in the years to come.

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