

Remarks on China's Currency Misalignment & Congressionally Mandated Trade Sanctions

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March 14, 2008

Based on “Undervalued Exchange Rates and Sovereign Wealth Funds: A New Role for the WTO” authored with *Aaditya Mattoo*, *World Bank*.

Paper available at <http://www.petersoninstitute.org/publications/interstitial.cfm?ResearchID=871>

Summary

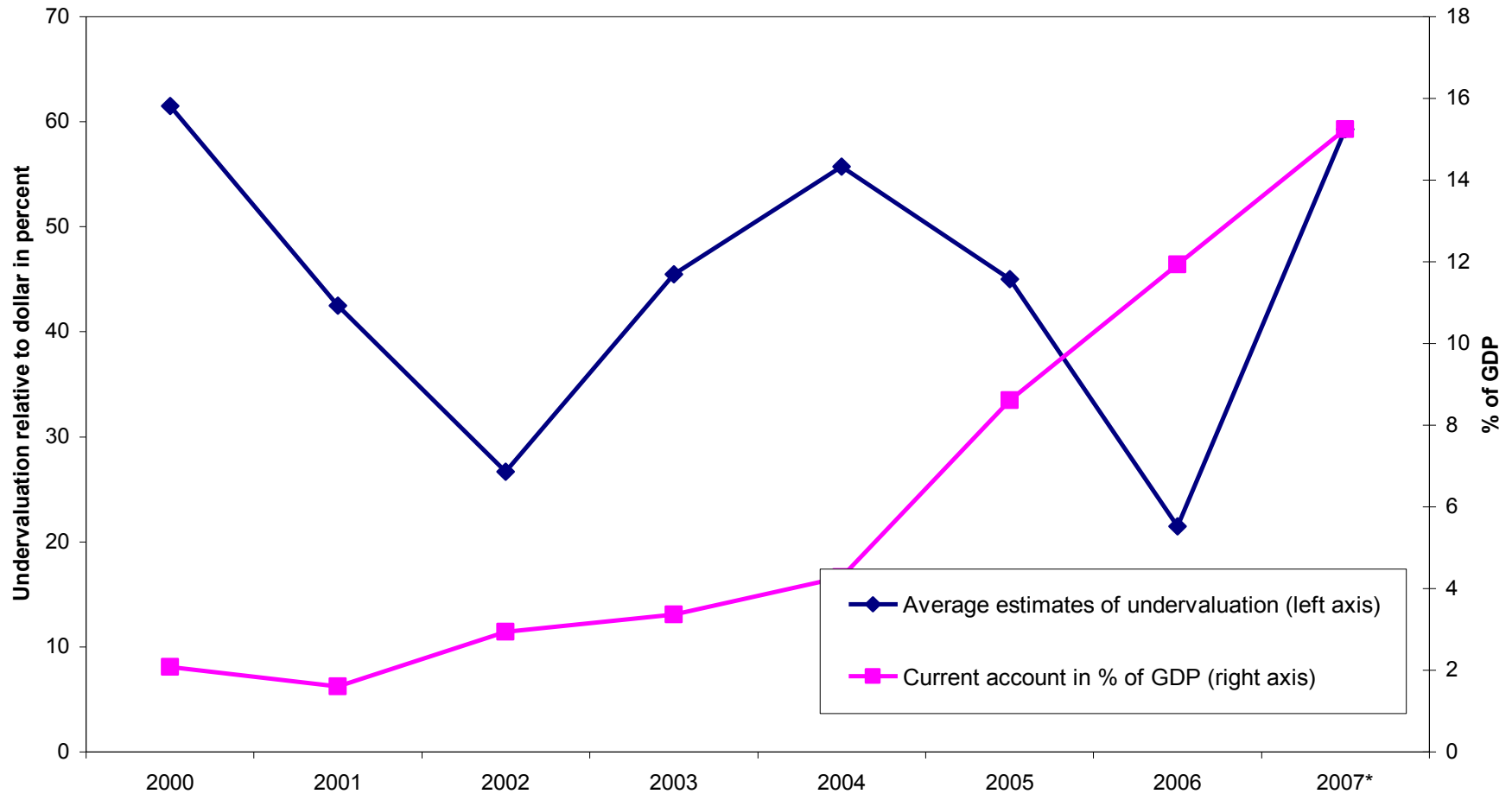
- There is a problem
- It is a systemic problem
- Unilateral solution by US undesirable and will be ineffective
- Multilateral solution through IMF desirable but infeasible
- Multilateral solution through WTO—with cooperation from the IMF—is desirable and offers the best prospects of feasibility

“Houston, we have a problem”

- The Chinese exchange rate is undervalued (Cline and Williamson, 2008)
- Estimates vary but a reasonable one is about 30-35 % (Goldstein and Lardy, 2008)
- Moreover, current account to GDP in 2007 is 12 % of GDP (== \$440 billion versus US trade deficit of \$700 billion)

Estimates of Chinese Undervaluation

Chart 1: Chinese Undervaluation and Current Account, 2000-2007



Source: Cline and Williamson, 2007, Table 1

For each year, the average of the estimates across studies is computed. Number of studies per year varies from 1 (2000) to 7 (2007)

*Current account figure for 2007 is an extrapolation

Systemic Problem

- Not just the U.S but..
- EU, now reeling from euro appreciation: Chorus for anti-dumping actions against China
- Brazil, Mexico, India, Turkey, and South Korea affected significantly
- Indian Prime Minister and Finance Minister called for greater exchange rate flexibility in China

Unilateral Trade Sanctions by US

- Doubtful legality:
 - Current WTO rules do not permit trade sanctions against undervalued exchange rates
 - Determining undervaluation is a fraught exercise, making unilateral determinations more suspect/less credible
- But CV and anti-dumping would not address problem of “import tax” aspect of undervalued exchange rates and competition in third markets
- Ineffective:
 - Numerous but aborted legislative initiatives
 - Unsuccessful efforts by Administration
- Underlying reason:
 - China too big even for US acting alone?
 - Corporate America is ambivalent about China’s exchange rate
- Hence, need for cooperative action

Cooperative Action in IMF?

- Desirable in principle
- But difficult in practice because of inadequate leverage and eroding legitimacy
- Leverage: IMF has never been able to change policies of large creditor countries
- Legitimacy: Developing countries find governance structure outdated
- No enforcement mechanism

New WTO Rule on Exchange rates

- Current rules do not regulate undervalued exchange rates
 - Article XV:4 does not provide clear obligations
 - Subsidy: financial contribution?
- But WTO prohibits tariffs and export subsidies separately and undervalued exchange rates are BOTH.
- Hence need new WTO rule: “Undervalued exchange rates caused by government action would be deemed to be export subsidies and import tariffs and prohibited.”

Exchange rates: Implementation

- Who determines undervaluation? IMF
 - Draw upon IMF as repository of technical expertise
- Design issues: model along existing WTO rules
 - For example: IMF plays a similar role in WTO's balance-of-payments consultations (Disputes on Korea Beef and India's restrictions on consumer goods)

Politics of Exchange Rate

- There will have to be a new rule which has to be negotiated. How?
- Potential coalition of the disaffected: labor in US, EU, and many emerging market countries
- Coalition should put undervalued exchange rates on the WTO negotiating agenda
- Doha stalled in part because of fear in Brazil, China etc. about Chinese competition
- But China is China. Need carrots as well
- Possible carrot: Prospect of market economy status in the WTO
- No guarantee of success but alternative? Status quo?

Doubts about Proposal

- Overloading the WTO
 - But undervalued exchange rates have large trade effects
- Turf battles within countries: USTR versus Treasury; Committees in Congress; trade versus central banks versus finance ministries. True but...
 - Responsibility for exchange rate management unaffected: small tail of outcomes (undervaluation) subject to trade action
 - Precedent for reconciling turf issues: Financial services agreement in GATS.
- Too big to litigate?
 - Distinction between: litigating before negotiating (for example, unilateral US trade sanctions) and litigating after negotiating

Historical Digression

- Problem of getting countries with current account surpluses/undervalued exchange rates to adjust
- Keynes and Scarce Currency Clause of the IMF
- Right idea but wrong institution
- Our proposal tries to rehabilitate Keynes by drawing upon comparative advantage of WTO (enforcement) and IMF (technical expertise)