Currency manipulation and its effect on international trade

Role of Currency in International Trade

Introduction

An exchange rate has been defined as a relative price of two national monies. More specifically, it can be stated that the exchange rate is " the ratio between a unit of one currency and the amount of another currency for which that unit can be exchanged at a particular time." (FASB 1975) Thus, it can be inferred that exchange rates are framed to facilitate exchange of two currencies with each other.

Exchange rates are normally quoted in terms of a buying rate, a flat rate, and a selling rate. The buying rate is that which a bank will pay for a foreign currency, the selling rate is the rate a bank will charge for the currency, and the flat rate is an average of the buying and selling rates. Also, the exchange rate actually traded depends upon type of market sector involved. There are mainly 4 types of markets: (I) retail – dealings with the general public; (2) wholesale – trading among banking institutions and, where permitted, between large firms and brokers; (3) foreign – dealings between domestic and foreign banks; and (4) supranational – dealings among large multinational corporations and large private banks.

Impact of Exchange Rates

On very fundamental level, exchange rate impacts overall exports, imports and trade balance of a country. A higher exchange rate will lead to rise in imports and fall in exports, which means depreciating of trade balance. This is because, customers will find it cheaper to buy imported goods and there will be a tendency to source intermediate goods from other countries.

Similarly, devaluation of currency will lead to soaring of exports. This wil lead to appreciation of general trade balance as imports get expensive while exports get more competitive.

Another important effect Exchange rate devaluation (or depreciation) has is inflationary pressure: imported good become more expensive both to the direct consumer and to domestic producer using them for further processing. In reaction to inflation (actual and feared), the central bank can rise the interest rates, thus sending a recessionary impulse.

Exchange rates also determine international purchasing power of residents abroad. A devalued currency would lead to smaller external purchasing power while greater purchasing power back home.

UNDERSTANDING CURRENCY MANIPULATION

Currency Manipulation

Currency manipulation is the practice of artificially setting exchange rates by the central bank of one country in order to gain an unfair advantage. Typically currency manipulation occurs when a country fixes the exchange rate of its currency relative to the currency of another country. It can include a requirement for a fixed exchange rate or the mandatory use of a country's central bank for foreign exchange sales.

Article IV of the International Monetary Fund (IMF) Agreement states that a member should " avoid manipulating exchange rates … in order… to gain an unfair advantage over other members," and related surveillance provision defines manipulation to include " protracted large scale intervention in one

direction in the exchange market." In other words if an India trading partner makes large scale purchasing of INR and other currencies that leads to lower than market based exchange rate, there is an evidence of currency manipulation to gain unfair competitive advantage according to IMF Agreement[2].

Fixed Exchange Rates

There are two ways the price of a currency can be determined against another. A fixed, or pegged, rate is a rate the government (central bank) sets and maintains as the official exchange rate. A set price will be determined against a major world currency (usually the U. S. dollar, but also other major currencies such as the euro, the yen or a basket of currencies). In order to maintain the local exchange rate, the central bank buys and sells its own currency on the foreign exchange market in return for the currency to which it is pegged.

If, for example, it is determined that the value of a single unit of local currency is equal to US$1, the central bank will have to ensure that it can supply the market with those dollars. In order to maintain the rate, the central bank must keep a high level of foreign reserves. This is a reserved amount of foreign currency held by the central bank that it can use to release (or absorb) extra funds into (or out of) the market. This ensures an appropriate money supply, appropriate fluctuations in the market (inflation/deflation), and ultimately, the exchange rate. The central bank can also adjust the official exchange rate when necessary.

Floating Exchange Rates

Unlike the fixed rate, a floating exchange rate is determined by the private market through supply and demand. A floating rate is often termed " self-correcting", as any differences in supply and demand will automatically be corrected in the market. If demand for a currency is low, its value will decrease, thus making imported goods more expensive and stimulating demand for local goods and services. This in turn will generate more jobs, causing an auto-correction in the market. A floating exchange rate is constantly changing.

In reality, no currency is wholly fixed or floating. In a fixed regime, market pressures can also influence changes in the exchange rate. There are cases when a central bank is forced to revalue or devalue the official rate which is more reflective of actual market determined rates.

In a floating regime, the central bank may also intervene when it is necessary to ensure stability and to avoid inflation; however, it is less often that the central bank of a floating regime will interfere.

U. S. – China – WTO Litigations

The renminbi-dollar exchange rate is the largest and most important of the economic disputes between the United States and China. It affects all US imports from China (valued at $243 billion in 2005) and all US exports to China (valued at $42 billion in 2005) and has repercussions throughout Asia. A revaluation of the renminbi and other Asian currencies by 20 percent, together with a sharp reduction in the US savings deficit, might reduce the

US global current account deficit ($760 billion in 2005) by as much as $120 billion per year.

China continues to refuse to substantially appreciate its currency, and US administration and congressional efforts have induced only slight changes in the Chinese exchange rate regime. To force a substantial revaluation, interested US groups are looking to advance a case against China in the World Trade Organization (WTO). The core of the case is that China's exchange rate policy allows Chinese firms to export goods to the United States at artificially low prices, resulting in US job losses. The protagonists contend that the undervalued renminbi violates Article XV(4) of the General Agreement on Tariffs and Trade (GATT) and the WTO Agreement on Subsidies and Countervailing Measures[3]. But the chances of a US legal victory in the WTO are modest, and the WTO Dispute Settlement Body would most likely reject the claims. Similarly, while a policy case against the renminbi value can be made in the International Monetary Fund (IMF), a legal case has no supporting precedent and faces an uphill battle.

Even if China re-values its currency, however, other conflicts threaten to worsen US-China economic relations. When import quotas imposed under the Multi-Fiber Arrangement ended in January 2005, Chinese textile and clothing exports expanded rapidly. Both the United States and the European Union then negotiated a fresh set of bilateral quotas with China. Disagreements over Chinese tax and tariff discrimination against imported semiconductors, automobile parts, and other products are also front and center on the trade agenda. Chinese violation of intellectual property rights (IPRs); US antidumping duties on bedroom furniture, color television sets, and other

products; and China’s nonmarket economy status add to the litany of commercial disputes.

The US decision to block China National Offshore Oil Corporation’s bid to acquire US Oil Company. Unocal may be a harbinger that investment issues will compound bilateral trade frictions.

As Chinese firms compete in new industries and expand their world market share in established lines of trade, and as the US economy slows from earlier brisk growth and US unemployment creeps above 5 percent, existing disputes in individual sectors will likely intensify and new disputes erupt. Geopolitical disagreements-punctuated by China’s rapidly expanding military arsenal-have every prospect of sharpening economic tensions. In short, however difficult 2006 may seem in US-China commercial relations, looking back from the vantage of 2011, the current era may seem placid.

USA, and China are very big trading partners, and this makes stakes for each of the player very high. But these trading countries have an acrimonious relationship with each other. Such is the high tension that USA has filed several cases against China regarding various issues. Some of the cases have been highlighted below.

VAT & Integrated Circuits – the case was filed by USA on March 18 2004. The U. S. contended that China was violating the National Treatment Principle of the GATT, and argued that the refund of the value added tax to Chinese manufacturers (or when Chinese designed chips were imported) violated the GATT.

Exemption from Taxes as to Domestically Produced Goods – The case was filed by USA on February 2, 2007. The U. S. contends that China is violating the Subsidies Agreement and National Treatment Principle. Specifically, the U. S. argues that China provides various tax rebates to a range of Chinese firms amounting to export subsidies. Mexico filed a similar case and a panel was established in September 2007. 5 The U. S. case was suspended in November after the parties reached a settlement.

Protection & Enforcement of Intellectual Property Rights- the case was filed on April 10, 2007. The U. S. alleges that China is violating the Intellectual Property Agreement (Trade-Related Aspects of Intellectual Property Rights, or TRIPS) by not enforcing its intellectual property obligations. For example, the U. S. argued that the threshold to establish trademark counterfeiting and copyright piracy under China's criminal procedures is too high. Moreover, the U. S. argues there is a lack of procedures and penalties.

Trading Rights and Distribution Services for Certain Publications and Audiovisual Entertainment Products – the case was filed on April 10, 2007. The U. S. argues that China maintains restrictions on the import of films and restricts foreign companies from distributing films and DVDs. The U. S. contends these restrictions violate market access obligations under the 1994 General Agreement on Tariffs and Trade (GATT) as to imports, as well as the Services Agreement concerning domestic distribution.

WTO-IMF Rules regarding Exchange Rates

The International Monetary Fund (IMF) is an organization of 187 countries (with the exception of North Korea, Vatican and a few small European

states), working to foster global monetary cooperation, secure financial stability, facilitate international trade, promote high employment and sustainable economic growth, and reduce poverty around the world. The IMF works to foster global growth and economic stability. It provides policy advice and financing to members in economic difficulties and also works with developing nations to help them achieve macroeconomic stability and reduce poverty.

Although IMF is mainly a monetary governing body, it is basically responsible for world peace and balanced international trade too. Article I of its Articles of Agreement says, among other things, that the IMF was created in order to " facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy." It was also created to " assist in the establishment of a multilateral system of payments in respect to current transactions between members and in the elimination of foreign exchange restrictions which hamper the growth of world trade."

Between 1946 and 1971, IMF personally monitored country's currency. This, it did by pegging each of the currency to that of US Dollar. The US Dollar was in turn pegged to the value of gold. Also the countries could not change the exchange rates by more than 10% without consent from IMF. Also, IMF required that " A member shall not propose a change in the par value of its currency except to correct fundamental disequilibrium."[4]But this system failed when in 1971 USA devalued its currency twice without discussing with

IMF. Following this, a turmoil in currency exchange rate regime existed till 1978 when an amendment was put. This led to a freedom for countries to follow either of fixed or floating exchange systems, so long as the basic guidelines were followed and the currency was not pegged to gold.

The new amendments under " Article IV – Obligations Regarding Exchange Arrangements" stated that countries should follow monetary policies so as to promote orderly economic growth and financial stability. To do this they 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"[5]. Some countries claim that the existing exchange rate is not to gain an unfair competitive edge but to to lend stability to the currency to prevent disruption to existing economic system.

WTO

The World Trade Organization (WTO) is an organization that intends to supervise and liberalize international trade. The organization officially commenced on January 1, 1995 under the Marrakech Agreement, replacing the General Agreement on Tariffs and Trade (GATT), which commenced in 1948. The organization deals with regulation of trade between participating countries; it provides a framework for negotiating and formalizing trade agreements, and a dispute resolution process aimed at enforcing participants' adherence to WTO agreements which are signed by representatives of member governments and ratified by their parliaments.[4][5] Most of the issues that the WTO focuses on derive from previous trade negotiations, especially from the Uruguay Round (1986-1994).

Currency Manipulation: Is it an Unfair Competitive Advantage?

As seen in the previous sections how countries manipulate their currency even when there are clear rules governing the same in the IMF and WTO. But does this give the manipulating currencies any clear unfair advantage. We will understand the way the various countries manipulate the currency to gain the unfair advantage in International Trade in this section.

When is Currency Manipulation Unfair?

First of all it is clear that for all the exchange rate issues the WTO refers to IMF rules and Articles. Article IV of the IMF which states that the members should " avoid manipulating the exchange rates …………. to gain an unfair competitive advantage over other members" and the related surveillance provisions defines manipulation to include " protracted large-scale intervention in one direction in the exchange market". Therefore, according to this IMF article if a member country makes protracted large-scale purchase or selling of a currency that leads to lower than market determined trade surplus, then there is evidence of exchange rate manipulation to gain unfair competitive advantage. There are two exceptions to this rule under which currency manipulation may not be judged as unfair. These are:

Adequacy of reserve Holdings: If a country has run down its reserves through previous sales of foreign reserves, the motivation for foreign currency reserve may be to restore its adequate level of reserves. WTO has benchmarked the reserves to be 25% of the annual imports.

Balance of Payments Adjustment: If a country is running a larger deficit or surplus on current and long term capital accounts then such currency manipulation may not be judged unfair but a means to bring external accounts back towards balance.

Now, let us see if a country is manipulating its currency and does not come under the above two exceptions, how does it gain an Unfair advantage. Under a market based exchange rate the currency exchange rates adjust depending on the inflow and outflow of foreign and domestic currency. But using currency manipulation the exchange rates can be either weakened or strengthened. This is generally done by intervention of the central banks. In doing so, the currency of the manipulator country is often undervaluing its currency. What it also does is that it overvalues the currency of the nation whose foreign currency is being bought to undervalue the currency. In some cases it also increases the Trade deficit of the foreign currency nation which will be explained using the US-China exchange Rate manipulation.[6]

China-Japan: Is the Exchange Rate Manipulation Unfair?

As seen in the previous section, Exchange rate manipulation can give unfair competitive advantage to nations. Now we take the example of China and Japan who have been often criticized of manipulating their exchange rates through buying and selling of foreign currencies particularly the dollar. The two adjectives of “ large-scale” and “ protracted” currency manipulation clearly apply to China and Japan. They have been involved in one-direction intervention to buy dollars since 1998 and have done with large purchases each year. If we check for the two exceptions for unfair exchange rate

manipulation we find that both China and Japan do not fall in that category as we see below:

Adequacy of reserve Holdings: Japan and China have reserves well above the 25% of annual imports as benchmarked by WTO. The foreign exchange reserves of China for example have increased steadily from $98 billion in 1998 to $ 2450 billion in June 2010. These reserves have been well above the 25% of annual imports.

Balance of Payments Adjustment: Both Japan and China have never had Balance of Payment issues during the currency manipulation regime. Both these countries run large trade and current account surpluses. China and Japan should be selling Dollars instead to reduce their huge surpluses on external account.

Thus, by looking at the above two points it is clear that China and Japan has been manipulating their currency to get an unfair advantage over other countries. By increasing their foreign exchange reserves they have been undervaluing their currencies.[7]

Impact on Dollar Exchange Rate and US Trade Deficit

The protracted and large scale currency manipulation has had a big impact on the US Dollar exchange rate and also the trade deficit. It was estimated in 2002 that the yen was at least 20% weaker than it would have been based on market forces alone, while the Chinese Renminbi was around 40% weaker as compared to the Dollar Exchange rate. Thus, in 2002 US trade deficit was about $100 Billion larger than what it would have been based on market forces alone.

Legality of Exchange Rate manipulation under WTO

We now know that China is manipulating its exchange rate to get an unfair advantage over other countries. But is it legal under the laws of WTO. We now look at what WTO rules say about the implications of currency manipulation.

Article XV of GATT

Article XV of GATT as discussed earlier is what stipulates the rules on exchange rates for WTO members. It basically suggests that for all problems concerning foreign exchange arrangements the WTO shall consult with the IMF. Also Article XV (2) provides the obligation for WTO members as " Contracting parties shall not, by exchange action, frustrate the intent of provision of this agreement, nor, by Trade action, the intent of the provisions of the Article of Agreement of the IMF." However, what should be the proper exchange rate not to frustrate the intent of GATT provisions are not clearly mentioned.

Exchange Rate manipulation – Is it an Illegal Export Subsidy?

If we see an undervalued exchange rate, it can be considered as an import tax and an export subsidy. The following criteria have to be met for China's exchange rate policy to be regarded as a subsidy under the SCM Agreement:

There must be a financial contribution by the government

There should be a benefit

The subsidy must be specific. Financial contribution is done by direct transfer of funds, foregone government revenues, the provision or purchase of goods or services other than general infrastructure, or payment to a funding mechanism.

It is however difficult to prove that Exchange rate manipulation is a financial contribution by the government because many suggest that it is a mechanism which absolutely improves the financial state and just affects the relative prices of traders which balances off the gains. The SCM agreement contains a closed list of financial contributions by the government and there is no mention of exchange rate valuation in that list.

Also the subsidy is not specific to the export industry as the undervalued exchange rate affects everyone who is buying or selling the currency. Thus, the exchange rate benefits apply across various transactions.

Thus, using the WTO current definition of Subsidies Exchange rate manipulation may not be termed as an export subsidy as it is difficult to prove that exchange rate manipulation is not a financial contribution by the government to confer specific benefits to the export industry.[8]

GATT: Non-violation Complaints

Under the non-violation complaint any member can file a complaint under Article XXIII(1b) in the Dispute Settlement Body even if an agreement has not been violated. It can do so if the government can show that its being deprived of a Benefit or expected Benefit because of another government's action, or because of any other situation that exists. Most members favored

banning the non-violation complaints at the Doha Mandate but no consensus was reached. The member filling the complaint must prove that:

A benefit was expected under the relevant agreement

Nullification or impairment of that benefit as the result of the measure or action

Application of the measure or action by the WTO member.

Under the WTO agreement it is difficult to prove that the crawling peg system or maintain the exchange rate for a prolonged period of time is a deliberate and specific action. This can only be understood as exchange action. Also, as seen earlier there is that the exchange rate manipulation Policy doesn't benefit a particular Export Industry but all transactions that involve buying and selling of currency. Thus, it is very difficult to prove that China's exchange rate policy satisfies a particular requirement.[9]

Analysis: Effects of Currency Manipulation

We have seen till now how IMF and WTO define currency manipulation done by nations like China mainly and how in spite of knowing that exchange rate manipulation gives an unfair competitive advantage to the manipulator country it cannot be clearly proven for subsidizing under the rules and regulations of WTO.

To understand the effects of exchange rate manipulation, we analyze the scenario using a hypothetical example to show exactly how this practice can affect the free and fair trade between countries.

For analyzing we assume that the world trade consists of three countries only. These countries are A, B and C. Country A is a strong economy and is used as the base currency for all transactions. Let the official currency of Country A be Dollar ($).

Further we assume that Country B and C are like countries at a similar stage of development and economy. Thus, it is assumed that the cost of Production and capital would be the same for both countries B and C.

However, we assume that country B uses a market based exchange rate system where as country C uses buying and selling of foreign currency (Dollar in this case) to undervalue its exchange rate.

Let us assume the following currency exchange rates for the two countries

Country A => Dollar (Base Currency)

Country B => 100 X = 1 Dollar

Country C => 100 Y = 1 Dollar (Under Market based currency i. e. no manipulation)

125 Y = 1 Dollar (Undervalued currency using manipulation)

Where, X is the currency of Country B and Y is the currency of Country C.

Now let us assume Trade occurs between all three countries as both exports and imports. Let us assume that Country A produces only Toys and Country B and C both produce only Garments. Now, Both country B and C export garments to Country A and Imports Toys from Country A. As both country B

and Country C are alike the cost of production of Garments will be same under similar currency values. For ease of understanding we assume trade occurring over a year where both Country B and C have exported 100 Garments each to country A and Country A has exported 200 Toys each to Country B and C. Further we assume that the cost of one Toy be 5 Dollar and cost of each garment be 10 Dollars each. Also we assume that the Selling Price be equal to the cost price of the goods i. e. Profits = Zero for both goods.

Now let us analyze the trade between these countries under two different cases.

Case 1: Country C does not manipulate its exchange Rate

Case 2: Country C manipulates Exchange rate by buying Dollars which undervalues its currency and overvalues Currency of Country A.

Case 1:

Both countries B and C export 100 Garments to Country A and Country A exports 200 Toys each to Countries B and C.

Thus, cost of Garments for Country B and C is 10 Dollars each or 1000X and 1000Y as per their home currencies. Cost of Toy would be 5 dollar for Country A.

Now, Trade Account = Exports – Imports

For, Country A = 5 * (200 + 200) – 10*(100+ 100) = 0 Dollars

Country B = 10 * (100) – 5 *(200) = 0 Dollars

Country C = 10 * (100) – 5 *(200) = 0 Dollars

Thus, the Trade Account of all the Countries is equal to Zero.

Case 2:

Now, in this case Country B maintains a market based exchange rate whereas Country C undervalues its currency by using exchange rate manipulation.

Thus, by using purchasing power parity principle the cost of garment in Country B will cost 10 dollars whereas the same would cost 10/1. 25 = 8 Dollars in Country C. Also, the Export price of Toy from country A to Country B would still be 5 dollars whereas the Export Price from country A to Country C would now increase to 5*(1. 25) = 6. 25 dollars.

In this case, Country A benefits from importing garments from Country C rather than Country B as it has become cheaper by 10-8 = 2 dollars and thus it stops buying from country B all together. Also, this will affect the export of country A to country C as the same Toy which was costing 5 dollar earlier now costs 6. 25 dollar.

Assuming that country A stops importing garments from Country B and instead imports the full quantity from Country C. Similarly, Country C stops importing Toys from Country A and develops its own industry to produce Toys. Thus, the trade equation changes as

Now, Trade Account = Exports – Imports

For, Country A = 5 * (200) – 8*(200) = -600 Dollars

Country B = 0 – 5 *(200) = -1000 Dollars

Country C = 8 * (200) – 0 = 1600 Dollars

Thus, we see that due to the manipulated exchange rates Country A and Country B have run into Trade account deficits whereas Country A has a trade account Surplus.

Also, if we see that Country C has got an unfair advantage over a country B even when both the countries are similar in economy and development stage. Also, this is a case of subsidizing because clearly due to financial assistance granted by the government through exchange rate manipulation the exports are getting benefitted.

If we look at the Trade relations between US and China it is obvious that the exports of China to US have increased over the Years and the exports of US to China have declined. This has caused huge Current account deficit to US over the years. This has further resulted in loss of employment in the manufacturing sector as shown by our hypothetical scenario where the exports of Toys fall down due to change in exchange rates. What this also does is that currency manipulation makes it easier for American manufacturing Firms to open factories in China which is kind of an artificial subsidy and also an explanation for the increasing Trade imbalance in case of US-China.

It has been estimated that China's currency Renminbi is 20% to 40% undervalued and the trade deficit of US due to the Currency manipulation has runs into 100s of Billions of dollars every year.

Recommendations: WTO and IMF

As seen in this report, it is clear that China manipulates its Exchange rate by pegging it against the US Dollar and gains an unfair competitive advantage in trade. But no case can be clearly formed against China as Exchange rate is not per se questionable under IMF regulations and WTO doesn't have enough measures.

Presently IMF can only exercise firm surveillance over a country but it cannot compel a country to change its exchange rate. Nor can it order commercial foreign exchange dealers to change prices of trading currencies. It can only advice and discuss it with member countries and provide an open forum where other countries can urge a country to change its exchange rate procedures. But still the authority to make the change lies with the country alone. Thus, on a whole IMF cannot force a country to change its exchange rate policy.

The WTO does not have enough measure to control situations arising out of exchange rate manipulation. It is also often debatable whether currency disputes fall under the purview of WTO or not. Most analysts agree that undervalued currency lower's a firms cost of production relative to world prices and therefore encourage world prices. However, this currency undervaluation cannot be defined as export subsidy under the WTO rules and conditions for subsidy as seen earlier. When the IMF's rules were

changed in 1978, so that it no longer governed world exchange rates, the GATT rules were not adjusted to reflect the changes in International Finance. Thus, WTO has adopted the GATT rules without any fundamen