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Currency Manipulation: The IMF and WTO

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Summary

The International Monetary Fund (IMF) and World Trade Organization (WTO) approach the issue of "currency manipulation" differently. The IMF Articles of Agreement prohibit countries from manipulating their currency for the purpose of gaining unfair trade advantage, but the IMF cannot force a country to change its exchange rate policies. The WTO has rules against subsidies, but these are very narrow and specific and do not seem to encompass currency manipulation. Several options might be considered for addressing this matter in the future, if policymakers deem this a wise course of action. This report will be updated as conditions require.

This report describes how the International Monetary Fund (IMF) and World Trade Organization (WTO) deal with the issue of currency manipulation. It also discusses apparent discrepancies in their charters and ways those differences might be addressed.

International Monetary Fund

The IMF is the leading international organization in the area of monetary policy. With the end of the cold war, its membership is now nearly universal. Only North Korea, the Vatican, and four other mini-countries in Europe — none having its own currency — are not members of the Fund. The IMF makes loans to countries undergoing financial or balance of payments crises, it provides technical assistance to governments on monetary, banking and exchange rate questions, it does research and analysis on monetary and economic issues, and it provides a forum where countries can discuss international finance issues and seek common ground on which they can address common problems.

Although the IMF is a monetary institution, the promotion of world growth and balanced international trade are also among its basic goals. 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, the IMF supervised a fixed parity exchange rate system, in which the value of all currencies was defined in terms of the U.S. dollar and the dollar was defined in terms of a set quantity of gold. Countries could not change their exchange rates from the level recognized by the IMF by more than 10% without the Fund's consent. Moreover, said the original language of the IMF Articles, "A member shall not propose a change in the par value of its currency except to correct fundamental disequilibrium."[1] This system broke down in 1971 when the United States devalued the dollar twice without any consultation with the IMF. After a period of turmoil in world currency markets, an amendment to the IMF Articles was adopted in 1978. It said that countries could use whatever exchange rate system they wished — fixed or floating — so long as they followed certain guidelines and they did not use gold as the basis for their currencies.

The new language of Article IV, which went into effect in 1978, said that countries should seek, in their foreign exchange and monetary policies, to promote orderly economic growth and financial stability and they should avoid manipulation of exchange rates or the international monetary system *to prevent effective balance of payments adjustment or to gain unfair competitive advantage over other members.* Some countries claim that their exchange rate policies are not in violation of Article IV because they are not seeking to gain competitive advantage (though this may be the result of their actions) but rather *to stabilize the value of their currency in order to prevent disruption to their domestic economic system.* To date, the IMF has not publicly challenged this statement of their objective.

The Fund was required to "exercise firm surveillance over the exchange rate policies of all members and [to] adopt specific principles for the guidance of all members with respect to those policies." The IMF adopted the requisite standards in 1977 (before the Amendment went into effect) and it updated them in 2007. The 1977 agreement said that, among other things, "protracted large-scale intervention in one direction in exchange markets" might be evidence that a country was inappropriately manipulating the value of its currency. The 2007 agreement added a requirement that "A member should avoid exchange rate policies that result in external instability." When a country's current account (balance of payments) is not in equilibrium, the IMF said in its explanation of the new provision, the exchange rate is "fundamentally misaligned" and should be corrected.[2]

The IMF can exercise "firm surveillance" but it cannot compel a country to change its exchange rate. Nor can it order commercial foreign exchange dealers to change the prices at which they trade currencies. It can offer economic advice and discuss how changes in countries' exchange rates might be in their own interest. It can also provide a forum, such as its new multilateral consultation mechanism or discussion on the IMF executive board, where other countries can urge a country to change its exchange rate

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[1] This language is quoted from Section 5 of the original language of Article IV as approved by the 1944 Bretton Woods conference and confirmed by all member countries when the IMF officially came into existence in 1946.

[2] IMF. *IMF Surveillance — the 2007 Decision on Bilateral Surveillance.* Factsheet, June 2007.

procedures. However, in the end, the authority to make the change resides with the country alone.

World Trade Organization

The WTO is the central organization in the world trade system. When the WTO was created in 1995, countries were required to accept as a condition of WTO membership the existing trade rules embodied in the General Agreement on Tariffs and Trade (GATT). They also had to accept new rules governing other areas of international commerce, such as services and trade-related international property rights. The agreement establishing the WTO says that the members recognize "that their relations in the field of trade and economic endeavor should be conducted with a view to raising standards of living, ensuring full employment and a steady growing volume of real income and effective demand, and expanding the production of and trade in goods and services" and to do this in a manner "consistent with their respective needs and concerns at different levels of economic development."[3]

Unique among the major international trade and finance organizations, the WTO has a mechanism for enforcing its rules. If a country believes another country has violated WTO rules, to its detriment, it may request the appointment of a dispute settlement panel to hear its complaint. The other country cannot veto the establishment of a panel or adoption of a WTO decision by WTO members. The panel reviews the arguments in the case and renders judgment based on the facts and WTO rules. If the losing party does not comply with the ruling within a reasonable period of time, the WTO may, if requested by the complaining party, authorize it to impose retaliatory measures (usually increased customs duties) against the offending country or to take other appropriate retaliatory measures against that country's trade.

Whether currency disputes fall under the WTO's jurisdiction is a debatable issue. The WTO rules specify that countries may not provide subsidies to help promote their national exports. Most analysts agree that an undervalued currency lowers a firm's cost of production relative to world prices and therefore helps to encourage exports. It is questionable, however, where currency undervaluation is an export subsidy under the WTO's current definition of the term.[4]

The term "subsidy" has a precise definition in the WTO. It requires that there must be a financial contribution by a government to the exporter or some other form of income or price support. Government financial support can take a variety of forms, such as direct payments to the exporter, the waiver of tax payments or special government purchases or the provision of low-cost goods or services (other than general infrastructure) that lowers the cost of production. Currency manipulation would not appear to qualify under the WTO definitions.

In addition, an export subsidy is a subsidy that is "contingent on export performance." In the case of an undervalued currency, everyone who exchanges money

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[3] *Agreement Establishing the World Trade Organization*, 1995, preamble.

[4] *Agreement on Subsidies and Countervailing Measures*, Articles 1 to 3.

will be affected by the current exchange rate no matter whether they are buying or selling and no matter whether or not they are involved in international trade. While subsidies must be "specific to an industry" to be actionable in the WTO, a prohibited subsidy, such as an export subsidy, is considered to be specific *per se*.

Until the world financial system frayed in the 1970s, the IMF exercised strict control over exchange rates. It was inconceivable that a country could persistently value its currency at a level below that approved by the IMF. 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 new reality of international finance. When the WTO was created in 1995, it adopted the existing GATT rules as its own without fundamental change.

Policy Options in the Multilateral Sphere

A number of countries have been suspected or accused in recent years of manipulating the value of their currency for the purpose of gaining unfair trade advantage. As noted before, the IMF Articles of Agreement prohibit this sort of behavior, but the Fund has no capacity to enforce that prohibition. By contrast, the WTO has the capacity to adjudicate trade disputes, but to date it has done nothing to suggest that trade issues linked to currency manipulation are within its zone of responsibility. If policymakers want to address this situation, several options might be considered.

Amend the Articles of the IMF. One option might be changes in the IMF's Articles of Agreement that would give the Fund more authority over international exchange rates and more authority to require that countries comply with its rules. This would restore, to some degree, the power the IMF exercised over exchange rates from 1946 to 1971. Two objections might be raised, however.

First, an 85% majority vote of the IMF member countries is necessary if any change in the IMF Articles is to become effective. Most countries seem to believe that the present system of floating and fixed exchange rates is working reasonably well and there seems to be little desire, on the part of the members, to amend the IMF's current rules.

Second, few countries want the IMF to have the kinds of power over their economies that it would need to compel violators comply with its rules. For example, if the IMF had the power to declare that China's currency was undervalued and to require adjustments, it would also have the power to declare the U.S. dollar or the Euro were overvalued and to require the United States or the Euro zone countries to make changes in their domestic policies in ways that would correct the situation.

Amend the WTO Agreements. Another possibility might be a formal change in the WTO agreements that would define currency manipulation as a prohibited form of export subsidy. It is not be easy to amend WTO agreements, however, since the process basically requires the unanimous consent of all Members. Countries that manipulate their currencies could easily block the approval of the amendment. However, they would have to argue that currency manipulation is an acceptable trade practice notwithstanding the language of the IMF's Article IV. It seems more likely that any such change in the WTO rules will be the result of discussions during multilateral trade negotiations, in which restrictions on currency manipulation will be balanced by other changes desired by the countries that believe currency manipulation is an acceptable trade practice.

Seek Adjudication. Alternatively, the United States might consider taking its complaint against countries that manipulate their currency to a formal WTO dispute settlement panel. While in the past, currency issues have not been seen as being encompassed by the WTO dispute settlement process, the United States could argue that changed conditions in the world economy now require adjudication of such disputes.

Article XV of the GATT agreement says that, when disputes between signatory countries involve questions about balances of payments, foreign exchange reserves or exchange arrangements, GATT countries shall "consult fully with the International Monetary Fund" and shall accept the IMF's determination as to matters of fact and as to whether a country's exchange arrangements are consistent its obligations under the IMF Articles of Agreement. GATT Article XV also says that countries "shall not, by exchange action, frustrate the provisions of this agreement nor, by trade action, the intent of the provisions" of the IMF Articles of Agreement.

Traditionally, these references to exchange arrangements have been seen as referring (as they did when the GATT was created in 1947) to currency controls, exchange licenses, transaction taxes and other official actions that limit a potential purchaser's ability to get the foreign exchange needed to purchase goods from abroad.[5] The GATT allows countries to impose temporary import restrictions when they face balance of payments difficulties (Article XII) or when they are at risk for a serious decline in their foreign exchange reserves (Article XVIII).

In recent decades, however, the term "exchange arrangements" has expanded to reflect new developments in the world economy. The language of Article IV, adopted by the IMF in 1978, says (section 2) that each member country shall notify the IMF of the exchange arrangements it intends to apply, in other words, whether its currency will float in value or be pegged to another currency. It says the IMF shall oversee the international monetary system to ensure that each country's exchange arrangements are compatible with its obligations under Article IV. IMF Article IV also says that, in its oversight of countries' exchange arrangements, the Fund shall exercise firm surveillance over the exchange rate policies of its member countries. In effect, a case can be made that the term "exchange arrangements" arguably has become synonymous with the concept "exchange rate regime" and "exchange rate policies."

As it is used in GATT Article XV, the term "exchange arrangement" refers to issues that are the sole province of the IMF. Thus, one could argue that the meaning of the term in the GATT should reflect its current meaning at the IMF and not the meaning prevalent in 1947. An undervalued currency encourages exports by reducing their cost and it discourages imports by making them more expensive than they might be otherwise. Consequently, one might argue that countries with this type of exchange arrangement are engaging in "exchange action" that may have the effect of frustrating "the provisions of the [GATT] agreement."

There has never been a definitive ruling by the GATT or WTO on the meaning of Article XV, including how provisions of the GATT agreement might be frustrated by

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[5] See, for example, John H. Jackson, *World Trade and the Law of GATT*. New York: The Bobbs-Merrill Company, 1969, pp. 479-495. .

exchange action. Some might argue that currency undervaluation raises the price of imports in a way that unilaterally rescinds tariff concessions approved during multilateral trade talks.

Accordingly, a case could be made that the WTO should use the broader meaning of the term "exchange arrangements" and take currency valuation arrangements into account in its dispute settlement process. There has also been increased interest, in recent years, in the issue of currency manipulation and its impact on world trade and financial relationships. It could be argued, therefore, that this might be an appropriate and perhaps auspicious moment for issues relating to the trade impact of currency manipulation to be raised in the WTO dispute adjudication process.

Improve the IMF-WTO Agreement. Another option is to strengthen the current interagency agreement between the WTO and the IMF. The present agreement was signed in 1996 and updated in mid-2006. Among other things, it says (paragraph 1) that the two organizations "shall cooperate in the discharge of their respective mandates."[6] It says (paragraph 2) the two agencies "shall consult with each other with a view to achieving greater coherence in global economic policymaking." It also says (paragraph 8) that the two agencies shall communicate with each other about "matters of mutual interest."

Article XV of the GATT agreement says that the GATT (now WTO) shall cooperate with the IMF in order to "pursue a coordinated policy with regards to exchange questions that are within the jurisdiction of the Fund." It is unreasonable to expect that the WTO should be expected to enforce the rules of the IMF. Nevertheless, one might expect that conversations about the ways the activities of one organization might be hindering the other "in the discharge of" its assigned duties could transpire. Their different policies towards the question of exchange rate manipulation do not seem to encourage "greater coherence in global economic policymaking."

Changes in the existing inter-agency agreement can be effected by a majority vote in each institution. No such agreement can change their basic rules. However, it might provide that their disparate treatment of currency manipulation is inconsistent with their promise to "cooperate in the discharge of their respective mandates" and to promote "greater coherence in global economic policymaking." The IMF and WTO could also work with each other to identify and mitigate situations where their rules and procedures were not consistent or not mutually supportive and areas where changes in policy or institutional arrangements might be recommended to their member countries.

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[6] *Agreement Between the International Monetary Fund and the World Trade Organization*, updated June 30, 2006.