The absence of currency-related trade policies in the World Trade Organization (WTO) and its future inclusion

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Abstract

It is unanimously agreed that currency policies of the countries, particularly their exchange-rate values, have a significant impact on trade as it alters exports and imports between one country and its trading partners. In spite of this, the rules of currency seem to be absent in World Trade Organization (WTO) framework.

The main purpose of this paper is to analyse the reasoning why such important rules are missing out in the multilateral trade sphere. It is divided into few sections; the first one examines currency manipulation and the significance of it for international trade, the second one analyses the existence of institutional gap between WTO and International Monetary Fund (IMF) in addressing the problem of currency manipulation, the third explains the reinforcement of status quo at multilateral sphere based on neorealism framework, and the last one will provide some insight on the possibility of inclusion of currency chapter at free-trade agreement level.

Introduction

Following the recovery of global financial crisis, many countries have resorted to use currency-related trade measures to gain competitiveness for their products and subsequently boost their exports and economic growth. China, with its boosted exports, is regarded as the most prominent currency manipulator, which mostly hurt US markets. Mattoo and Subramanian (2008) depicted that China's exchange rate undervaluation is ranging from 20-60% during the period 2000-07, indicating a manipulation of a great extent. Globally, currency manipulation is argued to have distorted capital flows by US$1.5 trillion every year (Gagnon 2012).

According to standard economic theory, it is undeniable that currency manipulation significantly affects trade among nations, both directly and indirectly. A question then arises on why the rules on currency-related trade policies are absent in World Trade Organization (WTO) framework. It is such an irony given WTO has extensive rules on property rights and foreign investment which only have indirect effects to trade. Furthermore, even inconclusive Doha Round focuses more on agriculture and does not have a tendency to focus on currency-related trade measures.

This paper attempts to analyse the underlying reasons why currency policies are absent in WTO framework and contends that the main reason is due to institutional discrepancies between WTO and International Monetary Fund (IMF). There is reason to believe that the future inclusion of currency chapter in WTO will remain unlikely. Nonetheless, there is possibility of rules of currencies to be included in free-trade agreements, on the condition that gains from trading without currency manipulation are greater than gains from trading with manipulation.

This essay first looks at the mechanism on why the countries resort to currency manipulation and how such policies affect international trade. It then explains the exclusion of currency-related trade measures in WTO. The last discussion explores the reinforcement of status quo with regard to currency rules in WTO as well as the possibility of inclusion in trade agreements based on neo-realism framework on international governance.

Currency Manipulation and Free-Trade

According to Gagnon (2012), currency manipulation happens when a government "buys or sells foreign currency to push the exchange rate of its currency away from its equilibrium value or to prevent the exchange rate from moving toward its equilibrium value." By this definition, government manipulates currency for not only boosting exports, but also other purposes such as stabilising exchange rates or managing inflation.

Laffer (2014) illustrated how currency devaluation will not only affect export but also employment in domestic economy. First, continued depreciation of real exchange rate will increase country's producers' competitiveness at international scale thereby boosting their exports. The producers will then use this revenue to diversify their goods and invest in large-scale production. At the same time, currency devaluation will cause domestic consumers to import less foreign goods, as they are now relatively expensive and in turn, they resort to local products. Increased demand for local products means that domestic employment will rise. In contrast, other things equal, employment level in its trading partners will fall. Thus, currency devaluation is regarded as beggar-thy-neighbour policies (i.e. gain by one country and loss for its trading partners). Nonetheless, this is politically appealing at national level, but at international level, concern will arise as countries would not want to be in the 'losers' position.

With reference to trade policies, since currency manipulation makes price of country's exports lower and price of its imports higher, it is equal to simultaneous export subsidy and import tariff, therefore it is the most protectionist policy in direct means (Bergsten 2014; Waibel 2010; Mattoo and Subramanian 2008). Nonetheless, other things equal, it does not affect global trade volume as it only distorts trade from one country to another. That is why somehow currency policies have been missing out from the trade discussion (Bergsten 2014).

Hypothetically, countries with export-led growth strategy (i.e. rely heavily on exports) view depreciation of their currencies as a good thing, thus there is a possibility that they will manipulate their exchange rate to a certain degree. This hypothesis is confirmed by Gagnon (2012) finding, which identified extreme currency manipulators over the past decade. It is found that currency manipulators are quite diverse in terms of their level of economic development. However, there are four groups of countries in general, which shares characteristics of great reliance on exports (1) advanced economies such as Japan; (2) newly industrialised countries such as Israel, Singapore, and Taiwan; (3) emerging Asian economies such as China, Malaysia, and Thailand; and (4) oil export-countries such as Algeria, Russia, and Saudi Arabia. Asian economies dominate the positions as currency manipulators; the plausible reason is that exporters in these countries are politically powerful in lobbying to resort for competitive devaluation, also, maintaining current account surplus is seen as ‘convenient way’ to maintain steady growth (Gagnon 2012). If all currency manipulation is valued at US dollars, the extent of impact for such manipulation is that US current account would have been pushed down by 4% of its GDP (Gagnon 2012); indicating a huge impacts for global trade and economy.

There is almost unanimous agreement that China is regarded as the greatest currency manipulator and its currency manipulation hurts not only advanced economies, particularly US, but also its Asian export-rivals. It has been studied extensively and the findings in 2009-2010 seemed to report that China has undervalued its currency by as high as 50% of its original rate with respect to US dollar (Throstensen, Marçal and Ferraz 2011). Throstensen et. al. (2011) shows the significance of this undervaluation in the form of tariffication (i.e. measuring impacts of changes in exchange rates in tariffs). The table below shows that for 20% devaluation, China bound and applied average tariffs increase dramatically, which can be regarded as increased tariff for imported products.

Tariffs	**China**
Simple average bound rates (2009)	10%
Adjusted simple average bound rates	32%
Simple average MFN applied rates (2009)	9.6%
Adjusted simple average MFN applied rates	31.5%
Trade weighted average applied rates (2008)	4.3%
Adjusted trade weighted average applied rates	25.2%

Source: Tariff Profile WTO. Elaborated by CGTI cited in Throstensen et al (2011)

As serious as it is, why currency rules remain absent in WTO framework? The following discussion will highlight how complex organisational capacities of WTO and IMF would undermine such enforcement.

Currency Manipulation: Whose Roles, WTO or IMF?

The simple answer to above question would be "both or none", depending on the perspective of looking at the extent of responsibility, either taken as partially or wholly. As have been mentioned earlier, currency manipulation is not merely for boosting exports, but also for various reasons, thus if the currency rules are put in WTO, it will overload the scope of WTO. In this case, at present WTO does not have mandate to justify any currency manipulation though it has potential capacity to enforce such rules as its dispute settlement mechanism (DSM) functions very well when it comes to punishment and retaliation from such practices. On the other hand, IMF, as a monetary institution, has been given explicit mandate to oversee exchange rate policies of its member states; nonetheless, it lacks capacity to enforce if any country is proven to manipulate their currency. This discrepancy is argued to be one of the reasons why currency manipulation proliferated over the years.

The reason why this is the case could be traced back to the history of establishment of international organisations during the Bretton Woods system. The Bretton Woods system, created in 1944 originally consists of three organisations, IMF –dealt with monetary practices, the Bank for International Reconstruction and Development, later expanded to the World Bank –managed post-war reconstruction, and ITO –was intended to deal with international trade, but later replaced by GATT (General Agreement on Tariffs and Trade) 1947 which become the basis of establishment of WTO in 1995.

IMF, a monetary institution, has a mandate to regulate international financial system to become stable. It is argued that in the 1930s following the Great Depression, countries had resorted to currency devaluation to gain competitiveness for the purpose of stimulating exports (Thorstensen, Muller and Ramos 2015). It is arguably true that principle of monetary sovereignty holds; which assumes that monetary policies remain in the hand of the national government, nonetheless as this will create global instability, countries decided to give in part of their monetary authority since they were afraid to losing out from other countries devaluation. During the Bretton Woods system (1946-71), IMF has mandate to supervise fixed parity exchange rate system, i.e. value of a currency was defined in terms of US dollar and US dollar was defined in terms of gold; this fixed exchange rate could not be changed by more than 10% without IMF's consent (Sanford 2011).

IMF, despite its monetary focus, has other basic goals which include the promotion of world growth and balanced international trade. It also says explicitly in its articles with regard to currency manipulation that affects international trade, in article IV(1)(iii) it says: "…Each member shall 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."

IMF article IV(3) also indicates Fund's mandate to oversee exchange rate of the member states:

a) "The Fund shall oversee the international monetary system in order to ensure its effective operation, and shall oversee the compliance of each member with its obligations under Section 1 of this Article.

(b)…The Fund shall 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…"

It is explicit from the above article that currency-related trade policies are the mandate of IMF, nonetheless, although IMF can "exercise firm surveillance", it cannot force the country to change its exchange rate as the countries can get away and claim that their exchange rate policies are not in violation of article IV, but only to stabilise their domestic economy (Sanford 2011), which can be translated indirectly as confirming IMF basic goal i.e. promotion of world growth. Eventually, it lacks capacity for such punishment and can only provide a space for multilateral consultation among its member states where other member states urged currency manipulators to compel to article IV; yet, in the end, monetary authority remains in the hand of the country alone (Sanford 2011).

GATT was drafted when Bretton Woods system operates and while IMF mandate to oversee the fixed exchange rate regime was in force. As such, currency manipulation would not be a major concern of GATT, thus, only few GATT articles dealt with exchange rates and trade, mainly article XV.

Article XV(4): Contracting parties shall not, by exchange action, frustrate the intent of the provisions of this Agreement, nor, by trade action, the intent of the provisions of the Articles of Agreement of the International Monetary Fund.

Yet, there has been no example in WTO of the application of article XV(4) as when a member states questions another member's exchange rate policies, it would be a time-consuming process and demands establishment for panel for its conclusion (Thorstensen et al 2011). Moreover, Denters (2003) argued that the problem with GATT article XV lies in what is considered as 'exchange action'. The IMF Article of Agreement stipulated that exchange action differs from exchange-rate policies. Exchange actions or exchange policies according to IMF are defined as the obligation of IMF members not to restrict exchange of local currency into other members' currencies. He quoted for the China case, it means that Chinese importers have the right to exchange Chinese yuan for other currencies required to purchase such goods. In this case, currency manipulation is not included as a part of exchange action, but rather exchange-rate policies. As such, WTO remains silent in currency manipulation in affecting international trade.

Then, what about WTO rules on subsidy and tariff, as currency manipulation would mean a double-edged protection, a tariff and subsidy at the same time. Article II(6) mentioned that tariff should be expressed in the appropriate currency value, but it does not extend beyond currency manipulation.

Article II(6): Each contracting party shall accord to the commerce of the other contracting parties treatment …*a*) The specific duties and charges…maintained by such contracting parties, are expressed in the appropriate currency at the par value accepted or provisionally recognized by the Fund at the date of this Agreement…

In the realm of subsidy, most economists would agree that currency undervaluation operates in the same mechanism as subsidy as it means lower costs of local production relative to world prices thereby stimulate exports (Sanford 2011). Nonetheless, the rules of subsidy in WTO do not regard currency manipulation as a form of subsidy. The term subsidy in WTO definitions only contains (i) a financial contribution (ii) by a government or any public body within the territory of a Member (iii) which confers a benefit.

Based on the above articles, it can be inferred that WTO does not have clear mandate in overseeing countries' currency policies, though they significantly affect trade. It has appeared that all articles seem to reiterate the role of IMF to deal with such matter i.e. demanding WTO consultation with IMF. This is why currency-relate trade policies will remain absent in WTO, as raising this issue inside WTO would signify an "infringement of the concerted code of silence" (Throstensen et al 2011). GATT article XV(2) mentioned the need of IMF consultation explicitly: "In all cases in which the CONTRACTING PARTIES are called upon to consider or deal with problems concerning monetary reserves, balances of payments or foreign exchange arrangements, they shall consult fully with the International Monetary Fund. In such consultations, the CONTRACTING PARTIES shall accept all findings of statistical and other facts presented by the Fund…"

The problem then arises on how IMF decides on the matter of currency manipulation. First, it does not have enforcement mechanism which means country will be able to get away from such infringement and second, it decides the issue in a political way through an agreement amongst the most influential parties, unlike WTO which decides by consensus (Throstensen et al 2011). It then may create a potential bias in favour of those who have more voting power. In China's currency manipulation case for instance, IMF reluctance to intervene in China currency policies, though it is really apparent that China manipulated its currency, is a proximate manifestation of "leverage and legitimacy" (Mattoo and Subramanian 2008). IMF would not be legitimate and influential without a leverage of financing; thus IMF has not been successful to change domestic policies of its large creditor countries as it means that it will potentially lose significant amount of financing from these countries. In this case, China has become one of major creditor for IMF, thus there is a tendency that the Fund become "soft" to China (Mattoo and Subramanian 2008).

<u>Reinforcement of status quo?</u>

This section will explore on the possibility of reinforcement of status quo regarding currency-related trade policies. As have been discussed earlier, complex institutional constraints between WTO and IMF would let currency manipulators slip in easily to manipulate their currencies, which ultimately hurt their trading partners. The following discussion will rely on neorealism framework to analyse power relations between member states in WTO and IMF and determine that the possibility of inclusion of currency chapter in WTO will remain unlikely so does the possibility of constructing enforcement mechanism in IMF.

Neoliberals, the opposite of neorealists, view that international institution has an ultimate power over its member states, while neorealists tend to view that its member states' powers determine how the institution operates. According to Keohane (1990 as cited in Steinberg 1995), neoliberals tend to believe that institution offers positive-sum outcome to its member states by reducing transaction costs and minimising uncertainty which would otherwise hinder international cooperation. In this case, all member states will gain by integrating themselves to such institution. In contrast, neorealists show that "the greatest power-fights about international institutions are not solving market failures, but about distributional consequences of particular institutional structure or law" (Steinberg 1995). Neorealists also view that international institution is seen as "brutal arena" where its member states tend to look for possibility of taking advantage of each other and also have minimal tendency to trust each other (Mearsheimer 1995).

Based on the above theories, this paper believe that neorealist framework will better fit the explanation on how power relations in IMF and WTO operates, where decision-making processes reflect power fights between member states to maintain their national interests. In the case of currency-related trade policies, there has been push from academia, as well as diplomats and trade lawyers and about the danger of currency manipulation. There are three alternatives being proposed (1) inclusion of currency chapter in WTO (2) setting up strong enforcement mechanism in IMF (3) strengthening the coordination between WTO and IMF. Nonetheless, none of these will be likely to be realised if we examine the voting power in WTO and IMF according to neorealism framework.

First alternative, the inclusion of currency chapter in WTO will demand its member states to agree upon such issue. Nonetheless, the consensus-based decision making of WTO, where all member have to agree on certain issues, will inhibit such inclusion as currency manipulators will be more likely to object such inclusion. This confirms neorealists view on how member states will look for opportunities to take advantage over each other through beggar-thy-neighbour policies, which in this case is currency manipulation. Second option, an attempt to build strong enforcement capacity for IMF will likely produce the same result, though it does not require a consensus, it will still require 85% of voting power depending on members' contribution toward the Fund. Considering Gagnon (2012) research on extreme manipulators, this paper has simulated the likely result for such proposal. Assuming all extreme manipulators object for such amendment, they will take up almost 24%[1] of IMF voting power, which eventually cancel out such proposal to take place. The last alternative will be much more complex as coordination requires consultation from both organisations. Thus such coordination demands voting from both institutions, and assuming currency manipulators would object, it will likely operate in the same mechanism like the other two alternatives. Bergsten (2014) argued that IMF and WTO have frequently discussed for better coordination and set up mechanisms to promote, but it only has minimal effect. For instance, IMF staff vetoed for "inclusion of currency considerations in China's protocol of accession to the WTO on the grounds that such a provision was within the jurisdiction of IMF rather than WTO" (Bergsten 2014).

Where to address currency manipulation?

Considering that the status quo in both WTO and IMF is likely to remain, the question is how to address the problem with currency manipulation which distorts global trade? This will require cooperation among the nations to agree on such deal. This could be framed within neorealists' argument on cooperation. Mearsheimer (1995) argued that though realist world is competitive in nature, certain level of cooperation between states is possible although it is difficult to achieve and sustain; it depends on two factors, relative-gains considerations and concern about cheating.

[1] As per 2011 see https://www.imf.org/external/np/sec/memdir/members.aspx

As multilateral governance fails to provide such possibility of inclusion, an alternative has to be in the form of free-trade agreements among nations. One plausible example would be The Trans-Pacific Partnership (TPP) as it is beyond the coverage of IMF and WTO. Currently, there are twelve countries participating in such negotiations; United States, Australia, New Zealand, Singapore, Japan, Malaysia, Brunei, Canada, Mexico, Chile, Peru and Vietnam. With regard to possibility of inclusion of currency chapter in TPP, opinions are divided into two; those who are sceptical and those who are optimistic for such inclusion.

When the paper analyses this possibility based on the afore-mentioned two factors, relative gains considerations for such inclusion will ultimately be dependent on the bargaining between gaining market access from such agreements in the absence of currency manipulation vs. gains from manipulating currency considering others will manipulate their currencies as well. If the participants see that gains without currency manipulation will be greater, they will likely to accept for such currency chapter inclusion. The second factor, concern about cheating, will be solved by formulating a mechanism for severe penalty (i.e. termination or membership and retaliation by other countries). Building this mechanism will relatively be less complex in such free-trade agreement than in the multilateral sphere (i.e. WTO or IMF).

The sceptical argument comes from Bernstein (2015) which frankly stated that six out of 12 countries participating in the deal are currency manipulators. Thus, they will most likely object such inclusion. Vinik (2015) also argued that even the US will object for such inclusion as he expressed that “Much of the world thinks that the Federal Reserve manipulated the dollar through its quantitative easing programs, so any chapter on currency manipulation that could possibly receive approval from the 11 other TPP countries would have to put restrictions on the Fed—something the Obama administration would never agree to…”

Nonetheless, this paper argued that there is some possibility of currency chapter in TPP deal. Adapting to neorealist framework, cooperation will be possible; if the gain from having a trade deal without any currency manipulation is greater than with the proliferation of currency manipulation, the member states will likely approve for such inclusion, regardless of their “currency manipulator” status. Johnson (2015) presented the positions of the countries participating in this deal. For instance, advanced economies with floating exchange rates such as

Canada, Australia, and New Zealand, do not encourage currency manipulation. Chile, with its sound macroeconomic policies would not favour currency manipulation. Mexico and Peru have been hurt by currency manipulators. Vietnam is more concerned with deal on labour rights thus will accept other deals without much objection. Brunei, a small economy, is unlikely to object as well. Meanwhile, Japan, Malaysia and Singapore, despite being labelled as currency manipulators, have been hurt by China, thus will much more likely to favour the inclusion of currency chapter (Bergsten 2014). United States, which has been hurt by other countries' currency manipulation, will be likely the first to propose such inclusion. Last but not least, China is not currently participating in the TPP negotiations, thus the possibility of inclusion of currency chapter in TPP will become likely.

Conclusion

This paper has attempted to analyse why currency manipulation have not been addressed by WTO, though it may affect trade in the form of double-protection i.e. tariff for imports and subsidy for exports simultaneously. It is also dangerous for global trade-balance, as it distorts the trade under "effective" exchange-rates and has been classified as one of beggar-thy-neighbour policies.

This paper has argued that complex mechanism on how WTO and IMF operate is the main culprit for such absence of currency rules. Currency policies are ultimately, under the jurisdiction of IMF yet the Fund does not have strong enforcement-mechanism to ensure that the countries will not resort to currency manipulation to boost their exports. On the other hand, WTO, with its well-built dispute settlement mechanism, does not have mandate to oversee countries currency policies and have to resort to consultation with IMF. Ironically, IMF consultation will be biased toward most powerful IMF donors, which China (the greatest currency manipulator) has recently become one.

This paper has explored the future possibility of addressing currency manipulation based on neorealism framework and conclude that any future multilateral negotiation (WTO and/or IMF) on strengthening the enforcement of rules on currency-related trade policies will only produce limited or even no result as decision making processes reflect power bargaining between member states and currency manipulators are much likely to object such insertion. The possibility of currency chapter thus remains at the free-trade agreements level so long as participating countries decide that gain from trading without currency manipulation is greater than with the existence of manipulation and the enforcement mechanism is in place.

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