China's Exchange Rate and What to do About It: Facts are Better than Fallacies

There they go again. In its response to the business community's June 30 letter to the Senate opposing counterproductive trade remedies to address exchange rate undervaluation, the Fair Currency Coalition distorts the facts and ignores economics and international trade law.

Currency Coalition Assertion #1: China's trade surplus proves engagement has failed.

<u>Fact</u>: The assertion that China's trade surplus proves that US policy has failed is based on the flawed assumption that China's exchange rate is a significant driver of the US-China bilateral trade deficit. History shows the fallacy behind this view. The Currency Coalition conveniently ignores the fact that in the three years from 2005 to 2008, China's currency appreciated about 20 percent, largely as a result of engagement. At the same time, the bilateral trade deficit <u>grew</u> during that period. During the past two years of financial crisis and economic recession, China's exchange rate was pegged to the dollar – yet the trade deficit decreased (recessions always reduce the US trade deficit, but we hope the Currency Coalition doesn't also recommend them as a solution). Engagement produced appreciation, but clearly, there are more important factors behind the trade balance than China's exchange rate.

The main factor in the growth of the bilateral trade deficit with China is the shift of America's longstanding trade deficits with other East Asian economies to China, as a result of companies in Japan, South Korea, Taiwan, Hong Kong and other economies moving their export manufacturing to China over the last decade or so. We agree that China's exchange rate should better reflect market influences. It just won't have very much impact on the trade balance.

On the other hand, China has become the US' fastest growing export market and has leapfrogged most other countries in the world to become the US' third-largest export market since it joined the World Trade Organization in 2001. In fact, it's the <u>only</u> US export market that has delivered the 15 percent annual growth required to meet the Obama administration's goal of doubling exports in five years. Representatives of a broad spectrum of US industries, engaged in both importing from <u>and</u> exporting to China, signed the business community letter out of concern over the potential damage to US companies from Currency Coalition-led efforts.

Currency Coalition Assertion #2: Using trade remedies to address exchange rates would not violate World Trade Organization (WTO) rules.

<u>Fact</u>: The Currency Exchange Rate Oversight Reform Act of 2010, supported by the Currency Coalition, violates the WTO's rules governing the proper imposition of both antidumping and countervailing duties.

In the interest of brevity, the business community letter to the Senate did not address these details, since they have been explained before and are obvious to those who know the rules.

With respect to antidumping, the WTO Agreement on Implementation of Article VI of the GATT (WTO AD Agreement) prescribes one very clear methodology for dealing with exchange rates, which the United States already uses in its antidumping remedies. This is not the methodology in the proposed bill, and no other language of the WTO AD Agreement provides support for allowing the proposed bill's approach. In the case of a non-market economy (NME) country like China, the application of the proposed bill's provision would also overcompensate for any

currency misalignment, since the NME normal value calculation uses third-country data – not China's prices or costs – and thus already captures exchange rate factors (see below).

With regard to CVDs, the WTO Agreement on Subsidies and Countervailing Measures requires that a subsidy provide a "benefit" and involve a "financial contribution" from the government to a "specific" firm or industry. Since an exchange rate applies to all companies in a country's economy, the application of CVDs for this purpose would diverge with the specificity requirement under WTO rules. Since currency policy does not involve the transfer of anything of tangible value from the government, use of CVDs in this manner would also be contrary to the financial-contribution requirement under WTO rules. Furthermore, currency policy also cannot meet the WTO definition of a prohibited subsidy because its benefit is not contingent on exportation nor does it require the use of domestic goods.

Currency Coalition Assertion #3: Antidumping rules do not remedy currency undervaluation.

Fact: If currency undervaluation makes Chinese exports to the United States artificially cheaper, then the current antidumping remedy process already addresses the issue.

US antidumping rules for nonmarket economies, which are employed in cases involving goods from China, calculate the normal value, not based on any undervalued Chinese costs or prices, but on the value of the costs and prices of that product as if it were produced in a comparable market economy. That comparison between the normal value and the actual delivered US price from the nonmarket economy (which includes any benefit from an undervalued currency) produces the AD margin. The suggestion that the US price needs to be adjusted further by the amount of currency undervaluation would lead to double counting and would certainly be contrary to WTO rules. In a recent legal opinion on this question, the Chief Judge of the US Court of International Trade agreed with this analysis.[1]

Currency Coalition Assertion #4: The International Monetary Fund (IMF) has an accepted methodology for calculating exchange rate valuations.

Fact: The IMF's review of its own exchange rate analysis indicate "widespread dissatisfaction," including wariness of the quantitative techniques used by staff.

In its April 2010 World Economic Outlook, the IMF said that the renminbi is "substantially" undervalued. But the IMF itself acknowledges that they are taking a stab at making any such estimation by calculating the "fundamental equilibrium exchange rate." Moreover, the IMF review of staff reports also found that too often the assessments are presented as a 'black box,' without adequate documentation of underlying assumptions made by staff."[2]

Clearly, the United States should not base duties on a black box methodology that even the IMF agrees can be subject to widely varying assumptions – which is our point. Better to multilaterally engage China to more quickly allow market influences to determine the exchange rate than to allow subjective and politicized guesswork that would arbitrarily raise prices for American households and businesses.

The Currency Exchange Rate Oversight Act is the wrong approach and should be rejected.

---

[1] GPX Int'l Tire Corp. v. United States, 645 F. Supp. 2d 1231 (CIT 2009).

[2] "2008 Triennial Surveillance Review," International Monetary Fund, September 2, 2008, p. 18.