

Conflicting Policies

The Chinese Yuan, the WTO, and the IMF

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On December 11, 2001 China joined the World Trade Organization (WTO).¹ What was once heralded as a diplomatic victory and a time of economic reformation for China² has become a diplomatic incident for other trade giants, one that even the International Monetary Fund (IMF) is trying to defuse.³ The United States Congress has gone so far as to introduce an act that would allow the United States to place duties on goods coming from countries with under-valued currencies.⁴ The question becomes one of how a pegged-currency is a threat to the current liberal trade regime. To understand this problem, one must examine the key principles of the WTO and IMF, the effects that a pegged-currency like China⁵ has upon a country such as the United States and then evaluate whether the principles of the WTO and IMF are undermined by the actions of China.

Before one begins to examine this complex topic there must be an understanding of how China operates its foreign exchange policy. The core principles around a pegged-currency system involve the Central Bank attempting to reconcile monetary and exchange rate policies. In a simplified form, this is done by the Central Bank through selling bonds to reduce its domestic economic footprint when facing “excessive” capital inflows. When “outflows” become excessive the Central Bank will purchase bonds, increasing the domestic element of its monetary base.⁶ It is through these types of measures that the Chinese Central Bank ensures that the yuan maintains its peg to the United States dollar (USD). A particular preference of the Chinese Central Bank is the purchasing of United States Treasury bills, effectively holding the majority of the US national debt until very recently.⁷ To purchase these bills, the Central Government in China must convert yuan

into USD, thereby increasing the amount of yuan in general circulation and decreasing the amount of USD available. This decreases the value of the yuan and increases the value of the USD through the basic laws of supply and demand.

The effect of having a low currency compared to the United States makes China's goods more cost-effective due to relatively low labour costs. This has caused an exodus of labour-intensive industry and jobs from the American economy.⁸ Despite this, the United States cannot complain that China is violating the WTO's rules against dumping⁹ as it is their currency creating this phenomenon, not a wilful act of exporting goods below cost. The implications of this will be discussed below.

Nicholas Lardy points out that China had little reason to revalue its currency prior to 2003.¹⁰ He argues that the current leadership is misguided in its understanding of "China's last macroeconomic cycle" and implies that the leadership within the government should listen to the advice of its Central Bank in allowing greater flexibility to the currency.¹¹ This advice was given in 2005 and could have done much to avoid the current circumstances.

The WTO and IMF

Established in 1995 from the principles of the General Agreement on Trades and Tariffs (GATT)¹², the WTO is the 'regulator' for international trade. It is founded upon the principles of treating other nations equally, treating foreigners and locals equally within ones domestic borders, lowering trade barriers, providing predictability to the system, promoting fair competition, and encouraging economic development and reform.¹³ The key principle to examine in the instance of China's currency would be the principle of promoting fair competition.

The WTO recognizes that trade issues can be complex, but it has a mandate to strive towards its goal of promoting “open, fair, and undistorted competition.” This is generally done with the above principles of non-discrimination, but also through anti-dumping regulations. As described in the introduction, this is not what is occurring within the United States. Instead, the US is being flooded by cheap goods due to a relatively low currency. There are no provisions within WTO regulations to deal with a market flood of this type. This has forced the United States to move towards enacting trade protections that may or may-not be in violation of the WTO’s rules on punitive measures.¹⁴

The other core international institution that has strong influence over trade and finance is the IMF. While the main goal of the IMF is to provide policy advice, research, and loans to member governments,¹⁵ there are key responsibilities outlined for the membership. All members must agree to a series of ‘articles of agreement’ to which they are expected to adhere.¹⁶ It is an examination of Article IV that reveals a reference to the manipulation of the financial markets with the intent of preventing a balance of trade. According to this article, preventing a balance of trade or acting with the intent of gaining an “unfair competitive advantage” is a forbidden practice by member states.¹⁷ This is important when assessing the need for International bodies to act in defense of either China or the United States.

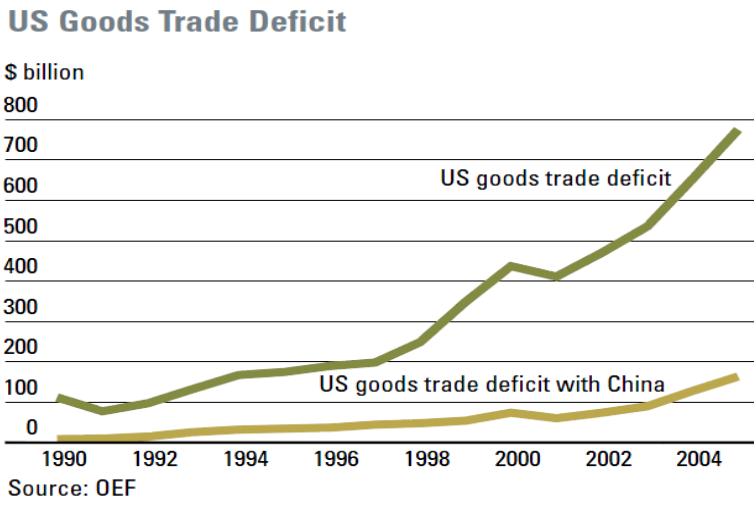
As the cornerstone of the current trade regime, the WTO and IMF often have to work in close conjunction with each other. According to the IMF they regularly consult one another and suggest that this level of coordination will continue to grow, as their interests are common.¹⁸ Despite this level of coordination, scholars rarely seem to research the organizations in conjunction with each other. One scholar will tend to view occurrences within the purview of the WTO¹⁹ or the IMF.²⁰ It is important to recognize the importance of their connected work in the context of

the international trade regime in order to effectively evaluate the outcome of this situation.

Trade Surplus and Currency Valuation

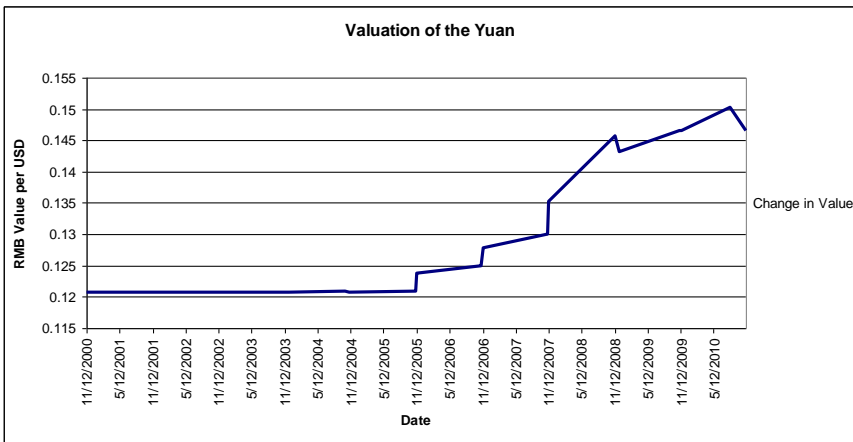
With China's change in market standards in the late 1980's and early 1990's, the doors to their markets began to swing open, inviting further foreign direct investment (FDI). Upon joining the WTO in 2001, China's ability to attract FDI increased, allowing them to export larger quantities of goods to countries such as the United States. As seen in Table 1 below, China's trade surplus was growing steadily with the United States until 2000, when there was a slight drop. However, upon joining the WTO in 2001 one starts to see a sharp increase in the amount of trade surplus being generated by the Chinese state. While the chart shown below only goes until 2004 with an estimated trade surplus of \$160 billion, this figure rose to over \$268 billion in 2008, dipping back down in 2009 with the economic recession.²¹

TABLE 1²²



Upon reviewing the data of the Chinese Yuan compared to the United States Dollar over the past decade since China joined the WTO, a pattern of relatively low valuation emerges when placed in comparison to the trade surplus with the United States. The total value of the Yuan has only risen 0.029474 compared to the United States Dollar since joining the WTO in 2001. Upon inspection China did not allow its dollar to rise in value at all between 2001 and 2005 and it has only been within these past four years that value has been added, however minimal.

TABLE 2²³



When one considers the massive trade surplus from the United States, within the framework of liberal economic theory, China’s Yuan should be valued much higher than it is within the floating market. Various internal pressures, such as low domestic interest rates, would have either pushed the value of the currency up or eliminated the trade surplus. However, this has not occurred under China’s highly regulated financial markets, helping to create the imbalance one sees within the system.²⁴

Assessing the Situation

Having established that China pegs its currency and examined the roles that the IMF and WTO play in regulating trade, it is important to analyze whether China's policy violate any of the rules of international trade, as suggested by countries such as the United States. When creating such a judgment it is important to understand that any change from the status quo would have an impact on both China as a domestic market and on the international system as a whole.

As discussed within the section regarding the WTO and IMF, member states of the IMF are forbidden from manipulating exchange rates for the purpose of gaining an unfair competitive advantage. With the Yuan being undervalued by People's Bank of China (PBC), compared to its assumed market value, China is creating an atmosphere of unfair competitive advantage within the labour and trade market. This is in violation of their agreement as a member of the International Monetary Fund.

Despite this, the IMF has been hesitant to enact a currency accord to work towards adjusting this imbalance.²⁵ This has led world leaders within the G20, such as South Korea, Japan, and the United States, to work towards creating this accord instead. This is not to say that they are undermining the authority of the IMF, as G20 leaders have promised that the accord would include amending some of the organizations functions, boosting its credibility.²⁶

Within the WTO there are no regulations regarding the treatment of exchange rates, however members are required, as a basic principle, to promote fair competition. One must examine the PBC behaviour in this matter and see if it falls within the guidelines of promoting or hindering fair competition. According to Anthony Makin, China's foreign exchange has become something akin to trade protection.²⁷ However, this is not entirely

accurate within the context of the WTO since the organization has no regulations against currency manipulation. A potential violation is the recent currency bill introduced to the United States Congress, which China has threatened to take to the WTO.²⁸ If this were to occur, the United States could conceivably complain to the IMF over China's currency policy, creating two conflicting rulings from the leading bodies within the international trade regime. Regardless, this issue is presenting a destabilizing effect to that regime. In this case it is possible that Western governments would find themselves in a situation where action against China is seen as legitimate, due to their own faltering economies.²⁹ This would not be in China's best interest. To be excluded or punished for their actions within the world markets would invite domestic economic disaster and strained international relations, in a time when the regime is attempting to grow.

The solutions to China's valuation circumstances depend heavily on how quickly and decisively the government chooses to act. Anthony Makin presents the idea that China could alleviate the concerns over the trade surplus through a small currency alignment, as well as increasing public spending on initiatives, such as health and education. Makin implies that these two items would go a long way to correcting the trade-imbalance problem.³⁰ He does emphasize the need for any changes to be made incrementally, due to the weakness of the banking sector.³¹ However, this is not the sole potential solution.

John Williamson from the Institute for International Economics suggests that China should consider, in addition to allowing its currency appreciate, switching to a consumption-based economy. He notes the fact that many Chinese families tend to save a significant portion of their incomes. Encouraging them to spend more, instead of saving more, would help to mitigate the negative implications of a rising value in currency.³² The general consensus amongst economic experts, even from within China, seems to be that the Government of China needs to move towards a

more floating currency or risk a destabilization in its trade relations as other countries, including the United States, begin to diversify.

Williamson's opinion is expanded upon by Nouriel Roubini at the Stern School of Business in New York. He argues that China's reliance upon exports, without building an internal consumer culture, will create larger consequences during economically turbulent times³³. This is particularly true if the current economic crisis continues to extend into the foreseeable future, as Roubini is predicting a second dip to the recession in the near future.³⁴ Another point he argues is that, not only is China placing their economic situation in the hands of the global markets, they are also creating massive losses for themselves financially. As the value of the yuan increases, the value of the foreign bonds already held diminishes. Roubini projects that, from 2006, the Chinese government could experience losses in upwards of \$600 billion on a \$2 trillion bond due to the appreciation of its own currency.³⁵

Conclusion

China's decision to continue to peg its currency rather than letting it float is a significant challenge for the international trade regime. It challenges the articles and conventions of two international organizations, the WTO and IMF, and threatens to create a diplomatically sensitive issue. What the Chinese government needs to recognize is that, not only will unpegging their currency relieve international concerns and tensions, but it is the most financially prudent course of action during the current economic climate; especially given the regime's present goals of continued growth.

A significant number of international economists agree that the Yuan is under-valued and that this is creating a number of issues within the international markets. An eventual correction of the trade imbalances with China will need to be solved and this

will likely occur in conjunction with an appreciated value of the Yuan. The Government of China needs to recognize that working towards bringing their currency into the floating market, along with realigning their economy so as to reduce excessive trade surpluses, is not an act of weakness in caving to Western powers but would serve their government's interests in promoting economic growth within their own borders, in addition to bringing further stability to the international markets. Appreciation of the yuan would also help the Chinese government in weathering the current financial crisis and avoid massive financial losses on its foreign holdings.

It is easy to focus solely on China but the lessons from this situation for the international trade regime should not be overlooked. Although presently two separate international bodies, the IMF and WTO have similar goals when it comes to regulating the fair competition of international trade. When rules and regulations are overlooked or ignored by a body this creates the potential for conflict. Both organizations should consider coming together to examine their articles and regulations in conjunction to ensure they compliment, instead of conflict, with each other. This would serve the purpose of bringing greater stability to the international trade regime.

Notes

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- ² BBC, "China joins the WTO – At last," BBC News, December 11, 2001, <http://news.bbc.co.uk/2/hi/business/1702241.stm>.
- ³ Sewell Chan, "I.M.F. Chief steps into dispute over China's currency policy," The New York Times, October 7, 2010, <http://www.nytimes.com/2010/10/08/business/global/08currency.html>.
- ⁴ Reuters, "US House panel approves China currency bill," Business Standard, September 25, 2010, <http://www.business-standard.com/india/news/us-house-panel-approves-china-currency-bill/409108/>.

- ⁵ China's history of trading with the rest of the world was hindered in the 17th and 18th centuries by the Imperial emperors of the day. At that time China was viewed as having everything and being the superior kingdom to all under Heaven. As such, trade was of no importance to the Empire and often China would receive an item as a tributary gift and in return give a greater gift as a sign of China's own wealth and prosperity. This came into conflict with British trading policy, creating a trade deficit for the British. To correct this imbalance the British introduced opium to China. This eventually led to the Opium Wars and the creation of special economic concessions in pre-revolution China – R. Keith Schoppa, ed. William A. Joseph, *From Empire to People's Republic* in *Politics in China: An Introduction* (New York: Oxford University Press, 2010), 37-41.
- ⁶ Steve Hanke, "Friedman: Float or Fix": *CATO Journal* 28, No. 2 (Spring/Summer 2008), 277-78, online, *Academic Search Elite*, EBSCOhost: University of Victoria Library, Victoria (accessed November 6, 2010).
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- ⁹ 'Dumping' involves the sale of goods within one country at a price that is lower than what they would offer the good within the home country – *Anti-Dumping, subsidies, safeguards: contingencies, etc.* in *The Agreements of the WTO: World Trade Organization*, http://www.wto.org/english/thewto_e/whatis_e/tif_e/agrm8_e.htm.
- ¹⁰ Nicholas Lardy, "Exchange Rate and Monetary Policy in China," *CATO Journal* 25, No. 1 (Winter 2005), 42, online, *Academic Search Elite*, EBSCOhost: University of Victoria Library, Victoria (accessed November 7, 2010).
- ¹¹ Lardy, "Exchange Rate," 46.
- ¹² The General Agreement on Trades and Tariffs stemmed out of World War II with the intention of creating a third international organization to handle the trade side of the Bretton Woods system and was to be named the International Trade Organization (ITO). The ITO failed to come into reality in 1950 with the failure of the Havana Charter, leaving GATT as the international authority for cross-national trade until 1994 – "The GATT Years: From Havana to Marrakesh," *Basics* in *Understanding the WTO*:

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- World Trade Organization, http://www.wto.org/english/thewto_e/whatis_e/tif_e/fact4_e.htm.
- ¹³ “Principles of the Trading System,” *Basics* in Understanding the WTO: World Trade Organization, http://www.wto.org/english/thewto_e/whatis_e/tif_e/fact2_e.htm.
- ¹⁴ While the World Trade Organization endeavors to move towards a reduction of tariffs, nation states may enact them as a punitive measure against a nation-state that is also violating the WTO’s rules – *Basics*, World Trade Organization.
- ¹⁵ “Key IMF Activities,” *What we do*, International Monetary Fund, <http://www.imf.org/external/about/whatwedo.htm>.
- ¹⁶ China became a member-state of the IMF upon its founding in 1945 – “At a Glance – China and the IMF,” in Country Info: International Monetary Fund, <http://www.imf.org/external/country/chn/rr/glance.htm>.
- ¹⁷ “Section 1 – General obligations of members,” *Article IV: Obligations Regarding Exchange Arrangements* in Articles of Agreement of the International Monetary Fund: International Monetary Fund, <http://www.imf.org/external/pubs/ft/aa/aa04.htm#2>.
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- ³⁰ Makin, "Is China's Exchange Rate Policy a Form of Trade Protection," 86.
- ³¹ Anthony J. Makin, "The Inflexible Yuan and Global Imbalances," *Global Economy Journal* 8, No. 3 (July 2008), 8, online, *Academic Search Elite*, EBSCOhost: University of Victoria Library, Victoria (accessed November 7, 2010).
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