

## Speakers

Clemens Boonekamp,  
CEO, World Trade Advisors

Michael Gadbow,  
Distinguished Senior Fellow  
and Adjunct Professor,  
Institute of International  
Economic Law, Georgetown  
University Law Center

Aluisio de Lima-Campos,  
Adjunct Professor,  
Washington College of Law  
(American University)

John Magnus,  
President, TradeWins;  
Adjunct Professor,  
Washington College of Law  
(American University)

Vera Thorstensen,  
Professor, Getulio Vargas  
Foundation (FGV)

Claus Zimmermann,  
Associate, Sidley Austin

## Moderator

Carlos Braga  
Professor of International  
Political Economy and  
Director of The Evian Group@  
IMD

## Research & Development

Athanasios Kondis

*In July 2014, about 60 participants attended a debate organized by The Evian Group@IMD. A panel of speakers, moderated by Professor Carlos Braga, engaged in a discussion with participants about ways of addressing currency misalignments (and the resulting trade imbalances) and the need for intervention by the WTO. The audience was asked, both before and after the discussion, to rate whether the WTO should get more involved, and the findings were shared in real time.*

*For more about The Evian Group@IMD see [www.imd.org/eviangroup/](http://www.imd.org/eviangroup/)*

# Dialogues on Globalization Series Exchange Rates and Trade: Should the WTO Get Involved?



## Another barrier to global trade?

Paul Volcker famously pointed out, “Trade flows are affected more by ten minutes of movement in the currency markets than by ten years of (even successful) trade negotiations.” Nevertheless, the practice of intervening in currency markets in order to influence exchange rates and affect trade has largely escaped the legal disciplines of both the IMF and the WTO. As countries seek to promote growth in the aftermath of the financial crisis, currency interventions have become more prevalent and distortions in exchange rates, with their resulting imbalances in trade flows, have prompted a call for new initiatives to address them, for example the ones being proposed as part of the Trans-Pacific Partnership (TPP) and the Transatlantic Trade and Investment

Partnership (TTIP) negotiations. Economic and legal experts have brought new insights into the impact of currency intervention on trade and a fresh legal perspective on the application of the WTO rules against measures that frustrate the intent of the GATT/WTO agreements.

The moderator, Carlos Primo Braga, invited participants to reflect on the above and vote on whether the WTO should take a more active role in disciplining currency misalignments. The audience appeared to be divided; 43% responded YES citing the unfair trade advantages generated by undervalued currencies and the fact that currency manipulation has similar effects to prohibited subsidies – a topic that is dear to the heart of the WTO community. However, the majority of people responded NO on the basis that active WTO involvement may worsen the situation, leading to a “cold trade war.” Interestingly, a large percentage of the NO camp, pointed out that the IMF is better positioned than the WTO to tackle this issue and that the track record of the WTO in delivering timely solutions to trade-related disputes is not a good one (see **Figure 1**). To kick off the debate, Professor Braga then turned to the panel of experts and asked them three questions, “Is there a problem? If yes, should the WTO do something about it? And what are the possible solutions?”

**Figure 1: Exchange Rates and Trade: Should the WTO get involved? If you answered No, which of the following reasons best inform your answer?**

1. There is no methodology that could muster consensus in terms of what exactly predatory currency manipulation means: **12%**
2. The IMF is better positioned than the WTO to discipline predatory currency misalignments: **20%**
3. The implications of active WTO involvement (the “cure”) may be worse than the problem, leading to a “cold trade war”: **44%**
4. The track record of the WTO in delivering timely solutions to trade-related disputes is not good: **20%**
5. None of the above: **4%**

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**Do we have a problem? Yes, from an economic perspective, but from a legal perspective, the situation is more complicated.**

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## **Position #1: A call for a radical approach**

Currency intervention is not about the so-called “currency war” between the US and China per se. According to Vera Thorstensen, it is a serious problem that concerns everyone, since one could argue that “half of the world is overvalued and half of the world is undervalued.”

One can get an estimate of currency misalignments by looking at three indicators: a purchasing power parity – related index (such as the Big Mac index), the equilibrium rate to current account balance (flow) and the equilibrium rate of net foreign assets (stocks). In general, the rich countries are undervalued – effectively giving subsidies to their exports and distorting the applied tariffs – and for the most part the poor countries are overvalued. Thorstensen proposes creating a “virtual world currency” based on a group of industrialized/developed countries’ currencies. A fluctuation band against this world currency could then be negotiated along with a bilateral conflict resolution mechanism for countries that exceed this band over a certain period of time. WTO instruments that can be used to neutralize the effect of currency misalignments include tariffs, countervailing duties, currency safeguards and compensation.

In short, the position of advocates of a dynamic WTO intervention is that currency misalignment concerns most countries and it is a serious threat to global trade that cannot be managed by the IMF because its governance is biased in favor of the main perpetrators of currency manipulation.

## **Position #2: Yes to supplementary measures but mind the legal challenges**

Supporters of this position recognize that there is a problem, and they would welcome supplementary measures that focus on exchange rates.

For some experts, like John Magnus, a large part of the problem can be addressed by the application of existing rules including the subsidy rules,

particularly in cases of currency outliers. One should bear in mind that the definition of subsidy depends on whether you are an economist or a lawyer – the legal definition tends to be narrower within the context of trade agreements. An interesting proposal by the Peterson Institute for International Economics is that currency misalignment should be measured based on an objective test, at least in the context of preferential trade agreements. As a benchmark, one could use a back-of-the-envelope rule that links the level of a country’s foreign reserves and its ability to buy imports over a certain period of time. An alternative and more cautious proposal that has attracted attention in the US is to incorporate currency misalignments in the calculation of countervailing duties. Currency interventions that qualify as countervailing subsidies could be captured when applying countervailing duty law. Defenders of this idea believe that if you get enough countries to back this proposal, it would be a significant first step toward dealing with the bigger issue.

Do we have a problem? Yes, from an economic perspective, but from a legal perspective, the situation is more complicated, argued Claus Zimmermann. Anyone attempting to tackle this issue will find it hard to comply with the existing multilateral legal architecture. Key legal challenges include: in the domain of the IMF, the inoperable intent requirement under IMF Article IV: 1(iii); the uncertainty as to whether GATT 1994’s Article XV: 4 could serve as an independent basis for a WTO claim; and the impact of the exception under GATT’s Article XV: 9(a) on a potential WTO dispute on this issue. Moreover, a critical question is how to align these rules with demands for unilateral trade action, given the increasing number of proposals for unilateral trade remedies against exchange rate manipulation – e.g. the discussion in the US about currency manipulation clauses as part of future free trade agreements. The IMF is frequently criticized for not enforcing the rules of the game, but for some experts, it is unfair to blame the IMF solely. “Rules are very complex and members have made a deliberate choice to grant a wide margin of maneuver,” Zimmermann observed.

### **Position #3: To blame the exchange rate is to blame the messenger!**

Clemens Boonekamp disputed the idea that action is required. The real exchange rate is an “endogenous” variable. Consequently, the real exchange rate is largely beyond the control of policy makers and equilibrates at a point where the current account stabilizes and becomes financeable. If a country is actually manipulating its exchange rate, this has consequences for the country concerned – e.g. its inflation rate will increase and its real exchange rate will appreciate, hindering exports and pushing imports up.

Quite often, the elephant in the room is the need for structural reforms, serving, *inter alia*, to raise productivity. For Boonekamp, it is the state of a country’s current account (saving/investment imbalance) that lies at the heart of the problem; if the current account is in significant deficit this will be reflected on the exchange rate. “Financial discipline together with structural reforms is the remedy, not rushing to the WTO asking for protection against the exchange rate,” he asserted.

While opponents of WTO intervention recognize that a problem exists, they are not convinced that the WTO is in a position to assess this volatile situation accurately and design and enforce appropriate and timely measures. Unlike trade, the real exchange rate is not a policy variable leaving no room for effective WTO-driven remedies.

### **Position #4: A multilateral solution of like-minded members with the participation of both the IMF and the WTO**

Exchange rate misalignments and the need for intervention is not a new debate but something that goes back to the days of John Maynard Keynes and Harry Dexter White. IMF acknowledges the problem and condemns manipulation. Should the WTO be directly involved in this?

Aluisio de Lima-Campos noted that the organization should focus on the impact of misalignments on trade and the violations,

and when and where these take place. An undervalued country effectively raises its protection level and lowers that of its trading partners by decreasing the price of exports – this is a WTO problem and the organization should deal with it. One of the proposals put forward by Lima-Campos is to introduce a permanent and sustainable mechanism to deal with countries that demonstrate predatory currency misalignment – a term used to define misalignment that is significant, persistent and not justified. Under this proposal, a government can hold onto its sovereign right to impose its own policies if the objective is to correct economic imbalances.

According to Michael Gadbow, governments need to face a new reality. When the financial system almost collapsed during the last crisis, the trading system successfully protected the world from a systemic failure. Today, the monetary system has been asked to step in and bail out the world economy. One of the fallouts is that an increasing number of governments are taking measures that lead to currency misalignments.

Proponents of a more proactive intervention by multilateral organizations believe that it is this type of behavior that can develop into a big global problem, and call for immediate action. Gadbow encourages approaching this topic on three dimensions: 1) the political–economy dimension in light of the bipartisan position in the US House and the Senate that there would be no trade agreement without a currency manipulation provision; 2) the interplay of rules and institutions, i.e. how do the institutions concerned interpret existing laws? and 3) as a global governance issue.

For Gadbow, currency is an affair that cuts across all four regulatory systems (monetary, trade, finance and investment) and the critical question is whether currency intervention violates any of the fundamental rules present in these international regulatory systems. “Extreme currency misalignment violates not only a monetary rule, but also a founding principle of the trade system,” he stated. Then he went on to share his proposal

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for a multilateral solution for actionable currency intervention that falls into the domain of selective safeguards. An additional element of this proposal is the recognition of a new category, where IMF might conclude that currency manipulation has not taken place but this behavior can still be actionable on the basis that it is not consistent with the IMF articles of agreement.

**While proponents of the multilateral solution recognize that current provisions are not effective, they view the IMF and the WTO as two complementary institutions that can work together to address the problem.**

In summary, while proponents of the multilateral solution recognize that current provisions (like those present in IMF's Article IV or GATT's Article XV) are not effective, they view the IMF and the WTO as two complementary institutions that can work together to address the problem. Consequently, they have come up with solutions with the participation of all parties concerned: the WTO, the IMF, manipulators and non-manipulators.

### A global challenge that will not go away

During the discussion, participants raised several issues. These included: the limited understanding of this complex and important subject by governments; the

development dimension of this debate given that many misaligned currencies are found in developing countries of the East; skepticism on whether international organizations can intervene in an area that is considered to be a sovereign right; and the possibility of taking a first small step by establishing an official platform for discussion in the form of a forum under the WTO umbrella.

The vote that followed the debate saw a 4% increase for opponents of WTO intervention. The NO camp appeared to have changed its mind concerning the risk of WTO intervention leading to a "cold trade war" (44% agreed with this statement before the debate compared to 18% after the debate). It highlighted an additional reason behind its stand – the lack of a methodology that could muster consensus in terms of what exactly predatory currency manipulation means. Nevertheless, the significant share of experts (39% of participants) who envisage a more active role for the WTO is a sign that this topic will remain high on the list of globalization challenges. Policy makers around the globe have another hot item for their agendas.

### Survey Results

Participants voted, both before and after hearing the speakers' arguments, on whether the WTO should get more involved. Figure 2 shows the results compared with those of an earlier survey, which The Evian Group@IMD had e-mailed to its community members in advance of the event. The degree of skepticism about the need for WTO intervention increased after the debate and approached the level found within the wider Evian Group@IMD community.

**Figure 2: Survey results: Exchange Rates and Trade: Should the WTO get involved?**

