IS IT A SUBSIDY? AN EVALUATION OF CHINA'S CURRENCY REGIME AND ITS COMPLIANCE WITH THE WTO

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INTRODUCTION

The Chinese government has pegged their currency – the renminbi or yuan – against the dollar since 1994, which prevents the yuan from fluctuating based on market forces.[1] Unlike the free floating U.S. dollar, China maintains a fixed exchange rate through governmental intervention.[2] Many U.S. labor and manufacturing organizations believe China's currency policy violates various provisions of the World Trade Organization ("WTO") and General Agreement on Tariffs and Trade ("GATT").[3] They claim that the exportation of U.S. jobs to China and increased demand for Chinese imports are a result of China's fixed currency regime.[4] The U.S.

[1] *See* Board of Governors of the Federal Reserve System, Federal Reserve Statistical Release: Foreign Exchange Rates, 1990-99 (indicating that China revalued its currency in relation to the dollar from 5.8 to 8.7 yuan on Jan. 3, 1994), *available at* http://www.federalreserve.gov/releases/h10/hist/dat96_ch.txt (last updated Nov. 8, 2004).

[2] *See* JOHN J. JACKSON ET AL., LEGAL PROBLEMS OF INTERNATIONAL ECONOMIC RELATIONS § 22.1 (4th ed. 2002)(distinguishing between floating exchange rates, which increase or decrease in value based on supply and demand; and fixed exchange rates, which remain pegged through government bank purchase of incoming currency or constraints on outflows of domestic currency).

[3] *See* China Currency Coalition, *The Section 301 Petition*, at 49 (Sept. 9, 2004)[hereinafter Petition](claiming that China's fixed-peg currency regime violates Article VI (Anti-Dumping and Countervailing Measures), Article XVI (Subsidies) of GATT, and the Agreement on Subsidies and Countervailing Measures (SCM Agreement) of the WTO Agreement), *available at* http://www.chinacurrencycoalition.org/petition.html (last visited Nov. 11, 2004).

[4] *See id.* at 6 (asserting that the China's maintenance of an undervalued currency has substantially increased demand for inexpensive Chinese exports and attracted U.S. businesses in search of cheap labor, which has produced a severe bilateral trade deficit).

Government also opposes China's currency policy, but believes a diplomatic approach, rather than a formal complaint to the WTO, is the appropriate governmental response.[5]

China is an enormous market.[6] With a population of more than one billion people and its gradual transition to a market economy, China has experienced increased trade and foreign direct investment ("FDI").[7] The Chinese economy is growing rapidly and is currently the United States' third largest trading partner.[8] In 2001, China became a member of the WTO and the United States was allowed greater access to China's vast market.[9] Exports from the United States to China have increased substantially since 2001, but are greatly outweighed by imports from China.[10] Consequently, a growing trade deficit exists between the United States and China.[11]

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[5] *See* Paul Bluestein, *China at G-7 Meeting for First Time: U.S. Sticks With Patient Approach On Currency Issues*, THE WASH. POST, October 2, 2004, at E1 (stating the approach of Treasury Secretary John W. Snow and the Bush Administration of coaxing the Chinese to change their currency policy rather than bullying them).

[6] *See* Office of United States Trade Rep., Fact Sheets: America's Trade with China (Apr. 21, 2004) (noting that between 2000 and 2003 U.S. exports to China grew by 76 percent and rising incomes of China's 1.3 billion consumers has made China the sixth largest market for U.S. exports), *at* http://www.ustr.gov/Document_Library/Fact_Sheets/2004/America's_Trade_with_China.html (last visited Nov. 11, 2004).

[7] *See* Export.gov, Office of China Economic Area: China Country Profile – Economy (May 24, 2004)(indicating that China's population is approximately 1.3 billion people and economic reforms that began in 1979 have lead to the largest amounts of foreign direct investment in the world - totaling $53 billion in 2002), *at* http://www.mac.doc.gov/china/Economy.htm (last visited Oct. 17, 2004).

[8] *See supra* note 6 (revealing that China surpassed Japan in trade with the United States and while global growth fell by 2 percent over the last three years, the Chinese economy expanded by more than 8 percent).

[9] *See generally Protocol on the Accession of the People's Republic of China*, WT/L/432 (Nov. 23, 2001)(outlining the trade liberalizing concessions and policies that China is responsible for implementing as a member of the WTO), at http://docsonline.wto.org/gen_home.asp?language=1&_=1 (last visited Nov. 1, 2004).

Although China has made significant progress in opening its economy to foreign competition, it has failed to implement several of its WTO obligations.[12] In addition to their WTO shortcomings, China continues to peg the yuan against the dollar, which many believe is an undervalued rate of exchange.[13] However, China recently indicated its desire to move towards a more liberal currency regime, but was hesitant to set a date because of domestic economic challenges.[14] Most of the disagreement revolves around the proper methods for the U.S. government to adopt in pressuring or forcing China to liberalize its currency policy.[15]

This comment will evaluate whether China's fixed currency regime constitutes a violation of the GATT or WTO concerning subsidies and dumping. The arguments charging

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[10] *See* U.S. Census Bureau, Foreign Trade Statistics: Trade with China (Nov. 10, 2004)(listing total exports from the United States to China during 2003 at approximately $28 billion, while imports from China to the United States totaled $152 billion), *at* http://www.census.gov/foreign-trade/balance/c5700.html#2003 (last modified Nov. 9, 2004).

[11] *See id.* (revealing the trade deficit between the U.S. and China for 2003 was $124 billion, an increase of $21 billion from 2002, and $41 billion from 2001).

[12] *See generally* Office of the United States Trade Rep., *2003 Report to Congress on China's WTO Compliance* (Dec. 11, 2003)(indicating that China failed to implement trade liberalizing commitments concerning Agriculture, Intellectual Property Rights, Services, Valued-Added Tax Policies, Transparency, Trading Rights, and Distribution Services), at http://www.ustr.gov/World_Regions/North_Asia/China/Section_Index.html (last visited Nov. 1, 2004).

[13] *See* Elizabeth Becker, *IMF Asks China to Free Its Currency From Dollar*, N.Y. TIMES, Sept. 30, 2004, at C1 (explaining that the IMF, the U.S. Government, and various labor groups agree that China's maintenance of the yuan at 8.28 to each U.S. dollar is contributing to increased Chinese exports and trade imbalances).

[14] *See* Neil King Jr. & Charles Hutzler, *China Tells U.S. Yuan Flexibility Is on the Horizon*, WALL ST. J., Sept. 29, 2004, at A2 (noting China's intent to adopt a more flexible exchange rate regime, but five percent inflation, inefficient state operated companies, and a banking sector encumbered with bad loans might prevent monetary policychanges in the near term).

[15] *See* Elizabeth Becker, *Industry and Labor Step Up Fight Over China's Currency*, N.Y. TIMES, Sept. 10, 2004, at C3 (reporting the U.S. Government's disagreement and dismissal of the Section 301 Petition submitted by various labor groups including the AFL-CIO, urging the U.S. Government to take legal action against China in regard to their currency policy).

China with violating the WTO and GATT have been articulated by the "Section 301 Petition" ("the Petition").[16] This comment will argue that a thorough examination of the relevant provisions reveals that China is not violating the WTO or GATT by maintaining a fixed currency regime.[17] Since a formal complaint to the WTO would probably fail, the United States should assist China in reforming its banking and financial services sectors while strongly urging compliance with existing WTO obligations.[18] Creating conditions of stability and security within China's banking and financial industries might obviate the Chinese Government's reluctance to adopt a more liberal currency policy.[19]

Part I of this comment provides a background on China's monetary policy; an overview of the Bretton Woods institutions; and relevant trade law concerning the dispute over China's currency policy.[20] Part II evaluates whether China's exchange rate policy constitutes a subsidy as

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[16] *See supra* note 3, at 50 (providing an analysis of how China violated Article VI and XVI of GATT and the SCM Agreement).

[17] *See* discussion *infra* Part II (arguing that China's currency policy is not a prohibited subsidy).

[18] *See* Sebastian Edwards, *China Should Not Rush to Float its Currency*, FINANCIAL TIMES, Aug. 3, 2003 (speculating that China's increased compliance with its WTO obligations and reform of its banking sector would relieve trade imbalances and promote monetary stability), *available at* http://www.globalpolicy.org/socecon/crisis/2003/0803rush.htm (last visited Nov. 1, 2004).

[19] *See* Embassy of the People's Republic of China in Australia, *China to keep rational exchange rates, continue financial reforms: Premier* (Feb. 11, 2004) (specifying that reform of state-run banks, improvement of financial asset management companies, and restructuring of the insurance sector are allissues that present obstacles to currency reform), *at* http://www.chinaembassy.org.au/eng/zggk/jj/t64282.htm (last visited Nov. 10, 2004).

[20] *See* discussion *infra* Part I (providing background on China's economy, an overview of the Bretton Woods Conferences, the scope of the IMF and GATT, and explanations of the relevant WTO and GATT provisions).

defined by relevant provisions of the GATT and WTO.[21] Part III provides suggestions on how to influence China to adopt a more liberal currency regime or reduce the bilateral trade deficit.[22]

I. BACKGROUND

Historically, China has been plagued with failed efforts to modernize and reform its economy.[23] In 1979, after the death of Zedong Mao, one of the most prominent political figures in Chinese history, veteran members of the Chinese Communist Party adopted a more liberal economic policy that minimized central planning and encouraged privatization.[24] During the 1980's, China continued to pursue market oriented reforms, which resulted in significant economic growth.[25] Rapid economic expansion produced inflation and the Chinese government reacted by adopting a strict monetary policy to reverse inflationary pressure.[26] Part of their monetary policy included pegging the yuan against the dollar in 1994, which helped reduce

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[21] *See* discussion *infra* Part II (evaluating whether China's currency policy violates WTO and GATT provisions on subsidies).
[22] *See* discussion *infra* Part III (reasoning that China might be more amenable to adopting a liberal exchange rate if the appropriate support structures were in place and full compliance with existing WTO obligations and elimination of capital flows restrictions would improve bilateral trade imbalances).

[23] *See* U.S. Dept. of State, Background Note: China (Oct. 2004) (tracing the failed effort of Zedong Mao to implement revolutionary economic policies starting in 1958, leading to years of political friction and economic stagnation), *at* http://www.state.gov/r/pa/ei/bgn/18902.htm (last visited Nov. 10, 2004).

[24] *See id.* (explaining the evolution of economic reforms adopted after the death of Mao in 1976, which included an increased emphasis on improving the standard of living, cultivating the arts, and allowance of political dissent).

[25] *See id.* (indicating that the reforms of 1979 led to annual growth rates of 10% in agriculture and industrial output, and doubled annual income in rural areas).

[26] *See* Dai Gen-you, *China's Monetary Policy: Retrospect and Prospect* (Nov. 3, 2001) (noting in 1995 the Central Committee of the Communist Party of China proclaimed that curbing inflation was the primary concern and implemented tight monetary policies to accomplish their goal), *at* http://unpan1.un.org/intradoc/groups/public/documents/APCITY/UNPAN002817.pdf (last visited Oct. 22, 2004).

inflation and maintain economic growth.[27] In addition, the tight monetary controls utilized by the Chinese Government allowed China to avoidthe effects of the Asian monetary crisis that occurred in the late 1990's.[28] Currently, China's economy is still expanding and strict monetary policies have continued to promote economic growth, despite inflationary pressure and large amounts of bad debt.[29]

A. Bretton Woods System

After World War II a series of conferences resulted in the creation of the International Monetary Fund ("IMF"), the World Bank, and GATT (1947).[30] Collectively they were known as the Bretton Woods System and were intended to prevent economic crisis and promote capitalism.[31] A principle concern during the Bretton Woods negotiations was the issue of free floating currencies and their detrimental effects on trade.[32] As a result, the participants agreed to

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[27] *See id.* (observing that the increase in broad money peaked in 1994, but decreased the following year, and by 1997 the consumer price and retail price had significantly decreased while maintaining 8.8% economic growth).

[28] *See id.* (citing China's use of monetary policy instruments during the Asian crisis to stimulate domestic demand by increasing money supply, resulting in a 15.3 percent gain in money supply in 1998 and 14.7 percent in 1999).

[29] *See supra* note 23 (mentioning that China experienced 8% growth in 2002 and 9.1% growth in 2003 amidst the severe acute respiratory syndrome (SARS) outbreak, defaulting loans, inefficient state owned enterprises, and increased rural unemployment).

[30] *See* JACKSON, *supra* note 2, § 5.4 (explaining that the Bretton Woods conference was held in New Hampshire (1944), where the IMF and International Bank for Reconstruction (World Bank) were created, but the GATT was completed later in 1948).

[31] *See* Wilkipedia, *Bretton Woods System* (listing the goals of participating countries: to eliminate economic policies that caused the Great Depression, prevent world war by promoting a liberal economic system, and encourage international economic cooperation through free trade), http://en.wikipedia.org/wiki/Bretton_Woods_Conference#.22Floating.22_Bretton_Woods_1968-1972 (last modified Nov. 8, 2004).

[32] *See* Benjamin J. Cohen, *Bretton Woods System* (indicating that the floating exchange rates in place during the 1930's reduced trade because of currency fluctuations caused by speculation

adopt fixed exchange rates and accepted the role of the IMF as the global supervisor of monetary policy.[33] Ironically, it was not until 1971 that the United States discarded its fixed exchange rate policy and floated the dollar.[34] Thus, a goal of the Bretton Woods Conferences was to encourage open markets and free trade, but stability was the main theme and resulted in the adoption of fixed exchange rates by all members.[35]

1. IMF and GATT: Scope

A central purpose of the IMF is to monitor the exchange rate policies of member countries.[36] Article XV of GATT (1947) reiterates that the IMF is responsible for exchange rate issues, while the GATT is responsible for trade related issues.[37] The IMF and members of the

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and government devaluation), *at* http://www.polsci.ucsb.edu/faculty/cohen/inpress/bretton.html (last visited Oct. 20, 2004).

[33] *See id.* (requiring that participating governments maintain fixed exchange rates within a range of one percent, unless balance of payments imbalances required revaluation of the currency). The IMF was given three functions – regulation of currency values, financial aid, and consultation. *Id.*

[34] *See China's Exchange Rate Policy Not Violate WTO*, CHINA DAILY, Feb. 26, 2004 (quoting U.S. Trade Rep., Robert Zoellick claiming that China's pegged currency does not violate WTO obligations and cites the fixed exchange rate employed by the United States until 1971 as evidence that China's currency policy complies with the WTO and GATT), *at* http://www.chinadaily.com.cn/english/doc/2004-02/26/content_309623.htm (last visited Nov. 10, 2004).

[35] *See supra* note 31 (detailing the use of gold as the standard for pricing currencies to the emergence of the dollar as the accepted standard used by countries to value their currencies), *at* http://www.state.gov/r/pa/ei/bgn/18902.htm (last visited Oct. 22, 2004).

[36] *See* Articles of Agreement of the International Monetary Fund, July 22, 1944, art. IV(3)(a) ("The Fund shall oversee the international monetary system in order to ensure its effective operation ... [T]he 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 ... the Fund shall pay due regard to the circumstances of members.").

[37] *See* General Agreement on Tariffs and Trade, Oct. 30 1947, art. XV(1), 61 Stat. A-11, T.I.A.S. 1700, 55 U.N.T.S. 194 [hereinafter GATT]("The CONTRACTING PARTIES shall seek co-operation with the [IMF] to the end that the CONTRACTING PARTIES and the Fund may

GATT are encouraged to collaborate when currency issues affect trade or vice versa, but there is no indication that the GATT has exclusive authority to address exchange rate policies of member countries.[38]

A report by the GATT Balance of Payments Committee provides further guidance on the topic of exchange rate measures when it stated "the [GATT] CONTRACTING PARTIES have no authority over exchange restrictions."[39] Another working paper indicated that when a question of overlapping jurisdiction arises, the GATT should only address trade issues.[40] Although exchange issues and trade issues are often hard to distinguish, the policy for resolving exchange practices that have trade effects is for GATT members to consult with the IMF.[41]

<u>B. GATT: Ad Article VI - Paragraph 2 & 3</u>

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pursue a coordinated policy *with regard to exchange questions within the jurisdiction of the Fund and questions of quantitative restrictions and other trade measures within the jurisdiction of the CONTRACTING PARTIES*")(emphasis added).

[38] *See* GATT art. XV(2) ("*In all cases* in which the CONTRACTING PARTIES are called upon to consider or deal with problems concerning ... *foreign exchange arrangements*, they *shall consult fully with the [IMF]*.")(emphasis added).

[39] *See* GATT, Analytical Index: Guide to GATT Law and Practice, 6th ed. (1994), art. XV(5)[hereinafter GATT Analytical Index] (noting that historically most GATT members used exchange measures to regulate trade, and a country's exchange rate system was rarely addressed by the GATT Committee).

[40] *See* GATT Working Paper, The Relationship between Trade Policy and the International Financial System (1983) *microformed on* L/5572 p. 2, 3 para. 9-11 (Geo. Int. Law Library) ("The most effective contribution the GATT could make to the resolution of trade and financial problems would be the energetic pursuit of its normal activities – identification of trade problems, efforts to define solutions and help in implementing them").

[41] *See* GATT Working Paper, Distinguishing between Trade and Exchange Measures (1960) *microformed on* BOP/W/51 p. 4-5 ¶¶ 9-14 (Geo. Int. Law Library) (stating that sometimes it is difficult or impossible to determine whether a governmental measure is "trade or financial in character" but the jurisdiction of the IMF focuses on the technical aspect of the measure, whereas the GATT emphasizes the effect of the measure on trade).

Generally, Article VI of GATT seeks to prevent dumping, which involves a country artificially lowering the price of its exports below market prices of comparable products.[42] Since the practice of dumping is analogous to a subsidy, it will be covered in subsequent sections.[43] This section will specifically analyze Ad Article VI, Paragraph 3 -- multiple currency practices.[44] Multiple currency practices are government measures that involve applying a favorable currency rate to exports in one category, but neglecting to apply the same currency rate to other exports in order to promote the exportation of the preferred product.[45] In some instances, if a country receives approval from the IMF, it can operate a multiple currency practice, but it is obligated to inform the GATT members if the multiple currency practice acts as a subsidy.[46]

<u>C. WTO: SCM Agreement</u>

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[42] *See* GATT art. VI(1) ("The contracting parties recognize that dumping, by which products of one country are introduced into the commerce of another country at less than the normal value of the products, is to be condemned if it causes or threatens material injury to an established industry in the territory of a contracting party...").

[43] *See* discussion *infra*, Part II (analyzing China's currency policy against Ad. Article VI regarding Multiple Currency Practices and the WTO Agreement on Subsidies and Countervailing Measures).

[44] *See* GATT Ad. Art. VI, ¶¶ 2-3 ("Multiple currency practices can in certain circumstances constitute a subsidy to export which may be met with countervailing duties ... or can constitute a form of dumping by means of a partial depreciation of a country's currency which may be met by action ... By 'multiple currency practices' is meant practices by governments or sanctioned by governments.").

[45] *See* GATT Sub-Committee Meeting, Negotiations on Ad Art. VI para. 2 and 3 *microformed on* E/PC/T/A/PV/20 p. 34-36 (Geo. Int. Law Library) (transcribing the negotiations surrounding Ad. Article VI, Paragraph 3 and explaining that a multiple currency practice involves a government applying a favorable exchange rate to a product they want to export, while applying less advantageous exchange rates to other products).

[46] *See* GATT Analytical Index, Article XVI (citing the Review Pursuant to Art. XVI:5, which indicated that a member was obligated to notify other GATT members if their multiple currency practice acted as a subsidy, regardless of whether the IMF approved of the practice).

The Subsidies and Countervailing Measures ("SCM Agreement") Agreement provides several elements that must be satisfied in order for a governmental measure to qualify as a prohibited subsidy.[47] In addition, Annex I of the SCM Agreement contains a list of practices, which represent export subsidies and have been cited in the Petition[48] as applicable to China's currency regime.[49] Lastly, there are several provisions of the SCM Agreement that provide exceptions for developing countries, existing programs, and countries moving toward market economies that might be applicable to China.[50]

1. Elements of a Subsidy

The elements of a prohibited subsidy are: (1) a government contribution, (2) a benefit conferred, and (3) specificity.[51] First, there are several methods by which a government can make a financial contribution under the SCM Agreement, including a direct transfer of funds, government revenue foregone, government providing goods or services, or a government making payment to a funding mechanism.[52] Second, a benefit must be conferred from the financial contribution.[53] Third, a subsidy must be sufficiently specific in order to be prohibited.[54]

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[47] *See* Agreement on Subsidies and Countervailing Measures, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1A, Legal Instruments—Results of the Uruguay Round 31 I.L.M. 81 (1994)[hereinafter SCM Agreement](stating that the elements of a prohibited subsidy are: a *financial contribution* from a government; a *benefit* granted; and the subsidy must be *specific* to a particular industry)(emphasis added).

[48] *See supra* note 3, at 66-69 (claiming that China's currency policy violates item (b) and (j) of Annex I of the SCM Agreement).

[49] *See generally* SCM Agreement, Annex I (providing an illustrative list of export subsidies that are both prohibited and specific).

[50] *See* SCM Agreement art. 27-29 (outlining exceptions to prohibited subsidies for developing country members, existing programs, and countries transforming to a market economy).

[51] *See supra* note 47 (articulating the elements of a prohibited subsidy).

There is an important exception to the specificity requirement stated in paragraph 2.3 of the SCM Agreement, which indicates a subsidy contingent on export performance is automatically specific.[55] A subsidy may be contingent in law[56] on export performance or contingent in fact on export performance.[57] A subsidy contingent in fact is more difficult to prove than a subsidy contingent in law because it cannot be observed from existing legislation.[58]

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[52] *See* SCM Agreement art. 1.1(a)(1) (providing that a direct transfer of funds might be grants, loans, equity infusion, and loan guarantees; and government revenue forgone could be a tax credit).

[53] *See* WTO, Analytical Index: Guide to WTO Law and Practice, 1st ed. (2001), SCM Agreement art. 1.1(b) [hereinafter WTO Analytical Index] ("[T]he ordinary meaning of benefit clearly encompasses some form of advantage ... a financial contribution will only confer a benefit, i.e., an advantage, if it is provided on terms that are more advantageous than those that would have been available to the recipient on the market), *available at* http://www.wto.org/english/tratop_e/dispu_e/dispu_subjects_index_e.htm#bkmk2 (last visited Nov. 1, 2004).

[54] *See* SCM Agreement art. 2 (stating that a subsidy must be specific to an enterprise or industry or group of enterprises or industries, and indicates a subsidy is not specific when objective criteria determine eligibility so as not to differentiate between enterprises).

[55] *See id.* art. 2-3 ("Any subsidy falling under the provisions of Article 3 shall be deemed to be specific ... the following subsidies ... shall be prohibited: subsidies contingent, in law or in fact, whether solely or as one of several other conditions, upon export performance, including those illustrated in Annex I.").

[56] *See* WTO Analytical Index, SCM Agreement art. 3.1(a) para. 31 ("[A] subsidy is contingent 'in law' upon export performance when the existence of that condition can be demonstrated on the basis of the very words of the relevant legislation, regulation or other legal instrument constituting the measure ... such conditionality can also be derived by necessary implication from the words actually used in the measure.").

[57] *See* SCM Agreement art. 3.1(a) n.4 ("This standard is met when the facts demonstrate that the granting of a subsidy, without having been made legally contingent upon export performance, is in fact tied to actual or anticipated exportation or export earnings. The mere fact that a subsidy is granted to enterprises which export shall not for that reason alone be considered to be an export subsidy within the meaning of this problem.").

[58] *See* WTO Analytical Index, SCM Agreement art. 3.1(a) para. 38 ("*Proving* de facto [in fact] export contingency is a *much more difficult* task ... the existence of the relationship of contingency, between the subsidy and export performance, *must be inferred from the total*

The Appellate Body has cited three elements that must be evaluated in order to determine whether a subsidy is contingent in fact: (1) the granting of subsidy; (2) tied to or conditioned upon; (3) actual or anticipated export earnings.[59] If the aforementioned elements are satisfied based on all relevant facts, then an export contingent in fact exists and the specificity requirement is satisfied.[60]

<u>2. SCM Agreement – Annex I</u>

Annex I contains a list of practices that are prohibited subsidies under the SCM Agreement, but only item (b) and (j) of Annex I were invoked by the Petition in their claim against China.[61] Item (b) involves currency retention schemes and item (j) addresses the allocation of government export credit guarantee programs.[62]

<u>3. SCM Agreement - Exceptions</u>

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configuration of the facts constituting and surrounding the granting of the subsidy, none of which on its own is likely to be decisive in any given case.") (emphasis added).

[59] *See* WTO Analytical Index, SCM Agreement art. 3.1(a) ¶ 39 (stating that the "granting of a subsidy" depends on whether the government provided a subsidy that was explicitly contingent on export performance; that "tied to" requires demonstration of conditionality or dependence; and "anticipated" should be understood as an expectation that exports will result from granting subsidy).

[60] *See* WTO Analytical Index, SCM Agreement art. 3.1(a) ¶ 41 ("Based on the explicit language of Article 3.1(a) and footnote 4 of the SCM Agreement, in our view the determination of whether a subsidy is 'contingent ... in fact' upon export performance requires us to examine all the facts concerning the grant or maintenance of the challenged subsidy, including the nature of the subsidy, its structure and operation, and the circumstances in which it was provided.").

[61] *See supra* note 48 (arguing that China's currency policy is a prohibited subsidy because it represents a currency retention scheme and a program to prevent exchange rate risk).

[62] *See* SCM Agreement Annex I (defining item (b): "Currency retention schemes or any similar practices which involve a bonus on exports"; and item (j): "The provision by governments (or special institutions controlled by governments) of export credit guarantees or insurance programs, of insurance or guarantee programs against increase in cost of exported products or of exchange risk programs, at premium rates which are inadequate to cover the long-term operating costs and losses of the programs.").

There are three exceptions in the SCM Agreement that might be applicable to China.[63] The first exception applies to developing country members and allows subsidies for a period of time to encourage economic development.[64] Second, the exception for existing programs permits countries with preexisting subsidies to gradually eliminate them over time.[65] The final exception is for countries transforming from centrally planned to market economies.[66] Each of the exceptions provides a time frame for member countries to bring their subsidies into conformity with the SCM Agreement.[67] Considering China's recent accession to the WTO, they might be able to invoke one of these exceptions if needed.[68]

II. ANALYSIS

Bringing a claim to the WTO concerning China's currency regime might pressure China to some degree, but achieving a favorable decision from the Dispute Settlement Body ("DSB") is

[63] *See supra* note 50 (noting that allowance and extension of time limits on prohibited subsidies are available for WTO members who qualify as developing countries, have existing subsidy programs, or are making the transformation to a market economy).

[64] *See* SCM Agreement art. 27.3 (stating that Art. 3 paragraph 1(a) shall not apply to developing members for a period of eight years after entry into the WTO).

[65] *See* SCM Agreement art. 28.1(b) (providing that members with existing programs shall not be subject to Part II [Art. 3] of the SCM Agreement for a period of three years after entry into the WTO).

[66] *See id.* art. 29 (indicating an allowance for subsidies in countries transforming from a government controlled economy to a free market economy and a period of seven years is permitted to bring such subsidies into conformity with the SCM Agreement, unless more time is needed for transformation).

[67] *See supra* notes 64-66 (allowing developing countries eight years from entry into the WTO to bring their subsidies into compliance, while existing programs are given three years, and countries transforming into a market economy are provided seven years to comply with the SCM Agreement).

[68] *See supra* note 12 (noting that China's accession to the WTO occurred on December 11, 2001).

unlikely.[69] The Petition, submitted by the China Currency Coalition,[70] articulates several legal arguments against China's currency policy and will briefly be alluded to in each section.[71]

A. China's Currency Regime and Multiple Currency Practices

The Petition stated that the Ad. Art. VI provision on multiple currency practices provided evidence that the GATT contemplated and therefore prohibited currency policies that acted as subsidies on exports.[72] The Petition argued that since China's currency regime benefited exports, the provision on multiple currency practices provided a basis for connecting currency policy to a trade violation.[73] This argument does not stand up to scrutiny.

Although multiple currency practices can amount to a subsidy on exports, there is no correlation between multiple currency practices and China's overall exchange rate policy.[74] Multiple currency practices are narrowly defined government measures that promote the export

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[69] *See generally* WTO Analytical Index, Dispute Settlement Understanding (outlining the structure and scope of the dispute settlement body and providing the procedure for bringing a claim including consultations and establishment of a panel), *available at* http://www.wto.org/english/res_e/booksp_e/analytic_index_e/dsu_e.htm (last visited Nov. 1, 2004).

[70] *See supra* note 3, at 4-5 (listing members of the China Currency Coalition, including the AFL-CIO, American Iron and Steel Institute, American Textile Machinery Association (ATMA), Associated Industries of Massachusetts, etc.).

[71] *See id.* at 50-71 (articulating the argument that China's currency regime violates: Ad Article VI of GATT, the SCM Agreement, and item (b) and (j) from Annex I of SCM Agreement).

[72] *See id.* at 54 (claiming that the inclusion of multiple currency practices as a possible violation of GATT demonstrates that currency policies that benefit exports were also contemplated as possible violations of GATT).

[73] *See id.* at 54 (attempting to connect foreign exchange rate policies that benefit exports to multiple exchange rate practices that act as subsidies on exports).

[74] *See supra* note 45 (indicating that multiple currency practices involve the government practice of applying favorable currency rates to certain products, while neglecting to apply those rates to other products).

of a certain product using preferential currency rates,[75] whereas China's currency regime is a broad monetary policy that was adopted to stabilize the Chinese economy.[76] In fact, China abandoned dual exchange rates in 1994, in favor of a centrally controlled unified rate, and there is no indication that China affords beneficial exchange rate treatment to specific products designated for export.[77] Consequently, China's currency policy would not represent a multiple currency practice.

A second issue is whether the provision on multiple currency practices contemplated a situation like China's where exchange rate policy benefits exports.[78] Accepting such a nexus would expand the meaning of multiple currency practices as intended by the framers of the amendment.[79] Just because a multiple currency practice is capable of being an export subsidy, does not mean all currency practices are vulnerable to being export subsidies.[80] Actually,

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[75] *See id.* (transcribing the negotiations of the committee that established Ad. Article VI, para. 2-3, note 2 and illustrating the meaning of multiple currency practices).

[76] *See supra* note 26 (noting China's implementation of a strict monetary policy in 1994 was to curb inflation and sustain economic growth).

[77] *See Evolution of renminbi exchange rate regime*, CHINA DAILY, Oct. 11, 2004 (noting that the unification of China's exchange rate occurred on Jan. 1, 1994, when the foreign exchange swap market rate and official exchange rate were consolidated into one centrally controlled exchange rate), http://www.chinadaily.com.cn/english/doc/2004-10/11/content_381264.htm (last visited Oct. 29, 2004).

[78] *See supra* note 44 ("Multiple currency practices can in certain circumstances constitute a subsidy to exports ... or can constitute a form of dumping ...").

[79] *See supra* note 45 (indicating that multiple currency practices are preferential currency rates targeted at specific products that a government is desirous of exporting).

[80] *See supra* note 38 (explaining that whenever a dispute arises between GATT members concerning an exchange rate issue, the member should consult fully with the IMF and accept their determinations on how to remedy the problem).

multiple currency practices that operate as export subsidies are sometimes permissible with the consent of the IMF.[81]

Therefore, China's currency policy is not a multiple currency practice and the existence of the provision does not make exchange rate policies as a whole susceptible to trade rules on subsidies.[82] Currency policy is an exchange measure, capable of having trade effects, but nevertheless under IMF jurisdiction.[83]

B. Is China's Fixed Exchange Rate a Subsidy?

The Petition asserted that China provided a prohibited subsidy by converting U.S. dollars into yuan at an undervalued rate, thereby conferring a financial contribution to Chinese exporters, whose products and labor are less expensive when compared to their American competition.[84] Furthermore, the Petition argued that China's fixed exchange rate provided a benefit to Chinese exporters because they would be unable to achieve the same price advantage on the open market.[85] Lastly, the Petition asserted that China's currency policy satisfied the

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[81] *See* GATT ad. art. XVI sect. B(1) ("Nothing ... shall preclude the use by a contracting party of multiple rates of exchange in accordance with the Articles of Agreement of the International Monetary Fund.").

[82] *See supra* note 45.

[83] *See supra* note 37 (stating that exchange rate issues are designated to the IMF and trade issues are left to the GATT).

[84] *See* Petition, at 58-61 (claiming that maintenance of the yuan at 8.28 to each dollar constitutes a government service under Art. 1.1(a)(1)(iii) and provides a financial contribution to Chinese exporters).

[85] *See id.* at 61 (asserting that Chinese exports and businesses are benefited by a fixed exchange rate, which maintains a cheap currency that would be markedly higher if exposed to market forces).

specificity requirement because it was contingent in fact on anticipated export performance.[86] Again, a close examination of the SCM Agreement leads to a different conclusion.

1. Financial Contribution

The first element of a subsidy is a financial contribution.[87] Article 1.1(a)(1)(iii) – government dispensation of goods or services – was the only form of financial contribution cited by the Petition and is the only provision that will be addressed in this section.[88]

The fact that China's currency policy benefits exports does not signify that a financial contribution – as defined by the SCM Agreement - was made by the Chinese Government to exporters.[89] The framers of the SCM Agreement wanted to avoid an effects approach that would permit any government measure that benefited exports to be labeled a subsidy.[90] Article

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[86] *See id.* at 62-66 (arguing that China's currency policy is contingent in fact on export performance because the fixed exchange rate is so closely linked to export performance).

[87] *See* SCM Agreement, art. 1.1(a)(1) (outlining the four methods of financial contribution by a government to be: (1) a direct transfer of funds, potential direct transfer of funds or liabilities; (2) government revenue that is otherwise due is foregone or not collected; (3) a government provides goods or services other than general infrastructure, or purchases goods; and (4) a government makes payments to a funding mechanism).

[88] *See* Petition, at 60-61 (claiming that China's artificial maintenance of an undervalued currency and elimination of necessity for hedging mechanisms constitutes a governmental service under Art. 1.1(a)(1)(iii)).

[89] *See* United States – Measures Treating Export Restraints as Subsidies, WTO Dispute Panel Report, WT/DS194/R ¶ 8.62 (Jun. 29, 2004) ("It does not follow ... that every government intervention that might in economic theory be deemed a subsidy with the potential to distort trade is a subsidy within the meaning of the SCM Agreement. Such an approach would mean that the 'financial contribution' requirement would effectively be replaced by a requirement that the government action in question be commonly understood to be a subsidy that distorts trade."), *available at* http://www.sice.oas.org/DISPUTE/wto/ds194/ds194re14.asp#downote162 (last visited Nov. 3, 2004).

[90] *See id.* at 8.68 (quoting Canada's statements concerning the adoption of a financial contribution test in determining whether a government measure is a subsidy and noting that almost any government measure can have effects on trade and there need to be limits on government activity that constitutes a subsidy).

1.1(a)(1)(iii) indicates that the Chinese government would have to provide a financial contribution in the form of goods or services to a private entity.[91] China's currency policy benefits a wide range of exports in various sectors and is not limited to a specific enterprise.[92] The benefit, however, does not derive from an explicit transfer of money, goods, or services from the Chinese Government to private businesses in order to promote exports.[93] To maintain the fixed rate of exchange between the yuan and the dollar, the Chinese Central Bank must purchase incoming dollars with yuan in order to control fluctuations.[94] There is no transfer of public assets to private exporters involved in the maintenance of a fixed exchange rate.[95] Asserting that the operation of a fixed exchange rate is equivalent to the Chinese Government providing a service to all Chinese exporters is an overly expansive application of the financial contribution provision.[96]

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[91] See id. at 8.65 ("The negotiating history confirms that items (i)-(iii) [of Article 1.1(a)(1)] ... limit these kinds of [government] measures to the *transfer of economic resources from a government to a private entity*. Under subparagraphs (i)-(iii), the government acting on its own behalf is effecting that transfer by *directly providing something of value* – either money, goods, or services – to private entity.") (emphasis added).

[92] *See supra* note 23 (noting that China's main exports include electric machinery and equipment, power generation equipment, apparel, toys, and footwear).

[93] *See supra* note 89, n. 155 ("Subsidies in international trade exist only when a financial charge has been incurred by a government or administrative authority on behalf of a beneficiary ... Only measures which constitute a charge on the public account or government budget ... constitute a subsidy ... Countervailing action ... [should] be made conditional upon a governmental practice which involves a net transfer of funds from public sources to the recipient.").

[94] *See* Reem Heakal, *Floating and Fixed Exchange Rates*, Investopedia.com (Feb. 6, 2003) (explaining the process of central bank intervention to maintain a pegged exchange rate and the need to buy and sell foreign currency to prevent currency fluctuations), *at* http://www.investopedia.com/articles/03/020603.asp. (last visited Nov. 5, 2004).

[95] *See id.* (noting that the currency used to maintain a fixed exchange rate is bought and sold on foreign exchange markets).

2. Benefit

The second element of a subsidy is a benefit conferred.[97] China's maintenance of a fixed exchange rate produces a beneficial effect on Chinese exports, which are less expensive than comparative products produced in the United States.[98] Unlike the financial contribution element of a subsidy, which focuses on the government activity, the benefit element switches the attention to the recipient.[99] Conferring a benefit requires that the recipient be put in a better position than would have been available in the open market.[100]

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[96] *See* United States – Measures Treating Export Restraints as Subsidies, WTO Dispute Settlement Reports, WT/DS194/R ¶ 8.34-34 (Jun. 29, 2001) ("We consider that it cannot be the case that the nature of a Member government's measure under the SCM Agreement is to be determined solely on the basis of the reaction to that measure by those it affects. Rather, the existence of a financial contribution by a government must be proven by reference to the action of the government.... [W]e do not see how the reaction of private entities to a given governmental measure can be the basis on which the Member's compliance with its treaty obligations under the WTO is established.... [A]pplying the 'effects' approach to the question of whether a financial contribution exists would have far-reaching implications. In particular, it would seem to imply that any government measure that creates market conditions favorable to or resulting in the increased supply [or demand] of a product in the domestic [or foreign] market would constitute a government-entrusted or government-directed provision of goods, and hence a financial contribution").

[97] *See supra* note 53 (describing the characteristics of a benefit as defined under Article 1 of the SCM Agreement).

[98] See Gary Clyde Hufbauer & Yee Wong, *International Economics Policy Briefs: China Bashing 2004*, Institute for International Economics (Sep. 2004) (noting that Goldman Sachs estimates China's currency to be undervalued by 10 to 15 percent, but Goldstein and Lardy at the Institute for International Economics estimates the yuan to be undervalued by 15 to 25 percent), *at* http://www.iie.com/publications/pb/pb04.htm (last visited Oct. 24, 2004).

[99] *See* WTO Analytical Index art. 1.1(b) ¶ 17 ("[W]e believe that Canada's argument that 'cost to government' is one way of conceiving of 'benefit' is at odds with the ordinary meaning of Article 1.1(b), which focuses on the recipient and not on the government providing the 'financial contribution'.").

[100] *See* WTO Analytical Index art. 1.1(b) ¶ 18 (stating that the word "benefit" implies a comparison and a benefit may only be conferred if the recipient is placed in a better position than he would have been able to attain in the open market).

Since each U.S. dollar is equal to 8.28 Chinese yuan, U.S. consumers can purchase Chinese products for less than comparable products produced in the United States.[101] Chinese exporters, therefore, have a cost advantage over U.S. producers, which is partially due to China's exchange rate policy.[102] The resulting cost advantage constitutes a benefit as defined by Article 1.1(b) of the SCM Agreement because Chinese exporters would be unable to achieve the same advantage on the open market.[103]

3. Specificity

The subsidy must be specific to be prohibited.[104] China's exchange rate policy is not specific to a particular industry or enterprise; it applies to the entire economy.[105] Since China's currency regime is not specific, it must qualify as a subsidy contingent on export performance to meet the specificity requirement.[106] The Petition conceded that there is no legislation explicitly

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[101] *See* Morris Goldstein, Testimony before the Subcommittee on Domestic and International Monetary Policy, Trade, Technology Committee on Financial Services (Oct. 1, 2003) (stating that the exchange rate between the dollar and the yuan has a direct impact on the U.S. trade deficit), *available at* http://www.iie.com/publications/papers/goldstein1003.htm (last visited Oct. 12, 2004).

[102] *See* Hufbauer *supra* note 98 (indicating Chinese manufacturing wages are 88 cents per hour, while comparable U.S. manufacturing wages are around 9 dollars per hour).

[103] *See id.* (estimating the undervaluation of China's currency to be between 10 and 40 percent, and indicating that the pegging of the yuan to the dollar has benefited Chinese exports).

[104] *See supra* notes 54-55 (explaining that a subsidy must be specific to a particular industry or enterprise in order to be prohibited, unless the subsidy is contingent in law or in fact on export performance, in which case it is automatically specific).

[105] *See* Hufbauer, *supra* note 98 ("An undervalued exchange rate is probably the least specific of any benefit that a government might confer ... WTO case law in other subsidy disputes runs strongly against the proposition that an undervalued exchange rate qualifies as a specific benefit.").

[106] *See supra* note 55 (outlining the process of satisfying the specificity requirement of a prohibited subsidy through Article 2.3 of the SCM Agreement).

stating that China's currency policy is contingent on export performance. Thus, a subsidy contingent in law on export performance is ruled out and only a subsidy contingent in fact could possibly apply to China's currency policy.

a. Subsidy Contingent in Fact on Export Performance

China fails to meet the requirements of a subsidy contingent in fact on export performance because its currency policy is conditioned on economic stability, not exports.[107]

i. Condition on Granting the Subsidy

The first step is to determine whether there is a condition of export performance on China's maintenance of a fixed currency regime.[108] Unlike a subsidy contingent in law,[109] the evaluation of a subsidy contingent in fact requires that all facts and circumstances surrounding the subsidy be taken into consideration.[110] Since China's monetary policy fails to meet the financial contribution requirement of Article 1, it is difficult to argue that a subsidy was granted.[111]

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[107] *See supra* note 26 (noting the purpose of China's strict monetary controls were to control inflation without eliminating economic growth).

[108] *See supra* notes 59-60 (indicating that the first step in determining the existence of a subsidy contingent in fact on export performance is whether the granting authority imposed a condition of export performance when providing the subsidy, and emphasizing that all relevant facts surrounding the maintenance the subsidy should be considered).

[109] *See supra* note 52 (explaining that subsidies contingent in law on export performance can be observed or implied from the text of legislation).

[110] *See supra* note 60 (indicating that a subsidy contingent in fact requires an objective assessment of all facts surrounding the grant or maintenance of the subsidy).

[111] *See supra* notes 89-90 (demonstrating that a subsidy requires a financial contribution, which entails the government incurring a charge for the benefit of a private beneficiary).

Nevertheless, China adopted a fixed exchange rate in 1994[112] to curb inflation that had resulted from rapid economic expansion during the 1980's.[113] In the late 1990's, when most Asian currencies were rapidly depreciating, China maintained its exchange rate while using other monetary policies to increase money supply and encourage domestic spending.[114] Currently, China is reforming its banking and financial sectors and is gradually making the transformation to a market economy.[115]

Ensuring economic stability is a principle concern of the Chinese Government as they attempt to cool their economy and avoid inflation.[116] With a multitude of economic considerations, any averment that the Chinese Government imposed a condition of export performance by pegging the yuan against the dollar excludes other important factors.[117]

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[112] *See* Gen-you *supra* note 26 (indicating that although China's economy grew at an average rate of 12 percent between 1991 and 1995, there were concurrent increases in annual inflation rates from 12.9 percent to 24.1 percent in 1994).

[113] *See supra* notes 24-25 (attributing the economic expansion that occurred during the 1980's to the liberal reforms that were implemented in 1979).

[114] *See id.* (summarizing China's repeated lowering of interest rates, expansion of open market operations, and increase of commercial banks credit scope to increase money supply and promote domestic spending during the Asian financial crisis).

[115] *See supra* note 19 (highlighting the goals of China's Premier, Wen Jiabao, to push forward with market oriented reforms including: privatization of state run banks, improving asset management institutions handling of bad loans, opening the capital and financial services market, and reducing overcapacity from investment in saturated industries).

[116] *See* James Cox, *Amid fears of inflation, Beijing ups lending rate*, USA TODAY.COM, Oct. 28, 2004 (commenting on China's decision to raise interest rates in order to slow economic growth and concluding that a de-acceleration of the Chinese economy would have significant global effects), *at* http://www.usatoday.com/money/world/2004-10-28-china-rates_x.htm (last visited Nov. 14, 2004).

[117] *See supra* note 18 (concluding that China should be hesitant to modify its exchange rate policy when its banking a financial sectors are underdeveloped).

Although a goal of China's monetary policy may be to encourage exports along with other market oriented practices; monetary policy represents a broader initiative than a narrow relationship of conditionality between China's exchange rate policy and export performance.[118]

ii. Contingent on Export Performance

The second step is whether the granting of the subsidy was tied to or dependent upon anticipated export performance.[119] Based on numerous instances of inflation, near financial disaster during the late 1990's, and ongoing transformation to a market economy; China's continued maintenance of a fixed exchange rate appears to be tied to preventing disasters and promoting economic stability.[120] Given the interdependent nature of the global economy, China's market is a vital cog in the global economic wheel.[121] Thus, to claim that China's exchange rate is dependent upon export performance excludes other economic factors essential to overall stability.[122]

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[118] *See supra* notes 23-25 (providing a history of China's attempts to implement market oriented policies including privatization of state run enterprises, acceptance of foreign investment, and accession to the WTO).

[119] *See* GATT Analytical Index art. 3.1(a) ¶ 39 ("[T]he facts must 'demonstrate' that the granting of a subsidy is tied to or contingent upon actual or anticipated exports. It does not suffice to demonstrate solely that a government granting a subsidy anticipated that exports would result. The prohibition ... applies to subsidies that are contingent upon export performance.").

[120] *See* Gen-you *supra* note 26 ("The objective of China's monetary policy is to maintain the stability of the currency value to advance economic growth.... The monetary policy to be pursued in the next five years should be designed to ward off deflation and inflation as well. This should be our cardinal principle").

[121] *See* Hufbauer *supra* note 98 (noting that China surpassed Japan as the world's third largest importer; Chinese importation of oil is second in the world and China's nickel imports will be number one in the world by the end of 2004).

[122] *See supra* note 14, (noting China's desire to revalue its currency but concerns over bad debt, banking and financial sector reforms, and inflation were preventing definitive action).

Arguably, since exports represent a fundamental component of China's economy, they might be necessary to economic stability. However, there are other aspects of the Chinese economy, like FDI, that could draw the same comparison.[123] China's economic stability is dependent on FDI because it contributes to the displacement of inefficient state-run enterprises with modern privately managed businesses, thereby reducing bad debt and improving productivity.[124] Providing a stable currency encourages foreign investment because it prevents large currency fluctuations, which deter foreign businesses from investing.[125] Therefore, China's economic stability can be attributed to various factors including exports, but export performance is not the sole objective of their currency policy.[126]

<u>iii. Expected or Anticipated Export Performance</u>

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[123] *See* Hufbauer, *supra* note 98 (indicating that China's accumulation of foreign exchange reserves is due in large part to foreign direct investment amounting to $53 billion in 2003, which is the highest FDI in the world and exceeded China's trade surplus of $45.9 billion in 2003).

[124] *See generally Country Briefings: China*, ECONOMIST.COM, Jan. 9, 2004 (noting that reform of poorly performing state-run enterprises, improvement of income disparities between rural and industrial workers, and reduction of bad debt are essential goals of Chinese economic policy), *at* http://www.economist.com/countries/China/profile.cfm?folder=Profile-FactSheet (last visited Nov. 15, 2004).

[125] *See* THOMAS L. FRIEDMAN, *Introduction*, THE LEXUS AND THE OLIVE TREE at xi-xv (Anchor Books 2000) (detailing the chain of events that caused the Asian financial crisis and illustrating the nexus between investor risk aversion, exchange rate instability, and economic catastrophes).

[126] *See* People's Bank of China, *Macro-control Policies Proved Effective, and Financial Industry Performance Remained Healthy and Stable*, (July 23, 2004) (noting the progress of various objectives of China's central bank during the first half of 2004: the faster than desired expansion of loans were brought under control, deposits increased steadily, and RMB [yuan] exchange rate remained stable; overall control of aggregate money and credit contributed to the healthy and stable performance of the financial industry), http://www.pbc.gov.cn/english/detail.asp?col=6620&ID=3 (last visited Nov. 2, 2004).

The third element focuses on whether exports were anticipated when the subsidy was granted.[127] As previously mentioned, China implemented strict monetary controls including a fixed exchange rate with the expectation of stabilizing its economy.[128] In *Canada – Aircraft*, "projected export sales anticipated to flow directly from [the subsidy]..."[129] demonstrated the necessary expectation of export performance. Unlike *Canada – Aircraft*, China's maintenance of a fixed exchange rate entails macroeconomic projections or expectations, not industry specific export projections.[130] While China may expect increased exports from their monetary policy; that alone is insufficient because their exchange rate policy is tied to overall economic stability, not export performance.[131] Therefore, China's expectation of increased exports from their maintenance of a pegged exchange rate is meaningless without a clear demonstration of conditionality between the exchange rate policy and exports.[132]

b. Annex I: item (b) and (j)

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[127] *See* WTO Analytical Index art. 3.1(a) ¶ 40 (noting that anticipation of export performance entails an expectation that exports will flow from the granting of the subsidy).

[128] *See supra* note 26 (indicating that controlling inflation was a primary concern of the Chinese Government during the 1990's).

[129] *See id.* (illustrating the level of factual evidence needed to prove an expectation of export performance).

[130] *See* Gen-you *supra* note 26 ("[In China's] Five-Year Plan for National Economic and Social Development and the Long-Range Objectives to the Year 2010, the Central Committee of the Communist Party of China specified in 1995 that curbing inflation was the primary task for macro-economic adjustment ... and stressed the importance of pursuing a moderately tight fiscal and monetary policies").

[131] *See supra* note 59 ("A subsidy may well be granted in the knowledge, or with the anticipation, that exports will result. Yet, that alone is not sufficient, because that alone is not proof that the granting of the subsidy is tied to the anticipation of exportation.").

[132] *See supra* note 96 ¶ 8.42 ("In other words, the Appellate Body found that a cause and effect relationship between the subsidy and actual or anticipated trends in exports was not sufficient to satisfy the 'tied to' standard of conditionality for export contingency to exist.").

The final way of meeting the requirement of specificity is through Annex I -- illustrative list of activities that constitute subsidies.[133]

Item (b) addresses currency retention schemes, which permit certain exporters to retain a portion of receipts from foreign exchange earnings notwithstanding a general rule for businesses to surrender receipts of foreign exchange to the central bank in exchange for local currency.[134] A currency retention scheme is wholly unrelated to China's exchange rate policy because it involves the Chinese Government's allowance of exporters to retain foreign exchange when they would normally be obligated to convert the currency to yuan.[135] Thus, China's maintenance of a pegged exchange rate is not sufficiently analogous to a currency retention scheme, and therefore fails to represent a subsidy.[136]

Item (j) addresses government credit programs that ensure exports against exchange rate risk.[137] Since the yuan is fixed at 8.28 to each dollar, there is no need for Chinese or U.S. businesses to spend money on hedging exchange rates.[138] The Chinese Government's

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[133] *See supra* note 49 (referring to Annex I – Illustrative List of Export Subsidies).

[134] *See* Deborah E. Siegel, *Legal Aspects of the IMF/WTO Relationship: The Fund's Articles of Agreement and the WTO Agreements*, 96 Am. J. Int'l L. 561, 596 (Jul. 2002) (defining currency retention schemes).

[135] *See* Petition at 67 n. 73 (citing China's rules and regulations concerning export collection of foreign exchange).

[136] *See* SCM Agreement article 3.1(a) (indicating that subsidies listed under Annex I are prohibited and automatically specific).

[137] *See supra* notes 61-62 (defining government credit programs that protect against the increase in cost of exchange risk programs at rates which are inadequate to cover the long-term operating costs and losses of the programs).

[138] *See* Ian H. Giddy, *The Corporate Hedging Process* ("Financial risks - regardless of whether or not they are managed - exist in every business. The manager who opts *not to hedge* is betting that the markets will either *remain static* or move in his favor. For example, a U.S. computer manufacturer with French franc receivables that decides to not hedge its exposure to the French

maintenance of a fixed exchange rate provides an indirect benefit by eliminating the need for hedging, but item (j) makes reference to the cost of the program when describing the government provision.[139]

The Chinese Government does not transfer funds or forego revenue in order to eliminate exchange rate risk.[140] Although a benefit is conferred to Chinese exporters by not having to hedge against currency fluctuations, the Chinese Government suffers no financial detriment to provide the program.[141] China's currency policy is distinguishable from item (j) because it does not impose a financial cost on the Chinese Government to eliminate exchange rate risk.[142]

c. China's Currency Policy is Probably Not a Prohibited Subsidy

The macroeconomic nature of China's exchange rate policy does not satisfy the SCM Agreement's requirements of a prohibited subsidy.[143] The Petition attempts to stuff a broad

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franc is speculating that the value of the French franc relative to the U.S. dollar will either *remain stable* or appreciate. In the process, the manufacturer is leaving itself exposed to the risk that the French franc will depreciate relative to the U.S. dollar and hurt the company's revenues.") (emphasis added), *at* http://pages.stern.nyu.edu/~igiddy/corphdg.htm (last visited Nov. 1, 2004).

[139] *See supra* note 48 ("The *provision by governments of* export credit guarantee or insurance *programs ... at premium rates which are inadequate to cover* the long term operating *costs* and losses of the programs.") (emphasis added).

[140] *See* People's Bank of China, *Monetary Instruments* (stating that the People's Bank of China uses monetary policy instruments such as: reserve requirement ratio, central bank base interest rate, rediscounting, central bank lending, open market operation and other policy instruments specified by the State Council), *at* http://www.pbc.gov.cn/english/huobizhengce/instruments.asp (last visited Nov. 1, 2004).

[141] *See supra* note 89-91 (indicating that a subsidy requires a transfer of assets whether it be direct payment or forbearance of payment from the government to a private entity).

[142] *See supra* note 126 (indicating that the policies used by the Bank are macroeconomic in nature and have broad economic effects).

[143] *See id.* ("Macro financial control polices have since proved quite effective as growth of money supply declined ... RMB exchange rate remained stable.... control of aggregate money and credit has contributed to the healthy and stable performance of the financial industry.").

monetary policy into the narrowly defined financial contribution and specificity elements of a subsidy.[144] China's exchange rate policy is not a subsidy because there is no transfer of assets from the government to private exporters and it is contingent on overall economic stability, not exports.[145]

C. Exceptions

If China's currency regime was held to be a prohibited subsidy, there are exceptions in the SCM Agreement which would either permit China to continue its currency peg or provide time to modify their exchange rate policy.[146]

1. Article 27: Developing Country Members

The SCM Agreement recognizes that developing countries might need the assistance of certain subsidies in furthering the goals of development and economic growth.[147] China is a developing country[148] and is actively attempting to raise standards of living through economic

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[144] *See* Petition at 58-69 (articulating the argument that China's Government provides an indirect subsidy to exports by sustaining the undervalued rate of exchange between the yuan and the dollar).

[145] *See* People's Bank of China, *Objective of the Monetary Policy* ("The objective of monetary policy is to maintain the stability of the Renminbi and thereby promote economic growth."), *at* http://www.pbc.gov.cn/english/huobizhengce/objective.asp (last visited Nov. 1, 2004).

[146] *See supra* notes 63-67 (noting that the SCM Agreement includes exceptions for developing countries, existing programs, and countries transforming to market economies).

[147] *See* SCM Agreement art. 27 (stating that developing countries sometimes need subsidies to encourage economic growth and that subsidies operated by developing countries are not subject to prohibition under Article 3.1(a)).

[148] *See* The World Bank Group, Data and Statistics: Country Groups (2004) (classifying China as a developing country in the East Asia and Pacific region and indicating a per capita GNI below 1000 dollars for 2001 and 2002), *at* http://www.worldbank.org/data/countryclass/classgroups.htm (last visited Nov. 1, 2004).

reform.[149] Developing countries are granted eight years from entry into the WTO to bring their subsidies into conformity.[150] Since China acceded to the WTO on December 11, 2001 they would qualify for an exception under Article 27 and would have over five years to modify their exchange rate regime.[151] Furthermore, China might be able to extend their exchange rate policy past the eight years if maintenance of the exchange rate is deemed necessary by the Committee.[152]

2. Article 28: Existing Programs

The second exception applies to subsidies that are already in place at the time of accession.[153] China implemented its pegged currency policy in 1994, well before 2001, and has remained in place since then.[154] Consequently, China would not be subject to the rules regarding prohibited subsidies until three years after the date of its accession into the WTO.

3. Article 29: Transformation To a Market Economy

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[149] *See supra* note 124 (indicating that unemployment is approximately 9 percent in China and a principle aim of the Chinese government is to reduce the income disparities between urban and rural areas through economic reform).

[150] *See* SCM Agreement art. 27 ("The prohibition of paragraph 1(a) shall not apply to ... developing country Members for a period of eight years, from the date of entry into force of the WTO Agreement...").

[151] *See supra* note 12 (stating that China became a member of the WTO on December 11, 2001 after 15 years of negotiations.).

[152] *See supra* note 150 ("If a developing country Member deems it necessary to apply such subsidies beyond the eight-year period, it shall not later than one year before the expiry of this period enter into consultations with the Committee, which will determine whether an extension of this period is justified, after examining all the relevant economic financial and development needs of the developing country Member in question.").

[153] *See* SCM Agreement art. 28 (noting that prohibited subsidy programs established before accession to the WTO shall be brought into conformity with the SCM Agreement within three years, but until then such programs are not prohibited).

[154] *See supra* note 1 (revealing that China pegged its currency against the dollar on January 3, 1994).

The last exception applicable to China is for countries moving toward a market economy.[155] Beginning in 1979, China has gradually changed from a state controlled economy to a market economy.[156] Continued efforts include China's accession into the WTO, privatization of state operated enterprises, and allowance of FDI.[157] China has stumbled, however, in fully implementing their WTO obligations and in reforming their banking industry.[158] Nevertheless, China has made significant progress while adjusting to the expected difficulties that accompany radical economic change.[159] Therefore, China would likely qualify as a country transforming to a market economy and be granted seven years from the date of their accession into the WTO to bring their currency practice into compliance.[160]

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[155] *See* SCM Agreement art. 29 (stating that countries moving from centrally planned economies to market oriented economies are permitted to use programs and measures necessary for that transformation).

[156] *See Country Briefings: China - Economic Structure*, ECONOMIST.COM (Feb. 9, 2004) ("Until 1978 output was dominated by large state-owned enterprises (SOEs). Since then much of the boom in manufacturing output has been produced by ... private entrepreneurs or foreign investors, either in wholly owned enterprises or in joint ventures with Chinese interests. By 2002 the share of state-owned and state-holding enterprises in gross industrial output value had shrunk to 41%. However, state-owned companies, controlled by economic ministries in Beijing, taken in isolation represented only 16% of industrial output."), *at* http://www.economist.com/countries/China/profile.cfm?folder=Profile%2DEconomic%20Structure (last visited Nov. 3, 2004).

[157] *See supra* note 115 (outlining the market reforms sought by the Chinese government).

[158] *See supra* note 12 (providing the areas where China has failed to comply with their WTO commitments).

[159] *See generally Report on the Development of China's Market Economy 2003*, China.org.cn (Nov. 2003) (detailing the market oriented reforms China has made across a wide spectrum of economic sectors including labor, capital, land, trade, and intermediary organizations), *at* http://www.china.org.cn/english/2003chinamarket/79411.htm (last visited Nov. 4, 2004).

[160] *See* SCM Agreement art. 29 ("For such members, subsidy programs falling within the scope of Article 3 ... shall be phased out or brought into conformity with Article 3 within a period of seven years from the date of entry into force of the WTO Agreement").

4. Summary

The likelihood of China's currency policy meeting the requirements of a subsidy is remote.[161] Even if their currency regime was determined to be a prohibited subsidy, China could avoid reprimand by citing one of the three exceptions. The developing country or transformation to market economy provisions seems preferable since they provide more time to eliminate prohibited practices.[162]

III. RECOMMENDATIONS

The United States has appropriately adopted a diplomatic approach to encourage China to revalue or float their currency.[163] Judging by the almost immediate dismissal of the Petition, the U.S. Government will not be initiating any legal action at the WTO.[164] Although diplomacy has not yet produced the desired result, there are additional initiatives the United States could pursue

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[161] *See supra* note 98 (mentioning that a complaint concerning China's currency regime would likely fail if it were submitted to the WTO Dispute Settlement Body because it fails to meet the financial contribution and specificity aspects of the SCM Agreement).

[162] *See supra* notes 63-67 (indicating that developing countries are given eight years or more to bring their subsidies into conformity and transforming economies are granted seven years to comply with the WTO).

[163] *See* Office of United States Trade Rep., Dept. of Treasury Efforts Yielding Results on China Currency (Sept. 9, 2004) (quoting Treasury Secretary John Snow: "With steady progress clearly being made, the most effective way at this time to achieve the goal of a flexible, market-based exchange rate in China is to maintain the persistent engagement we have established rather than through a trade petition. Economic isolationism does not work and it's a path we will not follow."), *at* http://www.ustr.gov/Document_Library/Fact_Sheets/2004/Dept_of_Treasury_Efforts_Yielding_Results_on_China_Currency.html.

[164] *See* Evelyn Iritani, *U.S. Rejects Petition to Punish China on Currency: Labor, textile and steel groups alleged that manipulation led to unfair trade advantages*, L.A. TIMES, Sept. 10, 2004, at C1 (explaining that the Bush Administration dismissed the Section 301 Petition within hours of its filing and called it a "reckless act of economic isolationism").

to either increase the likelihood of China altering its currency policy or reduce the bilateral trade deficit with China.[165]

A. Learning from History

Several countries have made the transformation from a fixed exchange rate to modified floating or full floating exchange rates.[166] Inherent in any government's decision to float are the possible risks associated with market based exchange rate.[167] Most countries that have adopted floating exchange rate regimes have done so because of a crisis or voluntarily, but not from coercion.[168]

Chile provides and example of a country that adopted a floating exchange rate, but first implemented supervisory mechanisms to protect against instability.[169] India also switched to a floating exchange rate, but decided to add supervisory mechanisms after the policy change

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[165] *See supra* note 163 (listing capital account liberalization, banking sector reform, financial product development, financial services opening, and current account reform as the areas of China's financial sector that need further reform in order to accommodate a more liberal currency regime).

[166] *See* Dalia Hakura, *Learning To Float: The Experience of Emerging Market Countries Since the Early 1990's*, IMF: World Economic Outlook 2004 (2004) (reviewing India, Chile, and Brazil's transformation from fixed exchange rates to floating exchange rate regimes), *available at* http://www.imf.org/external/pubs/ft/weo/2004/02/ (last visited Nov. 5, 2004).

[167] *See id.* at 89 (explaining the apprehension that many developing countries exhibit regarding the adoption of a floating exchange rate, which is derived from the possibility of exchange rate volatility).

[168] *See id.* at 90-91 (defining a crisis to include depreciation of the currency against the dollar of 20 percent or a doubling of depreciation of the currency from the previous year).

[169] *See id.* at 92 (noting that before implementing the floating exchange rate policy Chile had strengthened its banking supervision by passing laws which gave regulators the necessary tools to control exchange rate volatility).

instead of before.[170] Since the stabilizing mechanisms were not fully implemented, India's central bank was forced to intervene occasionally to maintain the stability of its currency.[171]

Like Chile, the United States could assist China in establishing the financial supervisory mechanisms that are necessary to ensure stability when implementing a liberal currency policy.[172] An obvious opportunity exists in China's banking sector reforms.[173] China is gradually allowing privately owned foreign banks to establish themselves and derivative markets are slowly being developed, which should reduce the issuance of bad loans and create essential hedging mechanisms.[174] U.S. financial institutions could play a pivotal role in the elimination of critical weaknesses in China's financial sector.[175]

In addition, the United States could urge the IMF to be more active in China's monetary reforms.[176] China is a member of the IMF and utilizing their expertise might produce a more

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[170] *See id.* at 92-93 (indicating that India made financial sector reforms during and after modification of their exchange rate policy and included greater interest rate liberalization, increased competition in the banking sector, development of domestic securities markets, and improvement of financial sector supervision).

[171] *See id.* at 93 (explaining that availability of derivatives and other controls assisted India's foreign exchange dealers in minimizing volatility, but the central bank was forced to intervene on several occasions to reduce large exchange rate fluctuations).

[172] *See supra* note 165 (indicating several areas of China's financial sector that need modernization and reform in order to accommodate a floating exchange rate).

[173] *See id.* (stating that an efficient well managed banking sector is essential to maintaining stability after removing controls on capital flows, interest rates, and exchange rates).

[174] *See id*. (indicating that in June of 2004, China's foreign exchange operational center announced that it will collaborate with the Chicago Mercantile Exchange to develop hedging instruments and China will allow foreign banks to open multiple branches per year, instead of one).

[175] *See id.* (noting that China is currently working on reforms with the New York Mercantile Exchange, Chicago Mercantile Exchange, and Automobile financing through Ford Motor Co.).

efficient transition toward a floating currency regime.[177] If China is reluctant to accept assistance, the United States might pressure the IMF to be more vocal concerning China's need to modify its exchange rate.[178] The faster China can effectively adopt the requisite supervisory mechanisms to prevent instability associated with a floating exchange rate, the more likely it is that a policy change will occur.[179]

B. Other Methods of Solving the Problem

There is a possibility that China will not modify their exchange rate policy.[180] Based on that assumption, the United States should increase pressure on China to comply with its WTO obligations.[181] Although China has made progress in opening its market to foreign competition, there are numerous areas of their economy that violate the WTO.[182] If China were to comply with all of their WTO commitments, the United States would gain greater access to Chinese

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[176] *See* Elizabeth Becker, *I.M.F. Asks China to Free Its Currency From Dollar*, N.Y. TIMES, Sept. 30, 2004, at C1 (noting that the IMF believes a more liberal exchange rate regime is not only in China's best interest, but the global economy in general).

[177] *See* IMF, Country Info: People's Republic of China and the IMF (stating that China became a member of the IMF on December 27, 1945), *at* http://www.imf.org/external/country/CHN/index.htm (last updated Nov. 5, 2004).

[178] *See supra* note 176 (indicating that the managing director at the IMF, Rodrigo de Rato, is dissatisfied with China's currency policy).

[179] *See supra* note 14 (noting that China intends to modify its exchange rate policy, but not until inflationary pressures are quelled and banking reforms have taken shape).

[180] *See supra* note 116 (noting that some economists view China's recent interest rate hike as a clear sign that a change in exchange rate policy is not going occur in the near future).

[181] *See supra* note 12 (outlining the areas where China is failing to meet its WTO obligations).

[182] *See id.* (indicating that China is not cooperating with its obligation to provide translation and public view of its trade laws before their implementation and that China provides favorable treatment to domestic products through value added taxes (VAT)).

markets that are currently protected, which would likely increase exports to China and reduce the trade deficit.[183]

Another aspect of China's economy that would decrease the current trade imbalance is a relaxation of constraints on capital flows.[184] Chinese exporters receive large amounts of incoming dollars that are converted into yuan, but Chinese businesses have only recently been able to invest that money or capital abroad.[185] If capital flows were completely unrestrained, then Chinese businesses would be free to invest in the U.S. economy, thereby alleviating upward pressure on the yuan and reducing the trade deficit.[186]

Furthermore, the United States risks creating a confrontational atmosphere if a legal course of action is pursued against China.[187] Conversely, a diplomatic approach might enhance our relationship with China and actually yield a favorable result faster than a drawn out decision before the WTO Dispute Settlement Body.[188]

IV. CONCLUSION

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[183] *See supra* note 18 (arguing that China's compliance with WTO obligations would raise the standard of living and reduce the trade imbalance by allowing Chinese consumers greater access to U.S. goods).

[184] *See supra* note 163 (claiming that China's restrictions on capital flows encourage upward pressure of the yuan by limiting the amount of foreign exchange that can be invested abroad and forcing domestic businesses to retain large surpluses of foreign currency).

[185] *See id.* (noting that since August 2004, Chinese insurance companies can now invest 80 percent of their current foreign currency holdings in foreign debt and money markets and in 2003 China introduced policies to encourage FDI outflows).

[186] *See supra* note 184.

[187] *See* Hufbauer *supra* note 98 (arguing that a high profile WTO case would lead to a backlash within China, rather than their assent to adopting a floating exchange rate).

[188] *See supra* note 163 (summarizing the progress that China has made towards establishing the supervisory mechanisms needed to successfully implement a floating exchange rate policy).

Countries have a great deal of freedom in selecting a currency regime and are only restricted by their willingness to accept advice from institutions like the IMF.[189] Even though China's peg against the dollar has adverse effects on the bilateral trade deficit and U.S. manufacturing jobs, it fails to represent a prohibited subsidy as defined by the SCM Agreement.[190]

By imposing narrow limitations on government activities that are considered subsidies, the SCM Agreement has excluded broad monetary policy from qualifying as a subsidy.[191] China's monetary policy fails to meet the element of a financial contribution by the government because there was no transfer of assets or services from a public account to a private entity.[192] In addition, China's currency policy is not contingent in fact on export performance because the circumstances reveal that their exchange rate policy is tied to stability, not export performance.[193] It was also evident that multiple currency practices, currency retention schemes, and credit programs were separate concepts and unrelated to macroeconomic currency policy.[194]

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[189] *See* JACKSON *supra* note 2 at § 5.4 (stating that members of the IMF may choose to adopt a floating rate or a fixed rate regime that is tied to another currency or formula).
[190] *See* discussion *infra* Part II (noticing that China's currency policy fails to represent a financial contribution and does not meet the specificity requirements or other means of satisfying that element).

[191] *See supra* notes 89-91 (explaining that for financial contribution the emphasis is on government activity as opposed to the effects of the activity on trade).

[192] *See id.* (illustrating that there must be a charge on the public account and a private sector beneficiary for a financial contribution to be present).

[193] *See supra* note 119 (indicating that there must be a prerequisite condition of anticipated or expected export sales when the subsidy is granted or maintained).

[194] *See* discussion *infra* Part II(A),(B)(b) (revealing that China's currency policy is a macro in nature, whereas currency retention schemes, credit programs, and multiple currency practices are specifically targeted to promote the export of certain goods).

Therefore, to effectively address the problems that stem from China's exchange rate regime, the United States should continue diplomatic negotiations, but increase pressure on China for WTO compliance and provide assistance with financial reforms necessary for market driven exchange rates.[195] A complaint to the WTO regarding China's currency policy would be misplaced because the IMF is responsible for exchange measures and is better suited to address the issue.[196]

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[195] *See* discussion *infra* Part III (arguing that increased pressure on China to continue financial sector reforms and full compliance with WTO obligations would alleviate the bilateral trade imbalance and contribute to China's likelihood of adopting a liberal exchange rate policy).

[196] *See supra* notes 36-41 (explaining that the IMF is supposed to be involved in all issue pertaining to exchange rate policy).