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HOW DOES INTERNATIONAL TRADE REGULATION ADDRESSES EXCHANGE RATES MEASURES?

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COMO A REGULAÇÃO DO COMÉRCIO INTERNACIONAL ABORDA AS MEDIDAS CAMBIAIS?

ABSTRACT

This is study seeks to analyze the international trade regulatory framework regarding exchange rate measures that bear an impact on trade. The present article will explore how the exchange rate issue relates to the WTO and affects its instruments and principles and, in the following, will look for provisions under the WTO agreements that could address the exchange rate issue and rebalance the impacts caused by misaligned currencies on trade.

KEYWORDS

WTO; exchange rates; international trade; IMF; exchange rate misalignments.

RESUMO

O presente estudo busca analisar o quadro regulatório internacional referente a medidas cambiais que trazem impactos no comércio. O artigo pretende explorar como a questão do câmbio se relaciona à OMC e afeta seus instrumentos e princípios para, em seguida, buscar dispositivos nos acordos da OMC que poderiam ser aplicados à questão cambial a fim de reequilibrar os impactos causados pelos desalinhamentos cambiais no comércio internacional.

PALAVRAS-CHAVE

OMC; taxas de câmbio; comércio internacional; FMI; desalinhamentos cambiais.

Introduction

The issue of exchange rate has been historically considered as a matter of the International Monetary Fund (IMF). When the Bretton Woods system was created, it was decided that the IMF would be responsible for the supervision of exchange rates and balance of payments and the General Agreement on Tariffs and Trade (GATT) would regulate international trade. At that time, since the IMF maintained a strict control on countries' currencies, based on a dollar/gold standard, the contracting parties to the GATT did not worry in incorporating the issue into the Agreement, drafting only a few provisions on the subject, such as GATT Article XV.

Even when a flexible exchange rate system was adopted, in the 1970s, the issue remained neglected by the GATT and, in the following years, by the World Trade

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Organization (WTO). Nevertheless, exchange rate misalignments can cause significant impacts on international trade instruments, creating incentives to exports and representing barriers to imports (THORSTENSEN et. al., 2012).

Since the 1970s, the problem has been addressed through negotiations between the major economic leaderships, the US and Europe, and the countries whose currencies were affecting trade. The Plaza Agreement, for instance, was negotiated in 1985 by the US, UK, Germany, France and Japan and aimed to address the overvaluation of the Dollar and the devaluation of the Yen. With the increasing participation of developing countries in the international arena, though, this kind of "agreement amongst a few" became increasingly harder to achieve.

The accession of China to the WTO, in 2001, its rise as the leading world exporter and its policy of pegging the renminbi to the dollar brought to the attention of WTO members once again the effects of exchange rate misalignments on trade. After the financial crisis of 2008, some countries, such as the US, the EU and Japan enhanced the use of expansionist monetary policies in order to stimulate their economies, causing an escalation of exchange rate misalignments, with serious impacts on international trade. This issue led to the consideration by academics and public agents of whether those misalignments could be questioned under WTO rules.

The concern that persistent exchange rate misalignments could be creating trade distortions was finally raised by Brazil at the WTO, in April 2011, when it presented a submission to the Working Group on Trade, Debt and Finance (WGTDF) suggesting academic research on the relationship between exchange rates and international trade (WT/WGTDF/W/53). In September 20th, 2011, Brazil presented to the same Working Group a second proposal on the theme, suggesting the exam of available tools and trade remedies in the Multilateral System that might allow countries to redress the effects of exchange rate misalignments (WT/WGTDF/W/56). In March 2012, a seminar on exchange rates took place at the WTO. The conclusions of this seminar were that exchange rate misalignments can affect trade and that the discussion should continue among WTO and IMF members. Finally, a third document was submitted by Brazil in November, 2012 (WT/WGTDF/W/68), bringing the discussion of the effect of exchange rate misalignments on trade instruments, as well as the possibility of exploring existing WTO rules to address such effects.

These were important steps to the discussions, but deeper debates are still required in order to find which WTO rules are affected by misaligned currencies and which mechanisms can be used to address their effects.

The present article is part of these debates, exploring the relationship between the exchange rate issue and the regulatory framework of international trade. In this sense, the first section of this article will discuss the current perception that the subject of exchange rate should be dealt with solely at the International Monetary Fund (IMF) and, in the following, will analyze how the exchange rate issue relates to the WTO

and affects its instruments and principles. The second section will then analyze the provisions of the WTO agreements and look for possible regulatory linkages between the Multilateral Trading System and the exchange rate issue. Both sections look at the history of negotiations and development of some trade provisions to argue that, although only a few specific mechanisms deal directly with the matter, the exchange rate issue has been an integral part of the Multilateral Trading System since its creation.

The article concentrates on the effects of sustained exchange rate misalignments on the multilateral trading system's legal framework as well as the existing rules that could be applicable to the subject and the need to address such effects. It is not the aim of this article to propose the use of exchange measures to regulate exchange rates. Rather, it focuses on alternatives that allow countries to compensate the negative effects that misaligned currencies have on international trade.

1 The Relation between Exchange Rates and the Multilateral Trading System

1.1 Are exchange rates an exclusive matter of the IMF?

Exchange rate and currency issues were historically considered as matters of the IMF competence. Accordingly, at the time of the creation of the Bretton Woods System in 1944, maintaining an international fixed exchange rate system based at par values to the dollar was the main objective of the IMF.

The economic impacts of exchange rate manipulations on international trade flows were very much in the minds of the political parties in the negotiations of the Bretton Woods agreements (BOUGHTON, 2004, p. 6). The chaotic consequences to trade of the practice of competitive currency devaluation in the years before the World War II were still very present and an international effort was sought to restrain these mutually damaging, "beggar thy neighbor", practices.

The fixed exchange rate system was anchored at the Article IV of the IMF's Articles of Agreement, which determined that every country should maintain their exchange rates within a 1% band of a par value to the dollar established by the IMF. This meant that the Multilateral Trading System, created a few of years later, would not have to focus on the issue of exchange rate manipulations, nor elaborate mechanisms to counter it.

This could offer evidence to explain why exchange rate manipulation and other currency issues are not present but in a few Articles of the GATT. The problem seemed surpassed, with the creation of the IMF, and the GATT could be roughly silent about it.

Concerns about the impacts of exchange rate misalignments on international trade, however, would resurface after the end of the par value system in the 1970s. The fall of the gold standard required major modifications of the IMF practice in

the coming decades, a process that came to be known as the organization's "silent revolution" (BOUGHTON, 2001, p. 582).

The extent and depth of such modifications had direct impact on the IMF rules, particularly on its Article IV, which was transformed from a rigid control to a flexible surveillance mechanism. Andreas Lowenfeld argues that, after the fall of the par value system and the creation of the new surveillance mechanism, "[i]f the Fund Agreement no longer described, let alone controlled, the international monetary system, then it seemed reasonable that the Articles should be rewritten" (LOWENFELD, 2010, p. 582). No such resurfacing, however, was done and "[t]he institution was preserved – that is, the skeleton; but the fundamental rule was replaced by a non-rule, and the mission gradually changed" (LOWENFELD, 2010, p. 582).

The new mission of the IMF was then focused on guaranteeing the balance of payment of endangered countries in a world of floating exchange rates. The objective of restricting exchange rate manipulations was allocated to the new surveillance mechanism. However, due to a change in the economic policies of the major international partners that relaxed concerns over exchange rate manipulations and the expansion of the IMF's surveillance mechanism, in order to include several currency mechanisms and other economic factors, the objective was never completely attained.

On that, Lowenfeld further states that:

> Article IV did not accomplish the objectives that the drafters had in mind. Governments were reluctant to answer inquiries put by the Fund, and had no real incentive to do so. [...] The idea that the IMF, or the international community through the IMF, could prescribe conduct under amended Article IV comparable with what the Fund prescribed under Article V did not prove viable, if indeed it was ever seriously considered (LOWENFELD, 2010, p. 585).

The consequence was that the IMF no longer had the mechanisms, or even the purpose, of exerting a rigid control over exchange rate manipulations. Although this reality fitted well the new role of the Fund in international economic governance, it striped the Multilateral Trading System of its safe-net against competitive currency devaluations.

In this sense, current arguments defending that exchange rate issues should be dealt with solely at the IMF are outdated. As IMF history has demonstrated, the IMF can no longer be the main forum where the impacts of currency issues on trade should be discussed, especially not when the control of exchange rate manipulations is the main focus of discussion. It lacks the mandate and the mechanisms to do so (THORSTENSEN et al., 2013).

1.2 Exchange rate impacts on the multilateral trading system

Although left unguarded since the mid 1970s, the Multilateral Trading System would not feel the consequences of exchange rate deviations until the 2008 financial crisis. In the present political landscape, however, such accords are harder to be reached. After the crisis and the political choice of some of the biggest economies to devaluate their currencies in order to stimulate economic recovery and growth (notably the US, the EU, China and some other Asian countries), the problem has again arisen and the Multilateral System has found itself unprepared to offer solutions.

Although the economic effects of exchange rate misalignments have been discussed at lengths by the academia (LASTRA, 2005, chapter 2), less has been said about their impact on the regulatory framework of the Multilateral Trading System. This section will discuss what are these impacts and how can they be measured.

1.3 The case of tariffs and trade remedies

The possible impacts that exchange rates could have on the Multilateral Trading System were perceived already in the beginning of negotiations of the Havana Charter, when guidelines for the negotiations of tariffs were decided. In section E of the Annexure 10 of the Report of the First Session of the Preparatory Committee of the United Nations Conference on Trade and Employment (E/PC/T/33) it is stated:

> **Avoidance of New Tariff or other Restrictive Measures.**
> It is important that members do not effect new tariff measures prior to the negotiations which would tend to prejudice the success of the negotiations in achieving progress toward the objectives set forth in Article 24, and they should not seek to improve their bargaining position, by tariff or other restrictive measures in preparation for the negotiations. *Changes in the form of tariffs, or changes in tariffs owing to the depreciation or devaluation of the currency of the country maintaining the tariffs, which do not result in an increase of the protective incidence of the tariff, should not be considered as new tariff increases under this paragraph.* (emphasis added)

The logic of the provision was that devaluation of exchange rates could have direct impacts on the tariffs being negotiated. Based on this provision, Brazil promoted an adjustment of its tariffs before its entry into negotiations, in 1947:

> Owing to the depreciation of the Brazilian currency (18.67 cruzeiros – US$1), the Brazilian import duties are reduced by 47 per cent. In order to correct this maladjustment the Brazilian Government decided to readjust the duties of its tariffs taking into account only part of the currency depreciation, i.e. 40 per cent. Otherwise, the Brazilian Government would

> initiate the multilateral negotiations at Geneva by making a gratuitous reduction of 47 percent of the duties of the Brazilian tariff. Furthermore, it must be pointed out quite clearly that the wording of Annexure 10 is "owing to the depreciation of the currency". This means that those provisions take into account not only the devaluation on the par value made by law or by agreement with the International Monetary Fund, but also the actual currency depreciation at the time of the multilateral negotiations at Geneva. (ECOSOC, *Note by the Brazilian Delegation on the adjustment of the Brazilian custom tariff*, Second Session of the Preparatory Committee of the United Nations Conference on Trade and Employment, August 5th, 1947, E/PC/T/151, p. 2).

In this sense, since its very beginning, the effects of exchange rate deviations on tariffs were already discussed by GATT contracting parties. Exchange rates can be defined as the rate at which a currency can be traded into another currency. In other words, it is the price of a country's currency represented in a second currency. It allows for the price comparison of two goods produced in different countries, using different currencies. In this sense, the exchange rate is directly associated with the price of a good in a given market.

Whenever an exchange rate is devalued it means that the import price of a product represented in another currency will be less than it should be if the exchange rate was at its equilibrium (assuming the export price of the product not to be too responsive to exchange rate misalignments). It affects, thus, not only the competitiveness of this product in a given market, but also the market access negotiated under the WTO and the effectiveness of import tariffs applied: since ad valorem tariffs are levied as percentages of a product's price, a devaluation of this price will impair its effectiveness, while specific tariffs will be enhanced by the devaluation of the exporting country's currency.

Besides the price effect, another possible way of examining these impacts is to use the concept of "tariffication", where *ad valorem* equivalent rates are calculated merging tariffs and exchange rate misalignments. Just like tariffs, the effect of the exchange rate can be transferred to imported and exported goods' prices. Persistent exchange rate misalignments do have significant distortion effects on *ad valorem* applied and bound tariffs negotiated in the WTO, being at the same time an incentive to exports from a country maintaining an undervalued currency, as well as raising additional barriers to the entry of imports into its market (THORSTENSEN et. al., 2012). However, import tariffs are not the only trade instruments affected.

Since the creation of the Multilateral Trading System, with the GATT, the contracting parties have sought to restrain protectionist measures to border tariffs. This would provide the system with better transparency and predictability. The notion of "tariffication" of trade instruments is of great importance to the Multilateral Trading

System and has been a key notion since its beginning. Many trade diversion studies make an effort to "tarifficate" trade restrictive measures in order to assess their impact on trade flows. The distortion effects of persistent and large exchange rate misalignments are not, in this sense, to be taken lightly.

Trade remedies such as antidumping and countervailing duties are themselves tariffs that are applied in amount to import tariffs at the border. Exchange rate misalignments can either strengthen or weaken the effect of trade remedy measures applied, in the case of a considerable variation between the currency used to levy the duty and the currency of the international price of the product after the investigation. That would mean a potential violation of the objectives of trade remedies.

If the aim of trade remedies is to address the effects of a determined unfair trade practice, its effectiveness depends on accurately accessing and countering such effects. Antidumping and countervailing measures, which both are levied, in general, as specific tariffs, will be distorted by exchange rate variations and will not accurately address the practice identified as unfair during the investigations, to the detriment of either the exporters or the affected sector involved. The measure would, possibly be recalibrated after its review. In the meantime, however, the exchange rate issue brings instability and unpredictability to yet this instrument.

In the same manner, the investigations prior to the application of trade remedies are themselves also affected by deep exchange rate misalignments. A country facing particularly deep devaluations can suffer additional antidumping duties if no proper consideration is done during investigations. The normal price construction and the price comparability both can be affected.

The issue was raised in a GATT panel brought by Brazil against EC's application of antidumping measures on cotton-yarn from Brazilian producers (EC-Cotton-Yarn, 1995). Brazil argued that the EC had violated its obligation under the Tokyo Round Antidumping Code (the predecessor of the Uruguay Round Antidumping Agreement – ADA) by not taking into consideration the particular volatile situation of Brazilian exchange rate concurrent with high inflation.

In early 1989, facing very high inflation, the Brazilian Government froze the exchange rate at one Cr$ ("Cruzeiro") to one US$ in an attempt to decrease money supply and control inflation. The exchange rate freeze continued for a period of three months. During this period domestic inflation continued to grow. Receipts from export sales (which were paid in US$), when converted into Cr$, remained stable. Following the unfreezing of the exchange rate, the Cr$ depreciated. Brazil argued that this combination of a fixed exchange rate and domestic inflation led to a gross distortion in the comparison between domestic prices (when used as the basis of normal value) and export prices, and this resulted in an inflated dumping margin.

Brazil argued that the phrase "particular market situation" in Article 2:4 (presently Article 2:2 of the ADA) included the relevant situations external to the domestic

market, such as exchange rates, which affect price comparability. Furthermore Brazil argued that Article 2:6 (presently Article 2:4 of ADA) required the EC to consider the particular exchange rate freeze situation in Brazil at the moment of export in order to respect the "fair comparison" requirement in the Article (EC-Cotton-Yarn, 1995, p. 77-81).

Although relating to a fairly specific situation involving exchange rate issues, the case was an opportunity in which both parts had to discuss particularly different views of the impact of exchange rate variations on antidumping investigations.

Brazil was of the view that the *EC's refusal to adjust the exchange rates used in its investigation violated a fundamental principle of the Agreement*, considering as "price dumping" what was, in fact, *the well-known phenomenon of 'exchange dumping'*. Furthermore, Brazil argued that in doing so, the EC *had relied on certain principles such as 'monetary neutrality' that were not valid in the context of antidumping proceedings*. (EC-Cotton-Yarn, 1995, p. 118).

The EC, on the other hand, argued that:

> The calculation of dumping margins had to be made on the basis of objective and verifiable information, and not on the basis of arbitrary and subjective aspects. Accepting Brazil's arguments in this regard would amount to introducing considerable amount of subjectivity and uncertainty into the system. It would go far beyond the scope of the Agreement, the possibilities and the competence of the investigating authorities, and the interests of the signatories to have security and predictability in international trade. (EC-Cotton-Yarn, 1995, p. 119)

Brazil disagreed that the clear intent of the negotiators was to leave "monetary aspects of dumping" outside the scope of the Agreement. Rather, the intent of the negotiators would have been to exclude the depreciation of exchange rate (the so called exchange rate dumping) from the antidumping mechanism. In other words, since exchange rate dumping was not part of the Agreement, due consideration to exchange rate situations should be done in order to respect normal price and price comparability, as well as to avoid considering such a phenomenon as "regular dumping" (EC-Cotton-Yarn, 1995, p. 280).

Both countries agreed that the present rules governing antidumping investigation excluded the possibility of considering exchange rate dumping in the "price dumping margin". Brazil however argued that completely excluding monetary aspects of dumping would do exactly the opposite, since it would open up the possibility of counting exchange rate dumping as regular dumping, while the EC feared the possible consequence of bringing unpredictability to the system if it considered such arguments.

The panel concluded that Brazil had not proved that the particular exchange rate situation at the time of the sells affected directly the prices practiced in its local market to render it inadequate as a basis for normal price consideration. On that, the Panel further stated that:

> Even assuming *arguendo* that an exchange rate was relevant under Article 2.4, it would be necessary, in the Panel's view, to establish that it affects the domestic sales themselves in such a way that they would not permit a proper comparison. Brazil had asserted that exchange rates were capable of affecting domestic sales and prices because, for example, the cost of raw materials could be affected by fluctuations in the exchange rate. In particular, domestic sales and prices could be affected if imported raw materials were used in domestic production. However, Brazil had not argued that the costs of raw materials used in manufacture of cotton yarn were in fact so affected. For the Panel to engage in such an exercise, it would have to exceed its scope of review. (EC-Cotton-Yarn, 1995, p. 479)

In this sense, the panel did not exclude completely the influence exchange rate misalignments could have on antidumping investigations. Actually, imported inputs were considerable costs in cotton-yarn production, and provided that Brazil presented this argument, exchange rate could be a relevant aspect in the investigation. In the Panel's view, there is no *a priori* exclusion of exchange rate considerations in the application of the antidumping rules.

Considering price comparability and Article 2.6 of the Antidumping Code, the Panel reached a narrower interpretation. It considered that:

> The exchange rate in itself is not a difference affecting price comparability. It is a mere instrument for translating into a common currency prices that have previously been rendered comparable in accordance with the second sentence of Article 2.6. In the view of the Panel, an exchange rate's function is to make it possible to subsequently effect an actual comparison on a common basis as provided under the other relevant provisions of the Agreement. (EC-Cotton-Yarn, 1995, p. 494)

The EC-Cotton-Yarn case exposed the lack of specific provisions to deal with the issue in the Antidumping Code. Such absence remained in the following Uruguay Round ADA. The same overall statement can be made in relation to the Subsidies and Countervailing Measures Agreement (SCM).

Other aspects of the Multilateral Trading System are potentially affected as well since they are based on tariffs in their functioning, The Dispute Settlement Mechanism

itself can be deeply affected in its efficiency since its most praised characteristic – the possibility of enforcing decisions through the allowance of retaliatory measures – would be softened were a country to maintain its currency persistently undervalued, weakening measures aimed at curbing its violating conduct. Naturally, different measures such the suspension of TRIPs rules would be immune to such effects, but a considerable part of the System could be jeopardized.

Furthermore, rules of origins can be distorted as well, since many rules depend on accurately assessing the value added to a product in different moments of the production chain. When dealing with severely distorted exchange rates, it becomes hard to determine the exact value added by a particular production stage. The assertion can be compromised, making it hard to guarantee the fulfillment of the objectives sought with rules of origin. This is particularly important in the context of Preferential Trade Agreements (PTAs), potentially being a cause of trade diversion and circumvention of the rules.

The Director-General to the WTO, Pascal Lamy, has already brought to the attention the difficulties modern production chains present to the traditional view of rules of origin and international trade negotiations in general (WTO News, Lamy: Global supply chains underline the importance of trade facilitation, 18 October, 2011). The "made in the world" initiative launched by the WTO to support measuring and analyzing international trade in terms of value added, can be severely impacted by exchange rate misalignments.

1.4 The overarching principles

A more disturbing picture can be drawn if one considers the impact of persistent exchange rate misalignments on some of the pillars of the Multilateral Trading System. One of the system's principles most hit by the different exchange rate fluctuations is the Most-Favored Nation (MFN) present in Article I of the GATT.

Under the MFN principle, each contracting party is broadly obliged to concede the same tariff treatment to every other contracting party. Furthermore, any kind of advantage or privilege one contracting party should have in relation to imports and exports with another contracting party should be "immediately and unconditionally" extended to all other contracting parties. This principle aims at bringing two main benefits to the system.

Firstly, it guarantees that no particular country will have a commercial advantage in its trade with another contracting party, which otherwise could raise tensions and divert trade. This is a broad guarantee, encompassing any kind of benefit a particular country could have in its trade with another country part to the system. The aim here is to avoid arbitrary allocation of trade flows between contracting parties, which could harm the benefits brought by international trade competitiveness.

The other benefit is the stability of the system. Since a producer knows he will face the same tariff barrier to export to a particular country no matter where he exports

from, he will be able to decide where to produce without taking applied tariffs into consideration. It also brings predictability and provides a better environment for production to seek whichever country presents better comparative advantages.

Misalignments and possible manipulations of exchange rates, however, bring another variable to the equation, with no direct connection to fair competition principle. The particular exchange rate of a country, and its variation from a level considered of medium term equilibrium, could represent an "advantage or privilege" in bilateral commercial relations between a set of countries when compared with other exchange rates portraying different levels of variation from their equilibrium. This is due to the effects exchange rate misalignments have on tariffs applied by each country.

After the fall of the fixed exchange rate system under the auspices of the IMF during the 1970s and its substitution with a floating exchange rate system, the contracting parties to the GATT have manifested their concern with its consequence to the multilateral trade system. In particular, the impact on market access actually faced by exporters was highlighted in a floating exchange rate system:

> 1. The CONTRACTING PARTIES, while not questioning the floating exchange rate system and the contributions it has made, acknowledge that in certain circumstances exchange market stability contributes to market uncertainty for traders and investors and may lead to pressures to increased protection; these problems cannot be remedied by protective trade action. (Exchange Rate Fluctuations and their Effect on Trade – Fortieth Session of the CONTRACTING PARTIES, Action taken on 30 November 1984 – L/5761)

When exchange rate misalignments are "tariffied" and applied to a country's tariffs, a better picture of the uncertainties brought to the system by the exchange market instability and the level of tariff barriers actually faced by exporters from a particular country can be perceived: each particular exporter, depending on where he exports from, will have different tariff treatments and privileges, meaning different market access levels, contrary to what the MFN principle states. The greater the length and persistence of such exchange rate misalignment, the greater the consequences for the most-favored nation treatment.

The absence of specific consideration to the broad and persistent exchange rate misalignments of WTO members means potentially innumerous different tariff treatments between any set of analyzed countries. This situation is directly the opposite of what the Multilateral Trading System sought with the establishment of the MFN principle.

Not only the MFN principle is affected but, with it, the principles of transparency and predictability. After the end of the fixed exchange rate system, the GATT

contracting parties, concerned with the negative effects of exchange rate fluctuations on international trade flows, made a statement urging the IMF to improve its system in order to take into account "the relationship between exchange market instability and international trade" (Exchange Rate Fluctuations and their Effect on Trade – Fortieth Session of the contracting parties, action taken on 30 November 1984 – L/5761).

In response, the IMF published in 1984 a study describing the ways by which such exchange rate instability could affect international trade flows (IMF, 1984). The academic and empirical evidences were inconclusive and no systemic adjustments were made by the contracting parties to the GATT in order to address the uncertainty and potential negative effects of exchange rate fluctuations. No particular study was commissioned by the GATT, however, to analyse the impacts of exchange rate manipulations on the instruments of the Multilateral Trade System.

1.5 Aid for trade and quota-free-duty-free initiatives

Finally, a crucial aspect of the WTO is also potentially affected by persistent exchange rate misalignments. Considered by many as the "social" aspect of the multilateral trade system, the Aid for Trade Initiative seeks to help least-developed countries to fight poverty and attain economic development through the insertion of their economies in the international market.

The outlaying idea is that through its insertion in the international market, small economies could get better prices for their products and better prospects for local producers. The volatility of exchange rates and, especially, the possibility of competitive devaluation of big economies currencies, bring deep instability and insecurity to such "export-led" and open economy strategies.

At the 1984 Declaration, the contracting parties had already identified the particularly fragile position that small trading countries would face in a floating exchange rate situation. At Paragraph 2 of the Declaration, it is stated that:

> The CONTRACTING PARTIES also recognize that adjustment to uncertainty over exchange market instability could be more difficult for small traders when hedging opportunities are limited, and for small trading countries and developing countries, *inter alia* when the geographical distribution of their trade cannot be easily diversified. (*Exchange Rate Fluctuations and their Effect on Trade* – Fortieth Session of the CONTRACTING PARTIES, action taken on 30 November 1984 – L/5761)

The following study by the IMF also acknowledge that small trading economies would be more vulnerable to intense exchange market instability since traders would have fewer hedging options (MF, 1984).

In this sense, Marc Auboin states that:

> Of particular concern to LDCs is the dilemma created by regular periods of losses in the terms of trade and at the same time the need to keep the nominal exchange rate relatively stable for domestic monetary policy reasons. In periods of terms of trade losses, this dilemma results in a constant real appreciation of domestic currencies, and hence an inducement to import, with adverse effects on the current account balance and debt to Bretton-Woods institutions. (AUBOIN, 2007, p. 26)

A recent OECD examined the impact of sharp exchange rate misalignments in two small open economies – that of Chile and New Zealand. It proved that small economies tend to be more impacted by exchange rate misalignments than larger economies such as the EU, the US or China (OECD, 2011).

The authors simulated misalignments, either upwards or downwards, of 10 per cent of these countries' exchange rates and analyzed the impact on their bilateral trade with bigger economies. Small trading countries have to bear the "full adjustment of exchange rate changes", as they have less diversified production and export base, being less in a position to move into economic sectors less affected by international trade. Bigger economies, when facing the appreciation of their currencies, are able to limit the damage done to their export position by moving up their production into sectors where price elasticity is wider. The study demonstrates, then, that smaller economies will be hit harder by exchange rate misalignments, either of their own currencies or of their bigger trading partners. Price elasticity and the structure of their production chains are also important, helping (or hindering) to mitigate negative effects.

The WTO has already acknowledged such problem. In a recent publication entitled "Aid for Trade at a Glance – 2011, showing results", published in conjunction with the OECD, the authors recognize that:

> If a currency is overvalued, trade liberalization can trigger rising imports and declining exports – because of the damage to cost competitiveness – with the excess demand for foreign exchange resulting in balance-of-payments problems. In addition, domestic economic activity usually declines and unemployment rises because the contraction in import competing sectors is not offset by an expansion of the export sector. Governments then face the choice of either adjusting the exchange rate or reversing trade reform. […] the impact of supportive macroeconomic policies is often larger than the impact of reducing binding export constraints through aid for trade. (WTO, OECD, 2011, p. 99)

This brings enormous challenges to the objective by the WTO to promote economic development of LDC through their insertion in the international market. These countries would depend on a very narrow band of export products, without any real space to divert their production or climb up the production chain. With whole economies dependent on such a small economic structure, exchange rate variations of any particular trade partner could have serious impacts to such programs.

In the same manner, the Quota-Free-Duty-Free Initiative, which the WTO Secretariat and some WTO members struggle to rescue out of the stalled Doha Round, could be offset by sharp variations of the exchange rates of either the conceding countries or of the beneficiaries.

The Quota-Free-Duty-Free initiative consists in an agreement between WTO members, in 2005, to make it mandatory for developed countries, and optional for developing countries, to give duty- and quota-free market access to all exports from least-developed countries. Members were allowed, nonetheless, to exclude up to 3% of tariff lines from this initiative, in order to protect sensitive sectors (LABORDE, 2008, p. 14).

When facing markets with undervalued currencies, LDC exports will be hurt by not zero but real positive tariffs.

2 WTO Agreements and the exchange rate issue

Considering the significant impacts that misaligned exchange rates have on trade, one might ask if the existing provisions under the WTO Agreements cannot address the matter, at least partially.

The issue is in fact already present at the WTO: even though it was not a major concern when the GATT was drafted, since, as explained above, the matter was considered under the competence of the IMF, two GATT articles dealt specifically with the issue of exchange rates. Furthermore, one might consider if other WTO rules, that were not initially intended to address the issue, can be applied in order to rebalance the impacts caused by misaligned currencies.

This section will first present the two GATT provisions that were drafted to deal with exchange rates, presenting its interpretation and the difficulties arising from its application to the current context of the multilateral trading system. In the following, other provisions of the WTO shall be interpreted in order to verify if they can properly address the issue of exchange rates.

2.1 WTO provisions on exchange rates

The provisions described below deal specifically with the impacts of exchange rates on trade. Nevertheless, it is necessary to verify if they are able to properly address the current challenges posed by misaligned exchange rates on the multilateral trading system.

2.2 Article XV

The main Article of the GATT to deal with exchange rates and its impacts on trade is Article XV. It establishes the cooperation between the GATT/WTO and the IMF for matters such as monetary reserves, balances of payments and exchange arrangements, denying the idea of a complete separation between WTO and IMF subjects.

The Article explicitly encourages WTO members to seek policy coordination on questions within the jurisdiction of the IMF that affect trade measures, recognizing the intrinsic relation between trade and finance and assuring the coherence of the international economic system as a whole, as designed at Bretton Woods.

Concerning the specific issue of exchange rates and its impacts on trade, Article XV:4 states that:

> Contracting parties shall not, by exchange action, frustrate the intent of the provisions of this Agreement, nor, by trade action, the intent of the provisions of the Articles of Agreement of the International Monetary Fund.

It puts on evidence the negative impacts that trade and exchange rate measures can have on one another, recognizing that exchange rate issues can affect international trade. The Article stresses the need for WTO members to take into account the relationship between the international trade and monetary systems and to avoid trade or exchange rate measures that could harm any of the purposes of both agreements.

Thus, an important question that has been raised by scholars is a about the relationship between GATT Article XV and Article IV of IMF's Articles of Agreement (See SIEGEL, 2002) and whether a violation of Article IV would be required in order to determine a violation of Article XV:4 (MIRANDA, 2010, p. 115-26). IMF's Article IV establishes the obligations of the Fund's members regarding exchange arrangements. Its paragraph (iii) reads as follows:

> Article IV: Obligations Regarding Exchange Arrangements
> Section 1. General obligations of members
> […] In particular, each member shall:
> (iii) avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members;

Much debate has taken place regarding the "intent" of "gaining an unfair competitive advantage over other members" and about the feasibility of the Fund identifying a member as a currency manipulator (ZIMMERMANN, 2011; FUDGE, 2011; IRWIN, 2011). It is fair to argue that, due to the deep transformation of the Fund's role in the international economic governance structure after the end of the dollar-gold standard

in the 1970s and 1980s (BOUGHTON, 2001), especially regarding the possibility of members choosing the "exchange arrangements of their choice" and the surveillance system in place, it is very unlikely that the IMF would recognize a country as in violation of its Article IV due to currency manipulation.

If that holds true, what are the consequences for the applicability of GATT Article XV:4?

The answer to these questions lies in the wording used in Article XV. Three different exchange terms are used throughout the Article, each bearing a specific meaning: exchange arrangements (Article XV title); exchange action (Article XV:4); and exchange controls or restrictions (Article XV:9). The link between GATT Article XV and IMF Article IV is made obvious by their titles, each citing exchange arrangements as their subject of regulation. The use of the term exchange arrangements at the title of both articles seems to indicate it as a general expression, encompassing the different actions and mechanisms provided for in these articles.

While the link between the two mechanisms is established, the limits and structure of the relationship, as well as each Organization's prerogative in the subject is somewhat less clear. Article XV:1 establishes a broad obligation for the WTO to cooperate and coordinate its actions regarding "exchange questions" with the IMF. Article XV:2, by its turn, establishes more specific obligations regarding consultations and prerogatives:

> In all cases in which the CONTRACTING PARTIES are called upon to consider or deal with problems concerning monetary reserves, balances of payments or foreign exchange arrangements, they shall consult fully with the International Monetary Fund. In such consultations, the CONTRACTING PARTIES shall accept all findings of statistical and other facts presented by the Fund relating to foreign exchange, monetary reserves and balances of payments, and shall accept the determination of the Fund as to whether action by a contracting party in exchange matters is in accordance with the Articles of Agreement of the International Monetary Fund, or with the terms of a special exchange agreement between that contracting party and the CONTRACTING PARTIES.

In this sense, in all cases in which Article XV is analyzed, and thus exchange arrangements are involved, the statistical findings (*e.g.* whether an exchange rate is misaligned) are presented by the Fund and must be accepted as part of the facts at disposal for an objective assessment by the panel/AB (India – Quantitative Restrictions, para 5.11-13). This interpretation is in line with the position held by the WTO Appellate Body in the case Argentina – Textile and Apparel:

> The only provision of the WTO Agreement that requires consultations with the IMF is Article XV:2 of the GATT 1994. This provision requires the WTO to consult with the IMF when dealing with 'problems concerning monetary reserves, balances of payments or foreign exchange arrangements'. (Argentina – Textiles and Apparel, AB Report, para 84-85)

This is the case of findings concerning GATT Article XV:4 obligation. In order to analyze the "exchange action" taken by a member that is allegedly frustrating the intent of the provisions of GATT, the contracting parties must consult with the Fund and accept its statistical findings.

It is important to emphasize, however, that this passage does not establish that the IMF will have the final word on whether a WTO member is in violation of Article XV:4 of GATT. The only judicial prerogative IMF has is on whether the exchange action is in accordance with the Fund's own obligations. One must bear in mind that the WTO and the IMF are two whole legal systems, each with its own peculiarities and legal reasoning, occupying two different worlds when it comes to legal and juridical interpretations. While the rules governed by the IMF are to be interpreted and applied by the Board of Governors of the IMF, the WTO is construed as a system where the legal obligations/principles are supposed to be given meaning by its dispute settlement mechanism.

This is important for the application of the exception present at Article XV:9. It reads as follows:

> 9. Nothing in this Agreement shall preclude:
> (a) the use by a contracting party of exchange controls or exchange restrictions in accordance with the Articles of Agreement of the International Monetary Fund or with that contracting party's special exchange agreement with the CONTRACTING PARTIES, or
> (b) the use by a contracting party of restrictions or controls in imports or exports, the sole effect of which, additional to the effects permitted under Articles XI, XII, XIII and XIV, is to make effective such exchange controls or exchange restrictions.

The *rationale* of this paragraph is to avoid the GATT mechanism of being in the way of the well functioning of the IMF. One of the main goals of the IMF is to ensure the stability of balance of payments (Article I:iv) and the financial health of its members (Art. I:i). In this sense, and in critical situations, the IMF allows for the exceptional use of capital controls and exchange restrictions throughout its Articles of Agreement.

Paragraph 3 of the Agreement between the IMF and the WTO further clarifies the issue of IMF decisions authorizing exchange restrictions, discriminatory

currency arrangements or multiple currency practices pursuant to the IMF Articles of Agreement:

> The Fund shall inform the WTO of any decisions approving restrictions on the making of payments or transfers for current international transactions, decisions approving discriminatory currency arrangements or multiple currency practices, and decisions requesting a Fund member to exercise controls to prevent a large or sustained outflow of capital. (Annex I, p. 3)

The Agreed Commentary on this provision provides as follows:

> Comment: This information on Fund decisions is relevant to the implementation of GATT and GATS because of certain consequences under these Agreements when a measure is consistent with the Fund's Articles (Article XV of GATT 1994 and Article XI of the GATS). Additionally, under the GATS, members are allowed to impose controls on capital transactions related to their scheduled commitments under certain circumstances, including if such controls are imposed at the request of the Fund. In practice, the Fund's authority to request capital controls (Article VI, Section 1(a) of the Fund's Articles) has never been used. (WTO, *Agreed commentary*, Annex III to document WT/L/195, 18 November 1996, p. 13-14)

Other GATT articles contain similar exceptions that take into account the functioning of the IMF, *e.g.* Article VII:c on multiple currencies conversion; Ad Note to GATT Article VIII regarding exchange fees for balance of payment reasons; Article XIV:1,3 and 5(a) on exceptions to the Rule of Non-discrimination; Ad Note to Section B of GATT Article XVI on multiple exchange rates.

A member will thus be allowed to depart from a GATT rule in order to duly apply an IMF provision. In such cases, as determined by GATT Article XV:2, the final word on whether the member is correctly applying the IMF provision and thus not violating the GATT obligation, falls onto the IMF prerogative. Article XV:9 is an example of such case.

GATT Article XV:9, however, makes clear reference to exchange controls or restrictions, while other GATT articles make direct reference to multiple exchange rates. These are the only exchange actions that are comprised in the exception. As noted above, these terms are found throughout the IMF's Article of Agreements and indicate specific exchange actions. It is then plausible to argue that exchange actions, other than exchange restrictions or controls and multiple exchange rates, even when operated in accordance with the Articles of Agreement of the IMF can still frustrate the intent of the GATT provisions and thus contravene GATT Article XV:4 (MIRANDA, 2010, p. 120).

The WTO Dispute Settlement Body (DSB) had the opportunity to analyze whether a measure was an exchange restriction in the sense of Article XV:9, and thus part of the exception rule and under the auspices of the IMF consideration, or whether it was an exchange action in the sense of Article XV:4. In the case Dominican Republic – Import and Sale of Cigarettes, Honduras argued that the foreign exchange fee charged on foreign exchange transactions by the Dominican Republic was computed on the value of imports at the selling rate of foreign exchange and applied upon the "importation" of a product, thus nothing more than an import charge, a trade measure within the jurisdiction of the WTO, although in the form of an exchange action (First oral statement of Honduras, para. 22).

On the other hand, the Dominican Republic argued that the foreign exchange fee was an "exchange restriction" because it was a direct governmental limitation on the availability or use of exchange as such and that the meaning of exchange restrictions should be interpreted by the IMF, citing the Article XV:9(a) exception (First written submission of the Dominican Republic, paras. 91-94).

Although the paragraph 4 of Article XV has not been directly cited by the parts, the underlying issue regarding the foreign exchange fee imposed by the Dominican Republic was whether it should be considered an exchange restriction part of the exception of Article XV:9 and under the jurisdiction of the IMF (as argued by the Dominican Republic) or a broader exchange action violating a trade obligation in the sense of Article XV:4 and thus a matter under the jurisdiction of the WTO (as argued by Honduras).

The Panel stated that Article XV:9 was an exception or an affirmative defense and, in so, that it would be Dominican Republic's burden to prove that the foreign exchange fee should be considered an exchange restriction. The panel noted that the foreign exchange fee only applied to importation of goods, but not to foreign exchange payments of non-import related services or to foreign currency payments made by Dominican Republic residents, nor to remittance of dividends from companies located in the Dominican Republic. The panel thus considered that the measure could not be considered a exchange restriction in the sense of Article XV:9 and stated that:

> The Panel considers that the ordinary meaning of the "direct limitation on availability or use of exchange … as such" means a limitation directly on the use of exchange itself, which means the use of exchange for all purposes. It cannot be interpreted in a way so as to permit the restriction on the use of exchanges that only affects importation. To conclude otherwise would logically lead to the situation whereby any WTO Member could easily circumvent obligations under Article II:1(b) by imposing a foreign currency fee or charge on imports at the customs and then conveniently

> characterize it as an "exchange restriction". Such types of measures would seriously discriminate against imports while not necessarily being effective in achieving the legitimate goals under the Articles of Agreement of the IMF. Therefore, the Panel finds that because the fee as currently applied is imposed only on foreign exchange transactions that relate to the importation of goods, and not on other types of transactions, it is not "a direct limitation on the availability or use of exchange as such". (Dominican Republic – Import and Sale of Cigarettes, Panel Report, para. 7.138)

The Dominican Republic further stated that the foreign exchange fee had been approved by the IMF as a part of its stand-by arrangement with the Fund and therefore it would be in accordance with the Articles of Agreement of the IMF (First written submission of the Dominican Republic, paras. 199-201). The Panel then decided to consult with the IMF, even though acknowledging it was not obligated to, and asked the Fund: i) how the measure was being applied by the Dominican Republic; and ii) whether the measure constituted an exchange restriction in the sense of the Articles of Agreement of the IMF. The IMF replied that the measure was not payable on sales of foreign exchange, rather, it was payable as a condition for the importation of goods (Dominican Republic – Import and Sale of Cigarettes, Panel Report, para.7.141).

It becomes clear from this case that the IMF has no jurisdictional say in exchange actions that may violate trade obligations in the WTO other than the specific cases of multiple currency practices or exchange restrictions or controls. The WTO must consult with the IMF in cases concerning exchange arrangements, but only to obtain statistical inputs.

This *rationale* is relevant in order to correctly differentiate between manipulators of exchange rate (IMF Article IV:3) and "frustrators" of trade objectives (GATT Article XV:4). Although related, such notions bear important differences. As indicated, the proof of, and IMF's political will to recognize, currency manipulation is complicated (ZIMMERMANN, 2011, p. 427-37). One could still argue that any exchange rate manipulation "to gain an unfair competitive advantage" over other countries will, if effective, frustrate trade objectives. The opposite is not necessarily true however. There may be other exchange actions that do not involve the specific action of exchange rate manipulation that can frustrate the intent of the GATT provisions.

The legal discussion at the WTO could, in this and other similar cases, shun the politically sensitive discussion of identifying currency manipulators and could focus on the analysis of the effects of exchange actions on trade. The IMF would be consulted to provide statistical inputs on exchange rate misalignments, while the WTO experts would determine if exchange actions were frustrating the objectives of GATT articles.

In order to declare a violation of Article XV.4, the WTO Dispute Settlement Body would need to determine that a member is taking an exchange action which is having consequences on trade and, furthermore, is frustrating the intents of the WTO.

The notion of exchange action is unclear and was never tested by the WTO Dispute Settlement Mechanism on a policy of currency devaluation. Although the expression has a wide meaning, one would still have to argue that policies of currency devaluation can be classified as exchange actions. It would be necessary to prove the existence of specific measures taken by a government that directly impacts on the misalignment of its exchange rate, either by provoking or sustaining the misalignment. The simple devaluation of a currency, without any identifiable "action" by the government, would not seem to be in violation of Article XV.4.

The second step to apply Article XV lies on the proof that the exchange action is frustrating the intent of the provisions of GATT. The meaning of the word "frustrate" is given in the Notes and Supplementary Provisions (Annex I) of Article XV, which explain that its intention is:

> […] to indicate, for example, that infringements of the letter of any Article of this Agreement by exchange action shall not be regarded as a violation of that Article if, in practice, there is no appreciable departure from the intent of the Article. […]

In order to violate Article XV, the exchange action must create a situation which departs "appreciably" from the economic situation provided for by another GATT article. In other words, a specific GATT mechanism "frustration" must be identified other than Article XV itself. Although not expressly invoked by the parts, it seems to be what happened in the case Dominican Republic – Import and Sale of Cigarettes regarding the violation of Article II.1. Concerning currency devaluations, Article II of GATT that deals with market access could be challenged. This interpretation will be developed below.

It is important to stress though that even in the absence of an independent violation of a specific article of the GATT – as it was the case in the Dominican Republic dispute – the argument based on GATT Article XV:4 obligation would only require to demonstrate that the exchange action frustrated the "intent" of the said provision. In other words, an exchange action can violate Article XV:4 even without violating completely the GATT mechanism whose intent has been frustrated – a *rationale* similar to the one present at GATT Article XXIII concerning non-violation.

2.3 Article II:6

The idea that exchange rate misalignments can affect the negotiated level of market access is evident under Article II:6. The Article allows the adjustment of tariffs in

order to reestablish the negotiated market access affected by misaligned exchange rates in one specific situation:

> The specific duties and charges included in the Schedules relating to contracting parties members of the International Monetary Fund, and margins of preference in specific duties and charges are maintained by such contracting parties, are expressed in the appropriate currency at the par value accepted or provisionally recognized by the Fund at the date of this Agreement. Accordingly, *in case this par value is reduced consistently with the Articles of Agreement of the International Monetary Fund by more than twenty per centum, such specific duties and charges and margins of preference may be adjusted to take account of such reduction*; provided that the CONTRACTING PARTIES (i.e., the contracting parties acting jointly as provided for in Article XXV) concur that such adjustments will not impair the value of the concessions provided for in the appropriate Schedule or elsewhere in this Agreement, due account being taken of all factor which may influence the need for, or urgency of, such adjustment. (Emphasis added)

A devalued currency has an effect of lowering the relative value of specific duties, enlarging the negotiated market access. It has the exact opposite effect of *ad valorem* tariffs, which have their relative value raised by a devalued currency, diminishing the market access. The Article allows, thus, countries to reestablish their negotiated market access that was unduly enlarged by the effects of the devalued currency, by negotiating a raise on their specific duties. This negotiation has occurred nine times during GATT era, between 1950 and 1975, allowing the raise of bound specific tariffs of Benelux, Finland (3 times), Israel, Uruguay (twice), Greece and Turkey.

Nevertheless, the provision encompasses only one of four possibilities of the effects of exchange rates on tariffs, the other three being: (i) overvalued currencies raise the relative value of specific duties, restringing the market access; (ii) devalued currencies raise the relative value of *ad valorem* duties, restringing the market access; and (iii) overvalued currencies diminish the relative value of *ad valorem* duties, enlarging the negotiated market access. If the Article recognizes the need that countries may have to adjust their tariffs in order to address to the impacts of currency misalignments, why not allow this adjustment in all four cases, instead of just one of them?

A second interesting issue raised by Article II:6 is the change in the international monetary system, from a par value to a floating exchange rate system. Initially, any devaluation that could give rise to the application of Article II:6 would be defined by the IMF, according with the par value system managed by the Fund. With the end of the gold standard, it would be necessary to adapt the Article, so misalignments could still be calculated, despite the lack of a par value.

The GATT contracting parties created a Working Group whose objective was to adapt the existing mechanism in Article II:6 to the new reality of floating exchange rates. From 1978 to 1980, the Working Group met and adopted, in January 29th 1980, the *Guidelines for Decisions under Article II:6(a) of the General Agreement* (L/4938, 27S/28-29). This document reaffirmed the importance of maintaining the mechanism in order to neutralize the effect of exchange rate devaluation on specific tariffs of contracting parties and created a methodology for the calculation of the currency depreciation, which shall be performed by the IMF. The calculation takes into consideration the import-weighted average exchange rate during the previous six months, and the depreciation shall be based on currencies of trading partners supplying at least 80% of the imports of the concerned country. This Guidelines have been incorporated under GATT 94, as established by its Article 1(b)(iv), and can be rightfully invoked by any WTO member.

It is also worth noting that, unlike Article XV, the provision of Article II:6 is focused on the misalignment itself and not on a governmental action that results in a currency misalignment.

Another relevant element of Article II:6 is the threshold of a 20% devaluation, to enable countries to adjust their tariffs. This is important as it shows that only large misalignments can have a significant impact on the level of market access, justifying an adjustment on tariffs. Under a floating exchange rate system, this threshold is even more necessary, since small variations and peaks in exchange rates occur often, but are not sufficiently grave to affect markets access. Only long standing misalignments, for the past six months, for instance, as established by the Guidelines, should be taken into consideration when evaluating the levels of market access. The Guidelines kept the threshold of 20% of exchange rate misalignment as a base for the renegotiation, but it should be noted that this threshold was considered reasonable based on the level of the tariff rates at that time. Due to the decrease of tariff rates levels, a new exchange rate misalignment threshold could be negotiated in order to allow a tariff renegotiation of the current systems of floating or administrated exchange rates.

Finally, it must be stressed that the negotiation mentioned in Article II:6 had the objective to assure that there has been an enlargement in the country s market access that surpasses the negotiated level and that the tariffs are not adjusted in such way as to restrain his access further than the original negotiated level. It is different, thus, of GATT's Article XXVIII, which allows members to withdraw its concessions, at the condition that it provides other compensations to maintain the general level of concessions. In the case of Article II:6, no compensation is required since the adjustment already aims to reestablish the level of concessions.

Of all the impacts of exchange rate on trade instruments, the impact on market access is the most relevant one, since it may impair the main aim of the WTO: to liberalize international trade, based on a balance negotiation of concession on market

access. Article II already provides some mechanisms to address the issue, but in an incomplete manner. Negotiations are essential to adapt the Article in a way it can fully prevent the distortions created by misaligned exchange rates on market access.

2.4 The applicability of other WTO provisions on the exchange rate issue

The following provisions were not drafted with the intention of dealing with the impacts of exchange rates on trade. They were designed to address other issues that could be faced at the multilateral trading system. Nevertheless, one can discuss if they can be applicable to the exchange rate issue.

2.5 Article II:1

The basic rules for market access in the context of the GATT/WTO are in GATT Article II. Article II:1(a) establishes that:

> Each contracting party shall accord to the commerce of the other contracting parties treatment no less favorable than that provided for in the appropriate Part of the appropriate Schedule annexed to this Agreement.

The paragraph states that the level of market access, determined by tariffs and other barriers, shall not be less than the negotiated level under each country s schedule of concessions.

The provision aims, thus, to assure that the negotiations made through GATT and WTO rounds are not impaired by any treatment imposed by a member that might increase or impose new barriers to international trade, reducing the market access. There is a worry of guaranteeing the respect of concessions in order to allow an increasing access to countries markets. Under this trade liberalization logic, the expression "less favorable treatment" should have a wide meaning, including all measures placed by a member that reduces the negotiated market access. Such is the understanding of the *EC – IT Products* case that has stated that a less favorable treatment should be understood as a measure that adversely affects the conditions of competition for a specific product (Panel Report, para. 7.757).

One could argue that since the provision makes reference to a treatment provided on a member s Schedule, this could only comprise tariffs. This interpretation is incorrect: Article II:1 (b) has specific provisions on customs and duties. If paragraph (a) was restricted to tariffs, both Articles would have the same exact purpose. The difference in the wording of both provisions should be taken into consideration. In Argentina – Textiles and Apparel, the Appellate Body found that 'Paragraph (b) prohibits a specific kind of practice that will always be inconsistent with paragraph (a): that is, the application of ordinary customs duties in excess of those provided for in the Schedule." (Appelate Body Report, para. 45). This leads to the conclusion that

paragraph (a) has a broader meaning that includes other practices besides the application of ordinary customs duties.

Another interpretation that leads to the same conclusion requires to "tariffy" exchange rate misalignment's effects, by calculating the percentage by which prices of products are increased or decreased due to the misalignment, as previously presented.

When dealing with converting currencies, the "tariffication" process can indicate distortions caused by misaligned exchange rates on prices. When this effect of misalignments is applied onto tariffs charged at the frontier, one can verify the real barriers imposed by a country to imported products and compare it to its WTO commitments.

In the case of devalued currencies, the final barrier imposed to imported products (tariffs adjusted to exchange rate misalignment) may be greater than the bound tariffs under the country s Schedule, reducing the market access and resulting on a less favorable treatment. This effect clearly impairs the aim of Article II, which is the maintenance of the negotiated market access, in a perspective of trade liberalization.

The provision requires, nevertheless, that such less favorable treatment is accorded by the country which is importing the products. In other words, the treatment must be attributable to governments. It cannot be a result of external circumstances. If one considers that the misalignment is a result of a country s policy, regardless if the devaluation was the aim of such policy or just a side effect, it is possible to argue that it is according a less favorable treatment than the one negotiated under the WTO, in violation of Article II:1(a).

Article II:1 (b), on its turn, states that products described on Schedules shall:

> [...] be exempt from ordinary customs duties in excess of those set forth and provided therein. Such products shall also be exempt from all other duties or charges of any kind imposed on or in connection with the importation in excess of those imposed on the date of this Agreement or those directly and mandatorily required to be imposed thereafter by legislation in force in the importing territory on that date.

In other words, countries have to keep their applied tariffs in an equal or lower level than their bound tariffs and shall not impose any other kind of duty connected with importation that exceeds the negotiated duties under the WTO. It should be noted that paragraph 1(b) is more specific than paragraph 1(a) and its violation automatically means a violation of paragraph 1(a).

Tariffs adjusted to the exchange rate misalignment may be considered as charged in excess of the ordinary customs duties settled on the country's Schedule. The exchange rate misalignment distorts the applied tariff and may increase it over the bound tariffs, especially in developed countries and countries that have recently acceded to the WTO, which have a very narrow margin between applied and bound tariffs. This tariff in excess

of the bound tariff would constitute a *de facto* violation of Article II:1(b) – and consequently of Article II:1(a), reducing the market access and disrespecting the negotiations of tariff reduction through the GATT and WTO rounds (HUDSON et. al., 2011).

The impacts of exchange rate misalignments on GATT Article II:1 are of great worry, since they directly affect the guarantees of the WTO system on the respect of market access commitments made by its members. The distortions caused by those misalignments on market access are undeniable and must be considered under the WTO, under the principles laid out on Article II.

Even if one considers that there is no violation of the letter of Article II:1, is still possible to argue that its intent has been frustrated, since misaligned exchange rates can reduce the negotiated market access. In this case, the frustration of such aim may give rise to a challenge under GATT Article XV:4, combined with Article II, as explained above.

2.6 Trade defense remedies

Other instruments that might be considered when dealing with the exchange rate issue are the trade defense remedies. Antidumping rights and countervailing measures are the two WTO instruments that can be used unilaterally against unfair trade. Those instruments allow countries that are importing products with unfair competitive advantage, due to the practice of dumping or the concession of subsidies, to implement duties up to the margin of this advantage, rebalancing the competition in their market. Considering the competitive advantages accorded by devalued currencies, in a manner that distorts many of the WTO instruments and principles, one can ask if there is an applicable trade defense remedy.

2.6.1 Antidumping

The Antidumping Agreement has very few dispositions on exchange rates. The Uruguay Round Agreement was based in the concept of dumping and the practices made during the GATT period, which, by its turn, was created under a context of par value system of currencies, where exchange rate misalignments where not a worry.

The concept of dumping is the practice of an export price below the comparable price of such product, in the ordinary course of trade, in the internal market of the exporting country (normal value). The concept of dumping, as presented above, is based on the difference of the two prices of a product (ADA, Article 2.1) and not on the comparison of the export price practiced and the export price that the product should have if the currency was not misaligned. This competitive advantage that products from countries with devalued currencies may have is not addressed under the Antidumping Agreement.

Under this "price dumping" concept, the issue of exchange rates appears only during the price comparison, when the normal value, in a local currency, must be

converted into the same currency used for the export price. Article 2.4.1 states that the conversion shall be made on the date of sale. During negotiations, such provision was proposed due the fact that "[...] the amount of the dumping margin may differ significantly, depending on the exchange rate to be used on specific case" (GATT, Submission of Japan on the Amendments to the Antidumping Code, Multilateral Trade Negotiations – The Uruguay Round, MTNNG/NG8/W/48, 1989, p. 5). An exception is made to fluctuations in exchange rates, which shall be ignored. Finally, exporters shall have at least 60 days to adjust their export prices to reflect sustained movements in exchange rates during the investigation.

The Article reflects some of the impacts of exchange rate fluctuations on trade, allowing mechanisms to adjust the calculation of dumping margins to sudden variations of exchange rates during the period of investigations, which could lead to an inadequate comparison between the export price and normal value. Nevertheless, it does not consider these variations after the implementation of antidumping rights nor it considers the effects of exchange rate misalignments on the determination of the injury.

Exchange rate misalignments can also affect antidumping rights in two different moments: during the investigation, when determining the injury caused by the dumped products and during the application of antidumping rights when there is variation of exchange rates.

When the conversion of the normal price is made in accordance with Article 2.4, there should be no impact of exchange rates on the determination of the margin of the dumping, since the same rate would be used for the establishment of the export price by the producer (considering the production costs in its local currency) and for the normal value, as converted to the export currency on the date of the sale. Since fluctuations shall be ignored, both rates should be the same, regardless of its misalignment.

The problem arises when determining the injury caused by the dumped products on the importing country's market. When a dumped product comes from a country with devalued currency, besides the unfair competitive advantage arising from the price dumping itself, it also has an advantage from its lower price due to the currency conversion at favorable rates. This second factor can increase significantly the injury caused by the imports of such product at the domestic industry of the importing country, which cannot compete with these artificially low prices. The amount of injury, used for the determination of the antidumping rights (Article 9.1), will be much greater than the injury that would be caused only by the dumping. This is relevant because the injury is essential to the application of antidumping rights. If no injury is caused by the dumping, but an injury is found due to currency devaluation, antidumping rights may be implemented in contradiction with its original aim of avoiding harmful price dumping.

In the case of antidumping, a devalued currency may facilitate the application of antidumping rights. This demonstrates the importance of addressing the issue of exchange rates under the WTO, since it distorts many trade instruments, in different manners. The correction of such distortions interests all countries, since countries with both overvalued and devalued currencies are being affected by exchange rate misalignments.

The second unaddressed impact on antidumping rights occurs after the investigation. Exchange rate fluctuations will affect the antidumping duties, frequently charged as specific duties in foreign currencies. This distortion will only be adjusted at the sunset review, until then, the producers may be charged of a much higher or lower antidumping duty, depending whether there was devaluation or overvaluation of the currency.

To address the competitive advantages of a product arising from currency devaluation, another instrument would have to be created, since the Antidumping Agreement has no provisions over the issue, except for the few ones mentioned above. This new instrument would be based on the comparison between the export price and the export price that would be practiced if the currency was in its medium term equilibrium. This is a concept of "currency dumping".

The concept is not new, and some countries had domestic provisions on it. The national legislation of South Africa, for instance, stated that:

> 84. The dumping duties which may be imposed in terms of section eighty-three, Shall be the following, namely – […] (e) "exchange dumping duty", which shall be the amount by which the actual cost of the goods as defined in section eighty-five is less than such cost expressed in the currency of the territory of origin or export of the goods and converted into Union currency at a rate which the Minister is hereby authorized to determine and notify in the Gazette. (*Anti-dumping and Countervailing Duties – Secretariat Analysis of Legislation*, Contracting Parties Twelfth Session, 1957, L/712, p. 94-95).

Furthermore, negotiations of the Havana Charter have considered this possibility, within a proposal of creation of four kinds of dumping, which could be object of antidumping measures: price, service (freight), currency and social dumping (UN, ECOSOC, Report of the Drafting Committee of the Preparatory Committee of the United Nations Conference on Trade and Employment, E/PC/T/34, 1947, p. 13).

The proposal was rejected possibly because in a par value system the idea of a currency dumping seemed a remote risk since the IMF would already provide enough guarantees to avoid countries manipulating their currencies to get competitive advantages. Nevertheless, in a floating exchange rate system, the concept of a currency dumping remedy seems very plausible, creating a trade defense mechanism

that would allow countries to offset the advantages acquired by imported products due to exchange rate misalignments.

Despite the lack of prevision of a currency dumping, GATT states, in its Second Ad Note to paragraphs 2 and 3 of GATT Article VI, that:

> Multiple currency practices can in certain circumstances constitute *a subsidy to exports* which may be met by countervailing duties under paragraph 3 or can constitute a *form of dumping by means of a partial depreciation of a country's currency* which may be met by action under paragraph 2. By "multiple currency practices" is meant practices by governments or sanctioned by governments. (Emphasis added).

This provision was included at the request of South Africa that stated that:

> Mr. Chairman, the South African delegation raised this matter of multiple currency rates in relation to what we term "exchange dumping duties", We had these expressions of opinion and we withdrew our endeavours to get the proposed new paragraph 7[1] written into this particular Article, by virtue of the fact that this commentary was to be included in the notes of this meeting. (ECOSOC, *Verbatim Report of the Twentieh Meeting of Commission A to the Second Session of the Preparatory Committee of the United Nations Conference on Trade And Employment*, E/PC/T/A/PV/20, 1947, p. 34)[2]

The provision shows that although no specific instrument to counter currency dumping was created and even though the IMF would exert control over exchange rates, some currency practices were still considered by members as a form of countervailable subsidy or dumping. It demonstrates that even with the supervision of IMF over exchange rates, a form of currency dumping was still addressed by the contracting parties.

2.6.2 Subsidies

Another trade defense instrument that should be analyzed when dealing with exchange rates is the countervailing measure. The SCM regulates the granting of subsidies and allows members to charge countervailing duties in order to offset the effects of subsidies on imports that are found to be injuring domestic producers.

Economically, a devaluation of a country's exchange rate can be considered as a subsidy, since it is a governmental policy, that includes the buying of foreign currency in order to keep its own currency at artificially low rates, and it has an effect of lowering the prices of exported products, granting them a competitive advantage in other markets. One can ask if this economic concept can be framed under the concept of subsidy under the WTO, allowing the use of countervailing measures.

The SCM has a much more restricted concept of subsidies:

> 1. For the purpose of this Agreement, a subsidy shall be deemed to exist if:
> (a)(1) there is a financial contribution by a government or any public body within the territory of a Member [...]; or
> (a)(2) there is any form of income or price support in the sense of Article XVI of GATT 1994; and
> (b) a benefit is thereby conferred.

In the case of devalued exchange rate, the conferred benefit is evident, as a devalued currency allows a product to have a lower price at the external market than it would have with an exchange rate at its equilibrium. The benefit could be recognized by the fact that the beneficiary would be placed in a *better position than it would be in the absence of the subsidy* (Canada – Aircraft, AB Report, para. 161).

A greater difficulty arises from the identification of a financial contribution. This requirement was intended to ensure that not all governmental measures that conferred benefits could be deemed to be subsidies (US – Export Restrains, Panel Report, para. 8.85). That indicates that the expression "financial contribution" cannot be understood in a wide sense, including all governmental measures that confer a benefit. A financial contribution is an act or an omission involving the transfer of money or the provision of certain goods or services (US – Softwood Lumber III, Panel Report, para. 7.24).

In order to classify a devalued currency as a subsidy, first of all it is necessary to prove that the government is taking action to maintain its currency artificially low. The devaluation cannot be a result of an external economic context, there must be a governmental act or omission. Nevertheless, even if a government is deliberately manipulating its currency, one has yet to identify the money transfer between the government and the beneficiary. It could be argued that this transfer lies in the act of converting a currency, by buying a foreign exchange rate at a lower price than the regular market price, or what should be the market price, since the official exchange rate would be the misaligned one.

Once again, the Second Ad Note to Paragraphs 2 and 3 of GATT Article VI states that multiple currency practices can in certain cases constitute a form of subsidy. As the Articles of GATT shall be read together with the SCM, this implies that, in some circumstances, one can identify a financial contribution – that would constitute a subsidy – in certain currency practices. The provision foresees, thus, that some currency practices might be deemed as subsidies by the contracting parties and should be object of countervailing measures.

To be actionable under the WTO, a subsidy must also be specific. A specific subsidy is either a prohibited subsidy (contingent upon export performance or upon the

use of domestic over imported goods), or a specific subsidy to an enterprise or industry or group of enterprises or industries (Article 2). In the case of multiple currency practices, the specificity was evident, since a lower exchange rate would be accorded only to some sectors, and thus an Ad Note was included under GATT Article XVI, in order to allow multiple rates in accordance with IMF.

In the case of a single devaluated exchange rate, it seems difficult to consider as specific a devalued exchange rate that should be available to all exporters, investors, etc. Nevertheless, if one can prove that the exchange rate is directly linked with the volume of a country s export, varying when this volume raises or diminish, it is possible to argue that the subsidy arisen from a devaluated exchange rate is contingent upon exports, and thus, a prohibited subsidy under SCM Article 3 – which could be object of a *fast track* panel.

Furthermore, by the provision on SCM Article 2.3, this prohibited subsidy shall also constitute a specific subsidy, actionable by countervailing duties if it is proved that it causes injury to the domestic industry of another member (LIMA CAMPOS; GIL, 2012).

A proposal dealing with trade defense remedies as a mechanism to address the effects caused by misaligned exchange rate is the "Currency Exchange Rate Oversight Reform Act of 2011". The American Act, still pending on approval, seeks to address to the effects caused by fundamentally misaligned exchange rates through negotiations or by implementing trade defense remedies.

The Secretary of Treasure shall submit to the Congress an annual report on monetary policy and currency exchange rates, which will include a list of currencies designated as fundamentally misaligned. Some of those currencies will be designated for priority action, according to factors such as: market interventions protracted in the currency exchange market; accumulation of foreign reserves; and restrictions on the inflow or outflow of capital, for balance of payment purposes.

The Secretary of Treasure shall seek bilateral consultations with countries with misaligned currencies, so these countries can adopt measures to address the issue, and also seek advice from the IMF, in case of currencies designated for priority action. In this last case, if no policy is adopted by the respective country, antidumping initiations taken by the US shall take into consideration the exchange rate effect, by adjusting the price used to establish export price to reflect the misalignment of the currency of the exporting country. The US government shall also: prohibit procurement by Federal Government of products and services from the country, if it is not party to the Agreement on Government Procurement; request that the IMF consult the country with misaligned currency under Article IV of IMF Articles of Agreement; and not approve any financing of projects located in the country.

One year after the designation of a currency for priority action, if no measure is adopted, the government of the US shall: request consultations at the WTO with

such country; and consider undertaking remedial intervention in the international currency markets.

The draft bill also proposes an amendment to the Tariff Act of 1930, in order to allow the initiation of investigations to determine whether currency undervaluation by the government of a country is providing a countervailable subsidy. The initiation of the investigation shall be mandatory for currencies designated as for priority action. The proposal also presents a provision that states that "the fact that a subsidy may also be provided in circumstances that do not involve export shall not, for that reason alone, mean that the subsidy cannot be considered contingent upon export performance".

The Act proposes, thus, both the creation of a currency dumping, that should be implemented together with regular price dumping, and the use of countervailing duties to address to exchange rate issues.

2.7 Article XXIII

One of the most unique rules of the WTO system is Article XXIII, which deals with non violation issues: measures that affect a member s benefits, gained through negotiations, although they do not violate any of the WTO rules.

GATT Article XXIII:1 (b) states that, if a member considers that a benefit accruing to it is being nullified or impaired as a result of the application by another member of any measures, whether or not it conflict with the provisions of GATT, the member may take the issue to the DSB. The disputes arising from Article XXIII can therefore be either violation or non-violation complaints.

The logic of this provision is that competitive opportunities, legitimately expected from tariff concessions, can be frustrated by both measures inconsistent and consistent with GATT (EEC – Payments and subsidies paid to processors and producers of oilseeds and related animal-feed proteins, para. 144; EC – Asbestos, AB Report, para. 185). Therefore, it is necessary to protect the balance of concessions under the WTO, by providing means to redress any actions that impairs member's legitimate expectations from tariff negotiations. In this sense, the Panel for Japan – Film considered that:

> [...] the safeguarding of the process and the results of negotiating reciprocal tariff concessions under Article II is fundamental to the balance of rights and obligations to which all WTO members subscribe. (Japan – Films, Panel Report, para. 10.35)

The possibility to pursue a complaint under Article XXIII based on misaligned currencies was affirmed in a Working Party of the GATT. In 1979, during the discussions on the application of Article II:6 (a), which allows the adjustment of specific duties by members with devalued currencies, under the new context of floating exchange rates,

a question was raised about the possibility of application of that Article in the opposite situation: whether contracting parties with appreciated currencies should be required to reduce their specific duties, in order to maintain the negotiated level of market access. The Working Party agreed not to pursue the matter, noting that contracting parties could resort to Articles XXII and XXIII of GATT if they considered that the currency appreciation impaired in a particular case the value of specific duty concessions (GATT, *Report of the Working Party on Specific Duties*, L/4858, 2 November 1979, p. 6).

A devalued currency that reduces or nullifies other members tariffs could, thus, affect the negotiated level of market access, and give rise to a complain, regardless of the violation of any WTO rule, if three elements are met: application of a measure by a WTO member; a benefit accruing under the GATT; and nullification or impairment of this benefit as result of the application of the measure (Japan – Film, Panel Report, para 10.41).

The word "measure" has a broad definition which encompasses binding government action as well as measures that have an effect similar to a binding one (Japan – Film, Panel Report, para 10.47-50). Regarding currency misalignments, one can argue that governmental policies that aim to keep exchange rates in a certain level below or above its fundamental equilibrium could be considered as a measure under the meaning of Article XXIII. It is important to notice that the Article requires an action by a government, which results on the misalignment. The misalignment itself cannot be object of a complaint under Article XXIII. Therefore, misalignments deriving from instability in the global economy, which express only the floating character of some exchange rates could not be charged under a non violation complaint.

Regarding the benefit, it is usually considered as legitimate expectation of improved market access. In a market with devalued currency, other members will face a more restricted market access, with higher tariffs, once considered the effects of exchange rates, which can easily be classified as an impairment of the legitimate expectation of improved market access. The opposite reasoning can also be done: when members with devalued exchange rates export their products, they are, by giving an incentive to their exports through devalued exchange rates, making other members concede a larger market access than the one that was negotiated, impairing expectations of a balanced level of concessions between these members.

An important aspect of those expectations of a benefit is that, in order to be legitimate, the measures must not have been reasonably anticipated at the time of the tariff concessions. This can be a problem when dealing with longstanding policies of currency devaluation. It could be argued that this specific situation could have been foreseen during the negotiations of tariff concessions and, therefore, there is no misbalance to be addressed to.

At last, one is required to prove the existence of a nullification or impairment of that benefit. Such nullification or impairment should be understood as upsetting

the competitive relationship between domestic and imported products, clearly caused by the measure at issue. When dealing with policies of currency devaluations, such nullification is evident, since it can give a significant competitive advantage to products, nullifying the protection performed by tariffs and further causing trade diversion.

Article XXIII can, thus, be a useful remedy to some cases of distortions caused by exchange rate misalignments. Nevertheless, it does not directly address the issue, maintaining the systemic distortions caused by misaligned exchange rates.

Conclusions

Although the GATT and, later, the WTO, have a few provisions on exchange rates, proving the direct relation between exchange rates and international trade, a more consistent regulation over the issue was never a primary concern. The exchange rate misalignments that have caused similar trade imbalance concerns after the end of the dollar/gold standard have all been met with political negotiations between a few interested parties. In the present political landscape, with multiple relevant actors, however, such accords are harder to be reached, as can be noted with the G-20.

After the 2008 financial crisis and the political choice of some of the biggest economies to devaluate their currencies in order to stimulate economic recovery and growth (notably the US, the EU, China and some other Asian countries), the problem has again arisen and the Multilateral System has found itself unfit to offer solutions. This issue has proved to be hard to solve, bringing unpredictability and tension to international trade, with arguments of trade protectionism from all sides.

Three alternatives can be foreseen to avoid the detrimental impact of persistent exchange rate misalignments over international trade context. First of all, although unlikely in the present international scenario, a political agreement to the likes of the Plaza and Louvre Accords can be met among the principal interested parties, namely China, the US and a few other countries, in order to achieve a compromise over the misalignment of their exchange rates.

Secondly, a multilateral negotiation should take place in the WTO to adapt the existing rules to the new international trade landscape, taking into consideration the new role and focus of the IMF and WTO. Exchange rates are no longer controlled efficiently by the IMF, being one of several macroeconomic tools that countries can resort to in order to equilibrate their balance of payments. Presently, IMF Article IV reviews take into consideration the renewed focus of the Organization and no longer demand countries that they avoid manipulating their exchange rates. This broad review and the place of exchange rates in this scheme are perfectly adapted to IMF's objectives, but they bring deep consequences for international trade and the well functioning of the WTO law.

The members of the WTO should address this new reality and work on reforms to the multilateral trading rules system in order to offer the necessary mechanisms to neutralize the effects of persistent exchange rate misalignments over members' trade. This negotiation has to be done alongside representatives of the WTO and IMF so as to guarantee the coherence between the organizations required be the Marrakesh mandate (Marrakesh Agreement Establishing the World Trade Organization, Article III:5).

Finally, there are a few provisions under the WTO Agreements that could be applicable to the exchange rate issue. A case study of a specific devaluated currency could conclude on the possibility to challenge a WTO member under the Dispute Settlement System, based on violation (and non-violation) of WTO provisions due to its currency misalignments. Article XXIII and, especially, Article XV:4 combined with Article II:1 could be argued before a panel in order to address specific governmental measures thought to be causing exchange rate misalignments.

In principle, countries that maintain devalued currencies violate Article XV:4 (frustration), through the frustration of Article II:1 intents (applied *ad valorem* tariffs above bound tariffs).

The evolutions suffered by the Bretton Woods System were not properly incorporated by the IMF and the WTO, and more rules could be negotiated in the multilateral trading system in order to create stronger mechanisms to deal with the impacts of exchange rates on trade. Nevertheless, in the absence of these new rules, the main provision on the relationship between exchange rates and trade – GATT Article XV:4 – can be an useful tool to prevent, through the WTO Dispute Settlement Mechanism, further damaging effects of misaligned exchange rates on the multilateral trading system.

NOTES

1 Paragraph 7 of Article 17 of the Havana Charter Draft would have established the concept of currency dumping.

2 UN, ECOSOC, *Verbatim Report of the Twentieh Meeting of Commission A to the Second Session of the Preparatory Committee of the United Nations Conference on Trade And Employment*, UN ECOSOC, E/PC/T/A/PV/20, 28 June 1947, p. 34.

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