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

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INTRODUCTION

The Chinese Government recently removed the decade-long peg of the *yuan* to the dollar, prompting widespread speculation among pundits and economists concerning the potential effects on the U.S. economy.[1] China's currency (the renminbi or yuan) was initially pegged against the dollar in 1994, which prevented the yuan from fluctuating in response to market forces.[2] Unlike the free-floating U.S. dollar, China maintained a fixed exchange rate through governmental intervention.[3] The value of the yuan is now tied to price movements within a basket of currencies, but the central bank still retains significant discretion in setting the yuan's value each day.[4] A consequence of China's strict mone-

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1. See Keith Bradsher, *China's Currency Shift: News Analysis; Saying Goodbye to Mr. Greenspan*, N.Y. TIMES, July 22, 2005 (explaining that the People's Bank of China revalued the currency by 2 percent, increasing the yuan's value in relation to the dollar from 8.277 to 8.11). The yuan is now permitted to trade in a range of 0.3 percent each day, theoretically creating the possibility of 6 percent appreciation each month. *Id.*

2. *See* Board of Governors of the Fed. Reserve Sys., Fed. Reserve Stat. Release: Foreign Exchange Rates, 1990-99 (indicating that China revalued its currency in relation to the dollar from 5.8 to 8.7 yuan on Jan. 3, 1994), *available at* http://www.federalreserve.gov/releases/h10/hist/dat96_ch.txt (last updated Nov. 8, 2004); *see also* Bradsher, *supra* note 1 (stating that before severing the peg, the yuan had remained at 8.28 to the dollar since 1997).

3. *See* JOHN J. JACKSON ET AL., LEGAL PROBLEMS OF INTERNATIONAL ECONOMIC RELATIONS § 22.1 (4th ed. 2002) (distinguishing between floating exchange rates, which increase or decrease in value based on supply and demand, and fixed exchange rates, which remain unchanged through central bank regulation of currency inflows and outflows).

4. Bradsher, supra note 1 ("To determine the new peg, the central bank will look at how a basket of foreign currencies moved the day before. But the central bank did not reveal which currencies it will track or their relative weightings within

tary policy and healthy trade surplus with the United States is an appetite for U.S. debt (U.S. Treasury Bonds, etc.) and abundant levels of foreign reserve, which are necessary to offset inflationary pressure and to maintain the desired exchange rate.[5] Many U.S. labor and manufacturing groups believed that China's fixed exchange rate policy violated the World Trade Organization ("WTO") and the General Agreement on Tariffs and Trade ("GATT").[6] They asserted that the exportation of U.S. jobs to China and the increased U.S. demand for Chinese imports were results of China's strict currency policy.[7] The U.S. government also opposed China's currency policy but believed that a diplomatic approach, rather than a formal complaint to the WTO, was the appropriate governmental response.[8] Some U.S. Congressmen, however, believed that countervailing measures were appropriate and introduced legislation to curb what they believed to be a manipulative currency policy that unfairly encouraged Chinese imports.[9] Depending on how one interprets China's new currency regime, the U.S. government's strategy was successful. However, the question still remains whether China's

the basket. This policy gives enormous discretion to China's leaders to push the yuan up or down as they choose.").

5. *Id.* ("Dollars have flowed into China for investments and to buy goods. To keep the yuan from rising against the dollar, the Chinese government has had to buy dollars, many of which have been invested in U.S. Treasuries."); *see also* China Knowledge, *China's Foreign Reserves Reach $740 Billion* (Sept. 19, 2005) (reporting that China's foreign exchange reserves reached $740 billion in July 2005 up from $711 billion in June), *at* http://www.chinaknowledge.com/news_detail.asp?cat=finance&ID=265.

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

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

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

9. *See* CATO Institute, Protectionism No Fix for China's Currency (June 25, 2005) ("On June 21, four members of the House introduced a bill that would impose steep tariffs on Chinese goods equal to the advantage they supposedly gain from that country's 'manipulated' currency. A similar amendment offered in the Senate by Charles Schumer (D-N.Y.) and Lindsey Graham (R-S.C.) won broad support in a test vote in April. Supporters of the get-tough approach claim that China's currency is fixed at an undervalued rate that makes imports from China artificially attractive while discouraging U.S. exports to China. As evidence, they cite America's $160 billion bilateral trade deficit with China."), *at* http://www.cato.org/pub_display.php?pub_id=3946).

maintenance of the peg was ever a subsidy as defined by the WTO. The murkiness of China's new currency policy and continued central bank intervention has led some to conclude that severing the peg was only a political or symbolic gesture and was not intended to relinquish governmental control over exchange rates or to permit meaningful appreciation of the yuan.[10] Indeed, shortly after announcing its new currency policy, the People's Bank of China (China's central bank) stated that subsequent revaluations or upward movement of the yuan was unlikely and any expectation of continued appreciation was unfounded.[11] Considering China's growing economic presence and the role of exchange rate policy in contributing to its expansion, an analysis of the relevant laws applicable to exchange rates is needed.

With a population of more than one billion people, China is an enormous market.[12] As it gradually transitions to a market economy, China has experienced increased trade and foreign direct investment ("FDI").[13] Its economy is growing rapidly and China is currently the United States' third-largest trading partner.[14] In 2001, China became a member of the WTO, allowing the United States greater access to China's vast market.[15] Exports from the United States to China have increased substantially since 2001 but are greatly outweighed by imports from China.[16] A growing trade deficit therefore exists between the

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10. *See* Chris Isidore, CNN Money, China revalues yuan, July 21, 2005 (quoting Professor Peter Morici who commented on China's new currency policy: "This is a fig leaf. It's an attempt by the Chinese to do the least amount possible.").

11. *See* Peter S. Goodman, *Don't Expect Yuan To Rise Much, China Tells World*, WASH. POST, July 27, 2005, at D01.

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

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

14. *See* Office of the U.S. Trade Rep., *supra* note 12 (revealing that China had surpassed Japan in trade with the United States and that while global growth had fallen by 2 percent over the past three years, the Chinese economy had expanded by more than 8 percent).

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

16. U.S. Census Bureau, Foreign Trade Statistics: Trade with China (Nov. 10, 2004) (tallying total exports from the United States to China during 2004 at approximately $34.7 billion, while Chinese imports to the United States totaled $196 bil-

United States and China.[17] Although China has made significant progress in opening its economy to foreign competition, it has failed to implement several of its WTO obligations.[18] In addition to its WTO shortcomings, China has maintained a peg against the dollar, resulting in what many believed was an undervalued rate of exchange.[19] China severed the peg on July 21, 2005, and has marginally revalued the yuan upward against the dollar.[20] With a multitude of economic concerns, China is reluctant to truly liberalize their currency regime and risk a financial crisis.[21] Most of the disagreement in the United States revolves around the proper approach for the U.S. government to adopt in pressuring China to liberalize its currency policy in order curb massive U.S. trade and budget deficits and to prevent further outsourcing of domestic jobs.[22]

This Comment will evaluate whether China's fixed currency regime constituted a violation of the GATT or the WTO provisions concerning subsidies and dumping. The arguments charging that China is in violation of the WTO and the GATT were articulated in the "Section 301 Petition" ("the Petition"),[23] in which various labor groups, including the AFL-CIO, urge the U.S. government to take legal action against China in regard to its currency policy. This Comment will argue that a thorough examination of the relevant provisions reveals that China was

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lion), *at* http://www.census.gov/foreign-trade/balance/c5700.html#2004 (last modified Dec. 14, 2005).

17. *Id.* (revealing that the trade deficit between the United States and China in 2004 was $161.9 billion, an increase of $39 billion from 2003 and $58.9 billion from 2002). The trade deficit for 2005 ($166.8 billion as of October 2005) surpassed the total for 2004 even without November and December. *Id.*

18. *See generally*, Office of the U. S. Trade Rep., *2003 Report to Congress on China's WTO Compliance* (Dec. 11, 2003) (indicating that China had failed to implement trade liberalizing commitments concerning agriculture, intellectual property rights, services, valued-added tax policies, transparency, trading rights, and distribution services), *at* http://www.ustr.gov/World_Regions/North_Asia/China/Section_Index.html (last visited Nov. 1, 2004).

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

20. *See* Bradsher, supra note 1.

21. *See* Neil King Jr. & Charles Hutzler, *China Tells U.S. Yuan Flexibility Is on the Horizon*, WALL ST. J., Sept. 29, 2004, at A2 (noting China's intent to adopt a more flexible exchange rate regime, but recognizing that 5 percent inflation, inefficient state-operated companies, and a banking sector encumbered with bad loans might prevent monetary policy changes in the near future).

22. *See* Elizabeth Becker, *Industry and Labor Step up Fight over China's Currency*, N.Y. TIMES, Sept. 10, 2004, at C3 (reporting the U.S. government's disagreement with and dismissal of the Section 301 Petition).

23. *See supra* note 6, at 50 (explaining how China violated Article VI and XVI of the GATT and the SCM Agreement).

not violating the WTO or the GATT by maintaining a fixed currency regime.[24] Since a formal complaint to the WTO would probably fail, the United States should assist China in reforming its banking and financial services sectors while strongly urging compliance with existing WTO obligations.[25] Creating conditions of stability and security within China's banking and financial industries might diminish the Chinese government's reluctance to adopt a currency policy that would permit the yuan to be valued based on market forces.[26]

Part I of this Comment provides background on China's monetary policy, an overview of the Bretton Woods institutions, and an examination of relevant trade law.[27] Part II evaluates whether China's exchange rate policy constitutes a subsidy as defined by relevant provisions of the GATT and WTO.[28] Part III provides suggestions as to how to influence China to adopt a more liberal currency regime and reduce the bilateral trade deficit.[29]

I. BACKGROUND

Historically, China has been plagued with failed efforts to modernize and to reform its economy.[30] In 1979, after the death of Mao Zedong, one of the most prominent political figures in Chinese history, veteran members of the Chinese Communist Party adopted a more liberal economic policy that minimized

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

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

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

27. *See* discussion *infra* Part I.

28. *See* discussion *infra* Part II.

29. *See* discussion *infra* Part III (reasoning that China might be more amenable to adopting a liberal exchange rate if the appropriate support structures were in place, and that full compliance with existing WTO obligations and elimination of capital flows restrictions could improve bilateral trade imbalances).

30. U.S. Dep't of State, Background Note: China (Oct. 2004) (tracing the failed effort of Zedong Mao beginning in 1958 to implement revolutionary economic policies, leading to years of political friction and economic stagnation), *at* http://www.state.gov/r/pa/ei/bgn/18902.htm (last visited Nov. 10, 2004).

central planning and encouraged privatization.[31] During the 1980s, China continued to pursue market-oriented reforms, resulting in significant economic growth.[32] But rapid economic expansion produced inflation, and the Chinese government reacted by adopting a strict monetary policy to reverse inflationary pressure.[33] One component of their monetary policy was to peg the yuan to the dollar in 1994; this helped reduce inflation and maintain economic growth.[34] In addition, the tight monetary controls utilized by the Chinese government allowed China to avoid the effects of the Asian monetary crisis of the late 1990s.[35] China's economy is still expanding, and strict monetary policies have continued to promote economic growth, despite inflationary pressure and large amounts of bad debt.[36]

A. Bretton Woods System

After World War II, a series of conferences resulted in the creation of the International Monetary Fund ("IMF"), the World Bank, and the GATT (1947).[37] They were known collectively as the Bretton Woods System and were intended to prevent economic crisis and to promote capitalism.[38] A principal concern during the Bretton Woods negotiations was the issue of free

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

32. *See id.* (indicating that the reforms of 1979 led to annual growth rates of 10 percent in agriculture and industrial output and doubled annual income in rural areas).

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

34. *See id.* (observing that the increase in broad money peaked in 1994 but decreased the following year, and that by 1997 the consumer price and the retail price had significantly decreased while 8.8 percent economic growth had been maintained).

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

36. *See supra* note 30, at 5 (mentioning that China experienced 8 percent growth in 2002 and 9.1 percent growth in 2003 amidst the severe acute respiratory syndrome (SARS) outbreak, defaulting loans, inefficient state owned enterprises, and increased rural unemployment).

37. *See* Jackson et al., *supra* note 3, at § 5.4 (explaining that the Bretton Woods conference, where the IMF and International Bank for Reconstruction (World Bank) were created, was held in New Hampshire in 1944 but that the GATT was completed later in 1948).

38. *See* Wikipedia, *Bretton Woods System* (listing the goals of participating countries: to eliminate the economic policies that caused the Great Depression, prevent world war by promoting a liberal economic system, and encourage international economic cooperation through free trade), *at* http://en.wikipedia.org/wiki/

floating currencies and their detrimental effects on trade.[39] The participants agreed to adopt fixed exchange rates and to accept the role of the IMF as the global supervisor of monetary policy.[40] Ironically, it was not until 1971 that the United States discarded its fixed exchange rate policy and floated the dollar.[41] Thus, while one goal of the Bretton Woods Conferences was to encourage open markets and free trade, stability was the main theme and resulted in the adoption of fixed exchange rates by all members.[42]

1. *IMF and GATT: Scope*

A central purpose of the IMF is to monitor the exchange rate policies of member countries.[43] Article XV of the GATT reiterates that the IMF is responsible for exchange rate issues, while the GATT is responsible for trade-related issues.[44] The IMF and members of the GATT are encouraged to collaborate when currency issues affect trade, or vice versa, but there is no

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Bretton_Woods_Conference#.22Floating.22_Bretton_Woods_1968-1972 (last modified Nov. 8, 2004).

39. *See* Benjamin J. Cohen, *Bretton Woods System* (indicating that the floating exchange rates in place during the 1930s reduced trade because of currency fluctuations caused by speculation and government devaluation), *at* http://www.polsci.ucsb.edu/faculty/cohen/inpress/bretton.html (last visited Oct. 20, 2004).

40. *See id.* (requiring that participating governments maintain fixed exchange rates within a range of 1 percent, unless balance of payments imbalances required revaluation of the currency). The IMF was given three functions: regulation of currency values, financial aid, and consultation. *Id.*

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

42. *See Bretton Woods System, supra* note 38 (detailing the shift away from the use of gold as the standard for pricing currencies and the emergence of the dollar as the accepted standard), *at* http://www.state.gov/r/pa/ei/bgn/18902.htm (last visited Oct. 22, 2004).

43. *See* Articles of Agreement of the International Monetary Fund, July 22, 1944, art. IV(3)(a) ("The Fund shall oversee the international monetary system in order to ensure its effective operation. . . . [T]he Fund shall exercise firm surveillance over the exchange rate policies of members, and shall adopt specific principles for the guidance of all members with respect to those policies . . . the Fund shall pay due regard to the circumstances of members.").

44. General Agreement on Tariffs and Trade, Oct. 30, 1947, art. XV(1), 61 Stat. A-11, T.I.A.S. 1700, 55 U.N.T.S. 194 [hereinafter "GATT"] ("The CONTRACTING PARTIES shall seek co-operation with the [IMF] to the end that the CONTRACTING PARTIES and the Fund may pursue a coordinated policy *with regard to exchange questions within the jurisdiction of the Fund and questions of quantitative restrictions and other trade measures within the jurisdiction of the CONTRACTING PARTIES*")(emphasis added).

indication that the GATT has exclusive authority to address the exchange rate policies of member countries.[45]

A report by the GATT's Balance of Payments Committee provides further guidance on the topic of exchange rate measures, stating that "the [GATT] CONTRACTING PARTIES have no authority over exchange restrictions."[46] Another working paper indicates that when a question of overlapping jurisdiction arises, the GATT should only address trade issues.[47] Although exchange issues and trade issues are often difficult to distinguish, the policy for resolving exchange practices that have trade effects is for GATT members to consult with the IMF.[48]

B. GATT: Ad Article VI - Paragraphs 2 and 3

Generally, Article VI of the GATT seeks to prevent dumping, a practice in which a country artificially lowers the price of its exports below the market prices of comparable products.[49] Since dumping is analogous to a subsidy, it will be discussed in subsequent sections.[50] This section will analyze Ad Article VI, Paragraph 3, which addresses multiple currency practices.[51] Mul-

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

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

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

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

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

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

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

tiple currency practices are government measures that apply a favorable currency rate to exports in one category, but neglect to apply the same currency rate to other exports, in an effort to promote the exportation of the preferred product.[52] In some instances, if a country receives approval from the IMF, it can implement a multiple currency practice, but it is obligated to inform the GATT members if the multiple currency practice functions as a subsidy.[53]

C. WTO: SCM Agreement

The Agreement on Subsidies and Countervailing Measures ("SCM Agreement") sets forth several elements that must be satisfied in order for a governmental measure to be deemed a prohibited subsidy.[54] In addition, Annex I of the SCM Agreement lists practices that represent export subsidies and have been cited in the Petition[55] as applicable to China's currency regime.[56] Finally, the SCM Agreement contains several exceptions—developing countries, existing programs, and countries moving toward market economies—that might be applicable to China.[57]

1. *Elements of a Subsidy*

The elements of a prohibited subsidy are: (1) a government financial contribution, (2) a benefit conferred, and (3) specificity.[58] Under the SCM Agreement, there are several methods by which a government can make a financial contribution, including a direct transfer of funds, revenue foregone, provision of goods

52. GATT Sub-Committee Meeting, Negotiations on Ad art. VI ¶¶ 2-3 *microformed on* E/PC/T/A/PV/20 p. 34-36 (Geo. Int. Law Library) (transcribing the negotiations surrounding Ad. Article VI, ¶ 3 and explaining that a multiple currency practice is a government's practice of applying a favorable exchange rate to a product it wants to export, while applying less advantageous exchange rates to other products).

53. GATT Analytical Index, art. XVI (citing the Review Pursuant to art. XVI:5, which indicated that a member was obligated to notify other GATT members if its multiple currency practice functioned as a subsidy, regardless of whether the IMF approved of the practice).

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

55. *See* Petition, *supra* note 6, at 66-69 (claiming that China's currency policy violates items (b) and (j) of Annex I of the SCM Agreement).

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

57. SCM Agreement art. 27-29.

58. *See* Agreement on Subsidies and Countervailing Measures, *supra* note 54 (articulating the elements of a prohibited subsidy).

or services, or a payment to a funding mechanism.[59] Second, a benefit must be conferred from the financial contribution.[60] Third, a subsidy must be sufficiently specific in order to be prohibited.[61]

There is an important exception to the specificity requirement stated in paragraph 2.3 of the SCM Agreement, indicating that a subsidy contingent upon export performance is automatically deemed specific.[62] A subsidy may be contingent upon export performance in law[63] or in fact. A subsidy contingent in fact is more difficult to prove than a subsidy contingent in law because it cannot be observed from existing legislation.[64] The WTO Appellate Body has established three elements that must be evaluated in order to determine whether a subsidy is contingent in fact: (1) the granting of a subsidy that is (2) tied to or conditioned upon (3) actual or anticipated export earnings.[65] If

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

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

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

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

63. *See* WTO Analytical Index, SCM Agreement 3.1(a) ¶ 31 ("[A] subsidy is contingent 'in law' upon export performance when the existence of that condition can be demonstrated on the basis of the very words of the relevant legislation, regulation or other legal instrument constituting the measure . . . Such conditionality can also be derived by necessary implication from the words actually used in the measure."); SCM Agreement art. 3.1(a) n.4 ("This standard is met when the facts demonstrate that the granting of a subsidy, without having been made legally contingent upon export performance, is in fact tied to actual or anticipated exportation or export earnings. The mere fact that a subsidy is granted to enterprises which export shall not for that reason alone be considered to be an export subsidy within the meaning of this problem.").

64. *See* WTO Analytical Index, SCM Agreement art. 3.1(a) ¶ 38 ("*Proving* de facto [in fact] export contingency is a *much more difficult* task . . . the existence of the relationship of contingency, between the subsidy and export performance, *must be inferred from the total configuration of the facts constituting and surrounding the granting of the subsidy, none of which on its own is likely to be decisive in any given case.*") (emphasis added).

65. *Id.* at ¶ 39 (stating that the "granting of a subsidy" depends on whether the government provided a subsidy that was explicitly contingent upon export performance; that "tied to" requires demonstration of conditionality or dependence; and

the aforementioned elements are satisfied based on all relevant facts, then a subsidy contingent in fact exists and the specificity requirement is satisfied.[66]

2. *SCM Agreement - Annex I*

Annex I includes a list of practices that are prohibited subsidies under the SCM Agreement, but the Petition involves only items (b) and (j) of Annex I in support of the claim against China.[67] Item (b) involves currency retention schemes, and item (j) addresses the allocation of government export credit guarantee programs.[68]

3. *SCM Agreement—Exceptions*

The SCM Agreement includes three exceptions that might be applicable to China.[69] The first exception applies to developing country members and allows subsidies for a limited period of time to encourage economic development.[70] The second exception, for existing programs, permits countries with preexisting subsidies to gradually eliminate them over time.[71] The final exception is for countries transforming from centrally-planned to market economies.[72] Each of the exceptions provides a time

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that "anticipated" should be understood as an expectation that exports will result from granting the subsidy).

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

67. *See* Petition, *supra* note 55 (arguing that China's currency policy is a prohibited subsidy because it represents a currency retention scheme and a program to eliminate exchange rate risk).

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

69. *See* SCM Agreement, *supra* note 57 (noting that allowance and extension of time limits on prohibited subsidies are available for WTO members that qualify as developing countries, have existing subsidy programs, or are making the transformation to a market economy).

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

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

72. *Id.* art. 29 (indicating that for subsidies in countries transforming from a government-controlled economy to a free market economy, a period of seven years

frame for the member country to bring its subsidies into conformity with the SCM Agreement.[73] Considering China's recent accession to the WTO, it might be able to invoke one of these exceptions if necessary.[74]

II. ANALYSIS

Bringing a claim to the WTO concerning China's currency regime might pressure China to some degree, but achieving a favorable decision from the Dispute Settlement Body would be unlikely.[75] The Petition submitted by the China Currency Coalition[76] articulates several legal arguments against China's currency policy that will be briefly discussed in each section.[77]

A. China's Currency Regime and Multiple Currency Practices

The Petition asserts that the Ad Art. VI provision on multiple currency practices provided evidence that the GATT contemplated and therefore prohibited currency policies that acted as subsidies on exports.[78] It argues that since China's currency regime benefits exports, the provision regarding multiple currency practices provided a basis for connecting currency policy to a trade violation.[79] This argument does not stand up to scrutiny.

Although multiple currency practices can amount to a subsidy on exports, the concept of multiple currency practices does

is permitted to bring such subsidies into conformity with the SCM Agreement, unless more time is needed for the transformation).

73. SCM Agreement, *supra* notes 70-72 (allowing developing countries eight years from entry into the WTO to bring their subsidies into compliance, giving existing programs three years to comply, and providing countries transforming a market economy seven years to comply).

74. *See* Office of the U.S. Trade Rep., *supra* note 18 (noting that China's accession to the WTO occurred on December 11, 2001).

75. *See generally*, WTO Analytical Index, Dispute Settlement Understanding (outlining the structure and scope of the Dispute Settlement Body and providing the procedure for bringing a claim including consultations and establishment of a panel), *at* http://www.wto.org/english/res_e/booksp_e/analytic_index_e/dsu_e.htm.

76. *See* Petition, *supra* note 6, at 4-5 (listing members of the China Currency Coalition, including the AFL-CIO, American Iron and Steel Institute, American Textile Machinery Association, Associated Industries of Massachusetts, etc.).

77. *Id.* at 50-71 (articulating the argument that China's currency regime violates: Ad Article VI of the GATT, the SCM Agreement, and items (b) and (j) of Annex I of the SCM Agreement).

78. *Id.* at 54 (claiming that the inclusion of multiple currency practices as a possible violation of GATT demonstrates that currency policies that benefit exports were also contemplated as possible violations of GATT).

79. *See id.* (attempting to connect foreign exchange rate policies that benefit exports to multiple exchange rate practices that function as subsidies on exports).

not apply to China's overall exchange rate policy.[80] Multiple currency practices are narrowly defined government measures that promote the export of a certain product using preferential currency rates,[81] whereas China's currency regime is a broad monetary policy that was adopted to stabilize the Chinese economy.[82] In fact, China abandoned dual exchange rates in 1994 in favor of a centrally-controlled unified rate, and there is no indication that China affords beneficial exchange rate treatment to specific products designated for export.[83] Therefore, China's currency policy does not constitute a multiple currency practice.

A second issue is whether the provision regarding multiple currency practices contemplates a situation like China's in which exchange rate policy benefits exports.[84] Accepting such a nexus would expand the meaning of multiple currency practices intended by the framers of the amendment.[85] Just because a multiple currency practice is capable of being an export subsidy does not mean that all currency practices are export subsidies.[86] Actually, multiple currency practices that operate as export subsidies are sometimes permissible with the consent of the IMF.[87]

Therefore, China's currency policy is not a multiple currency practice, and the mere existence of the multiple currency practices provision does not make exchange rate policy as a whole vulnerable to the trade rules regarding subsidies.[88] Currency pol-

80. *See* GATT Subcommittee, *supra* note 52 (indicating that multiple currency practices involve the government practice of applying favorable currency rates to certain products, while neglecting to apply those rates to other products).

81. *See id.* (transcribing the negotiations of the committee that established Ad Article VI, ¶¶ 2-3, n.2 and illustrating the meaning of "multiple currency practices").

82. Gen-you, *supra* note 33 (noting that China's implementation of a strict monetary policy in 1994 was intended to curb inflation and sustain economic growth).

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

84. *See* GATT Ad art VI, *supra* note 51 ("Multiple currency practices can in certain circumstances constitute a subsidy to exports . . . or can constitute a form of dumping. . . .").

85. *See* GATT Subcommittee, *supra* note 52 (indicating that multiple currency practices are preferential currency rates targeted at specific products that a government desires exported).

86. *See* GATT art. XV(2), *supra* note 45 (explaining that whenever a dispute arises between GATT members concerning an exchange rate issue, the members should consult fully with the IMF and accept its determinations as to how to remedy the problem).

87. GATT Ad art. XVI sect. B(1) ("Nothing . . . shall preclude the use by a contracting party of multiple rates of exchange in accordance with the Articles of Agreement of the International Monetary Fund.").

88. *See* GATT Subcommittee, *supra* note 52.

icy is an exchange measure that, although capable of having trade effects, is nevertheless under IMF jurisdiction.[89]

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

The Petition asserts that China provides a prohibited subsidy by converting U.S. dollars into yuan at an undervalued rate, thereby making a financial contribution to Chinese exporters, whose products and labor are less expensive than those of their American competition.[90] The Petition argues further that China's fixed exchange rate confers a benefit on Chinese exporters in that they would be unable to achieve the same price advantage on the open market.[91] Finally, the Petition asserts that China's currency policy satisfies the specificity requirement because it is contingent in fact upon anticipated export performance.[92] Again, a close examination of the SCM Agreement leads to a different conclusion.

1. *Financial Contribution*

The first element of a subsidy is a government financial contribution.[93] Article 1.1(a)(1)(iii)—government dispensation of goods or services—was the only form of financial contribution cited in the Petition and is the only provision that will be addressed in this section.[94]

The fact that China's currency policy benefits exports does not indicate that a financial contribution—as defined by the SCM Agreement—was made by the Chinese government to exporters.[95] The framers of the SCM Agreement wanted to avoid an

89. *See* GATT, *supra* note 44 (stating that exchange rate issues are designated for the IMF and trade issues are left to the GATT).

90. *See* Petition, *supra* note 6, at 58-61 (claiming that maintenance of the yuan at 8.28 to each dollar constitutes a government service under art. 1.1(a)(1)(iii) and constitutes a financial contribution to Chinese exporters).

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

92. *Id.* at 62-66 (arguing that China's currency policy is contingent in fact upon export performance because the fixed exchange rate is so closely linked to export performance).

93. SCM Agreement, art. 1.1(a)(1) (outlining the four methods of financial contribution by a government to be: (1) making a direct transfer of funds or potential direct transfer of funds or liabilities; (2) foregoing or not collecting revenue that is otherwise due; (3) providing goods or services other than general infrastructure, or purchasing goods; and (4) making payments to a funding mechanism).

94. *See* Petition, *supra* note 6, at 60-61 (claiming that China's artificial maintenance of an undervalued currency and elimination of the necessity for hedging mechanisms constitutes a governmental service under art. 1.1(a)(1)(iii)).

95. United States – Measures Treating Export Restraints as Subsidies, WTO Dispute Panel Report, WT/DS194/R ¶ 8.62 (Jun. 29, 2004) ("It does not follow . . . that every government intervention that might in economic theory be deemed a sub-

effects approach that would permit any government measure that benefited exports to be labeled a subsidy.[96] Article 1.1(a)(1)(iii) indicates that the Chinese government would have to provide a financial contribution in the form of goods or services to a private entity.[97] China's currency policy does benefit a wide range of exports in various sectors but is not limited to a specific enterprise.[98] The benefit, however, does not derive from an explicit transfer of money, goods, or services from the Chinese government to private businesses in order to promote exports.[99] To maintain the fixed rate of exchange between the yuan and the dollar, the Chinese Central Bank must buy and sell yuan in exchange for dollars to control fluctuations.[100] Maintenance of a fixed exchange rate does not involve any transfer of public assets to private exporters.[101] The assertion maintains a fixed exchange rate is the equivalent of the Chinese government providing a service to all Chinese exporters is an overly expansive application of the financial contribution provision.[102]

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sidy with the potential to distort trade is a subsidy within the meaning of the SCM Agreement. Such an approach would mean that the 'financial contribution' requirement would effectively be replaced by a requirement that the government action in question be commonly understood to be a subsidy that distorts trade"), *available at* http://www.sice.oas.org/DISPUTE/wto/ds194/ds194re14.asp#downote162 (last visited Nov. 3, 2004).

96. *Id.* ¶ 8.68 (quoting Canada's statements concerning the adoption of a financial contribution test in determining whether a government measure is a subsidy and noting that because almost any government measure can have effects on trade, there must be limits on what government activity constitutes a subsidy).

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

98. *See* U.S. Dep't of State, *supra* note 30 (noting that China's main exports include electric machinery and equipment, power generation equipment, apparel, toys, and footwear).

99. *See* WTO Dispute Panel Report, *supra* note 96, n. 155 ("Subsidies in international trade exist only when a financial charge has been incurred by a government or administrative authority on behalf of a beneficiary. . . . Only measures which constitute a charge on the public account or government budget . . . constitute a subsidy. . . . Countervailing action . . . [should] be made conditional upon a governmental practice which involves a net transfer of funds from public sources to the recipient.").

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

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

102. *See* United States – Measures Treating Export Restraints as Subsidies, WTO Dispute Settlement Reports, WT/DS194/R ¶ 8.34-34 (Jun. 29, 2001) ("We consider

2. *Benefit*

The second element of a prohibited subsidy is a benefit conferred.[103] China's maintenance of a fixed exchange rate has a beneficial effect on Chinese exports because they are less expensive than comparable products produced in the United States.[104] Unlike the financial contribution element of a subsidy, which focuses on the government activity, the benefit element shifts the focus to the recipient.[105] Conferral of a benefit requires that the recipient be put in a better position than would have been available in the open market.[106]

Since each U.S. dollar is now equal to around 8.0887 yuan, U.S. consumers can purchase Chinese products for less than comparable products produced in the United States.[107] Chinese exporters therefore have a cost advantage over U.S. producers that is due in part to China's exchange rate policy.[108] The resulting cost advantage constitutes a benefit as defined by Article 1.1(b)

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that it cannot be the case that the nature of a Member government's measure under the SCM Agreement is to be determined solely on the basis of the reaction to that measure by those it affects. Rather, the existence of a financial contribution by a government must be proven by reference to the action of the government. . . . [W]e do not see how the reaction of private entities to a given governmental measure can be the basis on which the Member's compliance with its treaty obligations under the WTO is established. . . . [A]pplying the 'effects' approach to the question of whether a financial contribution exists would have far-reaching implications. In particular, it would seem to imply that any government measure that creates market conditions favorable to or resulting in the increased supply [or demand] of a product in the domestic [or foreign] market would constitute a government-entrusted or government-directed provision of goods, and hence a financial contribution").

103. *See* WTO Analytical Index, *supra* note 60 (describing the characteristics of a benefit as defined under Article 1 of the SCM Agreement).

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

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

106. *Id.* ¶ 18 (stating that the word "benefit" implies a comparison and that a benefit may only be conferred if the recipient is placed in a better position than he would have been able to attain in the open market).

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

108. *See* Hufbauer & Wong, *supra* note 104 (indicating that Chinese manufacturing wages are 88 cents per hour, while comparable U.S. manufacturing wages are around 9 dollars per hour).

of the SCM Agreement because Chinese exporters would be unable to achieve the same advantage on the open market.[109]

3. *Specificity*

To be prohibited the subsidy must also be specific.[110] China's exchange rate policy is not specific to a particular industry or enterprise; it applies to the entire economy.[111] Since China's currency regime is not specific, in order to meet the specificity requirement it must qualify as a subsidy contingent upon export performance.[112] The Petition concedes that there is no legislation explicitly stating that China's currency policy is contingent upon export performance. Thus, a subsidy contingent in law upon export performance is ruled out, and only a subsidy contingent in fact upon export performance could possibly apply to China's currency policy.

a. Subsidy Contingent in Fact on Export Performance

China's currency policy fails to meet the requirements of a subsidy contingent in fact upon export performance because it is conditioned upon economic stability, not exports.[113]

i. Condition on Granting the Subsidy

The first step in the analysis is to determine whether China's maintenance of a fixed currency regime is conditioned upon export performance.[114] Unlike a subsidy contingent in law upon export performance,[115] evaluation of a subsidy contingent in fact

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

110. SCM Agreement, *supra* notes 61-62 (explaining that a subsidy must be specific to a particular industry or enterprise in order to be prohibited, unless the subsidy is contingent in law or in fact upon export performance, in which case it is automatically specific).

111. *See* Hufbauer & Wong, *supra* note 104 ("An undervalued exchange rate is probably the least specific of any benefit that a government might confer. . . . WTO case law in other subsidy disputes runs strongly against the proposition that an undervalued exchange rate qualifies as a specific benefit.").

112. *See* SCM Agreement, *supra* note 62 (outlining the process for satisfying the specificity requirement for a prohibited subsidy through Article 2.3 of the SCM Agreement).

113. *See* Dai, *supra* note 33 (noting that the purpose of China's strict monetary controls was to control inflation without eliminating economic growth).

114. WTO Analytical Index, *supra* notes 65-66 (indicating that the first step in determining the existence of a subsidy contingent in fact upon export performance is determining whether the granting authority imposed a condition of export performance when providing the subsidy, and emphasizing that all relevant facts surrounding the maintenance of the subsidy should be considered).

115. *See* SCM Agreement, *supra* note 59 (explaining that subsidies contingent in law on export performance can be observed or implied from the text of legislation).

upon export performance requires that all facts and circumstances surrounding the subsidy be taken into consideration.[116] Since China's monetary policy fails to meet the financial contribution requirement of Article 1, it is difficult to argue that a subsidy was granted.[117]

China adopted a fixed exchange rate in 1994[118] to curb inflation that had resulted from rapid economic expansion during the 1980s.[119] In the late 1990s, when most Asian currencies were rapidly depreciating, China maintained its exchange rate while using other monetary policies to increase money supply and encourage domestic spending.[120] Currently, China is reforming its banking and financial sectors and gradually making the transition to a market economy.[121] Even after abandoning the peg against the dollar, the Chinese central bank retained significant control over exchange rates to prevent large fluctuations that might result from currency speculation within a financial system ill prepared for sophisticated currency trading.

Ensuring economic stability is a principal concern of the Chinese government as it attempts to maintain economic growth and avoid inflation.[122] Given the multitude of economic considerations involved, any assertion that the Chinese government imposed a condition of export performance by pegging the yuan against the dollar ignores other important factors.[123]

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116. *See* WTO Analytical Index, *supra* note 66.

117. *See* WTO Dispute Panel Report, *supra* notes 95-96 (demonstrating that a subsidy requires a financial contribution, which entails a government incurring a charge for a private beneficiary).

118. *See* Dai, *supra* note 33 (observing that China's economy grew at an average rate of 12 percent per year between 1991 and 1995, but also noting concurrent increases in annual inflation rates from 12.9 percent to 24.1 percent in 1994).

119. *See* U.S. Dep't of State, *supra* notes 31-32 (attributing the economic expansion of the 1980s to the liberal reforms implemented in 1979).

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

121. *See* Embassy of the People's Republic of China in Australia, *supra* note 26 (highlighting the goal of China's Premier, Wen Jiabao, to push forward with market-oriented reforms, including privatization of state-run banks, improvement of asset management institutions' handling of bad loans, opening of the capital and financial services markets, and reduction of overcapacity from investment in saturated industries).

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

123. *See* Edwards, *supra* note 25 (concluding that China should be hesitant to modify its exchange rate policy when its banking and a financial sectors are underdeveloped).

Although one goal of China's monetary policy may be to encourage exports and other market-oriented practices, monetary policy represents a broader initiative than merely a narrow relationship of conditionality between exchange rate policy and export performance.[124]

ii. Contingent on Export Performance

The second step in the analysis is to determine whether the granting of the subsidy was tied to or dependent upon anticipated export performance.[125] Based on numerous instances of inflation, near financial disaster during the late 1990s, and ongoing transition to a market economy, it appears that China's continued maintenance of a fixed exchange rate is tied to the prevention of disasters and promotion of economic stability.[126] Given the interdependent nature of the global economy, China's market is a vital cog in the global economic wheel.[127] Thus, to claim that China's exchange rate is dependent upon export performance ignores other economic factors essential to its overall stability.[128]

Arguably, since exports represent a fundamental component of China's economy, they may be necessary to economic stability. However, the same could be said of other aspects of the Chinese economy, such as FDI.[129] China's economic stability is dependent on FDI because it contributes to the replacement of inefficient state-run companies with modern privately managed businesses, thereby reducing bad debt and improving productiv-

124. *See* U.S. Dep't of State, *supra* notes 30-32 (providing a history of China's attempts to implement market-oriented policies including privatization of state-run enterprises, acceptance of foreign investment, and accession to the WTO).

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

126. Dai, *supra* note 33 ("The objective of China's monetary policy is to maintain the stability of the currency value to advance economic growth. . . . The monetary policy to be pursued in the next five years should be designed to ward off deflation and inflation as well. This should be our cardinal principle.").

127. *See* Hufbauer & Wong, *supra* note 104 (revealing that China had surpassed Japan as the world's third-largest importer, that Chinese importation of oil is second in the world, and that China's nickel imports will be number one in the world by the end of 2004).

128. *See* King & Hutzler, *supra* note 21 (noting China's desire to revalue its currency but explaining that concerns over bad debt, banking and financial sector reforms, and inflation were preventing definitive action).

129. *See* Hufbauer & Wong, *supra* note 104 (indicating that China's accumulation of foreign exchange reserves is due in large part to foreign direct investment amounting to $53 billion in 2003, which was the highest FDI in the world and exceeded China's 2003 trade surplus of $45.9 billion).

ity.[130] A stable currency encourages foreign investment because it prevents large currency fluctuations, which deters foreign businesses from investing.[131] Therefore, China's economic stability can be attributed to various factors including exports, but export performance is not the sole objective of China's currency policy.[132]

iii. Expected or Anticipated Export Performance

The third element focuses on whether export earnings were anticipated when the subsidy was granted.[133] As previously mentioned, China implemented strict monetary controls including a fixed exchange rate with the expectation of stabilizing its economy.[134] In *Canada Aircraft*, "projected export sales anticipated to flow directly from [the subsidy]. . ." demonstrated the necessary expectation of export performance.[135] Unlike the practice at issue in *Canada Aircraft*, China's maintenance of a fixed exchange rate entails macroeconomic projections or expectations, not industry-specific export projections.[136] While China may expect its monetary policy to result in increased exports, that alone is insufficient to establish that the policy constitutes a subsidy contingent in fact upon export performance, because the exchange rate policy is tied to overall economic stability, not just

130. *See generally*, *Country Briefings: China*, ECONOMIST.COM, Jan. 9, 2004, *at* http://www.economist.com/countries/China/profile.cfm?folder=Profile-FactSheet (last visited Nov. 15, 2004).

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

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

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

134. *See* Dai, *supra* note 33 (indicating that controlling inflation was a primary concern of the Chinese government during the 1990s).

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

136. Dai, *supra* note 33 ("[In China's] Five-Year Plan for National Economic and Social Development and the Long-Range Objectives to the Year 2010, the Central Committee of the Communist Party of China specified in 1995 that curbing inflation was the primary task for macro-economic adjustment . . . and stressed the importance of pursuing a moderately tight fiscal and monetary policies").

export performance.[137] Therefore, China's expectation of increased exports resulting from the maintenance of a pegged exchange rate is meaningless without a clear demonstration of conditionality between the exchange rate policy and exports.[138]

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

The final way of meeting the requirement specificity is through Annex I—Illustrative List of Export Activities that Constitute Subsidies.[139]

Item (b) addresses currency retention schemes, which permit certain exporters to retain a portion of receipts from foreign exchange earnings notwithstanding a general requirement that businesses surrender receipts from foreign exchange to the central bank in exchange for local currency.[140] A currency retention scheme would involve the Chinese government's allowing exporters to retain foreign exchange when they would normally be obligated to convert the currency to yuan; this is wholly unrelated to China's exchange rate policy.[141] Thus, China's maintenance of a pegged exchange rate is not analogous to a currency retention scheme, and therefore does not constitute a subsidy.[142]

Item (j) addresses government credit programs that insure exports against exchange rate risk.[143] Since the yuan was fixed at 8.28 to each dollar, there was no need for Chinese or U.S. businesses to spend money on hedging against exchange rate volatility.[144] The Chinese government's maintenance of a fixed

137. *See* WTO Analytical Index, *supra* note 65 ("A subsidy may well be granted in the knowledge, or with the anticipation, that exports will result. Yet, that alone is not sufficient, because that alone is not proof that the granting of the subsidy is tied to the anticipation of exportation.") (internal citations omitted).

138. *See* WTO Dispute Settlement Reports, *supra* note 103 ¶ 8.42 ("In other words, the Appellate Body [in *Canada Aircraft*] found that a cause and effect relationship between the subsidy and actual or anticipated trends in exports was not sufficient to satisfy the 'tied to' standard of conditionality for export contingency to exist.").

139. *See* SCM Agreement, *supra* note 56 (referring to Annex I – Illustrative List of Export Subsidies).

140. *See* Deborah E. Siegel, *Legal Aspects of the IMF/WTO Relationship: The Fund's Articles of Agreement and the WTO Agreements*, 96 AM. J. INT'L L. 561, 596 (July 2002) (defining currency retention schemes).

141. *See* Petition, *supra* note 6, at 67 n. 73 (citing China's rules and regulations concerning export collection of foreign exchange earnings).

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

143. *See* SCM Agreement Annex I, *supra* notes 67-68 (defining government credit programs that protect against the increase in cost of exchange risk programs at rates which are inadequate to cover the long-term operating costs and losses of the programs).

144. *See* Ian H. Giddy, *The Corporate Hedging Process* ("Financial risks - regardless of whether or not they are managed - exist in every business. The manager who

exchange rate does provide an indirect benefit by eliminating the need for hedging.

However, in describing the government provision, item (j) makes reference to the cost of the program.[145] The Chinese government does not transfer funds or forego revenue in order to eliminate exchange rate risk.[146] Although a benefit is conferred upon Chinese exporters in that they need not hedge against currency fluctuations, the Chinese government suffers no financial detriment in providing the program.[147] China's currency policy is distinguishable from the programs described in item (j) because it does not impose a financial cost on the Chinese government in order to eliminate exchange rate risk.[148]

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

Because it is macroeconomic in nature, China's exchange rate policy does not satisfy the SCM Agreement's requirements for a prohibited subsidy.[149] The Petition attempts to stuff a broad monetary policy into the narrowly defined financial contribution and specificity elements of a subsidy.[150] China's exchange rate policy is not a subsidy because there is no transfer of assets

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opts *not to hedge* is betting that the markets will either *remain static* or move in his favor. For example, a U.S. computer manufacturer with French franc receivables that decides to not hedge its exposure to the French franc is speculating that the value of the French franc relative to the U.S. dollar will either *remain stable* or appreciate. In the process, the manufacturer is leaving itself exposed to the risk that the French franc will depreciate relative to the U.S. dollar and hurt the company's revenues.") (emphasis added), *at* http://pages.stern.nyu.edu/~igiddy/corphdg.htm (last visited Nov. 1, 2004).

145. *See* SCM Agreement Annex I, *supra* note 68 ("The provision by governments of . . . export credit guarantee or insurance programs . . . at premium rates which are inadequate to cover the long-term operating costs and losses of the programs.").

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

147. *See* WTO Dispute Panel Report, *supra* notes 95-97 (indicating that a subsidy requires a transfer of assets, whether it be direct payment by the government to a private entity or forbearance of collection by the government from a private entity).

148. *See* People's Bank of China, *supra* note 132 (indicating that the policies used by the Bank are macroeconomic in nature and have broad economic effects).

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

150. *See* Petition, *supra* note 6, at 58-69 (arguing that China's Government provides an indirect subsidy to exports by sustaining the undervalued rate of exchange between the yuan and the dollar).

from the government to private exporters and because it is contingent upon overall economic stability, not exports.[151]

C. Exceptions

If China's currency regime were held to be a prohibited subsidy, there are exceptions in the SCM Agreement that would either permit China to continue its strict monetary policy or provide time to modify it.[152]

1. *Article 27: Developing Country Members*

The SCM Agreement recognizes that developing countries might need the assistance of certain subsidies in furthering the goals of development and economic growth.[153] China is a developing country[154] and is actively attempting to raise standards of living through economic reform.[155] Developing countries are granted eight years from entry into the WTO to bring their subsidies into compliance.[156] Because China acceded to the WTO on December 11, 2001, it would qualify for an exception under Article 27 and would have several years to modify its exchange rate regime.[157] Furthermore, China might be able to extend its exchange rate policy beyond the eight-year period if maintenance of the exchange rate were deemed necessary by the Committee.[158]

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

152. SCM Agreement, *supra* notes 69-73 (noting that the SCM Agreement includes exceptions for developing countries, existing programs, and countries transforming to market economies).

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

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

155. Country Briefings: China, *supra* note 130.

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

157. *See* Office of the U.S. Trade Rep., *supra* note 18 (stating that China became a member of the WTO on December 11, 2001 after 15 years of negotiations).

158. *See* SCM Agreement art. 27, *supra* note 156 ("If a developing country Member deems it necessary to apply such subsidies beyond the eight-year period, it shall not later than one year before the expiry of this period enter into consultations with the Committee, which will determine whether an extension of this period is justified, after examining all the relevant economic financial and development needs of the developing country Member in question.").

2. *Article 28: Existing Programs*

The second exception applies to subsidies that are already in place at the time of accession.[159] China implemented its pegged currency policy in 1994, well before its accession to the WTO in 2001, and has maintained it for over a decade.[160] Consequently, China would not be subject to the rules regarding prohibited subsidies until three years after the date of its accession to the WTO.

3. *Article 29: Transformation To a Market Economy*

The last exception applicable to China is for countries moving toward a market economy.[161] Since 1979, China has gradually moved from a state controlled economy to a quasi market economy.[162] Continued efforts include China's accession to the WTO, privatization of state-operated enterprises, and allowance of FDI.[163] China has stumbled, however, in fully implementing its WTO obligations and in reforming its banking industry.[164] Nevertheless, China has made significant progress while adjusting to the expected difficulties that accompany radical economic change.[165] Therefore, China would likely qualify as a country transforming to a market economy and be granted seven years

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

160. Fed. Reserves Stat. Release, *supra* note 2 (stating that China pegged its currency against the dollar on January 3, 1994).

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

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

163. Embassy of the People's Republic of China in Australia, *supra* note 121 (outlining the market reforms sought by the Chinese government).

164. Office of the U.S. Trade Rep., *supra* note 18 (settling forth the areas in which China has failed to comply with its WTO commitments).

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

from the date of its accession into the WTO to bring its currency practice into compliance.[166]

4. *Summary*

The likelihood of China's currency policy meeting the requirements of a subsidy is remote.[167] Even if the currency regime were determined to be a prohibited subsidy, China could avoid reprimand by citing one of the three exceptions. The developing country or transformation to market economy provisions seem preferable because they provide more time to eliminate prohibited practices.[168]

III. RECOMMENDATIONS

The United States has appropriately adopted a diplomatic approach to encourage China to revalue or float its currency.[169] Judging by its almost immediate dismissal of the Petition, the U.S. government will not be initiating any legal action at the WTO.[170] Arguably, diplomatic pressure produced a very desirable result - China's elimination of the peg - but there are additional initiatives that the United States could pursue to either increase the likelihood of China further liberalizing its currency policy or reduce the bilateral trade deficit with China.[171]

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

167. *See* Hufbauer & Wong, *supra* note 104 (stating that a complaint concerning China's currency regime would likely fail if it were submitted to the WTO Dispute Settlement Body because the regime fails to meet the financial contribution and specificity requirements of the SCM Agreement).

168. *See* SCM Agreement, *supra* notes 69-73 (indicating that developing countries are given eight years or more to bring their subsidies into conformity and that transforming economies are granted seven years to comply with the WTO).

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

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

171. *See* Office of the U.S. Trade Rep., *supra* note 169 (listing capital account liberalization, banking sector reform, financial product development, financial services opening, and current account reform as the areas of China's financial sector that need further reform in order to accommodate a more liberal currency regime).