

The Future of the World Trading System:
Asian Perspectives
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Richard Pomfret and Victor Pontines:
“Exchange Rate Policy and Regional
Trade Agreements”

Comments by
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Key findings of the paper 1/3

This paper analyses the impact of the level and volatility of exchange rates on bilateral trade in 1990-2010 among sixteen East Asian economies (ASEAN+3, Hong Kong, Macau and Mongolia), many of which have shifted from being in no RTAs in 1990 to having a range of RTA partners in the region.

- Exports are positively related to the rate of exchange rate depreciation and to RTA membership and negatively related to exchange rate volatility.
 - confirms what one would expect to find

Key findings of the paper 2/3

- Novel finding: interaction terms indicate that both exchange rate effects are magnified when two given economies are parties to an RTA.
 - The level result is interpreted by the authors as indicating that, because an RTA restricts a government's trade policy instruments, they are more likely to use the exchange rate for trade policy ends.
 - The volatility result is interpreted as evidence that, because East-Asian trade agreements are related to fragmentation and regional value chains, exchange rate volatility is especially harmful to trade flows within RTAs.

Key findings of the paper 3/3

- This leads the authors to raise three fundamental questions:
 - Which is the right degree of regional integration? Paper suggests that, based on European experience, with deepening integration, the desire for exchange rate stability will eventually outweigh protectionist tendencies.
 - Will RTA members resort to exchange rate depreciation as a result of intensified pressure on import-competing producers? Paper suggests that there may be a need to set up monitoring / enforcement mechanisms within RTAs, also in order to avoid the identified “IMF-WTO policy gap at the global level”
 - Which is the right degree of international policy coordination in this field?
 - Paper reflects on the inadequacy of IMF surveillance and on the overlap of (unclear) competencies between the IMF and the WTO as regards the potential trade effects of an undervalued real exchange rate

Specific comments: exchange rates and the IMF-WTO relationship

- Quote from page 1:

“Since the advent of generalized floating in the 1970s, no multilateral organization has been responsible for the global exchange rate system.”

 - Key competence lies with the IMF; sovereign choice of the Members to essentially rely on soft law for this purpose; WTO competent to address potential trade effects of monetary measures
 - IMF surveillance is a subtle mechanism reflecting the complex reality of exchange rate shifts and of related policy objectives
 - Jurisdictional overlap yes, but rules are in place to avoid contradicting obligations of members common to both organizations

IMF Article IV:1 and the perennial struggle for domestic regulatory autonomy

IMF Article IV:1, a result of the 1978 second amendment of the Fund's Articles:

Recognizing that the essential purpose of the international monetary system is to provide a framework that facilitates the exchange of goods, services, and capital among countries, and that sustains sound economic growth, and that a principal objective is the continuing development of the orderly underlying conditions that are necessary for financial and economic stability, each member undertakes to collaborate with the Fund and other members to assure orderly exchange arrangements and to promote a stable system of exchange rates. In particular, each member shall:

- (i) endeavor to direct its economic and financial policies toward the objective of fostering orderly economic growth with reasonable price stability, with due regard to its circumstances;
- (ii) seek to promote stability by fostering orderly underlying economic and financial conditions and a monetary system that does not tend to produce erratic disruptions;
- (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; and
- (iv) follow exchange policies compatible with the undertakings under [IMF Article IV:1].

The IMF's 2007 and 2012 reforms of bilateral and multilateral surveillance

How to give meaning to the “net residue” of obligation of the chapeau of IMF Article IV:1?

Recognizing that the essential purpose of the international monetary system is to provide a framework that facilitates the exchange of goods, services, and capital among countries, and that sustains sound economic growth, and that a principal objective is the continuing development of the orderly underlying conditions that are necessary for financial and economic stability, each member undertakes to collaborate with the Fund and other members to assure orderly exchange arrangements and to promote a stable system of exchange rates. In particular, each member shall: ...

- 1977: The Fund's bilateral surveillance mechanism is set up
- 2007: Reform – Bilateral Surveillance Decision
- 2012: Integrated Surveillance Decision (adopted on 18 July 2012, entered into force on 18 January 2013)

The five guiding principles as emerging from the 2007 and 2012 surveillance decisions

- A. A member shall 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.
- B. A member should intervene in the exchange market if necessary to counter disorderly conditions, which may be characterized, *inter alia*, by disruptive short-term movements in the exchange rate of its currency.
- C. Members should take into account in their intervention policies the interests of other members, including those of the countries in whose currencies they intervene.
- D. A member should avoid exchange rate policies that result in ~~external instability~~. balance of payments instability. (principle originally added by the 2007 decision and changed again by the 2012 decision)
- E. A member should seek to avoid domestic economic and financial policies that give rise to domestic instability. (principle added by the 2012 decision)

Focus on exchange rate manipulation in the Annex to both the 2007 and 2012 decisions

- (a) “Manipulation” of the exchange rate is only carried out through policies that are targeted at – and actually affect – the level of an exchange rate. Moreover, manipulation may cause the exchange rate to move *or may prevent such movement*.
- (b) A member ... will only be considered to be manipulating exchange rates in order to gain an unfair competitive advantage over other members if the Fund determines both that: (A) the member is engaged in these policies for the purpose of securing fundamental exchange rate misalignment in the form of an undervalued exchange rate and (B) the purpose of securing such misalignment is to increase net exports.
- As recognized by the Fund’s Executive Board, “exchange rate manipulation can take many different forms, including intervention in the exchange markets and the imposition of capital controls for the purpose of directly targeting the exchange rate.”
- “Any representation made by the member regarding the purpose of its policies will be given the benefit of any reasonable doubt.”

The 2007 and 2012 decisions specify several events triggering the need for thorough review

In its surveillance of the observance by members of the [five Principles], the Fund shall consider the following developments as among those which would require thorough review and might indicate the need for discussion with a member:

(i) protracted large-scale intervention in one direction in the exchange market;

- (ii) official or quasi-official borrowing that either is unsustainable or brings unduly high liquidity risks, or excessive and prolonged official or quasi-official accumulation of foreign assets, for balance of payments purposes;
- (iii) (a) the introduction, substantial intensification, or prolonged maintenance, for balance of payments purposes, of restrictions on, or incentives for, current transactions or payments, or
(b) the introduction or substantial modification for balance of payments purposes of restrictions on, or incentives for, the inflow or outflow of capital;
- (iv) the pursuit, for balance of payments purposes, of monetary and other financial policies that provide abnormal encouragement or discouragement to capital flows;
- (v) fundamental exchange rate misalignment;
- (vi) large and prolonged current account deficits or surpluses; and
- (vii) large external sector vulnerabilities, including liquidity risks, arising from private capital flows.

How limited is the IMF really in compelling a country to change its policy?

- The key incentives to comply with IMF rules are of a soft law nature: reputational concerns, peer pressure
- IMF can gradually increase the pressure by moving towards a finding of violation in several steps
- In the worst case, recourse (rather theoretical) to the limited tools under IMF Article XXVI:2
 - Ineligibility to use the Fund's general resources
 - Suspension of voting rights
 - Compulsory withdrawal from the Fund

The consultation requirement under GATT Article XV:2 (and the analogous provision in GATS Article XII) guides IMF-WTO interaction

Article XV

Exchange Arrangements

1. The CONTRACTING PARTIES shall seek co-operation with the International Monetary Fund to the end that the CONTRACTING PARTIES and the Fund may pursue a co-ordinated 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.

2. 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. The CONTRACTING PARTIES in reaching their final decision in cases involving the criteria set forth in paragraph 2 (a) of Article XII or in paragraph 9 of Article XVIII, shall accept the determination of the Fund as to what constitutes a serious decline in the contracting party's monetary reserves, a very low level of its monetary reserves or a reasonable rate of increase in its monetary reserves, and as to the financial aspects of other matters covered in consultation in such cases.

Conflicting rights and obligations avoided by the exception under GATT Article XV:9(a)

Article XV

Exchange Arrangements

...

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, ...

- Formulated as a general exception, essentially prescribing that the IMF-consistent use of exchange controls or exchange restrictions could excuse a breach under the GATT, GATT Article XV:9(a) might well play a decisive role in a potential WTO dispute on the maintenance of an undervalued real exchange rate.
- If this reading of GATT Article XV:9(a) is correct, the measures that a country would typically rely upon in order to achieve and maintain an undervaluation of the real exchange rate, such as capital controls, surrender requirements, and the channelling of payments through the banking system, could not be found to violate the GATT if they were to amount to “exchange controls or exchange restrictions [applied consistently with the Fund’s Articles]” in the sense of GATT Article XV:9(a).

Issues fraught with complexity

- For my detailed views on these issues, see, for example:
 - Claus D. Zimmermann, “Exchange Rate Misalignment and International Law” (2011), 105(3) *The American Journal of International Law*, pp. 423-476.
 - Claus D. Zimmermann, “IMF-WTO Interaction: Institutional, Jurisdictional, and Procedural Aspects”, in Ole Kristian Fauchald and André Nollkaemper (eds), *The Practice of International and National Courts and the (De-)Fragmentation of International Law* (Hart Publishing, Oxford 2012), pp. 57-85.

Questions & Comments

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Thank you very much!