

# Trade Policy and Exchange Rates

Douglas Irwin

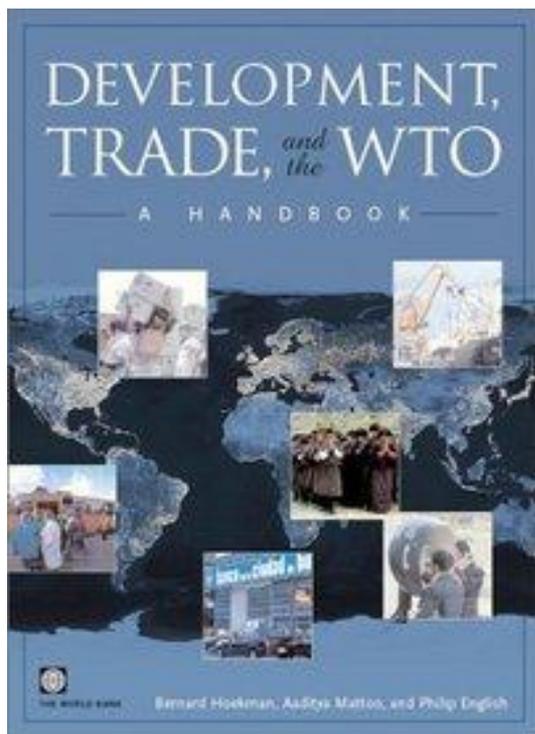
Dartmouth College

# Trade policy

- International monetary system in background
- Exchange rates affect resource allocation
- Keynes's theorem:
  - 10% devaluation = 10% import tariff + 10% export subsidy

# Misaligned exchange rates

- Overvalued currency
  - Common developing country problem
  - Leads to domestic protectionism
  - Remedy: devaluation and trade liberalization
- Undervalued currency



## EXCHANGE RATE OVERVALUATION AND TRADE PROTECTION

**A**LTHOUGH BOTH FIXED AND FLEXIBLE EXCHANGE RATE SYSTEMS (AND THEIR variants) have their advantages and disadvantages, more than half the countries in the world maintain fixed or managed exchange rates.<sup>1</sup> While we do not discuss the relative merits of these exchange rate systems in this chapter, we note that as a practical matter, exchange rate management in many countries in the world has resulted in overvaluation of the real exchange rate, in some cases leading to gross distortions.<sup>2</sup> (For further discussion of the links between trade and macroeconomic management, see the CD-ROM, "Applied Trade Policy," that accompanies this Handbook.)

Since governments are frequently confronted with the problems of external shocks and external trade deficits in the context of a fixed exchange rate regime, a concise survey of worldwide experience with the effects of overvalued exchange rates in terms understandable to policymakers should be useful. This chapter presents theory, cross-country econometric evidence, and important case studies of the effects of overvalued exchange rates.

Although as a group, developing countries progressively liberalized their trade regimes during the 1980s and 1990s, some governments continue to take actions to defend their exchange rates that are counter to their long-run trade liberalization efforts. One classic pattern is to attempt to defend an overvalued exchange rate through protectionist trade policies.<sup>3</sup> Experience shows that protection in

defense of an overvalued exchange rate will significantly retard the country's medium-to-long-run growth prospects. In fact, an overvalued exchange rate is often the root cause of protection, and the country will be unable to return to the more liberal trade policies that allow growth without exchange rate adjustment.

Moreover, a devaluation of the nominal exchange rate appears to be a necessary condition for achieving a large depreciation of the real exchange rate, as virtually all real devaluations (above 25–35 percent) have been accompanied by nominal devaluations (Ghei and Hinkle 1999). Sustained efforts to use downward adjustment of wages and prices as a means of restoring a competitive real exchange rate have frequently led to severe recessions or depressions.

Worldwide experience has shown that defending the exchange rate has no medium-run benefits, since falling reserves will eventually force devaluation. It is better that the devaluation be accomplished without further debilitating losses in reserves and lost productivity due to import controls. Experience with devaluations shows that after

# Overvaluation

- Schatz and Tarr (2002):
  - “one classic pattern is to attempt to defend an overvalued exchange rate by protectionist trade policies . . . . In fact, an overvalued exchange rate is often the root cause of protection”
- Drabek and Brada (JCE, 1998), “Exchange Rate Regimes and the Stability of Trade Policy in Transition Economies”

# Welfare cost of overvalued exchange rates

- Hause (JPE, 1966), “Welfare Cost of Disequilibrium Exchange Rates”
- Bhagwati & Krueger, 1970s NBER project
- Krueger (1999), “Nominal Anchor Exchange Rate Policies as Domestic Distortions”

# Currency Misalignments and Optimal Monetary Policy: A Reexamination<sup>†</sup>

By CHARLES ENGEL\*

Exchange rates among large economies have fluctuated dramatically over the past 30 years. The dollar/euro exchange rate has experienced swings of greater than 60 percent. Even the Canadian dollar/US dollar exchange rate has risen and fallen by more than 35 percent in the past decade, but inflation rates in these countries have differed by only a percentage point or two per year. Should these exchange rate movements be a concern for policymakers? Or would it not be better for policy makers to focus on output and inflation and let a freely floating exchange rate settle at a market determined level?

Empirical evidence points to the possibility of “local-currency pricing” (LCP) or “pricing to market.”<sup>1</sup> Exporting firms may price discriminate among markets, and/or set prices in the buyers’ currencies. A currency could be overvalued if consumer prices are generally higher at home than abroad when compared in a common currency, or undervalued if these prices are lower at home.<sup>2</sup> Currency misalignments can be very large even in advanced economies.

In a simple, familiar framework, this paper draws out the implications for monetary policy when currency misalignments are possible. Currency misalignments lead to inefficient allocations for reasons that are analogous to the problems with inflation in a world of staggered price setting. When there are currency misalignments, households in the Home and Foreign countries may pay different prices for the identical good. A basic tenet of economics is that violations of the law of one price are inefficient—if the good’s marginal cost is the same irrespective of where the good is sold, it is not efficient for the good to sell at different prices. We find that these violations lead to a reduction in world welfare and that optimal monetary policy trades off targeting these misalignments with inflation and output goals. In our model, because there are no transportation costs or distribution costs, any deviation from the law of one price would be inefficient. More generally, if those costs were to be included, then pricing would be inefficient if consumer prices in different locations do not reflect the underlying resource costs of producing and distributing the goods.

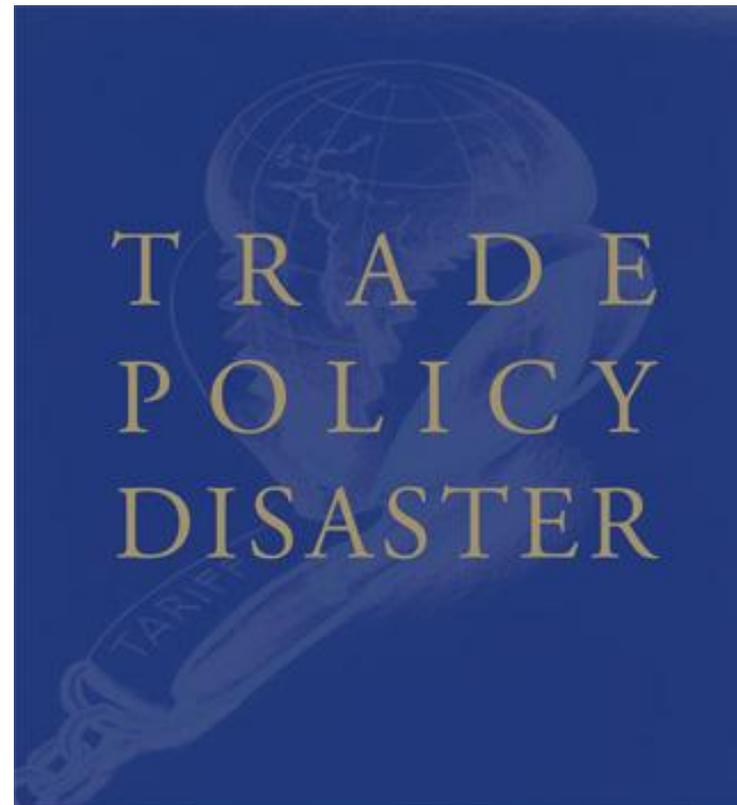
\*Department of Economics, University of Wisconsin, 1080 Observatory Drive, Madison, WI 53706-1393 (e-mail: cengel@ssc.wisc.edu). I am indebted very much to Gianluca Benigno, Giancarlo Corsetti, Michael B. Devereux, Jon Faust, Chris Kent, Giovanni Lombardo, Lars Svensson, Michael Woodford, and two anonymous referees for comments and suggestions at various stages of this work. I acknowledge support from the National Science Foundation through grant 0451671.

<sup>†</sup>To view additional materials, visit the article page at <http://www.aeaweb.org/articles.php?doi=10.1257/aer.101.6.2796>

<sup>1</sup>Many studies have found evidence of violations of the law of one price for consumer prices. Two prominent studies are Engel (1999) and Andrew Atkeson and Ariel Burstein (2008). The literature is voluminous—these two papers contain many relevant citations.

<sup>2</sup>A precise definition of our use of the term “currency misalignment” appears in Section III below.

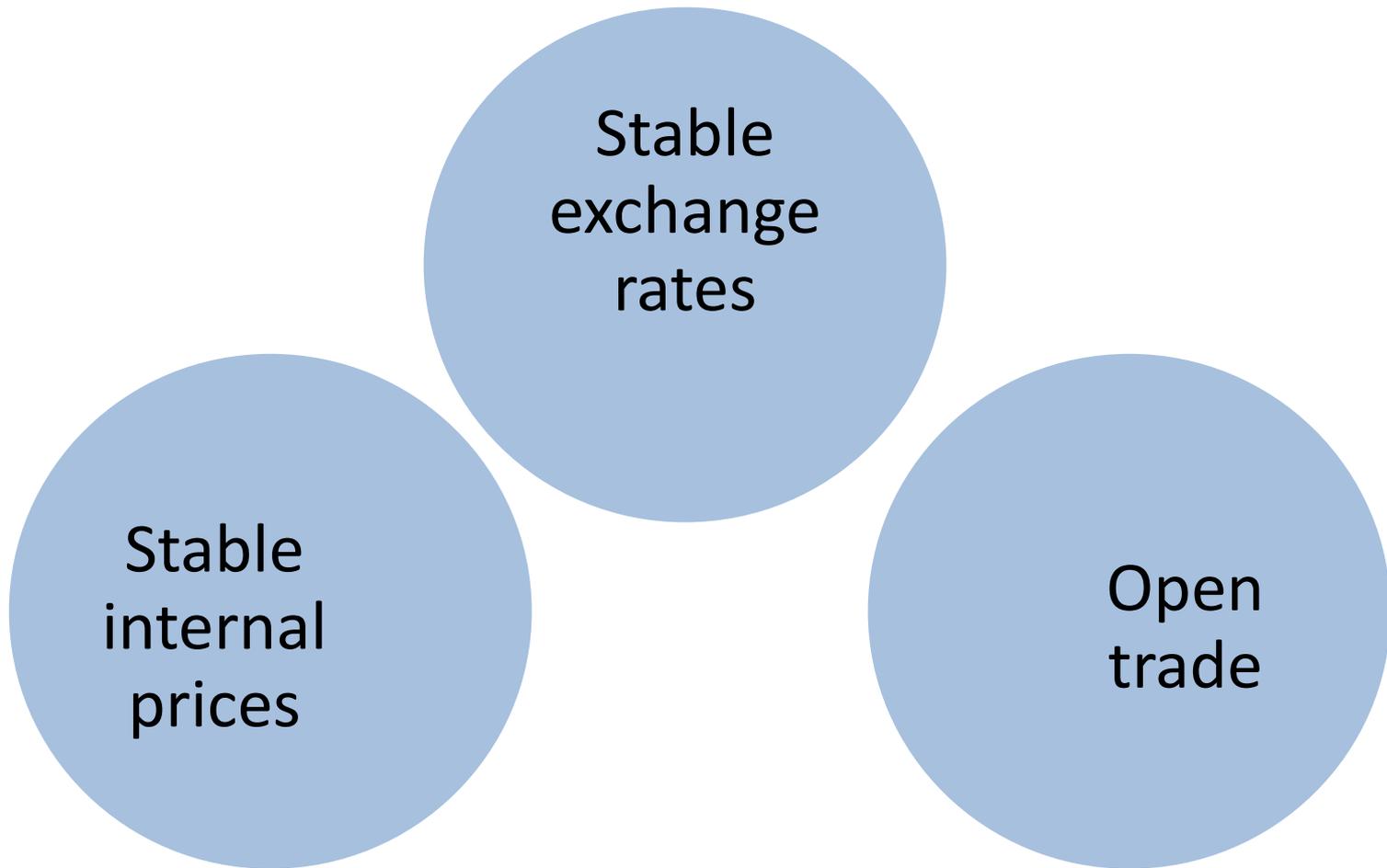
# Historical evidence



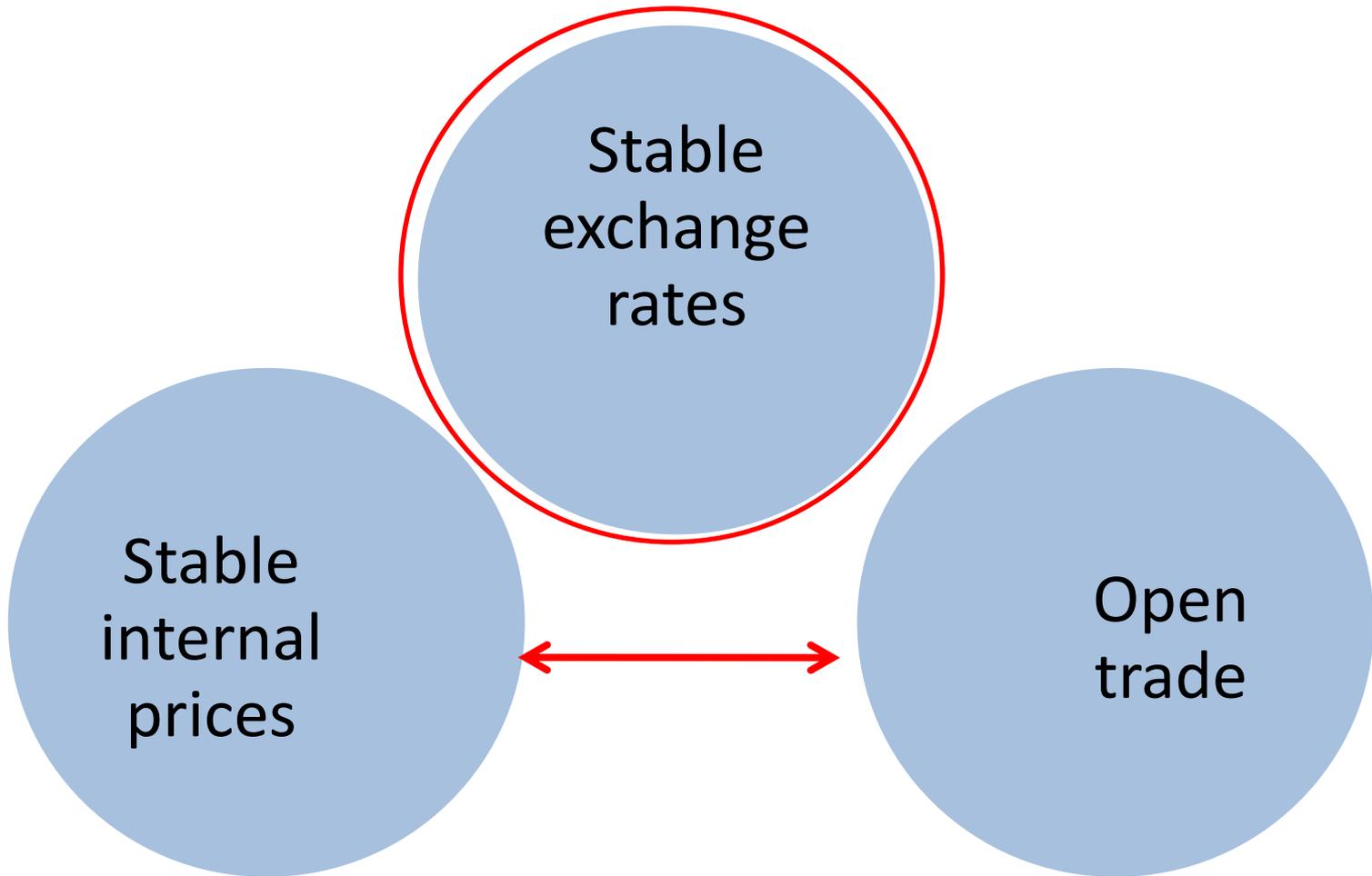
LESSONS FROM THE 1930s

Douglas A. Irwin

# The Trilemma



# The Trilemma



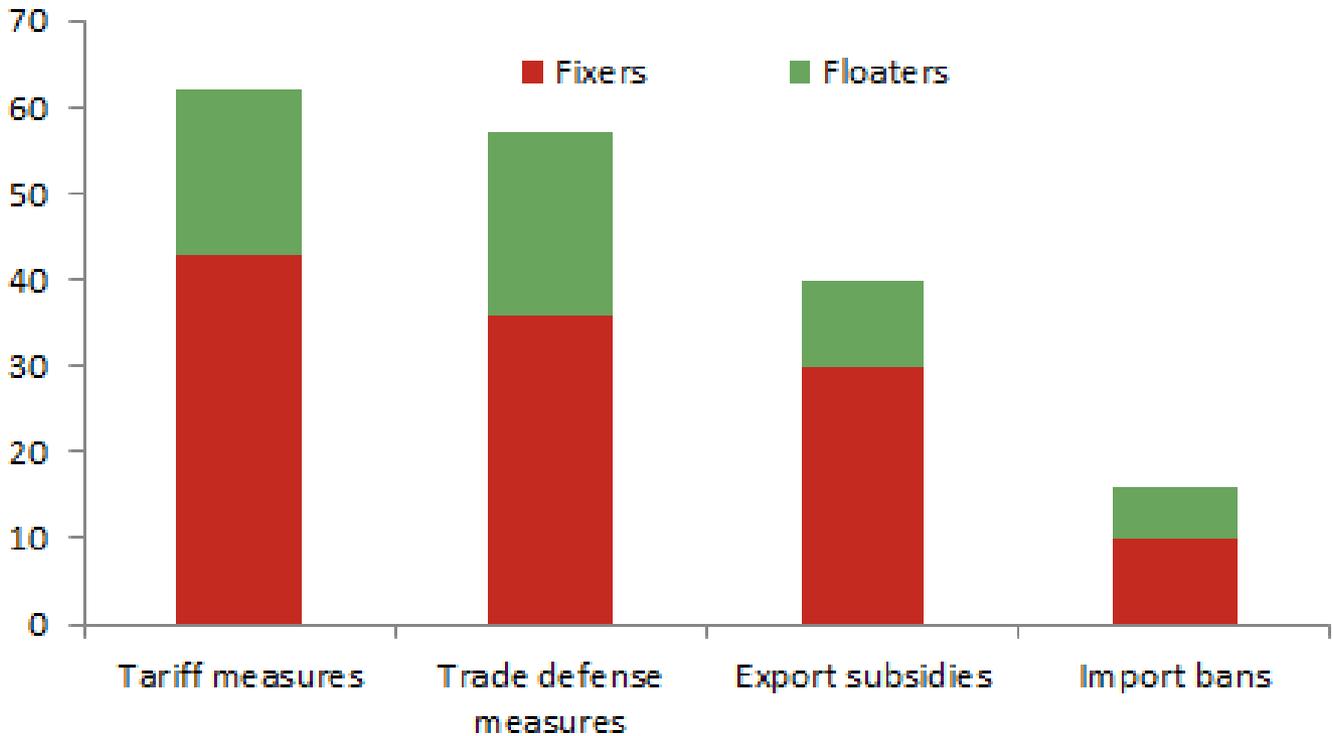
# Max Corden

- “the inability to use the exchange rate as a policy instrument provides an incentive to impose or increase restrictive trade policies at times of crisis, and thus leads to protectionist measures which often fail to be reduced when the short-term crisis is at an end”



# 2008-09 Crisis

Number of Countries that Implemented Discriminatory Trade Policy Measures since 2008



Source: authors' calculation based on Global Trade Alert.

# James Meade (1955)

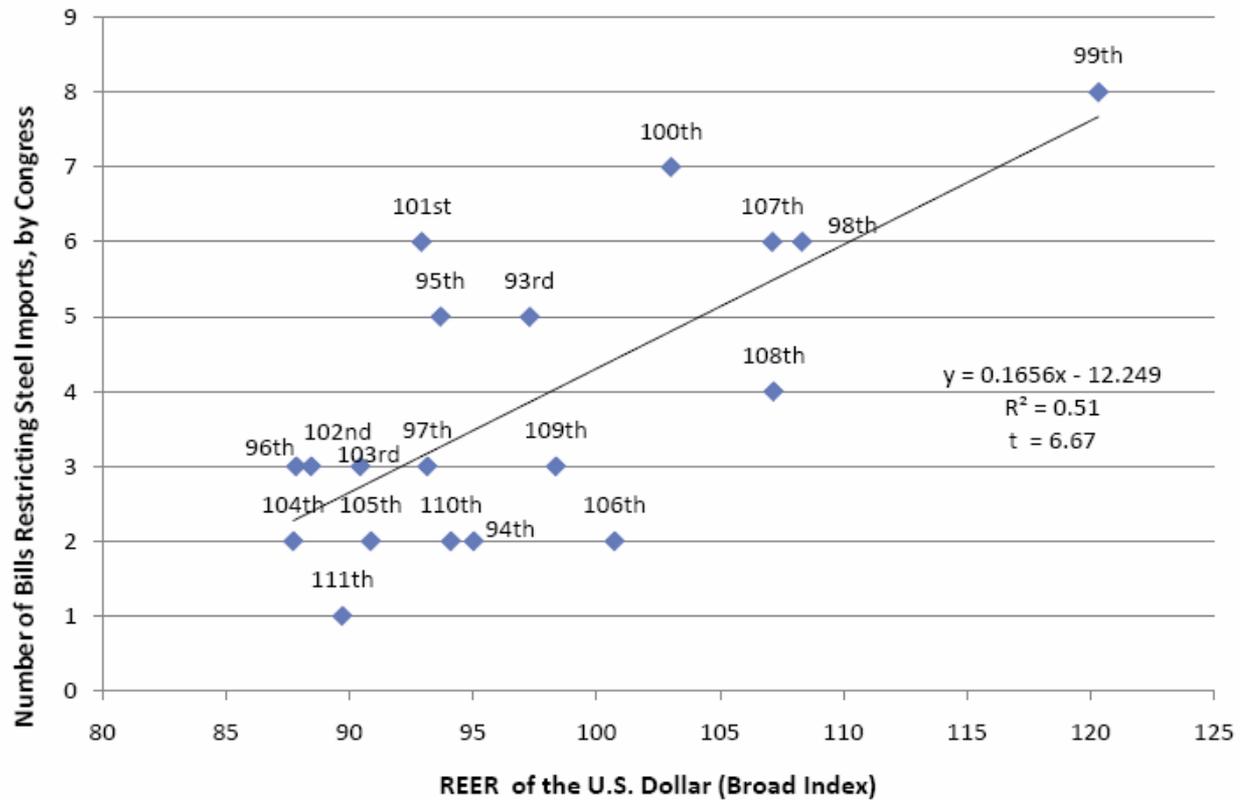
- “free trade and fixed exchange rates are incompatible in the modern world, and all modern free traders should be in favour of variable exchange rates.”



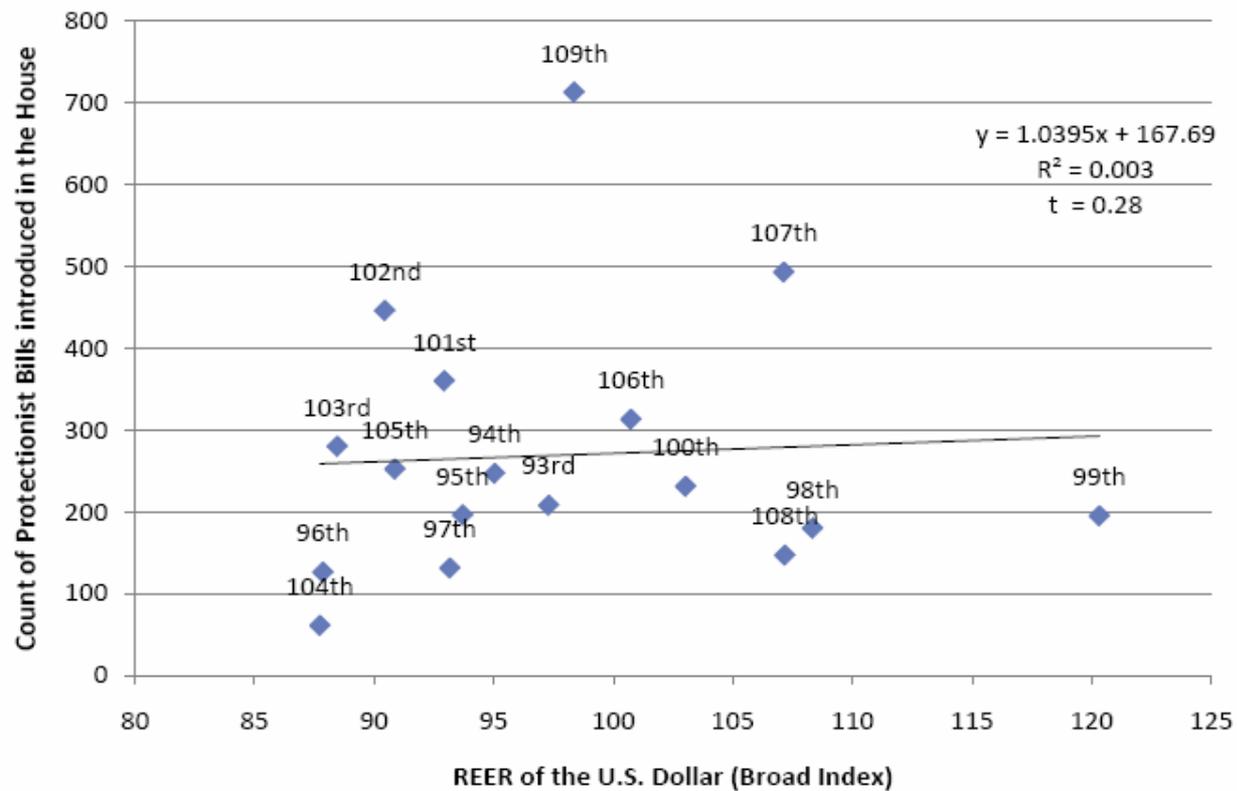
# Other evidence

- Great Depression
  - Eichengreen & Irwin (2010), Irwin (2012)
- Strong dollar in early 1980s
- Real exchange rate and antidumping
  - Knetter & Prusa (2003), Bown & Crowley (2011)
- Real exchange rate and protectionist legislation
  - Broz (2010), Oakley (2011)

**Figure 4: Protectionist Steel Legislation in the House of Representatives and the REER of the U.S. Dollar**



**Figure 5: All Protectionist Trade Legislation in the House of Representatives and the REER**

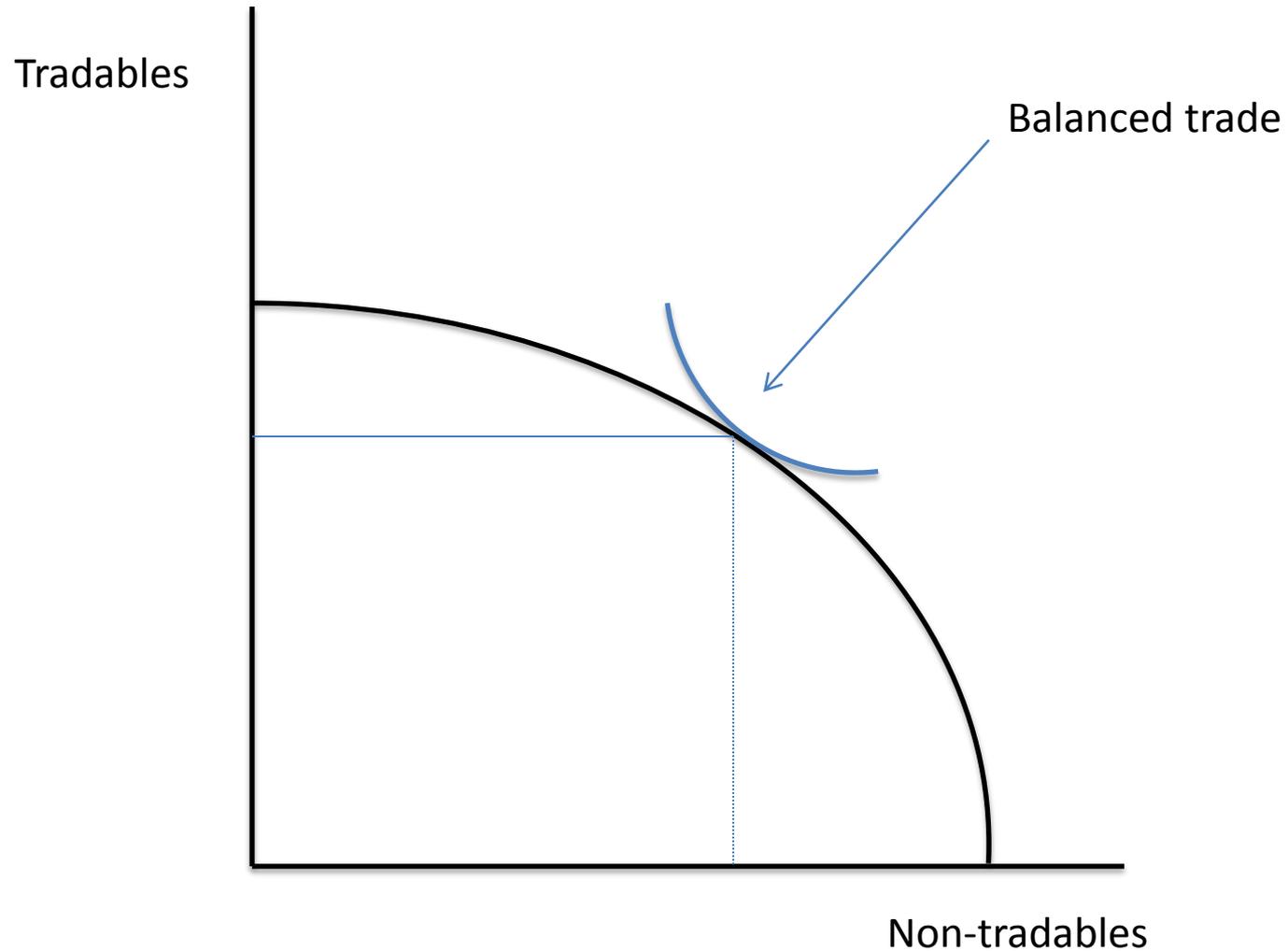


- Overvalued currency
  - Export tax and import subsidy
  - contract domestic production of tradables
  - protectionism at home
  
- Undervalued currency
  - Expand production of tradables
  - Protectionism abroad?

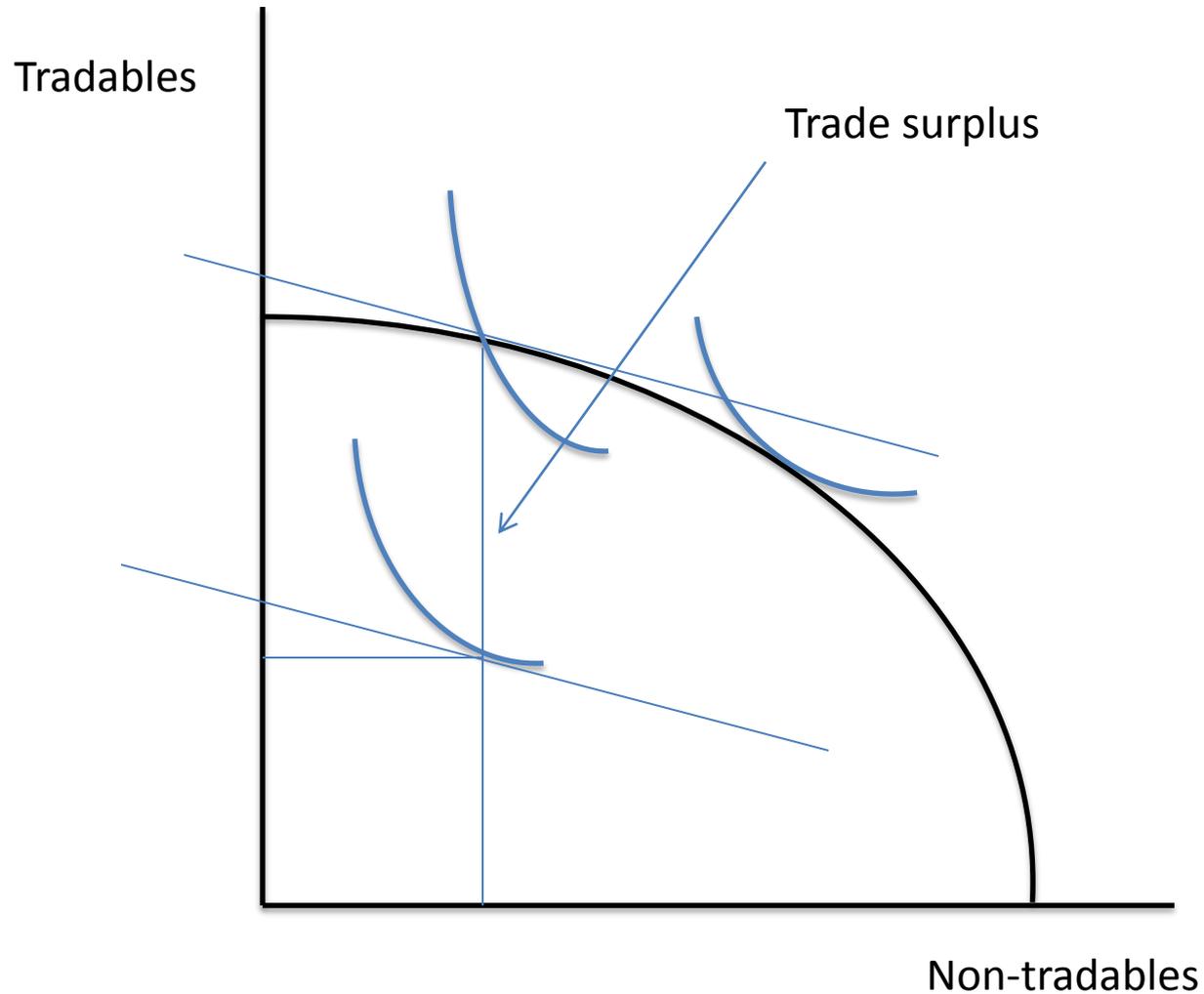
# Exchange rate protectionism

- Max Corden (1982)
  - Undervalued exchange rate
  - Protect tradables relative to non-tradables
  - Also distorts resource allocation

# Salter diagram



# Salter diagram



# Why undervalue?

- Rodrik (2008)
  - Undervalued currencies → faster growth
  - Overvalued currencies → slower growth
  - Externality in tradables sector?
  - Undervalued defined as deviation of real exchange rate from PPP



WORLD TRADE  
ORGANIZATION

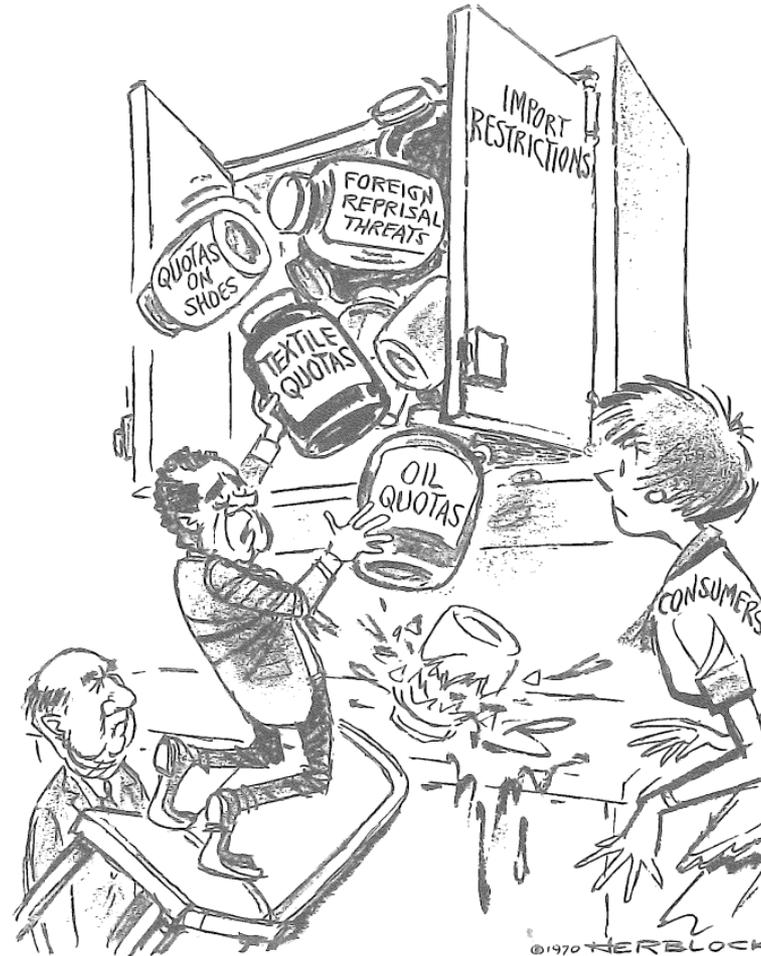
# IMF provisions

- Articles of Agreement:
  - “avoid manipulating exchange rates or the international monetary system to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members.”
- 1977 decision
  - “protracted large-scale intervention in one direction in exchange markets” evidence of currency manipulation

# WTO provisions

- Article 15:
  - Countries “shall not, by exchange action, frustrate the intent of the provisions” of the agreement
  - Meaning exchange controls, not exchange rates?
- Article 23
  - Nullification and impairment
- Subsidies and Countervailing Measures

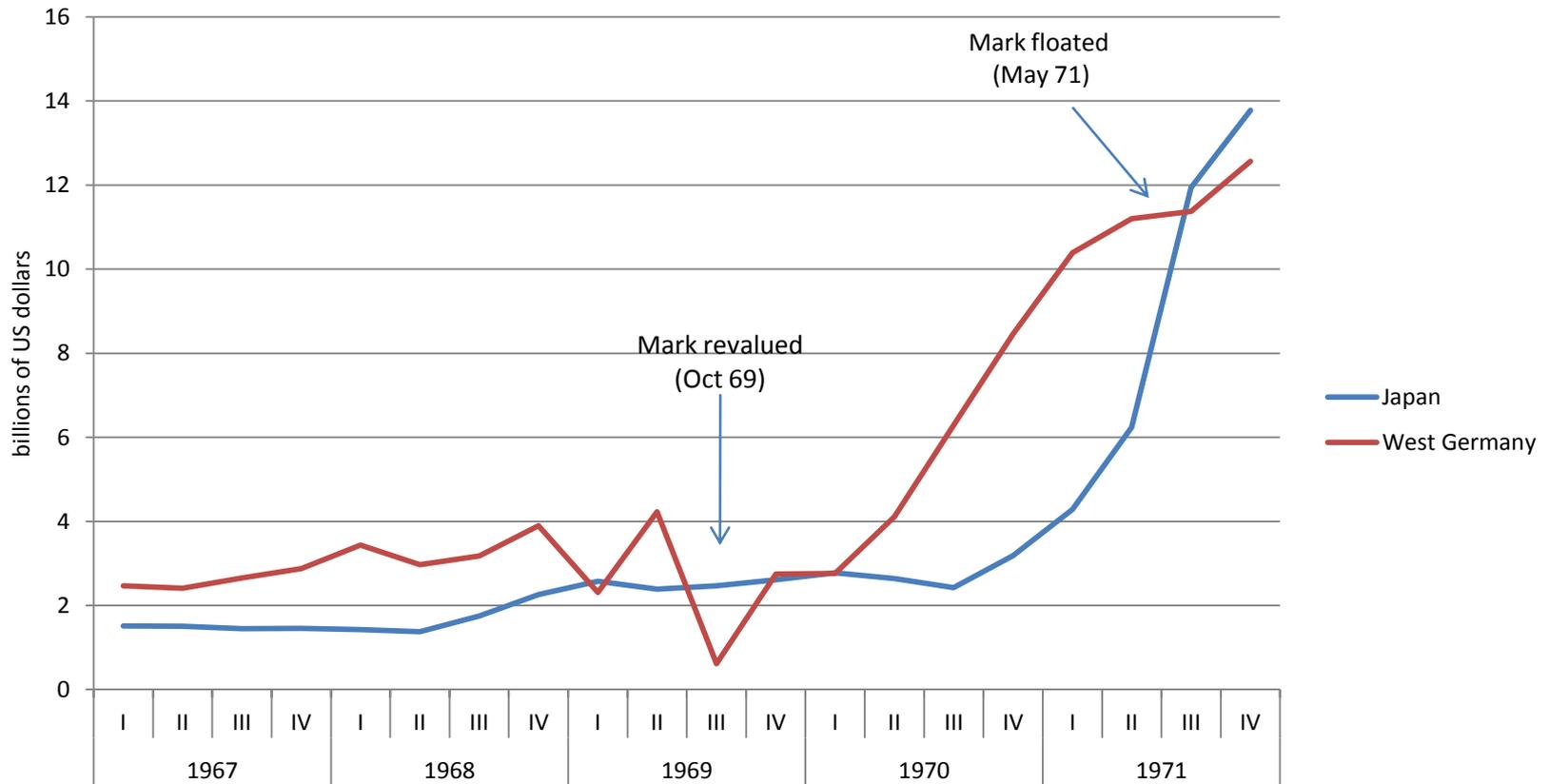
# Another history lesson



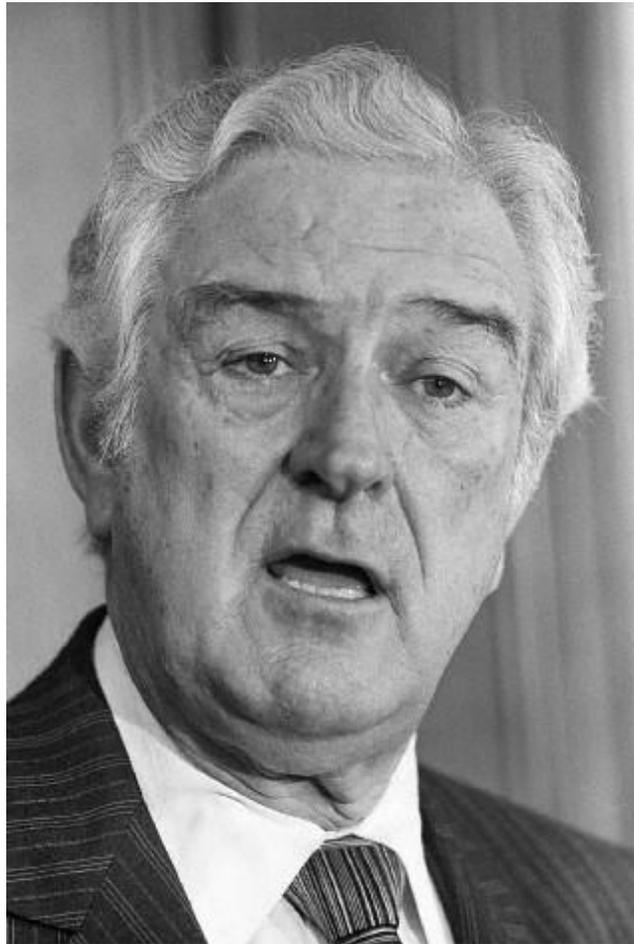
“I JUST OPENED IT TO GET  
SOME JAM FOR MY  
FRIEND STROM.”

7/29/70

# Resisting revaluation: foreign exchange reserves



# Treasury Secretary John Connally



- “Foreigners are out to screw us. Our jobs is to screw them first.”
- “The dollar may be our currency, but it is your problem.”

# Nixon shock of August 1971

## 10% import surcharge

## NIXON ORDERS 90-DAY WAGE-PRICE FREEZE, ASKS TAX CUTS, NEW JOBS IN BROAD PLAN; SEVERS LINK BETWEEN DOLLAR AND GOLD



As British soldiers take cover during a battle, a Londoner woman walks home.

### Hate Pursues British Troops in Ulster

By HERMAN WEINSTEIN

London, Aug. 15 — They were still in the thick of it when the British troops in Ulster were ordered to withdraw. The British troops in Ulster were ordered to withdraw. The British troops in Ulster were ordered to withdraw.



British soldiers armed with automatic weapons standing a perimeter in Belfast.

### U.S. WARNS HANOI OVER DMZ ACTON

Washington, Aug. 15 — The United States has warned North Vietnam that it will take action if the North Vietnamese government does not stop its military activities in the DMZ.

### A WORLD EFFECT

#### Unilateral U.S. Move Means Others Face Parity Decisions

By EDWIN L. DALE JR.

WASHINGTON, Aug. 15 — President Nixon announced tonight that his unilateral decision to convert the dollar into gold-backed units will automatically change the 20-year-old international monetary system.

### REACTION MIXED

#### Mansfield Pleased by Wage-Price Action—McGovern Critical

By CHRISTOPHER LYDEN

WASHINGTON, Aug. 15 — Republican and political observers who commented on President Nixon's speech tonight drew careful distinctions between the domestic and international elements of the package.

### Highlights of Nixon Plan

WASHINGTON, Aug. 15 — Following are the highlights of President Nixon's address tonight:

Wages and Prices—The President ordered a 90-day freeze on wages and prices and established a Cost of Living Council to administer the freeze and recommend measures to curtail wages and prices afterward. He also called on corporations to extend this freeze to all divisions.

### Suburbs Abandoning Dependence on City

By JACK ROSENTHAL

The largest city in America and when they live and work is now the suburbs of New York.



President Nixon after delivering impromptu address.

### SPRAKS TO NATION

#### Urges Business Aid to Bolster Economy—Budget Slashed

WASHINGTON, Aug. 15 — President Nixon shocked a new economic course tonight by ordering a 90-day freeze on wages and prices, repudiated Federal tax cuts and making a broad range of domestic and international moves designed to strengthen the dollar.

### U.S. WARNS HANOI OVER DMZ ACTON

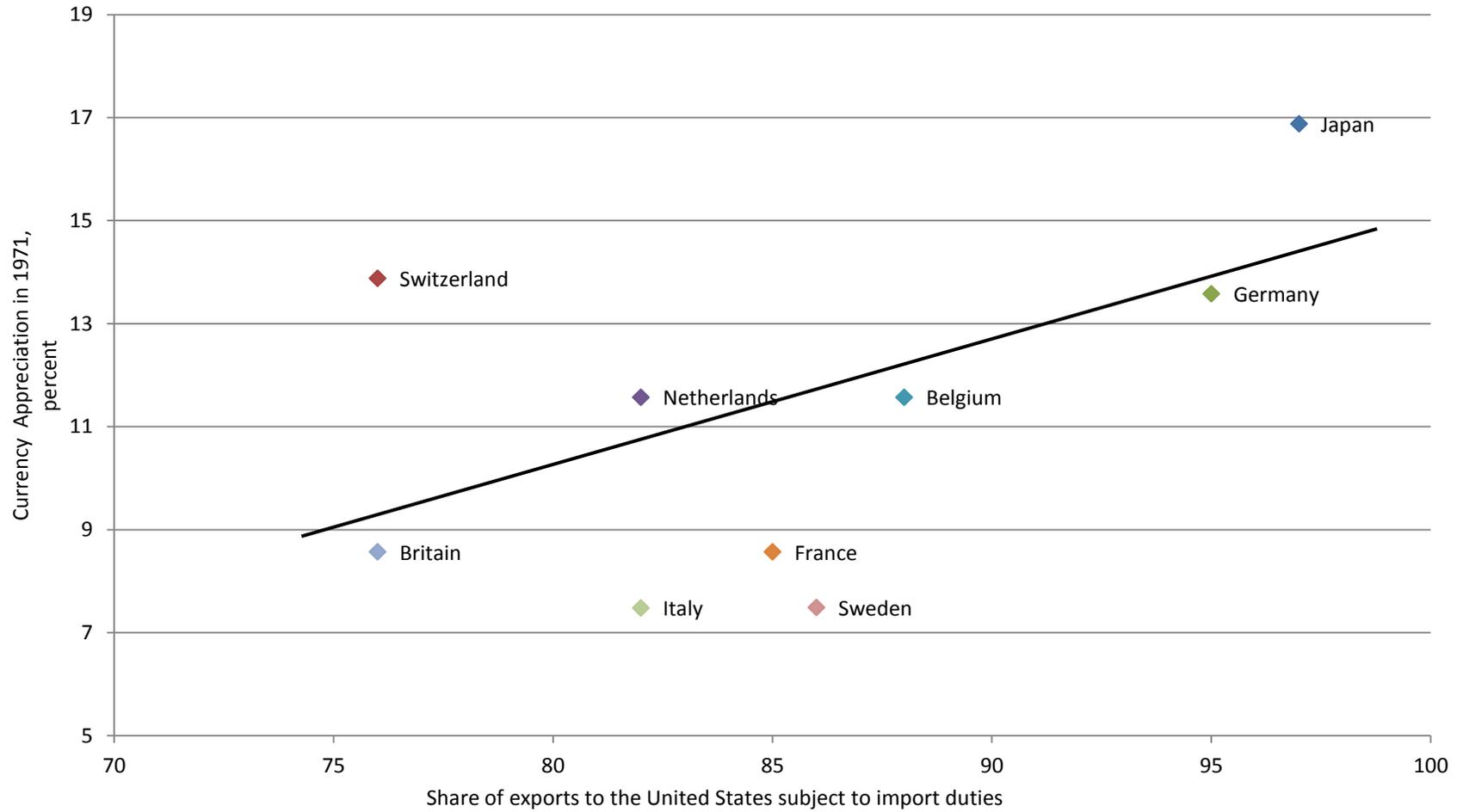
Washington, Aug. 15 — The United States has warned North Vietnam that it will take action if the North Vietnamese government does not stop its military activities in the DMZ.

### Autos Called Major Test; Lower Car Prices Likely

By JERRY M. HUNY

WASHINGTON, Aug. 15 — The high unemployment rate in the auto industry will probably lead to the auto industry, the major part of President Nixon's August 15th economic package, the President said in a 24-minute address to the nation.

# Coincidence?





- Article XV
  - Establishes GATT deference to IMF on all exchange rate matters
- IMF
  - “justified as a means of improving the U.S. balance of payments only until it is possible to supplant it by effective action in the exchange rate field”
- GATT
  - “inappropriate given the nature of the United States balance-of-payments situation and the undue burden of adjustment placed upon . . . the trade of other contracting parties.”

# Smithsonian agreement

- “the most important monetary agreement in the history of the world”

—Richard Nixon

A CHRISTMAS APPEAL: NEW YORK'S NEEDIEST CASES: SECTION 2

"All the News That's Fit to Print"

## The New York Times

LATE CITY EDITION

Weather: Possible light snow today; cloudy tonight. Warmer tomorrow. Temp. range today 17-31. Saturday 21-32. Full U.S. report on Page 71.

SECTION ONE

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NY 50 CENTS

### 10-NATION MONETARY AGREEMENT REACHED; DOLLAR IS DEVALUED 8.57%; SURCHARGE OFF

### Pakistan Calls Bhutto to Form Regime With New Charter

#### YAHYA DENOUNCED

Approval by President of Cease-Fire Spurs Demonstrations

By MALCOLM W. BROWNE  
Special to The New York Times  
WASHINGTON, Dec. 18—President Ayub Khan today asked Zulfikar Ali Bhutto, the Deputy Prime Minister and Foreign Minister, to return immediately from the United States to form a new government.

"On the arrival of Mr. Bhutto, power will be transferred to a representative government formed under the new constitution," an official statement said.

The announcement did not say what form the new constitution and government would take. Last night the President issued an outline of a new constitution and then withdrew it.

A few minutes later, the document had been written as if East Pakistan were still an integral part of the nation.

There were continuing indications today of political turmoil in West Pakistan, all related to the announcement yesterday that President Yahya Khan had accepted an Indian ceasefire offer.

Editorials Assail Him  
The President was denounced at angry demonstrations in various cities, by newspaper editors and even by politicians who owe the little authority they have to him.

A particularly bitter statement was issued by a coalition of major right-wing parties headed by Nurul Amin, the speaker, because when President Yahya Khan on Dec. 8 designated as Prime Minister Mr. Nurul Amin said later that the would not take office.

The statement by his party came from President Yahya Khan's immediate resignation.

"The tragedy of East Pakistan, the inextinguishable and humiliating manner in which the national army was forced to surrender its arms and the order of ceasefire against the soldiers of the people are the restoration of major powers on



REPORTS ON TALKS WITH NIXON: Zulfikar Ali Bhutto, Pakistani Foreign Minister, in Washington yesterday.

#### President Tells Pakistani Of Concern for Stability

By BERNARD GWERTZMAN  
Special to The New York Times

WASHINGTON, Dec. 18—(AP)—President Nixon today said in a joint several urgent messages to Pakistan's Deputy Prime Minister Zulfikar Ali Bhutto, that his "seriousness to press India not to power cooperation would be beyond the war into West Pakistan, and to press India not to break it off on the subcontinent."

Mr. Bhutto, who is leaving his continuing concern that "the security for Pakistan to help in developments in South Asia in the formation of a new civilian government weeks set back severely government, not with the efforts to bring greater stability to South Asia and to the world."

The two leaders, Mr. Zulfikar Ali Bhutto, reviewed the present situation following Pakistan's accession to West Pakistan and Mr. Nixon had told Mr. Bhutto that the "first requirement" in the wake of the war was to establish confidence that the people had in their government, and to secure the order of ceasefire against the soldiers of the people are the restoration of major powers on

#### REDISTRIBUTING BILL HELPFUL TO G.O.P., PAPPED IN ALBANY

Democratic Senators Seem Measure as Gerymander—Assembly Debate Heated

By WILLIAM E. FARRELL  
Special to The New York Times

ALBANY, Dec. 18—After predictable rounds of charges of Republican gerrymandering, the Legislature passed at a special session today a bill reneging the state's legislative districts and making them favorable to the Republican majority in both houses.

The Senate vote was 23 to 16, with seven Democrats voting in the affirmative either because they had fared well at the hands of the G.O.P. or because they feared their own constituents would be hurt if the bill passed.

The Assembly passed the bill 93 to 52, with some Democrats also voting for the bill to the chagrin of the Democratic minority leader, Stanley Stratton of Brooklyn, who had asked for a party vote in the majority.

Mr. Ziegler said that 30 of the bill's 30 amendments would be distributed directly to needy families for rent or even for the purchase of housing according to H.U.D. officials, according to H.U.D. officials, a national reduction of billions of dollars in subsidies now being spent on public housing and conversions to houses and land.

The Assembly debate was dominated by the bill's impact on the poor.

The bill was sent to Governor Rockefeller, who forwarded the measure, before signing it to the Attorney General for a determination on whether it could withstand inevitable court challenges. Mr. Rockefeller has 30 days to sign the bill.

The Governor formally summoned the Legislature to a second and special session, on his own initiative, to deal with the state's fiscal crisis, on Monday, Dec. 27, at noon.

The two leaders, Mr. Ziegler and Mr. Rockefeller, were of the opinion that the bill would be passed by the Legislature in its present form.

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ANNOUNCING MONETARY MOVE: President Nixon speaking at the Smithsonian Institute in Washington. At right is Kent Schiffer, Finance Minister of West Germany.

#### BLVD. TO GIVE POOR, SATO WELCOMES ACCORD BUT SEES SERIOUS IMPACT

By RICHARD HALLORAN  
Special to The New York Times

TOKYO, Sunday, Dec. 19—Premier Eisaku Sato of Japan said this morning that the revaluation of the yen would have a serious impact on the nation's economy but he expressed confidence that it would recover within a year.

Mr. Sato, in a televised newscast after an emergency Cabinet meeting, welcomed the realignment of currencies approved in Washington because it eliminated the "unnecessary" economic policy last August 15.

In Europe, a pickup in business confidence and flow of money from Europe to the United States were seen as major developments that would emerge from the monetary accord.

The Premier said that his Government hoped to increase the nation's economic growth to 7 per cent during next fiscal year that begins next April.

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#### NIXON HAILS PACT

He Makes a Surprise Appearance—Gold Goes to \$38

By EDWIN L. DALE JR.  
Special to The New York Times

WASHINGTON, Dec. 18—The world's 10 leading non-Communist industrial nations reached agreement tonight on a new pattern of currency exchange rates, including a devaluation of the United States dollar by 8.57 per cent.

Speaking to reporters as the negotiations ended, President Nixon said, "It is my great privilege to announce, on behalf of the finance ministers and the other representatives of the 10 countries involved, the conclusion of the most significant monetary agreement in the history of our nation."

The new United States 10 per cent import surcharges will be removed next week. The surcharge was imposed, and the so-called "gold standard" began, with President Nixon's dramatic monetary announcement on August 15.

Several other currencies, led by the Japanese yen, will be revalued upward.

Treasury Secretary John B. Connally said that the overall effect would be an effective devaluation of the dollar by 12 per cent. This figure is arrived at by allowing for United States trade with each of the countries. The Canadian dollar, which will continue to float in daily trading, was left out of the calculation.

A communiqué issued by the Group of 10, said that most foreign exchange markets would be closed on Monday, but Mr. Connally said the United States market would be open.

The dollar devaluation is encouraged by the agreement announced last night.

Connally results from a projected increase in the official gold price from \$35 to \$38.

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#### States Curtailing Polluters On Pollution Control Units

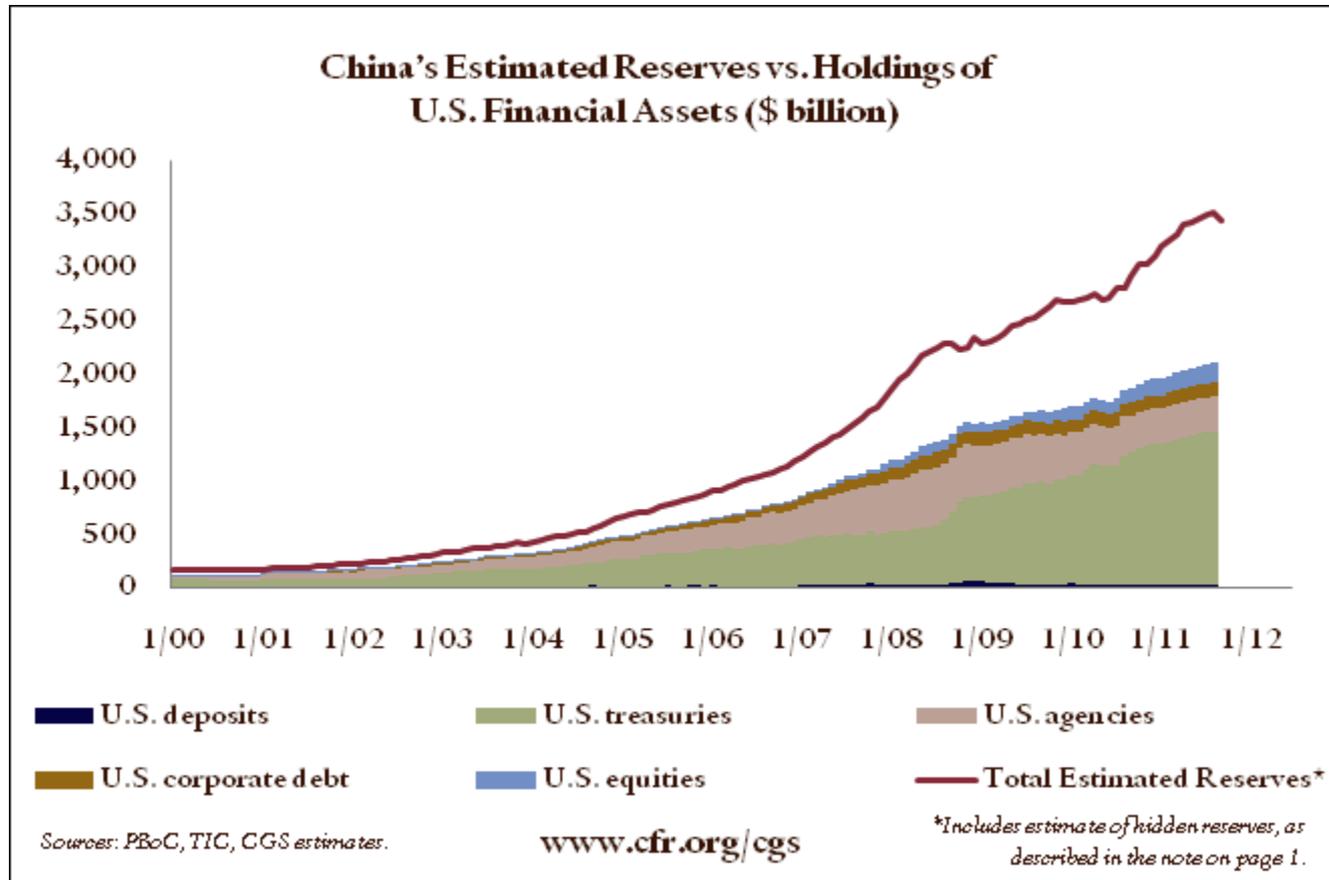
The States Curtailing Polluters On Pollution Control Units

# Volcker on the Nixon shock



- “The conclusion reached by some that the United States shrugged off responsibilities for the dollar and for leadership in preserving an open world order does seem to me a misinterpretation of the facts. . . . The devaluation itself was the strongest argument we had to repel protectionism. The operating premise throughout was that a necessary realignment of exchange rates and other measures consistent with more open trade and open capital markets could accomplish the necessary balance-of-payments adjustment.”

# China



## Tariffs can persuade Beijing to free the renminbi

By Robert Aliber

Published: December 7 2009 20:43 | Last updated: December 7 2009 20:43

International payments arrangements are at an impasse much as they were in the summer of 1971, when there was widespread recognition that trade imbalances were far too large.

Then, the values of the Japanese yen, the French franc and the British pound were frozen to the US dollar; no country wanted to take the initiative to realign currencies. Today the problem is the unsustainable US-China trade imbalance. China's exports of manufactured goods have increased at a rapid rate, but the adjustments that would have led to comparable increases in imports have not occurred because China **refuses to budge** in allowing the value of the renminbi to increase.

Beijing's unprecedented accumulation of \$2,000bn (€1,350bn, £1,225bn) of **US dollar securities** is the product of its "beggar-thy-neighbour" policy in importing jobs. The undervaluation of the renminbi has the same impact as an import tariff of 50 or 60 per cent.

A principal motive for the cheap renminbi policy is Beijing's concern that domestic unemployment will increase if the currency strengthens. Moreover, the low value for the currency facilitates China's move up the technological ladder, since imports of high-technology products from the US, Japan, Germany and other industrial countries are stalled while domestic production of similar goods is increased.

China's large holdings of US securities have enhanced its political clout and given it the standing to comment on US interest rates and the US fiscal deficit. And as long as China's trading partners are focused on the huge **trade surplus**, their other demands on Beijing are modest.

Americans have been patient – too patient – in accepting the loss of several million US manufacturing jobs because of China's determined pursuit of mindless mercantilist policies. The absurdity of the current situation is that China's currency protectionism has more of an impact on American manufacturing employment than US fiscal policy.

The US can help China make the necessary adjustments toward a reduction in imbalances by adopting a uniform tariff of 10 per cent on all Chinese imports, based on their values when they enter the US. Six months after the establishment of this tariff, the rate would increase by one percentage point a month until the Chinese trade surplus with the US declines to \$5bn a month.

September 29, 2010

## Eye on China, House Votes for Greater Tariff Powers

By DAVID E. SANGER and SEWELL CHAN

WASHINGTON — The House of Representatives sent an unusually confrontational signal to the Chinese leadership on Wednesday, voting overwhelmingly to give the Obama administration expanded authority to impose tariffs on virtually all Chinese imports to the United States.

The move, which could affect more than \$300 billion in goods this year, was made in retaliation for the country's refusal to revalue its currency.

The bill [passed 348 to 79](#) and included the support of 99 Republicans, a highly unusual bipartisan vote at a time when large numbers of House Republicans have rarely joined Democrats on an economic issue. House Speaker [Nancy Pelosi](#), who has long pressed China trade issues, personally gaveled the vote closed. Nonetheless, prospects for Senate approval are unclear.

The action was intended to hand [President Obama](#) new leverage in what has become a major flashpoint between the world's two largest economies. While tariffs have been placed on specific products, like steel and tires, because of evidence of unfair export subsidies, the threat of putting sizable tariffs on a country's entire line of exports to the United States is highly unusual — and, some argue, of dubious legality under international trade law.

It reflects both election-year politics over a loss of American jobs and great frustration over unfulfilled promises by China to allow its currency to rise in value, which would make Chinese goods less competitive in the United States.

The Obama administration never took an emphatic position on the legislation and some officials say that, if passed, signed into law and challenged at the [World Trade Organization](#), it might well be struck down. But this is a case where the symbolism may be more important than the legal niceties, and for that reason, the White House has been of two minds about the bill.

Mr. Obama has tried to use the rising public anger over China's trade advantage to argue to Chinese leaders that the United States would no longer tolerate deliberate currency manipulation, a point Mr. Obama made repeatedly in a meeting last week with [Wen Jiabao](#), China's prime minister. He did so again on Wednesday in Des Moines, where one businessman asked the president about the issue.

"The reason that I'm pushing China about their currency is because their currency is undervalued," he said, adding: "People generally think that they are managing their currency in ways that make

October 11, 2011

# Senate Jabs China Over Its Currency

By **JENNIFER STEINHAUER**

WASHINGTON — A bipartisan cross-section of Congress seems to agree that China manipulates its currency in ways that make it harder for many American manufacturers to compete. Where they cannot find alignment is on how best to address that problem, while maintaining America's relationship with its biggest lender and a major trading partner.

On Tuesday, the Senate passed a bill that would require the Treasury Department to order the Commerce Department to impose tough tariffs on certain Chinese goods in the event of a finding by the Treasury that China was improperly valuing its currency to gain an economic advantage.

The measure passed 63 to 35, with 16 Republican votes, an unusual dynamic in the Democrat-controlled Senate. It enjoyed rare support from members of both parties despite the strong disapproval of Senator Mitch McConnell of Kentucky, the Republican leader, who pressed his party colleagues to vote against it.

At the same time, House Republicans have made it clear they have no intention of bringing the currency measure to the floor, and the White House has given it a chilly reception, fearing it too blunt an instrument against China, which has slowly moved to increase its currency value.

This is a reverse of last year when a similar, though less stringent, measure passed the House and the Senate neglected to take it up, preferring its own bill. Democrats are now trying, against political headwinds, to force a vote on that same measure against the desires of Republican leaders.

MARKETS | NOVEMBER 16, 2011

## Debate on Yuan Manipulation Moves to WTO

By **MATTHEW DALTON** And **DIANA KINCH**

The World Trade Organization in the coming months will examine whether international trade rules can be used to punish governments that manipulate the value of their currencies, a debate driven by Brazilian anger over China's policy of keeping the yuan pegged to the U.S. dollar.

The review opens a new front in the debate over China's dollar peg, making the Geneva-based arbiter of trade disputes the latest international institution to tackle global angst over the issue. It comes as Western companies have started to make the argument that the peg amounts to an unfair export subsidy that should be fought with tariffs on Chinese-made goods.

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### More

- [Data Help China's Case on Yuan](#)

Brazil's government said Monday that the WTO had agreed to discuss the matter. The WTO on Tuesday confirmed that its 153 government members have agreed to hold a meeting on the topic, probably in the first half of next year, according to WTO spokesman Keith Rockwell.

Governments are also likely to discuss the issue at a meeting next month of trade ministers in Geneva, Mr. Rockwell said.

Brazil, which first raised the issue with the WTO in September, alleges the yuan's undervaluation is gravely damaging Brazil's industrial base. Though Brazil's economy is growing relatively quickly overall, the country's industrial production is now falling, partly due to a tide of cheaper Chinese goods.

"Exchange-rate factors are devastating the productive structure of Latin American countries," Brazilian trade and industry minister Fernando Pimentel told reporters this week.

# November 2011



## The Current Currency Situation

William R. Cline and John Williamson

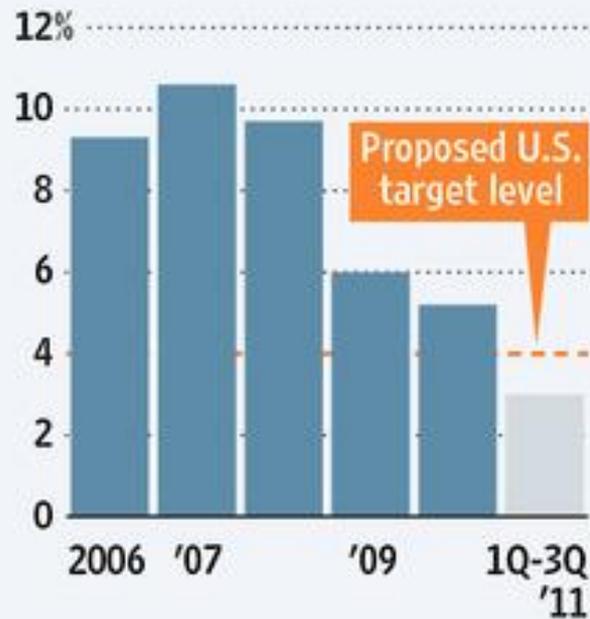
**The dollar remains overvalued by about the same amount as in April, about 9 percent. In contrast, the Chinese RMB is substantially closer to equilibrium, with its undervaluation falling from 16 percent to 10.6 percent.**

# FEER

- “Fundamental equilibrium exchange rate”
  - Rate at which external imbalances and capital flows can be indefinitely sustained
  - Current account deficit +/- 3% of GDP

## On Target

China's current-account surplus as a percentage of GDP



Sources: State Administration of Foreign Exchange; National Bureau of Statistics; Wall Street Journal calculations

## China's yuan-dollar exchange rates

Q1 2005=100



\*Using relative unit labour costs in industry

# Problems

- How do we know if a currency is “undervalued”?
  - Limits on accumulation of foreign exchange reserves?
- Can governments control the real exchange rate?
- What about capital account liberalization as a substitute?

# Conclusion

- Trade economists should pay attention to exchange rate policies
- Exchange rate misalignments & disputes can lead to trade policy interventions
- If the IMF & WTO don't provide guidance, countries will act unilaterally