
# APPLYING SUBSIDY RULES TO CHINA'S CURRENCY REGIME

***Statement of***

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**Committee on Ways and Means**

**Hearing on China's Exchange Rate Policy**

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# INTRODUCTION

It is a great honor to participate in this hearing, on a topic of such importance and alongside such distinguished witnesses.

I have worked for twenty years in the field of international trade law and policy, with a particular concentration in subsidy-related trade disputes across a range of sectors. I have taught in the field as well, for the last decade. I am currently President of TradeWins LLC, a solo consulting firm, and Of Counsel at the law firm Miller & Chevalier Chartered. I do no paid work related to the China currency issue. The views in this statement are personal ones.

I commend the Committee for holding this hearing and more generally for moving into an activist posture on the important topic the hearing addresses. The hearing focuses on China's exchange rate regime. My statement focuses more narrowly on one of the key questions presented: whether, and how, subsidy rules can be applied to address that currency regime's adverse trade consequences.

# KEY MESSAGES

There are two key messages I hope to leave with the Committee.

1. China is indeed, with its present currency regime, doing something it promised not to do -- that is, something inconsistent with WTO rules. The case for responsive action by the U.S. government is strong.

2. China's present currency regime meets the technical, legal definition (in current U.S. and WTO law) of an export-contingent subsidy. The Administration's failure to act on that basis reflects a failure to faithfully execute existing law. In such a circumstance, the case for Congressional action is strong.

I address the details below. But if the details fade, I hope the punch line will not. Our government should be acting, and under present circumstances that means *you* should be acting.

# FACTUAL AND LEGAL BACKUP

My statement does not purport to detail the operation of China's currency system, the economic analysis relevant to measuring the RMB's misalignment, or the consequences that misalignment is generating within the U.S. economy. Those matters have been well-ventilated already in the Committee's work on the subject, and also in the press. Rather, I address below certain key facts and legal points which perhaps have not received the attention they merit, and which collectively provide a very solid, confident basis for applying subsidy rules to China's currency regime. I conclude with some rebuttal points, and a prediction.

## 1. The facts of China's currency regime are distinctive.

Classic currency "manipulation" occurs when a government intervenes in a market where the value of its currency is being established through thousands of arm's length exchanges occurring in thousands of different locations. By buying or selling large amounts of its own currency, and signaling a willingness to do more of the same, the intervening government can influence the prevailing price in a desired direction. In the case of RMB/dollar exchanges, there isn't really a "market" in which to intervene. The Chinese government controls the price directly, by limiting where dollar/RMB exchanges can take place (at its own FOREX entities) and then executing those exchanges at an *administered* price. You could liken this situation to the weekly allowance my wife and I pay to our children. The amount is what we decree it to be. So China's manipulation consists, at least partly, in setting a price that reflects industrial policy considerations rather than economic fundamentals. This additional element, going beyond the classic notions of "manipulation" and "intervention" used in the IMF context and in our 1988 Omnibus Trade Act, has important consequences where application of subsidy rules is concerned.

## 2. Applying subsidy rules to China's currency regime should command broad consensus, even if views on other currency matters diverge.

Many people -- and perhaps some members of the Committee -- have a preconceived notion that currency problems are difficult to address using subsidy rules. This is understandable. In the classical scenario, when exporters bring home dollars and convert them into the local currency, they do so not at a government window but with a private bank. The price at which the exchange occurs may be influenced (distorted) by a recent episode of government intervention, but there is no financial contribution between the government and the exporter. To be sure, a financial contribution to one entity can confer a benefit upon another. A case based on this theory would be legitimate under the existing definition in the WTO Subsidies Agreement and U.S. law. But it would be more complicated than a case focusing on the benefit to the recipient of the financial contribution. Hence the conventional wisdom that anti-subsidy rules are difficult to apply to currency problems, and that they take a back seat to other tools like the IMF agreements and the 1988 Act.

I'm sure you need no reminder of how disappointing the performance of those other tools has been. Some blame the tools themselves, and some blame ineffective use of those tools. My message today is that *it doesn't matter where China is concerned -- because in China's case application of subsidy rules is quite straightforward*.

In China's case, there *is* a direct transaction between the government and the exporter who has brought home dollars. The exchange occurs at a government window. That transaction -- indeed, *any* swap of one thing and another, between a company and a government -- is a **financial contribution**. If the economists are to be believed, and the administered exchange rate is wrong in the direction of meaningful undervaluation of the RMB compared to what market forces would produce, then that financial contribution **confers a benefit**. That means you have a **subsidy**. And that subsidy is

plainly **export contingent**, as most of it goes to companies that can only get it by exporting. Indeed, this subsidy falls in the innermost core of the export-contingent category, on which no one I know of disagrees, in that it gives a producer a compelling reason to prefer selling a marginal unit of output abroad rather than at home.

So existing subsidy rules *do* cover this situation. This is significant because the legal definition of a subsidy is narrower than the economic definition. There are many government actions which economists would say amount to a subsidy but which do not satisfy the legal definition. The trade negotiators in the Uruguay Round intentionally chose a narrower definition. *China's currency regime satisfies even that narrower definition.*

### 3. The arguments against applying subsidy rules in this context are unpersuasive and, in some cases, dangerous.

I present here, in summary form, rebuttals to various arguments that seek to poke holes in a case that is really air-tight.

- The Import Administration seems to have no trouble spotting a subsidy (financial contribution conferring a benefit) here, but is apparently in some doubt about whether that subsidy is **export-contingent** or otherwise specific. This would be laughable if the error's consequences were not so serious. It is true that tourists and investors get the same unified exchange rate as Chinese exporters, and thus get the subsidy too. That does not prevent the subsidy from being export-contingent, as we learned not long ago in the WTO litigation over the Extra-Territorial Income (ETI) measure which temporarily succeeded to the Foreign Sales Corporation (FSC) provisions in U.S. tax law. As in that case, exporters are a discrete class of beneficiaries, and their access to the subsidy depends entirely on exporting. Beyond denying particular U.S. industries the full measure of CVD relief (or at least the full CVD investigation) they deserve, the agency's error has broader implications. If the crabbed notion of export contingency espoused by the Import Administration here wins any sort of broad acceptance, then the "prohibited" category of subsidies -- the one part of the multilateral anti-subsidy regime that has worked reasonably well over the years -- will be reduced to something very much like a nullity. An incalculable amount of U.S. political capital, expended over decades, will have been wasted. A specific example: if the Import Administration is right in what it is saying about export contingency in this matter, then the USTR lawyers are wrong in what they are saying about export contingency in the current Airbus litigation. The tie between subsidy receipt and exportation is even clearer in the China currency case than in the case of royalty-based launch aid.[1]

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1 Consider, in this regard, the following excerpt from a submission the United States filed just three weeks ago with the WTO Appellate Body, challenging panel findings that certain launch aid subsidies were not export-contingent. The focus was on the panel's over-emphasis on the subsidizing government's intent:

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- Ambassador Shapiro, meanwhile, according to his widely-circulated memorandum to the Board of the National Association of Manufacturers, doubts that there is a **financial contribution** when dollar/RMB exchanges occur at a government window. I assume he would have no such doubt if the exchange were one of pens for pencils, or RMB for stock shares, or dollars for bushels of wheat. Is there a previously-unnoticed gap in the definition when the exchange involves trading one currency for another? I don't see such a gap. And it is unimaginable to me that the U.S. government would take this position, given what it would mean for the efficacy of the WTO anti-subsidy regime. The Greenberg Traurig memo cites WTO precedent noting that to make a "direct transfer" the government must transfer something of value -- but of course the RMB provided in exchange for dollars do have value, so I don't think any doubt has been cast on the existence of a financial contribution.[2]

- And then there are some who think the RMB may actually be *over*-valued, or at least not under-valued by enough to confer any measurable **benefit** to Chinese exporters who swap dollars for RMB. I'm a recovering climate change skeptic myself, so I know how these poor souls must feel. To be sure, judging the presence (or absence) of a "benefit" is easier when a market-determined benchmark is available. Since none exists here, it takes some fancy high-stepping by economists to produce a credible estimate of what the exchange rate "should" be. But they've done that. There is a pretty solid consensus, and the direction of the misalignment is clear even if its precise magnitude isn't. Ambassador Shapiro's own memo, while skeptical on the other elements, clearly acknowledged the existence of a benefit here. My advice on this point is: if you

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> If, as the Panel's approach reflects, subjective motivation were a necessary requirement for reaching a finding of … export subsidization, a subsidizing Member could tie the grant of a subsidy to exports and still avoid a finding of WTO-inconsistency, for example, simply by ensuring no public statements of motivation were made or included in the measure or discussion of it, or by publicly declaring additional motivations that did not relate to the desire to increase exports.… Nothing in the SCM Agreement permits such a formalistic means of evading the prohibition against export subsidies.

*European Communities and Certain Member States – Measures Affecting Trade in Large Civil Aircraft (AB-2010-1 / DS 316)*, Other Appellant Submission of the United States of America (Aug. 23, 2010) at paras 21-22. One could change a few words and make the same argument against the Import Administration's present position on currency subsidy claims. According to that position, a subsidizing government could move a subsidy scheme out of the prohibited category by simply extending a small share of benefits to non-exporters, even when the lion's share goes to entities that can only get benefits by exporting. Nothing in the SCM Agreement, or in U.S. law, permits such a formalistic means of evading the export-contingent classification.

2 The Greenberg Traurig memo also contends that a WTO panel would be unlikely to see export-contingency here -- but the memo does not even mention the ETI decision which is probably the most relevant of the WTO precedents. Perhaps we can look forward to an updated Greenberg Traurig analysis taking account of that case and of the new learning on export contingency that is emerging from the WTO large civil aircraft litigation.

study the matter carefully, and read the analyses, and huddle with the experts on your own committee staff, and at the end of all that you wind up seriously doubting the "Bergsten-Krugman" consensus on RMB undervaluation, then don't vote in favor of legislation on this subject and don't pressure the Administration to act. Otherwise, you know what to do, and you know when to do it.

## A BRIEF LOOK BACK AND THEN FORWARD

Preparing this statement included a look back at some partially-overlapping testimony I delivered three years ago at a hearing of the Senate Committee on Finance. That hearing focused on S. 1919, which had various trade enforcement provisions including one that would have confirmed legislatively the applicability of the CVD law to non-market economy ("NME") products. I testified:

> As a policy matter, it makes sense for the law to apply to imports from NMEs. … The need for legislation formally extending the CVD law to China is debatable, given what DOC has done on its own. But court approval for DOC's new approach has not yet been secured, and in any event legislative clarification cannot be harmful.
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> There is a chicken that has not yet come home to roost, and you should be aware of it. DOC has ducked currency subsidy allegations in the China/CVD cases processed to date, asserting that these particular subsidy claims were inadequately pleaded. DOC has not yet specified in what respect the pleading was too thin, but it appears that DOC's answer (when the time comes) will be that there was no sufficient allegation of a "financial contribution." This would be a flimsy basis for declining to investigate, and unlikely in my opinion to survive judicial review. When Chinese exporters go to a government window and trade one currency for another, the exchange certainly seems to satisfy the statutory definition of a financial contribution -- just as if they exchanged currency for financial instruments or pencils or cement or anything else.
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> … The thought of DOC trying to make determinations about what the proper yuan/dollar exchange rate should be -- whether there is a "benefit" in the exchange transactions between Chinese exporters and the PRC government -- makes some observers nervous, and it would certainly represent a change in terms of the historical (and presumed) allocation of competence among U.S. government agencies where China/currency matters are concerned. But it may be an inevitable consequence of applying the CVD law to Chinese products, and DOC just might surprise its skeptics (I am not one of those) by doing a good job here as it has elsewhere. Some of you, including Chairman Baucus and Ranking Member Grassley, have already endorsed legislation that crosses this bridge and calls for DOC to take currency mis-valuation into account in trade remedy margin calculations. I believe the confidence you have shown in DOC, by taking these positions, will turn out to be justified.

Predicting is a hazardous business, and I achieved mixed results. Commerce did eventually offer a justification, but it was not a flimsy rationale involving financial contributions. It was a flimsy rationale involving export contingency and specificity. And

the Court of International Trade bypassed its first chance to review a non-initiation decision by Commerce on currency subsidies.[3]

Nevertheless, I will repeat here one prediction from 2007 that has not yet been tested: if Commerce does wind up investigating currency subsidies, it will do a good job and confound the skeptics. The agency just needs a strong nudge to get started. That nudge should come from the Congress, and it should come as soon as possible.

## CONCLUSION

I regard currency as the toughest in a list of tough issues on the Committee's trade agenda. The issue cuts awkwardly across jurisdictional lines within both political branches of the U.S. government, and successfully addressing it will require steely resolve along with statesmanship and bipartisan collaboration. Today's hearing is beneficial in itself, but it also highlights the distance still to be traveled along the road to a workable solution. I believe you will have allies in other capitals as you move forward, and I hope you will approach the next stages with both energy and confidence. I am grateful to have been included today, and look forward to continuing to support the Committee's work on the China currency issue.

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3 This opportunity arose in the *GPX* case, which has become famous for other reasons. Chief Judge Restani declined to examine the non-initiation decision on currency subsidies, stating that the petitioner had not tried hard enough throughout the agency-level investigation to get Commerce to change its mind. I disagreed with this aspect of *GPX* and felt it departed from established precedent on the reviewability of non-initiation calls in CVD cases. Regardless, the Court will get other chances, in cases where the petitioners will have made continuous, more-than-adequate efforts at the agency level.