THE RELATIONSHIP BETWEEN EXCHANGE RATES AND INTERNATIONAL TRADE

Exchange-Rate Misalignment and Trade Remedies: A Conceptual Note by Brazil

I. BACKGROUND

This conceptual note is a further contribution by Brazil to the discussions underway at the Working Group on Trade, Debt and Finance (WGTDF) on the interplay between exchange rate movements and trade.

Last year, following two proposals submitted by Brazil to the WGTDF (documents WT/WGTDF/W/53 and 56), a work programme was established to deal with the issue that included a number of activities. Some of them have already been completed, including a review of relevant literature that was compiled by the Secretariat (document WT/WGTDF/W/57) and an international seminar that took place on 27-28 March, 2012.

The March seminar has been considered overall as a positive initiative that provided the occasion for a rich discussion by several speakers representing different segments relevant to the debate. Some points have clearly emerged during the discussions:

- The relationship between exchange rates and trade flows is quite evident. One may differ on the nature of this relationship, but its existence is undeniable;

- there are two significant situations in which exchange rates affect trade: (a) exchange rate fluctuations (or volatility) and (b) misalignments of exchange rates. The focus of the contemporary debate on the matter, as underlined incidentally by the said literature review undertaken by the Secretariat, has been shifting from the former to the latter;

- that change of focus has, in turn, two major conceptual implications: (a) emphasis is placed less on the variability and more on the real level of exchange rates and (b) to the extent that any particular misalignment always expresses itself bilaterally, that is to say, in the value of one currency relative to another, the analysis of the trade impact of currency misalignments calls for the examination of country-specific trade flows and, within countries, of particular sectors and even individual firms. The more one moves away from macroeconomic aggregates, which are relevant for the analysis of exchange rates fluctuations, and the closer one gets to bilateral trade flows or even to sector-specific trade, the nature of the linkages between exchange rates and trade becomes clearer. This was a key point stressed in the seminar, in particular by private sector participants;

- both misalignments and fluctuations of exchange rates are hard to properly measure and assess. The presentation by the IMF itself underscored how difficult it is to
establish equilibrium models for exchange rates in different countries. This seems to confirm the view that it would not be useful to try to pin down in the WTO either the causes for misalignments or points of equilibrium for specific currencies. This Organization should not get involved in either analysis or management of exchange rates. This is the domain of other international institutions. The WTO could and should, however, deal with the effects of those fluctuations and misalignments.

Indeed, discussions during the seminar fell short of assessing precisely what specific role the WTO could or should play today. This conceptual note is intended to help members address that necessary component of the work programme by (i) recalling debates that took place in the history of the GATT/WTO; (ii) examining relevant existing WTO provisions and their effectiveness in dealing with concrete cases of currency misalignments, and (iii) suggesting possible approaches for our discussions in the WGTDF.

It has always been the view of Brazil that, whatever the causes of exchange rate misalignments, the WTO should look into ways to address their effects in a systemic manner. Throughout this process, one should always bear in mind that situations may and most likely will change over time. A currency that is presently overvalued might become undervalued tomorrow. So the challenge the WGTDF is faced with is to analyse the subject from a systemic perspective.¹

II. EXCHANGE RATES IN THE HISTORY OF THE GATT/WTO

The debate on the relationship between exchange rates and international trade is clearly not a new one. It was present at talks that eventually led to the design of the architecture of the Bretton Woods international institutions.

Before the inception of the GATT, during the negotiations of the Havana Charter, concerns over the potential negative effects of exchange rate movements on the trading system had already been expressed and led to a vivid debate. Guidelines for the negotiation of tariffs under the Havana Charter acknowledged the challenge posed by the direct impact of currency devaluation on tariff levels. Section E of the Annexure 10 to the Report of the First Session of the Preparatory Committee of the United Nations Conference on Trade and Employment (E/PC/T/33 - Annex 1), regarding "avoidance of new tariff or other restrictive measures" before engaging in tariff negotiations, called on countries not to make changes in the form of tariffs or in tariffs themselves due to devaluation of their currencies in such a manner that they would "result in an increase of the protective incidence of the tariff".

Also during negotiations of the Havana Charter, parties recognized that devalued currencies might constitute a form of unfair trade. Australia, supported by two other delegations, put forward a proposal intended to regulate the use of "currency dumping duties" so that they could only be imposed following a procedure determining that the dumping "is such as to injure or threaten to injure an established domestic industry".² That proposal on currency dumping was dismissed during the initial GATT negotiations and no such a provision was written into the GATT. Parties remained, however, concerned with the potential adverse effects of exchange rates movements on trade, particularly in the case of multiple currencies adopted by some countries. In this respect, two interpretative notes on paragraphs 2 and 3 of Article VI were added to the GATT in 1955, establishing that multiple currencies might constitute subsidization or dumping and could be countered by trade remedies.

¹ By way of illustration, a graph is attached to this paper with the evolution of currency misalignment in Brazil in the period 1980/2010.
As for the General Agreement itself, its provisions on exchange rates rely on and call for complementarity and coherence with the IMF's role in monitoring monetary policy, including exchange rates. Essentially, its disciplines are targeted at ensuring that exchange rates and trade policy disciplines are mutually supportive and based on predictability and certainty, both critical and indispensable elements for successive trade liberalizing rounds. Such clauses as Articles II:6(a) and Article XV of the GATT try to address the need to mitigate the potential disruptive effects of exchange rate on trade and to preserve the stability of the world economy, even at a time when a system of fixed exchange rates prevailed internationally, under the supervision of the IMF. Several GATT bodies looked into aspects of the relationship between exchange rates and trade, particularly in the late-1970s and early-1980s, when a special focus was placed on updating Article II:6. That interaction was also examined in several areas of the Uruguay Round negotiations.

Article II:6(a) of the GATT recognizes that exchange rate misalignments may affect the level of bound tariffs resulting from market access negotiations among different parties. It permits the negotiation of adjustments to specific (but not *ad valorem*) duties and charges and related margins of preference in order to restore effectiveness to tariffs unduly eroded by currency devaluation. Those negotiations occurred nine times between 1950 and 1975 and led to decisions that allowed for the raising of bound specific tariffs by Benelux, Finland, Uruguay, Greece and Turkey.3

Interestingly enough, the then Czechoslovakia laid down a proposal in 1954 to amend Article II:6(a) so that tariff adjustments could also be allowed *mutatis mutandis* in case of currency appreciation of more than 20 per cent.4

The replacement of the fixed exchange rate system by one based on floating exchange rates in the 1970s heightened the importance of properly discussing the effects of exchange rate movements on trade flows and on the stability of the multilateral trading regime. The role of the Fund under the new system would no longer comprise a strict oversight of countries' exchange rates *vis-à-vis* the par value. Rather, the IMF was mandated to "survey" the exchange rates policies of its members and set out principles for guidance with respect to those policies. At that time, GATT Contracting Parties initiated discussions on the possible impacts of the new monetary system on international trade rules. They dealt particularly with how existing GATT provisions, such as Article II:6, needed to be adapted to the new financial and monetary context.

A GATT Working Group tasked with adjusting Art.II:6 to the new reality of floating exchange rates adopted in 1980 the "Guidelines for Decisions under Article II:6(a) of the General Agreement" (L/4938, 27S/28-29 - Annex 6). The document reaffirmed the importance of maintaining the adjustment mechanism to cancel out the effects of exchange rate devaluation on specific tariffs and laid down a methodology for the calculation of currency depreciation, to be performed by the IMF. Such Guidelines have been incorporated into the GATT 1994 as established by its Article 1(b)(iv).

The question of whether or not Contracting Parties with appreciated currencies should be required to reduce their specific (again as opposed to *ad valorem*) duties was also raised at a 1979 meeting of the Working Party on Specific Duties (L/4858). Even though it was then decided that no work on the matter should be pursued, the Working Party noted that parties could resort

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to Articles XXII (consultations) and XXIII (impairment or annulment of benefits) if they felt that currency appreciation impaired the value of specific duty concessions in particular cases.

At a 1984 session on "Exchange Rate Fluctuations and their Effect on Trade" (L/5761 - Annex 3) the CONTRACTING PARTIES to the GATT recognized that, under the new monetary regime, "in certain circumstances exchange market instability contributes to market uncertainty for traders and investors and may lead to pressures to increased protection." They also took note of the frailty of small traders in the face of limited hedging opportunities and small trading countries and developing countries whose trade destinations could not be easily diversified. On that same occasion, the IMF was equally urged to take into consideration "the relationship between exchange market instability and international trade". In response, the IMF issued a study in that year that did not produce conclusive evidence on the effects of exchange rate instability on international trade flows.5

Later on, many Uruguay Round Agreements included provisions related to the use of exchange rates often prescribing market exchange rates and renewing the call for coordination with the IMF.

III. RELEVANT PROVISIONS IN THE MULTILATERAL TRADING SYSTEM

A. GATT AND WTO PROVISIONS APPLICABLE TO EXCHANGE RATES AND TRADE

A number of provisions in the GATT and in WTO Agreements contain safeguards against trade-related distortions caused by exchange rate instability, practices and restrictions. Upon its establishment, the WGTDF commissioned a paper by the Secretariat that covers this particular matter.6 The paper provides a descriptive rather than an analytical review of those relevant provisions. Most of them do not address directly the impact of currency misalignment on trade.

The three GATT provisions, corresponding notes and documents, that might arguably be invoked by Members troubled by trade-related adverse effects of currency misalignments appear to be Article II:6(a), Article XV and Article XXIII.

1. GATT Article II:6

Article II:6 of the GATT provides for very specific tariff adjustments. It is targeted at the impact of currency devaluation on negotiated specific duties and charges, and margins of preference thereof, on the assumption that a devalued currency lowers the protective effect of specific duties and, therefore, artificially improves market access conditions. Article II:6 foresees negotiations in case countries wish to raise their specific duties to restore them to the effective bound level in the face of currency devaluation. The Contracting Parties have the opportunity to make sure that the adjustments will not impair the value of the concessions provided in the "complainant's" schedule, while being mindful of all factors influencing the need and urgency for tariff adjustments. That provision appears to have been designed to prevent abuses in the right to raise specific duties vis-à-vis the obligation to maintain the value of concessions. The intent to preserve the balance of rights and obligations of the contracting parties in the application of the article, while acting on currency distortions, is reaffirmed in the guidelines for its implementation, adopted in 1980.

The Article fixes a threshold (20 per cent) over which devaluations vis-à-vis the par value might trigger tariff adjustments. Its guidelines also suggest a methodology for the calculation of currency depreciation so as to allow the application of Article II:6 when warranted by changes in

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5 The IMF study - IMF (1984), Exchange Rate Volatility and World Trade, IMF Occasional Paper 30 - is mentioned in the review of the economic literature on the relationship between exchange rates and international trade carried out by the Secretariat (WT/WGTDF/W/57).

6 WT/WGTDF/W/3.
international monetary conditions. Such calculation is to be carried out by the IMF. It should take into consideration also the import-weighted average exchange rate during the previous six months in respect of the currencies of trading partners supplying at least 80 per cent of the imports of the concerned country.

2. **GATT Article XV:4**

Article XV:4 provides that the "Contracting parties shall not, by exchange action, frustrate the intent of the provisions of this Agreement, nor, by trade action, the intent of the provisions of the Articles of Agreement of the International Monetary Fund." Its paragraph 9 also stipulates that "Nothing in this Agreement shall preclude: (a) the use by a contracting party of exchange controls or exchange restrictions in accordance with the Articles of Agreement of the International Monetary Fund or with that contracting party's special exchange agreement with the CONTRACTING PARTIES, or (b) the use by a contracting party of restrictions or controls in imports or exports, the sole effect of which, additional to the effects permitted under Articles XI, XII, XIII and XIV, is to make effective such exchange controls or exchange restrictions."

According to the first part of paragraph 4, exchange measures might be challenged if they violate GATT disciplines. However, its Supplementary Note grants a special treatment to Article XV exchange policies vis-à-vis other measures covered by the GATT. For an exchange measure to be found to "frustrate the intent" of a GATT article, and therefore contravene Article XV, the demonstration of violation of the letter of the provision would not suffice. Such measure would additionally have to lead to an "appreciable departure" in relation to the intent of the GATT provision. Even if it is attested that the exchange measure frustrates significantly the object of the provision, such a violation of Article XV:4 could still be tempered on the grounds of Article XV:9.

Article XV was not designed to equip Contracting Parties with the means to deal with new challenges created by the weakness of the international monetary system following the collapse of the gold standard, nor to settle any related trade disputes. It is not a mere coincidence that the dispute settlement mechanisms of the GATT/WTO have never been used to address complaints under Article XV.

3. **GATT Article XXIII:1(b)**

Article XXIII:1(b) of GATT 1994 enables WTO Members to question a measure which results in nullification or impairment of benefits arising out of the Agreement, irrespective of violation of multilateral obligations. The article provides that Contracting Parties "shall give sympathetic consideration to the representations or proposals made to it" regarding a measure subject to a complaint. Furthermore, Article 26.1 of the Dispute Settlement Understanding stipulates a few basic conditions for the application of non-violation complaints and situations, namely: (i) the complaining party must provide a detailed justification of its demand; (ii) the complained party is not obliged to repel the measure even if it nullifies or impairs benefits; however, the panel or the Appellate Body has to recommend that such a Member make a "mutually satisfactory adjustment"; (iii) compensations - a provisional remedy in non-violation complaints - may be part of such a mutually satisfactory adjustment "as final settlement of the dispute". Existing jurisprudence shows that the burden of proof on the complaining party tends to be rather hefty under Article XXIII. Apart from a detailed justification, the complainant is likely to have to demonstrate that the measure adversely affects the competitive position of its products and that it was impossible to predict the adverse competitive position stemming from the measure when the concessions affected by the measure were negotiated.
4. Further considerations

Having been crafted in respect of exchange and monetary policies belonging to a different period, the WTO provisions above do not seem to be adequate to provide solutions "to compensate for or otherwise redress those currency fluctuations that may impair commitments undertaken by Members in successive rounds of negotiations" (see document WG/WT/WGTDF/W/56).

Article II:6, specifically, fails to grasp the three other possibilities of impact of exchange rates on tariffs: (i) overvalued currencies raising the relative value of specific duties, restricting market access; (ii) devalued currencies raising the relative value of ad valorem duties, limiting market access; (iii) overvalued currencies diminishing the relative value of ad valorem duties, enlarging the market access beyond what had been originally negotiated.

One could hardly expect negotiations under Article II:6, due to uncertainty in their duration, to be able to deliver timely solutions for Members in need for immediate relief on account of more or less enduring but disruptive impacts of currency misalignments. For one thing, the membership as a whole would have to agree that no impairment of concessions had occurred before tariff adjustments could be authorized. Such negative effects may prove irreversible in the face of protracted action where they result, for instance, in bankruptcy of entire sectors and massive unemployment.

In the same vein, the much more erratic and dynamic behaviour of currencies under a free floating system poses a significant challenge to any attempts to establish appropriate time-frames for the duration of bound tariff adjustments under Article II:6. In light of the irregular and unpredictable nature of currency fluctuations, any adjustments to applied tariffs - both upwards and downwards - need to be carefully designed so as to avoid overshooting of level or duration.

In sum, provisions such as Article II:6 fall short of adjusting to the diversity of today's tariff regimes - which comprise differing combinations of ad valorem, specific and mixed duties - and the present characteristics of the international monetary system - subject to a myriad of policies ranging from the predominant free floating regimes to pegs to foreign currencies.

Though a clarification of Article II:6 was finally adopted in 1980, there have been no further studies on other trade instruments that might address the particularities of today's floating exchange rate system. Contracting Parties did not manage to promote a true aggiornamento of the GATT to deal with the effects of exchange rate misalignments.

Despite a few episodic initiatives in the GATT and during the Uruguay Round to update rules relating to exchange rates, none of the available disciplines seems to provide effective tools for countries affected by exchange rate movements to counter or alleviate the harmful effects of currency misalignments and fluctuations. One should recall that, particularly in periods of growth, such distortions are frequently compounded by speculative and undisciplined financial flows, usually from low interest to high interest rate countries, which tend to reinforce and magnify currency misalignment trends. This is especially true for countries with floating exchange rate systems and whose currencies are not international reserves.

In the absence of multilaterally agreed rules and corrective measures which take due account of the present financial and monetary situation, those countries most distressed by such adverse consequences are often tempted to, and at times compelled to, resort to intervention both in exchange rate and trade policies. Potential systemic risks entail from use intensification and overstretching of disciplines for trade remedies such as safeguards, anti-dumping, and countervailing measures.
B. TRADITIONAL TRADE REMEDIES UNDER THE WTO. ARE THEY APPROPRIATE?

It is also important to examine whether or not existing disciplines of trade remedies in the WTO may be used to correct the adverse impact caused by exchange rate misalignments.

There are three possibilities for a WTO Member to counter the adverse effects of trade practices of other Members: (i) the Agreement on Subsidies and Countervailing Measures (ASCM); (ii) the Agreement on Implementation of Article VI of the GATT 1994, also known as the Anti-Dumping Agreement (ADA); (iii) and the Agreement on Safeguards (AS).

Each of these agreements was designed to address a specific situation calling for the provision of instruments of defence to be used by one Member either against unfair trade practices by others or to combat import surges.

The ASCM is intended to address government policies. It establishes that prohibited and actionable subsidies which cause injury can be challenged either multilaterally, through the Dispute Settlement Mechanism (DSM), or through the application of a countervailing measure by the Member affected. In the first instance, a prohibited subsidy must be withdrawn without delay and an actionable subsidy must be withdrawn or its adverse effects removed. There is no definite time-frame for removing countervailing measures.

The architecture of the ASCM is built around a very particular definition of subsidy. A subsidy shall be deemed to exist if: (i) there is a financial contribution by a government or any public body within the territory of a Member; (ii) a benefit is thereby conferred; (iii) the subsidy is specific. These three criteria must be met for a subsidy, prohibited or actionable, to fall under the provisions of the ASCM.

The text of ASCM provides a non-exhaustive list of forms of financial contributions such as direct transfer of funds, foregone government revenue, the provision or purchase of goods or services other than general infrastructure, payments to funding mechanisms, etc. This list does not, as it is well known, include exchange rates undervaluation or misalignment. Assuming, hypothetically, that any of those terms or an equivalent one figured on the list, they should still meet the criteria of conferring a benefit and being specific to be considered a subsidy.

It is unclear whether a currency misalignment would fulfil the three requirements listed above, especially the one regarding specificity.

Furthermore, Article 3.1. (a) of the ASCM establishes that subsidies contingent upon export performance, including measures illustrated in Annex I of the Agreement, are prohibited. None of the measures of the Annex I expressly mentions exchange rate undervaluation or misalignment. Again, it would seem that the contingency test could be quite a challenge to Members trying to characterize exchange rate devaluations as prohibited subsidies.

What seems to be clear nonetheless is that the SCM Agreement does not offer clear guidance on how and whether WTO Members could use it to address the impact of exchange rate misalignments.

A second way for Members to counter the effects of unfair trade practices within the WTO is to be found in the ADA. Dumping can be countered only in circumstances under which a material injury has been caused or threatened to be caused to the domestic industry of the importing country, and there is a causal link between the dumping and material injury. There is no definite time-frame for withdrawing anti-dumping duties.
It should be noted that dumping is related to private corporation practices, not to government policies such as foreign-exchange policy or otherwise any kind of monetary policy. The ADA countermeasures are targeted at individual producers or companies selling products below their normal value to gain advantage in a foreign market. Again, undervalued or overvalued currencies apply horizontally to any given economy, however different their impact may be on different segments or industries. While they might benefit from certain currency movements, individual producers by themselves have no power to establish, "manipulate" or correct any macro-economic policy, including exchange rates.

The third defence instrument to be assessed here is the AS. This Agreement allows a WTO Member to apply safeguard measures whenever a product is being imported into its territory in such increased quantities as to cause or threaten to cause serious injury to the domestic industry producing the like or directly competitive product. The measures can only be applied to products, irrespective of their source. Therefore, a safeguard measure has to be imposed on all countries, except for developing countries under certain circumstances (de minimis clause).

In contrast to the ASCM and the ADA, the AS establishes stricter conditions for the application of remedies, especially because it requires that "serious injury" has to be established for producers of a specific and well-defined good. Unlike countervailing and anti-dumping measures, that have no predefined time-frame to expiry, a safeguard measure may last up to eight years (ten years for developing countries) and has to be phased out gradually. Simultaneously, the domestic industry of the Member imposing the measure has to undertake adjustment commitments.

In conclusion, the main player determining any country's exchange-rate policy is invariably its government and, more specifically, its monetary authorities. The effects of the policy are presumed to affect the whole economy of the country concerned, although not necessarily in a uniform manner. Using the ADA or the AS to offset currency undervaluation appears not to fit into the very rationale of both agreements. The ADA aims at products and thus companies, not governments or macroeconomic policies dictated by governments. The AS, in turn, was designed to target products and be applied erga omnes. While this might be appropriate under certain circumstances the AS was evidently not designed to address the type of wide-ranging impact and possible bilateral nature of the effects deriving from currency misalignments.

IV. IS THERE A NEED TO CRAFT TRADE REMEDIES THAT SPECIFICALLY ADDRESS CURRENCY MISALIGNMENTS?

Existing provisions related to exchange-rate movements in the WTO agreements as well as the three Agreements providing for trade remedies at the WTO were created to deal with situations unrelated to the dynamics of exchange-rate movements in today's volatile international monetary system. The WTO seems to be systemically ill-equipped to cope with the challenges posed by the macro and microeconomic effects of exchange rates on trade.

Members may wish, against this background, to consider the need for exchange-rate trade remedies and to start some analytical work to that effect. A non-exhaustive list of key elements that will necessarily have to be considered in this analytical work is provided below:

(a) Measuring currency misalignment

It will be necessary to define methodologies to assess currency misalignments and to establish triggers/benchmarks for specific action. Cooperation with the IMF could be explored. The purpose would not be to establish optimal or equilibrium exchange rates for particular currencies, but rather to detect significant departures from historical or reasonable levels. Issues such as the basis for
comparison - against other individual currencies; basket of currencies; both - and time-frames would be part of this evaluation.

(b) Product-specific/sector-specific or economy-wide scope

Should corrective measures be applicable only to a specific product or sector in the country affected or to its entire economy? What are the implications of either choice? The three agreements on trade remedies do not contain any provision on sector specific or economy wide corrective measures. A sector-specific approach would need a definition of and/or a classification of sectors.

(c) Time-frame

An appropriate time-frame for the application of corrective measures. The argument could be made that sustained long-term misalignments would no longer be a misalignment; rather, they would become a new structural point of equilibrium. The discussion on time-frames would equally touch on review and extension/termination of corrective measures.

(d) Origin of covered products

Should corrective measures be applied on an MFN basis or specifically for currencies against which the misalignment is found? As exchange rate misalignments may not necessarily occur against a large number of key trading partners and may have a focus on bilateral trade (or on a wider volume of world trade representing in any case the sum of a certain number of bilateral trade flows), it may be the case to consider a non-MFN approach.

(e) Injurious effects

Corrective measures could be crafted to be triggered automatically or, alternatively, following the finding of injury or threat of injury to the domestic industry. The automatic format would probably demand more stringent requirements.

(f) Investigation procedures

The need for investigation procedures would depend largely on the automaticity of the mechanism adopted. The more automatic, the less need for such procedures. In case these procedures are necessary, work could be inspired by the parameters found in the ADA, ASCM and AS.
ANNEX - GRAPH 7

CURRENCY MISALIGNMENT IN BRAZIL

Source: Professor Emerson Marçal ("Fundação Getúlio Vargas"), July 2012.