



FAIR CURRENCY COALITION

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FACT OF THE WEEK (October 13, 2009)

HOW ENFORCED UNDERVALUATION OF A COUNTRY'S CURRENCY UNLAWFULLY SERVES AS AN EXPORT SUBSIDY

In 1947, the General Agreement on Tariffs and Trade (“the GATT”) effectively banned export-contingent subsidies because they inherently distort the free and fair flow of international trade. When the World Trade Organization (“the WTO”) came into being in 1995, the global trading community emphatically reinforced this position in the Agreement on Subsidies and Countervailing Measures (“the SCM Agreement”), which elaborates upon the GATT’s subsidy provisions.

In particular, the SCM Agreement flatly prohibits governmental subsidies that are contingent in law or in fact, whether solely or as one of several other conditions, upon export performance (Article 3.1), and member states of the WTO are enjoined from granting or maintaining such subsidies (Article 3.2).

Certainly there is no more effective a way for a government to skew trade and investment across national boundaries than to engage in substantial undervaluation of its country’s currency over a protracted period of time. This sort of fundamental misalignment, achieved by various means such as large-scale interventions by a government in exchange markets, results in massive and destabilizing trade imbalances. At one stroke, the enforced undervaluation makes all of a country’s exports artificially inexpensive.

It is important to understand how a government’s undervaluation of its country’s currency *vis-à-vis* another country’s currency can advantage its exporters and lead to dangerous imbalances in trade if this mercantilist practice is extensive enough and prolonged enough. The table below illustrates the serious impact that undervaluation of a country’s currency can have.

Country A’s Currency (When <u>Undervalued</u> Relative to U.S. \$)	<u>Exchange Rate:</u> 1 U.S.\$ = 7 Units of Country A’s Currency (7 UA)	<u>Price Effect:</u> 700 UA = \$100
Country A’s Currency (When <u>Fairly Valued</u> Relative to U.S. \$)	<u>Exchange Rate:</u> 1 U.S. \$ = 5 Units of Country A’s Currency (5 UA)	<u>Price Effect:</u> 500 UA = \$100
Undervaluation Yields Additional Exports and Revenue for Country A’s Exporter	<u>Extent of Undervaluation:</u> 7 UA – 5 UA = 2 UA 2 UA / 7 UA = 28.6 Percent	<u>Subsidy:</u> 200 UA

As this hypothetical makes clear, enforced undervaluation of Country A's currency provides a considerable competitive edge and a powerful incentive for a producer or middleman in Country A to export to Country B. By exporting to Country B, the producer or middleman in Country A boosts the volume of production and significantly increases earnings expressed in Country A's currency. With more units of Country A's currency to spend or invest solely as the result of the exchange rate, the exporter in Country A can be expected to forego selling widgets in his home market to some extent in favor of continuing to export widgets to Country B.

A reasonable reading of the WTO's SCM Agreement (Article 1) leads to the conclusion that the actions of Country A's government bestow a prohibited, export-contingent subsidy on the exporter in Country A. First, Country A's government provides a financial contribution to Country A's exporter through its undervalued exchange rate. Second, the exporter in Country A benefits from this exchange by being given more units of Country A's undervalued currency than would be the case if it were not undervalued. This governmental financial contribution and this benefit together are a subsidy. Third, the receipt of this subsidy by Country A's exporter is contingent upon the exportation of the widgets to Country B and payment by the buyer in Country B's overvalued currency. Thus, all three of the WTO's legal requirements for deeming this practice an export subsidy are met. In these circumstances, Country A's undervalued currency constitutes a prohibited, export-contingent subsidy of the kind that the GATT has found to inherently distort trade since 1947.

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