

Possibility of WTO Dispute Settlement against the Undervalued Currency Exchange Rate—Impact of Exchange Rate under Economic Theories

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Abstract

There has been no actual case brought forward to the WTO dispute settlement process for issues related to the fixed currency exchange rate policy as of December 2012. However, there have been serious debates on the side of countries accumulating huge trade deficit from the trade with countries pegging their currency exchange rate to an undervalued level. Their voices seem to be gaining momentum and the first case to deliberate on this issue under the WTO-DSU may be realized in the near future. Since this is a new issue in the area of trade disputes, no specific directions have been identified neither in the field of economic theory nor in the field of international law. This paper discusses possible rules of the WTO which can be invoked to verify the justification of exchange rate fixing policy with a purpose to provide an academic insight on this issue for a possible WTO dispute in the future. Further, this paper intends to prove out of economic theories how significant the impact of the undervalued currency exchange rate to the actual trade and economy is, because the degree of impact which such a policy could induce to the actual flow of trade can be an important factor which may determine the direction of decision to be taken by the panel and Appellate Body of the WTO. Also, the Special and Differentiated treatment for developing countries under the WTO rules is examined as a built-in mechanism of the WTO which may affect the judgment of the WTO panel or Appellate Body for cases related to the undervalued exchange rate policies.

1. Introduction

There has been a notion in the globalized economy in the 21st century that the Dispute Settlement Understanding (DSU) of the World Trade

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Organization (WTO) would be utilized to deal with the fixed foreign exchange rate practices against countries keeping such an undervalued inflexible exchange rate pegged to major currencies. There has been no actual case brought forward to WTO under DSU as of December 2012, but the voices asserting utilization of DSU against currency manipulation seem to be gaining momentum. Many countries in Asia and Africa, including many member countries of the Asian-African Legal Consultative Organization (AALCO), maintain the fixed exchange rate policy. This paper intends to provide an insight and related information to the member states on this new issue for them to be prepared for possible actions to be taken under the WTO-DSU in the future.

2. Brief History of Academic Studies on Issues related to Trade and Currency Exchange Rate

The issue of the relations between the level of currency exchange rate and trade is new and academic debate on this matter is still in its infant stage. The end of the Bretton-Woods system in 1973 generated many academic debates and studies afterwards regarding the relations between volatility of currency exchange rate and trade. The concern of the economists and business then was the stability in the currency market, because the exchange rates fixed under the Bretton-Woods system became suddenly allowed to fluctuate, and it made the decision making process in business complicated. A number of research papers were produced to verify the effect of volatility in currency exchange rate to trade and business¹, but no substantive studies were conducted for the issue of the currency exchange level and its impact to trade until very recently. During the past four decades after the demise of the Bretton-Woods system, the major players in the global trade were all OECD members whose currencies were open to fluctuate in the global currency market.² Therefore, no serious attention was paid to the effect of the fixed currency

¹ See, for example, IMF (1984): Exchange Rate Volatility and World Trade, Hooper, Peter and Steven Kohlhagen (1978): The Effect of Exchange Rate Uncertainty on the Prices and Volumes of International Trade, Franke, Gunter (1991): Exchange Volatility and International Trading Strategy.

² In 1992, OECD member countries accounted for 73% of world trade and 79% of global GDP.

exchange rate policies adopted by a number of developing countries during the same period.³

Such a trend in the academic circle for the study of currency exchange rate began changing in 2000s, since major trading countries started observing a serious accumulation of trade deficit against those newly emerged economies in the global market whose currency exchange rates were fixed to major currencies. Many academic papers were recently produced, and the WTO itself published in 2011 a document titled “The Relationship between Exchange Rates and International Trade: A Review of Economic Literature,” as requested by its member states. However, this is obviously a very new field of study and the debate on this issue has not shown any specific directions. Nevertheless, economic theories introduced in these studies generally indicate that there is a certain impact caused by the fixed exchange rate to trade flows. For example, as early as 1931, Keynes stated that the undervalued exchange rate is similar to the imposition of a combination of export subsidy and import tariff on all goods.⁴ Such a view is common and it is often used as a basis of debate in economic theory literatures. However, the causes and effects are debated to be complicated and it is difficult at this stage to attribute all to the undervaluation. It is still not clear how significantly the fixed exchange rate impacts trade among many other elements, including interest rate, money supply, fiscal policies, industry structure, global production network, to list only a few. Still, it is quite clear that the focus in the economic and policy studies in currency exchange rate has completely changed into a new regime, i.e., from the research into the impact of volatility to the impact of the level of the fixed exchange rate, during the past decade, and the trend is being strengthened.

3. WTO-DSU Framework and the Currency Exchange Rate

There are a few ways that seem possibly applicable to utilize provisions of the WTO Agreements, if they were to be employed, to make DSU cases against fixed currency policies. Article XV of General Agreement on Trade

³ The reason these developing countries adopted the policy to peg their currencies to the global major currencies was that they also considered that the exchange rate stability was crucial for their economy. See IMF (2004).

⁴ Auboin, M., Ruta, M. *The Relationship Between Exchange Rates And International Trade : A Literature Review* (Geneve: WTO 2011), p. 10-11

and Tariff enacted in 1947 is an option. The mobilization of the Agreement on Subsidies and Countervailing Measures (“DCM Agreement”) is another. There is also a possibility to employ the GATT Article XXIII as a non-violent complaint.

A. Article XV of 1947 GATT

WTO Agreements have rules regarding the currency exchange. The Article XV of General Agreement on Trade and Tariff enacted in 1947, in particular, provides rules for the member countries to abide by in relation to currency exchange actions. However, there are no specific rules for or against the fixed exchange rate policy at all in the Article XV. This derives from the fact that the founders of the GATT system did not have to take into account of such an exchange action because major trade currencies at the time of inception of GATT rules were all fixed and the main purpose to introduce rules under the Article XV was to provide stability in the currency exchanges.

For example, Article XV (4) regulates that “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.” Also, the Article XV (5) regulates that “If the CONTRACTING PARTIES consider, at any time, that exchange restrictions on payments and transfers in connection with imports are being applied by a contracting party in a manner inconsistent with the exceptions provided for in this Agreement for quantitative restrictions, they shall report thereon to the Fund”. These articles provide a basis for member countries to abide by regarding currency exchange but there are no rules directly governing activities related to the rate of exchange. Again, this is considered to be derived from the fact that the founders of the Agreement took it for granted that the exchange rate should in principle be fixed and that the main international organization which should deal with the exchange matters was the International Monetary Fund (IMF), not GATT.

Nevertheless, the Article XV clearly states as seen above that member countries of WTO “shall not, by exchange action, frustrate the intent of the provisions of this Agreement.” This is a strong statement. There may be some interpretations open but the intent of the provisions of WTO

Agreements is generally considered to be the realization of fair trade system. Therefore, if a fixed currency exchange policy is identified under the DSU process as frustrating other member countries in terms of fair trade practices, the fixed exchange rate policy may be found inappropriate and may have to be abolished or modified to comply with the decisions to be made by panel or Appellate Body established under DSU. Otherwise, the country maintaining the fixed currency exchange rate policy may face retaliatory measures to be introduced by trade partners as admitted under DSU.

The question here is whether the fixed exchange rate policy can be recognized as an illegal exchange action as stipulated in Article XV by the WTO panel and Appellate Body. Since there has been no actual cases brought forward to WTO dispute settlement process so far, no one can clearly state that it is possible or not. Some strongly believe that the fixed exchange rate is the exchange action prohibited under the Article XV and some believe it is not because there is no specific wording against such a policy in the Article.

For example, Fred Burgsten, the Director of the Peterson Institute for International Economics, stated in his testimony at the US House of Representatives on September 15, 2010⁵, that “The Article XV action is preferable in principle because it would apply to.....exports of all products to all countries. However, the language and legislative history of the provision make it difficult to apply to the current....or any other foreseeable currency case. Some observers therefore oppose invoking the article because they fear that a negative ruling would make it harder to challenge currency undervaluation in the future and might also undermine very valuable dispute settlement mechanism of the WTO.” This is a typical example of concerns expressed at the side of countries implementing free fluctuation currency system. Owing to such concerns, the United States and other western WTO members have been hesitant to make a case under DSU so far. However, Burgsten also stated in his same testimony that “I would nevertheless urge its pursuit, including via a push from the Congress if necessary to convince the Administration, because doing so (1) would

⁵ Congressional Testimony; Correcting the Chinese Exchange Rate, Testimony before the Hearing on China’s Exchange Rate Policy, Committee on Ways and Means, US House of Representatives, September 15, 2010.

represent an impressive multilateral effort that (2) would publicize the need for (action from the country of currency manipulation) much more widely than at present and (3) highlight the desirability of reform of the WTO itself to handle such cases if the present language does in fact prove to be impotent.” As seen from this testimony, the United States seems to be becoming impatient as trade deficit accumulates and so do other western countries.⁶ As Burgstenurges, a case may be brought into WTO for the consideration under the DSU panel soon in the future.

B. Agreement on Subsidies and Countervailing Measures

As explained in details later in the Chapter 3 below, the currency exchange rate intentionally fixed at a lower level than the level market identifies itself can function exactly as subsidy does, at least from the view point of traditional economic theories mathematically. Therefore, it is possible that a country affected by a fixed exchange rate would bring a case under DSU by mobilizing the SCM Agreement.

In order for this SCM Agreement to be mobilized, the currency exchange rate must be identified as a form of subsidy under the Article 1: Definition of Subsidy. Among other definitions, the Article 1(a)(2) regulates that a subsidy shall deem to exist “if there is any form of income or price support in the sense of Article XVI of GATT.” The Article XVI of GATT 1994 is a set of original rules about subsidies and the Section A - Subsidies in General regulates that “If any contracting party grants or maintains any subsidy, including any form of income or price support, which operates directly or indirectly to increase exports of any product from, or to reduce imports of any product into, its territory.....In any case in which it is determined that serious prejudice to the interests of any other contracting party is caused or threatened by any such subsidization, the contracting party granting the subsidy shall, upon request, discuss with the other contracting party or parties concerned, or with the CONTRACTING PARTIES, the possibility of limiting the subsidization.”

The question here is whether the fixed currency rate can be considered as a form of subsidy under the Agreement. It may be possible to state that

⁶ See, for example, The U.S. Department of The Treasury (2010), “Presentation to the Treasury Burrowing Advisory Committee” on February 2, 2010,” Office of Debt Management

the fixed rate is a form of price support as stipulated in the Section A of the SCM Agreement. There is no doubt, as a general usage of language, that the intentionally lowered rate of currency exchange rate is a form to provide incentive to domestic exporters; however, if it is truly considered as the subsidy stipulated in the Agreement *legally* is a totally different matter. Since there is no specific mentioning about the fixed currency rate in the Agreement, it is very much possible that it does not fall in the list of categories under the Article 1 of SCM Agreement. Also based on the fact that the article specifically created for currency actions, i.e., the GATT Article XV, does not either state such words as fixed currency exchange rate, it may not be considered as a subsidy as well. As already stated above, this void of proper wording in the Agreements is because these articles were written before the issue of the fixed currency exchange rate policies in relation with trade became conspicuous. The WTO rules may not be in a manner ready for properly dealing with this new issue yet. There were some attempts to revise or introduce articles specifically mentioning rules against currency manipulation under the ongoing Doha Round negotiations, but the efforts were nullified due to the extremely difficult situation surrounding the Doha Round for plenty other crucially important issues for the Round to survive. The Round is still alive but there seems to be no sign of reaching any tangible agreement in the foreseeable future, even though the Doha Round was launched more than 10 years ago⁷, thereby making it also very unlikely that new rules governing the fixed currency exchange rate would be incorporated into the WTO rules in the near future.

In the same testimony as mentioned above, Burgsten stated that “In the meanwhile, the United States and as many allies as possible should act on their own to treat (currency) undervaluation as an export subsidy – as Fed Chairman Ben Bernanke has noted publicly that it is – that must be included in calculating countervailing duties.....The Department of Commerce has recently concluded that currency undervaluation is not actionable as a subsidy under current US law so Congress should pass

⁷ On October 3, 2012, the Director-General of WTO, Pascal Lamy, said “I am neither under any illusion that the factors that have shaped the impasse which we face have changed substantively, nor do I harbour any dream about achieving grand designs or comprehensive deals” for Doha Round.

legislation.”⁸ The United States has not enacted such a new law as to make currency undervaluation illegal under the US domestic law, but it may be enacted in any time. And if it is enacted, the United States would be less hesitant to make a case against currency manipulation to the WTO dispute settlement process.

Thus, there have been debates and movements for a possible invocation of the SMC Agreement against undervalued currencies. Another aspect of SMC Agreement which may relate to the invocation is how the Agreement defines the seriousness of market disruption caused by subsidy. The Article 4 (2) of the SMC Agreement states: “(a) In the investigation to determine whether increased imports have caused or are threatening to cause serious injury to a domestic industry under the terms of this Agreement, the competent authorities shall evaluate all relevant factors of an objective and quantifiable nature having a bearing on the situation of that industry, in particular, the rate and amount of the increase in imports of the product concerned in absolute and relative terms, the share of the domestic market taken by increased imports, changes in the level of sales, production, productivity, capacity utilization, profits and losses, and employment; (b) The determination referred to in subparagraph (a) shall not be made unless this investigation demonstrates, on the basis of objective evidence, the existence of the causal link between increased imports of the product concerned and serious injury or threat thereof. When factors other than increased imports are causing injury to the domestic industry at the same time, such injury shall not be attributed to increased imports; (c) The competent authorities shall publish promptly, in accordance with the provisions of Article 3, a detailed analysis of the case under investigation as well as a demonstration of the relevance of the factors examined.”

Thus, the Article 4 (2) clearly regulates that the link between the increased imports and injury to the domestic market must be proven by proper authorities and that the injury must be “serious”. Therefore, in order for the SMC Agreement to be invoked against currency exchange rate undervaluation, it must be proven that the undervaluation itself directly

⁸ Congressional Testimony (n 6).

caused injury to domestic market and that it was serious⁹. This implies that the seriousness of the market injury caused by the undervalued exchange rate is one of the important criteria for the WTO panel or Appellate Body to make decisions out of a possible DSU case related to currency exchange rate fixation policies.

Some may consider that the Anti-Dumping Agreement of WTO, i.e., The Agreement on Implementation of the Article VI of the General Agreement of Tariff and Trade 1994, may be invoked, because the effect of the undervalued currency exchange rates is the same as not only subsidy but also anti-dumping onto all products. In this sense, the “Anti-Dumping Agreement” may be considered as a means to verify the policy to peg the exchange rate to an undervalued level. However, the Anti-Dumping Agreement regulates very detailed process under which the member countries calculate dumping margins and prove the price tagged to the product under investigation is logically under the market price. Such specific regulations may not easily be applied to cases on the undervalued currency exchange rate. From this view point, it is not likely that any country would choose to invoke the Anti-Dumping Agreement to verify the justification of the pegging policies.

C. GATT Article XXIII

The Article XXIII of GATT provides rules when trade benefit of a member country is impeded without any breach of the Agreement by other members. In a manner, the founders of GATT predicted that some unforeseeable issues, such as the fixation of currency exchange rate, would arise, and they decided that GATT must be equipped with rules that could deal with such unforeseeable issues in the future.

⁹ The Article 4 (1) defines the terms used in this article that “For the purposes of this Agreement: (a) “serious injury” shall be understood to mean a significant overall impairment in the position of a domestic industry; (b) “threat of serious injury” shall be understood to mean serious injury that is clearly imminent, in accordance with the provisions of paragraph 2. A determination of the existence of a threat of serious injury shall be based on facts and not merely on allegation, conjecture or remote possibility; and (c) in determining injury or threat thereof, a “domestic industry” shall be understood to mean the producers as a whole of the like or directly competitive products operating within the territory of a Member, or those whose collective output of the like or directly competitive products constitutes a major proportion of the total domestic production of those products.”

The Article XXII 1 states “If any contracting party should consider that any benefit accruing to it directly or indirectly under this Agreement is being nullified or impaired or that the attainment of any objective of the Agreement is being impeded as the result of..... (b) the application by another contracting party of any measure, whether or not it conflicts with the provisions of this Agreement, or (c) the existence of any other situation, the contracting party may, with a view to the satisfactory adjustment of the matter, make written representations or proposals to the other contracting party or parties which it considers to be concerned. Any contracting party thus approached shall give sympathetic consideration to the representations or proposals made to it.”

As clearly stated in the sub article (b) above, member countries of WTO can make an issue out of a measure of another member country without having any conflicts with the WTO provisions. Thus, technically it is totally possible for any country to bring a case out of the fixed currency exchange rate under this Article. However, as also clearly seen from the above sentences, the tone of the rules is weak compared to sentences used under other specific rules. Since this is in a way a supplementary rule out of vast sets of specific rules of WTO, it should be inevitable. Most of all, since non-violation is used as a basis under this provision, it is a little difficult to predict that such non-violation rules or practices can easily be overturned. It should be noted, however, that the sub article 2 of the Article XXIII states “....If the CONTRACTING PARTIES consider that the circumstances are serious enough to justify such action, they may authorize a contracting party or parties to suspend the application to any other contracting party or parties of such concessions or other obligations under this Agreement as they determine to be appropriate in the circumstances.” Therefore, it is not totally impossible for fixed exchange rate measures to face authorized retaliation in the end as a result of DSU rulings under the Article XXIII of GATT, if only panel or Appellate Body identify the issue “serious enough”. Here again, the seriousness of the market injury seems to be an important criterion for the WTO panel or Appellate Body to decide on the justification of fixed currency exchange rate policies.

4. Economic Theories regarding the Trade Benefits

A. Trade Theories

As seen above from the sentences of related WTO articles, it seems crucial to understand how seriously the undervalued currency exchange rate directly causes injury to the domestic market of trade partners. Hence, it is imperative to illustrate the trade mechanisms in detail in order to properly understand the true impact of foreign exchange rate. As seen above in the Chapter 2, one of the important elements which determines the application of DSU rules to the fixed currency exchange practices is whether the effect generated by the practices is “serious enough” or not. An understanding on this issue from the view of economic theory would be helpful in predicting the possibility of DSU cases on this issue.

David Ricardo introduced the famous trade theory now called the “Comparative Advantage Theory” in 1817 in his famous classical thesis titled “On the Principles of Political Economy and Taxation.” Basically, this is still the principle economic theory that explains why trade can benefit all countries participating in trade through demarcation of work.¹⁰ Since the foreign exchange mechanism is deeply related to trade benefits, it is imperative to have a proper understanding why countries can be benefitted through trade, and the comparative advantage theory can provide an answer even today. Although there are many other new economic theories that may explain economic mechanism suitable to the reality of globalized economy in the 21st century, a simple and basic theory can provide a model that can be applied to all cases if numerous reality backgrounds are temporarily ignored.

B. Comparative Advantage Theory

In his thesis “On the Principles of Political Economy and Taxation” published in 1817, Ricardo used the example like the Figure1 reproduced hereunder, in order to explain why both participants can gain benefit through trade. Although this is very well-known basic economic theory, it would be necessary to be stated here for the better and proper understanding of the exchange rate impacts as explained later in this chapter.

¹⁰ See, for example, Daly (1994)

Figure 1.

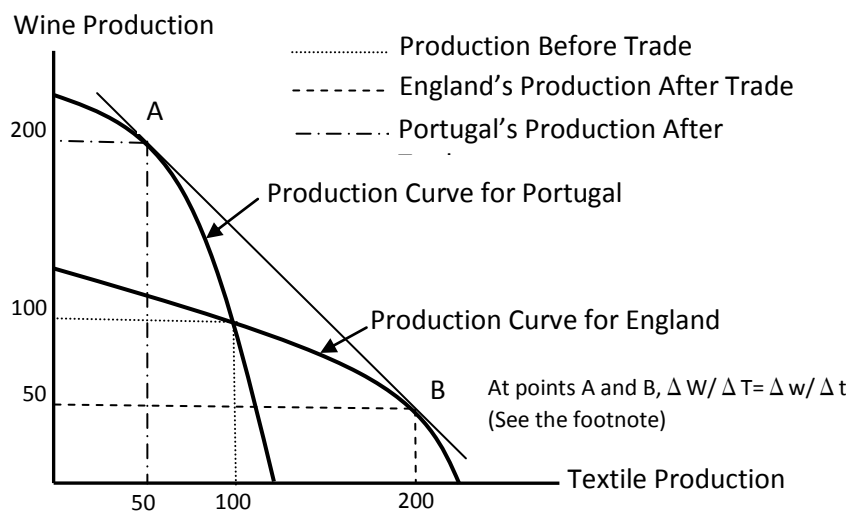
	Unit needed for wine production	Unit needed for textile production
England	120	100
Portugal	80	90

From these figures, the following can be derived:

- Portugal holds absolute advantage for both productions.
- Portugal conducts comparatively more effective production in wine than textile.
- England conducts comparatively more effective production in textile than wine.

Ricardo asserts that, even under the condition that England is in inferior state for both wine and textile productions, both countries can gain benefit through trade if England concentrates on textile production to which England holds comparative advantage and Portugal concentrates on wine production to which Portugal holds comparative advantage.

The graph shown below can illustrate the reason easier to understand.



Graph 1

In this Graph 1¹¹, it is presumed that both countries are producing 100 tons each for wine and textile for sufficient domestic consumption. Since England holds the comparative advantage for textile, the production curve is shifted toward textile. On the other hand, the production curve of Portugal shifted toward wine since Portugal holds the comparative advantage for wine. It should be noted that Portugal holds absolute advantage in producing both products as explained in the Figure 1, but it is a background and not depicted explicitly in this graph.

Let us then presume that the two countries are capable of going into trade for these products. Since these countries do not have to produce all products domestically to satisfy their domestic consumption if they can trade, they now have choices to take how much production they should make for each product. England holds the comparative advantage in textile production; therefore, England can produce relatively larger amount of textile with the same amount of production resources required to produce wine in England. Likewise, Portugal holds the comparative advantage in wine production; therefore, Portugal can produce relatively larger amount of wine with the same amount of production resources required to produce textile in Portugal. As a result of such shifts in these two countries, now the aggregate amount of production in England and Portugal combined has increased in both of products. The Graph 1 clearly shows that the amount of wine and textile increased from 200 tons to 250 tons respectively in the combined two-country market. Even though England has 50 tons of short fall in wine production to satisfy domestic consumption, England now can purchase 50 tons of wine from Portugal. Portugal has 50 tons of short fall in textile production but Portugal can now import 50 tons from England to stratify its domestic needs. Now the two countries can satisfy their domestic needs by supplementing the shortfall in domestic production through trade, and now they still hold production surplus. Even after the bilateral trade, England holds 50 tons

¹¹ The aggregate production of wine and textile within two countries is maximized at the points A and B respectively where $\Delta W/\Delta T = \Delta w/\Delta t$ (Δ (ectively where $\Delta W/\Delta T = \Delta n$ of wine and textile within two co Δ (ectpresents the marginal textile production of Portugal. Likewise, Δw represents the marginal wine production of England and Δt represents the marginal textile production of England). At these points, the marginal production of wine against textile becomes the same between two countries.

of surplus of textile and Portugal holds 50 tons of surplus in wine. They can sell these surplus productions to other countries to increase wealth of each country.

This is what Ricardo explained. Even though England holds the absolute disadvantages in both productions against Portugal, both countries can gain profits through trade.¹²

This theory is still true today though it was introduced almost two hundred years ago, since this is simple mathematics which cannot be wrong. In the world today, this 1817 Ricardo model may correspond to the trade relations between developed and developing countries. Many developing countries have emerged as important trade partners in the 21st century. Since their wages are much cheaper than those of developed countries, these emerging economies hold absolute advantages in not only primary products but also some industrial products as well. Still, they can both gain benefits and the wealth of the world can grow through trade, if the theory introduced by Ricardo works properly, by introducing a mutually beneficial production sharing network with proper division of labour.

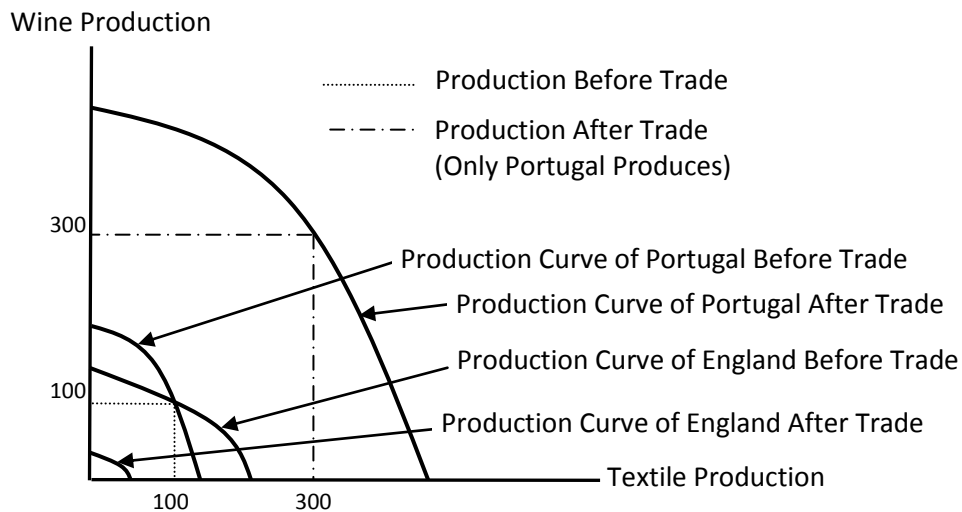
C. A Case where Comparative Advantage Theory does not Work

As stated above, the comparative advantage theory still, basically, is applicable in the globalized economy today. However, there can be cases where the theory by Ricardo does not function properly in the 21st century global economy. There can be cases where only one country gains all benefits and the other receives none through trade. This derives from the fact that there were crucially important conditions in the Ricardo's theory. The conditions were based on the reality in the 1817 economy. Namely, in the 1817 world economy, both capital and labour did not move across borders easily. In the globalized world today, however, capital moves very

¹² In the original theory of comprehensive advantage theory as introduced by Ricardo, both countries are stated to shift their production completely to one product on which they hold the comparative advantage, because the aggregate wealth is maximized under such complete shift in production. However, in reality, such a complete shift normally does not take place for many reasons including national security consideration or the general preference of people to their domestic products, etc. Therefore, in this Graph, it is presumed that a certain proportion of industry remain in both countries for both products.

fast and freely across borders¹³. Under such open economic system, the Graph 1, which is based on Ricardo's model, can be depicted as the Graph 2.¹⁴

The Graph 2 illustrates that if capital can move across borders, the country that holds absolute advantages for both products attract the capital from the other country, and all production eventually will be taking place only in one country. If labour also moves freely, the trend would be accelerated. It should be noted that the aggregate wealth does increase even under this case. Trade does provide benefits to the economy as a whole but it does not necessarily mean that all countries can gain profits out of trade if the comparative advantage theory does not work properly.



Graph2

¹³ Labour can also move to some extent today, but there remain still many restrictions, particularly for unskilled labours.

¹⁴ The Graph 2 illustrates the case where absolute advantage no longer exists. In this sense the Graph 2 is not a direct interpretation of the comparative advantage theory as originally introduced by Ricardo.

This state is the same as the phenomenon we see often in one country.¹⁵ Capital tends to concentrate in large cities and rural villages lose industry and labour to cities, as often observed in many parts of the world.

Nevertheless, this type of drastic shifts of capital and labour does not easily take place even in the globalized economy today. That is because there are limitations in the movement of labour. Even though capital may move completely freely across borders, people cannot easily abandon their birth places due to many constraints including cultural and language barriers. Therefore, there have to be some industries and productions left in countries where absolute disadvantages are observed, because people there must simply survive. Here, economic theories tell us that a balance of trade would be achieved in a long-run through market economy to let people in disadvantaged countries survive. The system which guarantees such function of market economy is the exchange rate based on the market principles.

Namely, under the free market economy, the foreign currency exchange rate fluctuates if and when capital moves across borders. The country with absolute advantage first attracts capital from the other country for cheaper and effective production. However, as capital moves into the country, the demand for the currency increase and the exchange rate is evaluated. Then the country that held the absolute advantage lose competitiveness and eventually the flow of capital or investment stops, which leads to the end of the production shift from one country to another. Completely opposite process is observed in the country which holds the absolute disadvantages. As capital flows out of the country, the demand

¹⁵ Ricardo states in his 1817 thesis, "It would undoubtedly be advantageous to the capitalists of England, and to the consumers in both countries, that under such circumstances, the wine and the cloth should both be made in Portugal, and therefore that the capital and labour of England employed in making cloth, should be removed to Portugal for that purpose. In that case, the relative value of these commodities would be regulated by the same principle, as if one were the produce of Yorkshire, and the other of London; and in every other case, if capital freely flowed towards those countries where it could be most profitably employed, there could be no difference in the rate of profit, and no other difference in the real or labour price of commodities, than the additional quantity of labour required to convey them to the various markets where they were to be sold." Thus, Ricardo himself did not use the term "absolute advantage" but the concept here is very clear that trade does not merit both countries if capital and labour move freely across borders.

for the currency decrease and the exchange rate is devaluated. Then the production in the country becomes cheaper and more competitive than before and eventually the flight of capital stops, which leads to the end of production shrink. Thus, the fluctuation of exchange rate supported by market principles can guarantee the benefits of trade to all countries even under the globalized economy in the 21st century.

If such an adjustment happens in the Graph 2, this mechanism prevents the full movement of Portugal's production curve from before to after, because the new exchange rate brings a new equilibrium somewhere between two curves. Likewise, the production curve of England does not shrink as much as illustrated in the Graph 2, because the new exchange rate provides competitiveness to production in England against Portugal.

For example, if trade takes place under the condition that capital moves freely under the Figure 1 of the Ricardo model, and if it is presumed that the exchange rate fluctuates freely in accordance with market principles, the exchange rate can adjust itself like illustrated in the Figure 2.

Figure 2	Unit Needed for Wine Production	Unit Needed for Textile Production
England	120→102	100→85
Portugal	80	90

This figure 2 shows that the currency of England is devaluated by 15% and the currency of Portugal is evaluated to the same extent. Under such a rate, England can still gain benefits through trade by shifting production to textile to which England holds the comparative advantage, and Portugal can also gain benefits by shifting production to wine to which Portugal still holds the comparative advantage. Thus, trade can still bring benefits to all participants even today just like Ricardo stated two hundred years ago;

however, only if currency exchange rate fluctuates under the market principles.¹⁶

D. Other Economic Theories

There are many other economic theories related to trade, including Heckscher-Ohlin model which refined the Ricardo theory, and New Trade Theory of Paul Krugman. These economic theories differ from Ricardo in a manner that they set their theoretical basis on specific issues such as intra-industry trade, geography, or relations between enterprises with diminishing return and the market size; however, they share the same basis with Ricardo in terms of maintaining the principles of competitive and free market economy. Namely, they are not designed to deal with economic externality such as the fixed exchange rate; therefore, they are not necessarily equipped with models that can deal with problems caused by the fixed exchange rate in the world today.

Among these new theories, some of them set their basis on the free movement of capital and labour. Scholars such as Krugman and Masahisa Fujita developed theories related to domestic market effect under which a country with large domestic market attracts industries by way of increasing return.¹⁷ Under such models, it is explained that countries holding absolute advantage can accumulate capital, just as the above Graph 2 indicates within the framework of Ricardo's theory, but the other trade partner may also receive benefits through the expanded and energized aggregate economy, if it happens at all. In other words, these new theories support the idea that the aggregate economy can enjoy the increase of wealth even under the fixed exchange rate economy and that it also generates the shift in the location of production. In this manner, the effects of the fixed exchange rate are similarly observed under new trade theories, just like under the model of Ricardo.

It also needs to be mentioned that the basic economic theories are constructed on a basis that all prices are presumed to converge into market equilibrium in a long run, because time allows market to adjust itself to reach the best competitive outcome. The fixed exchange rate, therefore, if

¹⁶ Under this condition, the graph would become exactly like the Graph 1.

¹⁷ See, for example, Krugman and Fujita, *The Spatial Economy; Cities, Regions and International Trade* (Cambridge, MA: MIT Press, 1999).

it is not considered as a pre-condition but a variable, defies this very basic principle of economics, by denying market to perform in a fair and competitive manner.

5. Economic Impact of the Fixed Exchange Rate

A. Exchange Rate as the basis to Guarantee Free and Fair Trade

The reason why such a lengthy introduction of economic theories is needed is to provide a solid explanation how important the exchange rate is in guaranteeing free and fair trade in today's globalized economy. Unlike the time of Ricardo, time has passed and now capital can move very freely across borders in a matter of a second. Under such economy, the fluctuation of the exchange rate is crucially important, as illustrated in the theories above, for making trade to generate benefits to all participants. Since virtually all economic activities are transacted through currencies and the exchange rate affects such a foundation of economy from its very root, the impact of the undervalued currency rate must be tremendous. Depending on the degree of its separation from the point of competitive equilibrium, the exchange rate can virtually annihilate all economic activities including trade, investment, interest rate, tariff, taxes, all of which have foundation in currency value. Its effect is huge and very often devastating for any economy.¹⁸

B. The Impact of Exchange Rate

If the exchange rate is devaluated, all goods and services produced in the country become cheaper than before; therefore, the impact to the market is huge. As known well, anti-dumping measures are prohibited under the WTO rules because it deforms market principles and generates unfair benefits to the exporters. Likewise, export subsidy is also prohibited under the WTO rules. Economically speaking, manipulated currency devaluation generates the same effect as anti-dumping or subsidy, and not only to one particular product but to all products. At least theoretically, as seen above, it is possible to term it as an overall anti-dumping measure, or subsidy on all products, as Keynes stated eighty years ago.

¹⁸ It should be emphasized here again that this effect is based on the simple Ricardo theory and that there are many other economic theories explaining different effects taking into consideration many other elements and conditions.

Some may think that the exchange rate fluctuation of 10%, for example, increase 10% in export, but very often it is not the case. Let us consider that two very similar products, one domestic and the other foreign, are sold at \$100 each competitively in your market. If the currency is evaluated against the foreign country by 10%, the foreign product becomes automatically cheaper by 10% from \$100 to \$90. Then people would buy only foreign product and the domestic product would be completely wiped out from your domestic market. This is the true impact of the exchange rate. The 10% change in the rate does not mean the 10% change in sales, it is much larger normally, and it effects not only one product but all products.

The exchange rate between US dollars and Japanese Yen used to be fixed at 1 dollar = 360 yen until 1973 under the Bretton Woods system. After the Nixon Shock, the currencies became fluctuated based on market principles and yen eventually became to the level 1 dollar = 75.32 yen at the highest. Namely, the Japanese yen was evaluated as much as 489% under the free market economy. This is an example how huge an artificial rate and the real exchange rate could differ to each other.

This is actually the theoretical background why so-called protectionists are raising their voices against trade as represented by the riot that thwarted the 1999 Seattle WTO Ministerial conference. The protectionists believe that the comparative advantage theory does not properly work in the globalized economy today and that trade damages local industries and welfare of people. Nevertheless, majority of economists assert that free trade is still beneficial for all countries and the most of governments still support free trade. That is why still Doha round negotiations are not totally abandoned. However, there is a certain rationale why the protectionists believe trade is welfare-damaging in this globalized economy as seen above, and the undervalued currency exchange rate policy is a significant culprit for this point of view.

C. The Balance between Fair Trade and Development

An important element which the WTO panel or Appellate Body may consider for a possible case dealing with undervalued currency exchange rate practices could be the balance between fair trade and development. As analyzed above, it is still not clear if the undervalued currency exchange

rate would be found illegal under the current WTO rules, but it is clearly not fair because the measure is unilateral. It goes without saying that the most important article of the WTO Agreements could be the Article I of GATT which determines the MFN (most favored nations) as the core of multilateral trade rules.¹⁹ In principle, if a country adopts the currency exchange rate fixation policy, the other trade partners also must be granted the same. Otherwise, it is not fair and it could be considered illegal from the rules stipulated in the Article I of GATT. However, in the case of fixed currency exchange rate, mutual freedom is not technically possible. If a country takes the non-floating currency exchange policy with certain exchange restrictions, the other countries that adopt currency fluctuation system cannot fix the rate at all. Some may assert that the country pegging the exchange rate must support the level of exchange rate with huge amount of market intervention, therefore it is a part of market economic activities and that it should not be blamed. If a country adopts a floating system and then tries to keep the level of the currency exchange rate by market intervention, it is true that it is a practice based on market principles and it does not become immediately illegal under the WTO rules. This type of market interventions are often implemented by governments even in this 21st century, though the actions are often not welcomed.²⁰ However, the problem currently observed in the global trade is that it is totally different today. In most cases currently creating trade friction in the world are based on the currency fixing policies adopted by those countries that do not allow their currencies exchanged freely in the international currencies market. Their currencies can partially be exchanged with foreign currencies as a means of payments of trade; however, they are not allowed to be exchanged in the currency market. Therefore, their trade partner cannot intervene into the currency market to move the level of exchange rate at all. In such cases, the level of exchange rate can beset at a completely arbitrary level to which the currency authority self-determinately prefers, where there is no room for their trade

¹⁹ The Article I of GATT states that “any advantage, favour, privilege or immunity granted by any contracting party.... for any other country shall be accorded immediately and unconditionally to all other contracting parties.

²⁰ For example, the government of Japan intervened in the currency market in 2011 a few times by buying 2-8 trillion yen value of US dollars each time in order to undervalue the Japanese Yen. The interventions were successful for a short time but it invited criticism from other trade partners.

partners to affect the level. Thus, the undervalued currency exchange level policy is at least not fair, as it is unilateral. The Preamble of the Agreement establishing WTO states clearly that “reciprocal and mutually advantageous arrangements” are desired by member states.²¹ Unilateral undervalued currency exchange rate policies are clearly against this core concept of the WTO agreements stated in its Preamble. The WTO panel or Appellate Body may take into consideration this aspect of undervalued currency exchange rate policies as against the very spirit of WTO as stipulated in its Preamble.

However, it also should be noted that the same Preamble emphasizes the necessity of securing growth for developing countries through multilateral trade.²² Since the majority of the 157 member countries of WTO are developing countries, the WTO Agreements hail highly that securing development for developing countries through trade is a very important target. The reason why the pegging practices are overlooked in the past may derive from the fact that the countries adopting the currency exchange rate fixation policy were all developing countries that required stability in exchange rate for their development. This principle of providing special and differentiated treatment for developing countries is still the core of the current WTO rules. Therefore, the WTO panel or Appellate Body will have to take into consideration also this aspect of the WTO rules in judging the justification of undervalued currency exchange rate policies if the party is classified as a developing country.

6. Conclusion

The impact of fixed currency exchange rate to trade is a new issue. A number of literatures have been issued and profound debates are being made in recent years, but there has been no specific direction as to identify the economic impact caused by a fixed level of currency exchange rate, nor

²¹ Preamble of the WTO agreements states that “*Being desirous* of contributing to these objectives by entering into reciprocal and mutually advantageous arrangements directed to the substantial reduction of tariffs and other barriers to trade and to the elimination of discriminatory treatment in international trade relations”.

²² Preamble of the WTO agreements states that “*Recognizing* further that there is need for positive efforts designed to ensure that developing countries, and especially the least developed among them, secure a share in the growth in international trade commensurate with the needs of their economic development”.

its legal posture within international law, particularly under the WTO-DSU rules. During the four decades after the demise of the Bretton-Woods system, the world trade was virtually controlled by OECD member countries, particularly by the United States and Europe whose currencies are floating in the global currency market. It is only after the turn of the century that the global trade began observing certain effect of the fixed currency exchange rate policies by witnessing a huge trade deficit in floating currency countries against fixed currency countries. The convergence of debate in this issue still remains to be seen.

The efforts in the area of economic theories have also been exerted in recent years to explain the impact of the undervalued currency onto trade, however, there has been no single theory identified to be a leading approach, either. However, there seems to be a general agreement that the undervalued currency exchange rate performs like subsidy and import tariff combined together onto all goods, just as Keynes argued eighty years ago. A basic explanation of this argument can be made through the introduction of the very basic and classical theory of comparative advantage. The model stands on many assumptions which makes it different from the reality of globalized economy in the 21st century, but it is a simple mathematic theory and in that sense it cannot be wrong to say that the fixed currency exchange rate at an undervalued level does not provide trade benefits to all players in trade but only to those countries maintaining the undervalued rate. At least, as far as economic theory is concerned, it is true that the fixing exchange rate at an undervalued level prevents fair competition.

As for the possibility of the utilization of WTO-DSU system to verify the justification of the policy to fix the currency exchange rate, it also remains unclear. Owing to the fact that the current rules of WTO Agreements do not take into consideration that such a policy to bind the currency exchange rate intentionally to an undervalued level, it is not straight forward at all that such a policy would be found legal or illegal under the current WTO rules.

However, as stated above, under general understanding, at least the undervalued exchange rate is understood not fair as a unilateral measure and to induce a devastating effect to other trade partners in a standard economic theory. If this general understanding and some expressions used

in WTO rules such as “in any case in which it is determined that serious prejudice to the interests of any other contracting party is caused or threatened” that appears in the SCM Agreement, there are chances that WTO panel and Appellate Body may find that the exchange rate fixation is serious prejudice to the interest of trade partners.

Nevertheless, the current WTO rules provide various provisions to guarantee special and differentiated practices securing development through trade for developing countries. If the country adopting the undervalued currency exchange rate policy is a developing country, as the most of the AALCO member states are, the WTO panel and Appellate Body may have to take into consideration that such a policy is protected under the WTO rules to enhance development needed to the country.