LEGAL WEAPONS IN THE CHINA CURRENCY DUEL:

THE CASE FOR APPLYING SUBSIDY RULES

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Presented to
American Enterprise Institute

Washington, DC
October 7, 2010

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-- SPEAKING NOTES --

Thanks to Claude for including me in today's panel. I'm going to start by providing some context and some factual information that has not yet surfaced this afternoon, and will then get to the legal analysis which is the main thing Claude asked me to cover. My presentation throughout will borrow heavily from recent House testimony.

I. CONTEXT

Four initial points might help to frame our discussion.

Proper Enforcement

Applying subsidy rules to China's currency regime is, in the CVD context, a matter of basic law enforcement. Some in the business community, in the press, and in Congress have allowed themselves to get pretty excited about it, but it's really very boring. To portray this as a policy choice is not accurate. *It's what the law already requires.* And to portray it as an either/or alternative to continued diplomatic efforts is totally disingenuous. The law should be enforced no matter what is, or is not, occurring on the negotiating front. Faithfully executing the laws figures prominently in the President's Oath of Office. The Commerce Department is stuck right now and, for reasons unrelated to the law as written, is not enforcing. It's like a record that is skipping, and will keep skipping until another government actor bumps the needle. There may be many good ways to bump the needle. Enacting the bill passed by the House is one of those ways.

Limited Coverage

Let me also start by acknowledging some things the bill does not do. It does not:

- Solve the larger currency problem with China (making a negotiating track unnecessary)
- Make it easier to use the law to reach other (traditional) currency manipulation scenarios
- Solve non-currency trade problems with China
- Cure cancer

To criticize the bill for the many things it does not do is ridiculous. No one disputes that there are other problems that would be good to tackle. You can complain all you want about other Chinese offenses in respect of which the USG has been insufficiently hawkish. But the relevant question today is whether what the House's currency bill *does* is appropriate.

Likely Reactions

The hand-wringing I have seen and heard, over potential retaliation by China, is badly lacking in perspective. At the level of rhetoric, the Chinese government will over-react if we begin to enforce our law on this point. But the Chinese government *always* over-reacts rhetorically, virtually every time one of our agencies issues a preliminary or final determination affecting Chinese products. That should not be allowed to define our government's options, or interfere with proper enforcement of existing U.S. law. Further, it is unlikely that China will do anything meaningfully retaliatory without having first brought and won a WTO case, waited for the "reasonable period of time" to expire, and obtained retaliation rights per the procedures in the WTO Dispute Settlement Understanding. What matters, then, is who would win that hypothetical WTO dispute. To believe that China would win, you have to believe that one of the three basic elements is missing: financial contribution, benefit, or export-contingency. As I will explain in a moment, China would not hold a winning hand on any of those three elements.

In the meanwhile, will proper enforcement *itself* help spur the revaluation everyone agrees is needed? Not in the short term, but over time -- maybe. Thoughtful observers of the CVD remedy, Professor Jackson among them, have noted that in addition to providing a border offset in individual cases, the remedy actually helps to deter subsidization. Imagine that: using subsidies isn't as much fun if they are being offset at someone else's border. If China found American CVD measures that catch the currency subsidy to be irritating, that would be one additional reason to shrink the currency subsidy. In other words, to revalue and thereby reduce -- maybe someday eliminate -- the benefit. China has other, much better, reasons to do this. But the contribution made by proper CVD enforcement would be modestly helpful, not counterproductive.

Expectations

A final contextual point: no one can fairly consider this a radical and unexpected application of the subsidy rules. Every government that has adhered to the WTO Agreement (and thereby to the Agreement on Subsidies and Countervailing Measures) knew that its financial contributions would be subject to examination under the "benefit" standard and, thereafter, under the further standards including export-contingency and adverse effects. And every one of them knew, also, that this examination could take place in Geneva or in the confines of a trading partner's CVD administering authority. Indeed, the expectation of WTO Members has always been that the legal definition of a subsidy, which is narrower than the economic definition, would be fully enforced. 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 legal definition. *China's currency regime satisfies even that narrower definition.*

II. FACTS

It is important to recall two respects in which China's currency regime is distinctive:

Administered price: 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 is no "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. When you fully control something, there is no need to influence it indirectly. China's distinctive "manipulation" consists in choosing an administered price that reflects industrial policy considerations rather than economic fundamentals.

Government transacts directly with exporters: In other countries, 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. Although a financial contribution to one entity (such as a currency trader) can in theory confer a benefit upon another entity (such as an exporter), a case based on this theory would be vastly more complicated than a case focusing on the benefit to the recipient of the financial contribution. The latter, simpler case is presented by China, where there *is* a direct transaction between the government and the exporter who has brought home dollars.

These additional elements, going beyond the classic notions of "manipulation" and "intervention" used in the IMF context and in our 1988 Omnibus Trade Act, make application of subsidy rules in China's case quite straightforward.

III. LAW

The agreed definition of a subsidy contains three elements.

Financial contribution: In China's case, there is a direct transaction between the government and exporters who bring home dollars. The exchange occurs at a government window. It's a direct transfer of funds. What the funds are *exchanged for* is irrelevant at this stage of the analysis. Funds transferred by a government are always (except in the case of grants) exchanged for something -- whether it be stock shares, or an IOU, or a truckload of matches. In fact, you can state the point more broadly: under ASCM Article 1 and the corresponding provisions of U.S. law, unless the government is buying services, the government's side of *any* swap with a company is a financial contribution. There is no gap in the definition when the exchange involves trading one currency for another. Opponents of the House bill have invoked WTO precedents noting that to make a "direct transfer" the government must transfer something of value, but those precedents do not help their case because the RMB provided in exchange for dollars *do* have value. The House bill, in any event, does not change existing U.S. statutory provisions on financial contribution. Rather, the bill very sensibly takes as a premise that currency swaps are financial contributions, and moves directly to the task of articulating a "benefit" rule applicable to this category of financial contributions.

Benefit: As previewed above, the benefit analysis here is quite straightforward in comparison with the situation where financial contributions conducted with one set of entities (currency traders) are alleged to confer a benefit on a different set of entities (exporters). Here, we can focus on whether the recipient of the financial contribution got a benefit. And we can ask the one and only interesting question: "does (or during an investigation period, *did*) the administered price for dollar/RMB exchanges undervalue the RMB?" 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 work by economists to produce a credible estimate of what the exchange rate "should" be. I am not here to replicate their analysis or defend every line of computer code they have used. But they've produced a pretty solid consensus, and the direction of the misalignment is clear even if its precise magnitude isn't. Even the vast majority of the House bill's opponents, including hearing witnesses and Republicans who voted against passage, had no trouble acknowledging that there is substantial undervaluation. 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 the financial contribution confers a benefit to the recipient.

Commerce's calculations to develop a benchmark and measure the *amount* of the benefit (as opposed to a range of under-valuation) will be subject to debate. This is always the case with Commerce's benchmark calls. I've litigated more than a few that my clients didn't like, and helped to defend more than a few that someone else's clients didn't like. Within our legal system, the standard Commerce must meet in this respect is one of reasonableness rather than perfection. WTO panels are supposed to apply a similar standard, although they often violate their mandate and apply a tougher one. None of this qualifies as a reason to throw our hands up and declare the entire project arbitrary and hopeless. Or, God forbid, "unilateral" -- as if an agency's benchmark calls could ever be otherwise. (Note, however, in this regard, that the House bill does instruct Commerce to use IMF data and methodologies both in determining whether a benefit exists and in measuring the benefit where one does exist.)

Fortunately, and unlike the 1988 Act, the CVD law does not contain an intent requirement. A government does not need to have exhibited any particular motivation for providing a financial contribution on beneficial (better-than-benchmark) terms. The analysis is dry and objective, and to most humans, unbelievably boring. This makes the CVD regime a much more desirable context for a formal U.S. government finding on RMB misalignment.

Export contingency: An export subsidy is one whose bestowal is contingent -- in law or in fact, and whether alone or as one of two or more criteria -- on export performance. The Chinese currency subsidy is plainly export contingent, as roughly ¾ 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, in that it gives a producer a compelling reason to prefer selling a marginal unit of output abroad rather than at home.

Correcting Commerce's misapplication of this existing rule is the primary business of the House bill. Commerce has mistakenly held that availability of the currency subsidy to non-exporters (tourists and investors) somehow dissolved the export contingency in respect of recipients that did have to export to get the subsidy. That was a misapplication of U.S. law, and also flatly inconsistent with how the identical language on export contingency has been construed and applied in WTO cases. The House bill corrects Commerce's error in the narrowest possible way, and does so using language taken directly from the Appellate Body's decision in the ETI case.

Instead of the alarmist reports we all saw, the headline following House passage of the currency bill ought to have looked like this:

As was true of the main group of beneficiaries in the ETI case, exporters are a discrete class of beneficiaries of the Chinese currency subsidy, and their access to the subsidy depends entirely on exporting. Availability or bestowal of the subsidy in certain circumstances not involving exportation cannot lawfully be treated as precluding a finding of export contingency. The House bill simply instructs Commerce not to treat this one fact as dispositive. The actual finding on export contingency (after an investigation) is left for Commerce to make, based on the facts and the law. The bill could have gone further, in this respect, and still been on solid ground WTO-wise. Hopefully the judgment that this was not necessary -- that Commerce next time will not only investigate but also get the final determination right -- will prove correct.

Opponents of the House bill have made some truly bizarre arguments in seeking to avoid or distinguish the ETI precedent. Here are a few:

- The ETI case involved *de jure* export contingency, while a China currency case would require a *de facto* export contingency analysis.

> *True, but many precedents make clear the contingency standard is the same in both contexts.*

- The ETI case was a compliance case, and came out as it did because we hadn't made sufficiently visible changes to the earlier-faulted FSC provisions

> *This is not a serious argument. The panel and Appellate Body were looking at a new measure and applying to that measure the rules in ASCM Article 3. Furthermore, the principle articulated in the ETI decision is perfectly consistent with Article 3 and its footnote 4.*

- Exporters (when given the choice) do not always convert their export earnings and collect the currency subsidy

> *True, but they get an export-contingent subsidy when they do convert.*

- The reported WTO cases on export contingency (Canada-Aircraft, Australia-Leather, EU-LCA) focus on "anticipated" exports.

> *Correct. That is why those cases are in the periphery of the prohibited category, whereas the China currency case is in that category's central core.*

IV. CONCLUSION

Need for legislation: As China with its present currency regime is doing something it promised not to do -- something inconsistent with WTO rules -- the case for responsive action by the U.S. government is strong. Further, China's present currency regime meets the technical, legal definition 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. Would starting to do what our law requires (countervail the currency subsidy) shift attention undesirably from China's behavior to ours? No, and even if it would, the law should still be enforced.

House bill takes the right approach: The House bill takes the narrowest possible approach, borrowing actual Appellate Body language, to achieve a result that should be happening anyway. It does not require or encourage Commerce to do anything WTO-inconsistent. It *does* correct an anomalous patch of non-enforcement within our CVD regime. The bill cannot be legitimately criticized for failing to solve other/unrelated problems in the China-US trade relationship, or for interfering with efforts on the "negotiating track" regarding currency because it *will not interfere with those efforts*. If anything, it will help on the broader currency problem.

Broader concerns: In the end, we are a nation of laws, and a situation of non-enforcement is not a durable situation. But what happens in the meanwhile matters. I am not referring here to the plight of particular industries that are getting only partial CVD relief. The arguments (and Additional Views committed to writing by certain W&M members) about export contingency are worrisome. If the crabbed notion of export contingency espoused by the House bill's opponents were to win 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 -- would be reduced to something very much like a nullity. A vast amount of U.S. political capital, expended over decades, would be squandered. Many U.S. industries and businesses, ECAT members included, benefit every day from the deterrent effect the prohibited category has in foreign capitals. Arguments that entail drastic shrinkage of that category are shortsighted. A topical example: if the opponents are right in what they are saying about export contingency in this matter, then the USTR lawyers are wrong in what they are saying about export contingency in the 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.