São Paulo Law School of Fundação Getúlio Vargas – DIREITO GV

Research Paper Series – Legal Studies

Paper n. 83

Global Governance, Currency and Trade:

Implications of one on the other, common problems and how to address
cooperation through law at the international level

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August 2013

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Final Paper presented to the course “Global Economic Governance”, taught by Professor Michelle Sanchez Ratton (April 2013).

Abstract: How to deal with the impacts of the exchange rate on the trade balance of Brazil? There is not a single answer to such question. In order to find out some legal approaches for this matter, this paper aims to describe and analyze the role of the IMF, WTO and the governments of Brazil and the United States on the currency misalignments, especially the extraterritorial effects of such misalignment on the Brazil's bilateral trade with the United States. The article concludes that the *Currency Swap Agreements* and other bilateral solutions may minimize the distortions that the Brazilian balance of payment against the USA is carrying, due to the lack of legal solutions for the problem of the exchange rate misalignments that Brazil is facing.

Keywords: currency swap agreement, currency war, exchange rate, global economic governance, IMF.

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1 Introduction

This paper will attempt to describe and analyze:

- (i) the role of the *Global Economic Governance and Law* (“GEG”) on the most recent side effect derived from the international financial crisis that shocked the world in 2007/2008. The so-called international *Currency War*, the term coined by the Brazil’s finance minister Guido Mantega in 2010, reacting to China’s attempt to protect the yuan (or renminbi) from the dollar; and
- (ii) the possible bilateral solutions that developing countries are seeking in order to bypass the inertial position of the IMF and the procedural difficulties from the WTO.

The *Currency War* that are damaging the international trade of Brazilian goods and consequently the Brazilian balance of payments links these two items.

Therefore, in the next sections it will be tried to deal with the interconnection between international financial crisis, currency, trade, GEG and Brazil in order to discuss the role of the International Monetary Fund (“IMF”) and the World Trade Organization (“WTO”) in the *Currency War*. After that, it will be analyzed the measures that Brazil and other developing countries are taking to minimize the inertial position of the IMF and the procedural difficulties that they may face before the WTO.

Thus, first, what *Currency War* is in fact?

2 The International Financial Crisis and its Implications on Currency and Trade

The forces unleashed by the subprime crisis will probably run rampant for years, threatening more and collateral damage. The disruption in our credit markets is already of historic proportions and will have important economic impacts. (SHILLER, 2008).

In the USA US\$11 trillion in household wealth and 8 million jobs were lost as the economy hit an annualized rate of decline in GDP of 6.2% in the last quarter of 2008². In 2009,

² Catherine Rampell, “GDP Revision Suggests a Long, Steep Dowfall”, New York Times, 27 February 2009, <http://www.nytimes.com/2009/02/28/business/economy/28econ.html> (visited at April 25, 2013).

the USA GDP fell by 2.4 percent in 2009 and the UK GDP fell by 4.9 percent (LYBECK, 2011). The crisis affected much deeper the developed countries than emerging economies, such as Brazil and China.

In this scenario, the developed countries – such as USA, UK and Japan – plus China cut their short-term interest rates to approximately zero or zero in order to recuperate their economies. In addition, in 2008, the Federal Reserve – Fed – released a monetary plan called the Quantitative Easing plan³ (“QE”) in a attempting to block a deflation in its economy. Yet, the Fed’s monetary policy will not affect just the U.S. economy, but the entire world, especially the international trade and the developing countries⁴. Consequently, the foundations of the so-called *Currency War* were launched with the QE plan.

UK and Japan released their QE plan too and China established its QE plan in 2008. Brazil and South Korea prepared their own economic reaction. Brazil has taken measures⁵ to devaluate its currency from appreciating too sharply and too fast against currencies of the central economies, such as USA and UK. RICKARDS points out that:

Printing dollars at home means higher inflation in China, higher food prices in Egypt and stock bubbles in Brazil. Printing money means that U.S. debt is devaluated so foreign creditors get paid back in cheaper dollars. **The devaluation means higher unemployment in developing economies as their exports become more expensive for Americans.** (G.N.).

Hence, the international financial crisis is echoing from 2007/2008 to 2013 in other ways, such as *Currency War*. Yet, what could be worse? A deterioration of these monetary measures to an aggressive trade war amongst the countries. It was not occurred yet, but the monetary avenues for that are already in place.

3 Quantitative Easing occurs when the USA government, due to its government monetary policy, increases the money supply of the international market, by buying government bonds from the market. This policy increases the money supply by flooding financial institutions with capital, in an effort to promote liquidity.

4 It is important to clarify that, for example, China is applying a similar Quantitative Easing plan that is affecting the world trade transactions as well, especially the USA. However, with the purpose of focus on the issue of the consequences of this monetary policy and because of the purpose of this paper, it will not be discussed here the QEs from other countries, such as UK, Japan and China.

5 Example: Protectionist measures were taken by Brazil through the control of capital. In order to block unwanted “hot money” flows, Brazil levied transactions with financial assets (example: 6% IOF Tax on foreign loans to five-year maturities).

2.1 Exchange Rate Misalignment and International Trade. Is there a connection?

2.1.1 - From the economic and historic point of view:

The financial economic history^{6 7} will tell us that manipulation or any kind of adjustment in the exchange rate do affect the international trade. Scholars⁸ agree that trade in fact is connected to the exchange rate. According to IRWIN from the Dartmouth College and IMF, the international monetary system is connected with the international trade system and this is a not new for the international financial market.

The international monetary system and the international trading system are usually considered distinct entities that serve different functions. But exchange rate policy and trade policy are highly interrelated. Tensions between the two have been evident throughout history – such as during the Great Depression and the Bretton Woods era – and may become increasingly apparent in the years to come. (IRWIN, 2011).

2.1.2 - From the legal point of view:

GATT Article XV⁹ Exchange Arrangements is the main legal link between trade and

6 Currency War was one of the main aspects that led the countries to create the IMF in 1944. In addition, such Currency War worsened the great depression of the 1930's.

7 “Though it came on the heels of the Great Depression and the beginning of the end of World War II, the Bretton Woods system addressed global ills that began as early as the first World War, when governments (including the U.S.) began controlling imports and exports to offset wartime blockades. This, in turn, led to the manipulation of currencies to shape foreign trade.” (TIME, Tuesday, Oct.21, 2008 – **Bretton Woods System** – <http://www.time.com/time/printout/0,8816,1852254,00.html> – visited at March 01, 2013).

8 For example, cf. studies and articles from: (i) Copelovitch and La Follete – University of Wisconsin-Madison in: **“Currency Wars by other means? Exchange Rates and GATT/WTO Dispute Initiation”** – http://ncgg.princeton.edu/IPES/2010/papers/F220_paper3.pdf; (ii) Irwin – Dartmouth College /National Bureau of Economic Research and the IMF in: **“Espirit de Currency”** - <http://www.imf.org/external/pubs/ft/fandd/2011/06/irwin.htm#author>.

9 **GATT Article XV:1**: “The CONTRACTING PARTIES shall seek co-operation with the International Monetary Fund to the end that the CONTRACTING PARTIES and the Fund may pursue a co-ordinated policy with regard to exchange questions within the jurisdiction of the Fund and questions of quantitative restrictions and other trade measures within the jurisdiction of the CONTRACTING PARTIES.”

GATT Article XV:4: “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.”

GATT Article XV:9: “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

exchange rates misalignments. The main provisions deal with *exchange arrangements* (XV:1); *exchange action* (XV:4); and *exchange controls and restrictions* (XV:9) that may interfere negatively in trade matters. According to article XV:4 of the GATT¹⁰:

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**. (G.N.).

It is worth trying to understand the word *frustrate* in this Article XV:4. In contrast with the word *manipulation* found in the IMF Article IV:6¹¹, we may infer that *manipulate* is a stronger word than *frustrate*. In addition, according to experts¹² it is difficult to prove or politically recognize – through the IMF – that a state or a central bank of a specific country employed an unfair monetary policy in order to damage intentionally the trade or the balance of payment of the other country.

In contrast, it is possible to frustrate – through adjustments in the exchange rate – the provisions related to a fair trade in accordance with the GATT rules without manipulating the exchange rate or without considering the politic aspects that do involve the relationship of the IMF with its members.

Although we could present several economic and legal examples, discuss all of them, and link monetary policies, exchange rate misalignments and international trade affairs, it is sufficient recognize that from the economic and legal sides, exchange rate and trade are strongly interconnected.

Consequently, the USA EQ plan and the so-called *Currency War*, for example, is a matter of a trade concern too, as “They are complementary and mutually dependent. They are the two sides of the same coin.” (BALTENSBERGER and COTTIER, 2010).

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.”

10 The General Agreement on Tariffs and Trade from the WTO – GATT.

11 **IMF Article IV (Section 1 – iii)**: “General obligations of members: Recognizing that the essential purpose of the international monetary system is to provide a framework that facilitates the exchange of goods, services, and capital among countries, and that sustains sound economic growth, and that a principal objective is the continuing development of the orderly underlying conditions that are necessary for financial and economic stability, each member undertakes to collaborate with the Fund and other members to assure orderly exchange arrangements and to promote a stable system of exchange rates. In particular, each member shall: (...) **(iii) avoid manipulating exchange rates** or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members; and (...).” (G.N.).

12 Cf. THORSTENSEN, Vera; RAMOS, Daniel; MÜLLER, Carolina, The “Missing Link Between the WTO and the IMF”, CGTI, unpublished manuscript, 2013.

3 Did the *Currency War* affect Brazil?

Brazil's bilateral trade with the United States presented a huge deficit in 2010. According to the Brazilian Government, in 2010 Brazil exported US\$19 billion dollars to the USA and imported US\$27 billion dollars from it, creating a deficit in the Brazilian Balance Payment of US\$8 billion dollars. This difference represents the major deficit with a trade partner in 2010, Brazilians officials said¹³. In 2012, such deficit remained in accordance with the recent Brazilian trade balance¹⁴.

Among other causes, such as tariffs and commercial barriers established by the American government against Brazilian agricultural products, the massive devaluation of the American currency – dollar – also activated the appreciation of Brazilian currency – Real – against the dollar. Therefore, Brazilian products, considered to be exported, became more expensive than the American ones. Accordingly, Brazil imported much more goods from the USA than exported them to it, because of the Brazilian products became much more expensive than those ones from the USA.

The monetary police led by the Federal Reserve and other central banks around the world (China, UK and Japan, for example) systematically devaluated currencies in such countries. Consequently, it decreased the export price of their goods as well¹⁵, affecting the trade balance of the developing countries, such as Brazil.

In fact, *Currency War* converted into *Exchange Rate Misalignments* that affected Brazil, distorting its trade balance with the USA. In order to proceed with the next items, it is important to clarify that *Currency War* is in fact triggering the *exchange rate misalignments* among the countries. For this purpose, the term *exchange rate misalignments* will be in place.

13 BBC Brasil - http://www.bbc.co.uk/portuguese/noticias/2011/03/110316_deficit_visita_bg.shtml (visited at April 25, 2013) and Secretaria de Comércio Exterior – Balance Trade Spreadsheet (Brazil and USA). <http://www.desenvolvimento.gov.br/sitio/interna/interna.php?area=5&menu=3158&refr=576> (visited at April 25, 2013).

14 Source: Balança Comercial Brasileira 2012 – Secretaria de Comércio Exterior / Ministério do Desenvolvimento, Indústria e Comércio Exterior/Balança Comercial de Países – Blocos Seleccionados.

15 The “International Currency War” comes from a monetary police called “Quantitative Easing”. In order to tackle the economic depression, countries around the world are increasing the money supply by buying government bonds from the market. In turn, it will increase the money supply by flooding financial institutions with capital, in an effort to promote increased lending and liquidity. Consequently, a devaluation of the currency occurs and the export price of a specific good becomes cheaper.

4 The Global Economic Governance Through International Economic Organizations – A Brief Introduction on the IMF and the WTO and their relationships with currency and trade

In order to prepare the grounds to evaluate the probable solutions related to the *exchange rate misalignment* and its impact on the trade sector, it will be described a framework of the *Global Economic Governance* and its main international economic organizations.

Governance has become an essential concept and certainly one of the most significant manifestations of the social sciences¹⁶ that scholars and practitioners may apply as a theoretical approach to understand the flaws and complexities of the economic and legal problems that they are facing after the international financial crisis, particularly the *Currency War*.

Global Economic Governance may be assessed via international public and private-sector bodies¹⁷ and / or through *Bretton Woods institutions* that comprise international economic organizations with responsibility to deal with monetary (IMF), financial or credit (World Bank) and trade (WTO) areas. This item will focus on the creation and scope of the IMF and the WTO.

4.1 IMF and WTO - An historical overview

Pre-Bretton Woods – 1918-1933

In 1918-19 in a Peace Conference in Paris, USA, France, UK, Italy and other European countries established a framework for restoring free trade and the flow of capital. In Genoa, 1922, it was re-established the gold standard for a group of mostly European countries. After the establishment of the gold standard, in 1930, the Bank of International Settlements was founded and finally, in 1933, in London, it was re-established the fixed parities for a wider range

16 LEVI-FAUR, David. Oxford Handbook of Governance. New York: Oxford University Press, 2012. Pg. 3.

17 These international and private-public bodies are responsible for establish recommendations (examples: Basel Committee and IOSCO – International Organization of Securities Commissions), model contracts or agreements that may be applicable in the cross-border financial transactions involving derivatives, such as ISDA – International Swaps and Derivatives Association.

of currencies. Later a Tripartite Agreement (US, UK and France), but it was plagued by lack of surveillance power¹⁸.

Bretton Woods – 1944

In 1944 – USA, politicians, economists, chief of states and other diplomats agreed to establish and create the foundations of the modern international financial organizations. The Fund (IMF), the Bank (World Bank) and the GATT were formed to deal with and to improve the international financial system in that time. They were created in order to organize the international financial world after de WWII. From the political side, they shaped conditions to re-establish the peace among European countries, Japan and the USA and from the economic side they had to work on the currency devaluation among countries and the *Beggars thy-neighbour* policies that were destroying the world economy.

Pos-Bretton Woods – 1970-1994

In 1971, the monetary system collapsed. Consequently, some reforms took place, such as¹⁹: **(i)** the end of fixed exchange rates, 1971-73 (suspension of the dollar's convertibility into gold è Second Amendment of the IMF Articles of Agreement in 1978); **(ii)** the enlargement of the World Bank: IBRD - International Bank for Reconstruction and Development; IDA—International Development Association; IFC—International Finance Corporation; MIGA—Multilateral Investment Guarantee Agency; IFC – International Finance Corporation; and ICSID—International Centre for Settlement of Investment Disputes; and **(iii)** the creation of the WTO (1994): a law based institution. The WTO fixed the Global Economic Coherence Policy; more rules and capacity for surveillance.

4.2 IMF and WTO – Their role and function

IMF, World Bank and WTO are the main international organizations that deal with the governance of the international economic and financial systems. They are the three pillars that

¹⁸ From the Global Economic Governance class – Michelle Ratton Sanchez, March 4, 2013/ DIREITO GV.

¹⁹ Ibid.

emerged from the Bretton Woods Conference and from the 1970s collapse of the international financial system in order to try to cope with the global economic and financial imbalances, such as exchange rate misalignments and trade.

Although the World Bank has an important role in the international economic and financial scenario, its role will not be evaluated in this paper.

IMF and WTO have been established to accomplish international coordination in the world economic forum. How? Easing collective action among countries to promote stronger economic growth and enhance financial stability (ALEXANDER, DHUMALE AND EATWELL, 2006).

IMF

The main purpose of the IMF to deal with imbalances of the international financial system, especially related to the exchange rates, international payments, and to “ensure the stability of the international monetary system”²⁰.

The IMF was established by treaty in 1944 and it is governed by an Articles of Agreement and by its member countries. Such articles are binding on their respective members, containing rights, obligations and methods of enforcement. These rights and obligations that are created under the articles are vertical. Why? Because such rights and obligations are *between the Fund and its members* and *not* among its own members.

Article IV (iii) of the IMF Agreement establishes that members shall avoid manipulating exchange rates or the international monetary system in order to hinder or affect negatively, for example, the balance of payments of other members. This provision obliges members in relation to the Fund and not members in relation to others.

WTO

WTO is a member-driven organization and currently it has more than 145 member countries. The main WTO Agreement for trade is the GATT, the General Agreement on Tariffs and Trade.

The WTO was created to: **(i)** deal with trade and its liberalization; **(ii)** to be a forum for members to negotiate trade agreements; **(iii)** to be a place to set and manage a body of rules

²⁰ Source: the IMF at a Glance – Fact Sheet - <http://www.imf.org/external/np/exr/facts/glance.htm>

related to fair trade practices and standard provisions and clauses in agreements between and among members; and **(iv)** to be, ultimately, a place for members to settle trade disputes.

In contrast to the IMF: **(i)** WTO's Dispute Settlement Body ("DSB") is a detailed set of rules and procedures for members to claim against other members for alleged violations of rules established in the WTO Agreements²¹; and **(ii)** the rights and obligations enclosed in the WTO Agreements oblige members in a horizontal way. The rules are enforced between members and not between members and the WTO, like IMF, in which rules are enforced from the IMF to its members (vertically).

4.3 IMF and WTO – Governance and Decision-Making Process

(...) the institutional structure of these international organizations significantly influences their decision-making processes with respect to developing standards of economic governance and financial regulation and therefore constitutes a global governance concern. (ALEXANDER, DHUMALE AND EATWELL, 2006).

The Board of Governors is the highest decision-making body of the IMF. It consists of one governor and one alternate governor for each member country. Such governor is appointed by the member country and is usually the minister of finance or the head of the central bank.

In relation to the approvals of the important issues, the Executive Board²² is the government body to deal with quota increases, special drawing right (SDR) allocations, the admittance of one new member, compulsory withdraw of member, and amendments of the Articles of Agreement. How much political force has one voting member country? It depends on the number of quotas allocated for each member country. According to the IMF:

"When a country joins the IMF, it is assigned an initial quota in the same range as the quotas of existing members that are broadly comparable in economic size and characteristics. The IMF uses a quota formula to guide the assessment of a member's relative position."

21 Main WTO Agreements: **(i)** Multilateral Agreements on Trade in Goods; **(ii)** General Agreement on Trade in Services (GATS); **(iii)** Trade-Related Aspects of Intellectual Property Rights (TRIPS); **(iv)** Dispute Settlement Understanding; **(v)** Trade Policy Review Mechanism; and **(vi)** Plurilateral Trade Agreements.

22 The Board of Governors delegated most of its powers to the IMF's Executive Board in accordance with the IMF Facsheet - <http://www.imf.org/external/np/exr/facts/glance.htm> (visited at March 02, 2013).

According to the IMF data, the division of the voting power of USA, Japan, Germany, France and UK may be checked below²³:

Casting Votes of	Votes by Country	Total Votes	Percent of Fund Total
United States	421,961	421,961	16.75
Japan	157,022	157,022	6.23
Germany	146,392	146,392	5.81
France	108,122	108,122	4.29
United Kingdom	108,122	108,122	4.29

Brazil and other ten countries of the Latin America and Caribe²⁴ represent 2,61% of Fund total votes. On the other hand, USA, Japan, Germany, France and UK represent roughly 38% of the votes in the IMF. It is clear that Brazil is *under represented* before the IMF board and that its political force is very fragile.

In contrast to the IMF, the WTO encompasses a different governance structure. All members have vote (one member à one vote). There is a political equilibrium inside the WTO in terms of vote. Although the political power in the WTO is very different from the IMF, in the WTO all controversies and agreements are reached by consensus. On the contrary, the alleged controversy or disagreement will be decided by vote.

Countries members make their decisions through various councils and committees, whose membership consists of all WTO members. The highest authority is the Ministerial Conference that can take decisions on all matters under any of the multilateral trade agreements.

4.4 IMF and WTO – The Legitimacy Matter

IMF has been facing the legitimacy problem, and it is becoming critical to the global governance. Developing countries, such as Brazil, are challenging the US to change the political

²³ Source: IMF - <http://www.imf.org/external/np/sec/memdir/eds.aspx> (visited at April 25, 2013). Note that the table was adapted to reflect only the voting power by country.

²⁴ Cape Verde; Dominican Republic; Ecuador; Guayna; Haiti; Nicaragua; Panama; Suriname; Timor-Leste and Trinidad and Tobago.

power of their quotas in order to give more representativeness to them.

Nonetheless, this claim remain unresolved by the Board of Governors of the IMF, especially because the unwillingness of the US to change its political force, as established above, Brazil is under represented when compared with the USA, Germany, Japan, France, and UK.

Unfortunately, this will damage the representativeness and legitimacy of the IMF to deal with the international financial crisis, especially because the developing countries will not feel that the IMF represents them. This fact may threaten the global governance of the financial system. Necessity for reforming in the governance of the IMF is a very urgent issue.

Is WTO facing the same problem of representativeness? Is not easy to answer. Why? Because of the rule “one country, one vote”. From this point of view, the representativeness of the countries in the WTO is preserved.

On the other hand, the WTO shall deal with the proliferation of bilateral agreements that are bypassing the WTO meetings and agreements, even the IMF and WTO rules. The FTA²⁵s may compromise the mission of the WTO that is to promote fair and free trade in services and goods.

4.5 IMF and WTO – The Enforcement Matter

How do the IMF and the WTO enforce their rules and agreements on their members?

IMF

The IMF may rely on: **(i)** Surveillance (Article IV:3 of the Articles of Agreement); and **(ii)** Conditionality powers (Article V, section 3(a)).

Article IV (3)(a) gives legal grounds to the Fund exercise its surveillance over exchange arrangements. In accordance with this article, the Fund shall “oversee” the international monetary system in order to ensure the compliance of its members with its rules established in the IMF Articles. This surveillance activity consists of evaluating and preparing annual reports on a member’s economic development and financial sector stability.

Unfortunately, according to the specialized literature (LOWENFELD, 2008), the

²⁵ Free Trade Area Agreement.

surveillance program has not been succeeded when have to impose its rules to the “major financial powers”, such as the USA the UK. Why? One of the reasons is that the USA, for example, has sufficient political power in the IMF governance to block, for example, any kind of punishment or report contained negative information and numbers that may be released by the IMF against the US and that reflects the surveillance work of the IMF.

According to Article V, section 3(a), the Fund may implement policies for “special balance of payments problems” and, assisting their members in accordance with the Articles of Agreement, the Fund may establish “safeguards”²⁶ to a member country. For example, in order to make disbursements of capital to a member, the Fund may link it to a specific fiscal and exchange arrangements activities that a member shall take.

Finally, the Fund may suspend the voting rights of its member and, lastly, the Fund may even require the member to withdraw from IMF Membership, if this member persists in violate an obligation of the Articles of Agreement (70% majority vote of its Executive Board is required to dismiss a member).

WTO

The Dispute Settlement Body provides a rule based dispute resolution process by which a member(s) may claim against other member(s) because of an alleged violation of the rules of the Agreement signed or due to a noncompliance in relation to the rules and provisions of the main WTO Agreements.

The success of the dispute settlement mechanism as a means of managing trade disputes – large and small, and between developed and developing countries – is the crown jewel of the global economic regulatory order. Moreover, the rate of adherence to the WTO rules, both in general and in response to disputes brought, is a singular achievement for the system and is at the heart of its success as a systematic regulator in the face of the recent crisis. (GADBAW, 2010).

26 Types of safeguards include limits on how much can be borrowed, conditions on the loans, measures to deal with misreporting or arrears, or “safeguards assessments” of central banks. Source: IMF - <http://www.imf.org/external/np/exr/facts/safe.htm>.

5 IMF and WTO – How to deal with the *Exchange Rate Misalignment* and its impact on the trade balance of Brazil?

There is no a single answer to such question. There are several approaches in accordance with the literature, scholars and practitioners. Some concerns will be addressed in order to deal with the problems raised in the previous items.

From the Point of View of the IMF and the WTO Rules

Article I of the IMF Articles establishes the importance of the *exchange rate* stability, and consequently of the currency to the international trade. It is interesting to highlight that these guidelines aim at the growth of the international trade market, as the exchange rate and its market (“the exchange market”) are the monetary side of the international trade. When a good or service is traded in the international market a correspondent transaction in the exchange market occurs. This is a guideline for Brazil.

Due to the purpose of the IMF, most of the IMF rules from the Articles are concerned to the *exchange rate*, *currency* and *capital control*. It will be analyzed just the rules that deem to be related to the theme of this paper. They are: **(i)** Article IV, Section 1; **(ii)** Article IV, Section 2 (b); **(iii)** Article VI, Section 3 (a); and **(iv)** Article VIII, Section 2 (b).

Article IV, Section 1 deal with the general obligations of members regarding exchange arrangements, in which they shall promote stable systems of exchange rates. They must endeavor reasonable price stability and members may not: **(i)** produce erratic disruptions in the financial conditions of the country; and **(ii)** manipulate exchange rates or the international monetary system in order to impede adjustments in the balance of payments or to “gain an unfair competitive advantage over other members”²⁷.

The manipulation of the exchange rate creates artificial conditions in the trade market and cause exchange rate misalignments. As discussed above, for example, if a country devalue its currency affecting the exchange rate, its export goods will become cheaper in the international trade market, increasing the export market of its products. This also will affect its balance of payment, as the inflow of capital will increase too. Consequently, the balance of payment will produce artificial surplus as well. Is the *Currency War* a case of manipulating the exchange rate?

27 IMF Articles: Article IV (1)(iii).

Brazil shall evaluate this rule.

From the trade rule point of view, for example, a manipulated rate of exchange may have a negative effect in the price of the product offered by the exporter in the importing country. This may become a case of dumping, for example. The Article VI of the General Agreement on Tariffs and Trade (GATT 1994 - Article 2.4.1 of the Anti-Dumping Agreement) carefully disciplines it. In this case, an authority from the WTO may investigate such manipulation of exchange rate²⁸.

According to Article IV, Section 2 (b), members of the Fund may have exchange arrangements in accordance with their choice. This is a “full freedom of choice” (LOWENFELD, 2008). Consequently, member states may maintain the value of their currency in accordance with their own economic reasons.

For example, the USA, Japan, Canada, and the UK have allowed the value of their currency to be established by the market (exchange fluctuation rate). Brazil also adopted the same criterion. Although there is no obligation with any target rate, it is important to highlight that the governments from such countries – through their Central Banks – interfere in the value and the fluctuations of their currency (“dirty exchange fluctuation rate”) – example: the *currency war*.

Could be this interference characterized as a manipulation too, in accordance with Article IV, Section 1? In the present case, that Brazil is facing problems with its trade balance with the USA due to, for example, the devaluation of the dollar, Brazil could analyze this rule with attention in order to frame the pitfalls that a claim before the *WTO Dispute Settlement Body* could raise.

Article VI (3). The focus of this article is on the *controls of capital transfers*. Members may control the outflow and inflow of capital in accordance with special circumstances. For example, in cases involving liquidity problems as Cyprus is facing nowadays, the Cyprus government may regulate and control the international capital movements. For example, Brazil has had already adopted this measure applying a tax²⁹ on the foreign investments in Brazil using capital control to calm volatile cross-border capital flows. It is symptomatic that IMF is accepting the capital control in a time that the USA is pushing the exchange rate to zero and devaluating the dollar. In a first moment, we may imply that Brazil did not violate the rule of

28 In order to analyze details on specific cases involving dumping and manipulation of exchange rates, please see LOWENFELD, Andreas A. **International Economic Law**. New York: Oxford University Press, 2011, pg. 278, 279 and 280.

29 IOF (taxation on the financial transactions).

the IMF. First, because the IMF Articles permit the capital control. Second, because Brazil took such measures in accordance with a pre-established tax rule that was not created just to fight against the *Currency War*, in which the minister of finance may change the base of this tax (this is considered a tool of economic policy).

Although the main WTO Rule that deals with the exchange rate misalignment was already analyzed in the item 2.1 (ii) above, it is important to highlight that the GATT Article XV is a real and an excellent legal tool and reason to submit a claim against the USA, Japan, UK and China before the WTO Dispute Settlement Body. In this case, this should be the last measure that Brazil could take, just if it find itself without other “weapons” to protect the Brazilian economy against the exchange rate misalignments created by the central economies plus China³⁰.

Instead of claiming against the countries before the WTO Dispute Panel, could Brazil require a study or a debate on the exchange rate misalignments, currency war and other related issues before a special WTO Committee? Yes. Brazil already did it³¹. However, the USA, the European Union, China and Japan requested that Brazil should present such inquiry before the IMF. According to them, the WTO is not the correct instance to discuss and deal with exchange rate misalignments.

On the other hand, the USA, Germany, Japan, France and the UK detain political power to establish the IMF agenda as it was described and analyzed in item 4.4 above (voting power and legitimacy).

These countries are able to block any attempt to appellate and interfere in the IMF surveillance³² against them that may result in negative reports or any IMF document that may support Brazil arguments. There is a lack of representativeness of Brazil and other developing countries in the IMF Board of Governors and the Executive Board. Moreover, from the legal point of view, Brazil has no voting power to demand a surveillance or any type of retaliation

30 It is important to stress that according to academic investigations conducted by scholars from the University of Wisconsin – Madison, found that countries facing exchange rate pressures – in order to relief its domestic market from political pressures for protection – probable will submit claims before WTO. They tested this hypothesis on a dataset of WTO disputes from 1995-2008. They concluded that countries are substantially more likely to file WTO complaints in times of exchange rate appreciation – cf. COPELOVITCH, Mark S. and LA FOLLETE, Robert M. **“Currency Wars” by other means? Exchange Rates and GATT/WTO Dispute Initiation.** University of Wisconsin and Princeton University - http://ncgg.princeton.edu/IPES/2010/papers/F220_paper3.pdf

31 WT/WGTDF/W/53 13 April, 2011; WT/WGTDF/W/56 20 September, 2011; and WT/WGTDF/W/68 5 November 2012 – WTO Working Group on Trade, Debt and Finance.

32 Cf. IMF Articles of Agreement - Article IV, Section 3. Surveillance over exchange arrangements.

against the central economies before the IMF.

Furthermore, it is clear that there is no procedure rules in the IMF, like WTO Dispute Settlement Body. The IMF will remain inert and “toothless”. There is material and substantial rules, but there is no rules that enable members to enforce their rights in accordance with the IMF Articles of Agreement. According to BALTENSPERGER and COTTIER:

The lack of procedural avenues for implementing these provisions is of particular relevance in addressing imbalances and the problem of under-or over-valued currencies. There are no procedures available to mandatorily address and solve such problems within the IMF. Members can simply refuse to discuss the matter before the appropriate bodies of the Fund.

Thus, the only multilateral solution that Brazil may exploit is the WTO Dispute Settlement Body, in which Brazil submit a claim against the central economies invoking article XV of the GATT in order to establish consultations with such countries. Yet, is this a good solution? Maybe not, as this WTO solution would be a *time consuming exit* for Brazil without any efficient outcome.

6 Exchange Rate Misalignments and Bilateral Solutions / Currency Swap Agreements

Due to the lack of legal solutions for the problem of the exchange rate misalignments that Brazil is facing, it will be natural to find out other kind of legal and useful solution that may minimize the distortions that the Brazilian balance of payment against the USA is carrying.

According to recent news, the international trade between Brazil and China are increasing in numbers and China is already the first trade partner of Brazil. Therefore, the devaluation of the Yuan by China is affecting the price of the Brazilian export goods. Brazil is facing problems related to the exchange misalignments against the USA and before China too. There are two fronts to deal with.

In the case of China, Brazil has recently entered into a derivative agreement with China, called Currency Swap³³. This agreement is a financial instrument that benefits Brazil and China

³³ Assessoria de Imprensa do Ministério da Fazenda – March 26, 2013 (website visited at April 30, 2013).

in deals involving their currencies (Real and Yuan), such as the international trade between them that result in payments in Reais and in Yuans.

The purpose of the Currency Swap is to hedge against risk exposure associated with exchange rate fluctuations. This agreement ensure receipt of foreign money in case of a lack of it. According to the Brazilian finance minister, Guido Mantega, the agreement will protect both countries from difficulties in their balance of payment accounts³⁴.

The operational side of this agreement may be summarized in accordance with the following description:

- First, there is a swap – Reais for Yuans – between the Central Bank of Brazil and the Central Bank of China. The exchange is based on the market exchange rate at the time of the transaction. The Brazilian Central Bank hold the Yuan in an account at the Central Bank of China, while the Chinese Central Bank deposits the Reais that Brazil provides in account at the Brazilian Central Bank.
- The two central banks agree to swap back the money at the same exchange rate, thus creating no exchange risk for the Brazilian Central Bank, for example. The currencies can be swapped back as early as the next day or as three years, for example.

This Agreement is legally supported by the article 6° of the Law number 11.908/09 and by the Resolution CMN number 4.200, published by the Central Bank of Brazil in the Official Gazette in March 27, 2013. These rules authorize Brazil to deal currencies swaps agreements with foreign central banks and to maintain the currencies in a special account without paying interest rates. In addition, according to the IMF Article VIII, Section 2 (b):

(b) **Exchange contracts which involve the currency of any member and which are contrary to the exchange control regulations** of that member maintained or imposed consistently with this Agreement shall be unenforceable in the territories of any member. In addition, members may, by mutual accord, cooperate in measures for the purpose of making the exchange control regulations of either member more effective, provided that such measures and regulations are consistent with this Agreement. (G.N.).

Although, is necessary more legal analysis on the wording of this IMF Article VIII, it seems that the *Currency Swap Agreement* does not represent any irregularity or any rule that is

³⁴ According to the Wall Street Journal: "...Finance Ministers and central bankers from Brazil and China on Tuesday signed an agreement to swap up to \$30 billion worth of Brazilian real and Chinese renminbi over the next three years, a pact they said could then be renewed." March 26, 2013, 7:21 a.m. ET / By Patrick McGroarty from Durban, South Africa - <http://online.wsj.com/article/BT-CO-20130326-703453.html> (website visited at April 25, 2013).

contrary to the exchange control regulations of the IMF Articles of Agreement.

On the other hand, in a Paper released by the IMF in March 25, 2010, the Fund approve the swap agreements made between the Federal Reserve and other foreign central banks. According to such paper³⁵:

In a move of seminal importance in controlling the crisis, the Fed established, on October 29, 2008, four swap lines for a uniform amount of up to US\$30 billion each with the central banks of Brazil (equivalent to 650 percent of quota), Korea (670 percent of quota), Mexico (620 percent of quota), and Singapore (2,300 percent of quota). This step brought to 14 the number of Federal Reserve swap lines established during the crisis to address the global break-down in the U.S. dollar wholesale funding and swap markets.

Finally, the *currency swap* Agreement justifies a deeper analysis from the legal and economic point of view, as this could be an intelligent solution that, although does not eliminate the exchange rate misalignments, may help the parties to alleviate the impacts of the so-called currency war.

7 Conclusion

The conclusion will be an obvious one that in fact, *currency war* affects the international trade in a negative way. Yet, as a collateral effect, a currency war may develop to a trade war, in which countries establish tariffs barriers and other non-financial barriers to the foreign goods and services. This would be a pre-Bretton Woods era again. The world will return to a *Beggar thy neighbour policy* that destroyed the economy in the beginning of the twentieth century.

In addition, the scenario may deteriorate more. According to IRWIN:

Left unresolved, these tensions over exchange rate policy could give rise to unilateral action. This would not only undermine the credibility of the international institutions that have responsibility in this area, but could lead to damaging retaliation that would be difficult to contain and further harm a weakened world economy.

Moreover, according to the vast majority of scholars and experts, the solution will be the cooperation between the IMF and the WTO to work out over new rules that may minimize the

³⁵ IMF – website: <http://www.imf.org/external/np/pp/eng/2010/032510a.pdf> (website visited at April 28, 2013).

effects of the exchange rate misalignments.

Finally, some questions will remain for further readings and considerations:

1. Would be the ultimate solution for the exchange rate misalignments the bilateral one, such as that answer that came out from Brazil and China, the currency swap agreement?
2. Will legal theories, and scholars, economists, lawyers, practitioners, diplomats, and politicians close the regulatory gaps and promote the IMF, the WTO and other international organization to cooperate and minimize or even solve the problem of the exchange rate misalignments?
3. Will be the international trade damaged because of lack of responsiveness of the political world?

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