A storm is brewing: China at the cross-hairs of U.S. trade sanctions for keeping yuan undervalued

by [Xingjian Zhao] December 30, 2010

China may soon be forced to pay the high price of its cheap currency. On September 24, 2010, the Ways and Means Committee of the U.S. House of Representatives approved H.R. 2378, the Currency Reform for Fair Trade Act of 2010. This Act amends Title VII of the Tariff Act of 1930 "to clarify that fundamental exchange-rate misalignment by any foreign nation is actionable under United States countervailing and antidumping duty laws." Although the House of Representatives overwhelmingly passed the bipartisan measure, its prospect in the Senate is less certain.

This bill reflects U.S. legislators' growing frustration with China's protectionist attitude towards its currency. American trade groups contend that the Yuan is undervalued by as much as 40 percent against the U.S. dollar, increasing the relative cost of American exports in China and making the price of Chinese imports artificially low in the United States. Many see this disparity as a major component of the U.S.'s large trade deficit with China. Notably, Nobel Prize winning economist Paul Krugman estimates that China's currency policy reduces

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the U.S. GDP by an annual rate of 1.4 percent. Other studies show that allowing the Yuan to appreciate to its actual market value would not only enable U.S. manufacturers to be more competitive overseas, but would also create upwards of 500,000 manufacturing jobs in the United States.

Rancor over China's currency policies has been exacerbated in recent months by China's continuing failure to deliver on its recent promise to move to a more flexible exchange-rate system. Since making such a pledge in mid-July at the Group of 20 summits in Toronto, the Yuan has risen less than 2 percent against the U.S. dollar.

The most important element of the bill gives the U.S. Department of Commerce plenary power to impose trade sanctions on foreign governments that engage in manipulative currency practices. As a general matter, under the existing U.S. countervailing duty law, remedial tariffs can be imposed on imports benefiting from foreign government subsidies for export, if it is shown that imports benefiting from such subsidies cause or threaten injury to a U.S. industry producing the same or similar products. To date, however, the Commerce Department has declined to investigate and classify foreign government currency practices as a convertible subsidy. The bill reverses the Commerce Department's longstanding reluctance to find a foreign government culpable of imposing an "export subsidy" if the subsidy in question is not limited exclusively to the circumstances of export (i.e., non-exporters may benefit from a particular currency policy). The bill precludes the Commerce Department from imposing this bright-line rule, and instead requires the Department to consider all the facts in making its export contingency determination. In effect, the Commerce Department may no longer dismiss a claim based on the single fact that a subsidy is available in circumstances in addition to export.

Moreover, the bill provides important guidance to the Department in assessing whether a "benefit" exists in circumstances involving material currency undervaluation resulting from government intervention. Specifically, the Department is directed to assess "benefit" in terms of the additional currency the exporter receives as a result of the undervaluation, and to use widely-accepted IMF standards for determining the extent of undervaluation.

In all cases, however, the bill, as amended, preserves the Commerce Department's authority – and responsibility – to consider each case on its facts and make a determination as to whether all the necessary legal elements of an export subsidy are met. In sum, the Currency Reform for Fair Trade Act aims to make U.S. commercial law and trade policy more consistent with prevailing WTO norms that tend to be more protectionist and less tolerant of manipulative practices such as currency undervaluation. Consequently, under the Act, countervailing duties may only be imposed when the Commerce Department finds, based on an assessment of all the facts, that the WTO criteria for an export subsidy have been satisfied – that is, only if: (1) the foreign government's interventions in the currency markets result in a "financial contribution," (2) a "benefit" is thereby conferred, and (3) the resulting subsidy is "contingent on export."

As a result of its near-universal appeal to diverse constituencies, support for the bill has been strong across the political spectrum. Token opposition during the House hearings has come mainly from those who fear retaliatory sanctions by China on U.S. exports. If ultimately passed by the Senate and signed into law by President Obama, this legislation sends an important message to China that the U.S. will no longer tolerate manipulation of the Yuan. However, the legislation would apply to only a relatively small share of the total trade between China and the United States. As mentioned, only products that are subject to countervailing duties will be penalized. Currently, fewer than 60 products from China are subject to antidumping or countervailing duties.

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Moreover, the Act does not by itself impose duties in any particular instance, for it would merely authorize the Commerce Department to treat currency manipulation as an illegal export subsidy in countervailing duty investigations. Consequently, there is now growing support for even more aggressive action against Chinese currency manipulation, such as a flat 25 percent tariff across all Chinese imports.

A storm is brewing, and China must now seek shelter.