

# **Exchange Rate Measures, Who Judges the Violation? sorting out prerogatives**

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## **INTRODUCTION**

For the last couple of years the effects of exchange rate misalignments on international trade has been discussed at length by the academy and the debate has seen its way into the agenda of the World Trade Organization (WTO).

Worried by the damages that devaluated exchange rates could cause to international trade flows, Brazil has, in April 2011, presented to the Working Group on Trade, Debt and Finance (WGTDF) of the WTO a proposal of an academic research on the relationship between exchange rates and international trade (WT/WGTDF/W/53). Discussions followed and, in September of the same year, the country proposed the examination of the available instruments and trade remedies in the multilateral system that might redress the impacts of exchange rate misalignments (WT/WGTDF/W/57). The WTO Secretariat, upon request of the WGTDF, elaborated a Note on a Review of Economic Literature, in September 2011. Finally, in November 2012, Brazil presented its third proposal, discussing the effects of exchange rate misalignments on trade instruments and examining the possibility of WTO rules to address such effects (WT/WGTDF/W/68). Discussions continue in the WGTDF.

However, although it affects international trade, the issue of exchange rates has been mainly dealt under the International Monetary Fund (IMF), which raises some difficulties regarding the competences of each organization to regulate the subject without overlapping the work of each other. Despite the recent discussions at the WTO, two key issues are still unclear and have been an obstacle to finding adequate solutions and alternatives to the regulation of exchange rate measures: what are the regulatory boundaries of the WTO and the IMF regarding exchange rates; and what are the prerogatives of each institution and the limits of their jurisdictions on the issue.

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Part of the academy as well as some international public agents and government officials believe that the exchange rate issue is exclusive to the IMF. Nevertheless, the history of the organizations and their regulatory systems prove that the WTO and the IMF both dealt in the past and have the legal prerogative to deal today with exchange rate measures<sup>2</sup>.

The lack of regulation on the issue under the multilateral trading system has motivated some actors to negotiate exchange rate clauses under preferential trade agreements. The United States' Automobile industry is now advocating to the inclusion of a mechanism to avoid exchange rate manipulations that may affect market access under the Trans-Pacific Partnership. The proposal bases the notion of manipulation on: (i) the existence of current account surplus over the previous six months; (ii) growth of foreign exchange reserves over the six months period; and (iii) if the country's foreign reserves are sufficient<sup>3</sup>.

This reasoning for the definition of exchange rate intervention is found in an article by Bergsten, that establish these three variables (current account surpluses, levels of reserves, and amounts of intervention) as sufficient to prevent a country from running large and persistent external surpluses that result from efforts to depress the value of its exchange rate<sup>4</sup>.

Bergsten's proposal is important because it shows solutions to the exchange rate issue can be drafted through the regulation of the subject under preferential trade agreements, where negotiations can be easier than under the WTO.

This article aims at adding to the debate by sorting out what are the prerogatives of each organization and which one would be responsible for addressing different types of state measures relating to exchange rates. Also, this article aims to decipher what would be the IMF role in a dispute involving exchange rate brought before the dispute settlement body (DSB) of the WTO.

It is organized in two sections:

First, the article demonstrates that the IMF was created to guarantee the global financial stability, creating mechanisms to further stabilize balance of payments and to manage a fixed exchange rate system. On the other hand an organization was conceived to deal with trade issues (ITO) including exchange rate measures which could bear important consequences to trade. This organization did not come into being and the survivor GATT held some of the legal instruments that dealt with exchange rate measures.

Nevertheless, during its existence, the IMF changed its role and prerogatives regarding exchange rate measures, especially after the fall of the par value system. The new role

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<sup>2</sup> See THORSTENSEN, Vera, RAMOS, Daniel, MÜLLER, Carolina, "The 'Missing Link' between the WTO and the IMF", *Journal of International Economic Law*, vol. 16, n. 2, July, 2013.

<sup>3</sup> American Automotive Policy Council, "To Ensure a Level Playing Field, US Automakers Support the Inclusion of Strong Enforceable Currency Provisions in the Trans-Pacific Partnership.

<sup>4</sup> BERGSTEN, Fred, "Addressing Currency Manipulations Through Trade Agreements", *Peterson Institute for International Economics*, PB14-2, January, 2014, p. 4

and mechanisms of the IMF were well adapted to the new economic reality, but no longer guaranteed exchange rate neutrality for trade purposes. It would now be incongruent, and politically implausible, for the IMF to condemn a country as a currency manipulator since it is one of the many macroeconomic mechanisms at the disposal of its members to deal with balance of payments difficulties. At the same time, without suffering any adaptations to this new reality, the multilateral trading system risked having its objectives frustrated by the effects of these unregulated exchange rates.

The second part of the article, and most important section, will analyze the main legal mechanism in GATT to deal with exchange rate measures: GATT Article XV. It is a complex article which brings several different obligations to the WTO and its members relating to exchange rates and the relationship between the WTO and the IMF. Through an analysis of the wording of the Article, it will be shown that some terms bear important consequences to the prerogatives of each organization and their jurisdiction over exchange rate measures. Some of these terms appear also in the Articles of Agreement of the IMF and their analysis offer further clarifications to sorting out each organization's prerogatives.

## **SECTION I**

The IMF was created after the economic turmoil of the 1930s, when competitive exchange rate devaluations became common practice amongst nations. The organization, created in 1944, in Bretton Woods, aimed at regulating the international financial system in order to promote global financial stability.

This stability would be achieved by the implementation of mechanisms to deal with balance of payments issues as well as the creation of a fixed exchange rate system, based on the dollar-gold standard, that would prevent the practices adopted in the 30's, of exchange rate devaluations aiming at improving countries' competitive positions, but that risked to initiate a vicious cycle of retaliatory actions<sup>5</sup>.

The monetary system comprehended a pair value system based on the convertibility of the dollar to gold. Each country should express the pair value of its currency in terms of gold or US dollars and were obliged to maintain such pair value within 1% of the parity established by the Fund<sup>6</sup>. The system would not only promote financial stability, but it would avoid competitive devaluations that could harm international trade.

Thus, the original Section 4 of Article IV of IMF's Articles of Agreement would read:

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<sup>5</sup> BOUGHTON, James, "The IMF and the Force of History: Ten Events and Ten Ideas That Have Shaped the Institution", *IMF Working Paper*, May, 2004 (WP/04/75), p. 5

<sup>6</sup> See original Article IV of IMF's Articles of Agreement

“a) Each member undertakes to collaborate with the Fund to promote exchange stability, to maintain orderly exchange arrangements with other members, and to avoid competitive exchange alterations.”

The Bretton Woods system was composed by another two pillars: the Bank for International Reconstruction and Development, created in 1944 and later expanded into the 5 institutions of the World Bank Group, which aimed to become a facilitator of the post-war reconstruction; and the International Trade Organization (ITO). The ITO intended to deal with the rules on international trade, but its agreement was never ratified by the US Congress, and did not enter into force. Nevertheless, the gap left by ITO was fulfilled by the General Agreement on Tariffs and Trade (GATT), which presented a narrower set of rules on international trade than the ITO, and which became the base of the international trading system until the creation of the World Trade Organization (WTO) in 1995.

The GATT was drafted taking into consideration the dollar-gold standard preconized by the IMF. In that context, the effects that competitive exchange rate devaluations could have on trade were a minor concern, since currencies were strictly controlled by the Fund, under a pre-established value. Due to this fact, only a few articles in the GATT expressly deal with the relations between exchange rates and trade, mainly Article II:6 and Article XV.

GATT Article II:6 allowed contracting parties to adjust their specific duties bound in their Schedules if their respective currencies had suffered a devaluation consistent with the IMF Articles of Agreement of more than 20%. There are two important aspects that should be noted in this article. First, it recognizes the effects that exchange rates have on tariffs and it provides a mechanism that allows addressing such effects in case of any devaluation promoted within the Fund<sup>7</sup>. Second, the article evidences that the multilateral trading system was drafted based on the pair value system assured by the IMF.

GATT Article XV also refers to the strong link between international trade and exchange rates. Paragraph 4 states that contracting parties shall not, by exchange action, frustrate the intent of the provisions of the GATT, nor, by trade action, frustrate the intent of IMF's Articles of Agreement. Again, the article expressly recognizes the impacts that exchange rate may have on trade and it completes the provisions of IMF Article IV, regarding the prohibition of competitive exchange rate devaluations.

This legal arrangement and the relative neutrality of exchange rates to trade were compromised when Nixon announced the end of the convertibility of dollars to gold, in 1971. Other currencies were pressured to float and the whole pair value system established in Bretton Woods collapsed.

IMF Article IV would have to be completely reformed to adapt to the new monetary context created after the Nixon shock. The Second Amendment of IMF's Articles of

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<sup>7</sup> For a deeper analysis on the effects of Exchange rates on tariffs, see: THORSTENSEN, Vera, MARCAL, Emerson, and FERRAZ, Lucas, 'Impacts of Exchange Rates on International Trade Policy Instruments: The Case of Tariffs', *Journal of World Trade*, 46(3), 2012.

Agreement, adopted on April 29<sup>th</sup>, 1977 (Decision n, 5392-(77/63)) would eliminate the obligation of members to maintain a fixed exchange rate and would allow them to choose between five different exchange policies: (i) a freely floating currency; (ii) the pegging of a currency to another currency or basket of currency; (iii) the adoption of the currency from another country; (iv) the participation in a currency bloc; and (v) the participation in a monetary union. Pegging a currency to gold was forbidden.

The strict control that the Fund had over its members' currencies was transformed into a Surveillance Mechanism over exchange rate policies, but even this mechanism evolved to encompass other macroeconomic considerations, leaving the surveillance over exchange rates to a second plan<sup>8</sup>.

The concern over the impacts of competitive exchange rate manipulations was kept in the new version of Article IV:

Section 1 – 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; (...)

Nevertheless, the wide range of exchange rate policies accepted by the fund, together with the lack of a mechanism of firm control over such policies would make the task of determining and effectively preventing any exchange rate manipulation extremely difficult.

It is important noticing that the wording of Article IV leads to the interpretation that members shall avoid exchange rate manipulations that have as intent gaining unfair competitive advantages. Since a series of exchange policies are allowed, it would be hard to determine whether an exchange rate measure would constitute a manipulation that intended to gain competitive advantages or if it is just a measure that has legitimate objectives even if it presents collateral impacts on trade. Originally, the IMF had an objective control over exchange rates – it could not vary more than 1% from the parity established by the Fund. In the new system, the evaluation became subjective – one needs to verify if the manipulation intended to achieve an unfair competitive advantage.

Although, as previously presented, the world trading system was drafted based on the collapsed dollar gold standard, the GATT did not promote structural changes in its rules.

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<sup>8</sup> For a deeper analysis, see THORSTENSEN, Vera, RAMOS, Daniel, MÜLLER, Carolina, “The ‘Missing Link’ between the WTO and the IMF”, *Journal of International Economic Law*, vol. 16, n. 2, July, 2013

After the Tokyo Round, the only relevant adaptation to this new context of floating exchange rates was related to Article II:6. The Guidelines for Decisions under Article II:6(a) of the General Agreement, adopted on January 29<sup>th</sup>, 1980 (L/4938, 27S/28-29), created a methodology for calculating the 20% currency devaluation that would trigger the right of countries to adjust their bound specific tariffs.

The contracting parties did not promote any further changes on trade rules regarding the new context of floating exchange rates. Article XV, the main link between the rules on exchange rates under the IMF Articles of Agreement and the regulation of international trade, remained the same.

In any case, the GATT provisions on exchange rates present important differences from the rules under the IMF. GATT Article XV:4, prohibits that, by an exchange action, the contracting parties frustrate the intent of the provisions of the GATT. The provision oversees actions that have as effect to frustrate the rules of the multilateral trading system, regardless whether the intent of the action was to gain an unfair advantage or if this frustration was just a side effect.

The interpretation on the exact extent of this paragraph, as well as the relationship of the whole Article XV with the IMF Articles of Agreement is complex. The revolution suffered by the international monetary system after the end of the dollar-gold standard and the lack of changes in the trading system regarding the matter rendered the task even more difficult.

The following section is an attempt to delimit the scope of Article XV and to define which is the role of each institution (the IMF and the WTO) in an eventual WTO dispute that deals with the impacts of exchange rates on international trade.

## **SECTION II**

The GATT has several mechanisms that deal with or that refer to exchange rate measures and their consequences on trade: the already mentioned Article II:6; the Ad note to paragraphs 2 and 3 of Article VI, regarding multiple currencies practices; Article VII, on customs valuation, amongst others. The main mechanism, though, is its Article XV. It establishes rules regarding exchange rate measures and it is the main link between the multilateral trading system and the international monetary system.

With the end of the par value system, exchange rates are no longer neutral regarding trade and the importance of Article XV has grown. However, since the IMF is the organization whose mandate expressly deals with exchange rate issues, many commentators have argued that the correct application of Article XV would depend on the IMF's judgment of the terms and mechanisms contained in the article.

In this sense, some important questions arise. What is its relation between GATT Article XV and Article IV of IMF Articles of Agreement? What is the difference between

manipulating exchange rates (intent) and frustrating trade objectives (effects)? What is the role of the IMF in a dispute before the DSB involving GATT Article XV interpretation? The answers must be found through a careful legal analysis of Article XV and other instruments of each institution. Four terms will be explored: exchange arrangements; exchange action; exchange restrictions and exchange controls.

### *Common titles – the meaning of exchange arrangements*

The term “exchange arrangements” is present in the heading of both GATT Article XV and IMF Article IV, showing the link between both provisions. Nevertheless, the “exchange arrangement” in the GATT has a broader meaning, which encompasses several exchange measures and policies. This interpretation can be confirmed by the French translation of the title – also authentic, according to GATT Article XXVI – which reads “*matière de change*”, pointing to its broad scope, while the French translation of IMF article IV reads “*régimes de change*”. There is, thus, a distinction of the precise meaning of both titles in the GATT Article XV and in IMF Article IV.

### *The obligation to coordinate*

Article XV brings several different legal obligations:

Paragraph 1 establishes the cooperation between the GATT/WTO and the IMF, in order to achieve a coordinated policy regarding exchange questions within the jurisdiction of the Fund. The article recognizes the relation between trade and exchange rates and the impacts that one can have on the other.

As presented before, the international economic system was designed as an integrated system of three institutions. The overlap of jurisdictions in some issues was always expected and the coordination between them was essential to assure the coherence of the international economic system.

The provision seems to define that the IMF deals normally with exchange questions and the multilateral trading system with quantitative restrictions and other trade measures. Still the paragraph restricts the coordination to each organization’s jurisdiction.

### *The obligation to consult on monetary reserves, balances of payments and foreign exchange arrangements*

Paragraph 2 deals with consultation with the Fund. The paragraph reads:

In all cases in which the CONTRACTING PARTIES are called upon to consider or deal with problems concerning monetary reserves, balances of payments or foreign exchange arrangements, they shall consult fully with the International Monetary Fund. In such consultations, the CONTRACTING PARTIES shall accept all findings of statistical and other facts presented by the Fund relating to foreign exchange, monetary reserves and balances of payments, and shall accept the determination of the Fund as to whether action by a contracting party in exchange matters is in accordance with the Articles of Agreement of the International Monetary Fund, or with the terms of a special exchange agreement between

that contracting party and the CONTRACTING PARTIES. The CONTRACTING PARTIES in reaching their final decision in cases involving the criteria set forth in paragraph 2(a) of Article XII or in paragraph 9 of Article XVIII, shall accept the determination of the Fund as to what constitutes a serious decline in the contracting party's monetary reserves, a very low level of its monetary reserves or a reasonable rate of increase in its monetary reserves, and as to the financial aspects of other matters covered in consultation in such cases.

The first sentence of the paragraph establishes an obligation to consult fully with the IMF in cases concerning monetary reserves, balances of payment and foreign exchange arrangements. The rationale of this provision is, once more, to assure coherence and a dialogue between the WTO and the IMF in trade matters that affect the jurisdiction of the Fund. In this sense, the Appellate Body, in the case *Argentina – Textiles and Footwear*, stated that:

The only provision of the WTO Agreement that requires consultations with the IMF is Article XV:2 of the GATT 1994. This provision requires the WTO to consult with the IMF when dealing with 'problems concerning monetary reserves, balances of payments or foreign exchange arrangements'.<sup>9</sup>

The conversations with the Fund are, thus, mandatory only in the specific cases concerning monetary reserves, balance of payments or foreign exchange arrangements. Furthermore, the obligation of entering into consultations does not imply that the WTO must accept all findings of the IMF.

#### *The obligation to accept facts and statistical findings*

The following sentence of Article XV:2 clarifies this point. It states that the parties shall accept facts and statistical findings presented by the Fund as well as determinations regarding the conformity of a measure with IMF Articles of Agreement. On the other hand, this means that any findings that do not fall under those specific definitions do not need to be accepted by the parties.

The logic is that the IMF has no jurisdiction on the interpretation of the WTO Agreements, but only on its own Articles of Agreement. In this sense, in a dispute settlement under the WTO, even if related to monetary reserves, balance of payments or foreign exchange arrangements which are issues also handled by the Fund, the IMF is not competent to analyze any eventual breach of WTO provisions, but only to establish the facts and statistics that may sustain the interpretation of the Dispute Settlement Body as well as the conformity of the measure with the Fund's rules. This assures that there is no overlapping of jurisdiction between the WTO and the IMF in matters that affect both organizations.

In this sense, the Appellate Body in *India – Quantitative Restrictions*, answering India's claim that the panel had delegated to the IMF the objective assessment of case – which

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<sup>9</sup> WTO, *Argentina - Measures Affecting Imports of Footwear, Textiles, Apparel and Other Items*, AB Report, WT/DS56/AB/R, 27 March 1998, para. 84-85



would be a violation of Article 11 of the Dispute Settlement Understanding (DSU), stated that:

The panel gave considerable weight to the views expressed by the IMF in its reply to these questions [asked by the panel in its consultation to the Fund]. However, nothing in the Panel Report supports India's argument that the Panel delegated to the IMF its judicial function to make an objective assessment of the matter. A careful reading of the Panel Report makes clear that the Panel did not simply accept the views of the IMF. The Panel critically assessed these views and also considered other data and opinions in reaching its conclusions.<sup>10</sup>

The statement confirms the interpretation that the panel is not obliged to accept the results from consultations with the Fund, unless they consist in facts and statistical findings. On the contrary, the panel must carefully analyze the conclusions of the Fund and other evidence and arguments at its disposal in order to reach its conclusion. The consultation under Article XV:2 promoted by the panel in the case had merely a status of consultations with an expert, in the sense of DSU Article 13.

#### *The obligation to accept findings of the Fund*

The third sentence of Article XV:2 refers to other situations where parties must accept the findings of the Fund, especially regarding monetary reserves, which is a matter within the jurisdiction of IMF.

Article XV:3 states that the CONTRACTING PARTIES shall seek agreement with the IMF on the procedures of the consultations of the previous paragraph.

#### *The obligation not to frustrate trade objectives: what are trade actions?*

Article XV:4 brings the most relevant provision regarding the exchange rate issue:

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.

The provision aims to avoid that exchange actions – under the jurisdiction of the Fund – harm international trade and hamper the objectives of multilateral trade rules.

The first step in interpreting this article is to demine the meaning of “exchange action”. As presented before, the title of Article XV is exchange arrangements. Since the title should guide the interpretation of the several provisions in the article<sup>11</sup>, one can assume that exchange action is an element comprised in an exchange arrangement, which has a broad meaning, encompassing several types of measures related to exchange rates.

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<sup>10</sup> WTO, India – Quantitative Restrictions on Imports of Agricultural, Textile and Industrial Products, AB Report, WT/DS90/AB/R, 23 August 1999, para. 149

<sup>11</sup> See WTO, China – Measures Related to the Exportation of Various Raw Materials, Appellate Body Reports, 30 January 2012, WT/DS394/AB/R, para.320

Nevertheless, there is no jurisprudence on the matter. The definition of the expression is complex and can lead to different interpretations. An exchange action could be understood both as a governmental measure that affects the availability or use of foreign exchange, or as an intervention on the exchange rate.

In the first sense, the action would deal exclusively with the access to currencies and not with the exchange rate of such currencies. GATS Article XI:2, for instance, when referring to the use of exchange actions in payments and transfers related to trade in services, seems to adopt this first meaning to the expression. The provision aims to assure access to international currencies in order to pay the provided services. In this sense, the Panel, on the case *US – Gambling* stated that “*In ensuring, inter alia, that services suppliers can receive payments due under services contracts covered by a Member’s specific commitment, Article XI is an indispensable complement to GATS disciplines on market access and national treatment.*”<sup>12</sup>

The second meaning of exchange action can be understood as an exchange rate action. In this case, the action would refer to a direct or indirect intervention in the exchange rate market, affecting the exchange rate of the currency. IMF Article IV deals with those exchange rate actions when referring to the obligation of members to avoid manipulating exchange rates, since the logic of the provision is to prevent members from promoting competitive currency devaluations – which are the result of a governmental intervention in the exchange rate market. Paragraphs 6 and 7 of GATT Article XV also seem to be concerned with governmental interventions on exchange rates. The main worry of those paragraphs was to assure the regulation of a contracting party’s currency by the Fund, in order to prevent that objectives of the GATT were frustrated by exchange matters.

As presented before, the GATT, in its origins, relied on the strict regulation imposed by the IMF to prevent competitive currency devaluations that could affect international trade. By assuring that contracting parties to the GATT were members of the Fund or had an agreement with it, the GATT could guarantee that competitive exchange rate devaluations would be avoided.

GATT Article XV:4, by its turn, could encompass both meanings of the expression. Competitive currency devaluations can affect international trade frustrating the objectives of the multilateral trading system, but measures that affect access to foreign currencies also have such effect, since they prevent the payment of the imports, restricting trade flows.

The precise meaning of the expression “exchange action” was never clarified by the GATT or WTO Dispute Settlement and the results of a dispute based on Article XV:4 is uncertain. The applicability of Article XV:4 is further affected by the exception in Article XV:9 that deals with exchange restrictions and controls, which will be explained below.

*The meaning of frustration x the meaning of manipulation: a matter of intent*

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<sup>12</sup> WTO, *US – Measures Affecting the Cross-Border Supply of Gambling and Betting Services*, Panel Report, 10 November 2004, WT/DS285/R, para 6.442

The next step on the interpretation of Article XV:4 is to define the word “frustrate” and analyze how it differs from the word “manipulation” present in IMF Article IV.

The Ad Note to Article XV:4 clarifies that:

The word “frustrate” is intended to indicate, for example, that infringements of the letter of any Article of this Agreement by exchange action shall not be regarded as a violation of that Article if, in practice, there is no appreciable departure from the intent of the Article. Thus, a contracting party which, as part of its exchange control operated in accordance with the Articles of Agreement of the International Monetary Fund, requires payment to be received for its exports in its own currency or in the currency of one or more members of the International Monetary Fund will not thereby be deemed to contravene Article XI or Article XIII. Another example would be that of a contracting party which specifies on an import licence the country from which the goods may be imported, for the purpose not of introducing any additional element of discrimination in its import licensing system but of enforcing permissible exchange controls.

In this sense, there will be a frustration of the intent of the GATT provisions if there is an “appreciable departure” from the situation provided by other GATT provisions. Therefore, although there may not be a direct violation of the provisions of the General Agreement, the aims of such rules will be disrupted due to an exchange action. In this sense, a violation of GATT Article XV:4 shall only be verified if there is evidence on which other GATT Article had its intents frustrated.

The “frustration” of the GATT provisions does not necessarily imply in the “manipulation” of exchange rates in the sense of IMF Article IV. While the manipulation of exchange rates in order to gain competitive advantages does frustrate the intents of the multilateral trading system, other measures related to exchange rate that do not constitute a manipulation may also frustrate trading rules.

In this sense, it is fundamental to separate the “frustrators” from the “manipulators”. A violation of the IMF is not required for the determination of a violation of Article XV:4, except in what relates to the exception of Article XV:9, explained below.

This is especially relevant if considered the great changes suffered by the IMF, where the strict control over exchange rates became a fragile surveillance system. Even though it has become difficult to determine the manipulation of an exchange rate, considering the wide range of systems allowed by the fund, an exchange action can still be considered to frustrate the intent of GATT provisions and thus, violate GATT Article XV:4.

The two concepts are distinct in what relates to the focus of the analysis: while the concept of manipulation looks at the intent of the measure – to prevent effective balance of payments adjustment or to gain an unfair competitive advantage – the concept of frustration looks at the effect of the measure – to frustrate GATT provisions, regardless the objective of the measure.

This means that to determine a violation of IMF Article IV, evidence must show that the measure had as its aim to effectively gain competitive advantages. Such determination also depends on the political will of the IMF, since the organization does not dispose of a dispute settlement system as the WTO. On the other hand, in the GATT, the mere verification of the impacts of the measures in the GATT rules is sufficient to constitute a violation of the provision, without the need to establish which was the primary aim of the measure. In this case, there is no need to find the manipulators, but only to tackle the effects caused by exchange rate misalignments.

Therefore, while a manipulator of exchange rates, in the sense of IMF Article IV is necessarily a frustrator of the provisions of GATT, in the sense of GATT Article XV:4, the opposite is not always true and there may be frustrators which are not manipulators.

*The exceptions of GATT Article XV:9 : exchange rate restrictions and controls*

The applicability of GATT Article XV:4 to exchange rate misalignments is restrained by the exception present in paragraph 9 of the same Article.

Article XV:9 reads:

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 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.

The paragraph aims to avoid that the trading system impairs the mechanisms and rules of the international monetary system. It creates an exception in order to prevent contradictions between the jurisdictions of the two institutions. One of IMF's main functions is to ensure the stability of its members' balance of payments. For this reason, some controls and restrictions are allowed in its Articles of Agreement. In such cases, the contracting parties to the GATT may depart from the provisions of the Agreement, as long as the controls and restrictions imposed are in accordance with the rules of the IMF. A similar exception is found in GATS Article XI, which safeguards the right of members to use exchange actions in accordance with the IMF.

Article XV:9 refers to yet another two expressions related to exchange rates: "exchange controls" and "exchange restrictions", which must be defined in order to determine the precise scope and range of the provision. It is necessary to remark that these expressions must have a different meaning that "exchange actions" present in Article XV:4. Otherwise, if all expressions had the same meaning, the exception of Article XV:9 would encompass all the obligation stated under Article XV:4, which would be devoid from any meaning. In this sense, the Appellate Body, in the case *Korea-Dairy*, affirms that:

In the light of the interpretative principle of effectiveness, it is the duty of any treaty interpreter to ‘read all the applicable provisions of a treaty in a way that gives meaning to all of them, harmoniously’. An important corollary of this principle is that a treaty should be interpreted as a whole, and, in particular, its sections and parts should be read as a whole.<sup>13</sup>

The IMF Articles of Agreement can help to shed some light in the interpretation of these expressions.

Regarding exchange restrictions, IMF Article VIII:2(a) restrains members from imposing restrictions on the making of payments and transfers for current international transactions without the approval of the Fund. According to Siegel, the provisions relates to outflows, such as payments for imports of goods and services, covering only current transactions<sup>14</sup>.

In 1960, the Executive Board established that a measure is a restriction on payments and transfers for current transactions if it involves a direct governmental limitation on the availability or use of exchange as such, regardless of the effect of the measure. Thus, a restriction would result from any governmental action that hampers the making of payments and transfers for current international transactions, including the acquisition of foreign exchange for such payments and transfers<sup>15</sup>.

According to Zimmerman, another form of restriction relies on capitals movements. IMF Article VI:3 allows members to regulate capital movements, covering both inflows and outflows, as long as they do not restrict payments for current transactions. This provision authorizes the regulation of international capital movements through both restrictive and nonrestrictive exchange measures.<sup>16</sup>

These definitions can be understood as the “exchange restrictions” referred in GATT Article XV:9, since the *rationale* of the article is exactly to avoid that measures allowed by the Fund are restrained by the trading system. In this sense, exchange restrictions related to payments and transfers, when approved by the Fund, under the conditions of IMF Article VIII:2(a), fall under the exception of GATT Article XV:9 and shall not be precluded by any provision of the General Agreement. Since, as a general rule, these kind restrictions are prohibited by the Fund, with only a few circumstances where they may be accepted – notably, for balance of payment purposes, there will only be a limited number of exchange restrictions related to payments and transfers that will be exempt from the obligations of the GATT. On the other hand, exchange restrictions related to the movement of capitals, which are allowed by the Fund, shall usually fall within the exception of Article XV:9, so that the GATT will not be able to address the impacts that might be caused by such restrictions.

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<sup>13</sup> WTO, Korea – Definitive Safeguard Measure on Imports of Dairy Products, Appellate Body Report, 14 December 1999, WT/DS98/AB/R, para. 79

<sup>14</sup> SIEGEL, Deborah, “Legal Aspects of the IMF/WTO Relationship”, *American Journal of International Law*, v. 96, 2002, p. 600

<sup>15</sup> SIEGEL, Deborah, “Legal Aspects of the IMF/WTO Relationship”, *American Journal of International Law*, v. 96, 2002, p. 601

<sup>16</sup> ZIMMERMAN, Claus, “Exchange Rate Misalignment and International Law”, *American Journal of International Law*, v. 105, 2011, p.465

Regarding exchange controls, Siegel affirms that they belong to a broader concept than exchange restrictions and extends to other kinds of regulation on current transactions, as well as capital controls, which may be permitted by the Fund as long as it does not fall in the category of prohibited exchange restrictions under IMF Article VIII. These nonrestrictive controls can comprise as well measures that do not affect the payments and transfers for current transactions, such as surrender requirements and controls on capital transfers.<sup>17</sup> All these measures fall within the exception of GATT Article XV:9 and outside the scope of the multilateral trading system.

It is worth noticing that the decision upon whether a control or restriction is in conformity with the IMF Agreement and, thus, fall within the exception of GATT Article XV:9 shall be promoted by the IMF, in accordance with GATT Article XV:2. This is due to the notion that each institution has jurisdiction over its own rules and the WTO could not analyze violations of an agreement outside its scope. Nevertheless, it is up to the WTO to decide whether a given measure constitute an exchange control or restriction in the meaning of Article XV:9.

The WTO Dispute Settlement Body has analyzed, in the case *Dominican Republic – Imports and Sales of Cigarettes*, whether a measure was an exchange restriction in the sense of Article XV:9. The Dominican Republic had imposed a foreign exchange fee for foreign exchange transactions which was computed on the value of imports at the selling rate of foreign exchange and applied upon the “importation” of a product. Honduras alleged that the measure was merely an import charge – under the jurisdiction of the WTO, while the Dominican Republic classified the measure as an exchange control, because it was a direct governmental limitation on the availability or use of exchange as such, which would fall under GATT Article XV:9.

The panel noted that the foreign exchange fee only applied to importation of goods, but not to foreign exchange payments of non-import related services or to foreign currency payments made by Dominican Republic residents, nor to remittance of dividends from companies located in the Dominican Republic. The panel concluded that the measure did not constitute an exchange restriction under Article XV:9 and further affirmed:

“The Panel considers that the ordinary meaning of the "direct limitation on availability or use of exchange ... as such" means a limitation directly on the use of exchange itself, which means the use of exchange for all purposes. It cannot be interpreted in a way so as to permit the restriction on the use of exchanges that only affects importation. To conclude otherwise would logically lead to the situation whereby any WTO Member could easily circumvent obligations under Article II:1(b) by imposing a foreign currency fee or charge on imports at the customs and then conveniently characterize it as an "exchange restriction". Such types of measures would seriously discriminate against imports while not necessarily being effective in achieving the legitimate goals under the Articles of Agreement of the IMF. Therefore, the Panel finds that because the fee as currently applied is imposed only on foreign exchange transactions that relate to the importation of goods, and

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<sup>17</sup> SIEGEL, Deborah, “Legal Aspects of the IMF/WTO Relationship”, *American Journal of International Law*, v. 96, 2002, p. 606

not on other types of transactions, it is not "a direct limitation on the availability or use of exchange as such"<sup>18</sup>.

The Dominican Republic alleged that the foreign exchange fee had been approved by the IMF as a part of its stand-by arrangement with the Fund and, thus, it would be in accordance with the IMF rules<sup>19</sup>. The Panel then decided to consult with the IMF, even though acknowledging it was not obligated to<sup>20</sup>, and asked the Fund i) how the measure was being applied by the Dominican Republic and whether ii) the measure constituted an exchange restriction in the sense of IMF Articles of Agreement. The IMF stated the measure was not payable on sales of foreign exchange, rather, it was payable as a condition for the importation of goods. It also stated that:

As applied since August 2002, the exchange commission is no longer a measure subject to Fund approval. (...) As such, it does not constitute *a multiple currency practice or an exchange restriction notwithstanding its label* or the fact that the commission is charged on the basis of the legal authority vested in the BCRD to charge an exchange commission on sales of foreign exchange. For the same reasons, it is not an exchange control measure (...) "the issue of its consistency or inconsistency with the Funds Articles for purpose of paragraph 8 of the Co-operation Agreement does not arise."<sup>21</sup> (Emphasis added)

It becomes clear from this case<sup>22</sup> that the IMF has no jurisdiction to analyze exchange actions that may violate trade obligations in the WTO other than the specific cases of multiple currency practices or exchange restrictions or controls.

#### *Other exchange actions than exchange controls or restrictions*

Based on these concepts of exchange controls and restrictions, one can wonder if there are other measures related to exchange rates that do not constitute exchange controls and restrictions allowed by the IMF, but that still can be classified as an "exchange action" in the meaning of GATT Article XV:4. These would be the measures that, when frustrating the intents of GATT provisions, could be addressed by the WTO without considering whether they violated IMF rules.

The relationship between paragraphs 4 and 9 of GATT Article XV can be explained by this reasoning. While exchange actions constitute a broad concept that may include a wide range of measures, including exchange controls and restrictions, these last two concepts should be understood as a sub-category of exchange actions. The Ad Note to Article XV:4 confirms this interpretation when affirming that a contracting party which imposes a measure as part of its exchange control operated in accordance with the IMF Articles of Agreement shall not be deemed to contravene GATT provisions.

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<sup>18</sup> WTO, Dominican Republic – Measures Affecting the Importation and Internal Sale of Cigarettes, Panel Report, 26 November 2004, WT/DS302/R, para. 7.138

<sup>19</sup> First written submission of the Dominican Republic, paras. 199-201.

<sup>20</sup> WTO, Dominican Republic – Measures Affecting the Importation and Internal Sale of Cigarettes, Panel Report, WT/DS302/R, 26 November 2004, para. 7.141

<sup>21</sup> Letter from the General Counsel of the International Monetary Fund, Annex D to the WTO, Dominican Republic – Measures Affecting the Importation and Internal Sale of Cigarettes, Panel Report, WT/DS302/R, 26 November 2004

<sup>22</sup> This particular point of the Panel decision was not appealed by either part to the dispute.

As presented, the exception of paragraph 9 encloses restrictions on current transactions if approved by the Fund, restrictions on capital movements, and exchange controls on current transactions and on capital movements. The main question is: are there any other types of exchange actions that are outside these listed measures?

For instance, how may exchange interventions be classified according to the definitions of exchange action, exchange restriction and exchange controls? How about accumulation of reserves?

## **CONCLUSION**

The exchange rate issue is closely linked to both the IMF and to the WTO. While the major responsibility of dealing with the subject fell under the IMF, which, at its beginning had as one of its main purposes to exert a firm control over the par value system, it is undeniable that exchange rates affect international trade. The GATT relied on the control promoted by the IMF but it has, nevertheless, regulated the impacts that exchange rate might have on trade through its Article XV, especially paragraph 4, that prevents exchange actions to frustrate the intents of the GATT.

The regulation of the relationship between exchange rates and trade became more complex with the fall of the par value system. The IMF suffered deep changes which led to a softer surveillance mechanism on the now floating exchange rates, but the GATT and later the WTO did not promote any adaptations in order to deal with this new context. The GATT Article XV, main provision on the issue, remained unchanged.

Due to the relationship between the IMF and the GATT/WTO regarding the exchange rate issue, addressing the impacts of exchange on trade faces many challenges. It is necessary to assure the coherence between the multilateral trading system and the international financial system and to avoid the overlapping of jurisdictions between the two institutions. For this reason, GATT Article XV cannot be read separately from the IMF's Articles of Agreement.

Nevertheless, despite the link with the Fund's rules, at least some of the impacts of exchange rates on trade can be addressed under the WTO, independently of IMF.

Article XV:2 states the need of consultations with the Fund in cases related to exchange rates, but it affirms that the conclusions of the Fund must be accepted only when related to facts and statistical findings and when related to the conformity of a measure with the IMF's own Articles of Agreement.

The exception of Article XV:9, regarding exchange controls and restrictions does prevent that some exchange measures are deemed as violations to the GATT. But other measures that do not fall in the category of exchange controls and restrictions in conformity with the IMF can be addressed by Article XV:4 regardless of whether they are in breach of



IMF rules. Such measures can include both measures in disconformity with IMF rules as well as measures outside the jurisdiction of the IMF, which are simply not regulated by the Fund.

The interpretation of paragraphs 4 and 9 of GATT Article XV is challenging due to a series of factors: the provisions were conceived under a different context of gold-dollar standard, that does not reflect the current reality, there is lack of previous GATT and WTO jurisprudence that could clarify some points of these provisions and finally, there is a vast number of measures that can be promoted by governments which affects exchange rates and may bear an impact on trade.

The analysis on the possibility of classifying the current practices that result in exchange rate misalignments under the expressions “exchange action”, “exchange control” and “exchange restriction” and, by consequence, the determination of the jurisdiction of the IMF or of the WTO over the issue is complex and challenging, but is the necessary path to deal with the impacts of misaligned exchange rates on trade.

Considering the magnitude and persistence of exchange rate misalignments applied in the recent period and their effects on trade instruments such as tariffs and trade defence, it is time to the affected members to take a more definitive position about the issue – either to negotiate a solution in General Council or to bring a case to the WTO Dispute Settlement Body to have a definitive interpretation on the matter. Time is ripe to open the discussion about exchange rate and the efficacy of WTO rules.

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