Export Enhancement, WTO Rules and Financial Crises

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Abstract

This paper reassesses the current WTO rules on export assistances in light of the global financial crisis. Our empirical analysis shows that export enhancing measures had positive effects on household consumption, implying that such measures were necessary to prevent the domestic economy from falling into deeper recession wrought by the financial crisis. The domestic economy is in a dilemma during a financial crisis because, on the one hand, it must rescue the economy, but on the other, it must not hurt the other exporters. In view of this polemic, this paper points out that the current law is inadequate in that it fails to take into account important and highly relevant economic issues pertaining to the current global financial crisis.

Keywords: Financial Crisis; export assistance; WTO; China.

I. *Introduction*

This article aims to shed new light on the controversial topic of export subsidies, which are commonly viewed to be in contravention of the rules of the World Trade Organization ("WTO"). The effects of government support on exports have been proven by previous research,[1] but are also widely recognized to adversely affect the trade interests of other WTO members. For example, not only may products of subsidized firms displace imports in the domestic market, but exports of subsidized firms may displace exports of third countries or products of otherwise competitive domestic producers in the importing country.[2] In the case of China, there is also widespread concern that the subsidizing of China's exports, especially via maintenance of RMB undervaluation, would lead to a worsening of the trade imbalance between China and the United States. However, the damage inflicted to the export industry by a global financial crisis ("GFC") and the importance of the export industry to China's economy may present a situation that necessitates assistance in some form or another. This paper shows using recent Chinese survey data that exports have a positive influence on China's consumption and thus its GDP.

As such, increased revenues from exports would help to keep producers afloat, prevent worsening unemployment, and contribute to the stability of the domestic and global economy. Furthermore, it would help to raise the consumption of imported goods, thus offsetting to some extent the worsening of the Sino-US trade imbalance. China's huge consumer market would also play a vital role in absorbing excess production by the rest of the world. A minimum threshold level of assistance that can be relied upon during times of economic distress would thus help to promote mutual tolerance in times of trouble and thus foster healthy relationships between nations. However, the need of China to provide sustenance for the level of its consumption through the support of exports must be balanced with the need to protect the trade interests of other members of the WTO. This dilemma that arises particularly during times of economic downturn therefore calls for a reexamination of the role of export subsidies and the WTO rules during a financial crisis. The importance and benefit of a rule-oriented system in promoting the efficacy of trade relations between nations cannot be refuted. According to Ruddy,[3] the WTO has stepped in to attempt to fulfill this vital role and has overall succeeded in minimizing the effect of protectionist measures accompanying the financial crisis.

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[1] See Sourafel Girma, Yundan Gong, Holger Görg and Zhihong Yu, "Can Production Subsidies Explain China's Export Performance? Evidence From Firm Level Data," (2008) Kiel Institute for the World Economy, Working Paper No. 1442.

[2] See John H. Jackson, The World Trading System: Law and Policy of International Economic Relations, 2nd edn (Massachusetts Institute of Technology: The MIT Press, 1997), p 280-281.

[3] Brendan Ruddy, "The Critical Success of the WTO: Trade Policies of the Current Economic Crisis," (2010) 13 Journal of International Economic Law 475.

Compared to the Great Depression of the 1930s, the extent of protectionism that has been relied on in the current financial crisis has been less. The explanations he gives for its success are indeed convincing and important:

> "One, economic efficiency drives countries to negotiate and promote multilateral trading rules. Two, the negotiated rules of the WTO make international trade relation transparent, which keeps countries politically accountable and focuses attention on eliminating known barriers to efficient trade. Three, the WTO dispute settlement body effectively enforces WTO rules, thereby allowing countries to rely on those multilaterally negotiated rules. And four, the WTO dispute settlement body's jurisprudence creates stable and predictable understandings of the negotiated rules, allowing governments and private businesses to operate under more secure and predictable conditions."[4]

Given that a rule-based system is what governs trade relations between countries, this article evaluates the WTO rules as they currently stand in relation to whether they allow for the achievement of the particular balance between helping the suffering export industry/country and excessive trade protectionism during times of economic downturn. It argues for some modifications to be introduced into the WTO law so that countries may legally support their ailing export industries without falling afoul of the WTO rules and hurting other countries in the face of economic hardship. This is in spite of criticisms that the WTO disciplines may already be too flexible in allowing protection for the domestic industry.[5]

This paper thus addresses the following important issues: What are the important policy considerations when regulating government export assistance? Should the circumstances and characteristics of a domestic economy be taken into account in deciding whether to sanction subsidies or is the upholding of a rule-based system more important, i.e. should we adopt a purposive approach or literal interpretation of WTO laws? Should any and every kind of assistance be allowed during a financial crisis or should only some forms of export assistance be allowed? In Section II, a regression analysis of cross-sectional data that consumption is significantly influenced by exports is undertaken to ascertain the importance of the role of exports in China's export-dependent economy. The ramifications of increasing Chinese consumption on the world economy will also be discussed. Section III examines and evaluates the current WTO rules on subsidies by way of assessing the legality of the undervaluation of China's Renminbi (RMB) exchange rate.[6] Section IV presents a case for modification of export subsidies/assistance to be introduced for emergency situations such as under a financial crisis. Section V concludes this study.

II. The Influence of Exports on Domestic Consumption

This section aims to investigate the implications of a fall in exports during a financial crisis by way of its effect on household consumption. This is in contrast to previous studies which often examined the direct effects of exports on GDP growth. This paper contributes to the literature by investigating the indirect impact of export growth on output growth via its impact on consumption growth, as implicit in the Keynesian equation. Analysis of the impact of export on consumption during an economic crisis is important for several reasons. First, domestic consumption is one of the major drivers of GDP growth. Second, given China's high saving rate, it is of interest to find out whether increases in export incomes raise domestic consumption. Third, domestic consumption comprises component of foreign goods, the absorption of which helps to reduce excess productions by the rest of the world concurrently facing economic hardship wrought by the GFC. Fourth, given the shrinkage of its exports due to the GFC, the PRC government has instituted a policy for economic growth to be sustained by domestic consumption (such as via the fiscal stimulus packages). It is not clear, however, if such generous fiscal policies could raise the domestic consumption. Fifth, asset evaporations, income losses, pay cuts and job insecurity threats posed by the GFC can exert immense psychological impacts on individual consumptions. In light of the above, a household consumption model is developed for capturing the various effects of the GFC.

Regression Model: Our regression model is written as:

$$C_j = a + \theta_i Y_{ij} + \sum_{i=1}^{2} \alpha_i G_i + \sum_{i=1}^{3} \beta_i F_i + \sum_{i=1}^{5} \phi_i P_{ij} + \varepsilon_j \qquad (1)$$

The dependent variable is consumption expenditure by individual j (C_j). In order to measure C, respondents were asked how their consumption expenditure had changed compared to before the GFC on a 5-point scale (1=reduced, 5=increased).

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[4] Ibid, p 483.

[5] See Anne van Aaken and Jürgen Kurtz, "Prudence or Discrimination? Emergency Measures, the Global Financial Crisis and International Economic Law," (2009) 12 Journal of International Economic Law 859, 893-94.

[6] Due to the onslaught of the GFC in 2008-2009, RMB revaluation was temporarily halted. This was possibly a policy instrument used by the PRC government to help the ailing export sector.

The model consists of 11 independent variables: income (*Y*), two types of government polices (*G*), three types of GFC incidences (*F*), and 5 types of psychological variables (*P*). These variables are summarized in the second column of Table 1.

The Data

In this paper, the household survey data were collected and used for our empirical examination. The cross-sectional sample was gathered over August-September 2009 (both the questionnaires and the data are available upon request). More than 10,000 households responded to the standard questionnaires. However, after dropping some missing data, there were 9784 data points left. The data were collected from across eight occupations, twenty different industries and nineteen Chinese provinces.[7] In this paper, cross-industry, cross-occupation, or cross-province heterogeneous effects were controlled using the cluster commands available in STATA. Cluster controls are important in this study: for example, the banking and construction industries might have declined faster than other economic sectors; some occupations, industries and provinces might be more adversely affected by the GFC than the others. The regressions were performed using the whole, employed and unemployed data sets: employed workers and unemployed (such as retirees and students) (a) have different income levels, (b) were affected to different extents, physically and psychologically, and (c) were confronted with very different job prospects.

Results

Table 1 showed that the GFC, indicated *inter alia* by declines in exports, increases in corporate bankruptcy and retrenchment,[8] was significant in affecting consumption. Among these indicators, export decline, as shown by the significant size of its coefficient, was found by far to be the most important factor affecting consumption (see Table 1). The government's expansionary monetary policy in the form of reducing interest rates, various psychological factors (such as fear, anxiety, future pessimism, etc), frugality (such as more calculated or budget spending, a typical Chinese saving culture), and changes in household income, were also significant in affecting he domestic consumption. However, the Chinese government's expansionary fiscal policy, specifically the RMB4.12 trillion stimulus packages, was found to be ineffective in influencing consumption. This result is of policy interest: export-enhancement policies were more important than Government spending in stimulating domestic consumption in China during a financial crisis. On the corollary, if direct export assistance were neglected, the economy could have fallen into deeper recessions given the ineffectiveness of some government policy initiatives in the short run coupled with the significant negative income and psychological impacts on the domestic consumption emanating from the GFC.

During the global economic downturn, many countries around the world depends on Chinese import consumption to help absorb some of their excesses. In the absence of any government export assistance, the continuing declines in exports and hence domestic consumptions, as demonstrated in this paper, would plunge the Chinese economy into deeper recessions. Failing to help itself, much of the production excesses by the rest of the world would remain unabsorbed, possibly leading to a deeper global recession. Hence, the rescue of a struggling economy (via some forms of export supports or otherwise) appears to be crucial in stamping out the flows of negative externalities and international contagion wrought by the GFC. The regression model shows that Chinese domestic and foreign consumptions are depended on exports. Hence, factors which depress exports (such as continuing RMB revaluations) would also depress consumptions. On the other hand, continuing export declines would lead to more corporate failures, shutting down of factories, massive retrenchment and job losses. These would give rise to income losses (*Y*), negative emotions or pessimisms (*P*) and more calculated or budget spending (frugality), which would collectively exert negative impacts on consumptions, as shown in the regression model. A series of such negative externality impacts on industries, consumers, family, workers, and even retirees provide some justifications for government supports for exports during periods of economic downturn.

[7] The 20 industries are farming, mining, manufacturing, utilities, construction, transportation, computer and information, wholesale and retail, hotels and catering, finance, real estate, business service, research, environment, residence services, education, social welfare, culture and sports, social organization, and international organization. The 8 occupations include managers in state enterprises, specialists, clericals, business and services employees, farmers, factory operators, army personnel, and others. The 19 provinces or counties are Beijing, Tianjin, Nei Monggol, Jilin, Heilongjiang, Shanghai, Jiangsu, Zhejiang, Anhui, Fujian, Hubei, Hunan, Guangdong, Guangxi, Chungking, Guizhou, Yunnan, Shaanxi, Ningxia.

[8] These variables were not mathematically constructed or measured but merely poised as given in the questionnaires in order to investigate if export declines for instance affect the households' emotion and consumption. On the likert scale of 1-5, a score of "3" means no change in the causal relation, "2" shows a small decrease, "1" shows a big decrease, "4" denotes a small increase and "5" denotes a big increase. The same qualitative measurements apply to the other variables in the questionnaires.

The positive effects of Chinese exports on consumption (which in turn stimulate domestic consumption of foreign imports, including parts, raw material and technology for outward processing production in China) help to stimulate world economic growth or prevent world economy from falling into deeper recession. Our empirical analysis implies that the rest of the world could also benefit from China's support of its export sector as a whole during the financial crisis. Our results support that of Staiger and Sykes (2010), pointing out that the ambiguity of the efficiency and equity trade effects of the government support on exports during the GFC, as demonstrated in our empirical analysis, undermines the ability of the WTO dispute resolution system to address the exchange rate policies, and calls into questions the wisdom and legitimacy of unilateral countermeasures that have taken by the US and others.[9]

Our empirical analysis shows that the domestic economy might need to be rescued during the GFC, as it appears to be senseless for country A to ignore its industries in dire straits (or severely affected by a crisis). However, in doing so, it appears to hurt other exporters and hence such practices are prohibited by the WTO. Many exporting countries faced such a dilemma during the GFC. In actual fact, the dilemma leads to retaliations across countries, such as engaging in a currency war or introducing counter trade protectionism measures. This threatens the trade liberalization process originally advocated by the WTO. In what follows, we examine the legal framework of the WTO laws which govern trade protectionist measures and see if there is a way out of this dilemma.

III. The Current Law

A. The Legal Framework

According to the WTO, "The WTO Agreement on Subsidies and Countervailing Measures ["the SCM Agreement"] disciplines the use of subsidies, and it regulates the actions countries can take to counter the effects of subsidies. Under the agreement, a country can use the WTO's dispute-settlement procedure to seek the withdrawal of the subsidy or the removal of its adverse effects. Or the country can launch its own investigation and ultimately charge extra duty ("countervailing duty") on subsidized imports that are found to be hurting domestic producers."[10] For a country to succeed in bringing an action against another country's use of subsidies in contravention with the SCM Agreement, firstly, a subsidy must exist. A subsidy will be deemed to exist if:

(1) There is a financial contribution by a government, or any form of income or price support, and
(2) A benefit is thereby conferred.[11]

However, the mere fact that a subsidy satisfies these two requirements does not yet justify any sanction being imposed on the contravening country. The subsidy must be either a prohibited or actionable subsidy for any sanction to be imposed. Both of these involve a requirement of specificity,[12] which will be deemed to be satisfied if the subsidy is held to be prohibited. For a subsidy to be prohibited from being granted or maintained, it must be contingent, in law or in fact, whether solely or as one of several other conditions, upon export performance, including those illustrated in Annex I; or contingent, whether solely or as one of several other conditions, upon the use of domestic over imported goods.[13] For a subsidy to be actionable, the offended member must show that adverse effects have been caused to it.[14]

This can be by way of injury to its domestic industry; nullification or impairment of benefits accruing directly or indirectly to it under GATT 1994 in particular the benefits of concessions bound under Article II of GATT 1994; or serious prejudice to the interests of another Member. However, this does not apply to subsidies maintained on agricultural products. Non-actionable subsidies are subsidies which are not specific within the meaning of Article 2, or subsidies which are specific but fall into certain categories.[15] These include assistance for research activities conducted by firms or by higher education or research establishments on a contract basis with firms; assistance to disadvantaged regions within the territory of a Member given pursuant to a general framework of regional development and non-specific; and assistance to promote adaptation of existing facilities to new environmental requirements imposed by law and/or regulations which result in greater constraints and financial burden on firms.[16]

[9] Robert W. Staiger and Alan O. Sykes (2010), 'Currency Manipulation and World Trade', (2010) 9 World Trade Review 583.
[10] Available at http://www.wto.org/english/tratop_e/scm_e/scm_e.htm (visited 1 December 2010).
[11] SCM Agreement, Art 1.1
[12] *Ibid*, Art 1.2
[13] *Ibid*, Art 3.
[14] *Ibid*, Art 5.
[15] *Ibid*, Art 8.1.
[16] *Ibid*, Art 8.2.

However, the rules regarding non-actionable subsidies are subject to provisional application for 5 years, beginning with the date of entry into force of the WTO Agreement.[17] They have therefore have lapsed and it is unclear whether they will be renewed. As such, they will not be further discussed herein. The particular interpretations of each criterion will be dealt with in detail later when assessing specifically the legality of China's undervalued currency (our case study).

B. China's Undervalued Currency

From July 21, 2005 to April 13, 2009, the RMB/dollar exchange rate appreciated by 18.7 per cent.[18] But in 2009, China halted the appreciation of its currency during the period of the financial crisis, which has sparked allegations that China is engaging in currency manipulation. The effect of such alleged manipulation is to indirectly make exports cheaper to foreign countries and therefore more competitive. China's undervalued currency has therefore been blamed for causing job loss in the United States due to producers being unable to compete with Chinese imports into the United States. It may also displace the imports into China and thus decrease the exports of foreign countries. The United States have drafted a bill treating undervalued currencies as illegal export subsidies. On the other hand, China argues that their exchange rate regime gives aid to its struggling exports during the financial crisis. However, this section shows, through an analysis of the legality of China's undervalued currency, that the WTO rules on subsidies as set out in the SCM Agreement do not include provisions for such emergency circumstances.

Financial contribution

Although China's undervalued exchange rate is likely the result of intervention by "a government or any public body", it does not appear to fall within the list of "financial contributions" in Article 1.1(a)(1), such as a transfer of funds, forgone government revenue, provision of goods or services, purchase of goods, government payments to a funding mechanism, etc. Any argument that an undervalued exchange rate is a measure that indirectly influences exports would unlike succeed as the only indirect financial contribution provided under Article 1.1(a) is a government making payments to a funding mechanism, or entrusting or directing a private body to carry out the above functions.[19]

Furthermore, a commentator has observed that the items in Article 1.1 of the SCM Agreement constituting a financial contribution involve "a charge on the public account",[20] which is not the case here, "since although the home currency is bought or sold at a currency market, something is sold or bought in return, thus keeping the government's accounts balanced in this regard."[21] The Panel on *US – Export Restraints* said that, a financial contribution involved "the transfer of economic resources". It also clearly does not constitute "income" or a "price support",[22] which in economics means the minimum legal price a seller may charge, typically above equilibrium. If it does, then any fiscal or monetary policy exercised in individual country would be seen as supporting incomes or prices.In *US – Export Restraints*, the Panel also acknowledged that "the requirement of a financial contribution from the outset was intended by its proponents precisely to ensure that not all government measures that conferred benefits could be deemed to be subsidies." One could therefore argue that the SCM Agreement does provide some flexibility for certain measures to be implemented during financial crises.

A benefit is thereby conferred

The second criterion for a prohibited subsidy is whether or not a benefit has been conferred by maintaining for instance an undervalued currency. It has been observed by the Appellate Body in *Canada – Aircraft* that the ordinary meaning benefit "clearly encompasses some form of advantage" and that "it is necessary to determine whether the financial contribution places the recipient in a more advantageous position than would have been the case but for the financial contribution". Others have interpreted it to mean "value to the recipient, whatever it may cost."[23]

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[17] *Ibid*, Art 31.

[18] Wayne M. Morrison and Marc Labonte, "China's Currency: A Summary of the Economic Issues", *Congressional Research Service Report for Congress*, October 1 2010.

[19] SCM Agreement, Art 1.1(a)(1)(iv).

[20] Catharina E. Koops, "Manipulating the WTO? The Possibilities for Challenging Undervalued Currencies Under WTO Rules," *Amsterdam Center for International Law Research Paper Series 2010*, p 3.

[21] *Ibid*.

[22] *Ibid*, Art 1.1(a)(2).

[23] Gary Clyde Hufbauer, Yee Wong, and Ketki Sheth, *US-China Trade disputes: Rising Tide, Rising Stakes* (Institute for International Economics, 2006), p 21

This is consistent with the Appellate body focus on whether the recipient obtained any cost rather than whether there was any "net cost" incurred by the government. It can therefore be argued that an undervalued currency provides value to exporting firms because exports become relatively cheaper to foreign importers. Exporters, therefore, have a price advantage over producers in the importing country, which could not be attained if the currency was left to the forces of demand and supply. However, if imported production inputs (e.g. fuel or raw materials) are needed to produce the product to be exported, an undervalued currency cannot be called a benefit as these would increase the cost of production. In China, many producers use imported raw materials, equipment and machinery, and it is mainly China's labor resources that are used to produce the final product. Hence, it is difficult to predict whether the overall effect would be a benefit or otherwise, and the effect on price would vary depending on the firm and their production structure.

Whether a prohibited subsidy

As noted above, any subsidy contingent, in law or in fact, upon export performance or upon the use of domestic over imported goods, is prohibited. The undervalued currency is clearly not contingent upon export performance *in law*, as it cannot be "demonstrated on the basis of the very words of the relevant legislation, regulation or other legal instrument constituting the measure."[24]Before considering whether it is *in fact* contingent upon export performance, it should quickly be noted that an undervalued currency probably does not fall within the Illustrative List of Export Subsidies in Annex I of the SCM Agreement. It mentions "currency retention schemes or any similar practices that involve a bonus on exports." But these are a feature of overvalued, not undervalued, exchange rate regimes permitting exporters to retain a certain amount of foreign exchange earned, either to purchase imported inputs or to sell at a premium to other importers.[25]

Footnote 4 of the SCM Agreement provides a test that can be applied to assess whether the requisite standard of contingency has been met: *Whether the grant of a subsidy is 'in fact tied to' actual or anticipated exportation or export earnings*. DSB reports have shown that an enhanced standard is imposed by the adjudicated body of the WTO. In the Panel Report on the case of *Australia – Automotive Leather II*, the Panel suggested that this "requires a close connection between the grant or maintenance of a subsidy and export performance." In *Canada – Aircraft*, the Panel and Appellate Body "a relationship of conditionality or dependence must be demonstrated… [i]t does not suffice to demonstrate solely that a government granting a subsidy anticipated that exports would result." However, the Appellate Body criticized the test of "whether the subsidy would have been granted *but for* the anticipated exportation or export earnings." As such, the fact that China anticipated an increase in exportation or export earnings and the fact that China's exports increased during the alleged period of subsidization does not by itself establish contingency.

The Appeals Board in *Canada – Autos* applied the test of whether the alleged subsidy "is simply not available to a manufacturer unless it exports motor vehicles". However, this test appears to specifically assess contingency on exportation of motor vehicles and not exports in general, as is the case of an undervaluation in the exchange rate. As such, this test would not be applicable in this case. Furthermore, such export contingency need not be the 'sole' condition governing the grant of a prohibited subsidy; it may be 'one of several other conditions.' China has expressed concern that floating its currency could spark an economic crisis in China and would especially be damaging to its export industries at a time when painful economic reforms are being implemented. As long as exports were a consideration in deciding whether to keep the currency undervalued, it is immaterial that there are many other valid reasons for a particular exchange rate policy. Similarly, it matters not that there are other beneficiaries of a cheap currency as long as the export industry is one of them.

The second way of arguing that the exchange rate undervaluation is a prohibited subsidy is that it is contingent upon the use of domestic over imported goods. However, this would be extremely difficult to prove, as it appears there has not been any clear motive that China is keeping its exchange rate undervalued so that domestic goods will be used rather than imported goods. The fact that the use of domestic over imported goods may be an incident of a lower exchange rate would be insufficient to satisfy the requisite standard of contingency.As stated above, if the offended party can establish that the undervaluation of China's exchange rate is a prohibited, the requirement of specificity will be deemed to be satisfied.

Whether an actionable subsidy

To be an actionable subsidy, access to it must be specific to an enterprise or industry, a group of enterprises or industries, or to certain enterprises within a designated geographical region.

[24] Appellate Body in *Canada – Autos*.

[25] *See* n 23, p 23.

However, according to *US – Softwood Lumber IV*, specificity does not just include limiting access to the subsidy to certain enterprises, but will exist if the subsidy distorts the allocation of resources and is not broadly available.[26] However, an undervalued currency has very broad implications, not just for the export industry. There is thus no convincing reason to believe that the alleged subsidy may in fact be specific. As such, it is unlikely that the factors in Article 2.1(c), which have almost no relevance to this case, will be considered. As to whether the undervaluation of the exchange would cause any adverse effects to other Members, the three types have been stated above. In this case, injury and serious prejudice are relevant. Injury to another member's domestic industry requires establishment of the same injury level as set forth in Part V of the SCM Agreement.[27] Consequently, an investigation in accordance with Article 11 of the SCM Agreement is necessary to prove such injury.

Likewise the indicators of serious prejudice in Article 6.3 must be proved, including displacement or impediment to imports of a like product into China's market; displacement or impediment of the exports of a like product of another Member from a third country market; a significant price undercutting by the subsidized product as compared with the price of a like product of another Member in the same market or significant price suppression, price depression or lost sales in the same market; and increase in the world market share of China in a particular subsidized primary product or commodity as compared to the average share it had during the previous period of three years and this increase follows a consistent trend over a period when subsidies have been granted. The difficulty with the investigation in the case of currency undervaluation is showing clearly which products have been subsidized and that it is significant. As noted above, this is because any alleged subsidization of many products would be offset due to imported production inputs having been made more expensive due to the low currency. Furthermore, it is hard to say that any increase in market share of Chinese exported products is due to the undervalued currency and not some other factors. Serious prejudice may be deemed to exist if the currency undervaluation was for the purpose of covering operating losses sustained by an industry.[28] During the financial crisis, because many exporting firms would be incurring losses due to decreased revenues, it is arguable that this may be the case.

General picture

It is unlikely that China's currency undervaluation will be considered as a prohibited or actionable subsidy because it likely fails to constitute a financial contribution and thus a subsidy. It is also hard to prove that an overall benefit has been conferred and it is unlikely to satisfy the requirement of specificity, being that it has broad implications for China as a whole. Export contingency and adverse effects will require more analysis. However, regardless of the result, the focus of this paper is on whether the issues raised under the SCM Agreement in assessing the legality of China's currency undervaluation are the relevant ones. It is argued that these are not the only important issues. It is also important to take into account the domestic situation of the offending country as well as the global situation given the integrated linkages across countries. As such, the next section proposes a modification to the WTO rules under emergency situations.

IV. A Modification to the WTO Rules?

Under the SCM Agreement, there were exceptions that countries could invoke to lawfully implement subsidies. For example, it is recognized that subsidies may play an important role in equitable economic development programs of developing country Members.[29] Also, members in the process of transformation from a centrally-planned into a market, free-enterprise economy may apply program and measures necessary for such a transformation.[30] However, the period within which countries have to phase out their subsidies under these exceptions has now expired.[31] It is fully acknowledged that introducing another exception for subsidies would likely be detrimental to the interests of other countries given their adverse effects. However, this section argues that there should be a slight modification to give some headroom for countries specifically in emergency situations such as financial crises.

A. Balance domestic economic considerations and trade protectionism

It can be seen from the outset that the SCM Agreement does restrict certain government measures from being financial contributions and thus falling under the definition of a subsidy. Exchange rate intervention will likely be excluded.

[26] See WTO Analytical Index: Volume II, p 772; Van den Bossche, P., *The Law and Policy of the World Trade Organization*, Cambridge University Press, 2005.
[27] SCM Agreement, Footnote 11.
[28] *Ibid*, Art 6.1(b).
[29] *Ibid*, Art 27.
[30] *Ibid*, Art 29.
[31] Ibid, Art 27.2 and 29.2.

One could therefore argue that countries are already permitted some (perhaps even too much) leeway to implement measures falling outside the SCM Agreement to help exports during financial crises. However, judging from the fact that the United States has taken action (or has retaliated) against China for the undervaluation of its currency, such flexibility may be in question. The fact that it has the same effect on exports (although in China this may be offset by more expensive imported production inputs) as the VAT rebate policy, which is likely to constitute an actionable or prohibited subsidy under the SCM Agreement, it has been subject to intense scrutiny. From the previous section, it can be seen that as the law is currently framed, arguing as to the legality of the subsidy involves the satisfying of certain definitions which boil down to technicalities in deciding whether a particular government policy is indeed a subsidy or not, whether it is specific, export contingency, etc. As important as these issues may be, what is lacking is the need to take into account other important considerations such as whether countries should be allowed to protect their struggling export industries and faltering economies during a financial crisis. If countries are not legally allowed to protect/assist their vulnerable industries during a financial crisis, the negative externality or contagion effects within the domestic economy and across countries would be considerable.

For example, in the case of China, currency intervention arguably was called for to mitigate the injury to and curb layoffs in the export industry, considering that in February 2009, during the global financial crisis, China's export and imports were down 25.7 per cent and 24.1 per cent, respectively, the biggest monthly decline recorded since reforms began in 2009.[32] Thousands of export-oriented factories have reportedly been shut down. The Chinese government has estimated that 20 million migrant workers lost their jobs because of the GFC in 2008.[33] According to Premier Wen, "An appreciation of 20 percent in China's currency would cause widespread bankruptcies in China's export sector, where firms operate on thin margins."[34] He further reasons that any appreciation in China's currency "would not bring jobs back to the United States because U.S. firms no longer make such labor-intensive products."[35] A leading expert also acknowledges that "[i]n the short run, China needs export growth in order to maintain job growth and preserve social stability."[36]

It is not enough just to focus on the adverse effects of subsidies on other countries in assessing legality, as this may be difficult to assess and therefore inconclusive and unfruitful. For example, the United States may blame China's low currency for the increasing unemployment in the United States. However, focusing on this one factor may overshadow other more important domestic factors in need of attention. As stated in the previous section, processing trade represents a large part of China's trade, which requires imported production inputs. This would therefore contribute to an increase in China's imports from other countries. It would therefore be difficult to clearly and convincingly attribute a worsening of unemployment to the undervaluation of China's exchange rate. As Greenwald comments, "it is neither fair nor productive to single out China for blame, much less to blame China's 'currency manipulation' as 'the most important cause of the financial crisis.'"[37] Regarding the bilateral deficit with China, he further notes that it is the imbalance in US trade with the world that is the problem.[38] Rather, it is more productive and less one-sided for countries to agree on assistance measures for a limited period, for example, during the wake of a financial crisis.

B. Limit trade disputes among members

Taking into account the structure of the process of WTO dispute resolution, the WTO is an organization that promotes and encourages countries to resolve their trade disputes by themselves before they reach the dispute settlement body. Litigation is costly, time-consuming, and detrimental to the trade relations between member states.According to Prasad, the economies of the United States and China are becoming increasingly integrated with each other through the flows of goods, financial capital, and people, and its relationship is therefore of considerable importance.[39] It is therefore vital that the law provides clarity and takes into account both the situation of the offending and offended country. Without the medication for emergency situations, such as the GFC, countries will be left to argue on secondary issues, while not taking into account each other's situation to promote mutual understanding and sympathy. Furthermore, as highlighted in Section II, countries may overlook the benefit of subsidies during the GFC.

[32] *See* n 18, p 4.
[33] *Ibid*.
[34] Available at http://www.reuters.com/article/idUSN2210215020100923 (visited 1 December 2010)
[35] *Ibid*.
[36] Eswar S. Prasad, "Effects of the Financial Crisis on the U.S.-China Economic Relationship," (2009) 29 *Cato Journal* 223, 224.
[37] John D. Greenwald, "At the End of a Long Trade Policy Road," (2009) 45 *Texas International Law Journal* 157, 158.
[38] *Ibid*.
[39] *Ibid*, at 223.

If experts could be brought in to properly investigate the effect of the subsidies, countries may find that it may not be as simple as they thought. This modification would therefore provide an opportunity for China to put forward the potential benefits that may accrue to the United States and the world from its limited subsidies, whereas the current law does not yet allow for such arguments. In addition to the potential benefits as shown in our empirical analysis, more exports from China during the GFC might also benefit the US by way of its foreign direct investment (FDI) in China. Some economists argue that, due to the massive outward processing trade in which China earns a meager processing or assembling fees[40], countries that have procured FDI in China will also gain from the Chinese exports.[41] Hence, a slight modification of the WTO rule with provision for the above may contribute to improved relations between countries.

C. Difficulties in introducing a modification

There are certainly the difficulties of defining what constitutes an emergency situation and when it can be said that such a situation has ended and therefore when the assistance measures should be withdrawn. This paper simply recognizes the dilemma poised by the GFC which may threaten trade liberalization and world peace. Further research is needed as a modification addressing this dilemma must be subject to careful drafting and clear delineation of circumstances which constitute emergency situations.

V.Conclusions

This study does not seek to undermine the importance and usefulness of WTO rules in regulating and eliminating protectionist trade behavior undertaken by countries that is anti-competitive and unfair to other member countries. It agrees that "it is essential to fair trade and to the well-being of domestic industries of the United States and other countries that China honors its WTO commitments."[42] It acknowledges the importance of fostering an international trade environment that is conducive to healthy economic development of the world economy. However, a body of laws that fail to give due weight to other vitally important considerations such as the domestic economic situation confronting the member states during financial crises and the domestic and international negative externality/contagion effects would be an imbalanced form of dispute resolution lacking in efficiency and fairness. Furthermore, the adversarial nature of this type of dispute resolution system that turns mainly on technical interpretations of legal provisions and fine conceptual distinctions means that countries will primarily be arguing over issues that do not touch on other important and relevant considerations. This would also perpetuate or aggravate the friction between other countries and China and threaten world peace.

In this paper, it has been shown that during a financial crisis, exports are vital to sustain domestic consumption and economic growth. Export assistance may also reduce the domestic and international flows of negative externality and contagion. It is clear that if exports are not helped, consumption will suffer, the ramifications of which will likely be widespread. If the result that such a body of laws encourages is the retaliatory imposition of countervailing duties that does away with permitting contracting member parties to invoke legitimate economic arguments to justify their actions as valid, then such a system would simply be inadequate to enable member states to address the issues in a mutually beneficial way. Authorities of member states would be better off resolving their disputes in another setting, such as a G20 meeting, rather than under the WTO, which with its flaws in its laws, is prone to evoke injustice in some form or another.

When the particular legal rules are examined, which in this paper has been done in the context of China's undervalued exchange rate, it can be seen that various interpretations may be put forth. But when one is consumed with finding convincing arguments among the thicket of technicalities in the law, there is a danger that progress towards both the goals of flexibility and predictability will suffer; the former because in interpreting the provisions, it is easy to lose sight of the more important issues and concerns surrounding the dispute, and the latter because there are measures which do not fall clearly within the ambit of the WTO rules. It is always important when interpreting the provisions to keep sight of the economic climate in both countries and in the world and to give effect to the policy and intention underlying the rules even in a rule-oriented system of dispute resolution. Otherwise the efficacy of the body of rules in achieving flexibility and predictability and the ultimate purpose for their enactment will be vitiated and arguments would be centered on points that are other than the main issues at stake.

[40] *See* also J.P. Voon, and Y.Y. Kueh, "Country of Origin, Value-Added Exports, and Sino-US Trade Balance Reconciliation," (2000), 34 *Journal of World Trade* 123.

[41] *See* n 36 above.

[42] Ann E. Christoff, "The Chinese Automobile Industry and the World Trade Organization: China's Non-Compliance with WTO Regulations Through its Subsidizing of Automobile Manufacturers," (2009) 19 *Indiana International & Comparative Law Review* 137, 165.

Indeed, it is during tough times that the cords of the WTO rules undergo a stress test to determine their effectiveness and continued ability to induce nations to comply and ensure that multilateral trade continues efficiently. During a time when each nation is compelled to institute protectionist and emergency measures to counter the adverse effects of the financial crisis, international trade will inevitably be restricted. However, where disputes involve issues of domestic and international importance, good relationships between countries must be preserved. Rigidity, however, may not help to promote these objectives. In order to remedy the flaws in the current law, this paper suggests a modification in the SCM Agreement that countries can invoke during periods of financial crisis, allowing them to assist export industries to prevent plunges of firms and industries as well as of the economy as a whole into deeper recessions. Although such an exception may bring with it its own difficulties such as what constitutes a financial crisis, when a country can be said to be in such a period, as well as other complex operational details, it does set up a platform for countries to focus on important issues.

Table 1. Impacts of the GFC on China's Domestic Consumptions

		Whole	Employed	Unemployed
Income	Income	0.300*** (0.011)	0.296*** (0.021)	0.303*** (0.025)
Government policies	Fiscal	-0.005 (0.006)	-0.007 (0.016)	-0.002 (0.022)
	Monetary	0.052*** (0.009)	0.047*** (0.013)	0.064** (0.023)
GFC Incidences	Export decline	-0.033*** (0.008)	-0.032** (0.011)	-0.034* (0.021)
	Bankruptcy	-0.030*** (0.007)	-0.034** (0.013)	-0.017 (0.019)
	Layoff	0.017** (0.007)	0.013 (0.015)	0.024 (0.024)
Psychology	Fear	0.027 (0.016)	0.028* (0.015)	0.013 (0.023)
	Anxiety	-0.068*** (0.012)	-0.066*** (0.017)	-0.069** (0.027)
	Work stress	0.164*** (0.027)	0.160*** (0.013)	0.200*** (0.033)
	Pessimism	0.022 (0.018)	0.006 (0.014)	0.070** (0.029)
	Frugality	-0.040*** (0.010)	-0.042** (0.015)	-0.034 (0.026)
Cluster Control	Occupation	-0.015*** (0.005)		
	Industry		0.006* (0.003)	
	Province			0.003* (0.002)

Note: p<0.10*, p<0.05**, P<0.01***. Standard errors are shown in parentheses.