The Legality of Japan's Current Monetary Policy under International Law

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In response to the 2008 global financial crisis, many of the world's largest central banks initiated unconventional monetary policies such as quantitative easing when standard open market operations became ineffective. The Bank of Japan, the US Federal Reserve, the Bank of England and the European Community Bank were among those that aggressively increased their respective monetary bases to purchase specified financial assets from commercial banks and financial institutions in order to lower interest rates interest rates for specific debt securities and stimulate their economies. Japan, which has long suffered from years of debilitating deflationary cycles, has targeted and committed to open-ended purchases until a stable two percent rate of consumer price inflation is achieved. Several of Japan's chief exporting rivals, in particular China, have publicly criticized the Bank of Japan for using its current monetary policy to intentionally devalue its currency and thereby benefit from an unfair trade practice. This criticism is unwarranted and Japan's policy complies with international law.

Keywords

IMF, WTO, Currency Devaluation, Exchange Rates, Quantitative Easing, Bank of Japan

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1. Introduction

Japan's 'Lost Decade' (or "Lost Two Decades") is characterized as a period of chronic deflation and stagnation triggered by collapses in the Japanese real estate and stock markets beginning in the early 1990s.[1] Average GDP growth in Japan was just 0.8 percent between 1993 and 2012, and consumer prices fell steadily beginning in 1998.[2] In 2008, Japan's economy was particularly battered by the Great (Financial) Recession; it was followed by the devastating Tohoku earthquake and tsunami, which killed almost 20,000 people and destroyed 275,000 homes.[3] The Great Recession caused output in Japan to fall 9.2 percent in the first quarter of 2009, from which it has not yet recovered, while the earthquake and tsunami were major culprits in reducing +4.7 percent GDP growth in 2010 to -0.5 percent in 2011.[4] Japan's low birth rate has exacerbated the situation by reducing the size of the workforce and increasing the Japanese government's debt obligations to seniors, which has risen steadily compared to GDP, from 66 percent in 1991 to 244 percent in 2014.[5]

Under normal economic downturns governments and central banks will conduct monetary policy in a manner to stimulate lending, investment and overall economic growth. Central banks will typically engage in open-market operations to increase or decrease interbank interest rates to stimulate the flow of capital.[6] If a central bank wishes to encourage lending and investment, *e.g.*, it will typically issue reserve notes and purchase short-term government bonds, thereby increasing money into the banking system. An increase in the supply of money will lower demand for short-term interbank loans, thereby lowering interest rates and stimulating lending, hopefully resulting in greater economic output, investment and low-to-moderate

1 *See generally* P. Krugman, *It's Baaack: Japan's Slump and the Return of the Liquidity Trap*, Brookings Papers on Economic Activity 2:1998, *available at* http://web.mit.edu/krugman/www/bpea_jp.pdf (last visited on Apr. 15, 2014).

2 *See* GDP growth (annual %), The World Bank, *available at* http://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG (click 'Download Data' showing 8.3 percent growth); *See also* Inflation, consumer prices (annual %), The World Bank, *available at* http://data.worldbank.org/indicator/FP.CPI.TOTL.ZG/countries?display=map (all last visited Apr. 11, 2014).

3 For details on the impact of the Tohoku earthquake and tsunami, *see* Jun Hongo, *Still hunting shadows three years after 3/11*, Japan Times (Mar. 8, 2014) *available at* http://www.japantimes.co.jp/life/2014/03/08/lifestyle/still-hunting-shadows-three-years-after-311/#.U0em5mqKDIU. *See* also J. Hausman, & J. Wiel, *Abenomics: Preliminary Analysis and Outlook*, Brookings Panel on Economic Activity 6 (Mar. 2014), *available at* http://www.brookings.edu/~/media/projects/bpea/spring%202014/2014a_hausman.pdf (all last visited on Apr. 14, 2014).

4 *Id*.

5 *Id.* at 7.

6 J. Daniels & D. VanHoose, International Monetary and Financial Economics 213-219 (3d ed. 2005).

inflation.[7]

However, in unusual economic environments (*e.g.*, where financial institutions are fearful of lending and credit ceases to flow, or when interest rates are at or near zero), open-market operations have limited effect, as many developed countries have learned in the wake of the Great Recession.[8] One reason is that banks are fearful to lend to each other because they cannot accurately assess the creditworthiness of another bank; or they may want to keep extra reserves in case they are not able to procure loans in the future.[9] If a bank's balance sheet contains assets that are questionable or difficult to value (*e.g.*, subprime loan portfolios or asset-backed collateralized debt obligations), it is less likely that the bank will be able to receive a loan for fear of default.[10] If many banks have toxic assets, as was the case during the peak of the Great Recession, this problem will be exacerbated by a financial institution's incentive to hoard money to cover potential defaults or write-downs on their own balance sheets.[11] Furthermore, as interest rates move closer to zero percent, the quantity of money in banks becomes irrelevant for short-term lending because there essentially is no return or financial incentive to lend money.[12] In such circumstances, a central bank's typical monetary policy "loses its grip" because interest rates cannot be lowered any further, which is referred to by economists as a 'liquidity trap.'[13] Therefore, many of the major central banks of the world have turned to an experimental monetary policy known as 'quantitative easing' to free up credit markets.

7 *See Credit and Liquidity Programs and the Balance Sheet*, Board of Governors of the Federal Reserve System, *available at* http://www.federalreserve.gov/monetarypolicy/bst_openmarketops.htm (last visited on Apr. 15, 2014).

8 R. Buckley & D. Arner, From Crisis to Crisis: The Global Financial System and Regulatory Failure 127-130 (2011).

9 A. Ashcraft, J. McAndrews & D. Skeie, *Precautionary Reserves and the Interbank Market*, Federal Reserve Bank of New York Staff Reports 11 (May, 2009), *available at* http://www.newyorkfed.org/research/staff_reports/sr370.pdf (last visited on Apr. 15, 2014).

10 *See generally*, *supra* note 8, at 122-126.

11 J. Berrospide, *Bank Liquidity Hoarding and the Financial Crisis: An Empirical Evaluation*, Finance and Economics Discussion Series Federal Reserve Board (Nov. 29, 2012), *available at* http://www.federalreserve.gov/pubs/feds/2013/201303/201303pap.pdf 9-10 (last visited on Apr. 17, 2014).

12 *Supra* note 1, at 137.

13 *Id*.

2. Japan's Quantitative Easing

Quantitative easing ("QE") departs from open-market operations generally in that QE does not focus on purchasing short-term government securities to stimulate interbank lending. Rather, central banks use QE to purchase specific asset classes (often from banks) to effect long-term yields and lending in targeted areas.[14] Following the Great Recession, some countries (*e.g.*, US, Japan) purchased long-term government securities to lower yield curves and encourage investment. Other countries have purchased specific assets, *e.g.*, 'toxic assets' such as mortgage-backed securities and collateralized debt obligations, corporate debt, credit card debt, etc. to increase liquidity and confidence in the financial system.

The extent of QE is unprecedented in its scope and tactics, as administered by major central banks including the Bank of Japan, the US Federal Reserve [hereinafter US Fed], the European Central Bank ("ECB") and the Bank of England. In May 2006, *e.g.*, just at the peak of the housing bubble, the US Fed had approximately 875 billion USD in assets, of which approximately 760 billion USD were in short-term US treasury securities.[15] As of February 2014, the US Fed's balance sheet assets had grown to over 4.2 trillion USD, including approximately 1.6 trillion USD in mortgage-backed securities and 2.2 trillion USD in long-term US treasury securities.[16] Likewise, ECB increased its assets from approximately 1.3 trillion Euros to over 3 trillion Euros at the peak of QE expansion between 2012 and 2013. The Bank of England increased from approximately 100 Pounds to 400 Pounds, and the Bank of Japan from approximately 10 trillion Yen to 100 trillion Yen. From 2006 until 2013, the balance sheets of these four large central banks grew as a percentage of GDP as follows:

14 *See generally* S. Krogstrup, S. Reynard & B. Sutter, *Liquidity Effects of Quantitative Easing on Long-Term Interest Rates*, Swiss National Bank Working Papers (Feb. 2012), *available at* http://www.snb.ch/n/mmr/reference/working_paper_2012_02/source/working_paper_2012_02.n.pdf (last visited on Apr. 15, 2014).

15 *See Factors Affecting Reserve Balances*, Federal Reserve Statistical Release (May 18, 2006) *available at* http://www.federalreserve.gov/releases/h41 (last visited on Apr. 11, 2014).

16 *Factors Affecting Reserve Balances*, Federal Reserve Statistical Release (Mar. 20, 2014), *available at* http://www.federalreserve.gov/releases/h41 (last visited on Apr. 11, 2014).

Figure 1: Balance of Sheets of Four Large Central Banks as a percentage of GDP (2006-2013)[17]

Central Bank	2006 (Assets as a % of GDP)	2013 (Assets as a % of GDP)
Bank of England	5%	25%
U.S. Federal Reserve	5%	22%
ECB	10%	25%
Bank of Japan	20%	45%

QE has been a critical tool for central banks in fighting deflation and reassuring financial markets.[18] Several economists have credited government use of quantitative easing as having lessened some of the worse effects of the Great Recession, including the International Monetary Fund ("IMF")'s Research and Monetary and Capital Markets Department.[19]

Prior to the Great Recession, the Bank of Japan had been engaging in QE due to its chronic deflation and stagnation. However, Japanese QE really began to expand following the December 2012 election of Prime Minister Shinzo Abe and his so-called 'Abenomics' plan to revitalize Japan's sluggish economy with a large fiscal stimulus, monetary easing, and structural reforms, i.e., the so-called 'three arrows.'[20] Since prime minister Shinzo Abe's election, the Tokyo Stock Exchange Tokyo Price Index ("TOPIX") has risen nearly 50 percent (750 : 1280), prices and inflation have increased, and there is a restored confidence in the Japanese public regarding economic recovery.[21] However, one side effect of the policy is that the nominal exchange rate of the Yen has decreased dramatically: approximately 30% against the US Dollar and 25% against the Chinese Yuan (Renminbi).[22] Bank of Japan Governor, Haruhiko Kuroda, testified: "BOJ's monetary policy is not at all targeted at pushing down the currency... By taking a bold monetary-easing policy and exiting deflation

[17] L. Ricketts & C. Waller, *The Rise and (Eventual) Fall in the Fed's Balance Sheet*, The Regional Economist (Jan. 2014), *available at* https://www.stlouisfed.org/publications/re/articles/?id=2464 (last visited on Apr. 14, 2014).

[18] *Id*. *See also* V. Klyuev, P. de Imus & K. Srinivasan, *Unconventional Choices for Unconventional Times: Credit and Quantitative Easing in Advanced Economies*, IMF Staff Position Note (Nov. 4, 2009), *available at* https://www.imf.org/external/pubs/ft/spn/2009/spn0927.pdf (last visited on Apr. 14, 2014).

[19] *Id*.

[20] L. Sieg, *Japan's Abe battles doctors' lobby over "Third Arrow" reform*, Reuters, Aug. 24, 2013, *available at* http://www.reuters.com/article/2013/08/25/japan-reform-idUSL4N0GL05P20130825 (last visited on Apr. 14, 2014).

[21] Tokyo Stock Exchange Tokyo Price Index TOPIX, Bloomberg News, Jan. 21, 2014, *available at* http://www.bloomberg.com/quote/TPX:IND/chart (last visited on Apr. 11, 2014).

[22] XE Currency Charts (JPY/USD; JPY/CNY), *available at* http://xe.com (last visited on Apr. 11, 2014).

as soon as possible, that is something good not only for Japan, but for the economies of Asia and the rest of the world."[23] However, a sharp decline in the nominal exchange rates has constituents in various countries claiming foul in that perceived unfair trade advantage Japanese exporters receive as a result of the depreciation of the Yen.[24]

3. International Response to Japan's QE

Amid the current drop in the nominal exchange rate of the Yen, international reaction has been quite vocal in protest. *E.g.*, Gao Xiqing, president of China Investment Corp. (China's largest sovereign-wealth fund) told the Wall Street Journal that Japan's policy of "deliberate devaluing of the yen" was treating its neighbors like a "garbage bin" and could lead to a global currency war.[25] Bank of Korea Governor, Kim Choong-Soo, said in December 2013 that a weaker yen had hurt South Korean steel, appliance and auto-manufacturers.[26] As of January 2014, the South Korean won rose to a five-year high against the yen, including a 16 percent change in 2013.[27] Governor Kim said the Won-Yen exchange rate would be monitored closely as South Korean currency is a *very important* consideration when the Bank of Korea makes policy decisions.[28]

In the US, Ford CEO, Alan Mulally, unequivocally stated that Japan is 'absolutely' manipulating its currency giving its local exporters an unfair edge as the weaker yen threatens US manufacturers.[29] During a US House Financial Services Committee hearing, Congressman Gary Peters (D-Michigan) questioned former US Federal

23 W. Lingling, *China Fund Warns Japan against a 'Currency War,'* Wall St. J. (Mar. 7, 2013), *available at* http://online.wsj.com/news/articles/SB10001424127887324034804578343913944378132 (last visited on Apr. 11, 2014).

24 *Id*.

25 *Id*. ("Treating the neighbors as your garbage bin and starting a currency war would not only be dangerous for others but eventually be bad for yourself," he said in the interview, at the annual National People's Congress in Beijing. "I would hope that [Japan] doesn't do that as a responsible government.")

26 *See Bank of Korea – 2014 Outlook*, Wall St. J.: Real Time Economics, Jan. 5, 2014, *available at* http://blogs.wsj.com/economics/2014/01/05/bank-of-korea-2014-outlook (last visited on Apr. 11, 2014).

27 *See Bank of Korea Holds Rate Even as Yen Clouds Export Outlook*, Bloomberg News, Jan. 14, 2014, *available at* http://www.bloomberg.com/news/2014-01-09/bank-of-korea-holds-rate-even-as-yen-clouds-export-outlook-1-.html (last visited on Apr. 11, 2014).

28 *Id*. [Emphasis added]

29 *See Ford's CEO Calls Japan Currency Manipulator amid Weaker Yen*, Bloomberg News, June 21, 2013, *available at* http://www.bloomberg.com/news/2013-06-20/ford-ceo-says-japan-is-currency-manipulator-most-closed-market.html (last visited on Apr. 11, 2014).

Reserve Board Chairman, Ben Bernanke, whether the global economic recovery was hurt by the Bank of Japan's current monetary policy, which he claimed targets a significant devaluation of the yen for the purposes of improving the competitiveness of Japanese exports.[30] Bernanke answered Peters' question by first distinguishing the alleged currency manipulation practices of China *vis-à-vis* Japan:

> China has managed its exchange rate and kept it for many years below its equilibrium level, in order to increase its exports. That's what economists call a zero-sum game; what they gain we lose basically.
>
> The Japanese approach is different. They are not manipulating their exchange rate, they are not directly trying to set their exchange rate at a given level. What they are doing is engaging in strong domestic monetary policy measures, trying to break the deflation they've had for about 15 years, and a side effect of that is that the yen has weakened.
>
> Over time, if they (Japan) do in fact achieve positive inflation, that increase in prices there will partially offset the exchange rate movement.[31]

Current US Federal Reserve Chairwoman, Janet Yellen, echoed this sentiment:

> Countries should be allowed to use monetary policy to pursue domestic aims . . . to address broad macroeconomic concerns . . . it is natural and logical that after such a long period of deflation [20 years of slow, chronic deflation] the Bank of Japan would want to put in place a set of policies to end that.[32]

She continued to testify that Japanese monetary extension policy seemed to be moving Japan out of the deflationary cycle to its target two percent inflation goals.[33] Chairwoman Yellen concluded that to the extent that their policy is effective and domestic spending and growth continue to increase, then the policy will redound to the benefit of neighboring countries and the world as a whole.[34]

30 G. Peters, *Peters Presses Fed Chairman Bernanke on Japanese Currency Manipulation*, News Release (July 17, 2013), *available at* http://peters.house.gov/news-releases/peters-presses-fed-chairman-bernanke-on-japanese-currency-manipulation (last visited on Apr. 14, 2014).

31 *See Highlights – Bernanke's Q&A Testimony to House Panel*, Reuters, July 17, 2013, *available at* http://www.reuters.com/article/2013/07/17/usa-fed-bernanke-idUSL1N0FM1MY20130717 (last visited on Apr. 11, 2014).

32 *See US House Financial Services Committee Hearing* (Feb. 11, 2014), *available at* http://www.youtube.com/watch?v=qkTCQ-rOI-A (last visited on Apr. 11, 2014).

33 *Id*.

34 *Id*.

Researchers at IMF agree that Japan's monetary policies have had little, if any, effect on the exchange rate:

> Quantitative and monetary easing appear to have no effect on the exchange rate, as we do not detect statistically significant systematic impact of the monetary policy variable on the exchange rate across the equations. This result is also consistent with recent studies. For example, Lam (2011) finds similarly that the announcement of the CME policy did not have an impact on the exchange rate. Ueda (2011) also finds no evidence that the BoJ's policy actions have had an impact on the exchange rate, which may be driven by external factors, particularly interest rate differentials, risk appetite, and safe haven flows.[35]

The above-remarks are logical in that while a weak yen may temporarily boost Japanese exports, it is not necessarily in Japan's best interest due to dependence on imports of raw materials and energy following the Fukushima disaster in which nuclear power was sharply curtailed.[36] Considering that Japan's population is aging each year with more citizens living on fixed incomes and government expenditures increasing, the cost of imported food, energy and other consumer goods would not be in Japan's long-term interest. Furthermore, investment may suffer as investors will demand higher returns to compensate for currency fluctuations, which is another logical reason as to why Japan would not be purposefully lowering the purchasing power of the Yen.[37]

4. Legal Challenges under International Law

A. IMF Article 4

IMF was established as a result of the negotiations that began during the 1944 Bretton Woods Conference, which formed the first international legal system to govern monetary and trade relations between States (consisting of IMF, World Bank, GATT, and later WTO).[38] The highest priorities of the post-war financial system architects (primarily the US and Britain) were to avoid another Great Depression or

35 P. Berkmen, *Bank of Japan's Quantitative and Credit Easing: Are They Now More Effective?*, IMF Working Paper 12 (Jan. 2012), *available at* http://www.imf.org/external/pubs/ft/wp/2012/wp1202.pdf (last visited on Apr. 14, 2014).

36 H. Sender, *'Abenomics' is not enough to rescue Japan*, Financial Times (Feb. 28, 2013).

37 *Id.*

38 R. Lastra, Legal Foundations of International Monetary Stability 355 (2006).

World War by creating a stable international financial system with a multilateral and rules-based approach to international economic relations.[39] Exchange rate stability was key to ameliorating volatile capital flows and prevent currency devaluations as a trade weapon and the imposition of trade restrictions.[40] The IMF Articles of Agreement imposed legal obligations on member States, and while having changed over time, provide the legal structure for international monetary governance.[41]

The IMF Articles of Agreement were amended in the 1970s following the United States' decision to free itself from the gold standard because States began realizing that the Bretton Woods' fixed exchange rate system was too rigid to cure balance of payments imbalances.[42] The key amendment was Article 4, section 2(b), which allowed countries to change from a fixed exchange rate to a floating exchange rate or any exchange rate of the member's choice.[43] Following the Second Amendment, IMF has no right to force a particular exchange rate system on a State, except that it is required to follow the prescriptions enumerated in amended Article 4 as follows:

> <u>Section 1</u>
>
> 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 shall:
>
> (i) endeavor to direct its economic and financial policies toward the objective of fostering orderly economic growth with reasonable price stability, with due regard to its circumstances;
>
> (ii) seek to promote stability by fostering orderly underlying economic and financial conditions and a monetary system that does not tend to produce erratic disruptions;

39 *Supra* note 8, at 2-3.

40 *Id*. at 4.

41 *Supra* note 38, at 356.

42 *Id*. at 365. *See also supra* note 41, at 8-12 (States were not free to devalue their currency except in exceptional circumstances).

43 IMF Articles of Agreement art. 4,§ 2(b): Under an international monetary system of the kind prevailing on January 1, 1976, exchange arrangements may include (i) the maintenance by a member of a value for its currency in terms of the special drawing right or another denominator, other than gold, selected by the member, (ii) cooperative arrangements by which members maintain the value of their currencies in relation to the value of the currency or currencies of other members, or (iii) other exchange arrangements of a member's choice.

> (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...[44]

Article 4, Section 3 provides IMF with surveillance tools to enforce the above-restrictions on members' monetary policies:

> (a) The Fund shall oversee the international monetary system in order to ensure its effective operation, and shall oversee the compliance of each member with its obligations under Section 1 of this Article.
>
> (b) In order to fulfill its functions under (a) above, the Fund shall exercise firm surveillance over the exchange rate policies of members, and shall adopt specific principles for the guidance of all members with respect to those policies. Each member shall provide the Fund with the information necessary for such surveillance, and, when requested by the Fund, shall consult with it on the member's exchange rate policies. The principles adopted by the Fund shall be consistent with cooperative arrangements by which members maintain the value of their currencies in relation to the value of the currency or currencies of other members, as well as with other exchange arrangements of a member's choice consistent with the purposes of the Fund and Section 1 of this Article. These principles shall respect the domestic social and political policies of members, and in applying these principles the Fund shall pay due regard to the circumstances of members.[45]

Of the three substantive prohibitions in Article 4, Section 1, only subsection (iii) is specific as opposed to the subsections (i) and (ii) which frame a member's obligations in general terms like "endeavor to direct" and "seek to promote." With regards to the specific rule to "avoid manipulating exchange rates to prevent effective balance of payments adjustment or to gain an unfair competitive advantage" IMF has historically provided little guidance to its meaning. However, in 2007, the IMF's Executive Board adopted a decision approved on June 15 that provides guidance to members as to what constitutes a violation of subsection (iii):

> A member would be "acting inconsistently with Article IV, Section 1 (iii)," if the Fund determined it was both engaging in policies that **are targeted at—and actually affect—the level of exchange rate**, which could mean either causing the exchange rate to move or preventing it from moving; and doing so "**for the purpose of securing fundamental**

[44] *Id*. art. 4, § 1.

[45] *Id*. art. 4, § 3.

> **exchange rate misalignment in the form of an undervalued exchange rate" in order "to increase net exports**."[46]

In determining a member's intent for its exchange rate policy, IMF will base its decision "on all available evidence, including consultation with the member concerned. Any representation made by the member regarding the purpose of its policies will be given the benefit of any reasonable doubt.[47]

China or any other country would be hard pressed to prove that Japan has violated Article 4. First, Japan would argue that its policy is not targeted at exchange rate, but rather at eliminating a nearly 20-year period of deflation and economic stagnation. Japan's claims are supported by US Fed Chairman Ben Bernanke[48] and by similar, large-scale QE programs pursued by several other central banks. To claim an Article 4 violation against Japan would be tantamount to accusing the US, EU, England, as well as others, of similar violations.

Second, the claim against Japan is primarily coming from China, who has for years been suspected of currency manipulation either through its open-market operations, or increased reserve requirements. Since its purpose is ostensibly to keep the yuan devalued and exports high, the Chinese claim against Japan is rather hypocritical.[49] Complaints from the US or Europe would also lack credibility due to the similarities of the QE policies instituted by their central banks.[50] Proving that Japan has devalued the yen for the purpose of increasing net exports would be virtually impossible considering the IMF's policy to give a country the benefit of any reasonable doubt regarding its intent.

Third, even if Japan's intent was proved to manipulate the value of the yen, it would still be a challenge to confirm that Japan's QE policy has *actually* affected exchange rates. [Emphasis added] Japan's QE policy is similar to the European and American QE ones, but on a much smaller scale. One may thus expect to see similar devaluations of the US Dollar and Euro to the same extent, if not more than the

46 *See Surveillance Guidelines: Landmark Framework for IMF Surveillance*, IMF, Box 2 (June 21, 2007), *available at* http://www.imf.org/external/pubs/ft/survey/so/2007/pol0621b.htm (last visited on Apr. 11, 2014). [Emphasis added]

47 IMF, Selected Decisions and Selected Documents of the International Monetary Fund, 35th Issue (2011), *available at* http://www.imf.org/external/pubs/ft/sd/2011/123110.pdf (last visited on Apr. 14, 2014).

48 *Supra* note 30.

49 T. Wang, *China Resumes Dollar Pegging On The Sly*, Forbes, Mar. 27, 2009. *See also* Guonan Ma, Yan Xiandong & Liu Xi, *China's Evolving Reserve Requirements*, BIS Working Papers (Nov. 2011); W. Morrison & M. Labonte, *China's Currency Policy: An Analysis of the Economic Issues*, CRS Report (July 22, 2013), *available at* https://www.fas.org/sgp/crs/row/RS21625.pdf (all last visited on Apr. 15, 2014).

50 *See generally* E. Yardeni & M. Quintana, *Global Economic Briefing: Central Bank Balance Sheets*, Yardeni Research (Apr. 15, 2014), *available at* http://www.yardeni.com/pub/peacockfedecbassets.pdf (last visited on Apr. 15, 2014)

yen. However, supported by the IMF's own researchers,[51] Japan's QE policy has not actually been the cause of the exchange rate changes. Furthermore, the Yen is worth more today in USD than it was prior to the Great Recession, and only marginally less when compared to the Yuan during the same time period.[52] The public outcry against the recent *depreciation* of the Yen compared to the US dollar and the Yuan do not fairly take into account the significant *appreciation* of the Yen during the Great Recession as QE was being implemented in many countries.[53]

Finally, even if Japan had violated Article 4, in practice, there would have only been a few cases over the past 35 years when IMF was prepared to enforce violations of international currency manipulation. In 1982, several Nordic countries requested formal special consultations after Swedish Prime Minister Olaf Palme announced a devaluation of the Swedish krona by 16 percent to improve Swedish industry.[54] Likewise, the US requested consultations following devaluation of the Korean won in 1987.[55] In both cases, IMF neither made formal decision, nor imposed sanctions against either country, with Korea's account deficit rising to 14 billion USD in the following year.[56] If IMF could not enforce Article 4 against Switzerland and Korea, it seems unlikely to do so against Japan because the Fund has little practical leverage over a country the size of Japan. Theoretically, the IMF could even suspend or terminate Japan's membership and borrowing privileges.[57] However, it would have minimal impact because Japan has over 1 trillion USD in foreign currency reserves.[58] Therefore, it is highly unlikely that China or any other country would be successful in bringing an IMF Article 4 claim against Japan.

B. WTO/GATT Article 15

Article 15(4) of the GATT provides an alleged exchange rate manipulation as follows:

51 *Supra* note 35. Japan's quantitative and monetary easing appear to have no effect on the exchange rate, as we do not detect statistically significant systematic impact of the monetary policy variable on the exchange rate across the equations.

52 XE Currency Charts (JPY/USD; JPY/CNY), *available at* http://xe.com (last visited on Apr. 11, 2014).

53 *Id*. [Emphasis added]

54 *Supra* note 38, at 365.

55 A. Mukherjee, *U.S. Gains Little by Urging IMF to Hound China*, Bloomberg (Oct. 5, 2005), *available at* http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aI.W60VQPDXw (last visited on Apr. 11, 2014).

56 *Id*. *See also supra* notes 45-46.

57 IMF Articles of Agreement art. 26.

58 *See* Japan International Reserves and Foreign Currency Liquidity, IMF (Mar. 12, 2014), *available at* http://www.imf.org/external/np/sta/ir/IRProcessWeb/data/jpn/eng/curjpn.htm (last visited on Apr. 11, 2014).

> 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.[59]

No other provisions in the GATT provide any explanation as to what kinds of *exchange actions* would be permissible and which actions would frustrate the intent of the GATT. [Emphasis added]. Additionally, no case has ever been brought before the WTO Dispute Settlement Body regarding this clause so there is very little guidance provided by WTO with respect to exchange rate actions.[60] However, several other provisions of Article 15 of the GATT refer to IMF and its rules, *e.g.*:

- Parties shall seek cooperation with the IMF to pursue a coordinated policy with regard to exchange questions;[61]
- Parties shall consult fully with the IMF regarding any problems concerning monetary reserves, balances of payments or foreign exchange arrangements. In all such cases, Parties shall accept all findings of fact and conclusions of the IMF;[62] and
- Parties shall refer any violations of GATT Article 15 to the IMF.[63]

Furthermore, Article 15(9) provides that nothing in the GATT shall preclude a party from using *exchange actions* in accordance with the IMF Agreement.[64] Therefore, a plain reading of Article 15 would imply that if an exchange action does not violate Article 4 of the IMF Agreement, then it cannot violated the GATT per Article 15(9). As argued above, Japan would neither lose an IMF Article 4 claim, nor violate Article 15 of the GATT. Although a violation of Article 4 could be used to support an alleged Article 15(4) violation, which could lead to more serious sanctions by the WTO Dispute Settlement Body, the WTO likely would not find a violation of Article 15(4) without the support of the IMF whose main function is to promote exchange stability and collaboration regarding monetary issues.[65]

59 GATT art. XV(4).

60 E. Posner & A. Sykes, *International Law and the Limits of Macroeconomic Cooperation*, Chicago Institute for Law and Economics Working Paper No. 609 (July, 2012), at 40, *available at* http://www.law.uchicago.edu/files/file/609-396-eap-cooperation.pdf (last visited on Apr. 15, 2014).

61 GATT art. XV(1).

62 *Id*. art. XV(2).

63 *Id*. art. XV(3).

64 *Id*. art. XV(9)(a). [Emphasis added]

65 IMF Articles of Agreement art. 1. The purposes of the International Monetary Fund are:

> (i) To promote international monetary cooperation through a permanent institution which provides the machinery for consultation and collaboration on international monetary problems;

C. WTO SCM Agreement

The WTO rules provide that countries may not provide certain subsidies to promote export growth.[66] The Agreement on Subsidies and Countervailing Measures [hereinafter SCM Agreement] defines the term 'subsidy' within the context of WTO:

1.1 For the purpose of this Agreement, a subsidy shall be deemed to exist if:

(a)(1) there is a **financial contribution** by a government or any public body within the territory of a Member (referred to in this Agreement as "government"), i.e., where:

(i) a government practice involves a direct transfer of funds (e.g. grants, loans, and equity infusion), potential direct transfers of funds or liabilities (e.g. loan guarantees);
(ii) government revenue that is otherwise due is foregone or not collected (e.g. fiscal incentives such as tax credits);
(iii) a government provides goods or services other than general infrastructure, or purchases goods;
(iv) a government makes payments to a funding mechanism, or entrusts or directs a private body to carry out one or more of the type of functions illustrated in (i) to (iii) above which would normally be vested in the government and the practice, in no real sense, differs from practices normally followed by governments;

or

(a)(2) there is any form of income or price support in the sense of Article XVI of GATT 1994;

and

(ii) To facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy;
(iii) To promote exchange stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation;
(iv) To assist in the establishment of a multilateral system of payments in respect of current transactions between members and in the elimination of foreign exchange restrictions which hamper the growth of world trade;
(v) To give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity; and
(vi) In accordance with the above, to shorten the duration and lessen the degree of disequilibrium in the international balances of payments of members.

66 GATT art. 16.

(b) a **benefit** is thereby conferred.[67]

Furthermore, subsidies must be specific to an enterprise or industry;[68] they must be contingent upon export performance to be prohibited.[69]

There are several problems apparent in arguing that Japan's QE program violates the SCM Agreement. First, there is no payment, tax benefit, or government service provided to an exporter per Article 1.1. The Bank of Japan is purchasing primarily long-term government bonds to lower interest rates and stimulate lending and investment. As such, QE actions are not a subsidy defined by the SCM Agreement. Second, there is substantial disagreement whether exporters in general benefit from lower exchange rates since many of largest exporters are also the largest importers, and the gains made through exports tend to be off-set to the extent that imports increase their cost of production.[70] Third, even if Japan's QE policy could be construed as a 'subsidy,' it is neither given to a specific industry, nor related to export performance because anyone exchanging the currency would get the same rate, even those who import Japanese goods and benefit from the lower rate. As such, it would fail the specificity requirements of the SCM Agreement.

5. Conclusion

Japan's current QE monetary policy does not violate international law, in particular IMF and WTO/GATT Agreements. There is no definitive evidence that Japan's QE policy actions might have an impact on the exchange rate, which may be driven by external factors, particularly other QE programs, interest rate differentials, risk appetite, and safe haven flows. Given the enormity of foreign exchange markets and numerous possible causes for the recent fluctuation of the Yen *vis-à-vis* the US dollar and Chinese Yuan, it is difficult to prove a causal relationship. Even if Japanese monetary policy might cause the Yen to depreciate, it is merely an unintended

67 Agreement on Subsidies and Countervailing Measures art. 1.1, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, The Legal Texts: the Results of the Uruguay Round of Multilateral Trade Negotiations 275 (1999), 1867 U.N.T.S. 14, *available at* http://www.wto.org/english/docs_e/legal_e/04-wto_e.htm (last visited on Apr. 14, 2014). [Emphasis added]

68 *Id*. art. 2.1.

69 *Id*. art. 3.1.

70 M. Amiti, O. Itskhoki & J. Konings, Importers, Exporters, and Exchange Rate Disconnect, Federal Reserve Bank of New York Staff Reports 1-2 (Dec. 2012), *available at* http://www.princeton.edu/~itskhoki/papers/ImportsAndPassThrough.pdf (last visited on Apr. 14, 2014).

consequence for which there is no remedy under international law. Japan has suffered through a 20-year period of chronic deflation and stagnation, which were exacerbated by the Great Recession and other factors. As such, the Bank of Japan took unprecedented actions to loosen credit in the financial system. They are very similar to those taken by the US Fed, ECB, and the Bank of England which have been credited by many economists as preventing further economic turmoil.[71] Since it is so difficult to distinguish valid monetary policy from potential nefarious interference with the foreign exchange rates, it is inappropriate for IMP and WTO to use international legal mechanisms to sanction a country's actions. This is why IMF has not enforced its anti-currency manipulations against any country and will not do so in this instance. Countries with legitimate grievances against the Yen's devaluation should work with Japan to find an amicable solution rather than threatening to engage in retaliatory actions.

71 *See*, *e.g.*, J. Stein, Evaluating Large-Scale Asset Purchases, Speech at the Brookings Institution (Oct. 11, 2012); B. Plumer, *QE3: What is quantitative easing? And will it help the economy?*, WASH. POST, Sept. 13, 2012, *available at* http://www.washingtonpost.com/blogs/wonkblog/wp/2012/09/13/qe3-what-is-quantitative-easing-and-will-it-help-the-economy (last visited on Apr. 15, 2014).