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Currency Manipulation Provisions Do Not Belong in Trade Agreements

By Phillip Swagel

May 11, 2015

Demands for provisions to stop currency manipulation by foreign governments have become central to the congressional debate over proposed trade agreements, including the Trans-Pacific Partnership and Transatlantic Trade and Investment Partnership, under negotiation with our economic partners in Asia and Europe. Such provisions would require the U.S. to take action against countries that intervene in currency markets to keep their own currencies weak to obtain a trade advantage. Those calling for action against manipulators argue that the practice leads to a wider U.S. trade deficit, which in turn costs U.S. jobs. This assertion is not correct. Other countries do intervene, but this has a variety of effects on the U.S., many of them good. It is true that some firms and workers are hurt, but overall consumer spending and business investment rise and the cost to taxpayers for paying government debt is reduced. Indeed, the most important factors in affecting the U.S. trade balance, job creation and economic growth are to be found here, in the U.S. The idea of including currency manipulation provisions in trade agreements is misguided.

When we have a strong U.S. economy, it is not surprising that the dollar is strong, and likewise that the Yen is weak when the Japanese economy is weak. With a strong U.S. economy, we tend to import a lot and have a large trade deficit — but this is a sign of strength, because it is what happens when we are creating jobs and when the incomes of American families are rising. One way to reduce our trade deficit and have a weak dollar is to have a severe recession. We saw that just after the financial crisis in 2009, and it's hard to say that was a great period for the U.S. economy. A weak dollar is good for some people — and the idea of adding anti-manipulation provisions in trade agreements is the brainchild of the people who would benefit. That is fine; in our democracy, that is the way advocacy works. But adding these provisions would harm our nation as a whole.

I understand the political appeal of legislation that seems to hit at countries that intervene in currency markets. This feels like we are taking a stand against an unfair trade practice. But in reality, it hurts more than it helps. Currency manipulation is not a trade issue but a macroeconomic one. And while foreign competition has some negative effects on some Americans, on the whole, we gain a lot from trade and financial flows. This includes the sale of our Treasury bonds to foreigners; after all, we have to sell an awful lot of bonds to fund our government. So, the basic premise behind the currency manipulation provisions in trade agreements is faulty.

JAPAN

This flawed logic began with people in one industry upset at the weak Japanese yen. At first, it seems to make sense to say that Japan is a currency manipulator. In fact, Japan intervened in currency markets hundreds of times during the 1990's, though over the last 10 years Japan has intervened fewer than 10 times, almost entirely in the wake of their earthquake and tsunami.

Japan is going on its third lost decade and we have had strong growth exactly when they are supposedly manipulating their currency to our harm. The Yen's weakness actually reflects problems in Japan: the state of their economy and their attempt to avoid deflation by quantitative easing monetary policy.

Japan's policy makes the yen weaker against other currencies, including the dollar. But Japan is doing is exactly what our own Federal Reserve has done, and what we have been urging on Japan for many years. I have serious concerns about the easy money policy at the Fed right now giving rise to potential financial market bubbles. But if we had a threat of deflation, as does Japan, we would want the Fed to do what Japan is doing. We would want the central bank to go all-out with money creation to avoid a situation in which families and businesses delay spending in anticipation of lower prices. Aggressive monetary policy is the way to avoid a deflationary spiral. Japan is our ally, and a Japan with a revitalized economy would be an important contributor to stability in Asia, and to growth in a region, East Asia, that is responsible for about one quarter of our total exports. So it has become awkward to point the finger at Japan. As a result, the people pushing for anti-manipulation provisions now say it is about China. I will turn to China next, but it is helpful to remember that this idea started with Japan and that the switch from Japan to China took place because the original justifications were exposed as inaccurate.

CHINA

China is a currency manipulator. Not nearly as much as in the past, but China still takes steps to ensure stable changes in the value of its currency. China had a fixed exchange rate against the U.S. dollar from 1994 to 2005. This is no longer the case, and the Chinese currency has appreciated considerably since

2005. The government of China now intervenes in both directions to avoid both rapid strengthening and rapid weakening of their currency.

Like other emerging countries, China has built up a large stock of dollar-denominated foreign exchange reserves because the dollar plays a unique role in the international monetary system. What China does is not unusual, though China is by far the holder of dollar-denominated reserves.

The Chinese policy of currency intervention is profoundly misguided and inappropriate for China. Along with other policies that distort their economy, it leads to asset bubbles and inflationary pressures. (That sounds familiar to concerns about the Fed.) But consider the impact on the U.S. During the time that China acted to fix its exchange rate against the dollar, the U.S. economy had strong growth, interrupted by the slowdown arising from the 2000 collapse of the Internet bubble and the 2001 terror attacks. Chinese exports to the U.S. increased substantially, but we had strong overall economic growth. The Chinese exports did not prevent our growth; to an important degree, they reflected our growth. China's currency appreciated against the dollar from 2005 to 2008 and Chinese exports continued to grow. From 2008 to 2010, China's currency was again fixed against the dollar. Now according to the currency manipulation story, this must mean that Chinese exports would boom with this unfair advantage of a fixed exchange rate keeping China's currency weak. But it was actually the opposite. Chinese exports to the U.S. were flat, which reflected the weak U.S. economy, of course, in the aftermath of the financial crisis.

The lesson here is that the ultimate driver of U.S. growth, job creation and the trade balance is not China but the U.S. What happens in the U.S. is far more important than exchange rates.

On the down side, there is considerable evidence that particular industries are affected by competition with low-cost imports. But does anyone really think that if China did not exist, we would produce all of those made-in-China products here? No, of course we wouldn't. American families find that their purchasing power grows as a result of competition and low prices. Some of our workers are hurt, but it is mostly other countries that are suffering from Chinese competition.

Proponents of currency manipulation provisions next say that China is different than Japan because China buys dollar bonds while Japan's monetary policy intervention is buying yen bonds.

There is irony in the fact that we get upset when China buys our Treasury bonds. First, they do this because they have more faith in our economy than their own. And I agree with that assessment. Second, we sell Treasury bonds because we have a government deficit and those bonds are how we borrow money to pay our bills. China did not cause our deficit — that's our issue to address. If China did not buy our bonds, then U.S. interest rates would go up and it would be more difficult and more costly for us to carry our debt. Higher interest rates would also have a negative effect on business investment and consumer spending. So, China's inappropriate monetary policy hurts some U.S. businesses and workers, but overall, our levels of business investment and consumer spending would be weaker without Chinese purchases of dollars.

China has accumulated some $4 trillion in dollar-denominated assets, including something like $2 trillion of Treasury bonds. Because of China's inappropriate monetary policy, they have done this with an undervalued currency, which means that they overpaid. We ripped them off, and now we're complaining about it. The IMF calculates that the Chinese currency is about at equilibrium, but there were estimates that over the past decade, the renminbi was undervalued by 25 percent. A 25 percent undervaluation means that China paid $4 trillion for assets that were worth $3 trillion. It is baffling that some complain about that.

There are all sorts of difficulties with the kinds of calculations that organizations such as the IMF use to assess whether the Chinese currency is at equilibrium. It would be a mess to implement currency manipulation legislation because results of the assessments themselves would be subject to, well, manipulation. But set that aside for a moment.

Imagine if China were actually to liberalize their economy, to stop their monetary policy interventions and to open up capital flows that are now restricted, both in and out. If you were a family in China and you had all of your assets stuck in the Chinese real estate market, in banks controlled by the government, and in cash in your mattress — the assets you are allowed to have right now. The first thing you would do is move some of your money to dollars, with some of actually it going to the U.S. Maybe you would even move a lot of it because you would feel a lot safer investing your money in the U.S. than keeping it in China. More than a billion people taking money out of China and putting it into the U.S. is a vote of confidence in our system and of no confidence in theirs. If China actually implemented the reforms they need, it is likely that their currency would actually get weaker at first because of this capital flight into dollars. They would do exactly the thing we say we want, and their currency would get weaker — and then some of us would complain because they want to invest in our economy. In other words, as long as Chinese investors — be it government or individuals — have more faith in the U.S. economy than in their own, China will accumulate dollars.

It would be good for China to run a better monetary policy and to open up to trade and capital flows because their current growth model is not sustainable. Huge problems are building in their financial sector. But that will not be solved by adding currency manipulation provisions to trade agreements. The solution to the Chinese government's misguided intervention is not misguided intervention by the U.S. For sure, including currency manipulation provisions in trade legislation would help some Americans — those who are pushing for it — but it would hurt many more.

This issue of currency manipulation is a distraction from the serious problems we have with China. We should be focused instead on preventing them from ripping off our intellectual property, breaking into our computers and threatening their neighbors and our allies in the Pacific.

If anything, a vote for trade right now is a way to support our allies against China. The Trans-Pacific Partnership (TPP) provides Japanese Prime Minister Abe with political cover for doing difficult things, such as opening Japan's agriculture sector and other domestic markets to U.S. competition. Everyone understands that currency manipulation provisions are a poison pill for the trade agreement with Japan. China is not in the TPP. The TPP disadvantages China and favors Japan, so undercutting TPP is harmful for Japan and helps China.

Finally, let me briefly address the claims that we have lost millions of jobs because of currency manipulation. This claim is made by saying that currency manipulation causes trade deficits and that lead to job loss in the U.S. For sure, our job market would be stronger now if we were exporting more, but the problem is that our partners in Europe and in other places are suffering from weak economic growth, and that leads to lower U.S. exports. Our recovery is still uneven, but it is stronger than in other countries and U.S. imports have rebounded along with overall business and family spending. In other words, our economy is driving trade flows and driving the value of the dollar.

Again, Chinese practices pose real problems and we should stay focused on them. However, amending trade agreements to prevent currency manipulation will result in higher prices for American families, and higher costs for our government which, also, will ultimately hurt taxpayers.

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