*Image by Richard I Houghton*

# Chinese Currency Manipulation: U.S. Inaction Speaks Louder than Words

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China clearly manipulates its currency. Sounds sinister, doesn't it? While sovereign nations have the right to manage their currencies under international law, China's membership in the International Monetary Fund (IMF) requires China to avoid manipulating exchange rates.[1] For years, China has bought U.S. dollars (USD) and U.S. government debt, flooding the market with Chinese yuan to keep its value down relative to the USD preventing the exchange rate from reaching its natural equilibrium. More sinister, in the prevailing American view, pegging the value of the yuan to the USD, or at least maintaining its value within a narrow range rather than freely floating the value of the currency to market exchange rates, keeps Chinese exports less expensive for Americans to buy while making American exports more expensive for the Chinese import market. This sustains a trade imbalance that heavily favors China ($342B in 2014) due in part to this currency intervention by China's State Council.[2] One U.S. think tank recently reported that the United States, at no cost to the government, could create up to 5.8M jobs and reduce the overall U.S. trade deficits by up to $500B in just three years simply by addressing the world's currency manipulators.[3]

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Despite consistent rhetoric over the years on the presidential campaign trail that China plays unfairly in the international economic arena, the United States persists in its refusal to take assertive actions against China for its continuing interventionist currency policy. The U.S. Treasury Department continues to refuse to name China a "currency manipulator."[4] That declaration would provide the first step towards more aggressive U.S. actions to level the playing field.

Populist rhetoric campaigning for more aggressive measures may provide a boost at the domestic political polls but have not been followed up in practice. This failure, however, does not demonstrate lack of U.S. resolve, but rather an enlightened and pragmatic policy that maintains U.S. economic strength seemingly through inaction. An overtly confrontational and protectionist U.S. response to China's currency manipulation to undervalue the yuan would be myopic and run counter to both the United States' short-term economic and long-term strategic interests. Continued inaction, a counterintuitive proposition, remains the United States' best policy option.

**Background**

Accusing rival incumbents of mishandling China with weak foreign policy has provided American presidential election campaigns with a string of sound bites since the Dwight Eisenhower campaign. In 1992, when Ross Perot charged President George H. W. Bush with shipping jobs to China, these accusations began focusing on America's failure to check China's economic rise. Candidate George W. Bush vowed to treat China as an economic competitor. Four years later, John Kerry maligned President Bush as "asleep at the wheel" for failing to address China's currency manipulation. During a 2008 Democratic Party primary debate, Senator Barack Obama vowed to "take (China) to the mat on (currency manipulation)" while Senators Joe Biden and Hillary Clinton agreed.[5] Despite the tough talk from the current President, Vice President, and the two most recent Secretaries of State, Obama's Treasury Secretary has not taken steps to address China's currency manipulation either. Perhaps this led Candidate Mitt Romney to make the boldest campaign promise on the issue during a 2012 presidential debate, vowing to label China a currency manipulator on "day one" in office.[6]

Why has this consistent bipartisan tough talk failed to translate into action on China? There are four reasons the United States exercises restraint in dealing with China's currency manipulation: lack of effective measures, the relative unimportance of currency exchange rates in a globalized economy, the benefits to the United States of an undervalued yuan, and the strategic disadvantages that a weak yuan presents to China.

**The United States Lacks Effective Measures to Deal with Currency Manipulators**

The 1988 Omnibus Trade and Competitiveness Act requires the Treasury Department to report annually on exchange rate policies of countries with trade surpluses with the United States. This report determines whether predatory currency manipulation has put the United States at a competitive disadvantage. If the U.S. Treasury Department declares a country a "currency manipulator," the law mandates opening economic negotiations with the violator. Failure of these negotiations would pave the way for follow-on protectionist measures such as trade sanctions or the imposition of tariffs on imports from the currency manipulator. The efficacy of these mandated negotiations are doubtful; the ensuing sanctions and tariffs could potentially raise the price of raw materials and consumer goods with no locally produced alternatives and prove to be more damaging to both the U.S. economy and global economic stability than the currency manipulation itself. For these reasons, the U.S. Treasury Department has never labeled China a currency manipulator nor triggered the lengthy and potentially self-destructive ensuing results.[7,8]

Not only are the economic returns on such an action dubious, but the potential exists to elicit unfavorable international criticism. First, China does not stand alone as a currency manipulator. Other currency manipulators include significant U.S. trade partners and allies: Denmark, Hong Kong, Korea, Malaysia, Singapore, Switzerland, Taiwan, and Japan.[9] Continuing to ignore these currency manipulators, which include three of the United States' top ten trade partners, while aggressively confronting China would dilute the U.S. case against China. The United States even enjoys a trade surplus with some of the manipulators (Hong Kong and Singapore) which raises doubt regarding the true impact of currency manipulation.[10]

Furthermore, any unilateral U.S. condemnation of China for artificially devaluing the yuan to create an unfair subsidy on Chinese exports will likely be met with scorn. The international community easily could characterize U.S. condemnation of China as hypocritical given the recent subsidies the United States provided its own automotive, insurance, and financial sectors through the Troubled Asset Relief Program (TARP) and Emergency Economic Stabilization Act of 2008 (i.e. the "too-big-to-fail" bailouts).[11]

Unfortunately the IMF and World Trade Organization (WTO) lack effective mechanisms to address currency manipulators multilaterally. China agreed to avoid manipulating exchange rates, limiting its internationally recognized sovereign rights to manage its currency, in order to gain membership into the IMF. Yet the IMF realistically can do very little to enforce this agreement and curb China's interventionist currency policy. In fact, no country has ever been designated a currency manipulator by the IMF. Designation as a currency manipulator requires a majority vote which China easily could use its influence to block. Even if such a vote passed, the IMF lacks the authority to impose any economic sanctions. The strongest action the IMF could take—expulsion—requires an improbable 85 percent majority vote.[12]

On the other hand, the WTO can impose trade sanctions but not without its own limitations. First, the WTO requires a determination from the IMF that an offender manipulates its currency. Thus, the WTO relies on the same political process that prevented the IMF from ever designating a currency manipulator in the first place. Second, the WTO does not have provisions explicitly covering currency manipulation. A case against China would rely on an untested strategy that argues China illegally subsidizes its exports vis-à-vis currency manipulation rather than a case against currency manipulation per se.[13] Like the IMF, the WTO has never pursued such action against a currency manipulator, and it is doubtful such a complaint could successfully be used to authorize sanctions leaving the United States without effective unilateral or multilateral options for challenging China.

**Globalization Diminishes the Significance of Exchange Rates and Deficits**

When American political candidates, business leaders, or pundits condemn China for currency manipulation, the narrative remains simple and straightforward: China cheats at international trade. China buys U.S. dollars and debt to strengthen the dollar against the yuan. This makes Chinese products cheaper than their American competitors and conversely makes American goods more expensive in the Chinese market. This currency intervention effectively advantages Chinese exports, ultimately resulting in both the loss of U.S. jobs to Chinese labor and a persistent U.S. trade deficit with China. This narrative, however, ignores the realities of globalization, attributing too much blame for job loss and the trade imbalance to an unfavorable exchange rate and characterizing China purely as an economic competitor rather than an interdependent collaborator.

Chinese and U.S. manufacturers do not produce the same things. Chinese exporters do not compete with U.S. firms for American market share: they compete with other developing economies. Likewise, U.S. firms do not compete with Chinese firms for a share of the Chinese market but with firms from developed countries in Europe and Japan. A stronger yuan, even an overvalued yuan, therefore cannot significantly close the U.S. trade deficit. A correction of the exchange rate indeed would increase the cost of Chinese goods to the U.S. consumer, but there would not be any American-made substitutes readily available to replace the higher priced Chinese consumer goods. Americans simply will pay more for these Chinese imports or look to other developing economies for cheaper substitutes, potentially increasing the trade imbalance with China.[14]

Correcting the currency exchange rate would also lead to U.S. manufacturers losing their market share in China to European and Japanese firms. The increased cost of Chinese components and raw materials imported by U.S. manufacturers would drive up the price of U.S. manufactured goods versus the global competition. The increased cost of the imported components and raw materials would also inflate the trade deficit in China's favor as the United States pays more for these Chinese imports.[15] As an illustration, the yuan appreciated by 21 percent against the U.S. dollar between 2005-2008; during that same period, the U.S. trade deficit with China increased by almost one third.[16]

Clearly exchange rates affect but do not alone determine the trade deficit. Measuring the trade imbalance became more difficult with globalization. Historically relied upon econometrics exaggerate the imbalance. For instance, research indicates less than one half of the value of Chinese exports to the United States is actually added in China. The rest (materials, labor, overhead) of the value added comes from other countries, the United States included. For example, iPhones are assembled in China, where laborers add $6.50 to the total $178.96 wholesale value. The hardware and software are designed in the United States, and U.S. firms, in addition to Apple, add value through marketing, logistics, etc. Yet the trade statistics are tabulated in a manner that credits China with exporting the full value of the iPhone.[17]

Politicians continue to mistake currency exchange rates as a barometer for trade deficits and U.S. employment; globalization challenges the underlying assumptions in the relationships. Exchange rates factor less in determining the trade imbalance than the ability one country has to provide goods its trade partner cannot produce for itself. Correcting the exchange rate could potentially increase the trade deficit as both imported intermediate components for domestic manufacturers and goods without locally manufactured substitutes become more expensive. Current economic statistics fail to account for collaborative ventures between U.S. and Chinese firms, thus exaggerating the value of Chinese exports and therefore the trade deficit.

Finally, consider that the United States and China do not trade in a vacuum. The interconnected network of globalized economies ensure that any depreciation of the U.S. dollar in an attempt to improve the bilateral trade imbalance with China would have unintended consequences for the global economy. An improved USD/yuan exchange rate more likely would result in increased U.S. trade deficits with other developing nations than in a decreased trade deficit with China or increased U.S. exports or employment.[18]

**A Weak Yuan Benefits the United States**

A weak yuan relative to the U.S. dollar benefits not only the American consumer but also benefits U.S. firms, their employees, and the U.S. government. Starting with the American consumer, the benefits are rather straightforward. By keeping the yuan undervalued, China artificially keeps the cost, particularly the cost of labor, of Chinese exports to the United States low. This allows American

consumers access to cheap Chinese goods. Revaluation of the yuan would be tantamount to a tax on the American consumer, decreasing the consumer's purchasing power and thus standard of living.[19] The availability of cheap consumer goods ameliorates decades of flat real wage growth in the United States as wages have failed to keep pace with increases in productivity.[20]

Despite cries that China's policies unfairly disadvantage U.S. industry and the U.S. worker, the reality proves more complex. Many U.S. firms and multinational corporations that have outsourced production to China benefit from the low cost of Chinese labor where the weak yuan improves the profitability and competitiveness of these firms. This same phenomenon indeed displaced hundreds of thousands of low-skill, low-wage jobs to China at the immediate expense of the U.S. worker. However, these jobs cannot be recaptured by strengthening the yuan relative to the dollar. The trade imbalance does not determine overall levels of U.S. employment but rather in what sectors Americans find employment. If Chinese labor costs increased because of a strong yuan, the Chinese will lose those same low-skill, low-wage jobs to workers in other developing economies. The availability of low-cost Chinese labor instead created hundreds of thousands of U.S. jobs in engineering, design, finance, logistics, retailing, and marketing. As firms in the United States adopt international supply chains, they create a collaborative vice competitive effort between themselves and Chinese factories.[21] Allowing the Chinese to devalue the yuan may in the long run stimulate a more resilient U.S. economy and labor market that capitalizes on innovation and high-skill jobs.

Just as a weak yuan provides the U.S. consumer with access to cheap consumer goods, it also benefits the U.S. government by providing access to cheap credit. In order to keep the yuan undervalued, the Chinese must buy USD and U.S. government debt. China does so at terms favorable to the United States since the exchange rate is not determined strictly by market forces but rather by the Chinese flooding the market with yuan to buy foreign reserves. The Chinese do not have limited alternatives with either European or Japanese government bonds that are as attractive as U.S. treasury securities. In turn, this allows the United States to continue to cheaply run budget deficits. While the prospect of China holding significant amounts of U.S. debt may be unsettling, China has become inextricably interested in the continued strength of the U.S. economy in order to maintain the value of its investments.[22]

**A Weak Yuan Fetters China's Rise**

Finally, the artificially weak yuan prevents China from assuming worldwide economic leadership, inflates the price it pays for commodities, and forces China to devote resources to its internal security. The United States enjoys benefits as the supplier of the world's reserve currency. Not only can the United States raise capital more cheaply than other nations, but it also enjoys the clout of world economic leadership in multilateral organizations such as the World Bank, IMF, and WTO. China desires the status the United States enjoys because of the dollar's reserve currency status.[23] Despite being projected to displace the United States as the world's largest economy—at least in nominal terms—in the near future, the yuan will not displace the dollar as the world's reserve currency. The policies used to devalue the yuan do so in part by preventing it from being fully convertible, or exchanged without restrictions, on the open market. Even with reforms to Chinese policy, the yuan will not be able to replace the dollar for at least several decades.[24] Chinese currency intervention has delayed and may deny the changing of the guard as the United States will maintain economic hegemony for many years to come.

The artificially weak yuan makes dollar-denominated commodities, most significantly oil, more expensive for the Chinese. As the Chinese intervene in currency exchange rates to fuel economic

growth, the resources required for that growth are more expensive. This tempers Chinese demand for resources, preventing China from driving up the price of resources, keeping oil available relatively cheaply for the U.S. market.[25]

In the long run, an artificially undervalued yuan cannot be sustained; a stronger yuan would fuel China's rise. A stronger yuan would allow China to shift from an export based economy to a consumption based economy.[26] The implications are significant. A stronger yuan would lead to increased Chinese wages, increased purchasing power, and improved standards of living. Current economic growth does not enhance the welfare of the Chinese population as the U.S. dollars that flood into the Chinese economy are returned to the United States in the form of foreign reserve and securities purchases. At some point, the Chinese population will demand reforms and increased living standards on par with those enjoyed by the populations of developed economies. As long as the yuan remains artificially weak, the potential for social instability and threat of challenges to the one-party system will force China to focus security resources inward while the United States rebalances to the Pacific in an effort to maintain its edge.

**Does U.S Inaction Speak Louder than Words?**

China's currency manipulation may be necessary to support its short-term economic prospects but cannot be sustained in the long run. Those that would scapegoat China for the loss of low-skill, low-wage U.S. jobs exaggerate the exchange rate's impact on the U.S. trade deficit with China. They also ignore the realities of U.S. relations with China; China is as much an economic collaborator as competitor. They also gloss over the potentially devastating effects of engaging in an economic tit-for-tat with China—a policy shift that would invite retributions and potential escalation into a trade war.

A confrontational approach does not provide the answer. Indeed, absent an overt U.S. response, the Chinese will continue to gradually revalue the yuan in their own self-interest and at their own pace. In fact, a milder approach that included closed-door negotiations and avoided public condemnation saw the Chinese real exchange rate with the United States, which provides a better measure than the nominal exchange rate as it compares the cost of equivalent goods and services between the countries, rise by nearly 50 percent between 2005-2010.[27] In other words, the Chinese revalued their currency in the absence of an adversarial approach. This allowed the United States to focus on developing, in the words of the 2010 National Security Strategy, "a pragmatic and effective relationship between the United States and China" rather than antagonizing China for a questionable economic gain.[28]

Despite the campaign rhetoric, the failure of both Democratic and Republican administrations to take a stronger stance on China's monetary policy neither reflects a decline in U.S. economic influence nor a lack of U.S. resolve. Rather, the U.S. response has strengthened its long-term economic security while recognizing mutual economic interests with a trade partner it has grown inextricably interdependent upon.

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