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Currency warriors rise again

By Steve Hanke

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The spectre of currency wars rises like a phoenix once again, with a strong US dollar inflaming the currency warriors.

These warriors (read mercantilists) are mainly based in the United States and are led by Senator Chuck Schumer, a Democrat from New York, and Senator Lindsey Graham, a Republican from South Carolina.

They argue that “cheap” foreign currencies give US trading partners an “unfair” advantage, something worth doing battle over. About the only thing the mercantilists have right is the fact that the dollar has been strengthening.

The currencies of all of America’s top trading partners have lost value against the greenback over the past six months. The losses have ranged from around 2 per cent for the yuan to about 40 per cent for the rouble.

The combined Sino-Japanese contribution to the US trade deficit has actually declined from its 1991 peak

So the currency hawks want to go to war and they see a potential trigger in the Trans-Pacific Partnership (TPP), a trade agreement between Asian countries and the United States. They want to insert enforceable rules against so-called currency manipulation into the TPP.

This sabre rattling has a familiar ring to the biggest US trading partners in Asia – Japan and China – which have accounted for the lion’s share of the US trade deficit over the past 20 years.

From the early 1970s until 1995, Japan was viewed as the enemy. Unfair Japanese trading practices were blamed for the US trade deficit, which could be reduced primarily by the yen’s appreciation against the US dollar.

Washington even tried to convince Tokyo that an ever-appreciating yen would be good for Japan. Unfortunately, the Japanese complied and the yen strengthened, moving from 360 to the greenback in 1971 to 80 in 1995.

In April 1995, then treasury secretary Robert Rubin belatedly realised that the yen’s great appreciation was causing the Japanese economy to sink into a deflationary quagmire. The US arm-twisting on the value of the yen suddenly stopped and Rubin evoked his now-famous strong-dollar mantra. While this policy switch was welcome, it was too late and Japan continues to suffer from the mess created by the yen's appreciation.

As Japan's economy stagnated, its contribution to the increasing US trade deficit declined, falling from its 1991 peak of almost 60 per cent to 9.3 per cent today. While Japan's contribution declined, China's surged from slightly more than 9 per cent in 1990 to 47.2 per cent today and the yuan replaced the yen as the mercantilists' whipping boy.

Interestingly, the combined Sino-Japanese contribution to the US trade deficit has actually declined from its 1991 peak of more than 70 per cent to 56.7 per cent. This hasn't stopped the mercantilists from claiming that the yuan is grossly undervalued, and that this creates unfair Chinese competition and a US bilateral trade deficit with China.

This raises an obvious question: does a weak yen or yuan vis-à-vis the dollar (in nominal terms) explain the contribution of Japan and China to the US trade deficit? After all, this exchange-rate argument (read: competitive advantage) is what the mercantilists use to wage war.

When it comes to Japan, there is a clearly weak relationship between yen strength and the trade deficit. It is certainly not something worth going to war over.

And as for China, the relationship between the strength of the yuan and China's contribution to the US trade deficit contradicts the mercantilist analysis. The yuan has appreciated in nominal terms versus the dollar over the past 20 years, yet so has China's contribution to the US trade deficit.

That shouldn't happen if the mercantilist analysis is correct, but the evidence fails to sway them. They still want tough currency manipulation provisions inserted into the TPP. They don't realise that the term "currency manipulation" is not an operational concept that can be used for hard economic analysis and that any rules would be almost impossible to implement.

The US Treasury has acknowledged this fact in reports to Congress. Indeed its 2007 attempt to have the International Monetary Fund (IMF) act as a global currency cop and go after manipulators was declared an "unmitigated disaster" by the IMF's then chief economist, Raghuram Rajan, who is now governor of India's central bank.

But it isn't only mercantilist politicians who don't understand that nominal exchange rates don't have much to do with trade deficits. Some economists – most notably Fred Bergsten of the Peterson Institute for International Economics and supply-side guru Arthur Laffer – don't seem to understand the economics behind the US trade deficit, which has been with us since 1975.

Those economics were fully explained by one of my occasional collaborators, the late Ronald McKinnon from Stanford University. Indeed, he elaborated on them in his last book, The Unloved Dollar Standard: From Bretton Woods to the Rise of China (2013).

In short, the US trade deficit is the result of a US savings deficiency, not exchange rates. As a result, the trade deficit can be reduced by some combination of lower government consumption, lower private consumption or lower private domestic investment.

You wouldn’t know this basic truth by listening to the rhetoric coming out of Washington.

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