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Foreign 'Currency Manipulation' Does Not Warrant Washington's Attention

By: Dan Ikenson – January 8th, 2013

In a *Wall Street Journal* oped today, Ed Lazear, former chairman of the Council of Economic Advisors, pokes some big holes in the theory that Chinese currency manipulation explains that country's big trade surplus. He looks at the numbers – as I did a few years ago – to demonstrate that the relationship between relative currency values and trade flows is no longer quite what the old textbooks told us.

The timing of Lazear's oped is very good, as the Peterson Institute is back on its hobbyhorse, recommending strong measures to bring an end to global currency manipulation. In a new paper titled "Currency Manipulation, the U.S. Economy, and the Global Economic Order," coauthors Fred Bergsten and Joseph Gagnon argue that, as a result of massive currency interventions on the part of some 20 foreign governments, the United States has incurred heavy losses, including the dubious claim that annual trade deficits have been $200 billion to $500 billion higher than they would have been, depriving the economy of one million to five million jobs. (I find these numbers tough to accept because there is plenty of evidence – see Lazear, see this, see that – supporting the conclusion that currency values are weak determinants of trade flows, and there is the fact that the U.S. economy has "created" more jobs in periods when the trade deficit was growing than in periods when it was shrinking – see this testimony and the chart in this post.)

Since U.S. fiscal policy tightening is inevitable and since monetary policy options have been exhausted, Bergsten and Gagnon argue, reducing the U.S. trade deficit is the only way to "accelerate growth and restore full employment," and that will require "insist[ing] that other countries stop manipulating their currencies and permit the dollar to regain a competitive level."

By "insisting," the authors mean that U.S. officials should seek voluntary agreement from foreign governments to stop or "sharply reduce" their interventions and then, if they don't agree to those terms, deploy four policy tools to compel them to change course:

1. Engage in countervailing currency interventions to neutralize the exchange rate impacts of the offending interventions;
2. Restrict purchase and/or tax profits of U.S. assets owned by the interveners;
3. Treat manipulated exchange rates as subsidies and impose countervailing duties;

4. File a formal complaint with the World Trade Organization.

Although 20 governments are identified as having intervened in currency markets to the tune of about $1 trillion annually for several years, the authors excuse most of them on policy rationales deemed to have sufficient legitimacy, leaving China as the real focus of the paper. China has certainly been the world's most prominent currency market intervener in recent years and the authors' interest in grouping her with 19 others is probably tactical; China might be more cooperative on the issue if she is not being singled out. Fair enough.

But while persistent, large-scale government interventions into currency markets are distorting, and the global economy would operate more efficiently if currency values were determined exclusively by market supply and demand factors, I wonder whether this issue warrants the remedial approach – or even the serious attention of policymakers – prescribed by Bergsten and Gagnon. I wonder whether the current account imbalances and reserve accumulations aren't themselves responses to perceived (or symptoms of actual) policy errors in the United States and Europe and that they will correct in response to smarter policy without need of resort to the authors' also distorting, second-best policy interventions. And I wonder whether the changing nature of trade and investment – particularly the proliferation of transnational supply chain trade and its mitigation of the effects of currency values on final trade flows – has been given adequate consideration in the Peterson analysis. (I've raised the issue in response to previous Peterson analyses, but have never seen a response).

The assumption of the Peterson paper is that currency interventions are undertaken by foreign governments to suppress domestic currency values in order to render export prices more competitive. Certainly, that's one motivation. But in a world where intermediate goods trade – cross-border exchange of inputs and raw materials used in production of final products – accounts for the majority of the value of international trade flows, undervalued currencies have countervailing effects on final prices. China, which is a large export processor, imports on average about half of the value of its exports. In some products, such as smart phones and high tech gadgets, upwards of 95 percent of the value is imported. This all means that an undervalued Yuan makes input prices (and production costs) higher than they otherwise would be. An appreciating Yuan reduces production costs, which enables Chinese processors to lower their prices for export and still earn profits, mitigating (sometimes entirely) the higher prices otherwise associated with a stronger currency.

But, as acknowledged in the paper, governments intervene in currency markets to pursue a variety of policy objectives (not just to secure an exporter advantage), including to defend the currency from competitive devaluations. In fact, several of the 20 offending governments ultimately are excused from malfeasance by the authors because they are intervening, allegedly, to countervail the actions of instigators. Likewise, expendable-resource-rich countries, such as the oil-producing nations, might want to build up reserves (and establish sovereign wealth funds) to share their blessings with future generations who may no longer be able to depend on that resource. The United Arab Emirates does it. Norway does it. The U.S. state of Alaska does it.

The U.S. Federal Reserve has had an easy money policy almost continuously for more than a decade, in fact pre-dating China's U.S. dollar purchasing and reserve accumulation policies. Might the Chinese have been concerned that loose Fed policies would create inflation and that their intervening to buy dollars was an insurance policy

intended to protect the value of its dollar-denominated assets, particularly its now $1.2 trillion in U.S. Treasury securities? Might building some insulation from those and other ill effects of U.S. monetary policy have been a contributing factor to China's currency interventions? Without question, the Fed's quantitative easing has suppressed the value of the dollar, arguably giving U.S. exporters a competitive advantage and prompting some foreign governments to complain that the U.S. policy is akin to currency manipulation.

For U.S. policymakers to single out currency manipulation as a primary concern for remediation (as the Peterson paper does), the United States should have clean hands. But is currency intervention a more aggressive distortion than U.S. pump-priming – or a reaction to it? The U.S. government engages in all sorts of market-distorting behavior, the consequences of which cut in many different directions: the Federal Reserve's open market operations are distinct interventions that affect the supply and demand of money and credit; tax credits and other government subsidies to, say, green energy production are interventions into goods markets; "Buy American" and other buy local laws, minimum wage laws, and government-administered bankruptcy proceedings are interventions into labor and goods markets. The purchasing, production, and investment decisions of state-owned enterprises, nationalized industries, sovereign wealth funds, and other government-influenced actors all affect markets in ways that skew outcomes away from their optimums. So the argument that currency manipulation is somehow more odious or problematic than these other interventions, which all spill over into the real economy, is not all that compelling, particularly when it may be symptomatic of, or responsive to, problems caused by the U.S. savings gap.

U.S. policymakers (though not necessarily U.S. taxpayers and especially not the next generations' tax payers) have some distinct advantages in the U.S. dollar being the world's chief reserve currency. The dollars that other governments want to accumulate by building current account surpluses and squirrel away in case of economic emergencies can simply be printed by the U.S. government. The imperatives of current account surpluses or fiscal responsibility are apparently not quite so pressing when the rest of the world is prepared to lend you what you need in your currency. How long that remains the case is unclear, but as long as the dollar is the world's primary reserve currency, foreign governments are somewhat hostage to the policy decisions made in Washington. Foreign government accumulation of dollar reserves provides some measure of assurance against the ill effects of U.S. policy.

Bergsten and Gagnon conclude that "Trade balance improvement is essential if the United States is to reduce its high unemployment and underutilized capacity as a satisfactory rate, under current and prospective macroeconomic policies at home and abroad." Ed Lazear reminds us that foreign currency policies would be the wrong focus. If restoring the U.S. economy to "full-employment" output is the objective, then there are plenty of domestic foci for policymakers to incentivize economic growth. Regulations are estimated to cost U.S. business about $1.75 trillion per year. Many of them are superfluous or deleterious. Overhaul them. U.S. Customs collects over $30 billion per year in import duties, raising U.S. costs of production and costs of living. Eliminate them. We have recently begun deploying new technologies to extract vast reserves of natural gas, which is relatively expensive abroad. Liquify and export it. Many smart, productive, entrepreneurial people who happen to be from foreign countries, want to come here to learn, work, and create, but our restrictions limit their (and our) prospects. Fix the immigration system. By agreeing to a more fiscally responsible government and establishing the rules of the road for the next several

years, policymakers could introduce a greater degree of certainty, which would spark greater investment, hiring, output, and trade. Do it.

Let's not encourage policy that effectivelyscapegoats others for our economic problems. They are homemade. So should be our solutions.