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The Senate's Currency Manipulation Bill Is Not Only Bad Policy, but Unnecessary

Author: Ed Dolan (/blog/author/edolan) · October 12th, 2011 · Comments (0) (http://www.economonitor.com/dolanecon/2011/10/12/the-senates-currency-manipulation-bill-is-not-only-bad-policy-but-unncecessary/#idc-container)

China's currency manipulation is bad policy. So is the Senate's latest crackdown on it. The bill passed yesterday is not only bad policy, but unnecessary. Here's why.

First of all, before we get hysterical about Chinese policy, we should recognize that currency manipulation is the global norm, not the exception. By a recent count, only 14 percent of the IMF's member nations allow their exchange rates to float freely. Some 58 percent manipulate their exchange rates by holding them above or below the level to which the market would move them.

The remaining 28 percent pursue an even more rigid policy: They give up their own currencies altogether and put some other country's money directly into circulation. How would we like it if China put the U.S. dollar into circulation as legal tender, the way Ecuador, Panama, and several others do? The same flag-waving Americans who don't like a fixed rate for the yuan would probably be proud, but the result would be subject to all the same criticisms, and more, that are made against the current policy of a semi-transparent sliding peg.

The long an the short of it? Currency manipulation per se is neither unusual, nor automatically bad, nor a violation of internationally accepted rules of the game.

China comes in for special abuse because it is big. Switzerland has recently started manipulating its currency far more aggressively than China does. The Swiss added 11 percent to their currency reserves in September alone in an attempt to hold the franc below its market equilibrium. In proportional terms, China doesn't come close to that scale of intervention. But Switzerland is tiny, so who cares?

Because China is a big trading partner of the United States, there might be some legitimate

on climate change, ecosocialism, energy policy, and more.

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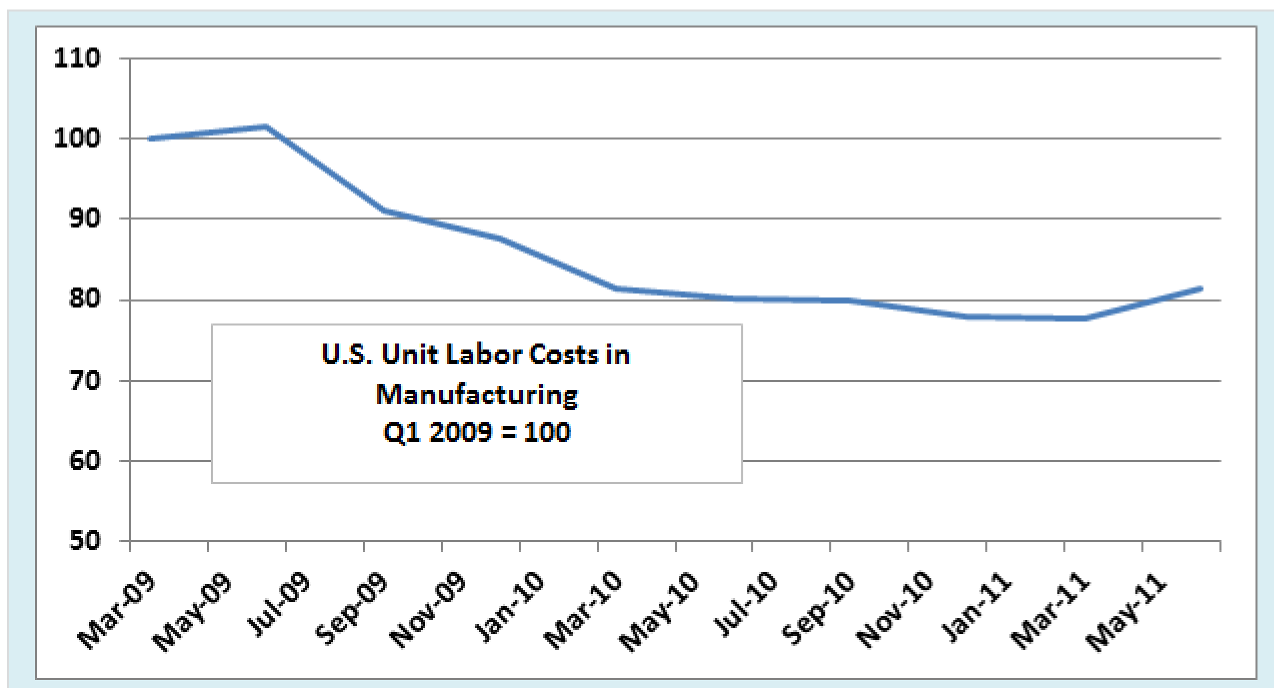
grounds for concern if its currency were stuck at a deeply undervalued level and showed no signs of change. That was the case from July 2008 to June 2010, a time during which China froze its exchange rate at 6.82 yuan to the dollar. By the end of that period economists were estimating that the yuan was undervalued by 20 to 40 percent, depending on the exact methodology they used.

Since June 2010, however, the People's Bank of China (PBoC) has been allowing the yuan gradually to strengthen in nominal terms. The cumulative change has been about 6.5 percent over 15 months, or roughly 5 percent per year. Not enough, you say? But wait, that's only the beginning of the story.

As I have noted in several earlier posts (here most recently) (http://www.economonitor.com/dolanecon/2011/06/13/one-year-later-how-much-has-chinas-yuan-appreciated/), what really matters for US-China competitiveness is not the nominal exchange rate, but the real exchange rate. The simplest way to calculate the rate of real appreciation of the yuan against the dollar is to add the inflation differential between the two countries to the rate of nominal appreciation. Recently, inflation in China has been running about 3 percentage points higher than in the United States, depending on what price index you apply. That implies a rate of real appreciation of about 8 percent per year. Such a rate is enough to wipe out a 20 percent undervaluation in less than 3 years or a 40 percent undervaluation in less than 5 years. That's change you can start to believe in.

There's more to the story than that, however. What really matters for jobs and competitiveness is not consumer price inflation, but the rate of change of unit labor costs. (Unit labor costs are wage rates adjusted for changes in productivity.) A recent study from the Boston Consulting Group (http://www.bcg.com/media/PressReleaseDetails.aspx?id=tcm:12-88775)suggests that Chinese unit labor costs will grow at about 8.5 percent per year over the next five years. Meanwhile, U.S. unit labor costs in manufacturing, where the head-to-head competition for jobs lies, have been on a steady downward trend, because productivity growth has been strong and wage increases moderate. The most recent data, which show a tiny upturn, are the first increase in 10 quarters.



(http://www.economonitor.com/dolanecon/files/2011/10/P111012-1.png)

Conservatively speaking, then, it appears that over the past couple of years, the real exchange rate of the yuan, deflated by unit labor costs, has been appreciating against the dollar at a rate of something like 15 percent per year. Even if the U.S. unit labor cost trend flattens out, a continued 10 percent rate of appreciation appears likely.

Let's remember that back in the spring of 2010, when the Chinese were still holding firm to their peg of 6.82 yuan to the dollar, the maximum demand being made by American China-bashers was a 40 percent revaluation. In the fifteen months have elapsed since the peg was abandoned, a third, maybe even half, of the gap has vanished. At the rate things are going, the yuan will reach parity against the dollar, measured by unit labor costs, about two years from now, possibly sooner. How does that compare with the timetable set by the bill just passed by the U.S. Senate?

If you are an impatient person, you will be disappointed to learn that the Senate bill does not call for an immediate revaluation of the yuan, not by 40 percent or by any other number. What it does is to direct the Secretary of the Treasury to use a more aggressive methodology in deciding whether officially to declare China a currency manipulator.

Let's suppose the bill becomes law and the Secretary duly makes the declaration, say, sometime next summer. That would then trigger mandatory consultations with the Chinese. If those went nowhere, as would surely be the case, the United States could then slap on compensatory duties, which would be immediately challenged at the WTO. If the WTO ruled in favor of the United States with exceptional swiftness, and if the Chinese made no further appeal, the Senate's bill might come fully into effect—I'm just guessing here—sometime in 2015, or about two years after market forces had fully eliminated the 40 percent competitiveness gap that everyone was whining about in the first place.

But wait, you might say, isn't it possible that if the United States fails to show resolve by enacting this bill into law, the Chinese will realize we are a bunch of wimps and will stop their halfhearted revaluation policy? No, for two reasons, there is no danger of that.

The first reason, as I have detailed elsewhere, (http://www.economonitor.com/dolanecon/2010/11/29/how-chinas-inflation-policy-will-shape-the-yuan-dollar-exchange-rate/) is that any efforts the PBoC makes to slow the rate of nominal appreciation of the yuan automatically add to inflationary pressure in China. Since real appreciation is the sum of nominal appreciation plus the inflation differential, the competitiveness gap continues to close, one way or another, no matter what the PBoC does.

The second reason we can be pretty sure the Chinese will not try to hold on indefinitely to a 20-40 percent undervaluation is that doing so is enormously costly for them. A recent study by the Peterson Institute for International Economics (http://www.economonitor.com/piie/2011/10/06/the-internal-cost-of-china%e2%80%99s-currency-policy/) estimates the cost at $240 billion per year, more than China's entire trade surplus, and about 4 percent of its GDP. To be sure, even if an undervalued currency imposes a loss on the Chinese economy as a whole, there are winners as well as losers. Some of the winners among China's export industries are said to be politically powerful. But even by the mysterious standards of Chinese politics, $240 billion a year is a lot of money to throw away just to please your friends.

The bottom line? The Senate's latest assault on Chinese currency manipulation makes no sense at all. Its economic goals will already have been reached long before the tortured procedures it calls for could ever work themselves out. The bill is a blatant play for ephemeral domestic political gain at the risk of unneeded diplomatic conflict. We can only hope that the legislation will die in the House, or if it passes there, that it will be vetoed by the White House, and if so, that any attempted override falls short. Thank goodness for checks and balances.

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