Insight

Understanding the U.S.-China Currency Battle

JACQUELINE VARAS | AUGUST 13, 2019

Last week, President Trump claimed China intentionally lowered the value of its currency to give itself an advantage in the U.S.-China tariff battle, and the Trump Administration officially designated China a currency manipulator. These developments have further escalated trade tensions between United States and China as the nations face ever-increasing tariffs and negotiators struggle to reach a deal. What does this latest development mean, and how does it impact the relationship between the two countries?

What Happened?

President Trump announced that the United States will impose a 10 percent tariff on the remaining roughly $300 billion of Chinese goods – making the entirety of U.S. imports from China subject to new tariffs. The value of China's currency then fell abruptly by 1.6 percent last week to its weakest level relative to the U.S. dollar since 2008. Upon this news, the Treasury Department designated China as a currency manipulator for the first time since 1994. China's currency devaluation also followed a Federal Reserve decision to cut the federal funds rate by .25 percentage point: a move that lowers the cost of borrowing by driving down the value of the dollar, and a decision made in part because of the economic uncertainty surrounding the president's mounting trade war.

What Is Currency Manipulation?

Currency manipulation occurs when a nation artificially devalues its currency to make its goods cheaper on the world market. As a result, the intervention boosts exports while making imports more expensive, lowering the trade deficit. There are several different policy actions that cause currency to lose value: when a central bank lowers interest rates, purchases foreign-denominated assets, or engages in quantitative easing – an expansion of the money supply made by purchasing assets denominated in the home currency. The question of whether these actions explicitly imply currency manipulation gets a bit hazy, as they can also be used to boost economic growth. Currency manipulation can also occur when a nation fixes its currency value relative to another at an undervalued rate.

What Caused the Depreciation?

President Trump alleges that the drop in China's currency was driven by overt currency manipulation. This allegation is ostensibly based on China's history of managing its currency value: From 1994 to 2005, China fixed the exchange rate at 8.3 renminbi (RMB) per one U.S. dollar, artificially depressing its value. In 2005, China abandoned this fixed bilateral exchange rate for a more market-oriented system that pegged the RMB to a weighted basket of currencies, allowing its value to fluctuate within a band of plus or minus 0.5 percent of a the basket of currencies. The band has since increased to plus or minus 2 percent. Furthermore, leaving the direct peg to the dollar caused the RMB to appreciate 42 percent against the dollar on an inflation-adjusted basis over the next 10 years.

It is useful to understand how China manages its currency. Each day, the Chinese central bank sets a reference rate – a midpoint exchange rate within the 2 percent band – based on the previous day's closing currency value. Last week, the bank let that exchange rate depreciate to above 7 RMB/dollar, a rate that has since persisted.

This recent depreciation *could* be the Chinese central bank actively buying dollars or dollar-denominated assets to force a relative RMB depreciation. The more likely scenario, however, is that China did not actively intervene to keep the value of the RMB stronger than it would be naturally – a departure from its recent, more interventionist monetary policy strategy of purchasing RMB to keep its value from falling. Economic forces resulting from President Trump's tariffs on China are naturally putting downward pressure on the RMB, as the tariffs reduce demand for the RMB. The fact that the RMB's depreciation occurred shortly after the United States' latest tariff announcement, given that the RMB floats within a band, is no coincidence.

Additional evidence suggests that China is probably not manipulating its currency. Just three months ago, in its yearly review, the Treasury Department did not find that China met the definition of a currency manipulator. And in early August, the International Monetary Fund (IMF) released a report finding that the RMB is not undervalued and remained broadly stable against a basket of currencies last year.

What Are the Implications of the 'Currency Manipulator' Designation?

The United States has only made currency manipulator designations three times in the past: Taiwan and Korea in 1998, and China from 1992 to 1994. According to the Omnibus Trade and Competitiveness Act of 1988, once a country is designated a currency manipulator, the Treasury Secretary must "initiate negotiations with such countries in the International Monetary Fund or bilaterally to ensure that they regularly adjust the exchange rates between their currencies and the U.S. dollar." If no reforms are made, these negotiations may lead to IMF sanctions.

After the past designations, all three nations made substantial reforms to their exchange rate regimes following negotiations, resulting in currency appreciation and a decrease in their trade surpluses. These same results may be difficult to obtain from China today, however, given that experts and the IMF agree the RMB is not currently undervalued. Furthermore, the IMF's recent findings of no currency manipulation may also make it difficult to impose penalties against China.

That being said, the penalties that can be given to currency manipulators may soon expand: A new rule proposed by the Trump Administration would empower the Department of Commerce (DOC) to impose countervailing duties (tariffs) against currency manipulators as designated by the Treasury Department. The president has already imposed or ordered tariffs on all imports from China for unfair trade practices, increasing nationwide prices for both producers and consumers and hurting business investment. Extending the DOC's authority by allowing it to impose tariffs for currency manipulation will exacerbate the negative economic impacts already being felt.

Finally, imposing trade penalties for a country's independent monetary policy decisions opens the United States to the risk of currency manipulation penalties from other countries – interfering with our ability to conduct expansionary monetary policy at a time when economic growth is slowing and the likelihood of a U.S. recession may be rising.