

Is China a Currency Manipulator?

During a speech at Gettysburg, Pennsylvania in October 2016, Donald Trump laid out his own plan for what he'd do in his first 100 days in office. Near the top of his list was "Direct his Secretary of the Treasury to label China a currency manipulator." Asked about this pledge last month, President Trump said, "Well [the Chinese], I think they're grand champions at manipulation of currency. So I haven't held back. We'll see what happens."

Now that we're within a few days of the 100-day deadline, though, President Trump has changed his mind. Yesterday, he said he will not be labeling China a currency manipulator.

Whatever you feel about the flip-flop, Trump's rhetoric had caught up with reality: China hasn't devalued its currency since 2014. In fact, for the past few years China has tried to prop up the *renminbi* (their currency, which we know as the "yuan") for to keep it from falling.

But what does it mean for a nation to be a "currency manipulator," and why does it matter? Before we answer those questions, let's first look at a couple of others:

Who is considered a currency manipulator?

In 2015, Congress passed the Trade Facilitation and Trade Enforcement Act. This Act requires that the Treasury Department "undertake an enhanced analysis of exchange rates and externally oriented policies for each major trading partner that has: 1. a significant bilateral trade surplus with the United States, 2. a material current account surplus and 3. engaged in persistent one-sided intervention in the foreign exchange market."

Since 2015, no country has met that definition, though six major trading partners are included on the “Monitoring List”: China, Japan, Korea, Taiwan, Germany and Switzerland. The country that comes closest to meeting the criteria for being a currency manipulator is not China, but Switzerland.

What happens if a country is officially designated as a currency manipulator?

If Treasury were to designate a country as a currency manipulator, it would allow the Secretary of the Treasury to affix a 25 percent tariff onto imports into the U.S. The designation essentially provides the Treasury Department with an official justification for implementing protectionist trade policies.

Okay, so what does this mean in the real world?

Any issue that includes global trade, currency markets and monetary policy is obviously going to be complex. But the basic idea can be conveyed rather simply. As Jonathan M. Finegold Catalan says:

Oftentimes, when looking at international trade from a macroeconomic bird's eye view, one loses perspective on how trade actually works. The truth is that trade between China and the United States works no differently than trade between a tailor and a neighboring baker. It is far easier to objectively assess the current trade situation between China and the United States by looking from the perspective of the individuals who make up the exchanges. In other words, trade between two countries is nothing more than exchanges between individuals from Country A and individuals from Country B. Taking money into consideration makes the concept only slightly more complex.

Let's consider an example from my own life. When I was stationed on a U.S. Marine Corps base in Japan in the 1990s I had to make a choice every day about where I would eat lunch:

Get a hamburger at the American restaurant available on the military base or get some yakisoba (similar to ramen noodles) at the Japanese restaurant outside the main gate.

If I bought the hamburger, I only had to deal with one price—the price of the burger. But if I bought a bowl of yakisoba I had to deal with two prices—the price of the noodles and the price of yen, the Japanese currency. The price for the burger and the yakisoba rarely changed. But the price of the yen fluctuated frequently, sometimes daily.

Just as there is a market for burgers and yakisoba, there is a market for dollars and yen (i.e., the currency market). And like all markets, the price is determined in part by supply and demand. If more people on base want burgers than yakisoba, then the price of the former should eventually rise and the latter will eventually fall. This is the basic rule of supply and demand and it works for both food and money.

To make the math easier, let's say that on the first day of the month a burger cost \$1 and the yakisoba cost 100 yen. Let's also set the exchange rate at 100 yen to the dollar. To pay the woman who made the yakisoba I first had to "buy" a dollar's worth of yen (i.e., 100 yen) from a currency exchange. Whether I buy the burger or the bowl of noodles, I'm going to pay the same price for each because the "price" of the currency is equal (i.e., a ratio of 100 cents to 100 yen).

Now let's say the Japanese government wants to sell more yakisoba and decides to "manipulate" the yen. To make their currency cheaper compared to the dollar, the central bank of Japan can manipulate the normal supply-and-demand for dollars and yen by printing more yen and using the newly minted currency to buy more dollars. The bank has thus done two things that effect global currency: increased the supply of the yen above what is required by the normal currency market (thus lowering the "price" of yen) and increasing the "price" of the dollar by reducing their supply (i.e., by buying them

up and taking them out of circulation).

Let's say the government prints more yen until the exchange rate now equals 200 yen to the dollar. What has happened and how will affect much lunch decision?

Well, the dollar is now more "expensive" than the yen (50 percent more expensive). But I don't buy yen just to buy yen. I buy yen so that I can pay for yakisoba. The yakisoba is the same price (100 yen) but now it cost me only 50 cents for a bowl. That makes it cheaper to eat yakisoba than it does to eat hamburgers.

So who benefits and who loses in this scenario? It's not as obvious as it may seem. Clearly, people like me—those who have dollars and want to buy Japanese products—benefit because we can buy their goods and services cheaply, allowing us to get more for our dollar. The person who is selling burgers on base may (though not necessarily) be harmed since there may be less demand for their product.

It would also seem like the woman selling the yakisoba would benefit since she is selling more of her product. But the yakisoba lady lives in Japan and pays for everything in yen. The currency manipulation has made it easier for her to sell to Americans but has made it more expensive for her to buy American goods. It has also made the yen she earns worth less relative to the goods and service that she can buy in her own country (this is known as inflation).

In the short run, the currency manipulation has helped me (i.e., the person "importing" Japanese goods) while hurting the American "manufacturer" (i.e., the American burger-maker) and Japanese consumers (including my yakisoba-seller). In the long run, though, the inflation caused by the currency manipulation will result in a rise of the price of nearly all Japanese products. This will, at least partially offset the benefit of the currency manipulation.

We also need to ask, "Who bought the dollar I traded for 200 yen?" The person selling the yen was likely the Japanese government (it is, after all, their currency and it cost them almost nothing to "produce") so they can either use their dollar to buy goods from countries that sell products for dollars (like the United States) or they have to trade it back to yen (which because of supply and demand would cause the yen to become even more inflated).

If Japan just buys back goods and services with their dollars, it quickly offsets the reason they manipulated their currency in the first place. But foreign dollar-buyers have another use for our currency: buying U.S. government debt. In fact, this is a significant use of the dollars that Japan gets from us. Currently, they own \$ trillion of U.S. government debt. By holding 5 percent of our national debt, Japan is our biggest overseas creditor. (China comes in at #2 with \$ trillion.)

In exchange for interest payments on U.S. Treasury bonds (which foreign governments will likely use to buy even more of our debt), the U.S. government gets to keep spending more than it takes in without it having a negative effect on interest rates. So if you have a cheap mortgage, you can thank (in part) China and Japan.

If the long-term effects of a country manipulating their currency is to hurt their own economy, then why do that do it? The primary answer is that governments are run by politicians—and politicians in every place and in every era have incentives to focus only on the short-term. Chinese politicians who thought manipulating their currency would benefit them are thus no dumber than American politicians who vote every year to increase the deficit, thereby adding to the \$19 trillion national debt. They do it because, when it comes to economics, governments do not focus on the long-term. As the British economist John Maynard Keynes' once said, "The long run is a misleading guide to current affairs. In the long run we are all dead."

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