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The Myths of China's Currency 'Manipulation'

Movements in the yuan's nominal exchange rate do not affect long-term trade flows or jobs in the U.S.

By Matthew J. Slaughter

Global equity markets have experienced steep declines since the new year, and many assert the devaluation of the yuan by the People's Bank of China is a major cause of this week's turmoil.

These devaluations have fueled long-standing outcries that China is playing dirty. Presidential hopeful Donald Trump, for example, recently claimed on these pages that "the wanton manipulation of China's currency" is "robbing Americans of billions of dollars of capital and millions of jobs."

To cut through all the hyperbole, the mechanics and consequences of China's exchange-rate regime need to be understood—not only for this week but also for the coming year, when the yuan will be debated in the context of other issues such as the Trans-Pacific Partnership. Here are three essential points.

First: The legal monopoly power to create money that each central bank enjoys allows it to fix one nominal price—which can legitimately be an exchange rate—to achieve policy goals such as price stability or full employment.

Today many central banks choose to fix a nominal interest rate. The U.S. Federal Reserve targets the federal-funds rate, the interest banks charge each other for overnight loans. The European Central Bank targets the rate on the "marginal lending facility," its version of that overnight market. Other central banks fix a nominal exchange rate; China's central bank, for example, for years fixed the yuan-U.S. dollar rate and since last month fixes the yuan price of a basket of 13 currencies (in which the dollar still figures prominently).

Business World Columnist Holman Jenkins Jr. analyzes the economic factors, from China's debt to the oil price, influencing market moves. Photo credit: Getty Images.

Currency devaluation or revaluation is a common exercise of sovereign monetary policy. During the post-World War II Bretton Woods regime, dozens of countries pegged their currencies to the dollar while, in turn, the Fed pegged $35 to an ounce of gold.

Reasonable people can and do disagree about how countries conduct their monetary policies: what price should the central bank fix, or at what pace should that fix evolve. But to label as manipulation the conduct of monetary policy itself betrays a fundamental confusion about the operation and goals of central banks. If Zhou Xiaochuan, governor of the People's Bank of China, is a currency manipulator, then Janet Yellen is an interest-rate manipulator.

Second: Movements in the nominal yuan exchange rate have almost no long-term impact on global flows of exports and imports or on broader considerations such as average wages. The exchange rate that matters for trade flows is the real exchange rate, i.e., the nominal exchange rate adjusted for local-currency prices in both countries.

The real exchange rate, in turn, reflects the deep forces of comparative advantage such as technology and endowments of labor and capital. These forces drive trade regardless of monetary policy.

Think about the companies involved in trade. Yuan depreciation tends to be partly offset by Chinese companies raising their yuan prices. A large academic literature has repeatedly found that profit competition among a country's exporting companies typically undoes about half of that country's nominal exchange-rate swings. Today more companies operate in global supply networks—in which trade and investment link different stages of production across different countries. Because these networked companies incur both revenues and costs in many currencies, their trade competitiveness tends to vary little with the movement of any one currency.

Long-term movements in nominal exchange rates often have nothing to do with the evolution of global trade flows. In the generation after the Bretton Woods system dissolved, the dollar steadily depreciated against the Japanese yen, from its fix of 360 yen per dollar

to an average of just 94 in 1995. Over that time did the U.S. swing into a massive trade surplus with Japan? No.

From $1.2 billion in 1970 the U.S. trade deficit with Japan rose by a factor of 50, to $59.1 billion in 1995. From 2004 to 2014 the dollar similarly depreciated—note, not appreciated—against the yuan by about 25%. Over that decade the U.S. trade deficit with China soared—not fell—from $161.9 billion to $342.6 billion.

Third: As China relaxes its many capital controls—per the entreaties of America and many others—strong forces will be pushing down the value of the yuan. The main such force will be the pent-up demand of Chinese households and companies to diversify their wealth into non-Chinese assets.

The surging incomes and wealth in China over the past 35 years have had very little access to global assets, a restriction that has contributed to surging Chinese real-estate prices and to high saving rates of Chinese households. Relaxing controls on outward capital flows will expand Chinese demand for non-Chinese assets—and thus will expand demand for non-Chinese currencies.

The world has legitimate concerns about several Chinese economic policies. China has too many barriers to trade and investment, too much favor for local companies, too weak protection of intellectual property. But the more leaders in America and elsewhere hector China over the yuan, the less ability these leaders have to encourage China to overcome its policy shortfalls that truly do cost America good jobs at good wages.

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