The *Myth* of Currency Manipulation

The Bergsten/Schumer/Portman theory is wrong.

By Richard Katz

By the narrowest of margins, 51–48, the U.S. Senate defeated on May 22 an amendment to the Trade Promotion Authority that would have required that trade pacts such as the Trans-Pacific Partnership include a provision penalizing countries found to be "currency manipulators." No other members of TPP would have agreed to such a provision; hence, it would have killed TPP.

In fact, killing TPP was one of the objectives of policymakers such as Senator Charles Schumer (D-NY) as a way of charging China with currency manipulation. Others, such as Senator Rob Portman (R-OH), were determined to show how tough they could be toward Japan in a difficult reelection year in an auto state. Portman was one of the lead sponsors of the currency amendment that would have won had just two senators changed their minds.

And yet, most of the talk about currency is based on total myths.

CHINA, JAPAN NOT MANIPULATORS, SAYS IMF

Neither of the two biggest targets of the currency hawks, China and Japan, meet the International Monetary Fund criteria for being a currency manipulator. This is acknowledged even by Fred Bergsten, the founder and former chief of the Peterson Institute for International Economics, a champion of adding currency clauses to trade pacts. Bergsten is one of the originators

Richard Katz is editor of The Oriental Economist Report *(www.orientaleconomist.com).*

THE INTERNATIONAL ECONOMY
THE MAGAZINE OF INTERNATIONAL ECONOMIC POLICY
220 I Street, N.E., Suite 200
Washington, D.C. 20002
Phone: 202-861-0791 • Fax: 202-861-0790
www.international-economy.com
editor@international-economy.com

of the notion that currency manipulation by China and nineteen other countries is costing America anywhere from one to five million jobs. Bergsten says China was a "manipulator" in the past, but no longer is. (On the whole currency issue, Bergsten is speaking for himself, not the Peterson Institute, where many other experts have publicly taken an opposite view.) As we will detail below, this charge of millions of lost jobs is a complete myth.

It seems that those wanting to target China are willing to blame it for all sorts of America's self-created problems, including the housing crisis and consequent 2008 Lehman shock. In a February 24 statement explaining his call for putting enforceable currency provisions in TPP, Rep. Sander Levin (D-MI) favorably cited an op-ed by Sebastian Mallaby in the *Washington Post* which falsely claimed that China's alleged currency manipulation "is arguably the most important cause of the financial crisis. Starting around the middle of this decade, China's cheap currency led it to run a massive trade surplus. The earnings from that surplus poured into the United States. The result was the mortgage bubble." Bergsten has also repeated this charge. (In reality, the fault lies not in Beijing, but in America's homegrown financial malfeasance).

RMB UP 33 PERCENT AGAINST THE DOLLAR

It is true that China runs a "floating peg" system rather than a free-floating currency. But that does not in itself violate any international trade rules, as even Levin admits. For several years before July 21, 2005, the RMB was pegged at a fixed rate versus the dollar. Since then, Beijing has let the currency appreciate over many years, rather than letting the market send it up so abruptly as to destabilize its economy.

The upshot is that, in the past ten years, the RMB has appreciated 33 percent against the dollar. It did this at the same time that the broad currency index of all of America's trading partners fell 5 percent against the dollar. Had China merely matched others' behavior, the RMB, too, would have fallen against the dollar, especially during the crisis years of 2008–2009. Instead, it rose (see Figure 1). On a "real" basis, that is, adjusting for differing rates of inflation in the United States and China, China's RMB was up 42 percent as of 2013, according to the Congressional Research Service. It is even higher today.

On a "real" basis, China's RMB was up 42 percent as of 2013.

Meanwhile, against a broad index of China's major trading partners, the RMB is up 45 percent in nominal terms, and up 60 percent in real terms, or an average pace of 6 points per year for a decade (see Figure 2).

Bergsten says China was a "manipulator" in the past, but no longer is.

Nonetheless, many U.S. critics talk as if there had been no appreciation at all. Ten years ago, Schumer and others said the RMB was undervalued by around 25–35 percent, and some of them still say that. In a May 6 interview with the Huffington Post, Schumer claimed the RMB was still undervalued by 33 percent, despite its 33 percent appreciation since he first made the charge ten years ago and got the Senate to pass a bill that would have put a 27 percent tariff on imports from China unless the RMB appreciated by that amount. That bill never became law.

IMF SAYS RMB NO LONGER UNDERVALUED

In reality, announced the International Monetary Fund on May 26, the RMB is "no longer undervalued."

Bergsten, too, admits that the RMB is no longer undervalued. In an email note to us, he stated, "My colleague William Cline at the Peterson Institute has just completed his latest semi-annual estimates… His methodology seeks to keep countries' current account positions within 3 percent of their GDPs. On that basis, he finds that the RMB is not undervalued at all."

Normally, it is believed that a current account surplus of 2–3 percent of GDP is sustainable. However, Bergsten points to one report by IMF staffers calling on China to totally eliminate its current account surplus, and says he concurs. "On that basis, Cline's analysis suggests that the RMB needs to appreciate by about 10 percent on a trade-weighted basis and somewhat more against the dollar."

We don't expect the U.S. Treasury to change its official view that the RMB remains "significantly

In 2009, China produced more than four times the industrial output that it had produced in 1995, with not a single additional factory worker.

undervalued," because Congress would riot if it did so. Indeed, a senior U.S. official, when asked about the IMF's new view, told the *Financial Times* that, while the United States welcomed the recent appreciation in China's currency, it remained of the view that the RMB was "significantly undervalued" with China's trade surplus with the United States and other nations providing strong evidence of that.

AUTO CAUCUS TARGETS YEN

Even though Tokyo has not intervened in currency markets in a sustained way for more than a decade, Japan is still labeled a "currency manipulator" by the auto lobby and its allies on Capitol Hill.

In reality, the movements of the yen and euro are artifacts of their monetary easing policy and of expectations in the market that U.S. interest rates will rise. The U.S. Treasury and the European Union demanded in 2013 assurances that the Bank of Japan's monetary easing under Prime Minister Shinzo Abe and Governor Haruhiko Kuroda would not include any purchase of foreign assets, and Tokyo agreed. It is private financial markets, not Japanese intervention, that have sent the yen to its lowest real value since the early 1970s.

Nonetheless, American Automotive Policy Council President Matt Blunt claimed on the eve of a summit of Asia-Pacific leaders in November 2104: "The Bank of Japan has undertaken an unprecedentedly large monetary policy change that must be addressed immediately and forcefully by the Administration. The Bank of Japan's action is extreme in size and *designed to devalue its currency to gain an unfair competitive advantage globally* [emphasis added]."

THE "MILLIONS OF LOST JOBS" MYTH

Schumer and his allies claim that America has lost millions of manufacturing jobs due to the deficit with China caused by an undervalued RMB. He cites, among other things, a report by Bergsten to the effect that, "The United States has lost one million to five million jobs due to this foreign currency manipulation." While that is the total for twenty countries whose currencies Bergsten claims are kept undervalued, Bergsten adds, "China is by far the largest in terms of both economic importance and size of intervention." Robert Scott of the union-financed Economic Policy Institute claimed in 2014 that America could create "2.3 million to 5.8 million jobs over the next three years by ending currency manipulation by a group of about twenty countries, with China as the linchpin."

It is true that, after being flat at around 16–17 million jobs, American factory jobs started a steady decline around the same time that China entered the World Trade Organization in 2001. This is the alleged "turning point" cited by Scott. But that's like saying the sun rose after the rooster crowed.

In reality, factory jobs have fallen for the same reason that farm jobs have fallen, even as American farms produce a record amount of food: improved efficiency.

While manufacturing jobs have declined by 30 percent since 2000, manufacturing output rose by 20 percent

In the last five years, the U.S. trade deficit in non-oil goods has gotten even worse, despite the fact that the RMB has gotten stronger.

during the same period. Jobs declined because, back in 1987, it took more than seventeen workers to produce $1 million worth of manufacturing output per year; by 2000, it was down to eleven workers; now it takes just six (all in constant 2009 dollars). If it still took eleven workers to produce $1 million worth of manufacturing ouptut, then today the United States would employ 21 million manufacturing workers instead of just 12 million.

So improvements in efficiency have cost the country nine million factory jobs since 2000, almost twice as much as the maximum number of jobs (five million) that Bergsten, Scott, and others claim were taken by currency manipulation. That efficiency gain may mean fewer factory jobs, but it also means that it costs 300 million American consumers—not to mention billions of overseas customers—a lot less to buy all sorts of U.S.-made goods than would otherwise be the case.

Efficiency is a good thing, and it is taking place in China as well as the United States. In 2009, China produced more than four times the industrial output that it had produced in 1995, with not a single additional factory worker.

In 2001 Congressional testimony on this issue, Lois Kletzer, a visiting fellow at the Peterson Institute, pointed out that over the twenty-one-year period from 1979 to 1999, 6.4 million factory workers were displaced from an import-competing industry. While these industries accounted for about 30 percent of manufacturing employment, job losses in these industries represented about 38 percent of all manufacturing displacement. After taking account of the age, tenure, sex, and education of the workers, there was no difference in the rate of job loss between import-competing industries and others. In short, imports are being scapegoated for broader problems. (By the way, jobs increased in the export-oriented sectors of manufacturing.)

It is true that workers in import-competing manufacturing sectors have to take a 20 percent pay cut when they move to another sector. However, this huge wage cut is not an import problem; it's an American problem. Among fourteen European countries, the average pay cut is just 2.7 percent according to a 2005 OECD study. Moreover, it is not an import problem, but a manufacturing problem. American workers in service sectors suffered a much smaller wage cut—just 7 percent—when they moved to a different sector. In Europe, displaced workers in service sectors enjoyed a 7 percent wage gain when they moved to a different sector.

Manufacturing jobs do best when the trade deficit happens to be larger.

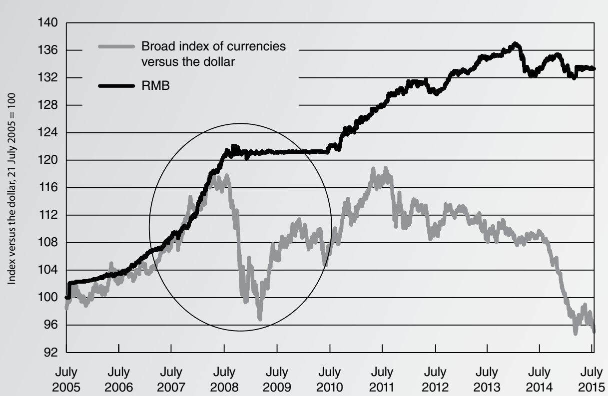
For the economy as a whole, "creative destruction," that is, the shift of capital and labor resources, helps nurture productivity and therefore overall GDP growth. But at the micro level, it means wage cuts for millions of workers. And that creates political resistance to free trade agreements. Protectionism is a false answer to a very real problem.

DOES THE TRADE DEFICIT CAUSE JOB LOSSES?

When the Chinese RMB is cheaper, according to the Schumer/Bergsten/Scott argument, this worsens the U.S. trade deficit. That, in turn, means less demand for American-made factory goods and hence factory jobs. But is it really true that America's trade deficit gets larger when the RMB is cheaper? Not according to Figure 3. In fact, in the last five years, the U.S. trade deficit

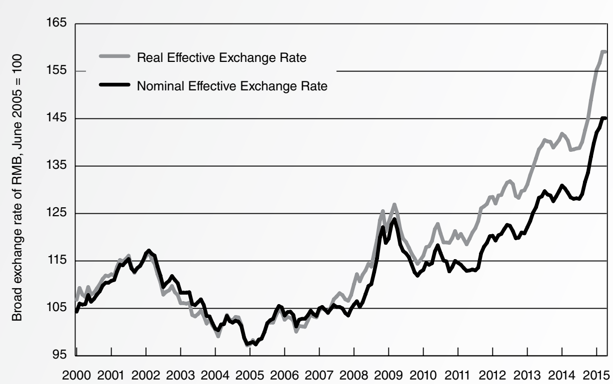
Continued on page 63

Fig. 1: Renminbi up 33 percent vs. dollar since 2005



Source: U.S. Federal Reserve
Note: Data as of June 12, 2015

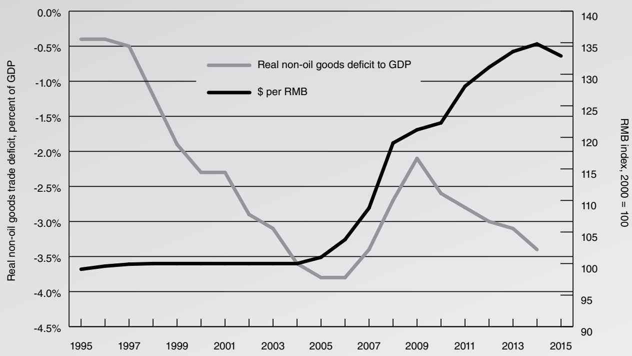
Fig. 2: RMB up 57 percent vs. all trading partners since 2005



Source: International Monetary Fund
Note: Data as of March, 2015

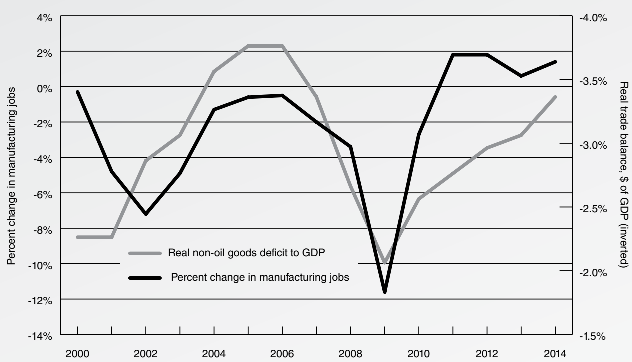
Continued from page 43

Fig. 3: No link between U.S. trade deficit and Chinese RMB



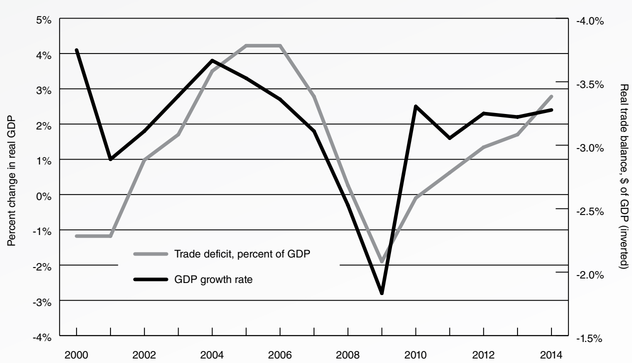
Source: U.S. Department of Commerce, U.S. Federal Reserve

Fig. 4: Manufacturing jobs do best when trade deficit is biggest



Source: Bureau of Labor Statistics, U.S. Federal Reserve
Note: This includes just the real (price-adjusted) non-oil trade balance in goods; note that a higher negative number means a bigger trade deficit; trade balance is inverted to better show the relationship between factory jobs and the trade deficit; job growth in 2010–2015 in mainly a recovery from the big Lehman shock drop in 2009.

Fig. 5: Trade deficit gets bigger when GDP grows faster



Source: U.S. Department of Commerce
Note: Real non-oil goods trade balance is inverted to better show the relationship between the trade deficit and GDP growth.

in non-oil goods has gotten even worse, despite the fact that the RMB has gotten stronger. We are not denying the obvious fact that China's currency rate will have some impact on demand for certain U.S. factory goods. However, whatever impact it has is dwarfed by many other factors.

Besides, unlike the case of Japan and the United States, where both countries produce the same sort of goods, China and the United States are at very different stages of development and mostly produce complementary goods rather than competing goods. For example, less than 1 percent of the value of an iPhone comes from assembly work in China; most of the real fabrication work for the parts is done elsewhere (such as Japanese or Korean LCD screens or computer chips, because China cannot make those). Yet American trade statistics count the entire value as an import from China.

A higher RMB does not send low-skill jobs in textiles or electronics assembly to the United States, but to other low-wage countries such as Bangladesh. So a higher RMB doesn't make the U.S. trade deficit any smaller; it simply shifts it from China to other countries.

Why then is there so much anger over China? One reason, aside from finding a scapegoat for America's troubles, is that, in the few sectors where imports from China do compete with U.S. manufacturers, Chinese goods have achieved an inordinately large market share. So while the impact of Chinese imports is narrow, its intensity in certain sectors provokes phone calls to Congressional offices and those squeaky wheels get the political grease.

THE DEFICIT, JOBS, AND GDP GROWTH

If the Bergsten/Schumer/Portman theory were true, then a fall in manufacturing jobs should correlate with a bigger trade deficit. In fact, the opposite is the case. Factory jobs do best at exactly those times when the trade deficit is growing (see Figure 4).

How is that possible? It would seem like common sense that a trade deficit would mean less demand for American manufactured goods and thus fewer jobs. Here's the answer.

As GDP growth improves, particularly relative to growth in other countries, higher demand in America tends to suck in imports faster than America can expand its exports. So, as GDP growth improves, the U.S. trade deficit gets bigger (see Figure 5). However, at the same time,

We don't expect the U.S. Treasury to change its official view that the RMB remains "significantly undervalued," because Congress would riot if it did so.

better GDP growth also means more demand for manufactured goods, which, in turn, means more factory jobs.

In short, manufacturing jobs do best when the trade deficit happens to be larger because both job gains or losses and the size of the deficit are artifacts of the same fundamental factor: the growth rate of real GDP. Consider the alternative: In 2008 and 2009 the United States "enjoyed" a 30 percent plunge in its trade deficit, but that resulted from a financial crisis that caused a 3 percent drop in GDP and a loss of 1.6 million factory jobs.

WHAT IS TO BE DONE?

Increasingly, trade has become the focus of anger for those frustrated by all the forces that have hurt workers' real disposable incomes in the past few decades—from a low minimum wage to the decimation of union membership to the flattening of taxes. And there is no question that trade has hurt many of those working in import-competing manufacturing sectors, but not more than those factory workers who lose their jobs for other reasons.

Rather than searching out scapegoats, the real solution is to find new jobs for workers displaced by productivity gains and technological improvements and to give them the skills needed to fill those jobs. Countries such as Germany and Holland spend 1–2 percent of their GDPs on "active labor measures" like retraining, matching employers to employees, and even temporary subsidies for on-the-job training. The United States spends just 0.1 percent of GDP on such efforts, the least among developed economies. And even the minimal amount it spends on these activities under the Trade Adjustment Assistance law is under attack by the Republican majority in Congress as wasted money.

If the programs are flawed, the answer is to fix them, not end them. But a Congressionally commissioned study has found that workers under age fifty who take TAA unemployment compensation plus retraining get much better wages at their next job than those who simply take the compensation, but not the retraining. Surely it is no coincidence that some of the countries in Europe that spend the most on helping workers transition from job to job and provide a social safety net during the transition are also the most politically open to expanded trade. That should be a lesson for those in the United States who desire free trade.

Admittedly, taking the proper remedial steps is easier said than done—particularly in today's political atmosphere. But it would be a whole lot more helpful than throwing stones at Beijing or Tokyo or Mexico. And given temporary near-defeat of TPA in Congress—and the continued uncertainty regarding TPP—political

Those wanting to target China are willing to blame it for all sorts of America's self-created problems, including the housing crisis and consequent 2008 Lehman shock.

and business supporters of free trade should recognize it as both a political necessity and a boost to America's growth potential. ◆