Chinese currency manipulation not a problem *East Asia Forum*, **forthcoming, 2015**

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America's two political parties rarely agree, but one thing that unites them is their anger about 'currency manipulation', especially by China. Perhaps spurred by the recent appreciation of the dollar and the first signs that it is eroding net exports, congressional Democrats and Republicans are once again considering legislation to counter what they view as unfair currency undervaluation. The proposed measures include countervailing duties against imports from offending countries, even though this would conflict with international trade rules.

But this approach is misguided.

Even if one accepts that it is possible to identify currency manipulation, China no longer qualifies. Under recent conditions, if China allowed the renminbi to float freely, without intervention, it would be more likely to depreciate than rise against the dollar, making it harder for US producers to compete in international markets.

But there is a more fundamental point: from an economic viewpoint, currency manipulation is exceedingly hard to pin down conceptually. The renminbi's slight depreciation against the dollar in 2014 is not evidence of it; many other currencies, most notably the yen and the euro, depreciated by far more last year. As a result, the overall value of the renminbi was actually up slightly on an average basis.

The key criterion of manipulation is currency-market intervention: selling the domestic currency and buying foreign currencies to keep the foreign-exchange value lower than it would otherwise be. To be sure, the People's Bank of China (PBOC) did a lot of this over the last ten years. Capital inflows contributed to a large balance-of-payments surplus, and the authorities bought US dollars, thereby resisting upward pressure on the renminbi. The result was as an all-time record level of foreign exchange reserves, reaching US$3.99 trillion by July 2014.

But the situation has recently changed. In 2014, China's capital flows reversed direction, showing substantial net capital outflows. As a result, the overall balance of payments turned negative in the second half of the year, and the PBOC actually intervened to dampen the renminbi's depreciation. Foreign-exchange reserves fell to US$3.84 trillion by January 2015.

There is no reason to think that this recent trend will reverse in the near future. The upward pressure on the dollar relative to the renminbi reflects the US economy's relatively strong recovery, which has prompted the Federal Reserve to end a long period of monetary easing, and China's economic slowdown, which has prompted the PBOC to start a new period of monetary stimulus.

Similar economic fundamentals are also at work in other countries. Congressional proposals to include currency provisions in the Trans-Pacific Partnership (TPP), the mega-regional free-trade agreement currently in the final stage of negotiations, presumably target Japan (as China is not included in the TPP). Congress may also want to target the eurozone in coming negotiations on the Transatlantic Trade and Investment Partnership.

But it has been years since the Bank of Japan or the European Central Bank intervened in the foreign-exchange market. Indeed, at an unheralded G-7 ministers' meeting two years ago, they agreed to a US Treasury proposal to refrain from unilateral foreign-exchange intervention. Those who charge Japan or the eurozone with pursuing currency wars have in mind the renewed monetary stimulus implied by their central banks' recent quantitative easing programs. But, as the US government knows well, countries with faltering economies cannot be asked to refrain from lowering interest rates just because the likely effects include currency depreciation.

Indeed, it was the US that had to explain to the world that monetary stimulus is not currency manipulation when it undertook quantitative easing in 2010. At the time, Brazilian Finance Minister Guido Mantega coined the phrase 'currency wars' and accused the US of being the main aggressor. The US has not intervened in a major way in the currency market to sell dollars since the coordinated interventions associated with the Plaza Accord in 1985.

Other criteria besides currency-market intervention are used to ascertain whether a currency is deliberately undervalued or, in the words of the International Monetary Fund's Articles of Agreement, 'manipulated' for 'unfair competitive advantage'. One criterion is an inappropriately large trade or current-account surplus. Another is an inappropriately low real (inflation-adjusted) foreign-exchange value. But many countries have large trade surpluses or weak currencies. Usually it is difficult to say whether they are appropriate.

Ten years ago, the renminbi did seem to meet all of the criteria for undervaluation. But this is no longer the case. The renminbi's real value rose from 2006–13. The most recent purchasing power statistics show the currency to be in a range that is normal for a country with per capita real income of around US$10,000.

By contrast, the criterion on which the US Congress focuses — the bilateral trade balance — is irrelevant to economists (and to the IMF rules). It is true that China's bilateral trade surplus with the US is as big as ever. But China also runs bilateral deficits with Saudi Arabia, Australia, and other exporters of oil and minerals, and with South Korea, from which it imports components that go into its manufactured exports. Indeed, imported inputs account for roughly 95 per cent of the value of a 'Chinese' smartphone exported to the US; only 5 per cent is Chinese value added. The point is that bilateral trade balances have little meaning.

Congress requires by law that the US Treasury report to it twice a year which countries are guilty of currency manipulation, with the bilateral trade balance specified as one of the criteria. But Congress should be careful what it wishes for. It would be ironic if China agreed to US demands to float the renminbi and the result was a depreciation that boosted its exporters' international competitiveness.

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