Trump Administration Labels China a "Currency Manipulator": What's behind the accusation, and who's right?

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Abstract

Is China a currency manipulator? This article explains the meaning and implications of the term "currency manipulator" and reviews the history of the RMB/USD exchange rate. The implications of the exchange rate for the US-China trade are elucidated.

At 5 o'clock in the morning on August 5, 2019, unable to sleep, Trump tweeted about China—not for the first time accusing it of being a "currency manipulator,"[1] and describing this as a "major violation." (See Figure 1 below.) Treasury Secretary Mnuchin followed with an official announcement later that day.[2]

What triggered Trump's reaction was that the renminbi yuan (RMB)[3] had devalued and breached the 7.0 RMB per US dollar (USD) rate for the first time since 2008.

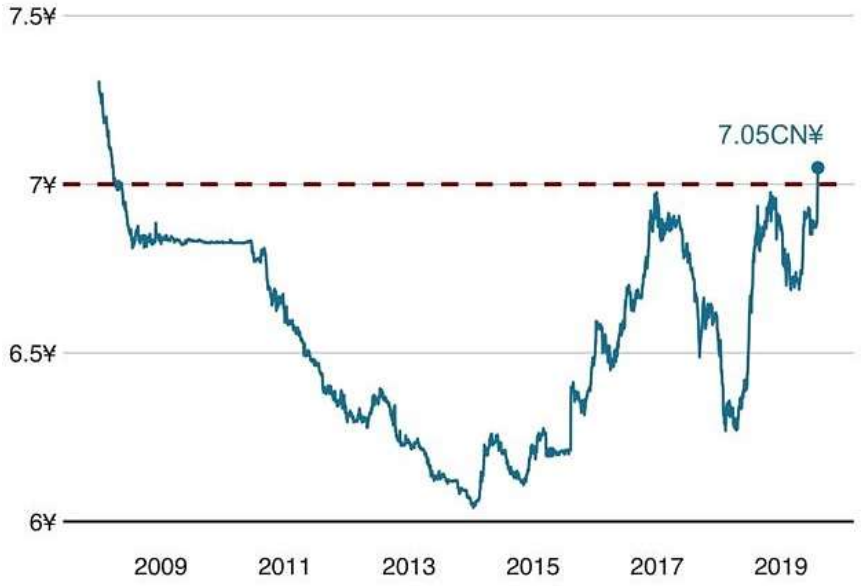
Figure 1. Trump Tweet of August 5, 2019

Source: Twitter

The term "currency manipulator" has no regulatory import or effect. It is only an accusation that further escalates the building tension between China and the US. Indeed, on August 5, 2019, the Chinese currency (RMB) had devalued to a rate of 7.05 per USD. This means that a dollar converts into more RMB than before, thereby increasing the Chinese exporters' margins and—irritating to Trump—insulates them from the effects of the Trump tariffs.

American administrations, going as far back as Ronald Reagan, have argued that the RMB exchange rate is under the control of China's central bank—the People's Bank of China (PBoC)—which follows the orders of the Chinese government. Since 2012, market forces have been allowed to have an influence. However, the PBoC has the ultimate say, and every morning, fixes or announces a rate that all traders must obey.

Figure 2. RMB Exchange Rate 2008 – 2019



Source: Bloomberg & BBC[4]

This article shows in a simple calculation how a further devaluation of the RMB could completely neutralize the Trump tariffs. Then it reviews how China's leadership, going back 40 years, managed their currency's exchange rate to jump-start the Chinese export engine and make China the "factory of the world."

A Simple Calculation of the Tariff – Exchange Rate Tradeoff

Simple calculations (shown below in Tables 1a, 1b, and 1c) illustrate how the exchange rate between the RMB and the USD can profoundly affect the

profit or loss of Chinese exporters, US importers, and the pocketbooks of American consumers. (In a previous article,[5] I calculated the extra cost to the average US household at $2,380, or a total additional outlay for the US economy of $295 billion each year—if hypothetically all consumer items imported from China were replaced by US domestic production.)

Let's do some simple calculations, starting with the June 2018 exchange rate of 6.5 RMB/USD. (Trump began to impose tariffs on China the following month.) The calculation below assumes a 10% tariff levied on Chinese-made imports. But a similar calculation could be done for alternate tariff rates.

Table 1a. RMB exchange starting with June 2018

As recently as June 2018, the exchange rate was 6.50 RMB = 1 USD:
➢ If Chinese exporters invoice a shipment at $100, they earn (100 x 6.50) = **650 RMB.**
➢ But with a 10% tariff, the cost to US importers or consumers is $100 + $10 = **110 USD.**
➢ If Chinese exporters absorb the burden of the tariff so that US importers or consumers pay only $100, how much would they earn?
▪ Put x + (0.10) x = $100. Hence, x = $90.91. The Chinese exporter would have to invoice or charge only $90.91—well below $100—in order to keep the import cost (including tariff) to the US importer at $100.
▪ $90.91 converted at the Chinese bank means the Chinese exporter gets only 90.91 x 6.5 = **590.91 RMB**—which is well below the 650 RMB calculated above.

Table 1b. RMB exchange rate implications on August 5, 2019

On August 5, 2019, the exchange rate was 7.05 RMB = 1 USD:
➢ If Chinese exporters invoice a shipment at $100, they earn (100 x 7.05) = **705 RMB**—which is more than the 650 earned in June 2018 (see Table 1a).
➢ But with a 10% tariff, the cost to the US importer or consumer is $100 + $10 = **110 USD.**
➢ If Chinese exporters absorb the burden of the tariff so that US importers or consumers pay only $100, how much would they earn?
▪ The Chinese exporter would have to invoice or charge only $90.91-well below $100 in order to keep the import cost (including tariff) to the US importer at $100 (as seen above.
▪ $90.91 converted at the Chinese bank means the Chinese exporter gets 90.91 x 7.05 = **640.92** RMB-which is only a bit below the 650 RMB earned in June 2018.

Table 1c. RMB exchange rate implications for the future

In the future: What RMB/USD exchange rate would neutralize 10% tariffs?
➢ **Question:** If the RMB exchange rate devalues further, at what exchange rate would the Chinese exporter earn the original 650 RMB, while the US importer still pays only $100 (including tariff)?
➢ **Answer**: 7.15 RMB per USD because $90.91 x 7.15 = 650 RMB.
▪ Hence, a 7.15 RMB/USD exchange rate nullifies the Trump tariff of 10%
▪ i.e., a 7.15 exchange rate restores the US consumer's cost to $100, while at the same time restoring the Chinese exporter's earning to 650 RMB.
▪ Hence a 7.15 RMB/USD rate would completely neutralize the 10% tariff for both the Chines exporter and for the US consumer.

It would take only a small further devaluation of the RMB by the Chinese government—to 7.15 RMB/USD—in order to nullify a 10% tariff. (Indeed, as an update to this article, written in August 2019, the RMB had devalued further on September 25, 2019 to 7.13 RMB/USD, close to the 7.15 target rate calculated above. As to whether the Chinese will devalue further is an open question.

Will the Chinese Devalue Their Currency Further to Counteract US Tariffs?

Some economists, such as those at *Capital Economics,* expected the yuan to devalue further and "*end the year at 7.30 per US dollar*." [6] But further devaluations are by no means certain since the Chinese government is beset with contrary pressures and is issuing mixed signals. On Monday, August 5, the PBOC, in a candid statement, said that the devaluation was driven by "*unilateralism and trade protectionism measures and the imposition of tariff increases on China.*" [7] But the next day, a more conciliatory and high-minded statement was issued, saying "*China has refused to engage in a competitive devaluation despite the US escalating trade tensions from 2018, nor has it used [the exchange rate] as a tool to address [the trade conflict].*" [8] This reflects the contrary pressures facing the Chinese and its central bank.

Pressures to Devalue or Not to Devalue

Pressures to devalue come from the fact that perhaps one in seven jobs in the organized sector are in export-oriented companies. Creating and maintaining jobs has been the number one priority of the Chinese regime ever since 1949 (although this pressure is now easing as the population begins to plateau). There are likely well over 100 million jobs related to China's

export sector, including the 16 million Chinese jobs I estimate that are devoted to exports to the US.[9] Export-oriented Chinese firms competing everywhere are forced to keep abreast of the latest global technologies, and upgrading to world-class technologies is a national goal.

What are the pressures to *not* devalue? The PBoC does control the exchange rate by fiat, but it increasingly also wishes to present to the world an image of a responsible economic superpower (and not a reactor to, or tit-for-tat imitator of, what they consider the erratic policies of the US government).

Besides accusations of an undervalued currency from various past US presidents, there have been similar complaints from the European Union. "Undervaluation" is another term for "*too much devaluation*." For further details, see my article, "*What Do We Mean by Undervalued or Overvalued Currencies?*" [10]

Another deep background pressure to not devalue comes from the PBoC's aversion to, and prevention of, capital flight. There is enormous middle- and upper-class wealth bottled up inside China,[11] which seeks to diversify its assets by converting part of its wealth into other currencies or into an apartment in Manhattan, Vancouver, or Sydney. Moreover, there remain some financial and tax benefits by "round-tripping" funds from China to Hong Kong and back to the mainland again.[12] The PBoC's rules restrict unbridled selling of RMB for US, Canadian, or Australian dollars, but the selling pressure from the asset-diversification desires of Chinese individuals and companies has been so strong that the RMB has been devalued since 2014. (See Figure 2.)

Another reason to not devalue is that after a devaluation the cost of imports to the Chinese economy in RMB would rise commensurately (and China imports $1.731 trillion worth, not too far behind the US total). Higher local RMB import costs could also, conceivably, trigger inflation.

While today the Chinese are on the cusp of, or in a balance between, competing considerations regarding the RMB exchange rate, historically this was not the case. Below, we discuss the long history of the currency and the strategic and deliberate use of devaluations and undervaluation of the RMB, which remained Chinese policy for 25 years until 2005.

A Policy of Undervaluation (1980 – 2005) That Made China the "Factory of the World"

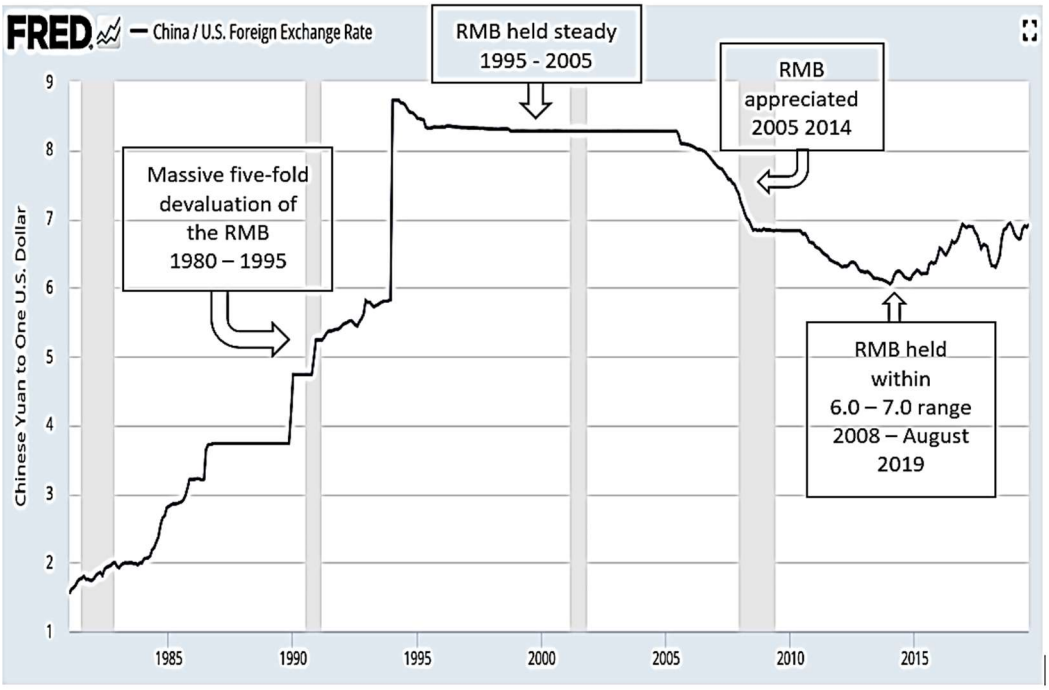
At the death of Mao Zedong in 1976, the Chinese population already stood at 931 million. Although the population growth rate had declined to 1.5 percent per annum (it had approached an explosive 3 percent in the 1970s), that still meant that up to 14 million young new job seekers entered the labor

market each year. If there was one historical memory the regime remembered, it was the social danger of hordes of disaffected young persons without a job. With the ascent of Deng Xiaoping, the Chinese began to liberalize their domestic economy, and began a conscious policy of devaluing the RMB, in order to jump-start the Chinese export engine and create good jobs.

Table 2. The Long 25-Year RMB Devaluation/Undervaluation (1980 – 2005) That Made China the "Factory of the World"

Date(s)	RMB/USD FX Rate	Regime Leader(s)
Aug. 1980	1.80	Deng Xiaoping
Sep. 1986 – Nov. 1989	3.73	Deng Xiaoping
Dec. 1993	5.82	Jiang Zemin / Xhu Rongji
Jan. 1994	8.72	Jiang Zemin / Zhu Rongji
Jun. 1995 –Jun. 2005	8.27	Hu Jintao
Jan. 2014	6.05	Xi Jinping
Dec. 2016	6.93	Xi Jinping (Trump begins Presidency)
Nov. 2018	6.93	Xi Jinping
Aug. 5, 2019	7.05	Xi Jinping
Sep. 25, 2019	7.13	Xi Jinping

Figure 3. China/US FX Rate



Source: Federal Reserve of the US

At first incrementally through 1989, and then dramatically in the 1990s, the RMB was devalued to benefit Chinese exporters. Starting with a mere 1.80 RMB per USD in August 1981, by January 1994 one dollar earned by the exporter converted into as much as 8.72 RMB at the Chinese bank[13]—an almost fivefold increase in the exporter's revenues. With the spirit of Chinese entrepreneurship, talent, the mobilization of (often state-supported) capital, and the willingness to "price low," factories mushroomed to fulfill the eager foreign import demand. As many as 200 million workers may have moved from the interior to the eastern seaboard provinces, where most manufacturing is done. And China became the "factory of the world."

A Policy Change After June 2005: The RMB was Allowed to Appreciate and Kept in the 6.0 – 7.0 Range

However, after June 2005, under pressure from American and European administrations, accusing China of undervaluing its currency (i.e., devalued too much), the PBoC began to grudgingly allow an appreciation or strengthening of the RMB. Note in Figure 3 that the RMB was appreciated from 8.27 in June 2005 to 6.05 per dollar in January 2014, after which it devalued again, breaching the 7.0 level on August 5, 2019. For the past 11 years, from 2008 to 2019—despite what Trump may assert—the Chinese had kept their currency more or less stable in the 6.0 to 7.0 range. (See Figures 2 and 3.) However, as of August 2019, with tariffs and additional threatened tariffs, it is unclear as to where the RMB will go.

Conclusion: Both China and the West Have Benefited Greatly

China's opening up to the world has transformed that country. Perhaps 700 million Chinese have been lifted out of poverty into an at least tolerable existence, with another 600 million of them now considered middle-class or affluent by international standards. This is not entirely attributable to globalization; their domestic market has also grown. With the export experience that forced Chinese firms to compete with western companies, they were quick learners and absorbed western technology (to the point where many Chinese companies are considered a technological threat by the Trump administration).

We should not neglect to mention that consumers in the US and EU (whose combined population is around 838 million) also benefited greatly by being able to buy reasonably well-made Chinese products, purchased at a much lower cost than if the items were made domestically. The annual consumer benefit of Chinese imports to the US consumer is at least $295 billion (as I observed above), and since this does not include industrial or

intermediate goods, the overall benefit to the US economy may well exceed $400 billion annually.

Of course, Chinese imports have also displaced some American and EU jobs (in manufacturing, not in services). US manufacturing jobs today number only around 40 percent of such jobs in 1980. During the same period, US manufacturing output ($ value) zoomed by 250 percent (and the US remains, far and away, the most competitive and productive producing nation on earth).

How can this discrepancy be explained? Studies by economists at Boston Consulting Group, the Wharton School, and the Center for Business and Economic Research at Ball State University conclude that *"...only 13 percent of the overall job losses in manufacturing had resulted from trade*."[14] The real explanation for the sharp decline in US manufacturing jobs—and yet accompanied by a big surge in US manufacturing output—is in automation, robotics, and information technology, in which US companies have massively invested since 1980.

Critics will aver that, whether it is automation or globalization, the net result is the same—loss of jobs, especially in rust-belt US states and in parts of Europe. This is true, and part of the anti-globalization backlash.[15] However, many of the displaced have found new jobs and the "overall" unemployment rate in the US and Europe is at low levels. The word "overall" is, of course, cold comfort to someone who has lost a job and now perhaps works harder, at lower pay.

But such is the nature of the modern economy. A segment of the population in the US and in Europe is worse off. But "overall" or "on average" all three regions—China, the US, and Europe—have greatly benefited over the past 40 years.

Author

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Endnotes

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