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CURRENCY MANIPULATION

History Shows That Sanctions Are Needed

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Growing U.S. trade deficits with China—due, in part, to the Chinese government's manipulation of its currency—**caused 2.4 million U.S. jobs** to be lost or displaced in manufacturing and other trade-related industries between 2001 and 2008 alone,[1] and 100 million workers experienced lower wages due to competition with imports from low-wage countries (Scott 2010b). Ending China's currency manipulation could help create at least 1 million U.S. jobs in the next few years, but Treasury Secretary Timothy Geithner delayed a semiannual report on currency manipulation, scheduled for release on April 15, in which the Treasury would have been forced to name China as a manipulator. There may have been sound reasons for delaying the report, but there is no reason why Secretary Geithner needs to wait another day to simply identify China—as well as Hong Kong, Malaysia, Singapore, and Taiwan—as currency manipulators and then to immediately begin formal negotiations with those countries.

President Obama went one step further at the recent nuclear summit when he said "China rightly sees the issue of currency as a sovereign issue." But there is no need to give in to China on currency. While it may be literally true that the United States cannot "force" China to revalue, the United States can make China's policy of currency manipulation so expensive that China will have no choice but to revalue.

The failure of the Treasury and the president to act does not prevent other policy makers from doing something to stop currency manipulation. Congress should immediately pass legislation to bypass the failed Treasury foreign exchange review process, require the Treasury secretary to begin negotiations with these countries, and impose tariffs of at least 25% within 90 days if any country fails to revalue when identified by the Treasury as a currency manipulator.

China has purchased more than $2.2 trillion in foreign exchange reserves since 2001 in order to maintain an artificially undervalued currency. "China's exchange rate policy violates all relevant international norms" (Bergsten 2010). The **best estimates** show that the renminbi (RMB), or yuan, is undervalued by more than 40% relative to the U.S. dollar (Cline and Williamson 2010). This provides an artificial subsidy of approximately 40% to China's exports and acts as a 40% tax on U.S. imports, which puts U.S. firms at a huge competitive disadvantage both here and abroad. **Paul Krugman (2009a)** has said that China's currency policies support a trade policy that is "predatory," and has reduced world gross domestic product (GDP) by about 1.5 percentage points.

Although China has hinted that it will revalue slightly, and may allow the yuan to trade flexibly (within a narrow band), this is no substitute for the fundamental, 40% revaluation of the yuan that is needed now to rebalance global trade and capital flows.[2]

While the evidence is clear that the Chinese currency is being manipulated, the Treasury Department has repeatedly failed to act. Since 2001, the Treasury has issued more than a dozen semiannual reports on currency manipulation. Many have reached conclusions similar to **the May 2008 report**: "on balance….the pace of appreciation needs to continue in order to address the continuing substantial undervaluation of the RMB," (U.S. Treasury 2008) but all have refused to declare officially that China was manipulating its currency.

China is not the only country that manipulates its currency. Cline and Williamson (2010) estimate that the currencies of Hong Kong, Malaysia, Singapore, and Taiwan are also undervalued by 25% to 32%. The Japanese yen is undervalued by approximately 14%. On the other hand, some currencies have recently become overvalued relative to the U.S. dollar including those of Brazil, Canada, Australia, and New Zealand. Global currency realignment is needed to eliminate large, persistent trade imbalances.[3] These adjustments would result in a 5% to 10% decline in the real, trade-weighted value of the U.S. dollar. The U.S. global trade balance would improve as a result of increased net exports to Asia and the rest of the world.

What has worked in the past?

The first significant U.S. trade and current account deficits in the post-war era occured in 1971.[4] They were caused, in part, by a series of competitive devaluations by major trading partners in Japan and Europe in the 1960s. From 1947 to 1971, the United States operated under a fixed exchange rate system based on the gold standard, which committed the United States to exchange dollars for gold at $35 per ounce under the Bretton-Woods system of fixed exchange rates. On August 15, 1971 President Nixon suspended the convertibility of gold and imposed a 10% surcharge on all imports (Stewart and Drake 2009).

The Nixon administration had three goals for the surcharge: pushing Japan and members of the European Community to revalue, elimination of trade barriers by those countries, and additional contributions to common defense projects by U.S. allies. By December 1971, Japan and the European countries had agreed to revalue, and Nixon suspended the import surcharge. Over the next two years the gold standard and Bretton-Woods were eliminated, and in 1973 the United States moved to a flexible exchange rate. By 1973, the United States was again running trade and current account surpluses.

The U.S. dollar became heavily overvalued in the mid-1980s in the wake of high interest rates and monetary tightening in the early 1980s, during Paul Volcker's term as chairman of the Federal Reserve. As a result, the United States developed large trade deficits that reached 3.4% of GDP in 1987. The United States lost 2 million manufacturing jobs between 1980 and 1985, and pressures for action began to grow in the summer of 1985. The House passed legislation (the Rostenkowski-Gephardt-Bentsen Trade Act) in the summer and fall of 1985 that would have imposed a 25% import surcharge on countries such as Japan, Brazil, Korea, and Taiwan that maintained large trade surpluses with the United States (Scott 2009, 8).[5]

Although the Senate never approved the Trade Act, and the bill never reached the president, it did spur the G-5 countries to negotiate an agreement to reduce the value of the dollar. On September 22, 1985, the United States announced that it had reached the "Plaza Accord" with other members of the G-5 group of finance ministers and central bank officials (representing the United States, Japan, Germany, France, and the United Kingdom) in order to head off Congressional threats to impose trade restrictions and in response to substantial pressure from other members of the G-5 and other leading industrial nations (Funabashi 1989, 15-16).

The dollar fell steadily from early 1985 until February 22, 1997, when another agreement (the Louvre Accord) was reached to stabilize the dollar and prevent further depreciation. Overall, the dollar fell 29% from a peak in 1985 to its trough in 1991, and the trade deficit improved to rough balance, also in 1991.[6]

TABLE 1

Trade shares of currency manipulators

Country	*Period*	Maximum share of *U.S. trade deficit*	*Total U.S. trade*
Nixon import surcharge			
Japan	1971-72	80.5%	11.6%
Western Europe	1971-72	1.0	30.2
Plaza Accord			
Japan	1985-87	37.5	18.1
Western Europe	1985-87	19.7	25.2
Sum-Plaza Accord		57.2	43.3
Currency manipulators			
China	1991-94	18.9	4.1
South Korea	1988	7.0	4.1
Taiwan	1988	12.8	4.8
China	2008	31.9	12.0

SOURCE: Council of Economic Advisors (Economic Report of the President), U.S. Department Commerce and Census Bureau.

Currency manipulation reports

Treasury was first required to make semiannual reports on economic and exchange rate policies under the Omnibus Trade Act of 1988. Since 1988, Treasury has identified three countries as currency manipulators: Taiwan, Korea, and China, with Taiwan cited in 1988 and again in 1992. Each citation lasted for at least two six-month reporting periods, while China's lasted for five periods, ending in 1994 (GAO 2005, 13).

In each case, Treasury entered into negotiations with the offending country. Each ultimately made "substantial reforms to their foreign exchange regimes (GAO 2005, 14)." Their currencies appreciated and trade balances declined significantly, according to the Government Accountability Office (GAO). However, review of U.S. trade flows reveals a different pattern. U.S.-goods trade deficits with Korea and Taiwan were relatively small (never more than 7% and 13%, respectively) and did shrink after those countries were named as currency manipulators, as shown in **Table 1**. China, on the other hand, was a much bigger trading partner even in 1994 (U.S. Census Bureau 2010). In that year it was responsible for 17.8% of the U.S.-goods trade deficit. Although this share was down slightly from 1992 (18.9%), the U.S. trade deficit with China has increased every year since 1988, and China was responsible for 31.9% of the U.S. goods trade deficit in 2008 (Table 1). China was responsible for even larger shares of the total U.S. non-oil goods trade deficits: 68% in 2008 and 80% in 2009 (Scott 2010a). Naming China as a currency manipulator alone in the early 1990s failed to slow the trend growth in its trade surpluses with the United States. In the past decade, China's global current account surpluses have become so large that they are the mirror image of overall U.S. current account deficits.

The enforcement problem

The Treasury has not identified any countries as currency manipulators since 1994. While the Treasury should identify China as a currency manipulator and begin negotioantions immediatetly, the fact is that an act of Congress will likely be needed to spur China to act.

The countries identified as currency manipulators prior to 1994, including China, played a relatively small role in overall U.S. trade, as shown in Table 1. Furthermore, prior to the formation of the World Trade Organization (WTO), the United States had the authority to impose unilateral trade sanctions under Section 301 of the Trade Act of 1974 (as amended), under authority to address unfair trade practices. When the United States joined the WTO in 1994, it agreed to "pursuing the resolution of trade disputes with other WTO member countries through the WTO dispute settlement mechanism" (including section 301 enforcement actions), according to trade attorneys from **Stewart and Stewart (2004)**.

Thus, under the WTO the United States cannot threaten China with immediate consequences, even if it is found guilty of currency manipulation. Furthermore, China is now responsible for a much larger share of total U.S. trade than it was when last cited for currency manipulation in the early 1990s, as shown above. Currently, U.S. trade with China is similar to that with Japan and Western Europe when Nixon imposed the 1971 import surcharge (when those regions were responsible for up to 80% of U.S. trade deficits and 40% of total U.S. trade), and during the years of the Plaza Accord (when that group of countries was responsible for up to 57% of U.S. trade deficits and 43% of total U.S. trade), as shown in Table 1.

In sum, the United States lacks the direct enforcement tools needed to persuade China to revalue its currency. On the other hand, past experience demonstrates that even large and important trading partners such as Japan and the major countries of Western Europe can be persuaded to revalue if confronted with the threat of a sizeable import tariff. Were the United States to pursue a WTO dispute settlement of this issue—even if it identified China as a currency manipulator—the case would involve a prolonged investigation and a highly uncertain outcome since the WTO has never resolved a currency manipulation dispute.

The solution

There is a better option—congressional action pursuant to GATT and WTO rules—to create a trade-remedy for currency manipulation that can be implemented immediately. In 2005, Senators Charles Schumer and Lindsey Graham introduced legislation (S. 295) that would have imposed a 27.5% tariff on all imports from China if it failed to revalue within 180 days.[7] This legislation was approved by the Senate by a veto-proof margin of 67-33. The authority to impose tariffs in this legislation was based on Article XXI of the GATT, which allows "a member of the WTO to take any action which it considers necessary for the protection of its essential security interests." The legislation found that protecting U.S. manufacturing is "essential to the interests of the United States." Senators Schumer and Graham also introduced legislation designed to reform the oversight of exchange rate policy in March 2010 (S 3134). However, this legislation would impose much weaker penalties if China refuses to revalue.[8]

The United States has nothing to fear from getting tough with China

In 2009, U.S. imports from China exceeded U.S. exports to that country by more than four to one. The United States and other countries have tremendous leverage over China because it is so overdependent on exports, which support nearly one-third of China's GDP. China's exports to the United States are far more important to its economy than they—or U.S. exports to China—are to the United States. China's exports to the United States, alone, accounted for $296 billion or 6.2% of its GDP in 2009. In contrast, U.S. exports to China were only $70 billion in 2009, less than 0.5% of U.S. GDP. Most U.S. exports to China are raw materials, such as steel and paper scrap, petrochemicals, feedstocks, and electronic components. All these materials are used to make products that are exported back to the United States. If China were to limit its imports of these commodities, it would only further reduce its exports to this country.

There is no reason for concern over China's large holdings of Treasury bills and other assets. If China tried to sell some of these assets, there would be little effect on interest rates. As **Paul Krugman (2010)** has pointed out, "Short-term U.S. interest rates wouldn't change: they're being kept near zero by the Fed, which won't raise rates until the unemployment rate comes down. Long-term rates might rise slightly, but they are mainly determined by market expectations of future

short-term rates. Also, the Fed could offset any interest-rate impact of a Chinese pullback by expanding its own purchases of long-term bonds."

Thus, the United States has all the leverage it needs to persuade China to change its currency policy, and China has little to no ability to do any real harm to the U.S. economy. More important, there are several reasons why a revaluation would actually benefit China. First, a stronger yuan would help restrain inflationary pressures, which have been growing in China. Second, it would increase the purchasing power of Chinese businesses and consumers. It is important to note that a group of Chinese CEOs of state-controlled enterprises recently came out publicly in favor of a stronger yuan (**Bloomberg 2010**). Finally, if China stopped intervening in the currency market, it could invest those resources in projects to meet pressing social needs, such as housing, environmental clean-up, and infrastructure.

Unilateral action by the U.S. will trigger a multi-lateral response

Many countries around the world are suffering from China's currency manipulation policies. By pegging its currency to the dollar, the yuan falls against other currencies, such as the Brazilian real and the euro when these currencies rise against the dollar, as they did in 2009. These countries also have large and growing trade deficits with China. However, many are too small to act against China on their own. While the United States could impose sanctions on China with little fear of reprisal, the same cannot be said for countries such as Canada and Mexico.

If the United States were to impose trade sanctions, then other countries are likely to follow suit and impose similar penalties in short order, simply to avoid being overwhelmed with a flood of goods from China diverted from the United States. Thus, U.S. leadership is likely to result in common, global policies designed to address China's currency manipulation. This could lead to global negotiations through world forums such as the G-20, and a global plan for currency realignment, similar to the 1985 Plaza Accord.

The way forward

The Treasury Secretary should immediately identify China, Hong Kong, Malaysia, Singapore, and Taiwan as currency manipulators and immediately begin formal negotiations with those countries. Meanwhile, Congress should pass legislation such as the Schumer-Graham bill of 2005 (S. 295) to require the president to impose a tariff of at least 27.5% on currency manipulators if the Treasury Secretary is unable to persuade those countries to revalue within 90 days. This legislation should be based on the president's authority under Article XXI of the Global Agreements on Tariff and Trade (GATT) and WTO charters. The president should be allowed to waive the tariffs under extraordinary circumstances, or if resolution to a currency dispute is imminent. Congress would have to approve the waiver on an expedited basis (not subject to filibuster in the Senate).

Given that U.S. trade deficits have begun to grow again (Krugman 2009b; Bertaut, Kamin, and Thomas 2009) and are now projected to reach 5.5% to 6% of GDP by 2012, and given that these deficits will require rapid growth in international borrowing or sale of net U.S. financial assets, and given that the U.S. net international investment position in December 2008 was -$3.5 trillion, continued growth of U.S. trade deficits represent a serious threat to domestic and international financial stability. Any disruption to international financial markets could pitch the United States into an even deeper recession, one from which it has yet to recover and is the worst on record since the 1930s.

Currency manipulation has cost the United States and other countries more than a million jobs. It has put downward pressure on the wages of upwards of 100 million workers in this country. We must put an end to currency manipulation before it wreaks even more havoc on the United States and other economies around the world. Currency realignment can create more than 1 million U.S. jobs, at no cost to the Treasury. Congress should get tough with China and other currency manipulators who have refused to make the major revaluations needed to rebalance global trade flows. They are unlikely to change their ways unless faced with the threat of imminent, significant economic harm, which can best be achieved with an across-the-board tariff on all imports from China and other currency manipulators.

Endnotes

1. These jobs were displaced by the growth of the U.S. trade deficit with China. High tariff and non-tariff barriers to imports, extensive export subsidies, and China's abuse of core labor standards also contributed to trade-related job losses.
2. A closely watched, one-year forward contract on the value of the RMB projects that it will gain 3% against dollar in that period (Bradshear 2010).
3. Currency realignment will reduce or eliminate current account imbalances. The current account is the broadest measure of trade in goods, services, and income.
4. Trade refers here to annual goods and services trade flows (there are significant quarterly variations in these data). The current account is the broadest measure of all international payments for goods, services, and income.
5. This bill, known as the "Trade Emergency and Export Promotion Act," was approved by the House on two occasions. It was also introduced in the Senate as S. 1449, but was never approved by that body.
6. The recession of 1991-92 also contributed to cyclical reductions in the trade balance that year. Large transfer payments from Middle Eastern governments to the United States, in compensation for expenses related to the gulf war, generated an unusual net income on transfer payments and a small current account surplus in 1991. Nonetheless, by the early 1990s the current account deficit was reduced to approximately 1% of GDP.
7. **S 295**, a measure "To authorize appropriate action if the negotiations with the People's Republic of China regarding China's undervalued currency are not successful," would have determined that China was manipulating its currency. It would have compelled the U.S. Treasury and the U.S. Trade Representative to immediately begin negotiations designed to convince China to revalue. If China failed to do so within 180 days, tariffs would have been imposed. They could have been waived, but only if the president certified that China was no longer acquiring foreign exchange reserves to manipulate its currency value, or that China was making a good faith effort to revalue.
8. **S 3134, the Currency Exchange Rate Oversight Reform Act of 2010**, would create a new standard defining currency "misalignment." If a country failed to revalue a misaligned currency within 90 days, it would impose a series of penalties, including authorization to impose additional penalties for currency manipulation in anti-dumping cases, prohibitions on federal procurement from offending countries, requests for action from the International Monetary Fund (IMF), prohibitions on financing through the Overseas Private Investment Corporation, and U.S. opposition to new financing for the subject country by multilateral development banks.

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