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A Tale of Two Twists: Is China a Currency Manipulator?

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< ”Naming of a Manipulator on the Inaugural Day” Deferred >

Much attention has been paid on whether President Trump names China a currency manipulator as one of the initial measures the increasingly protectionism-leaning Trump administration will implement. Mr. Trump had reiterated his intention to name China as a currency manipulator “on the first day in his White House”, and although he revealed his intention to defer the decision in an interview with WSJ on January 13, he clearly stated that “Our dollar is too strong” and “the US companies can’t compete with [China] because our currency is too strong”. Also Mr. Mnuchin, a Treasury Secretary nominee, testified in a Senate confirmation hearing and others held on January 19th that “he’s willing to label China as a currency manipulator if warranted.” So we should be prepared for a high probability that the Trump administration would name China a currency manipulator at such timing as the next publication of Treasury Department Report on Foreign Exchange Policies of Major Trading Partners of the United States (hereinafter Foreign Exchange Report) slated for nest April.

<Chinese RMB Running into aTrump Turbulence>

Being named as a currency manipulator means that the country formally becomes a target for protectionist policies of the new US administration and if it is the case, an increased pressure for higher exchange rate of the yuan should be the initial response at the market. On the other hand, the economic fundamentals and monetary policy management both in the US and China would not warrant a prolonged high exchange rate of the yuan. In fact, the consensus view of the market it that “the Chinese authority is currently trying to push the yuan moderately lower in such a way not to induce rapid capital outflows.” This seems to be very probable and for some time the exchange rate of the yuan would fluctuate quite nervously amid the conflicting speculations on the policy stances of the US and China in the market. In addition, the issue of naming China a currency manipulator involves “two twists”, which makes the case more complicated.

<China meets only one of three criteria for unfair currency practices>

One of the twists is that China has not fully filled the criteria for a "currency manipulator" set by the US Treasury Department. In its April 2016 Semiannual Foreign Exchange Report submitted to the Congress, the Treasury Department specified three criteria for judging a currency manipulator. As Chart 1 shows, they include (i) trade surplus with the US (in excess of $20 billion), (ii) current account surplus (exceeding 3% of GDP) and foreign exchange intervention (net purchase of foreign currency in excess of 2% of GDP) and if a country meets two of them it will be posted in the Monitoring List, and when it meets all of the three it should be designated as a currency manipulator.

Chart 1 ＜Evaluation of Major US Trading Partners＞

	① Bilateral Goods Trade Balance (in US bio)	② Current Account Surplus (% of GDP)	③ Intervention：Net FX purchases (% of GDP)
Key Criteria	More than 20 $billion	Exceeding 3% of GDP	Exceeding 2% of GDP
China	**356.1**	**2.4%**	**-5.1%**
Germany	**71.1**	**9.1%**	—
Japan	**67.6**	**3.7%**	**0.0%**
Mexico	**62.6**	**- 2.9%**	**- 2.2%**
Korea	**30.2**	**7.9%**	**-1.8%**
Italy	**28.3**	**2.3%**	—
India	**24.0**	**- 0.8%**	**0.3%**
France	**18.0**	**- 0.5%**	—
Taiwan	**13.6**	**14.8%**	**2.5%**
Switzerland	**12.9**	**10.0%**	**9.1%**
Canada	**11.2**	**-3.4%**	**0.0%**
UK	**-0.3**	**- 5.7%**	**0.0%**

Compiled by IIMA based on "Foreign Exchange Policies of Major Trading Partners of the United States" October 14, 2016

(Notes)

1. Figures in red meet the criterion
2. Six countries shadowed in green are listed in the Monitoring list as they meet two of the three criteria.

However, China has not only reduced its current account surplus substantially but also has been intervening in the foreign exchange market to buy up its own currency. So China meets only one criterion. Although these criteria were set in the days of the Obama Presidency, even President Trump may have withheld the judgment to instantly label China a currency manipulator based on these criteria. It may be only an author's simple speculation, but this fact seems to be in the technical background of his deferral of his commitment of "labeling it on the first day in his White House." Therefore, sooner or later some kind of measures to change the criteria would be implemented to pave the way for the new administration to actually specify China as a currency manipulator.

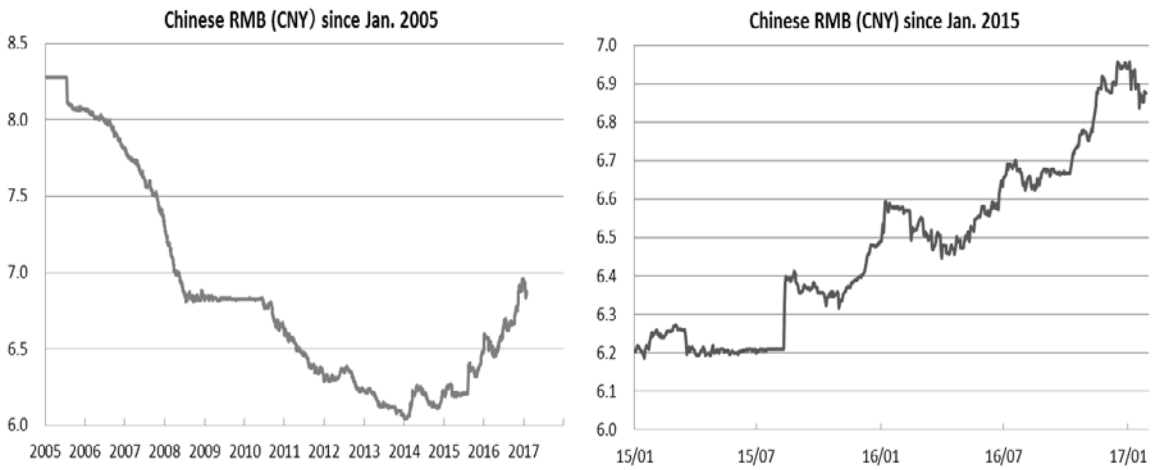
In fact, despite the fact that China has met only one of the criteria, namely that on trade surplus with the US, China was included in the Monitoring List in the October 2016 report. This fact indicates by itself that the absolute amount of trade surplus with the US is the most important point in naming a currency manipulator. And if the trade surplus with the US (an imbalance of bilateral trades) is the top priority of the new administration, there is a substantially high possibility that the administration will seek to correct the imbalance not necessarily through the price channel of currency adjustment but rather implement quantity adjustment through institutional channels like intensified customs tariffs

＜Largest Drop of Chinese Yuan in 2016 followed by an upward reversal this year＞

Another “twist” is that, despite President Trump’s belief that the yuan is too weak, the Chinese yuan is now appreciating owing to the massive buying intervention of its currency and intensified capital controls by the Chinese authorities.

In the first place, the perception about the present situation that the Chinese currency is undervalued and strong anticipation of its prolonged fall derived from the shocking devaluation of the currency implemented in August 2015. It was a great shock to the market that the rising trend of the yuan that had continued for a long time ever after the historic revaluation of the Chinese yuan announced in July 2005 came to an explicit end by the political judgment of the Chinese authority and it accelerated the depreciation of the currency and capital outflows in the market. The depreciation of the yuan continued during the last year, with the yearly fall of 6.5% against the dollar, the largest drop since 1994, to fall to the level recorded in May 2008.

Chart 2 ＜Chinese Yuan (CNY) vs the US Dollar＞



Source：Thomson Reuters

According to Mr. Trump, the Chinese yuan has been manipulated by the Chinese authority to an excessively cheaper level in the mid-to-long run. But the Chinese authority has been engaging in a massive yuan-buying intervention to control the pace of depreciation. This is reflected in the rapid decline of its foreign exchange reserves from about $4 trillion at its peak time to nearly $3 trillion in November 2016. This stance has been maintained even in the beginning of this year, and coupled with the intensified capital control, the exchange rate of the yuan has reversed its trend this month to a rapid rise (Chart 2). The IMF estimates in its report issued in 2015 that the minimum level of foreign exchange reserves that China needs to maintain should be $2.8 trillion. Based on this premise, a large intervention should gradually be faced with this critical limit. If we take this in light of so-called “international financial trilemma theory”, we will have to judge that “freedom of capital movements” will have to be given up after all in order to maintain “stabilized foreign exchange rates” and “independent monetary policy.” Already restrictions on purchase of foreign currencies, lowering of ceiling for authorized foreign remittances and others restrictions have been implemented, and for the moment the Chinese authority may be tempted to seek a market stabilization through various capital control measures.

＜Anti-Free trade vs Anti-Market Force＞

As the world sees that the US is tilting in the direction of anti-free trade in such a magnitude as never anticipated, the most targeted China seems to have been compelled to strengthen capital controls in so-called anti-marketism actions. However, that the temporary putting of brakes on the depreciation of the Chinese yuan may not be a bad thing in the sense that it will ease the rising pressure on the domestic inflation, reduce the amortization costs on its dollar-denominated debts, and it will help China to maintain the confidence in its currency in an internationalization process of the yuan.