

Trump's currency confusion continues

By Jeffrey Frankel

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Ever since the 2016 US presidential campaign, Donald Trump has falsely accused the Chinese of keeping the renminbi artificially weak. But the fact is that Trump's own economic policies are driving up the value of dollar – an outcome that would have been foreseen by anyone with a basic understanding of economics.

Next month, the US Department of the Treasury is due to submit to Congress its biannual report detailing which countries, if any, are manipulating their currencies to gain an unfair trade advantage. For his part, President Donald Trump is already accusing China of doing so, as he did throughout the 2016 election campaign. And he is reportedly trying to influence the Treasury Department's deliberations.

What has changed since the last report in April? That document, like similar reports written during the previous two administrations, did not find China guilty of manipulation. In fact, the last time the Treasury Department declared China (or anyone else) a manipulator was in 1994.

The reason for this is simple: China does not meet the three criteria that Congress has set for determining currency manipulation. It has not been persistently intervening in foreign-exchange markets (at least not to push down its currency), and it is not running an overall current-account surplus greater than or equal to 3% of GDP (its surplus in 2017 was 1.3%).

China does meet the third criterion: a bilateral trade surplus with the US in excess of \$20 billion. But Congress was wrong to set the bilateral balance as a criterion in the first place. The huge US trade deficit worldwide is sufficient to explain the bilateral deficit. China accounts for 15% of the world economy, so even its proportionate share of the US's \$600 billion deficit would be \$90 billion – well over the \$20 billion threshold. Yes, the bilateral deficit is much higher than even that level; but

that is partly because China's exports to the US contain so many imported inputs.

So, as of April, China had met just one of the three congressional criteria, and thus did not qualify as a currency manipulator. (Germany, India, Japan, South Korea, and Switzerland each met two criteria.) Since then, the renminbi has depreciated by 6% against the dollar. But that is because the dollar itself has appreciated by 7% on a broad average basis against its trading partners' currencies.

Exchange rates do not always accord with economists' models. But in this case, the dollar's appreciation can be explained by Trump's own economic policies.

For starters, Trump and congressional Republicans have pursued a massive pro-cyclical fiscal expansion, producing virtually unprecedented peacetime budget deficits in the absence of a recession. This expansion includes the tax cuts passed in December, rapid increases in government spending, and recent proposals for further tax cuts.

Macroeconomic theory predicts that such policies will drive up interest rates, attract capital from abroad, and strengthen the dollar. That is what happened when the US had a similar fiscal-monetary mix under President Ronald Reagan in 1981-1984.

Moreover, Trump has launched a trade war by imposing import tariffs on America's major trading partners. Most recently, he announced tariffs on another \$200 billion of Chinese exports, to take effect on September 24. He thinks this will improve the US trade balance,

but does not understand that if foreign exporters are cut off from the US market, they will not have the dollars to buy US goods.

A tariff-induced reduction in US imports can be offset in a number of ways. Most tangibly, other countries can retaliate against the US by imposing their own tariffs on, say, US agricultural exports. But even if they don't, measures that make it harder for foreign exporters to earn dollars will create a dollar scarcity, which, in an environment of floating exchange rates, will automatically boost the greenback's value. Trump's escalation of the trade war over the course of 2018 appears to have had the effect on the dollar predicted by economic theory.

To be sure, China did hold down the value of the renminbi ten or 15 years ago. Alongside rising trade and current-account surpluses, the People's Bank of China (PBOC) maintained a policy of intervening in the foreign-exchange market to dampen appreciation, thereby amassing huge foreign exchange reserves. But China then adjusted its currency policy. The renminbi appreciated by 37% between 2004 and 2014, at which point its undervaluation had been eliminated.

In 2014, capital started to flow out of China and the currency started to depreciate, perhaps owing to a slowdown in the Chinese economy, relatively strong growth in the US, and a corresponding shift in their respective monetary policies. Just as the PBOC had intervened to dampen the appreciation of the renminbi from 2004-2014, it began intervening to dampen its *depreciation* after 2014.

This pattern of intervention is called "leaning against the wind." The PBOC spent a record-setting \$1 trillion trying to stop the renminbi's

slide after 2014. If Chinese authorities had acceded to US demands and allowed the market to determine the exchange rate, the renminbi would have depreciated further still, and US exporters would have had a harder time competing.

Eventually, US politicians came to understand this basic fact. The last one to grasp it was Trump. As late as April 2, 2017, Trump labeled the Chinese the "world champions" of currency manipulation, only to reverse his position a week later, telling *The Wall Street Journal*, "They're not currency manipulators." After that, he let the subject rest for a year, before reprising his original accusation this summer.

As it happens, the year during which Trump stopped accusing China of pushing down its currency was also the year that China suspended its efforts to *prop up* the renminbi. Its foreign-exchange reserves stopped declining in 2017. But now the Chinese have resumed their efforts to defend the currency, just when Trump is renewing his accusations. To slow the renminbi's depreciation, the PBOC recently signaled that it will apply a so-called counter-cyclical factor in its daily "fixing" of the currency against the dollar.

Why does Trump keep getting things backwards? It is not just his perverse personality. Trump makes the charge when the renminbi depreciates, which also happens to be when the PBOC intervenes to support it. What he misses are two fundamental drivers of that depreciation: his own fiscal and trade policies.

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