

Mitchell's Musings 8-17-15: Money Talks

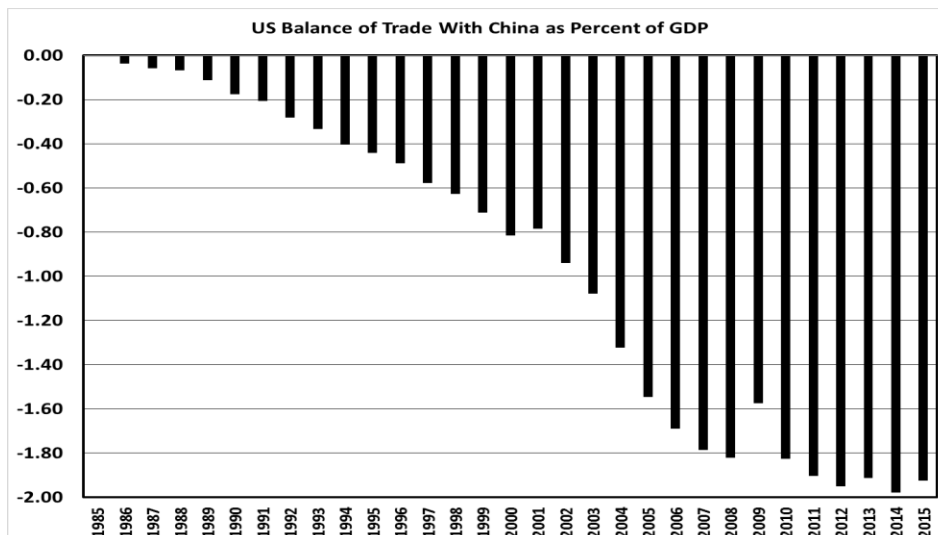
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From time to time, these musings have talked money, specifically currency exchange rates. There has been much news media discussion in the past week about the recent China devaluation of the Yuan. So let's start with terminology. A freely floating currency – one that is not “manipulated” – sometimes rises in value relative to other currencies and sometimes falls. It sometimes appreciates and sometimes depreciates. That's the terminology we use for those movements when they occur due to market forces. No government or central bank or any other official agency is responsible. Appreciation or depreciation just happens due to market conditions.

In contrast, the word “devaluation” implies that a policy decision was made to change (lower) a currency's value relative to another. The word devaluation, put another way, implies “manipulation.” (The opposite is “revaluation.”) You can't talk about a “devaluation” and then ruminate over whether manipulation has occurred. It has occurred by definition.

Now there is a longstanding history in international monetary affairs about the pluses and minuses about systems of fixed exchange rates, freely floating exchange rates, and arrangements that fall somewhere in between. The old gold standard was a system of fixed exchange rates. The Bretton Woods system set up towards the end of World War II was a fixed exchange rate system. When Bretton Woods fell apart in the early 1970s, a mix of arrangements developed. The U.S., however, largely left its dollar to float. Some countries attempted to maintain fixed arrangements relative to one another but float against others. Some tried to keep their currencies within a band of some other currency. The Eurozone eventually formed and some countries abandoned their internal currencies for a common, international currency. There were experiments with “currency board” systems in which a country pegged its currency to another through a kind of central bank operating by formula.

To the extent that a country chooses to have some say in its currency's value, and not leave the exchange rate entirely to market forces, there has to be some regime of regulation and/or intervention in currency markets, i.e., “manipulation.” You can debate whether the result of such manipulation is a Good Thing or a Bad Thing, but (again) that there is manipulation taking place is not a matter for debate.



When you look at China's trade with the U.S. as shown on the chart, there is an anomaly. You have a rich country – the U.S. – borrowing from a developing country, essentially to finance current consumption. As the chart above indicates, that odd situation has persisted for a long time. The U.S. trade deficit with China now is close to 2% of U.S. GDP. That figure may not sound like much. But, to put it in perspective, the peak-to-trough drop in U.S. real GDP during the Great Recession was around 4%. So the impact of 2% is hardly negligible.

China, from time to time, says that it wants to move (gradually) to a floating exchange rate. But the chart surely suggests that what it has been doing is maintaining an undervalued currency. The recent devaluation was said to be part of a move to a market exchange rate. Numerous journalists repeated that interpretation. But any such move would have to be a *revaluation* (increase in the Yuan's value), not a devaluation.

Moreover, as noted earlier, the very word “devaluation” implies an official policy, not some blind market force. So it's hard to get away from the fact that China views the exchange rate as a macroeconomic tool, not something to be left to the forces of currency markets. It “manipulates” its currency value. Actions speak louder than words, although apparently not to those journalists who repeated the self-contradictory move-towards-the-market story. The Chinese economy was slowing down and to stimulate demand, the Yuan was devalued by the powers-that-be in China. It isn't complicated. No elaborate interpretation is needed. And it's a move away from the market, not towards it.

What is the impact on the U.S.? Again, the story is not complicated. If boosting Chinese exports to the U.S. and discouraging Chinese imports from the U.S. is a stimulus to China's economy, it has to be a negative, other things equal, for the U.S. Commentators quickly chimed in to say that, yes, there is a negative effect, but it will be small. After all, the trade deficit with China is only 2% of the U.S. GDP and the devaluation will only have an incremental effect on that pre-existing deficit.

The problem, however, is that for a country such as the U.S., marginal shifts in trade patterns are always in some sense small in their overall impact. But they can be large in individual industries or sectors. As we have pointed out in past musings, manufacturing – which is now only about an eighth of U.S. GDP - is especially affected by trade shifts since much of trade involves manufactured goods. So what happens in trade and exchange rates matters to manufacturing and to jobs in manufacturing.

Rather than discuss what the Chinese devaluation means – when it's obvious what it means – isn't it time to revisit U.S. exchange rate policy, a policy discussion that really hasn't occurred since the early 1970s when fixed exchange rates were abandoned? At that point, the U.S. essentially said it would not intervene in exchange markets in order to affect the value of the dollar, but that other countries could do what they liked. The problem with that approach is that an exchange rate inherently involves *two* currencies; it is the price of one currency relative to another. So the decision to float the dollar and let others do what they liked was essentially a *de facto* decision to let other countries “manipulate” the value of the dollar, if they so wanted. It might have been the best policy choice back then. But over four decades later, it's time for a review.