Mitchell's Musings 11-16-15: Currency Matters

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From time to time, I am asked what I think about the "TPP," the recently-concluded Trans-Pacific Partnership deal that President Obama hopes to sell to Congress. Let's note first that the deal is a lengthy agreement that virtually no one, certainly no one in Congress, is likely to read in its entirety in any detail. The Canadian Financial Post recently provided a link to the entire text, but it appeared to be something of a we-dare-you-to-try-and-read-it stunt.[1] TPP, like the Keystone Pipeline (recently rejected by the President), has become a symbol and not something opponents and proponents carefully subject to some sort of dispassionate cost/benefit analysis.

There is, however, an empirical test that will soon be available for judging one piece of the TPP debate, the piece dealing with currency valuation. In the view of this author, much of the problem of the modern international trade regime for the U.S. is not protectionism (trade barriers) but mercantilism. Mercantilism in its contemporary form is the following of economic policies that lead to the accumulation of large dollar reserves through the running of perpetual export surpluses. Essentially, these policies seek to create an artificial exchange rate advantage in the U.S. market for net exports of the country undertaking contemporary mercantilism. So how does TPP address the currency issue? A summary from The Hill:

> *Three years ago, (Fred) Bergsten (and) Joseph Gagnon… wrote (an) oft-noted currency research report that became the bedrock of the congressional argument that deliberate exchange rate intervention was the reason for trade deficits and had cost the United States between 1 million to 5 million jobs — a rallying cry for trade detractors. Their plan quickly gained traction on Capitol Hill, attracting the support of a bipartisan majority of lawmakers and even business and labor groups, resulting in the currency issue becoming a key negotiating objective in trade promotion, or "fast-track" authority.*
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> *But President Obama argued that adding currency rules into the TPP would be too complicated and could torpedo a final deal.*
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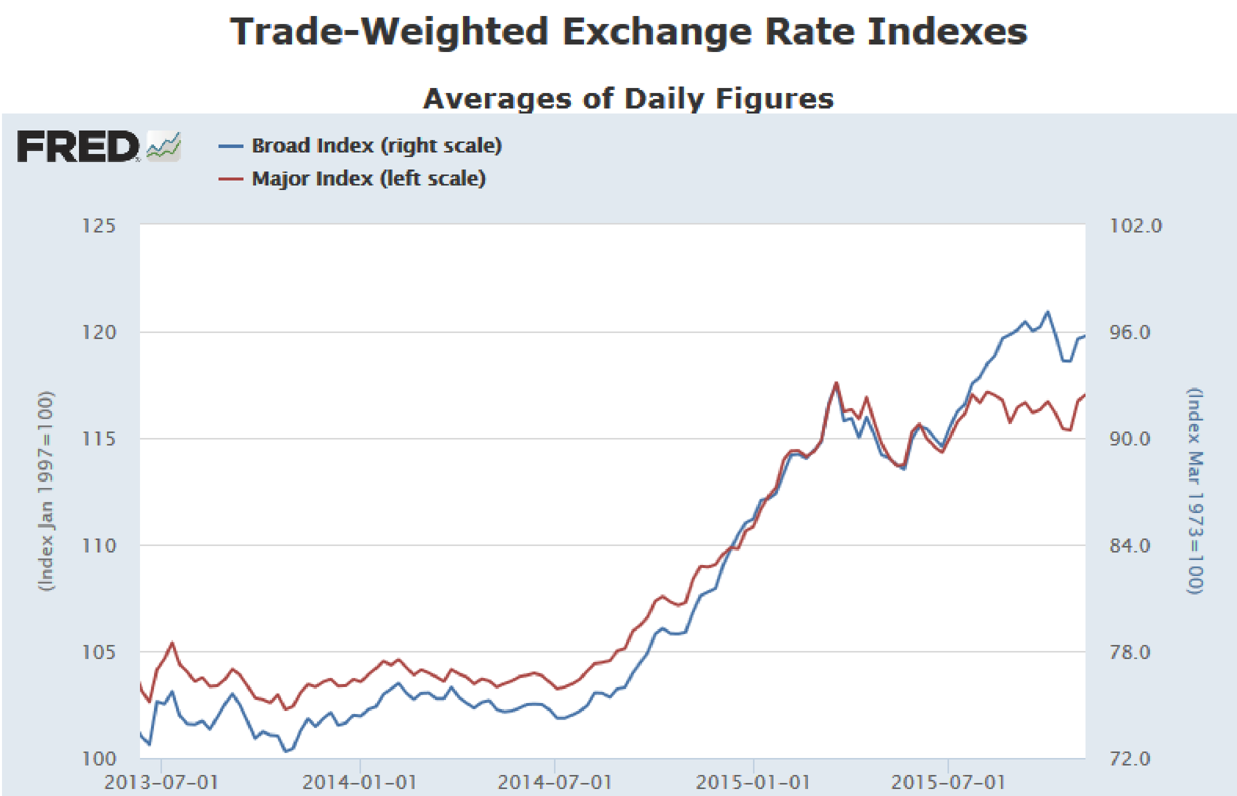
> *Bergsten and (Jeffrey) Schott noted that TPP negotiators opted for what they consider an early warning system that requires enhanced reporting and frequent monitoring and consultations instead of the "hard deterrence" approach preferred by some lawmakers in Congress who wanted a system that could impose trade sanctions on violators. "In*

[1] http://business.financialpost.com/news/economy/trans-pacific-partnership-trade-deal-unveiled-heres-your-chance-to-read-the-mysterious-trade-agreement-everybody-is-talking-about and http://www.mfat.govt.nz/Treaties-and-International-Law/01-Treaties-for-which-NZ-is-Depositary/0-Trans-Pacific-Partnership-Text.php (The link in the Financial Post was provided by a New Zealand government agency.)

addition, the requirements for more transparency and public disclosure of data on exchange rate policies, including currency intervention, should make the 'naming and shaming' of manipulators more effective," they wrote.[2]

Now "naming and shaming" may not seem to you to be a particularly effective policy instrument. A country that is named may not be shamed and it may simply deny that what it is doing is aimed at creating an artificial currency advantage. But perhaps naming and shaming could work. In any event, there will be a handy empirical test available soon to see how effective naming and shaming actually is.

Currency exchange markets are like markets for other financial assets. If market participants expect the value of an asset to fall in the future, they are likely to bring down that value today. Why hold an asset today that you expect to fall in value in the future? So if currency market participants think that the TPP mechanism will in the future reverse policies that cause under-valuation of foreign currencies relative to the U.S. dollar, presumably the dollar should fall in value relative to those currencies now that the naming and shaming regime is public knowledge.



[2]http://thehill.com/policy/finance/259756-tpp-currency-side-deal-gets-key-endorsement. (Bergsten, Gagnon, and Schott are all connected with the Peterson Institute for International Economics.)

Above is a chart of two indexes of the U.S. dollar's value relative to other currencies in recent history.[3] Its time series run just up to the period in which the new TPP naming and shaming regime became known. Going forward beyond the final date of the chart, with the new policy now known, we should have an indication of the impact of that policy. If the dollar declines significantly relative to such currencies as the Yuan (which was recently explicitly devalued by China relative to the dollar), the Yen, and the Euro, that decline can be taken as an indication that the new regime is having the desired effect of discouraging policies abroad that lead to over-valuation of the dollar. If the dollar's value doesn't decline (a lot and soon), you can take that lack of decline as an indication that currency market specialists think the new regime will have little impact.

The chart could also provide another empirical test. If the dollar doesn't decline (a lot and soon), and if Congress endorses TPP anyway, you can assume that despite the public rhetoric on the subject, the complaints about currency valuation were not actually major Congressional concerns.

[3]The chart is from the FRED database of the St. Louis Federal Reserve Bank. The final date shown is November 4, 2015. The broad index is a weighted average of the foreign exchange values of the U.S. dollar against the currencies of a large group of major U.S. trading partners. The index weights, which change over time, are derived from U.S. export shares and from U.S. and foreign import shares. The major currencies index is a weighted average of the foreign exchange values of the U.S. dollar against a subset of currencies in the broad index that circulate widely outside the country of issue. The weights are derived from those in the broad index. Seven of the twenty-six currencies in the broad index—the euro, Canadian dollar, Japanese yen, British pound, Swiss franc, Australian dollar, and Swedish krona—trade widely in currency markets outside their respective home areas, and these currencies (along with the U.S. dollar) are referred to as ''major'' currencies. Source: http://www.federalreserve.gov/pubs/bulletin/2005/winter05_index.pdf.