

The U.S.-China Trade Balance and the Theory of Free Trade: Debunking the Currency Manipulation Argument

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Trump, 2015: The Chinese are “devaluing their currency to a level that you wouldn't believe. It makes it impossible for our companies to compete, impossible. They're killing us.”



Navarro, 2011:
“Death by Currency Manipulation”

Geithner, 2009: *“President Obama – backed by the conclusion of a broad range of economists – believes that China is manipulating its currency.”*

Obama, 2007: *“Treasury’s refusal even to acknowledge the costs of Chinese currency manipulation justifies the fear of many Americans that this administration lacks the will to stand up against trade abuses”*

1. Currency Manipulation as Instrument in US Foreign Economic Policy

- Since 1988 Omnibus Trade Act Treasury issues semi-annual reports to “*consider whether countries manipulate the rate of exchange between their currency and the U.S. dollar for purposes of preventing effective balance of payments adjustments or gaining unfair competitive advantage in international trade*” (Section 3004)
- Initially targeted Asian Newly Industrialized Economies (NIE) (i.e. Korea, Taiwan, Hong Kong and Singapore), monitoring of China since 1991, more recently Germany, Switzerland, and India
- Trade Facilitation and Trade Enforcement Act of 2015

1. Currency Manipulation as Instrument in US Foreign Economic Policy

Trump's turnaround and Treasury's acknowledgement that China has taken steps to appreciate the RMB but adherence to currency manipulation continues:

- * China once more not labelled currency manipulator, but again warning “to refrain from engaging in competitive devaluation and to not target China’s exchange rate for competitive purposes”
- * expression of deep concern over the significant trade imbalances in the global economy
- * claim that China’s *slow* and *gradual* strengthening of the RMB causes the distortion in the global trading system resulting from China’s previous currency policy to continue and imposes long-lasting hardship on American workers and companies

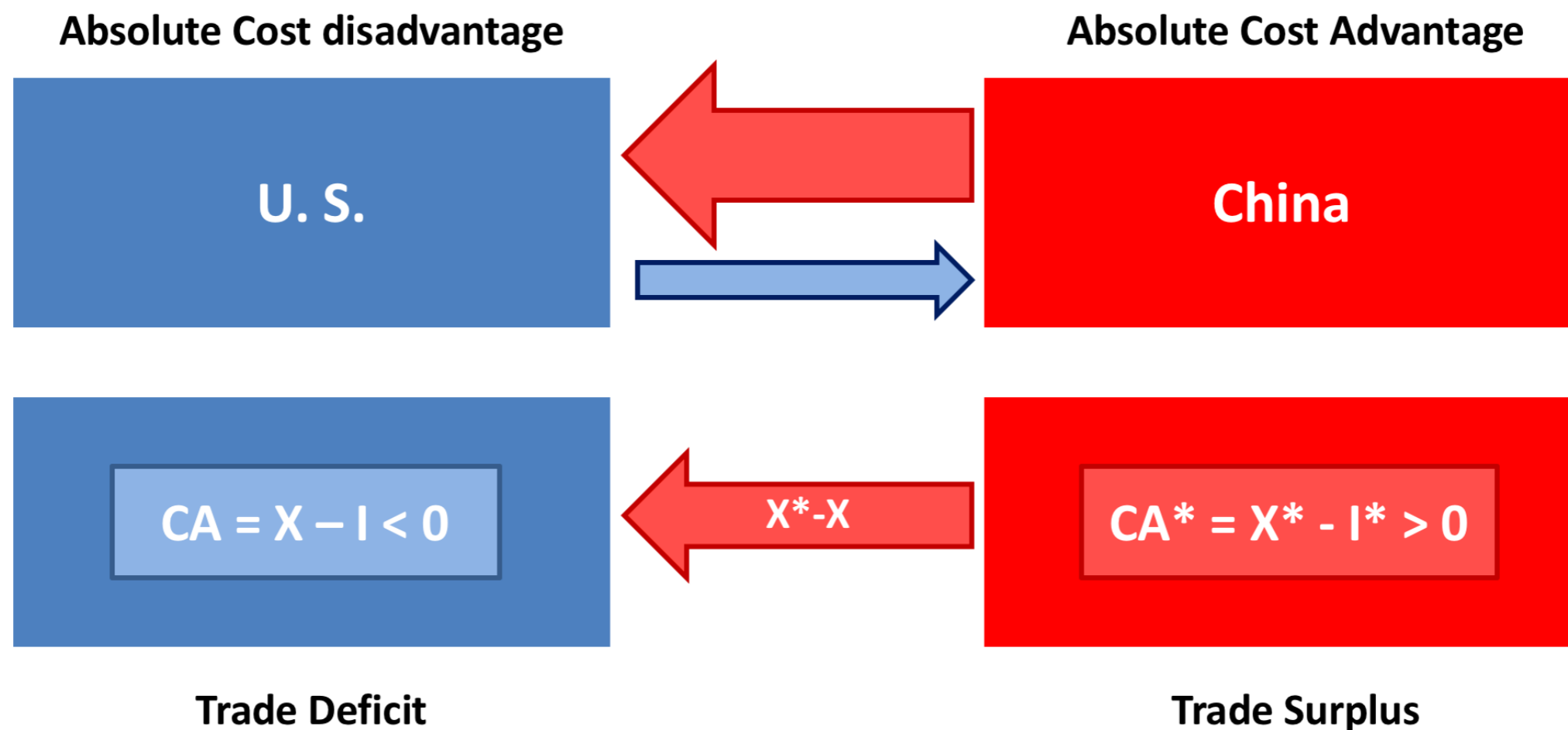
(Treasury, 2017, 2018)

2. Ricardian Underpinnings of the Currency Manipulation Argument



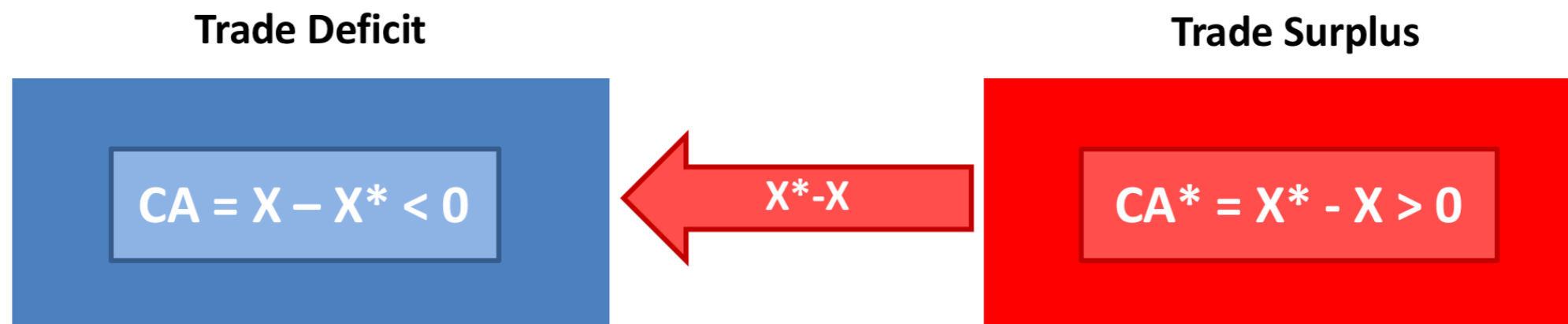
2. Ricardian Underpinnings of the Currency Manipulation Argument

REAL EXCHANGE RATE ADJUSTS SUCH AS TO BALANCE TRADE
The Basic Ricardian Mechanism

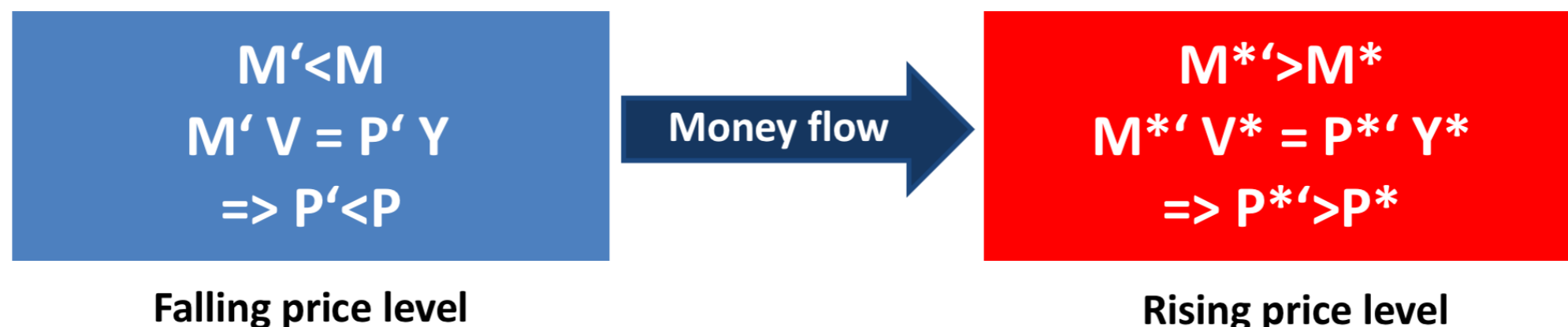


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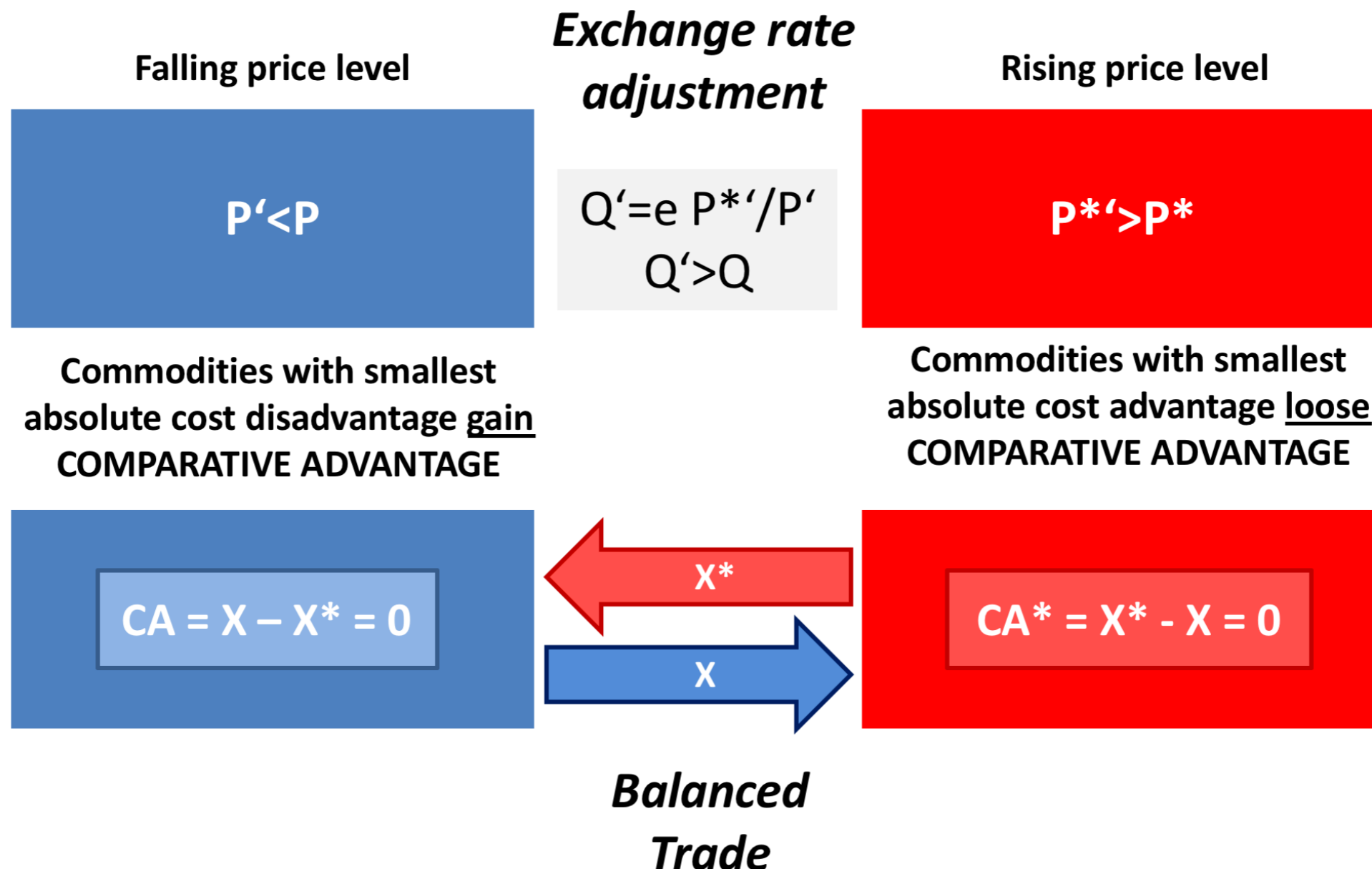


Quantity Theory of Money



2. Ricardian Underpinnings of the Currency Manipulation Argument

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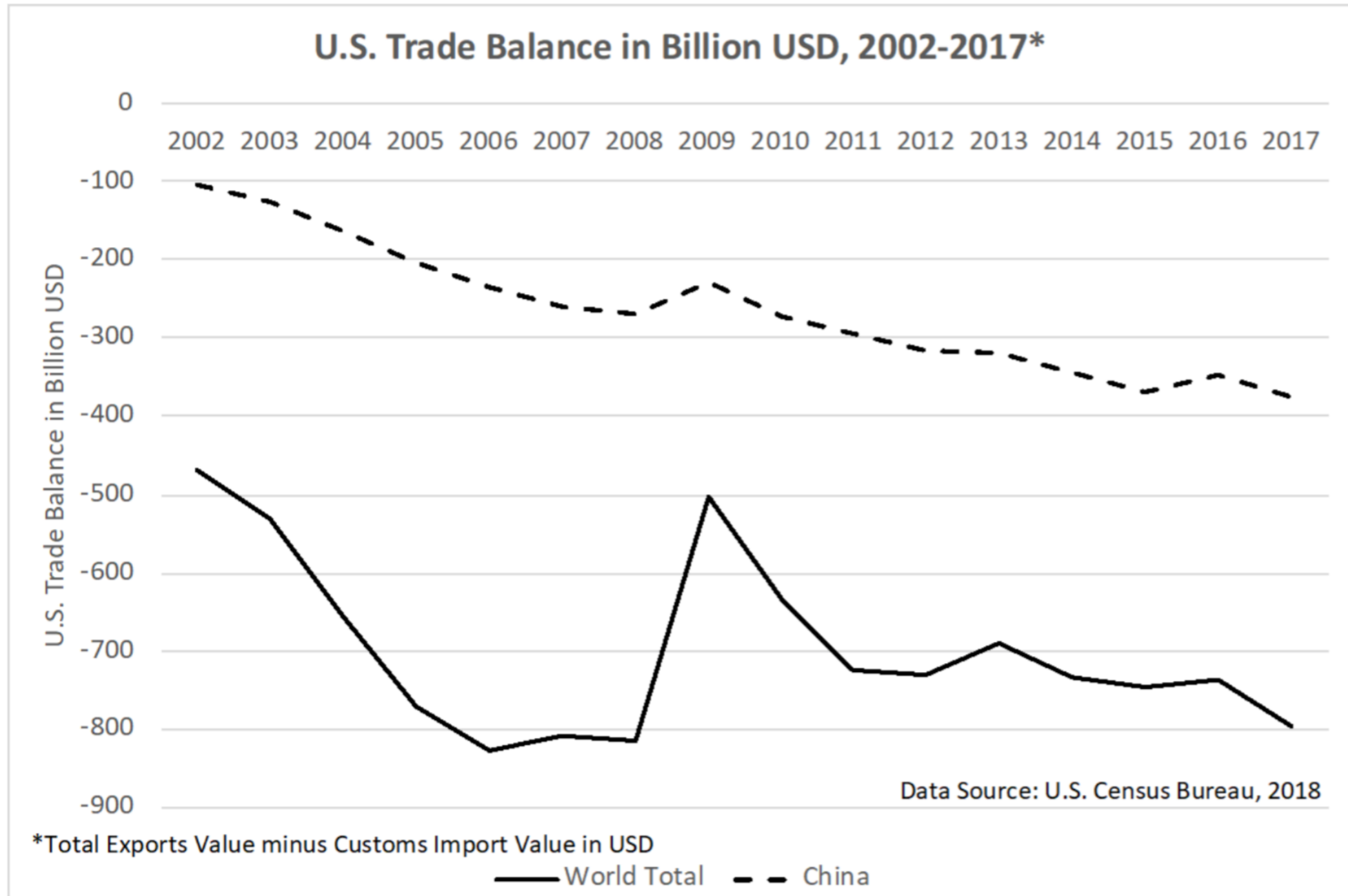
“Natural state”

Trade balances through real exchange rate adjustment

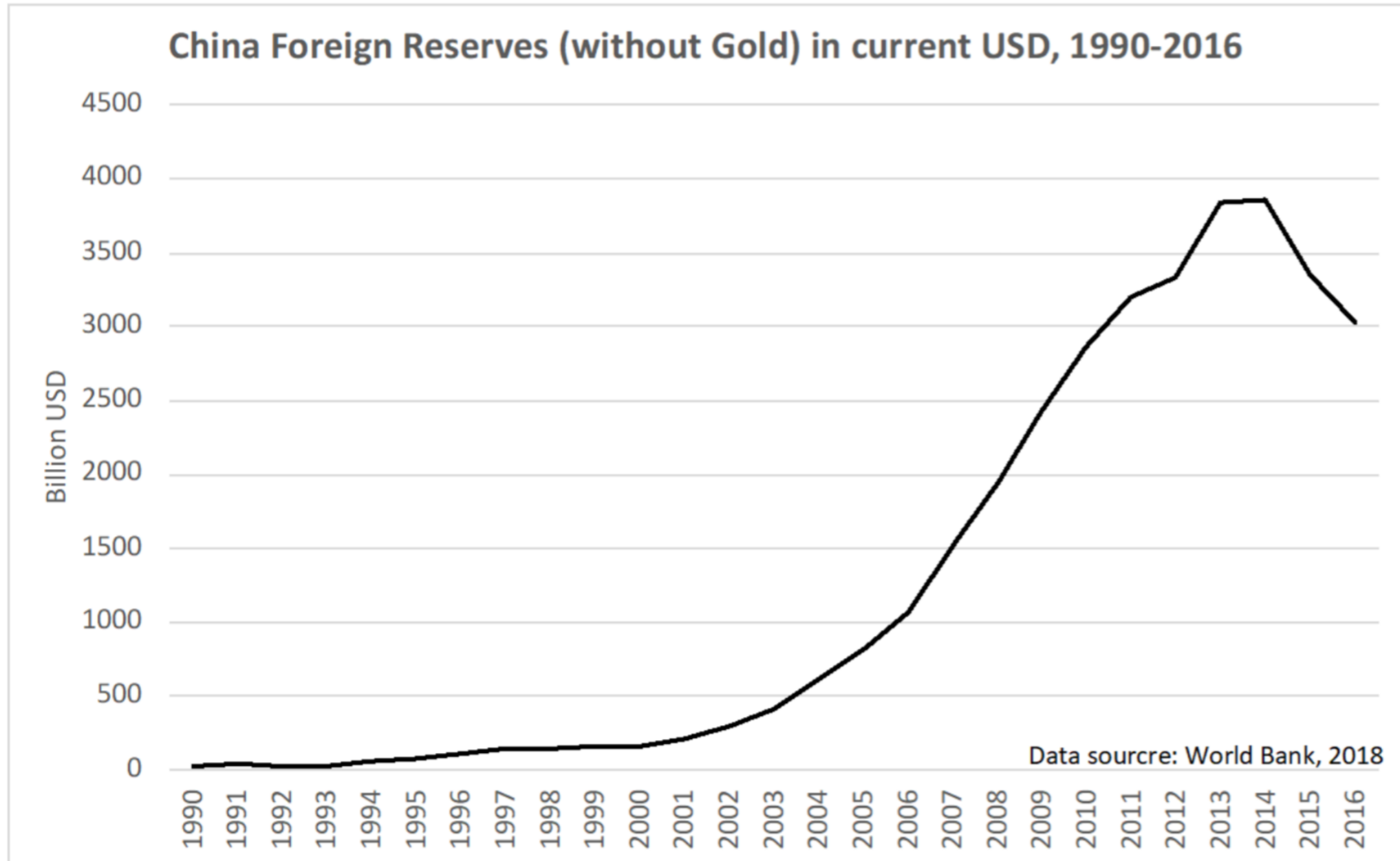
“Distorted state: currency manipulation”

Unbalanced trade indicates that real exchange rate is prevented from adjusting such as to balance trade by currency manipulation

3. Measuring RMB Misalignment



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Currency Misalignment

= current real exchange rate (RER)

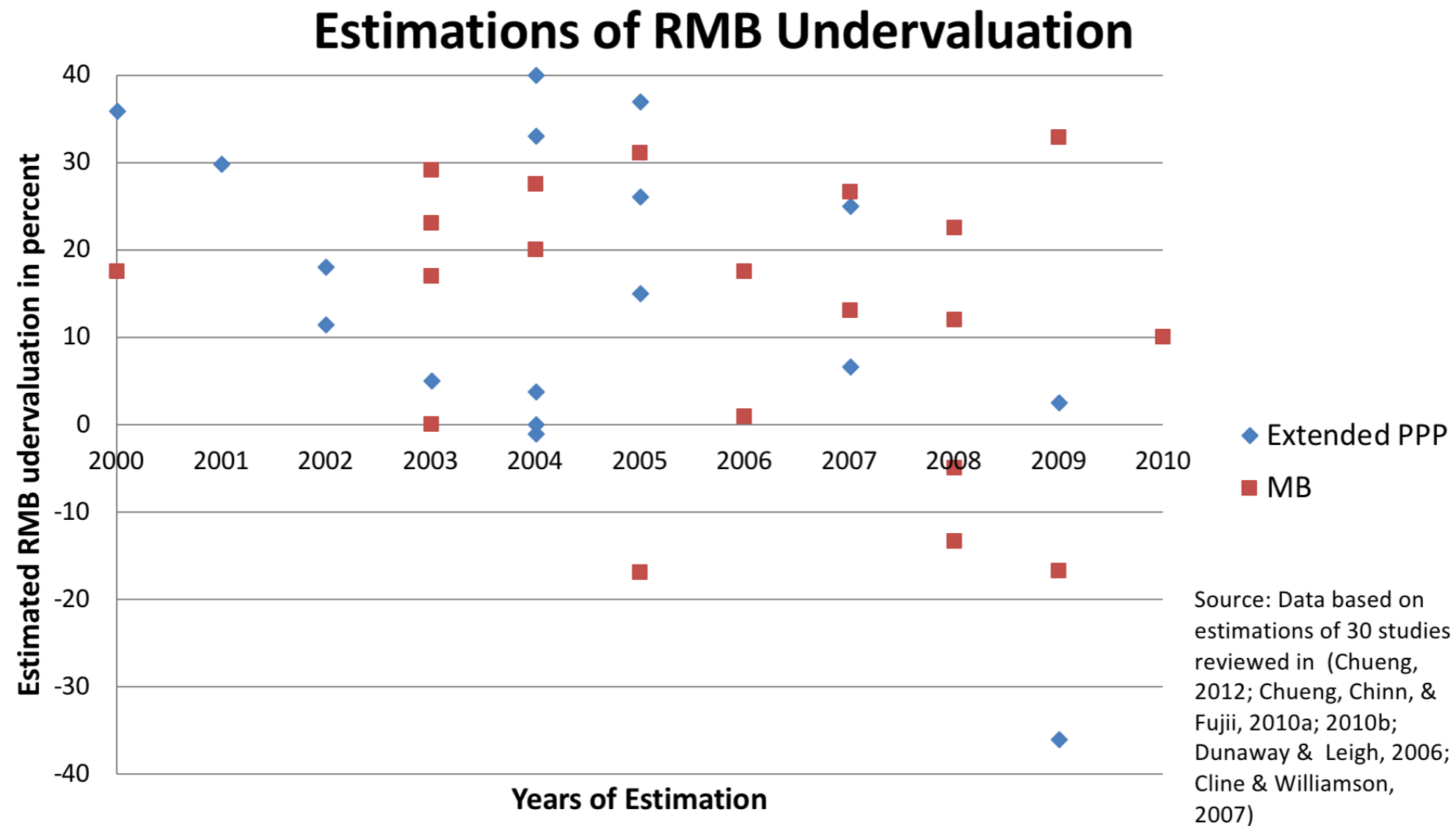
– equilibrium real exchange rate (ERER)

= exchange rate adjustment needed to balance trade

BUT: No consensus on how to determine ERER
and hence on how to derive RMB adjustment
needed to balance trade

3. Measuring RMB Misalignment

ESTIMATION RESULTS IN THE LITERATURE

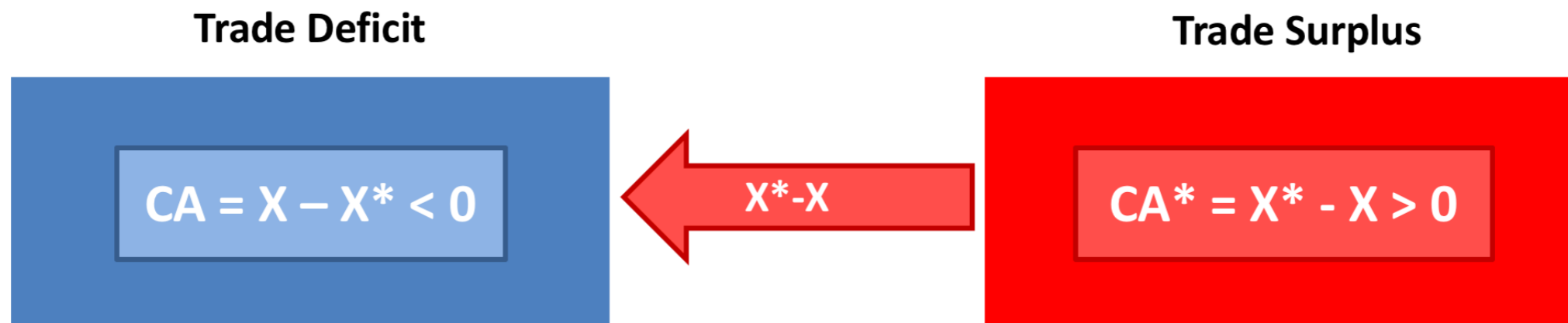


4. An Alternative 'Natural State' of Unbalanced Trade

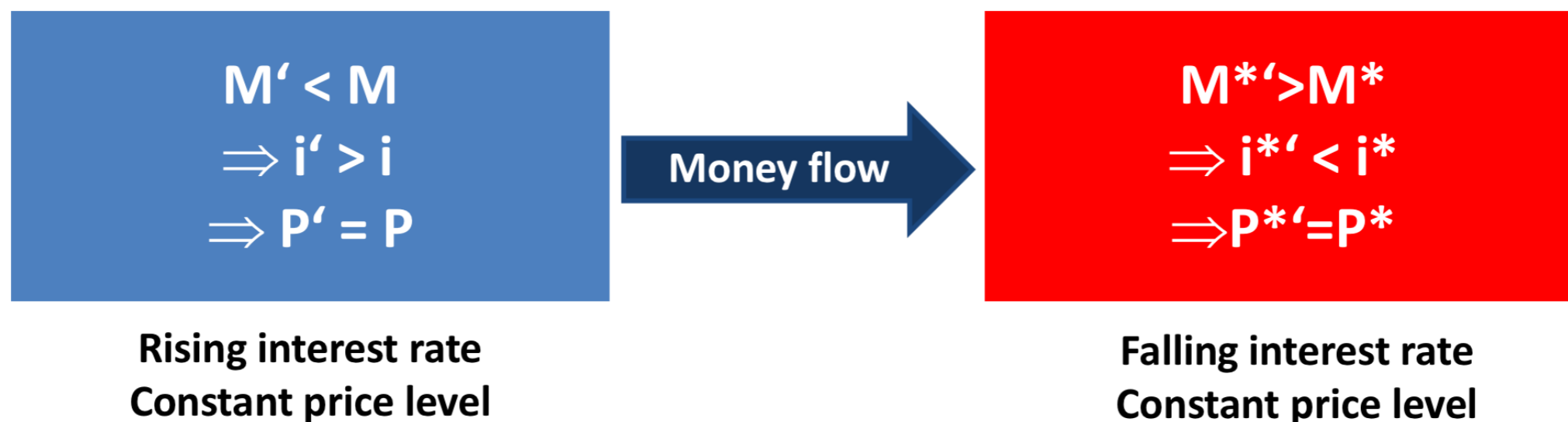
- Smith and later Marx and Harrod (1957) reject Ricardo's magic that turns absolute cost disadvantages into comparative advantages
- Based on alternative theories of money they extend the finding of trade imbalance as the result of free trade between regions within one nation to the international level

4. An Alternative 'Natural State' of Unbalanced Trade

An alternative to the basic Ricardian mechanism

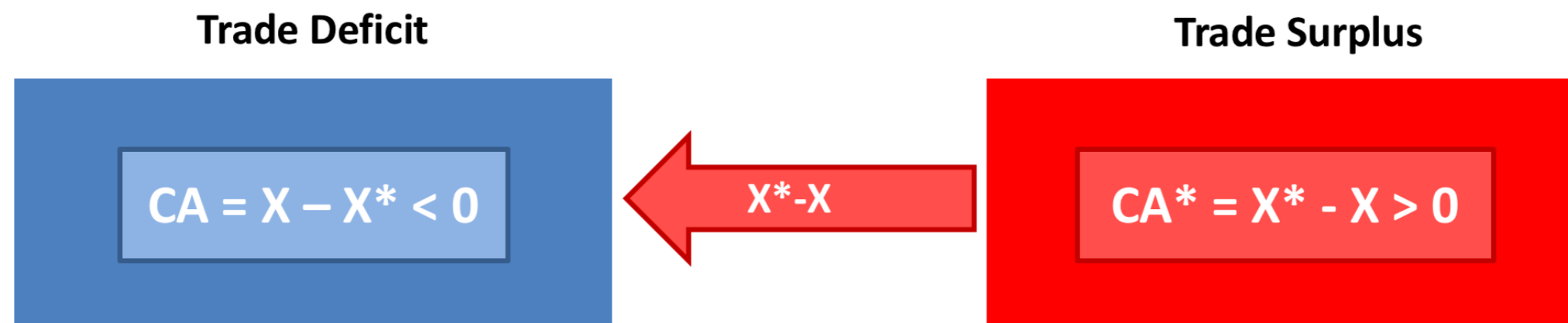


Liquidity Theory of Money

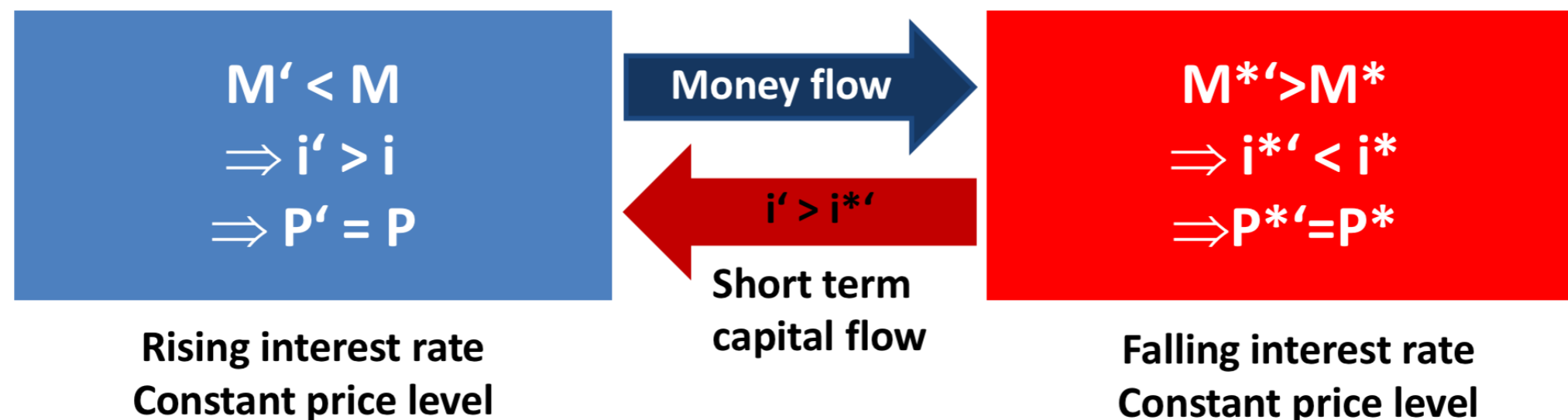


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Liquidity Theory of Money

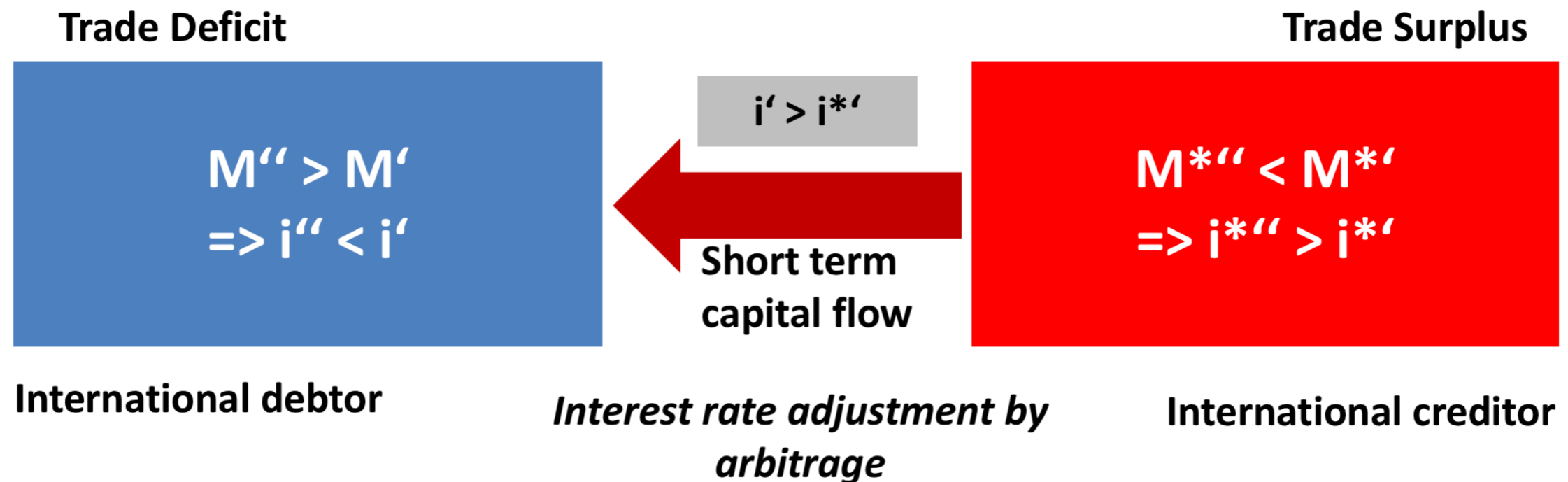


Interest rate adjustment by arbitrage

4. An Alternative 'Natural State' of Unbalanced Trade

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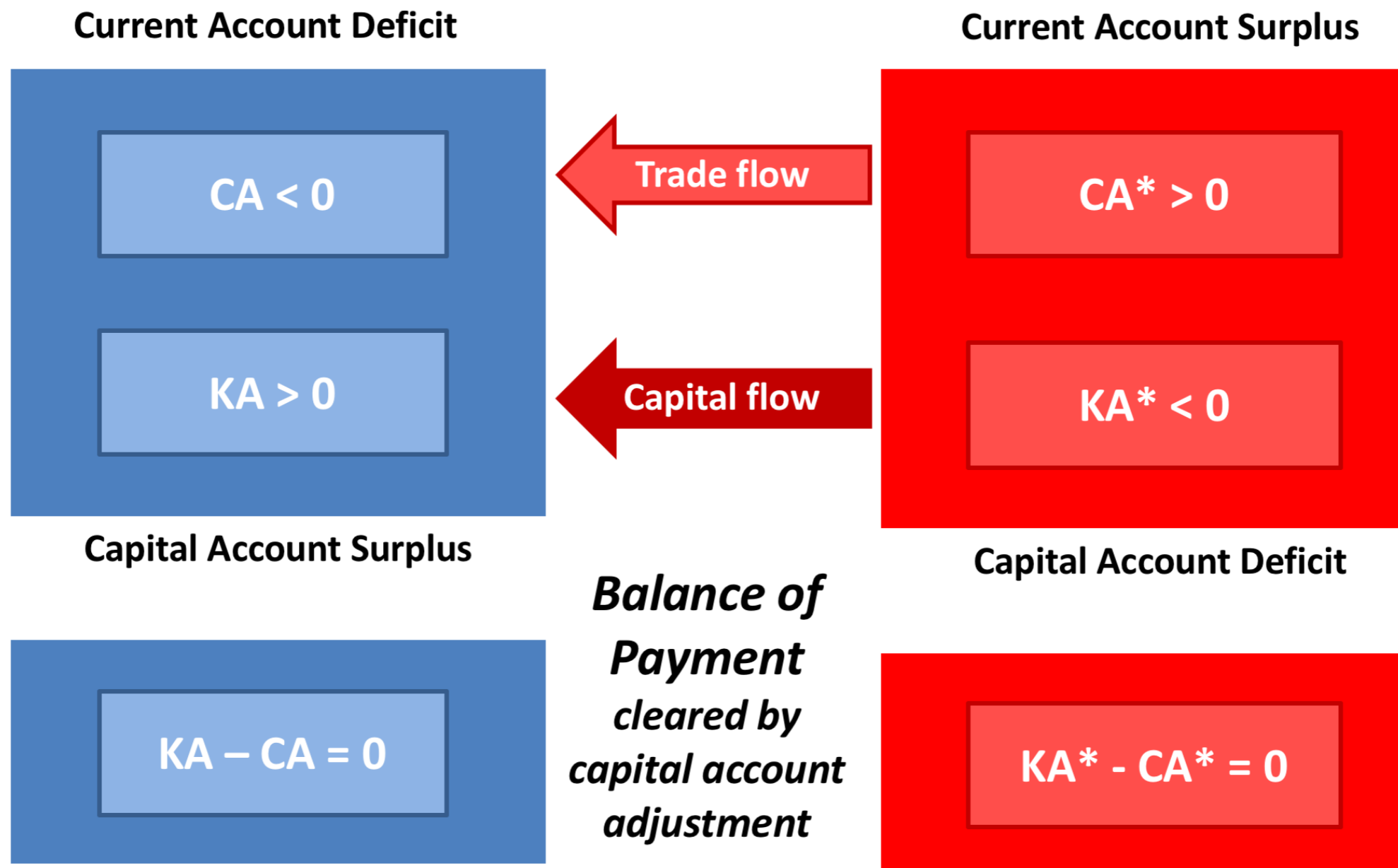
Liquidity Theory of Money



Persistent trade imbalances and international debtor and creditor positions as outcome of unequal real competitiveness under free competition

4. An Alternative 'Natural State' of Unbalanced Trade

An alternative to the basic Ricardian mechanism



5. Conclusion

- No conclusive empirical evidence for currency manipulation.
- Logic of currency manipulation is rooted in Ricardian 'natural state' of balanced trade, which sees imbalance as distortion.
- In contrast, a Smithian, Marxian, Harrodian 'natural state' predicts persistent trade imbalances and international debt as outcome of capitalist competition, not of policy intervention. Note: This does not imply policy nihilism!
- Allegations of currency manipulation as a political tool of US foreign economic policy, targeted at market opening and protection of globalised business structure more than trade.
- In times of trade war, it is important to widen the scope of analysis beyond competition between countries to consider competition between capitalist firms and class conflict.