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Dollar & Sense: Is China really manipulating its currency?

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PARTICIPANTS:

Adrianna Pita – Office of Communications, The Brookings Institution

David Dollar – Senior Fellow, Foreign Policy, Global Economy and Development, John L. Thornton China Center, The Brookings Institution

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PITA: Today, the Brookings Podcast Network brings you a joint episode of Dollar & Sense and The Current around the news that on Monday the U.S. Treasury Department declared China to be a currency manipulator. Today, we have host of “Dollar & Sense,” David Dollar, a senior fellow at the John L. Thornton China Center and myself, Adrianna Pita, the host of “The Current.”

David, while President Trump accused China of manipulating their currency during the 2016 campaign, this is the first time that Treasury has made an official designation like this since the mid-1990s. Why has Secretary Mnuchin made this call now and how accurate is it?

DOLLAR: So, I think it's not accurate to say that China is manipulating its currency. Currency manipulation has a specific definition under U.S. law. It's a situation where the market is driving a currency up and the Central Bank intervenes to limit that, usually by buying dollars and accumulating reserves. In the case of China, they're not in that situation. The market is driving their currency down, that's the main thing. The Trump administration is unhappy about that, but that is a market result and ironically it's very much related to this trade war.

I would point to two factors driving down the Chinese currency. First, we're limiting China's ability to export. That's what we're doing with the tariffs and it's succeeding to some extent. So, China's not earning as many dollars as it used to. So, there's a shortage of dollars in their foreign exchange market. The price is bid up. And basically, the exchange rate, this 7:1 that we're talking about, that's the price of a dollar in China -- seven Chinese yuan to the dollar. And then a second factor that may be more important, we're trying to slow down their growth, and again succeeding to some extent. So, there are fewer investment opportunities, prospects for China are not as bright, and that means people are trying to move money out of the country and in doing that, they're also depreciating their currency.

PITA: Treasury’s announcement came after a really rough day in the stock market, both for the U.S., but for other markets around the world as well. The Dow fell something at around 3 percent. Today, Tuesday, things seem to be stabilizing a little bit more. Why did the yuan’s depreciation have such a dramatic effect?

DOLLAR: Well, for a long time, there's been this weak market pressure for the Chinese currency to depreciate and they've mostly resisted it and currency was around 6.8, 6.9. Seven is just an arbitrary number but it became kind of a red line. It's been a long time since China's currency was that low -- have to go back to 2008, so 11 years ago.

And then, I think a key reason why markets reacted so strongly on Monday is they don't know how far this depreciation could go. The move from 6.9 last week to seven, that's actually very minor. We see that in currency markets all the time. But the sense that this could be the beginning of a new regime in which there's a large depreciation of the Chinese currency, that spooked a lot of investors. Other countries have very close economic ties with China. If China depreciates, probably a lot of other emerging markets in Asia and Latin America will depreciate. Many of their companies have borrowed in dollars. This is the kind of recipe for a financial crisis. So, I think it was the sense that this could precipitate financial crises in the developing world that really spooked investors on Monday.

PITA: So, what happened that made it level off and we're seeing a little bit of recovery today. Why did the panic stop?

DOLLAR: So, I think the main reason the panic stopped is that on Tuesday, the Chinese clearly were working to stabilize the currency at 7.02. So right now, it looks like they've allowed a small amount of depreciation, they crossed that magic 7 number, but they're stabilizing their currency at 7.02, so that other worry that this could go a lot further and precipitate, big depreciations in other countries -- for the moment, that does not seem to be happening.

PITA: You mentioned that that seven number is a little bit arbitrary, it's just sort of a customary line. Is there a line that's further ahead where it is a factual, a more serious question?

DOLLAR: Well, starting from where we are now, any large depreciation – by large we usually mean something like 10 percent or more – starting from where we are, that would be taking the currency to say 7.7. That's really getting back to the exchange rate that China had 20 years ago. So, I think that would be you know that would be taken as a very bad signal. That would put a lot of pressure on other developing countries. That would be the main concern.

PITA: So now that Treasury has made this call, they're accusing them of manipulating the currency, are there substantive consequences to that or is it more diplomatic?

DOLLAR: I would argue it's largely symbolic. Under U.S. law, at this point, what is supposed to happen is having named them as a currency manipulator, Treasury is now supposed to consult with the Chinese, but I would argue they consult with the Chinese practically every day. So, that's really nothing new. Under U.S. law, if someone's a currency manipulator and after those consultations you're not happy, you're empowered to impose tariffs. But we've already imposed 25 percent tariffs on most of the products from China. So, we've already gone down that road. So, I think it's pretty much a symbolic gesture, but it was taken seriously in Beijing as another sign of ratcheting up the trade war.

PITA: What are the prospects for de-escalating these tension points? Is there a sort of off-ramp that you are hoping to see?

DOLLAR: Right now prospects are not very good for an off-ramp. It's certainly helped that on Tuesday, China stabilized its currency at 7.02. I think they did that for their own reasons. They're worried that a large depreciation will accelerate capital outflows from China. So I don't think they were necessarily being nice to the world or that wasn't their primary motivation, but that had a positive effect on markets. So they look like the adult in the room at the moment. Given these tit-for-tat moves, they're the one who then stepped in on Tuesday and stabilized their currency and markets around the world took that positively.

The last thing the U.S. has done up till now is name them as a manipulator, which is a somewhat hostile gesture. Both sides have dug their heels in pretty hard. So, that's why it's hard to see a good off-ramp in the near future. If the U.S. keeps ratcheting up the tariffs, if they go ahead with the 10 percent on September 1, or worst case, increase that to 25 percent, before long, I think markets are going to react very badly to that.

And then ultimately, the off-ramp, the two presidents need to talk on the phone and one phone call is not going to solve this. They need to tell their negotiators to get together and approach this from the point of view of compromise. You've got two big elephants and the only way we're going to reach an agreement is if there's some kind of compromise where each side gets something, each side gives something. Neither one of these countries is going to roll over and play dead.

PITA: David, thanks so much for being here explaining this.

DOLLAR: Great to talk to you.