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Dollar & Sense: How do we police currency wars and manipulation?

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(Music)

DOLLAR: Hi, I'm David Dollar, host of the Brookings trade podcast, Dollar & Sense. Today my guest is Mark Sobel. He's the U.S. Chairman of the Official Monetary and Financial Institutions Forum, which is a London-based think tank, and he's also a non-resident senior advisor at CSIS here in Washington.

Before joining the think tank world, Mark had a long and distinguished career in the U.S. Treasury, dealing with international monetary issues. That's primarily what we're going to talk about. So, welcome to the show, Mark.

SOBEL: Thank you. It's a great honor to be here, and it's a great honor to be here with my former colleague in the Treasury, Mr. David Dollar.

DOLLAR: Great. So, let's start with currency. The issue keeps coming up. President Trump raises it from time to time. Some of the Democratic candidates raise it, the issue that the value of the dollar is too high. Are we in a currency war? Is there something we should be doing about this? What's your view on the dollar?

SOBEL: Well, let me break this down into a few questions. The first question is: What is a currency war? The term was first coined, to the best of my knowledge, in 2010 by then Brazilian Finance Minister Guido Mantega. And, he argued that the United States in particular was pursuing rate cuts and quantitative easing at the time to lower the currency's value and boost exports, including at Brazil's expense.

We, of course, thought this was absolutely ridiculous. We were pursuing an accommodative monetary policy to bring the U.S. back from the depths of the recession and to restore growth. And, as you and I know, no emerging market country has ever complained about increased export opportunities to the United States.

So, as you said, President Trump has recently been alleging that Europe in particular has pursued intensified monetary policy accommodation to weaken the euro. And, as you know better than I do, a monetary policy works for various transmission mechanisms -- so, lower interest rates aimed to lift investment, boost asset prices, compress spreads, spur confidence and the like. But, of course, monetary policy also affects exchange rates.

Now, in the current environment where the effective lower-bound -- zero lower-bound -- whatever you want to call it -- questions are raised about whether monetary policy is really boosting economic activity and whether the impact of the exchange rate channel is more pronounced. I'd say Europe has low growth, a weak outlook, and well below target inflation.

So, the ECB, in my view, has perfectly valid internal reasons to pursue accommodation, even if the exchange rate is affected. I'd say the same about Japan. And, the use of accommodated monetary policy is consistent with G7 language about pursuing domestic objectives with domestic instruments.

So, meanwhile, the U.S. is outperforming Europe and Japan and many emerging markets. Our financial markets are more dynamic and attractive. Our rates are higher because of the stronger performance. And, then, President Trump's trade wars and tariffs are a factor hurting Europe, and they create a risk-off environment in financial markets, which lends further support to dollar appreciation.

So, no, we're not in a currency war. I don't see countries purposely depreciating their currencies to gain competitive advantage in growth. Now, you asked the corollary question -- Is the dollar strong? So, it's not off-the-charts strong as it was in the mid-'80s at the time of the Plaza deal. It's not even as strong as it was in the early 2000s, but it is robust.

Now, we certainly don't want to tamper with the U.S. economy's relative outperformance to the extent that's the cause of dollar strength. We'd like to see other countries strengthen their performance. I do think, though, that if the President would end his trade wars, this would improve the global economic outlook, create a more favorable market environment for appreciation of foreign currencies, and some would also say that lower U.S. fiscal deficits would reduce the need for the United

States to import capital from abroad.

DOLLAR: Thank you, Mark. So, there's a lot there. I really like that subtle point that when the U.S. imposes protection, a lot of it's against China, but also we've done things against European partners, other countries. It's natural for the dollar to appreciate, partly because it's harder for countries to earn dollars, so that tends to drive up the price of the dollar, which is the exchange rate. And, of course, there's retaliation. And, then, you've got the safe-haven issue, that people don't know what the heck's going on, so move money into the U.S. So, that all kind of backfired on the administration.

SOBEL: Absolutely. I think that's spot-on analysis. I see the dollar because of the relative outperformance of the U.S. economy maintaining its firmness, you know, whether it's a few points higher or lower on a trade way to basis. I don't know. But, I think the dollar is going to remain firm regardless.

DOLLAR: So, in thinking about currency values, your first instinct was to go to the euro and the yen, and I sympathize with that. But, there's also a lot of attention about China, of course. And, as this U.S.-China trade negotiation drags on, right now it looks rather promising. We can come to that in a moment. But, a couple of months ago it was not going very well, and the U.S. Treasury designated China a currency manipulator. It was a moment when the Chinese currency had crossed this psychological level of 7 Chinese yuan to the U.S. dollar. So, is China a manipulator? What did you think of that designation?

SOBEL: Well, let's step back a second for your listeners. If you hear the word manipulation, which is the word people use, plain English would tell you that anything you've touched involves manipulation, right. But, that would rule out currency boards, adjustable pegs. It would even rule out intervention and only allow for pure free floating. Now, that's not the right way to think about exchange rate issues.

The international standard that's used by the IMF as well as the Treasury and its Foreign Exchange Report involves manipulation for the purposes of gaining unfair competitive advantage in international trade or preventing effective balance-of-payments adjustment. So, manipulation, in my view, could be said to be occurring if a country is intervening in foreign exchange markets buying dollars to hold this currency down to run a large current account surplus.

Now, one can certainly debate whether China manipulated its currency in 2005, 2009, et cetera. But, now in 2019, frankly for the last few years, the case has been weak. And, it's weak, according to the Treasury's own criteria on standards for assessing manipulation and harmful currency practices. So, the Chinese current account surplus is small. Last year, it was roughly half a percent of GDP, much lower than the Treasury's own former 3 percent current account surplus threshold or the 2 percent threshold it recently adopted.

Looking at Chinese reserve data, China hasn't been intervening much at all in recent years. And, to the extent it has, it has sold dollars to slow the RMB's decline. And, the Chinese have actually acted to cushion selling pressures on the RMB. They've maintained tight capital outflows [and] controls to do so. They have jawboned the markets, et cetera.

And, I think it's also worth noting that the IMF found the RMB's value broadly in line with underlying fundamentals, even if the underlying fundamentals are distorted. So, yes, China has a large bilateral surplus with the U.S., but economists tend not to ascribe much significance to those. So, the bottom line, China is not manipulating the RMB.

Now, can I say a word about the mini-deal that we're now talking about in the press, or Phase One as it is? Because, we're told it's going to have a currency piece. Now, of course, none of us have seen what's there. But, based on the press reports and what we've seen now that the administration and some of the past trade deals, I think we can offer a few thoughts on the matter.

First, I'd assume there might be some provisions for greater currency intervention transparency for China. I think that's good, particularly if it encompasses some of the activities of state on entities. But, as I said, based on reserve data, China isn't intervening. I assume there would be some re-affirmation of G20 language, refraining from competitive devaluation, not manipulating or targeting exchange rates, pursuing greater market orientation, et cetera, et cetera. Good stuff. It's a rehash, though. I assume there would be some reference to stability, and I assume the administration might spin that into saying that China has agreed to keep the yuan steady.

Now, you and I probably have read Chinese Central Bank's speeches over the year, particularly as they relate to currency issues, and you know, and I do, that the Chinese have long declared their wish to maintain currency stability against an effective basket. Not against the dollar per se, but stability is something that they have always talked about. So, there isn't going to be much there.

I could imagine something about consultation processes. You and I know from our careers that we talk to the Chinese behind the scenes all the time. There's very good dialogue, whether we agree or not. So, I don't really see any currency deal changing the basic dynamics of RMB trading.

In my view, China is a modest current account surplus and capital outflow to match it. Capital controls are staunching a much greater outflow of capital from China, which could put downward pressure on the RMB, perhaps offset, to some degree, by increased inflow as the RMB is including global stock and bond indices.

DOLLAR: Right. So, you reference some of the commitments that China and others have made through the G20 where for years there's been pretty standard language about not manipulating currencies for export advantage and more transparency, et cetera. So, I know you negotiate a lot. I know you spend a lot of nights negotiating those things. So, it's helpful to get a sense that what we're talking about for this part of the mini-deal is probably mostly the same language we've seen before, perhaps a little bit of real advance on transparency, which would be great. But, there's not really going to be much change in Chinese currency practice.

SOBEL: So, again, we don't really know what's in the deal, but I think that it might be reasonable to conclude that these will be the elements of it. Perhaps there are some surprises there. But, I think this is what it's going to be, and, again, I don't think that that's going to change the fundamental dynamics of trading in the RNB market. Absolutely.

DOLLAR: So, let's broaden it out a little bit and talk about this mini-deal. As you say, we don't know the details yet. Probably, it'll involve China making some agricultural purchases. It would take them a while just to get back to where they were. Their peak year was about $30 billion in purchases from the United States and agriculture. So, it'll probably take a little while to get back to that.

It might involve what we were just discussing on currency, which, it's hard to see there's a big breakthrough there. Perhaps some language on improving intellectual property rights protection. But, China has its own political system, and they're not going to be preparing a new law in the next 2 or 3 weeks. They're not going to be making fundamental structural changes.

So, were you surprised when President Trump said this first phase would be about 60 percent of what we were looking for from China?

SOBEL: Yes, but, you and I both know that when you talk about a percentage figure, you have to look at the numerator and the denominator. So, let's delve into that a bit, as you already have begun to do. So, basically, as you have said, it appears that what we have is a basic trade for increased agricultural purchases, which China needed to do anyway, in return for suspending tariff hikes. And, maybe there'll be some rollbacks. I don't know. And, maybe there'll be a little currency piece, as you said, and maybe a little something on IPR.

You and I know that USTR Lighthizer has put forward a broad structural agenda, and it involves IPR, yes, but it involves things like forced technology transfer and the Chinese state heavy subsidization of industry and industrial policies. And, I want to be very clear on this. I think the Lighthizer agenda is valid and justified. And, as you and I know from our experience is, the heavy role of the state has been a recurring feature of the U.S. discussions with the Chinese, whether you call it Indigenous Innovation or Made in China 2025. This is not new.

And, on top of that, you have Huawei in the background and discussions of technological cold wars, et cetera. So, I think that these structural issues go quite to the heart of the U.S.-China economic competition in the future of the relationship. I don't think these issues can be meaningfully addressed in the short run, and they're certainly not going to change overnight, as you say. So, if it's 60 percent, it's 60 percent with a very small numerator and a very small denominator.

DOLLAR: Right. So, I think that makes sense. The Chinese seem not to be willing to really tackle some of these deeper issues, like state enterprises and industrial policy. So, that leaves a question there which I think we can't answer is: Do we actually get to this second phase anytime soon? Probably, the U.S. would have to accept a pretty significant compromise from that full structural agenda in order to get to there.

SOBEL: I agree with that. I mean, I think that the Chinese have an interest in tackling some of these issues, but, at their own pace, in their own way, and it's going to take a long time. This is a whole economic system and growth model that they need to address. I think the leadership gets it, but how you get there is another question.

I also am very much in agreement with you on your assessment of, shall we call it, Phase Two. At least for the next year I think that China's not going to tackle these structural issues. I think that you and I know the Chinese well enough to know that if you put a gun to their head and say you're going to negotiate with us, they're going to say, no, we're a proud country and we don't do business that way. And, they're certainly not going to do business when they fear a tweet could come out saying you lost, or the goalposts could get moved.

I think Trump also will want to go to the electorate next year and say: I was tough on China. I identified this as the issue. Past presidents were nowhere near as strong. My opponent is nowhere near as strong. But, to be able to do that, if he makes a compromise, then the Democrats may attack him from the left. And, you and I both know that Senator Schumer, for example, is very tough on China. So, I really don't see the rationale for making big compromises or agreeing to a Phase Two from the administration, unless the stock market were utterly falling, which, so far, it's been holding up quite nicely.

DOLLAR: Right. The stock market seems happy with the prospect for Phase One, which looks pretty good. Mark, since I've got you here, I'd like to ask you about a couple of topics that you've written about recently. So, coming back to the currency issue, our Commerce Department has its own solution to this issue, which is to treat currency as essentially -- potentially a subsidy. So, if you've got a manipulated currency, you could think of it as an export subsidy that would typically be illegal under WTO or certainly under U.S. law, and you might have some kind of countervailing duty to deal with that subsidy. So, do you have a reaction to this approach?

SOBEL: Oh, I absolutely do have a reaction to this approach, and I'm quite opposed to it. The Commerce proposal is an undervalued currency should be countervailable. Presumably, that would include manipulation, but it's an easier standard. It's undervalued. So, there's no doubt that the Trump administration has been taking a very aggressive stance towards currency issues -- in my view, a harmful one, and I think it's often based on misplaced analysis and it's not going to do any good for the dollar's role in the international monetary system.

And, to me, the Commerce proposal's an excellent example of this. And, this is an idea that the Bush administration squarely rejected. So, as I said, the Commerce proposal is to treat currency undervaluation as a countervailable subsidy.

So, first of all, there's no precise way to measure equilibrium exchange rates and misalignments. The IMF in its economic balance model has the best approach for doing so, but it's based on a range of assumptions. And, in fact, they use three models. It's main model, the current account model, yields valuable information about misalignments, but it's not precise and it's not scientific. Second, these models look at currency undervaluation or overvaluation on a multilateral or trade way to basis.

So, let's stipulate, for the sake of argument, that a model could accurately pinpoint that currency X is undervalued by 10 percent. We'll just stipulate it. I don't believe you can, but we'll stipulate that. Even that doesn't tell you why that number is 10 percent. So, for example, did country X's exchange rate policies alone cause the 10 percent undervaluation, or is it country X's monetary and fiscal policies?

Then, what if the dollar is overvalued by 10 percent, because of better U.S. performance, a bad policy mix, or we have higher interest rates and better financial markets which attract flows, and country X's currency undervaluation is just the flipside or the mirror image of that? How do you apportion or ascribe the blame and the sanction for country X in those circumstances?

And, then, the Commerce Department really shouldn't be interested in the multilateral rate undervaluation but the bilateral undervaluation relative to the United States. But, how do you compute that? How do you disentangle that from a multilateral exchange rate calculation? And, let's take the RMB relative to the dollar. The amount of undervaluation you ascribe to the RMB would differ if you think the optimal bilateral balance between the U.S. and China is $400 billion, which is kind of where it is now, or zero. So, I think it's very difficult to drive calculations.

And, finally, I'd say that exchange rates reflect not just trade flows but flows throughout the entirety of the balance of payments -- and that includes the capital count. And, as we both know, the capital count flows can swamp the trade flows, and they're going to be heavily responsive to monetary policy, fiscal policy in particular, plus other developments. In my view, such policies are in the domain of treasuries and central banks. Trade authorities have no business getting into fiscal policy and monetary policy, in my view.

DOLLAR: Okay. So, that was very clear, and I tend to agree with you. You mentioned the IMF, Mark. So, I know for a long time you played a key role in U.S. policy toward the IMF. So, a couple of questions about the IMF. So, first, sticking with currency misalignment and the larger issue of imbalances, could the IMF be doing more in policing this, or are they doing an excellent job?

SOBEL: Much of my career has been consumed with this issue. So, allow me to step back in memory lane and say that you're raising one of the more searing and agonizing chapters of my career. So, when China was running a 10 percent of GDP current account surplus and adding hugely to reserves in the 2005 period and thereafter, there were obviously and understandably complaints about currency manipulation. And there was a case to be made.

The U.S. at the time pursued very vigorous bilateral diplomacy with the Chinese behind the scenes. Secretary Snow did, Secretary Paulson did. Secretary Paulson established a strategic economic dialogue. He was on the phone with the Chinese every day.

But, we also pursued a multilateral track through the IMF, and we felt that the IMF should, at a minimum, call out China and perhaps launch special or ad hoc consultations. These were things that were well within the Fund's toolkit. Now, we did that, that is, the pursuit of a multilateral track, because we honestly believed that the Fund was created to prevent a repetition of the beggar-thy-neighbor policies of the 1930s and to avoid the bilateralization of exchange rates disputes.

Now, the Fund's view at the time, in many respects, was it takes two to tango in creating global imbalances, and why should the IMF do America's dirty work? Admittedly, the U.S. fiscal policy at the time wasn't ideal. So, yes, we were contributing to global imbalances from DS minus I perspective. But, I would say our fiscal policy at the time was hardly analogous to harmful Chinese currency practices.

And, as reflected in then Under Secretary Tim Adams' comment, the fund was asleep at the wheel on these issues. We just felt the fund should do its job. So, it wasn't about dirty work. We felt the fund literally should be doing its job. Perhaps, in hindsight, we were naïve to think that the Fund would get between the two elephants for fear of being the grass that got stomped on. But, I think what the incident or the episode showed me is that the Fund won't be a policeman, maybe not even a ruthless truth-teller. However, I think what the Fund has shown is a willingness to step up its technical analysis on external policies in exchange rates.

I saw the beginnings of this in 2008. The crisis then hit, and then in 2012 after quite a bit of back-and-forth, the fund started producing its annual external sector report, which looks at whether a country's external policies and positions are broadly consistent with underlying fundamentals as well as currency valuations.

I think it's a useful report. But, even that, which is very dry and technical and written kind of in an esoteric manner, even that has given rise to huge squabbles in the IMF board that I've seen. So, again, the fund is not going to play the role of a policeman, even if it is one of the basic reasons it was created. It will provide sharp analysis.

DOLLAR: So, that was really interesting. When I put together the different comments you've made about different questions, ten-plus years ago you really had serious imbalance from the Chinese side and undervalued currency. Now, that's largely gone.

SOBEL: Mm-hmm.

DOLLAR: So, I take your point it wasn't easy getting here, but we actually have managed to get to a pretty good place in terms of Chinese currency in China's overall current account surplus.

SOBEL: I agree with that. You've seen demographic changes in China. You've seen internal wages rise. You've seen the exchange rate appreciate. You've seen the entire Chinese cost structure go up, current accounts come down. And, I'm sure a good economist such as yourself would tell me that that's the natural progression of things, but it took time and it was quite turbulent, the relationship. I would say we've gotten to a much better place. China still has huge challenges in its growth model to adjust to, but on this external front, maybe something positive has been achieved.

DOLLAR: So, last question, Mark. Sticking with the IMF, where do we stand in terms of IMF resources? Do they have enough to deal with the next big global crisis, and how come we're not increasing IMF quotas?

SOBEL: So, let me unfortunately get a little technical. The IMF has three buckets of resources -- quotas, which determine voting power based upon relative global weight. When these run low, the fund can turn to its emergency backstop, multilateral line of resources, something called the New Arrangements to Borrow. And, if those run low, then the fund can turn to bilateral borrowing lines that it has.

So, in passing IMF legislation a few years ago, Congress said the U.S. had to leave the New Arrangements to Borrow, which now total about 250 billion, and we're, I think, around 16 or 17 percent of that. We would have to leave in 2022 unless Congress decided otherwise in the meantime. Meanwhile, $440 billion of the bilateral line, the third line, shall we say, is technically slated to expire late next year.

So, if all of that disappeared, the NAB, New Arrangements to Borrow, and the bilateral loans, you could imagine the fund would lose a ton of resources. It would still have quota lines. I think currently available resources for lending, something they call the Forward Commitment Capacity, is probably around $250 billion. That might sound like a lot, but when you have a big crisis, let alone and given the growth of capital markets, you want to make sure you have enough resources in hand to deal with a bad situation. That's not enough. So, the fund would be very low on resources in that scenario.

Now, quotas, as I said, are the first line of IMF resources. China is currently about 6 percent of the IMF voting power. And, you may know it better than I do. I think on kind of a market exchange rate basis, perhaps they're 15 percent of the global economy, PPP, it gets you up to 20 percent. But China is much bigger than 6 percent of the global economy. So, China clearly deserves more voting power.

Now, this administration has agreed that overall IMF resources should be kept constant, and I welcome that, but it opposes a quota increase. Now, quota increases are extremely difficult to negotiate. If one country gains voting power, somebody else has to lose voting power, and they don't like it. And, then, the U.S. has to deal with Congress, which is always tough.

But, one of the main reasons the administration doesn't want to support a quota increase at this time is it just doesn't want to give China an increase in its voting power in the IMF. I think that's a mistake. Based on weight, China deserves more voting power.

It may be easier for a U.S. representative in the Fund, as I was, to deal with the Europeans, but I think, to keep the fund modern and relevant, we have to deal with the world as it is. And, I think increasing the weight of a country that obviously deserves a boost would be helpful for keeping that country from further drifting away from multilateralism. From being more prone to go the BRI route, for example, or the AIB route.

Plus, the Chinese Central Bank represents China in the IMF. The Chinese Central Bank works really well with the IMF. You and I know the Chinese Central Bank is a bastion of reformers who really want to push China forward in a more reformist direction. And, I think it would be helpful to them and their role in the Chinese economy to give China a boost.

But, again, I welcome that the administration at least wants to keep the overall IMF resource levels constant by doubling the NAB and retaining some bilateral resources. If they go down that route, I hope that America will come back to quotas and their distribution shortly.

DOLLAR: I'm David Dollar, and I've been talking to Mark Sobel about currencies and international monetary issues and getting a lot of in-the-weeds insight into how the international monetary system actually works. So, thank you very much, Mark.

SOBEL: My delight and pleasure to be with you.

DOLLAR: Thank you all for listening. We'll be releasing new episodes of Dollar & Sense every other week. So, if you haven't already, make sure to subscribe on Apple Podcasts or wherever else you get your podcasts, and stay tuned.

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