US policy update
On currency manipulation

April 7, 2017

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- China does not meet current Treasury criteria to be named a "currency manipulator"
- Treasury could attempt to rejigger the criteria to capture China or other countries, though current penalties would have little impact on China
- The Administration may instead focus on the broader trading relationship with China and "kick the can down the road" on currency issues by launching a Commerce Dept. process to declare currency manipulation an unfair trade subsidy

During his election campaign, President Trump pledged to declare China a currency manipulator on his first day in office. This has not happened yet, and China does not meet current Treasury Department criteria for currency manipulation. The next version of Treasury's report to Congress on currency manipulation is expected mid-April. President Trump may try to follow through on his campaign promise by naming China a currency manipulator, however under the current legislation, this may be difficult.

THE CURRENT POLICY FRAMEWORK

The procedures to designate countries as currency manipulators were first established in the Omnibus Foreign Trade and Competitiveness Act of 1988, which directs the Secretary of the Treasury to "consider whether countries manipulate the rate of exchange between their currency and the United States dollar for purposes of preventing effective balance of payments adjustments or gaining unfair competitive advantage in international trade." In 2015, Congress supplemented the 1988 Act by providing detailed criteria in the Trade Act of 2015 (specifically the Bennet-Hatch-Carper Amendment). This Act "establishes a process to monitor key indicators related to foreign exchange operations, engage economies that may be pursuing unfair practices, and impose meaningful penalties on economies that fail to adopt appropriate policies."

The 2015 Act requires Treasury to undertake "an enhanced analysis of exchange rates and externally-oriented policies for each major US trading partner." The Act defines three criteria: (1) a significant bilateral trade surplus with the US, (2) a material current account surplus, and (3) persistent one-sided intervention in the forex market. The statute leaves it to Treasury's discretion to determine the thresholds for each metric (Table 1). If all three criteria are met by a country, a procedure is initiated that could ultimately result in that country being labelled as a currency manipulator.

Table 1: Criteria and thresholds

Criteria	Current Treasury threshold	Act of 2015 criteria definition
1	Bilateral trade surplus with the US >USD 20 Bn	"A significant bilateral trade surplus with the United States"
2	Current account surplus > 3% of that economy's GDP	"A material current account surplus"
3	Country has conducted *repeated* net purchases of foreign currency that amount >2% of its GDP over the year	"Engaged in persistent one-sided intervention in the foreign exchange market"

Source: US Treasury, IIF

Table 2: Monitoring on currency manipulation

end-2016	Bilateral Trade (USD BN)[1]	Current Account (% GDP)[2]	Δ net FX reserves (% GDP)[3]
CN	-27.76	1.84	-2.81
JP	-6.53	3.72	-0.45
DE	-5.31	8.63	0.01
RU	-0.9	3.04	-0.11
IT	-2.55	2.17	-0.02
CA	-2.15	-3.70	0.25
KR	-1.20	7.24	0.23
MX	-4.39	-2.73	0.04
CH	-1.02	9.24	11.22
TW	-0.73	15.01	1.57
IE	-3.24	9.46	0.22
VN	2.62	0.38	-13.91

1Red: >$20BN. Yellow: <$20BN, >$2BN. Green: <$2, month avg.
2Red: >2.9%. Yellow: <2.9%, >1.5%. Green:<1.5%; IMF, IIF estimates
3Δ=2016-2015 Red: >2%. Yellow: <2%, >1%. Green: <1%
**Countries in bold are included in Treasury's monitoring list*
Source: Bloomberg, IMF, Dept. of Treasury, IIF.

In its last report, published October 2016, Treasury found that no economy met all three criteria; however, six major trading partners were included in a so called "monitoring list" – China, Japan, Germany, Korea, Switzerland, and Taiwan.

CHINA MEETS ONLY ONE OF THE THREE CRITERIA

China has been the focus of this debate due to its large trade surplus against the US (USD31 bn in 2016). In fact, China's bilateral trade surplus against the US has been greater than Treasury's USD20 bn benchmark every year throughout the past decade (Chart 1).

However, China does not meet Treasury's two other thresholds. China's current account as a percentage of its GDP (the second criteria) was 3% in 2015 but only 2.4% in 2016 (Chart 2). Moreover, China does not meet Treasury's third benchmark: repeated net purchases of foreign currency that amount to >2% of its GDP. Indeed, since summer 2015, the PBOC has used reserves to control RMB depreciation as capital outflows picked up. Consequently, Chinese FX reserves have fallen for the last two years (see our latest Capital Flows Tracker). The last time that China's net FX reserves were above Treasury's 3% threshold was in 2013 (Chart 3). China's current interventions fall outside of both the Treasury benchmark and the underlying statutory standard. which asks whether a state's intervention is "for purposes of ...gaining unfair competitive advantage in international trade."

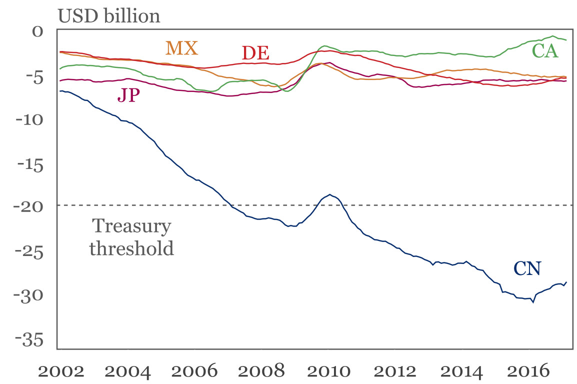
MOVING THE YARDSTICKS

Treasury could attempt to creatively interpret the underlying statutes to adopt new benchmarks. For example, Treasury could look at a country's intervention over a longer period, rather just the past year (though it is unclear whether currency practices that have been abandoned are "persistent.") In the decade before 2015, China accumulated reserves. Though only 1.8% of GDP in 2016, China's current account surplus would be 4.6% of GDP if averaged over the past decade.

Though it might not impact China, Treasury could lower other benchmarks to allow it to designate Japan or Germany, for example. If the required size of trade surplus is lowered from currently USD20 billion a year to say $4 billion, Japan and Germany would qualify.

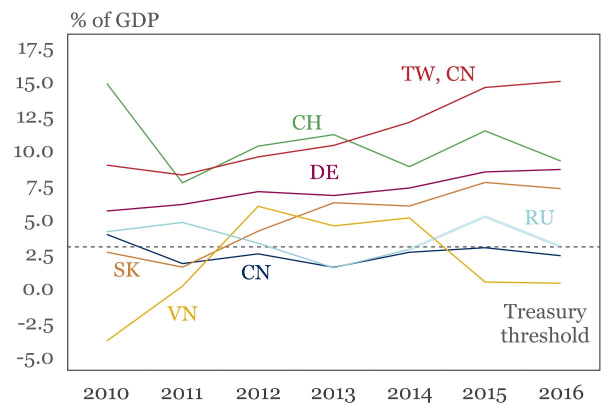
Some members of the Trump administration also contemplate expanding the definition of 'currency manipulation' to include monetary policies that can weaken its currency. BoJ's QQE (quantitative and qualitative monetary easing) would fit the bill. Even discussion of this may have had an

Chart 1: Bilateral trade balance with selected partners



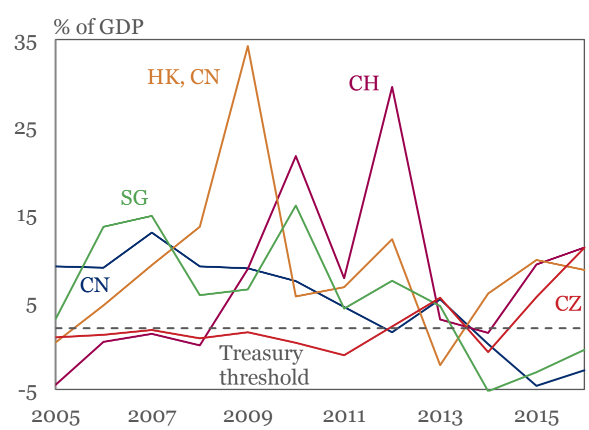
Source: US Census Bureau, IIF

Chart 2: Current account balance



Source: IMF, IIF

Chart 3: Yearly net change in foreign exchange reserves



Source: IMF, IIF

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impact. Japanese Prime Minister Abe announced on his recent Washington visit new bilateral trade talks with the US that could be expanded to monetary topics (see our take on PM Abe's visit).

Even so, any manipulation of the thresholds can be tricky, both technically and politically. First, the Trump administration needs to decide whether to just single out China or cast a wider net to catch other economies on the "monitoring list." Economies such as Switzerland, Taiwan and Korea all have large current account surpluses and rising FX reserves. Japan and Germany (Chart 4) have also been singled out by Trump's economic team as "playing the devaluation market" and utilizing "grossly undervalued" currencies, despite not meeting current Treasury thresholds. However, strong rebuttals by those economies can be expected. German Chancellor Merkel stated, "We have, at the moment, in the euro zone of course a problem with the value of the euro... if we still had the (German) Mark it would surely have a different value than the euro does at the moment."

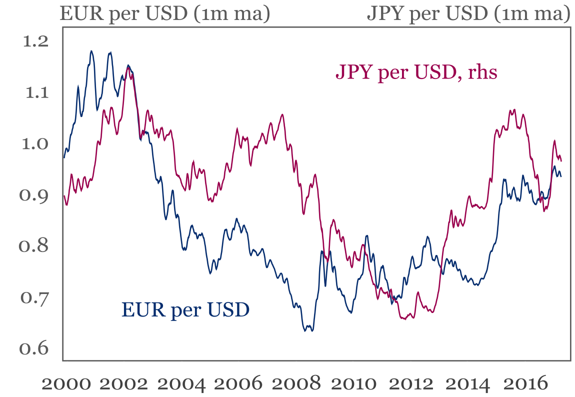
CONSEQUENCE OF THE 'MANIPULATOR' LABEL

The process leading to "manipulator" labeling has two stages. First, if an economy meets all the three criteria established by Treasury, then the President through the Secretary of the Treasury is required to commence "enhanced bilateral engagement with that country." Second, after one year of this "bilateral engagement", the Secretary of the Treasury is required to evaluate if this engagement was successful. If unsuccessful, then the country is labelled as a currency manipulator.

Once named as a "currency manipulator", the legislation mandates to initiate sanctions against that country (Table 3). However, none of the potential sanctions listed in the statute would have teeth against China, which does not need OPIC financing and has little US government procurement. Treasury would need to expand its list to include something like punitive tariffs.

The US has declared China a currency manipulator before (in 1992), after sticking the same label to Korea and Taiwan (China) in 1988 (Table 4). Treasury stated that these economies made a "substantial reform to their foreign exchange regimes" when they were removed from the currency manipulation list. However, the efficiency and effectiveness of the manipulation list seem to be questionable. The bilateral trade deficit with Japan, China, and Taiwan (China) has increased in the last 20 years—globalization has perhaps been a more powerful force (Chart 5).

Chart 4: Spot exchange rate EUR and JPY



Source: Bloomberg, IIF

Table 3: Actions to be taken against manipulators

1	Denying access to OPIC financing
2	Excluding the country from US government procurement
3	Calling for heightened IMF surveillance
4	Instructing the US Trade Representative to take into account such failure to adopt appropriate policies in assessing whether to enter into a trade agreement or initiate or participate in trade agreement negotiations
*	The President may waive the remedial action requirements

Source: US Treasury, IIF

Table 4: Economies declared manipulators in the past

Country or region	Year declared	Time in manipulation list
KR	1988	Two six-month reporting periods
TW, CN	1988	Two six-month reporting periods
CN	1992	Five six-month reporting periods
TW, CN	1992	Two six-month reporting periods

**Currency manipulation declarations above were done under the 1988 Omnibus Trade Act*
Source: US Treasury, IIF

ALTERNATIVE APPROACHES

The new administration may explore alternative avenues outside the Act of 2015 to fulfill Trump's campaign pledge and narrow US's trade deficit.

One alternative is to have the US Department of Commerce, instead of Treasury, designate the practice of currency manipulation as an unfair subsidy allowing it to put in place countervailing measures, based on the amount by which China's currency was undervalued. This would require the reversal of an August 2010 decision, in which the Department of Commerce rejected the currency as a subsidy argument.

There are several challenges to this approach. First, a case could be brought to the WTO on both the definition of an unfair subsidy and the amount to which China's currency is undervalued. WTO would defer to the IMF on the valuation decision, and IMF staff has traditionally been reluctant to take a definitive view on currency disputes. Second, US companies would be required to bring anti-subsidy cases to the US Department of Commerce against trade partners and consequently the Department of Commerce would enact policies against a currency manipulator. However, US companies can be reluctant to bring trade cases for fear of retaliation.

Another policy option—a long shot—is to weaken the dollar through another Plaza Accord. However, the likelihood for BOJ, ECB and PBC to come onboard for another Plaza Accord is very low.

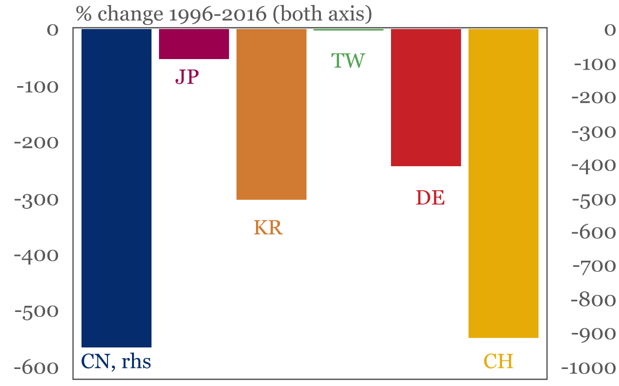
The third possibility is for US to initiate counter-interventions. As RMB is now a SDR currency and China's bond market is technically completely open to foreign sovereign investors, there is now no technical barrier for the US to purchase RMB and intervene in the USDCNY market. Of course, the political and market risks of such action can be extremely high.

The fourth alternative, in the case with China, is to attempt to secure concessions from the Chinese through bilateral discussions. The Chinese will be very reluctant to publicly negotiate away any flexibility with regards to currency policies; they would be much more likely to offer other kinds of concessions such as greater investment in the US, an apparent outcome of President Xi's meeting with President Trump.

A TWO-WAY HIGHWAY

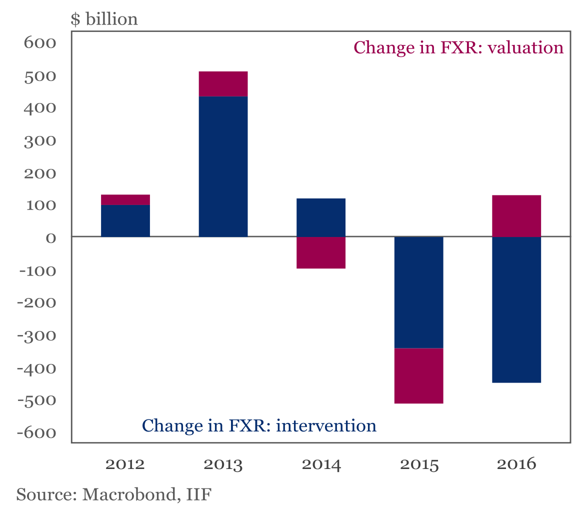
Using FX policies and hence also monetary policy as trade tools should be done with care because it could also carry limitations to US monetary policy going forward. In 2011, Brazil called for a debate on exchange rates and trade within

Chart 5: US Bilateral trade balance 1996-2016



Source: US Census Bureau, IIF

Chart 6: FXR valuation and intervention in China



Source: IMF CDIS, IIF

Table 5: Selected US-CN WTO pending disputes

Dispute case	Against	Complainant
Subsidies to producers of Aluminum	CN	US
Tariff rate quotas for agricultural products	CN	US
Measures of price comparison methodologies	US	CN
Export duties on raw materials	CN	US
Measures affecting imports of vehicles	US	CN
Value added tax measures	US	CN
Blocking China's request to be treated as a "market economy	US	CN

Source: WTO, IIF

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the World Trade Organization after the US announced its second QE program. Brazil circulated a proposal which requested the WTO to act directly when dealing with currency-related trade distortions. The proposal was ultimately rejected, but the precedent was established. It is possible that a greater number of countries could follow this route to counteract any effort by the Washington to label them as manipulators.

CONCLUSION

At the end of the day, the Administration may opt for a "kick the can down the road" type of approach, which claims victory on any broader trade concessions from the Chinese. This would then launch a process at Commerce to allow currency manipulation to be deemed as an unfair subsidy.

The declaration of China as a currency manipulator seems to be only one piece on the greater trade plan of the Trump Administration. They have also focused their attention on policies dealing with Germany, Japan, Mexico and other countries. The latest executive order regarding the Omnibus Report on significant Trade Deficits signed by president Trump late March is clear proof of this. However, Trump's focus on China during his Presidential campaign suggests the "China issue" is likely to be a top priority.

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ANNEX: TIME SERIES, CURRENCY MANIPULATION MONITORING (SELECTED COUNTRIES)

Table A: Bilateral trade balance (USD bn)[1]

	2012	2013	2014	2015	2016	avg14-16	avg13-16	avg12-16
CN	-24.55	-24.51	-28.24	-27.87	-27.76	-27.96	-27.10	-26.59
JP	-5.80	-5.89	-5.70	-6.56	-6.53	-6.26	-6.17	-6.09
DE	-5.60	-5.80	-6.39	-6.72	-5.31	-6.14	-6.05	-5.96
IN	-0.54	-1.46	-1.52	-1.47	-1.35	-1.45	-1.45	-1.27
IT	-1.65	-2.00	-2.18	-2.23	-2.55	-2.32	-2.24	-2.12
CA	-3.59	-3.29	-4.07	-1.89	-2.15	-2.70	-2.85	-3.00
KR	-1.15	-0.97	-2.08	-1.99	-1.20	-1.76	-1.56	-1.48
MX	-3.91	-4.03	-5.25	-4.64	-4.39	-4.76	-4.58	-4.44
CH	-0.27	-0.78	-0.89	-1.25	-1.02	-1.05	-0.98	-0.84
TW, CN	-0.95	-0.68	-0.87	-1.26	-0.73	-0.95	-0.88	-0.90
IE	-1.36	-1.71	-3.07	-2.94	-3.24	-3.08	-2.74	-2.47
VN	-1.33	-1.67	-2.02	-2.40	-2.62	-2.35	-2.18	-2.01
RU	-1.11	-0.49	-1.16	-0.43	-0.88	-0.82	-0.74	-0.81
CZ	-0.13	-0.19	-0.26	-0.24	-0.18	-0.22	-0.21	-0.20

Table B: Current account (% of GDP)[2]

	2012	2013	2014	2015	2016	avg14-16	avg13-16	avg12-16
CN	2.51	1.54	2.63	2.96	1.84	2.65	2.38	2.40
JP	1.00	0.94	0.79	3.29	3.72	2.60	2.19	1.95
DE	7.02	6.74	7.28	8.45	8.63	8.12	7.77	7.62
IN	-4.80	-1.73	-1.31	-1.07	-1.42	-1.27	-1.38	-2.07
IT	-0.36	0.95	1.92	2.20	2.17	2.10	1.81	1.37
CA	-3.60	-3.15	-2.28	-3.16	-3.70	-3.05	-3.07	-3.18
KR	4.16	6.22	5.98	7.68	7.24	6.97	6.78	6.25
MX	-1.43	-2.46	-2.02	-2.86	-2.73	-2.54	-2.52	-2.30
CH	10.31	11.14	8.83	11.42	9.24	9.83	10.16	10.19
TW, CN	9.53	10.37	12.04	14.56	15.01	13.87	12.99	12.30
IE	-2.62	2.14	1.66	10.23	9.46	7.12	5.87	4.17
VN	5.96	4.54	5.12	0.47	0.38	1.99	2.63	3.29
RU	3.29	1.50	2.83	5.20	3.04	3.69	3.14	3.17
CZ	-1.56	-0.53	0.17	0.91	1.54	0.87	0.52	0.11

Table C: Δ Net FX reserves (% of GDP)[3]

	2012	2013	2014	2015	2016	avg14-16	avg13-16	avg12-16
CN	1.52	5.29	0.21	-4.58	-2.81	-2.40	-0.47	-0.07
JP	-0.47	0.19	-0.06	-0.50	-0.45	-0.34	-0.20	-0.26
DE	0.00	0.02	-0.04	-0.02	0.01	-0.02	-0.01	-0.01
IN	-0.05	0.36	1.31	1.63	0.33	1.09	0.91	0.71
IT	0.03	0.03	-0.10	0.06	-0.02	-0.02	-0.01	0.00
CA	0.13	0.17	0.24	0.41	0.25	0.30	0.27	0.24
KR	1.53	1.44	1.27	0.36	0.23	0.62	0.82	0.96
MX	1.35	1.20	1.28	-1.47	0.04	-0.05	0.26	0.48
CH	29.58	3.01	1.48	9.29	11.22	7.33	6.25	10.92
TW, CN	3.56	2.67	0.41	1.35	1.57	1.11	1.50	1.91
IE	-0.01	0.00	0.08	0.19	0.22	0.16	0.12	0.09
VN	7.74	0.19	4.48	-3.09	-13.91	-4.17	-3.08	-0.92
RU	1.47	-0.75	-6.34	-1.38	-0.11	-2.61	-2.14	-1.42
CZ	2.20	5.48	-0.74	5.55	11.19	5.33	5.37	4.74

1Red: >$20BN. Yellow: <$20BN, >$2BN. Green: <$2, monthly avg
3Δ=2016-2015 Red: >2%. Yellow: <2%, >1%. Green: <1%

2Red: >2.9%. Yellow: <2.9%, >1.5%. Green: <1.5%; IMF estimates
**Countries in bold are included in Treasury's monitoring list*
Source: Bloomberg, IMF, Dept. of Treasury, IIF.

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