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The Difference Between Currency Manipulation and Monetary Policy

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International policymakers and analysts have recently traded accusations of "currency manipulation." China's premier, Wen Jiabao, suggested that current U.S. monetary policy—quantitative easing—is "a kind of trade protectionism."[1] Meanwhile, the U.S. Congress stands ready to brand China a currency manipulator, and Federal Reserve Chairman Ben Bernanke has diplomatically pointed out the dangers of currency undervaluation, which creates macroeconomic imbalances.[2] What is currency manipulation, who is doing it, and why? And how does it differ from traditional monetary policy?

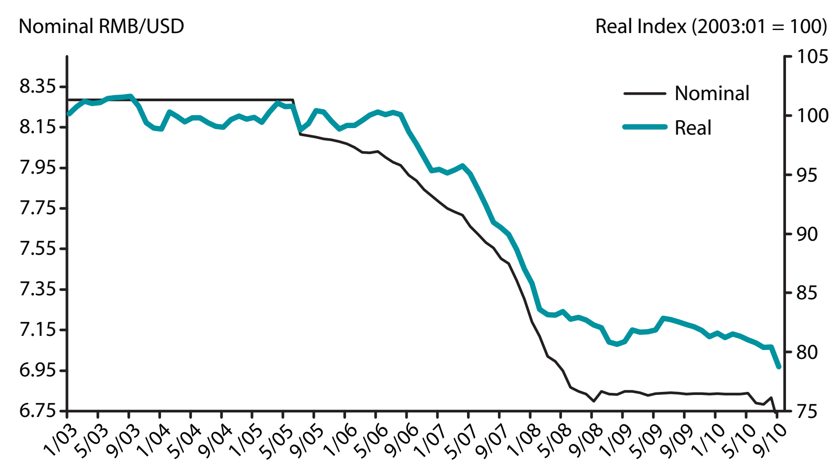
First, it is important to note that the real (i.e., inflation-adjusted) exchange rate matters for international trade, not the nominal exchange rate. Manipulation of real exchange rates can affect trade because an "undervalued" currency makes a country's tradable goods relatively cheaper on world markets and stimulates domestic production at the expense of its trading partners.

Currency manipulation is usually considered to be synonymous with prolonged sterilized foreign exchange intervention in one direction—usually to weaken the home currency—or the use of laws or regulations to keep a country's currency undervalued to gain a trade advantage.[3] The International Monetary Fund (IMF) Articles of Agreement prohibits these tactics but contains no enforcement mechanism.[4]

Many economic policies (e.g., monetary policy, such as the recent U.S. quantitative easing) affect interest rates, prices, and exchange rates but are not considered currency manipulation because such changes are made primarily for domestic purposes and have only modest and transitory effects on real exchange rates.

In contrast to such internally focused policies, many emerging economies have closely managed exchange rates to assist export-led growth strategies. The People's Bank of China (PBC, the central bank of China) has prevented rapid appreciation of the renminbi (RMB) by purchasing U.S. dollar (USD) assets (i.e., selling their own currency, the RMB) and prohibiting most international purchases of RMB assets (capital controls). In addition, the PBC uses reserve requirements to restrain domestic inflation that would produce real appreciation. China could argue that a stable RMB benefits China *and* the world

But because this [Chinese] exchange rate policy is externally focused and relies heavily on regulations, which restrain normal market forces, it is reasonable to say that the policy constitutes currency manipulation for purposes of gaining an advantage in trade.



NOTE: RMB-to-USD ratio (left scale) and the normalized real exchange rate index (the Chinese good basket-to-U.S. good basket ratio; right scale) from 2003 through September 2010.

economy. But because this exchange rate policy is externally focused and relies heavily on regulations, which restrain normal market forces, it is reasonable to say that the policy constitutes currency manipulation for purposes of gaining an advantage in trade. The chart shows that despite these measures, both nominal appreciation and rising Chinese inflation have recently combined to appreciate the real value of the RMB versus the USD by over 20 percent in real terms since mid-2006.

The Chinese are correct, however, when they argue that the huge U.S. trade deficit is chiefly due to Americans' savings/investment decisions, which are probably relatively insensitive to changes in the real RMB/USD exchange rate. Ultimately, an appreciated RMB would benefit Chinese consumers and U.S. producers but would probably only very modestly affect the overall level of the U.S. trade deficit. ■

[1] Batson, Andrew; Johnson, Ian and Browne, Andrew. "China Talks Tough to U.S." *Wall Street Journal*, March 15, 2010; http://online.wsj.com/article/SB10001424052748703457104575121213043099350.html; and Censky, Annalyn. "What Is Currency Manipulation, Anyhow?" CNNMoney.com, November 11, 2010; http://money.cnn.com/2010/11/10/news/economy/what_is_currency_manipulation/index.htm.

[2] Bernanke, Ben S. "Rebalancing the Global Recovery." Speech at the Sixth European Central Bank Central Banking Conference, Frankfurt, Germany, November 19, 2010; www.federalreserve.gov/newsevents/speech/bernanke20101119a.htm. See Jones, Clayton. "Bernanke Blasts China for Currency Manipulation." *Christian Science Monitor*, November 19, 2011; www.csmonitor.com/Commentary/Editorial-Board-Blog/2010/1119/Bernanke-blasts-China-for-currency-manipulation.

[3] Central banks can "sterilize" foreign exchange intervention by reversing its effects on the domestic monetary base.

[4] The IMF Articles of Agreement (Article VI, section 3), signed at the Bretton Woods conference in 1944, explicitly permitted capital controls; www.imf.org/external/pubs/ft/aa/index.htm.