COMMENT ON "CURRENCY BATTLE IS TETHERED TO OBAMA TRADE AGENDA"[1]

The US congressmen who seek redress for currency manipulation by other countries may find that prohibitions on currency intervention could boomerang on Washington, as noted in the article. This brief comment is intended to explain why.

A currency, such as the Chinese RMB, is said to be manipulated if the Chinese authorities take action that is intended to lower the value of the RMB over what it would be without such action. The action must be deliberate and it must succeed in achieving a currency value that would not otherwise apply. Does this sort of thing happen? Yes it does, but when it does attribution cannot be proved conclusively. Motive and the absence of other influences that lower the value of the currency are difficult to establish.

The procedure for the manipulation was explained graphically by Derek Thompson in the March 2011 edition of *The Atlantic*.[2] The basic elements of the process are as follows. Chinese manufacturers earn US dollars by exporting merchandise to the US. They may either choose to have these earnings deposited with, say, the Chase Manhattan Bank in New York for future investment in shares of stock or real estate in the US (or perhaps in other countries using US dollars), or they may want the US currency to be exchanged for RMB to be used in China. The later would require the People's Bank of China (China's central bank) to organise the exchange, leaving the bank with US currency. If the Bank of China monetised the exchange by selling the US dollars on the open market and depositing the proceeds in the Chinese banking system, it would obviously increase the liquidity of the system. Perhaps the authorities do not want that to occur. It could lead to price inflation in China or it could endanger the Chinese financial system if too much bank credit has already been extended. This represents a different type of motivation to intervene in the currency exchange market.

Can we determine whether Chase Manhattan or the Bank of China served as the agent of exchange? We could ask them, but especially with Chase Manhattan, the transaction may have occurred through an American custodian or nominee company and the name of the Chinese exporter who earned the US dollars could be regarded as confidential.[3] Then the

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[1] The article referred here was written by Jonathan Weisman and published by *The New York Times*, 15 February 2015. Available at: http://www.nytimes.com/2015/02/16/business/economy/obamas-trade-agenda-may-hinge-on-attacking-currency-manipulation.html.

[2] "Infographic: How China Manipulates Its Currency," 29 March 2011. Available at: http://www.theatlantic.com/business/archive/2011/03/infographic-how-china-manipulates-its-currency/73201/#disqus_thread.

[3] See the Annex for an illustration of the difficulty in determine beneficial ownership with custodian or nominees companies.

Bank of China might say: "It may have been us, but then again it may not have been us. No one can be sure."

What might the congressmen who have a long-held complaint about Chinese authorities do in this case? They could state that the economics they were taught at university, or acquired elsewhere, led them to believe that the rate of exchange between two national currencies should be self-correcting if the exchange market is free of government intervention. Therefore, if it does not begin to self-correct after an extended period of time, it must be because of government intervention.

This would be a valid point if all currency transaction were based upon international trade in goods and services, but that is not so. The United Nations Conference on Trade and Development reported that only 1 per cent of foreign exchange trading can be attributed to merchandise trade.[4] The remaining 99 per cent arises from financial transactions (referred to as the capital account). Multinational companies tend to reduce the risk of adverse changes in foreign exchange by hedging, and other companies with retained earnings might seek the safest, or the highest interest-bearing, bank accounts. All of these transactions add to a daily foreign exchange trading activity of about US$4 trillion *a day*. This is well above the expected outlays of households and it therefore tends to nullify any thoughts that global finances are the same as household finances. It also suggests that the role of treasurer for a nation-state is somewhat more complicated than that of treasurer of the local bowling club.

Where does the boomerang effect come in? An example may help to clarify it. In July of last year the governor of the Reserve Bank of Australia (RBA) tried to "talk down" the Australian dollar by saying it was overvalued and needed to fall further by "more than a few cents."[5] It subsequently did so. Could this be interpreted as currency manipulation? Probably not in and of itself, but it could be associated with other actions that bring the value of the Australia to the point at which the RBA thinks it *should be*, in much the same way that the Bank of China makes an assessment of what the RMB rate *should be*.

There is of course a major difference between the circumstances in China and Australia in regard to the central bankers' view of the respective exchange rates. As indicated in the chart of the next page, China current account balance (broadly the value of a nations' exports minus its imports[6]) and it is clear that China's current account was in surplus for the

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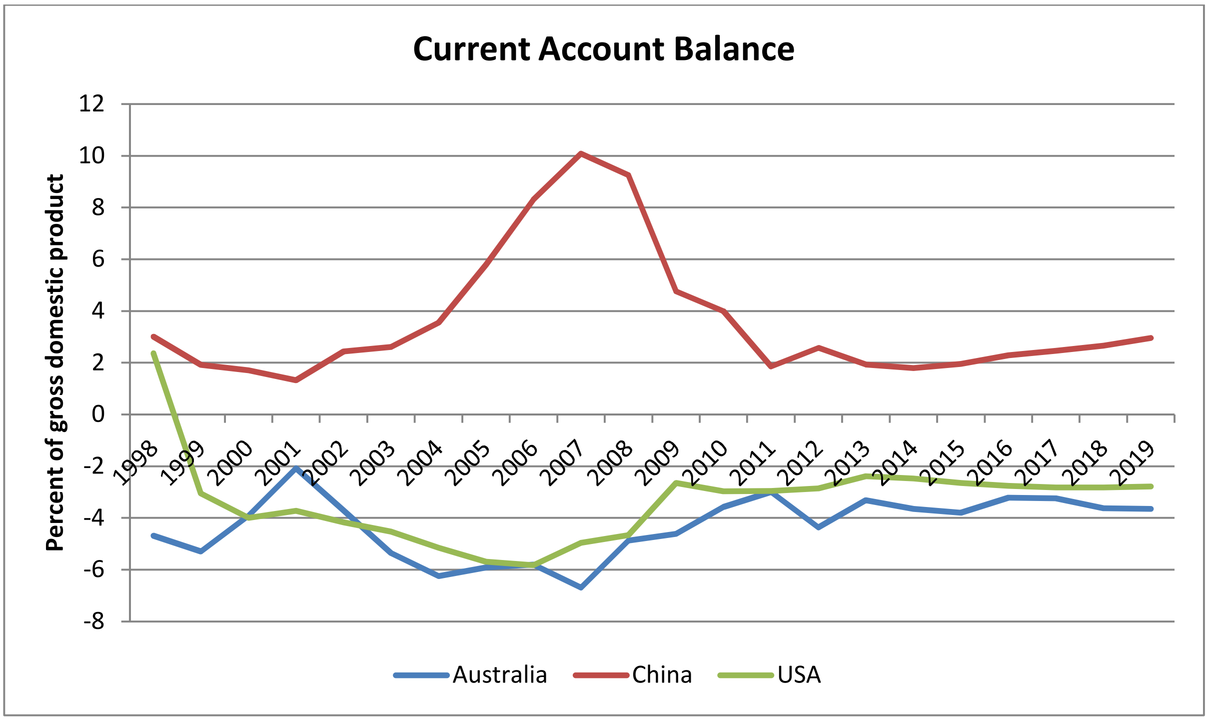
[4] See http://www.accci.com.au/CommentonYeats.pdf for additional information, including a chart from UNCTAD and a citation for the publication of the data.

[5] Jessica Sier, "RBA Governor Glenn Stevens Talks Down 'Overvalued' Australian Dollar," *The Sydney Morning Herald*, 3 July 2014. Available at: http://www.smh.com.au/business/markets/currencies/rba-governor-glenn-stevens-talks-down-overvalued-australian-dollar-20140703-zsv4x.html.

[6] The current account also includes earnings on foreign investments minus payments made to foreign investors and net cash transfers that have taken place within the specified time period.

period shown, while for Australia the account was in deficit for the entire period. China's surplus means that at least one other country must have experienced a deficit and, typically, people like the congressmen mentioned above, view this as unfair if it becomes locked into the trading system. Thus, any suggestion that China's currency exchange rate is being manipulated will carry much more concern with such people than a similar suggestion for Australia's exchange rate.



Source: International Monetary Fund, World Economic Outlook Databases, 7 October 2014. Available at: http://www.imf.org/external/ns/cs.aspx?id=28.

There is something more to the assessment of current account surpluses and deficits. A deficit can only occur if another nation is willing to loan a portion of their national savings to the deficit nation, and similarly, the deficit nation must be willing to accept the implicit conditions of the loan. The loan can be avoided by purchasing domestically produced merchandise, rather than importing it, but this decision will be greatly influenced by the relative prices. For many of the major traded items, China has been the lowest cost supplier, but we, as consumers, should nevertheless factor in the cost of servicing our nation's debt to China as a result of our purchases of Chinese goods. Few of us do that. It is easier to say that China is using unfair labour practices or is manipulating the exchange rate.

A final point should be made in reference to the chart shown above. China's substantial increase in its current account surplus occurred during the global, pre-crisis spending spree, and the subsequent contraction of the global economy had a visible effect of that surplus. The data shown on the chart after 2013 represent forecasts made by the IMF staff, based at least partly on information supplied to them about budgetary strategies of the respective countries. This can of course be changed by a shift in strategies, but the present expectations are for a continuing *surplus* of slightly less than 4 per cent of GDP for China and a *deficit* for both Australia and the US of about the same percentage, relative to their respective GDP magnitudes. Those who consider this to be “unfair” would make a greater contribution by seeking ways of improving productivity in their domestic economy in order to minimise their nation’s current account deficit. Seeking ways to achieve trading parity by political means may be more expedient, but expediency often coincides with short-term convenience, not with a long-term solutions.

ANNEX: A DIGRESSION ON BENEFICIAL OWNERSHIP OF THE NATIONAL DEBT

A chart showing non-resident holdings of Australian government securities (Treasury bonds, Treasury indexed bonds and Treasury notes) is available from the Australian Office of Financial Management, AOFM, and indicates that the proportion was 61 percent, at the end of the first quarter of 2015.[7] This is an estimate made independently by both AOFM and the Australian Bureau of Statistics and then averaged. The estimation procedure for both begins with Australia’s aggregate balance of payment data and then works backward by allocating the portions for which beneficial ownership is known. The remaining portion, or residual, is then allocated to non-residents not elsewhere counted. It may be accurate, but calculations of residuals suffer the disadvantage of accumulating measurement errors for the previous allocations.

The AOFM also keeps a record of beneficial ownership by country of residence of Australian government securities and state government securities guaranteed by the Commonwealth. These can be obtained as spreadsheets from http://aofm.gov.au/statistics/public-register-of-government-borrowings/#Compilation_of_the_Bond_Register. Table 2 of this set gives the allocation by percentages and indicates that at the end of December 2014 only 17.7 per cent of the total can be attributed to Australian residents, 8.3 per cent to residents of Asian countries, 5.4 per cent to resident of European countries, 0.9 per cent to residents of North America and 67.2 per cent to Australian custodian and nominee companies. This last category is important since it comprises more than half of the total. It means that combining this share with that of Australian residents would represent 86 per cent of the total *legally held* by Australian residents and Australian companies. The companies act on behalf of their clients, some of whom could be Australian residents (trust accounts by Australians, for example) but much is likely to be owned by non-residents who use the custodian or nominee company to act as agent in purchasing and managing the ownership of the bonds.

If half of the holdings by custodian and nominee companies can be beneficially attributed to Australian residents, or to non-residents who use the holdings as part of the process of

[7] Available at: http://aofm.gov.au/statistics/non-resident-holdings/.

obtaining business visas and residency, then the portion allocated to Australian residents would be 48.2 per cent. That is probably close to an upper limit for Australian beneficial ownership since we should expect that non-residents benefit more from custodian or nominee company participation than residents. This implies that at least half of the interest payments to holders of Commonwealth government securities and state government securities guaranteed by the Commonwealth will leave Australia sooner or later.

The Reserve Bank of Australia publishes a breakdown of holdings of Commonwealth securities only and indicates that at the end of 2013 financial institutions in Australia held less than 25 per cent of the total. Some economists prefer to classify these holdings as a debt incurred by the Commonwealth government for budgetary deficits so that it is kept in the economy. Debt incurred through Australia's trading account is then an external debt to other nations that supplied the imported goods and services less the value of Australian goods and services they purchased from us. It may be convenient to do so, but as long as non-residents are able to purchase Commonwealth bonds, some of the interest payments leave Australia, and in treating that as a "leakage" it does not matter whether it is a debt-service payment for the government's fiscal debt or for the nation's trading debt. It does of course matter if we are interested in establishing who caused the debt, with the government of the day responsible for fiscal deficits and Australian residents responsible for the net effect of purchasing more imports that we are able to sell in the form of exports. This is not a fruitful pursuit, however, since interest should not be in who did it, but in who can improve it.

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