Why has the U.S. accused China of deliberately weakening the yuan?

Writer - Prashanth Perumal J. (Editor)

This article is related to General Studies-Paper II -International Relations) & III (Indian Economy)

The Hindu

12 Aug, 2019

What does it mean for the global economy?

On Monday, the United States designated China as a "currency manipulator". The move came immediately after the People's Bank of China (PBoC), the Chinese central bank, let the yuan weaken past the psychologically significant CNY7 (CNY or the yuan is the basic unit of the renminbi, China's official currency) to the dollar mark. The yuan, it is important to note, was last at this level against the dollar more than 10 years ago in April 2008. The present devaluation of the currency has gained significance in light of the ongoing trade war between the U.S. and China; both countries have slapped high tariffs on goods worth billions imported into their countries from the other side.

What does the move imply for China?

The tag of a "currency manipulator" per se does not mean any penal action against China. But it could be used by the United States as an excuse to justify other retaliatory sanctions against the country. The U.S. could also drag China to the International Monetary Fund (IMF) although the IMF does not have the teeth to punish China.

Why has the U.S. taken this stand?

The U.S. believes that China has been deliberately weakening its currency (the yuan) in order to boost exports to the U.S. The Trump Administration, which has been trying to discourage the import of Chinese goods into the U.S. by imposing high tariffs since early last year, thinks that the inflow of Chinese goods will affect the business of local U.S. manufacturers. While the tag of a "currency manipulator" that has been slapped on China is largely symbolic, it sends across the signal that economic ties between the U.S. and China are set to worsen further. It is also worth noting that the PBoC exerts far more direct control over the exchange rate of its currency by intervening in the forex market. Other central banks such as the U.S. Federal Reserve for instance, usually employ general monetary policy tools, which they use to regulate the money supply in the overall economy, to weaken or strengthen the exchange rate of their currencies. Although the U.S. accuses China of deliberately weakening the yuan, many analysts believe that while the PBoC may have intervened in the forex market in the past by deliberately selling yuans to weaken the currency against the dollar, it is no longer the case. Instead, they believe that the PBoC today may, in fact, be selling dollars in the forex market to prop up the value of the yuan against the dollar as the market tries to push the yuan down.

Why is China letting the yuan weaken against the dollar?

Devaluing the currency is a common ploy employed by economies that face a slowdown in order to help boost demand for their goods. A currency is devalued (or weakened) using the central bank to increase the supply of the currency in the forex market. This allows more units of the currency to be purchased using fewer units of various other foreign currencies. In the case of the yuan, increasing its supply will allow more units of it to be purchased in exchange for fewer U.S. dollars. This is a way of transferring more of the purchasing power to buy Chinese goods away from the hands of the local Chinese and into the hands of Americans. The Chinese believe this will help boost the value of China's exports and also kick-start growth. Since the Chinese economy has been witnessing a general slowdown, with growth dropping to a 27-year low of 6.2% in July, it is no surprise that China has decided to depend more heavily on exports as a way to boost demand for its goods.

What does this mean for the global economy?

If the U.S. weakens the dollar to retaliate against China's yuan devaluation, it will enter a currency war. The U.S. President, Donald Trump, on Thursday, in fact, signalled his desire for a weaker dollar by blaming the U.S. Fed for keeping the dollar too strong with its tight monetary policy. The last time the world was engaged in an all-out currency war was during the Great Depression of the 1930s, when countries facing a domestic slowdown tried to boost their economies by devaluing their currencies in a retaliatory fashion. This caused terrible uncertainty for businesses. Combined with high tariffs, this led to a steep fall in international trade. An all-out currency war would have similar effects today. Currency devaluation will also not undo any of the negative effects of the high tariffs that have already been slapped by the U.S. and Chinese administrations. Tariffs, which are really taxes by another name, will remain and discourage production. Currency devaluation may temporarily boost exports by transferring more purchasing power to the hands of foreigners, but it will not boost domestic production. Eventually, as in the past, such competitive devaluations can cause the size of global trade to shrink.

GS World Team...

US-China currency dispute

Why in discussion?

- The US has officially declared China as a currency manipulator.
- The US has accused China of using the yuan to take an 'unfair competitive advantage' in trade.
- The yuan is the currency of China. The value of the yuan has gone below 7 against a US dollar.
- This move by the US is expected to increase the confrontation between the two largest economies of the world on the trade front.
- The move by US comes after China allowed its currency to hold the yuan below the level of seven against the dollar.
- It may be noted that Trump had promised to make China a currency-manipulator country during the 2016 presidential election campaign. But the Finance Ministry refused to take this step and put China on the watch list.
- China exports its products made all over the world. Keeping the value of its currency low helps it to keep the prices of its products low in the global market. This is the reason why it does not let the value of its currency rise.

What is currency devaluation?

- The devaluation in relation to other currencies is the reduction in one currency value. It is a deliberate downward adjustment of the value of a country's currency relative to another currency, group of currencies, or standard.
- Devaluation seeks to reduce domestic demand for imports in the country by rising prices in terms of currency and to increase foreign demand for the

country's exports by lowering their prices in terms of foreign currencies.

- The devaluation can therefore help to correct the balance of payments shortfall and sometimes provides a short-term basis for the economic adjustment of the national economy.

What is currency war?

- To increase their exports by various economies, intentionally reducing the value of their currencies is called currency war.
- This phenomenon is also known as 'Competitive Devaluation'.
- This competitive devaluation results in dramatic changes in foreign exchange, leading to a sudden increase and fall in international trade and investment.
- The size of capital flow in the economy shrinks when foreign investors withdraw money from the market, which may result in deflationary pressure on the economy.
- Currently we have entered the third round of the currency war. There have been two currency wars before this.
- First- it lasted from 1921 to 1936. The circumstances arising from the First World War forced countries like Britain, France, Germany and the US to devalue their currency, which resulted in uncontrolled inflation.
- Second, in 1971, the US President prohibited the convertibility of dollar gold by foreign central banks and imposed an additional surcharge of 10% on all imports.

Problems caused by it

- Due to currency war, there has been an increase in dumping and import duties and counter wellbeing charges between different countries.
- Countries that have limited resources depend on strong export-oriented economies.
- In such a situation, the weak currency of these countries increases the cost of import, and also the currency weak also becomes it difficult because inflation also increases due to increased liquidity in the market.

Exchange rate?

- Exchange rate means the relative price of two different currencies, that is, "the value of another currency relative to one currency".
- The market in which currencies of different countries are exchanged is called the foreign exchange market.\
- There are three types of exchange rates:
  1. Floating Exchange Rate
  2. Fixed Exchange Rate
  3. Managed Exchange Rate
- Floating Exchange Rate: It is a system of exchange rate in which the value of a currency is allowed to be determined independently or the value of the currency is determined based on the demand and supply of a currency, called the feoating exchange rate. |
- Fixed exchange rate: The system of exchange rate in which the exchange rate is determined not by the demand and supply but by the government, it is called fixed exchange rate.
- Managed Exchange Rate: It is a system of exchange rate in which the government allows exchange rate fluctuations of 1 to 3 percent, it is called managed exchange rate.
- In this system, the exchange rate is neither constant nor independent. The International Monetary Fund (IMF) interferes with the determination of this exchange rate.

Expected Questions (Prelims Exams)

1. Consider the following statements-

1. Deliberately devaluating the value of its currency to increase import by various economies is called 'Currency war'.
2. The relative value of one currency to other is called exchange rate.

Which of the above statements is/are correct?

(a) Only 1

(b) Only 2

(c) Both 1 and 2

(d) Neither 1 nor 2

Expected Questions (Mains Exams)

Q. Discuss the effects on global economy due to the devaluation of its currency by China.

(250 Words)

Note: Answer of Prelims Expected Question given on 10 Aug. is 1 (c)