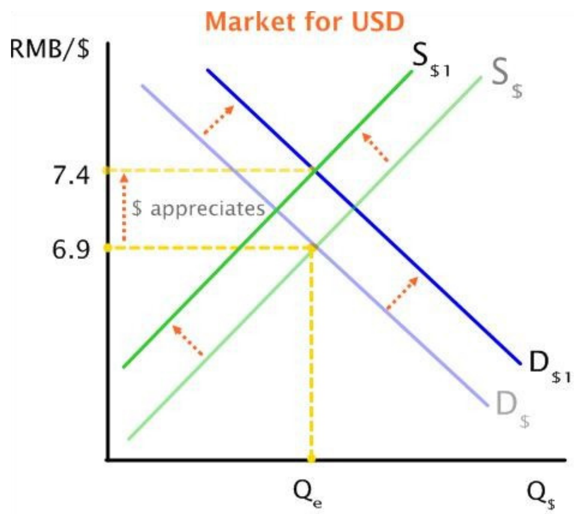
Worksheet 23.1

Exchange rates, currency manipulations and the balance of trade

While the market for a particular currency reflects many of the same characteristics as a product market (i.e. upward sloping supply curve, downward sloping demand curve), the consequences of a change the *price of a currency (the exchange rate)* is far more powerful than a change in the price of a particular good or service in a product market.



How does the value of a country's currency affect that country's balance of trade with other countries? To understand this important concept, we first need to know something about the process by which currencies are exchanged when two countries trade.

Let's look at an example:

When an American consumer wants to buy an iPod that was made in China she will have to pay for it in US dollars, since that's what she earns her wages in from selling her labor in the resource market. Apple now has the consumer's $300, which gets split up to cover all the costs the company faced in the manufacture, distribution, marketing and sale of the iPod. Part of that $300 (say $100) will go to the manager of the factory in China where it was made.

The factory manager in Shanghai faces his own costs he must cover. He must pay rent on his factory space, interest on the loans he took out to acquire capital, and wages to the workers assembling iPods on his factory floor. The problem is, these costs are all in Chinese yuan, but he's holding the US dollars that Apple paid him for his iPod. In order to cover his costs, the Chinese factory owner must take the $100 to a Chinese bank and swap it for RMB. The local bank that changes his money now hands the $100 over to China's central bank (the PBOC) which prints and exchanges RMB to the bank at whatever the prevailing exchange rate is at the time.

Ultimately, China's central bank will decide what to do with its holding of US dollars. Most of the dollars are loaned back to the United States through China's purchase of US Treasury securities (the bonds the US government sells to finance its deficits). China's voracious demand for US dollar denominated assets keeps the demand for (and the the value of) dollars high on foreign exchange markets, meaning the RMB remains relatively cheap for Americans and therefore Chinese manufactured goods attractive.

China's policy of exchange rate manipulation has upset many American politicians over the years, who often blame China for America's shrinking manufacturing sector. A weak RMB means the cost of producing things like iPods in China is far lower than it would be in the US. By keeping demand for dollars high on the foreign exchange markets through its incessant demand for US treasury securities and other financial and real assets, while simultaneously hoarding vast reserves of US dollars in its central bank, thus keeping supply of dollars on foreign exchange markets low ***(see graph)***, China has prevented the RMB from appreciating, fueling the growth of the country's export-manufacturing sector.

With sluggish growth and high unemployment in the United States, the US government has considered taking action against China in response to its continued manipulation of the Chinese currency's exchange rate. According to the Financial Times blog 'the Economists' Forum': read from 'If the US economy' to 'currency manipulation.' from this link.

The 'competitive currency' perceived to pose the greatest threat to America's industrial sector is certainly the Chinese RMB. Currency manipulation is a form of protectionism, which in a time of global economic slowdowns poses a larger threat than ever to both developed and developing nations' economies alike. For this reason, the World Trade Organization may need to employ carrot and stick methods to create incentives for China to liberalize its currency controls and allow the RMB to strengthen against the dollar and other major currencies: read from 'How would this new rule' to the end of the article from the link above.

Discussion Questions:

1. How does China continuing to undervalue its currency threaten the industrial economies of its largest trading partners?
2. What is China's purpose for maintaining the low value of the RMB relative to the currencies of other nations?
3. What would be a unilateral protectionist measure the US government may advocate if the WTO refuses to take action against China's currency manipulations? How would you advise president-elect Obama on the issue of whether to take protectionist action against China in the context of the current economic crisis in America?