Foreign Currency Manipulation

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In 1993 my son made an extremely low-budget trip around the world. When he traveled through Western China he was able to get between 5 and 6 Chinese Yuan (remembi) per US dollar. The next year I taught in China. I was able to get approximately 8.3 Yuan per US dollar. In other words, the value of the Yuan had fallen by around 50% in one year. This meant that I could pay 1/3 less than my son had for similar items. It also meant that foreigners who bought Chinese goods would be able to pay 1/3 less in dollars than they had the year before. Thus, they had a great incentive to buy and import Chinese goods. At the same time, Chinese people had to pay 50% more in their currency for every dollar's worth of goods they imported from abroad. Thus, they purchased less from abroad and China ran a large trade surplus—earning more in dollars than they spent. They invested much of their trade surplus in US Treasury bonds. In order to buy the bonds, they first had to buy US dollars. Their buying pressure on the dollar kept the value of the dollar up relative to the value of their currency, so the Yuan continued to be cheap relative to the US dollar.

China is not the only country that has tried to support the value of its currency relative to US dollars. The Japanese are large purchasers of US dollars and also have an economy that exports much more to the US than it buys from the US, so the US trade deficit with Japan is also large. Other countries may engage in currency manipulation by issuing great quantities of money and artificially depressing their interest rates so their investors will export their currency in order to buy higher yielding government bonds and other assets in other countries. The Japanese presently have interest rates near zero, as do many European countries. By stimulating exports and discouraging imports with a weak currency, a country may hope to stimulate its domestic economy by encouraging domestic production and discouraging imports.

The US Congress tried to call out countries that tried to manipulate their currencies to boost exports and reduce imports by calling them "currency manipulators." However, the Treasury Department has always found a reason not to do so. The Treasury must sell many bonds to finance the US deficit and doesn't want to discourage anyone from buying them.

Currency manipulation may be widely used by countries who want to increase their exports and decrease their imports. It is not always easy to see and, thus, is not easily prevented. However, it does distort the relative prices of goods involved in international trade, and therefore biases trade flows. It should be noted. However, if someone or some country wants to sell you goods cheaply, it is to your benefit. Nonetheless, there could be a future cost if the interest payments on the debt they receive in return poses a payment problem for you, your children, or your grandchildren in the future.

The Gold Standard.

Currency manipulation can occur with fiat currencies (which is what countries use today). However, it could not exist under a gold standard. Under a gold standard each country's' currency would have a specific value in terms of ounces of gold. In 1914, an Austrian Ducat was worth about .1132 ounces in gold while a British Sovereign was worth about .2254 ounces of gold. Thus, the sovereign was worth about 2 Ducats and people could compare prices across countries by assessing how much it would take in each currency to buy goods in various places. If a country had high prices, people would tend to buy similar goods elsewhere. In so doing their gold backed currency, and gold, would leave the country. As a country lost gold, its money supply and its economy would decelerate, thereby causing prices to fall. At the same time, the country with low prices would receive more gold so its money supply could increase and prices could rise. Thus, the price differences would automatically diminish over time. The main problem with the gold standard is that prices didn't adjust up or down smoothly, so periodic "panics" could exist as people ran short of gold before prices adjusted downward. After some notable panics in the US, the Federal Reserve was created.

Value Added Taxes (VAT) and Border Adjustment Taxes

Value added taxes are basically consumption taxes. They are added to the final price of domestic goods sold and are included in the price the consumer or business user has to pay. For any individual producer (say Producer A) the VAT is levied upon the value of goods sold. However, when time comes to settle up with the tax authority, Producer A is allowed to deduct the value of taxes already paid by his or her suppliers form the final tax bill due. Thus, the total VAT paid by any producer only applies to the value added by that producer in the final stage of production prior to sale.

For example, assume producer A sells $120 worth of goods to final consumers. However, Producer A has paid Producer B $60 for the goods prior to sale. Producer B is due to pay $10 in tax on the goods sold to producer A. Thus, while producer A may be billed initially for $20 in taxes due, he or she needs to pay only $10 after adjustment for the fact that Producer B is liable for $10 in tax on the $60 worth of supplies purchased by producer A. The tax is due only on the net value added by producer A.

Value added taxes are widely popular in Europe and many other countries. Their tax rates may range between 15% and 30% but the consumer doesn't see them because they are included in the sales price of goods, rather than being added on separately as sales taxes are. Value added taxes are also popular with governments because they can be used to stimulate exports and discourage imports.

Value added taxes can be used to stimulate exports and foreign purchases of domestic goods because they are often rebated at the border when domestically produced goods are exported. Foreign visitors who take domestically purchased goods may also be eligible for rebates of the value added taxes they paid if they apply for the rebates and still have the goods and purchase information when they leave the country in which the purchase was made. Thus, sales of domestic goods to foreigners are encouraged by the rebates of value added taxes at the border.

At the same time, imports of goods from abroad may be discouraged by the existence of value added taxes. Because goods imported from abroad may be used either in final sales to consumers or as intermediate goods by producers (such as producer B0, value added taxes tend to be levied upon them when they are imported into a country. That raises the net cost to domestic consumers and producers if they purchase foreign products, and thereby discourages imports.

There are several drawbacks to value added taxed that have made them unpopular in the US. First, unlike sales taxes, they cause the measured price of goods to increase and their imposition would increase measured inflation. Second, they require extensive bookkeeping by private producers. The Obama Administration, nonetheless, tried to lay a framework for potential value-added taxes by requiring that sellers of goods file reports with the IRS on all people or businesses whom they had paid more than $600 in a year.

Border Adjustment Taxes

In 2017 the US proposed border adjustment taxes as a way to raise revenue and counter the effect of Value added taxes levied by trading partners. Rather than account for all the internal bookkeeping, the border adjustment taxes would be levied directly upon the value of imports that came into the country, and possibly could be rebated on certain exports. The border adjustment taxes could be quite flexible since they could vary with the nature of the product and even with the foreign country involved. However, such variation would likely violate WTO rules in one way or another if they were not applied equally. Also, retailers made sure that consumers would know that they would result in higher prices for imported goods so even their proposal was politically unpopular.