



American Enterprise Institute for Public Policy Research

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AEI Economic Policy Studies Working Paper 2011-04, June 28, 2011

<http://www.aei.org/paper/100233>

The United States and China: Macroeconomic Imbalances and Economic Diplomacy

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Preliminary
Comments welcome

8 June 2011

ABSTRACT: This paper explores the ways in which macroeconomic imbalances have driven policy discussions between the United States and China in the last decade. China's current account surplus, its growing foreign exchange reserves, and its shifting policies on exchange rate adjustment have become a central preoccupation of United States trade policy. The paper considers the evolving political economy of the U.S. policy stance and of the Chinese response; it assesses the opportunity costs of an approach that has sometimes focused on the exchange rate to the exclusion of other issues; and it explores the ramifications for economic governance in the short- and medium-run. The paper finds that there has been ample mutual misunderstanding between the United States and China in their economic arguments; that the momentous debates have the potential to severely impair the institutions of global economic governance; and that there is likely to be an important race between economic and demographic forces that will naturally redress the imbalances and the political imperatives for each country to stand tough and fight.

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The United States and China are now the two largest economies in the world. For the last decade, the United States has been an important net source of demand for the world economy, running persistent large current account deficits. China has been an increasingly important net source of supply for the world economy, running persistent large current account surpluses.

The relationship between the two countries is multifaceted and goes well beyond economic relations, but questions of macroeconomic imbalances have remained at the heart of bilateral discussions between the two. Given their importance to the world economy, these imbalances have also become central to multilateral discussions about global economic governance. In fact, the issues surrounding China's trading relationships have been sufficiently important to help prompt a restructuring of the institutions of global economic governance. The Group of 8 countries (G8), which did not include China, has been largely set aside in favor of the Group of 20 (G20), precisely because that group does include China and is therefore deemed more relevant.

Despite the centrality of U.S.-China macroeconomic imbalances, there has been an unhealthy tendency to oversimplify the issue by seeing the countries as unitary actors. When the role of interest groups is acknowledged, it may be only to declare one such interest group predominant and responsible for whatever wayward policy the country has adopted.

This study examines the two countries' macroeconomic imbalances of the last decade and the diplomacy surrounding them through the lens of political economy, positing that there are significant internal divisions within each country and that the policy outcomes that emerge may differ significantly from those that a powerful, unitary actor might impose. Such a decomposition of the forces shaping national policies is substantially easier to perform when the subject polities are transparent and public in their debates over policy formation. When they are not, one is left to rely on suggestive signs and inferences, which can be far short of dispositive. One central thesis of the paper, however, is that the acknowledgement of heterogeneity among important interest groups can suggest very different approaches to economic diplomacy than those that might be optimal for a homogeneous counterparty.

The choice of a decade as the period under discussion is not entirely driven by a fetish for round numbers. It was in 2001 that China joined the World Trade Organization, after 15 years of accession negotiations.¹ Although China had experienced remarkable rates of GDP growth before that date, it was in the last decade that the country crossed an invisible threshold from being a heavily populated underperformer to being a leading actor on the global economic stage. For China, 2001 marked a transition from seeking admittance to institutions such as the WTO to a period of implementing the obligations that came with membership and adapting to the responsibilities of its enhanced role. For the United States, 2001 marked the transition from the Clinton administration, which had overseen the bulk of the WTO accession negotiations, to the Bush and Obama administrations, which largely dealt with China as an established, significant member.

This paper focuses on the political economy of the macroeconomic imbalances and on economic diplomacy largely in lieu of important, but purely economic questions. These include questions such as what has caused the large imbalances (see, e.g., Huang and Tao (2011) or Du and Wei (2010)) and what role an exchange rate adjustment would play in tempering the imbalances (see, e.g., Eichengreen and Rua (2011) and Thorbecke and Komoto (2010)). Whether or not a significant revaluation of the renminbi would balance the trading relationship, the perception that it would has played a significant role in the political debate in the United States and has helped shape the economic dialogue between the countries. Of course, one hopes that over time perceptions shift to take economic realities into account. That seems to have happened in the U.S. debate over China policy. Over the period in question, the RMB-dollar exchange rate has gone from being treated as a panacea to a lesser role as one of a number of factors in a broader and more subtle discussion. One interesting question is to try to discern how and when this shift came about.

To address all this, the next section lays out the key economic variables that drove the political debate and how they evolved. Section 3 considers the political debate and the motives of key participants in both the United States and China. Section 4 looks at how these political forces shaped the economic dialogue between the United States and China both bilaterally and through the major global institutions of economic governance. Section 5 considers potential outcomes, projecting these issues forward into the near future. The conclusion draws out the central themes: that there has been ample mutual misunderstanding between the United States and China in their economic arguments;

¹ Bhattasali, Li, and Martin (2004).

that the momentous debates have the potential to severely impair the institutions of global economic governance; and that there is likely to be an important race between economic and demographic forces that will naturally redress the imbalances and the political imperatives to stand tough and fight.

I. What happened? The economic record

Given China's remarkable growth over the last decade, it can be difficult to go back 10 years and recall China's more modest role in global economic affairs. In 2001, China's GDP, measured with the exchange rates of the time, lagged behind that of the United States, Japan, Germany, the United Kingdom and France. By 2010, China lagged only the United States.² At the start of the last decade, China was already many years into its outward-oriented growth experiment (see Lardy (2002)), but it was largely prospering by tapping into the economically vibrant production networks of East and Southeast Asia. Unlike predecessor countries of an earlier age, who had to develop internationally competitive industries before they could take a place of prominence in global commerce, China was able to take advantage of modern methods of geographically dispersed production and use its bountiful labor supply to tackle limited tasks in the production of manufactured exports.³

This approach, whereby Chinese value added might be a small fraction of a good's value, had an important implication for macroeconomic imbalances. Global trade accounts track the flows of final goods, mostly ignoring the multiple sources of value added and attributing everything to the country in which the good was completed.⁴ So long as observers focused on a country's current account balance with the entire world, this made little difference. If a country like China were to provide only 10 percent value added on its manufactured exports, the imported raw materials and intermediate goods would show up in its global import statistics. However, if anyone were to focus on bilateral balances, the export statistics might differ wildly from value added, since the imported intermediate materials could come from a third country. There could thus be a disconnect between modest multilateral imbalances and dramatic bilateral imbalances.

² IMF, World Economic Outlook database, April 2011.

³ For detailed descriptions of China's economy and its functioning, see Naughton (2006) and Brandt and Rawski (2008).

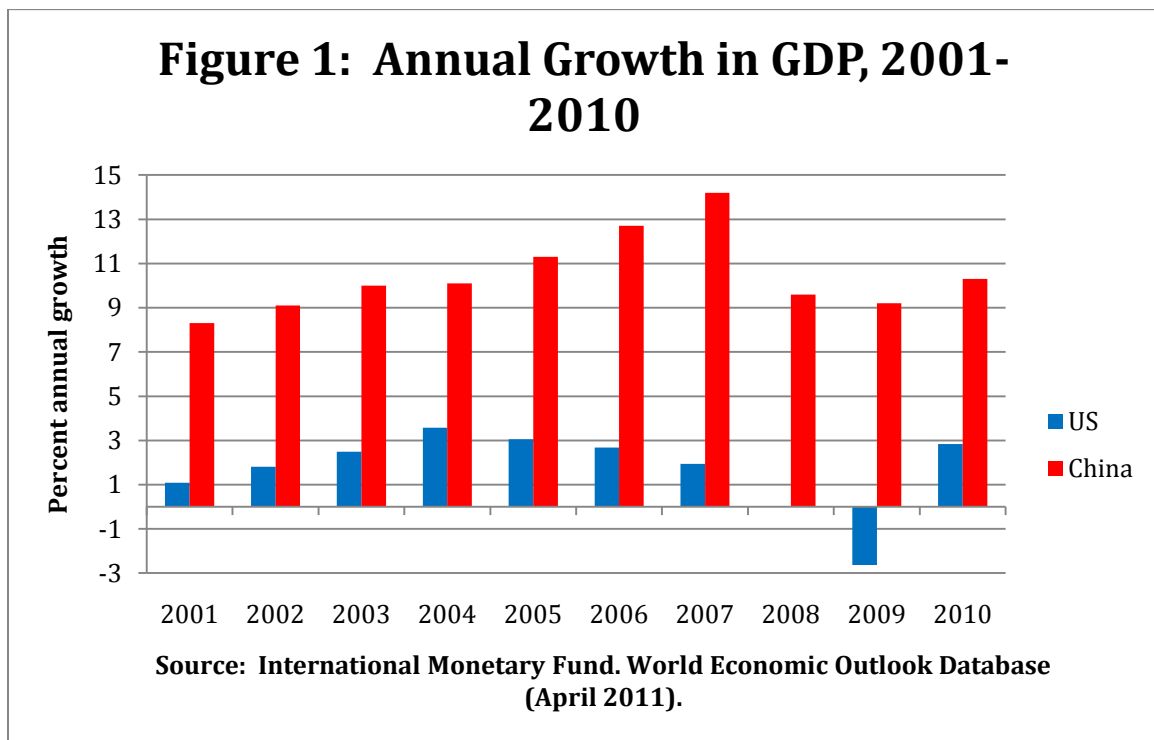
⁴ One exception to this rule occurs in preferential trading arrangements, when it may be necessary to show that a good meets rules of origin requirements to qualify for preferential treatment. For a detailed treatment of how it can be misleading to ignore the global distribution of value added, see Dedrick, Kraemer, and Linden (2008).

This, in fact, was what happened between China and the United States in the early part of the last decade. That disconnect initially played heavily into U.S. political concern about Chinese policies. Later, when China's multilateral imbalance had grown to match its bilateral imbalance, Chinese officials would still claim that the United States was making the fundamental error of fixating on misleading bilateral statistics. This section reviews the central data about the relative growth performances and trade imbalances of the two countries.

Comparative Experiences

GDP growth

In any conventional sense, disparate growth rates do not constitute a macroeconomic imbalance. There are ample explanations for China's extraordinary record of economic growth, including catchup from previous periods of damaging economic policies and remarkable rates of investment and savings.



The very different GDP growth records of China and the United States, as depicted in Figure 1, serve as important background for the political economy of relations between the two countries. The disparity contributed to very different

perceptions on either side of the Pacific. In the United States, China was commonly seen as an unmitigated success. China, on the other hand, was more prone to look at data on a per capita basis and argue that it was still a relatively poor developing country and should be left alone to address its development problems. For comparison, China's income per person is between \$3,000 and \$6,000. The comparable figure for the United States is over \$45,000.⁵

The other relevant episode that leaps out from Figure 1 is the different experiences of the two countries during the recent global financial crisis. The United States went into a steep recession, while China maintained a rapid rate of growth. This contrast changed Chinese perceptions of the United States and had a notable impact on the tenor of economic discussions in the wake of the crisis. Whereas Chinese government representatives had previously been willing to acknowledge the United States as a global financial leader – and therefore accept advice about financial practices – a new skepticism emerged in 2009.

Levels of exports

From 2001 to 2010, Chinese merchandise exports grew at an average annual rate of 21.8 percent, far exceeding the growth rate of GDP (Figure 2). There have been

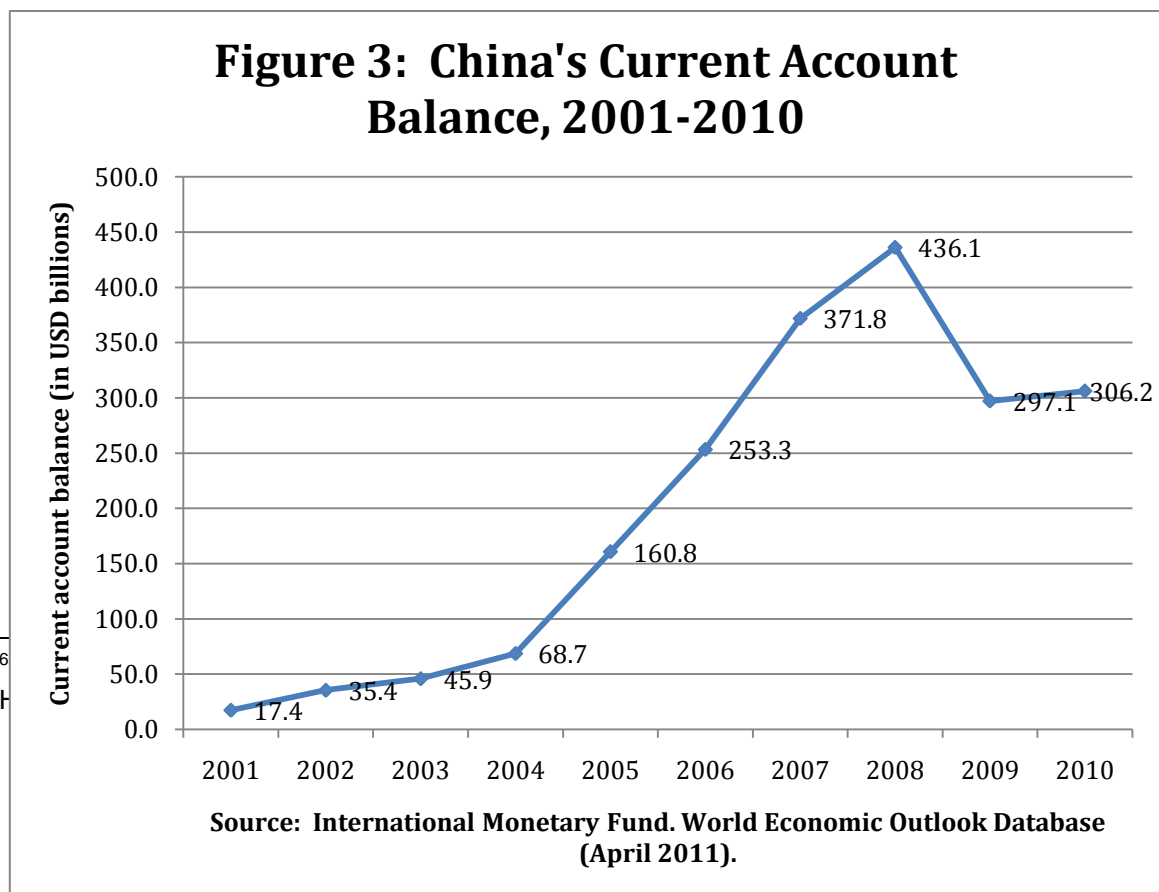


debates in the literature about the relative importance of exports in China's economic performance. On the one hand, gross export figures fail to account for the processing trade, which matched many of these exports with imports of intermediate goods. Furthermore, exports constituted a limited, albeit growing, percentage of Chinese economic activity. The counterargument, stressing the importance of the export sector, argues that it played a disproportionate role, both through its greater responsiveness to market signals (specifically, a greater propensity to use labor-intensive techniques) and through its role as a means of introducing new technology.⁶

Current account balances

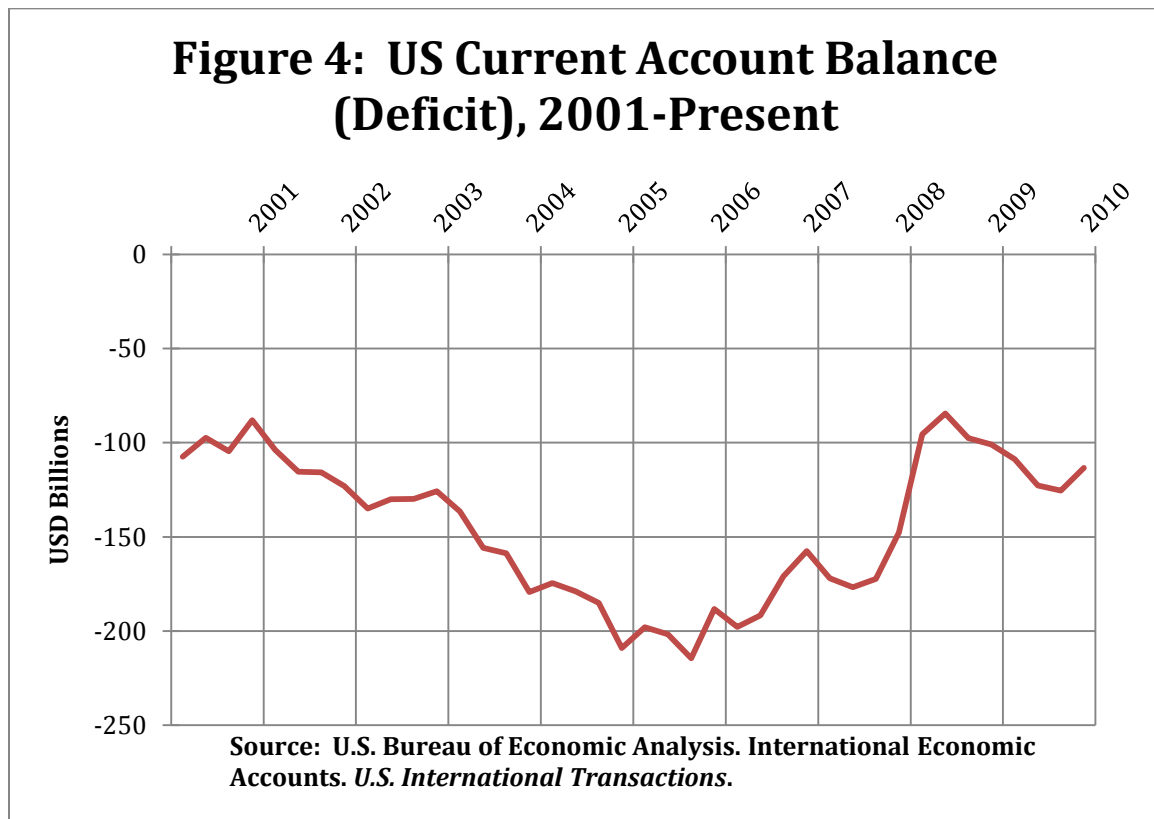
For the purposes of this paper, the more relevant figures are the macroeconomic imbalances themselves. Figure 3 depicts China's current account surplus and its evolution over the last decade. While the surplus grew rapidly from 2001-2004 (almost quadrupling), it was doing so from a relatively low base.

From 2004, the rapid increase continued and the numbers reached globally significant magnitudes. There are two important features to note about this data. First,



as will be shown below, the period from 2005 to 2008 marked China's major experiment with currency appreciation. As discussed below, the contemporaneous growth of imbalances at a time of appreciation led some to question the efficacy of exchange rate movements as a means of addressing the problem. Second, the takeoff point for China's macroeconomic imbalance occurred several years into the decade.

That is important because, of the three depictions of trade imbalances offered here, it is Figure 3 that stands apart. Figure 4 depicts the U.S. current account deficit over the same time period. The deficit appears to grow rapidly from 2002 on, which was a major source of concern domestically.



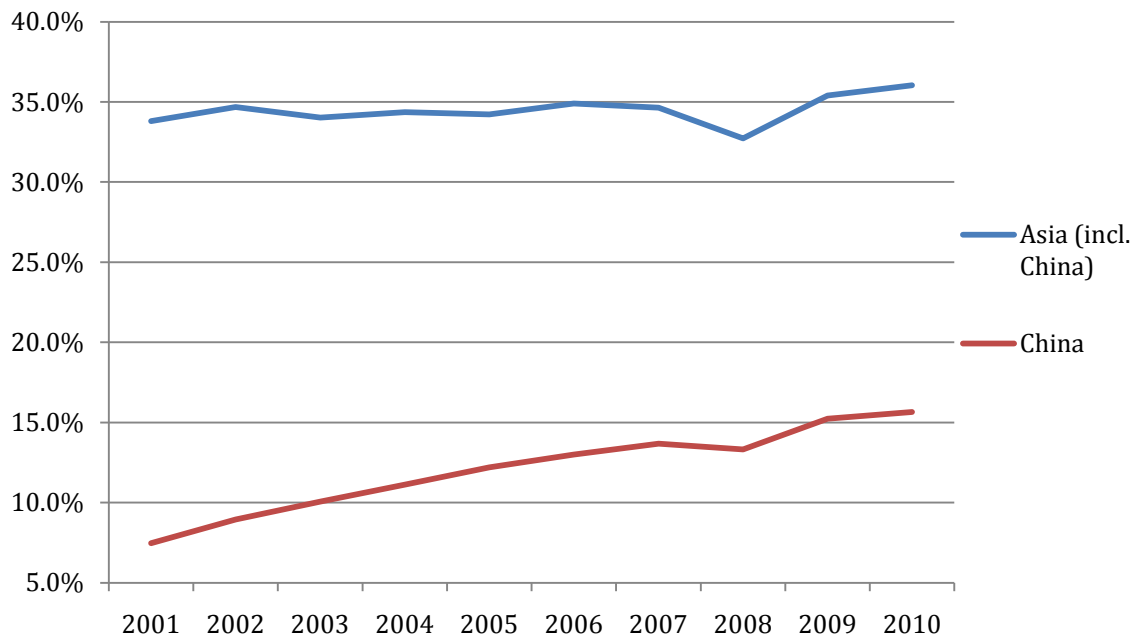
The growth of the U.S. current account deficit in Figure 4 seems to mirror the growth of the bilateral surplus in trade between China and the United States, as depicted in Figure 5. This correlation, to some observers, implied causality. The result was a stretch of time in which the expansion of China's bilateral trade deficit was sometimes blamed for the rise in the U.S. global trade deficit. That deficit, in turn, was blamed for a number of economic ills, including the decline of the manufacturing sector. It was during

this period that China became a major culprit for those decrying the effects of an open U.S. trade policy. The *prima facie* evidence was the exploding trade deficits.



There are, of course, economic inconsistencies in this story, and Chinese officials were aware of them. Given the possibilities for triangular trade, there is no economic significance to bilateral trade balances. They can coexist with global surpluses, deficits, or balance. In the case of China's emergence as a trading power, as discussed above, there was particular reason to think that triangular trade was important. Goods that had once been finished in neighboring Asian nations were now being finished in China. Because of standard international accounting practices, the entirety of these goods were attributed to China, rather than just the value added. Figure 6 provides data that are consistent with this version of events. Over the first part of the last decade, the share of U.S. imports from Asia, including China, held roughly constant at around 35 percent. China's share of U.S. imports grew strongly over the same period, suggesting that goods finished in China were replacing goods produced in the rest of Asia, rather than augmenting Asia's share.

Figure 6: Share of U.S. Imports



Source: U.S. Bureau of Economic Analysis. International Economic Accounts. *U.S. International Transactions*.

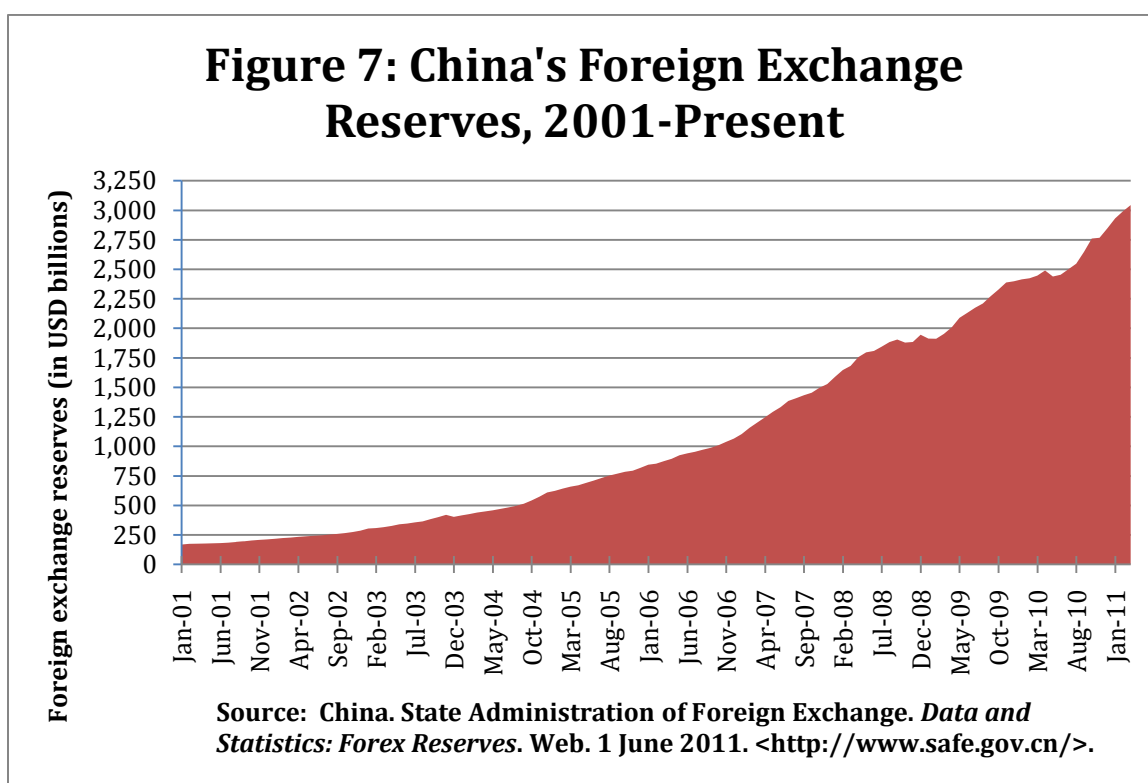
There were repercussions to U.S. reliance on economically weak arguments in public discourse. It meant that Chinese officials initially learned to respond to complaints about macroeconomic imbalances with patient lessons about basic economics. As

Figure 3 shows, however, the argument of 2003 that macroeconomic imbalances were only a bilateral problem – and therefore unimportant – no longer held in 2005 when China’s global current account balance grew dramatically. Yet the inclination to downplay concerns as reflections of economic ignorance persisted.

A final, cumulative measure of China’s macroeconomic imbalances is the size of its foreign exchange reserves (Figure 7). There is a strong macroprudential argument for accumulating foreign exchange reserves, of course. Particularly for countries trying to achieve macroeconomic stability through a fixed exchange rate, a healthy stash of reserves provides insurance against adverse events, such as a run on the currency. It is worth remembering that the decade under consideration in this paper closely followed the Asian currency crisis of the late 1990s (See, e.g., Radelet and Sachs (1999)). One lesson of that crisis seemed to be that countries without adequate reserves could find themselves at the mercy of capricious markets and, subsequently, in the unenviable

position of taking direction from the International Monetary Fund in exchange for a rescue.

China was able to ride out the turmoil of the Asian crisis, but was keenly aware of the travails of its neighbors. This certainly provided some justification for the accumulation of foreign exchange reserves. Yet, as the last decade proceeded, the reserves continued accumulating in Chinese coffers at an alarming rate and have most recently exceeded \$3 trillion. The rapid accumulation has continued even as China's current account surpluses have moderated, likely indicating an inflow of "hot money" – bets that investments in China will earn not only the regular return on investment but anticipating a currency appreciation as well.



By most any measure, the reserves now appear excessive. In an April 2011 speech, Zhoé Xiaochuan, governor of the People's Bank of China, said, "Foreign exchange reserves have exceeded our country's rational demand, and too much accumulation has caused excessive liquidity in our markets, adding to the pressure of the central bank's sterilization."⁷

⁷ Li (2011).

The expanded monetary base and pressures on sterilization are only one of the problems associated with excessive reserve accumulation. More fundamentally, the accumulation of foreign exchange reserves that accompanies China's currency undervaluation has meant that China has been extending large volumes of loans to the rest of the world. Given that China is a relatively poor country that is rapidly getting richer, such lending makes little economic sense under any model of consumption smoothing. Further, it has been increasingly difficult for China to earn much of a return on those loans. In the wake of the global financial crisis, government bond yields have been strikingly low. An alternative approach, of investing the reserves in the private sector through sovereign wealth funds, has stirred suspicion and opposition in recipient countries.

What may be worse, from a Chinese perspective, is that China faces the prospect of significant capital losses on its foreign exchange holdings. Either an increase in global interest rates or an appreciation of the renminbi would cut into the RMB value of China's foreign exchange holdings. As the reserves grow, so do the potential losses. It is exceedingly difficult to extricate oneself from a \$3 trillion position without significantly moving market prices. When such losses have occurred in the past, as with unfortunate overseas investments, they have been accompanied by public complaint within China.

The fear of further losses was a major factor behind Chinese urgings for the United States to adopt more conservative monetary and fiscal policies. In 2009, Premier Wen Jiabao called on the United States to "maintain its good credit, to honor its promises and to guarantee the safety of China's assets."⁸

Thus, from a Chinese perspective, its foreign exchange reserves present a rapidly growing problem, threatening a loss of monetary control, inflation, and capital losses. Unfortunately, as discussed below, there is no certifiably painless way for China to extricate itself from this situation.

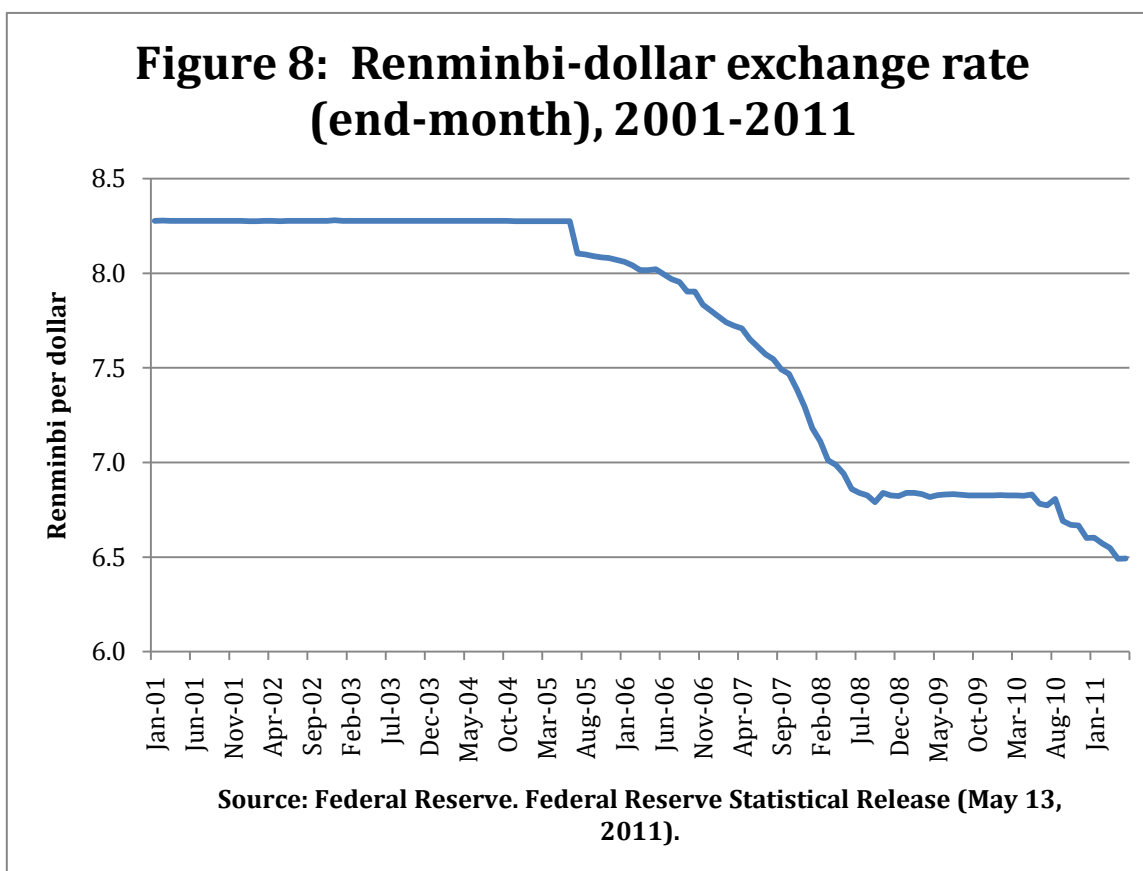
In the context of U.S.-China diplomacy and political economy, the growing hoard of Chinese foreign exchange reserves has an important, additional role. In the United States, it can foster the impression that China is endlessly wealthy. The reserve pile is often misinterpreted as a measure of the success of China's policy and leads to concerns that this is a slush fund to buy up key parts of the U.S. economy or the world. The former interpretation undermines public sympathy for the raft of developmental

⁸ Wines (2009)

problems facing Chinese leaders. The latter interpretation leads to suspicions about Chinese motives and a potentially adversarial stance.

Exchange rate

Whatever the merits of U.S. concerns about the aforementioned macroeconomic imbalances, they resulted in an intense focus on the RMB-dollar exchange rate, which is depicted in Figure 8. China has held its currency roughly fixed against the U.S. dollar for most of the last 13 years. From October 1997 to July 2005, the official exchange rate



was 8.28 RMB to the dollar.⁹ The currency appreciated to 6.83 RMB to the dollar between the summer of 2005 and late 2008, an appreciation of roughly 20 percent. As the global financial crisis unfolded in 2008 and 2009, the appreciation of the RMB ceased. The slow and steady appreciation – roughly a 6 percent annual rate – resumed in the summer of 2010, leaving the RMB at 6.48 to the dollar in early June 2011.

⁹ Goldstein and Lardy (2007).

It is worth noting that China's adherence to a fixed exchange rate preceded and endured the Asian financial crisis of the late 1990s, when the country resisted pressures to *depreciate*. Nor is there anything novel objectionable about a fixed exchange rate per se. Until the breakdown of the Bretton Woods exchange regime in the 1970s, most of the globe operated under a system of fixed exchange rates. This was seen as one means of promoting stability and predictability in an economy.

In the context of the growing macroeconomic imbalances described above, however, there has been a political and academic focus in the United States on the undervaluation of the Chinese currency.

The conclusion that China's currency is significantly undervalued has been reached by a wide range of analysts. A well-publicized range of estimates in the middle of the last decade that the RMB was 15 to 40 percent undervalued prompted legislation seeking to apply a 27.5 percent tariff on Chinese goods (splitting the difference). The Peterson Institute has very publicly estimated that the renminbi is 20 to 40 percent undervalued.¹⁰ In the most recent estimate, from May 2011, Peterson scholars find that the RMB is 22.2 percent undervalued relative to the dollar (Cline and Williamson 2011, p. 14). This analysis is based on estimates of the adjustment that would be necessary to correct the macroeconomic imbalances, the targets for which are limited to no more than 3 percent of GDP (p. 4). The multicountry analysis highlights several important points of the currency debate. First, China's estimated imbalance is far and away the largest of any of the G-20 currencies. Indonesia is the second most undervalued at 12.8 percent. The Euro, as of April 2011, was estimated to be 4 percent undervalued relative to the dollar. Second, those who stress the importance of Chinese exchange rate adjustment justifiably note that while China may account for a limited share of U.S. trade, it is very difficult for China's neighbors to adjust when China does not. Thus, Korea and Japan are estimated to be almost 10 percent undervalued against the dollar and would both be expected to face easier adjustments if they came alongside RMB appreciation. Finally, there is a sharp distinction between China's global overvaluation (13.8 percent) and its overvaluation relative to the dollar (22.2 percent).

Such analyses have been politically influential in the era in which China's global current account surplus have been rising. They have been especially potent in the midst of the United States recession, since it is a relatively straightforward (if flawed)

¹⁰ See discussion by Peterson Institute Director C. Fred Bergsten, March 12, 2010. http://www.epi.org/resources/event_20100312/

calculation to extrapolate from a current account deficit correction to a projected increase in American jobs (Levy 2010).

The assertions about RMB undervaluation are not limited to American critics. The World Bank last year recommended that China appreciate its currency to head off inflation.¹¹ The European Union trade commissioner, Karel De Gucht, asserted that the renminbi was underpriced.¹² The IMF Managing Director added that “The opinion of the IMF... is still that the renminbi is very much undervalued.”¹³

The motivations for lodging complaints about the exchange rate and for resisting those complaints are addressed in the next section. We can characterize the experience of the RMB-dollar exchange rate as having two speeds: full stop, and a steady 6 percent appreciation. Full stop applied until the summer of 2005, and then again from mid-2008 to mid-2010. From 2005-2008 and 2010 to present, 6 percent appreciation was in force. And China’s macroeconomic imbalances grew all the while.

II. Motives and Politics

The previous section reviewed the economic record. This section delves into the political forces that were stirred by that record and the arguments that motivated the diplomatic endeavours that are discussed in the section that follows. Given the importance of perceptions, this section attempts to describe not only the importance of actual forces in the debate, but the perceptions of those forces as seen across the Pacific.

Forces driving the U.S. debate

In the United States, the currency debate in the wake of the global financial crisis is not the same as the currency debate of 2003. This is a distinction that has often been lost on official Chinese observers. While arguments that were prevalent in 2003 persist, the coalition of critics has grown and new, qualitatively different arguments have been added to the discussion.

At the core of those with a negative view of the impact of trade with China and the macroeconomic imbalances that have characterized it lies the American union movement. Organized labor in the United States had a negative view of trade with China in 2003 and that view has only strengthened since. To some extent, this reflects a

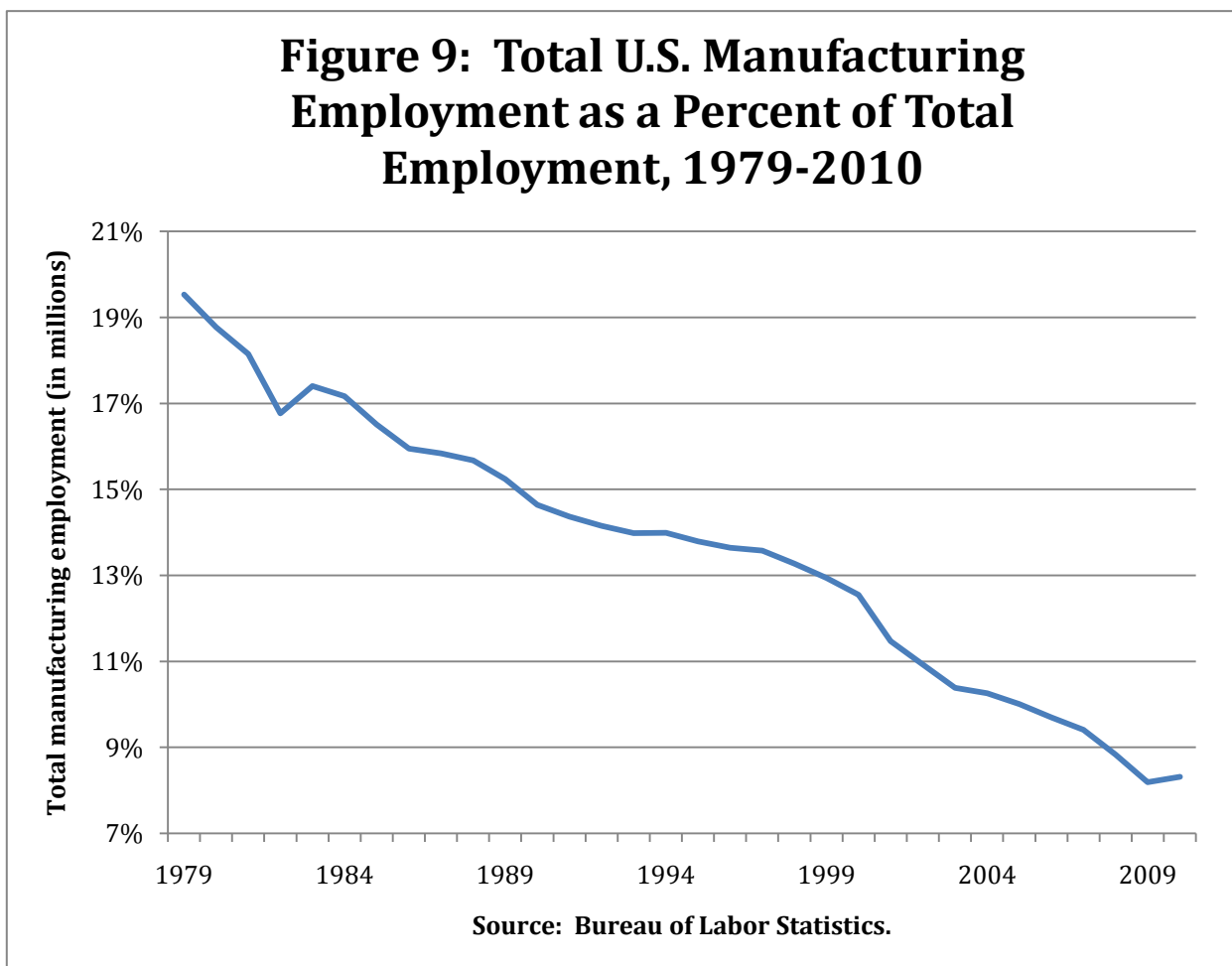
¹¹ World Bank (2010).

¹² Chaffin and Beattie (2010).

¹³ *Wall Street Journal*, “IMF Strauss-Kahn: China's Currency Is Undervalued,” March 17, 2010.

negative view of international trade in general. Trade with developing countries is held responsible, by some, for the decline in manufacturing sector employment in the United States. China is the prime target of this wrath, in part because of its dominance in the supply of consumer goods.

This viewpoint, while strongly held by organized labor, is not unique to that group. Americans who check the origin of their toys or electronics at the local Wal-Mart are likely to see “Made in China.” It is not hard for them to believe that this is where all the well-paid union jobs have gone. They are unlikely to think much about value added, country of origin, or the reshuffling of production through an integrated East Asian supply chain.



To understand this view and to put it in broader context, it is worth reviewing the role of manufacturing in the U.S. economy, as depicted in Figure 9. In both levels and as a percentage of total employment, manufacturing has provided a declining share of American jobs since 1979. This has been profoundly unsettling for an entire class of

American workers. Whereas manufacturing jobs once could be relied upon as a route to a middle class lifestyle with minimal educational requirements, those jobs seem to have been drying up and the educational requirements of those that remain have been increasing. There are a number of explanations for this trend, most notably shifts in technology that have placed an ever higher premium on skills (see Goldin and Katz, 2010). Figure 9 also shows that the trend long predates China's emergence as a trading power. Yet there is a powerful temptation to attribute the shift to imports of inexpensive manufactures from China. Those imports have been heavily concentrated in inexpensive consumer non-durables, which are the goods that American consumers purchase most frequently (almost by definition). The underlying presumption is that if the goods were not made in China, they would be manufactured in the United States.¹⁴

Closely related to the concern that American manufacturing jobs have decamped to China is the perception that foul play was involved. There is a pervasive concern that China has not always played by the rules. The argument is that Chinese competitors succeeded because they received subsidies, or were sheltered from competition, or were able to take advantage of the intellectual property of others. The relevant website of the Alliance for American Manufacturing, a vigorous organization critical of Chinese policies, goes under the [rubric](#) "China cheats." There is a degree of unfairness to this critique. The "rules" are not always formally defined, nor internationally agreed upon. Nonetheless, the perception and the accusations exist.

The concerns above are the most long-standing and deeply held driving the American debate. They are also the most readily countered with accepted economic arguments. These sentiments dominated the debate until 2005. At that time, another line of critique opened with then-Fed Governor Ben Bernanke's thesis about a global savings glut (Bernanke 2005). Bernanke attributed growing current account surpluses in Asia in part to a reaction to the Asian financial crisis and in part to policies of export-led growth. His central theme was that Asian surpluses were the exogenous spur driving the reaction in the developed world:

The current account positions of the industrial countries adjusted endogenously to these changes in financial market conditions. I will focus here on the case of the United States, which bore the bulk of the adjustment. From the trade perspective, higher stock-market wealth increased the willingness of U.S. consumers to spend on goods and

¹⁴ This presumption was made explicit in an AFL-CIO filing for a Section 301 case against China, focusing on its hukou labor restrictions in 2005. The model contained only two countries.

services, including large quantities of imports, while the strong dollar made U.S. imports cheap (in terms of dollars) and exports expensive (in terms of foreign currencies), creating a rising trade imbalance.

This analysis was put forward at a time of substantial concern about growing U.S. current account deficits, but a time of relative economic prosperity. It was revisited with much greater attention in the wake of the global financial crisis a couple years later, when the search began for culprits behind the bubbles that had burst so painfully. Of course, Bernanke's ascension to the chairmanship of the Federal Reserve also helped draw the spotlight.

If the global savings glut hypothesis placed partial blame for the onset of the crisis on macroeconomic imbalances emanating from Asia, liquidity trap theorizing in the wake of the crisis explicitly blamed China for causing American job loss. Some prominent and respected voices, such as Paul Krugman of Princeton and Fred Bergsten of the Peterson Institute, have been highly critical of Chinese exchange rate practices. Krugman wrote in 2009:

Right now we're in a liquidity trap, which... means that we have an incipient excess supply of savings even at a zero interest rate. ...In this situation, America has too large a supply of desired savings. If the Chinese spend more and save less, that's a good thing from our point of view. To put it another way, we're facing a global paradox of thrift, and everyone wishes everyone else would save less.¹⁵

In this scenario, Krugman and Bergsten argued that a full revaluation of China's currency (perhaps by 25 to 40 percent) could boost demand for the rest of the world's exports, cut the U.S. trade deficit, and expand U.S. employment.¹⁶ Even if China's policies do not hurt in normal times when we are eager for cheap loans, the argument went, they are hurting in crisis.

This new line of thought identified a central macroeconomic challenge as excessive global savings. This can only be remedied if major deficit countries borrow more – problematic because of debt accumulation – or if surplus countries save less. Not only is China seen as a major surplus nation, but its recalcitrance on currency appreciation has made it difficult for other nations in Asia and elsewhere to undertake

¹⁵ Krugman (2009).

¹⁶ Dickson, David M., "China's yuan value hits U.S. economy, two experts say," *Washington Times*, March 15, 2010.

adjustment. In the Krugman/Bergsten school of thought, these are emphatically *not* domestic issues (in contrast to the diminished manufacturing sector concern). Currency policies are integral to either preventing or facilitating global adjustment and there are real limits to what can be done without addressing these external imbalances. Thus, they argued that the RMB was significantly undervalued and that this undervaluation had an important negative effect on the United States.

This view was not universally shared. There was another school of thought that holds that China's currency is undervalued, but that the undervaluation's effect on the United States is less clear.¹⁷ This more cautious group of analysts acknowledged the problematic role of a persistently misvalued major currency, but places more emphasis on the economic factors beyond exchange rates that can affect trade balances and on the likely role of other relatively low-wage nations in potentially replacing Chinese exports to the United States in the event of a major revaluation.

Both groups of economic analysts agreed that the undervalued RMB was poor policy from China's perspective and that the global economic system is impaired when currencies cannot respond to market forces. The difference lies in their assessment of the implications for the United States economy.

A final constituency that has had an important change in approach over the past decade is the business lobby. Here one can think of groups like the U.S. Chamber of Commerce. In the past, such groups have publicly criticized plans for aggressive trade actions against China. They remain critical of some recent proposals, but their enthusiasm has significantly diminished. In light of their concerns about other Chinese economic policies – indigenous innovation and intellectual property protection, market access concerns, government procurement, and the investment environment – they have little appetite for taking on the thankless role of defending China in heated debates.

To sum up, as the nature and magnitude of China's macroeconomic imbalances evolved over time, so did the nature of arguments within the United States over the impact of those imbalances. This evolution was not always readily apparent, in part because the initial arguments blaming China for U.S. manufacturing job loss and cheating, persisted relatively unaltered throughout the period. The coalition of critics grew importantly, however, when this relatively facile analysis was backed by a more sophisticated critique that held China responsible for distorting the U.S. economy in the lead up to economic crisis and then for impeding adjustment in the crisis' aftermath.

¹⁷ See, for example, Fair (2010).

In China

It is inherently more difficult to characterize the nature of political debates and motives within China than within the United States, given the relative opacity of political processes in the Chinese system. Nonetheless, there are a number of themes that have emerged from Chinese statements and practices.

A first such theme is the principle of noninterference. Chinese leaders have repeatedly put this forward as a theme of Chinese foreign policy. In part, it serves as an example of “doing unto others as you would have them do unto you.” While the principle usually applies to questions of seeking governance changes in other countries, it can be extended arguments that China should be free to pursue whatever economic practices it chooses. This claim can become awkward when it is extended to claims that China’s exchange rate is a purely internal matter. The expectation that China should be left alone to pursue its problems may also reflect the country’s recent past as a relatively small player in global economic affairs, one that was small enough to escape notice. This approach has become increasingly untenable after China’s decades of economic growth.

A second theme is the importance of economic performance. As ideology has receded as a guiding force in Chinese politics, the legitimacy that comes from mounting prosperity and poverty alleviation has partially taken its place. This imposes serious pressures on China’s leaders. A principal explanation for China’s reluctance to appreciate its currency is the fear of the economic dislocation that could ensue. The Chinese government has conducted studies that reportedly show substantial job losses that would flow from even modest currency appreciation. China’s export sector is replete with low-margin businesses that are very sensitive to price shifts. As exchange rate adjustment has been postponed, the exporter sector has steadily grown, raising the potential adjustment costs.

The imperative to deliver economic performance in China cuts both ways, however. China’s undervalued exchange rate poses serious difficulties for controlling Chinese money supply and, in turn, inflation. The exchange rate is not the only driver of inflation; China’s post-crisis stimulus was important as well. But the exchange rate makes monetary control more difficult and imports more expensive. Appreciation of the renminbi would directly cut into import costs, which is particularly important for an economy that assembles foreign inputs and is heavily dependent on getting natural resources from abroad.

This threat is taken seriously in China. The leadership has a longstanding fear of inflation because of the public unrest it can cause. Some analysts have described a burst of inflation as one contributing cause of the Tiananmen unrest in 1989.¹⁸

The Japanese economist Takatoshi Ito argued that Chinese policy is cultivating a real estate bubble to compare with that of Japan before its bust in the 1990s. He writes:

The [Chinese] central bank is... hesitating to take up the best policy - interest rate hikes and appreciation of the Chinese renminbi. The property bubble is a clear sign of overheating. China's reported inflation rate does not show rampant inflation, but that was also the case in Japan in the 1980s. If the renminbi is appreciated, any overheating of China's export sectors will be slowed, while standards of living will improve with higher purchasing power.¹⁹

Chinese officials are aware of the dangers of inflation, of the unmet domestic needs, and of the potential for capital losses. The counterbalancing fear is that appreciation could lead to significant unemployment at a time when global demand for Chinese exports fell.

A third theme is national pride. A frequent theme in discussions of Chinese foreign policy is redress for past humiliations at foreign hands. These grievances may be specific, as with China's war with Japan, or they may relate more generally to the "century of humiliation" dating back to the opium wars of the mid-19th century – an earlier attempt to open China to trade.

The practical implication of Chinese nationalism in this context is that there is a sensitivity to slights on the international stage. While restrictions on the freedom of inquiry in China make it very difficult to make an objective assessment of public opinion, there is evidence that nationalist sentiment is not entirely under government control. Government officials thus may feel constrained in their actions and may play to this sentiment.

Last year, a New York Times reporter in Beijing described the dynamic:

After decades of comparatively quiet diplomacy, China has taken increasingly muscular stances in the past year on relations with the United States and on global economic and environmental matters. Many analysts say the shift is due not only to China's sudden arrival as a global economic power after the financial crisis, but also to domestic political issues.

¹⁸ See, for example, Keidel (2007).

¹⁹ Ito (2010).

The ruling Chinese Communist Party will select successors to President Hu Jintao and Prime Minister Wen Jiabao in 2012. In the jockeying to choose new leaders, some analysts say, there is scant incentive to take positions that rivals could criticize as weak.²⁰

In the context of Chinese currency appreciation, Chinese leaders would likely consider not only the economic implications, but the domestic political repercussions of acquiescing to foreign threats or demands. From the leadership's perspective, the worst possible outcome would be a policy concession that combined economic turmoil with a loss of face from crumbling under Western pressure.

Each sides misunderstands the other

As a final note on the motivations of the United States and China, it is worth observing that the multiplicity of motivations driving each party in their economic diplomacy has not been well understood by the other side. While each side has negotiators and experts who are well versed in the subtleties of forces behind their counterparts' arguments, this understanding has not been broadly shared. This has resulted in instances in which popular perceptions have threatened to drive the debate in contentious and unfortunate directions. The stereotypes – that China is simply pursuing mercantilist lucre as a means of furthering its indisputable prosperity and influence; or that the United States is simply using China as a scapegoat for domestic political and economic problems in its manufacturing sector – tend to push toward conflict.

III. Diplomatic efforts

This section has two distinct parts. The first indulges in a modicum of formality to illustrate the choices facing the United States in its economic diplomacy. The second part characterizes the nature of bilateral economic diplomacy between the United States and China over the decade, emphasizing the considerations developed in the theoretical section. These considerations include the opportunity costs of diplomatic requests, the willingness of a negotiating counterparty to comply, and the payoff to compliance when it is achieved.

Opportunity Cost of prioritizing currency

At one level, the economic diplomacy between the United States and China in recent years can appear rather simple. The United States government consistently

²⁰ Wines (2010).

called for China to appreciate its currency against the U.S. dollar. This was not the only matter of economic concern raised by U.S. negotiators, but it stood well above the rest. That seemed to offer a correspondingly simple metric to judge the success of the diplomacy: Rapid appreciation of the RMB would indicate success; slow appreciation or stagnation in the exchange rate would indicate failure.

In fact, this interplay was part of a broader game in which strategic choices were made implicitly or explicitly. As a device for sorting out those broader choices, we present a simple model of the negotiations, starting from an exceedingly crude depiction of the negotiating game and then adding layers of complexity. The point is not to prove a theorem, but rather to provide a framework for conceptualizing recent experience, which is discussed in the section that follows.

Simple Opportunity Cost

To begin, consider a setting with two players, the United States and China. The United States is demandeur, China is demandee. We will assume that there are two dimensions in which China can act. It can adjust *policies*, p , or its *exchange rate*, x .²¹ We will assume for the moment that the adjustment is from the initial level (p_0 or x_0) to the level that would be ideal for the United States (\hat{p} or \hat{x}), where the ideal level is $\text{argmax } W$, with the other variable held constant at its initial level.

To coax Chinese action, the United States must expend diplomatic effort,

. We will assume that the United States objective function can be depicted as:

$$(1) W(p,x) - e$$

where we define p and x such that

$$\frac{\partial W}{\partial p} > 0, \frac{\partial W}{\partial x} > 0$$

Thus, there is a welfare payoff to Chinese actions. The only action in this initial version is that the United States must choose whether to expend its effort requesting p or requesting x ; it cannot do both.²² Thus, the government maximize its welfare (assumed equivalent to national welfare) by choosing:

²¹ To be more concrete, for “policies” one could think of investment restrictions, border barriers, intellectual property rights enforcement, or government procurement policies.

²² Although in theory one could imagine a mixed strategy in which diplomatic effort is apportioned between the two objectives, in practice there tends to be a principle “ask” which is identified as a top priority. It could be interesting to consider why this is, though that question is not pursued in this paper. One possibility might involve the imperatives of headline writers, who need to identify the most important aspect of what has happened, and who serve to shape public opinion about

$$(2) \begin{cases} e_p & \text{if } W(\hat{p}, x_o) > W(p_o, \hat{x}) \\ e_x & \text{otherwise} \end{cases}$$

Moral #1: There is an opportunity cost to the pursuit of one set of policy objectives over another.

Compliance

Next, we enrich the model slightly by imposing constraints on China's willingness to respond to U.S. diplomatic efforts. We now assume that U.S. efforts, p , elicit corresponding Chinese responses \bar{p}, \bar{x} where $\bar{p} < \hat{p}, \bar{x} < \hat{x}$. This is a crude form of a reaction function. Instead of picking over the entire range of values of the target variables, the U.S. government is offered a limited menu. Now the U.S. government's optimal strategy from (2) becomes:

$$(3) \begin{cases} e_p & \text{if } W(\bar{p}, x_o) > W(p_o, \bar{x}) \\ e_x & \text{otherwise} \end{cases}$$

This is unremarkable, except that it is now possible that the U.S. government will optimally choose to focus on policies, p , even when an ideal move on currency would have a greater effect on national welfare (i.e., choose e_p even though $W(p_o, \hat{x}) > W(\hat{p}, x_o)$).

Moral #2: The optimal strategy depends not only on the potential economic impact of the policies in question, but on the responsiveness of the negotiating counterparty to diplomatic efforts.

Political Economy Objective Function

Next, we consider a more general objective function for the government.

$$(4) W(p, x) \circ \hat{a}_i w_i(p, x) + W(p, x)$$

the success or failure of the diplomatic attempt.

Although the discussion is simplified by forcing a discrete choice between the two types of diplomatic effort, the lessons carry through so long as there is a limited amount of effort the government can expend and it is divided between the set of diplomatic options.

where i indexes politically important groups within the United States, $w_i(p,x)$ represents each group's valuation of the target variables, and α_i is the weight attached to that group. Note that if all such weights are zero, this reduces to (1).²³

Under these assumptions, it is now possible that the U.S. government will optimally choose to focus on currency, x , even when the achievable national welfare payoff to a focus on policies would have been greater (i.e., choose e_x even though $W(\bar{p}, x_o) > W(p_o, \bar{x})$).

Moral #3a: Political considerations can divert a government away from economically optimal diplomatic strategies.

Moral #3b: Shifts in political constraints can induce shifts in diplomatic strategies, even without changes in the underlying economics.

Suggestive Considerations

To minimize the formality and to bridge some of the gaps between this exercise and the actual narrative of U.S.-China economic diplomacy, this section concludes with some suggestions of further features that could be incorporated to make this model more realistic.

First, it is misleading to represent U.S. welfare as a fixed function of Chinese policies. It would be far more realistic to depict the two stages of this relationship: the government's welfare depends on economic growth, on factors such as the trade balance, and above all on employment. These all can be affected by Chinese policies, but that relationship certainly would not have been stable over time, as China grew and took on a larger share of U.S. imports.²⁴

Second, there is a useful distinction to be made between the actual relationship and the perceived relationship between Chinese actions and U.S. economic performance. The shifts in perceptions could swing even more dramatically than the shifts in the actual relationship. The most prominent example of this was the reaction to the experience of 2005-2008, when the RMB appreciated by over 20 percent against the U.S. dollar. At the same time, China's trade surplus with the United States continued to

²³ We omit the diplomatic effort cost, since it is assumed to be a constant.

²⁴ For one estimate of the relationship between Chinese exchange rate practices and U.S. jobs, see Fair (2010), who concludes that Chinese undervaluation provided net benefits to the United States.

grow. Of course, we would not necessarily expect exchange rate changes to have an instantaneous impact on any trade balance, much less a bilateral one. Some, such as Cline (2010) have argued that the exchange rate change had the desired effect, when lags are calculated appropriately. But this point is a subtle one and does not lend itself to the rough and tumble of policy debates. The more common lesson was that Chinese exchange rate appreciation was not the panacea it had once seemed. For the purposes of modeling, this amounts to a reevaluation of the perceived relationship between the target Chinese policy variables and the key domestic determinants of welfare.

Third, a more accurate depiction would allow for the U.S. government to vary its diplomatic effort. This should not be thought of as the number of sleepless nights that lead negotiators put in preparing for talks, nor the stridency with which they make their points. Rather, it concerns the policy changes that the United States government was willing to offer to China in return. China has had a number of persistent requests that it has made of the United States. It has sought market economy status as a way of minimizing the impact of U.S. antidumping practices. It has also sought greater access to U.S. high technology exports, some of which are currently subject to restrictions because of national security concerns. Putting these issues on the table could be thought of as increasing U.S. diplomatic efforts to effect change in Chinese policies.

Fourth, the price that China might demand for a policy change shifted over time. Effectively, for issues on which China was determined to follow its own course without bowing to U.S. influence, the price went from infinity to zero. This occurred because China, too, seeks to maximize its government's welfare and its perception of the optimal exchange rate policy shifted over time, from periods when it feared a slump and needed a healthy export sector, to periods in which it feared overheating and inflation and contemplated the use of the exchange rate as a tool to cool the economy down.

Finally, a more careful depiction would address the specifics of the interactions between the Executive and Legislative branches of the U.S. government, rather than handling this implicitly by allowing for the overweighting of certain groups in a political objective function. Congress had a limited number of crude but potentially potent tools at its disposal to try to push the Executive Branch in a favored direction. It could impose reporting requirements, such as the semi-annual report from the U.S. Treasury on which countries manipulate their currencies, or it could pass bills. Those might range from a broad 27.5 percent tariff on Chinese goods to revisions of antidumping policy to mandated discussions to address currency undervaluation. The president, of course,

retained the power to veto such legislation, but there was concern about the signal that even partially-completed legislation could send as it advanced, in addition to concern about serious political costs should a presidential veto be required.²⁵

What is the goal of diplomacy?

Before working through the avenues of economic diplomacy that were actually employed, the next section pauses to consider the objective of those negotiations. This is closely related to the broad motivations described above in Section II, of course, but the connection between overarching goals and specific policy desires has not always been clear in discussions about U.S.-China macroeconomic imbalances.

What did the United States want?

Two central questions about the object of U.S. economic diplomacy were:

1. What was the ultimate objective of negotiation? Was it the exchange rate, the level of trade flows, the bilateral trade ledger or China's current account balance? This is essentially asking which Chinese policies should be seen as the appropriate arguments in objective function modeled above.
2. If U.S. negotiators had been granted a free hand to set Chinese policies, what would they have done? This is essentially asking what the values of \hat{p} and \hat{x} are in the modeling framework.

Until relatively recently, the exchange rate crowded out almost all other issues. Rep. Rick Larsen (D-WA), co-chair of the bipartisan congressional U.S.-China Working Group, describing the period from 2004-2005 until very recently, said, "the currency issue took up all the air. There was no air left for other issues."²⁶ Through the end of

²⁵ In October 2010 discussions with the author, Chinese officials at the Ministry of Commerce and the People's Bank of China expressed serious interest and concern about advancing currency legislation in the U.S. House of Representatives. This concern was less focused on the particular economic impact the bill would have had, which appeared minimal, than on the symbolic affront of anti-China legislation.

²⁶ Response to author's question, public presentation at the Center for Strategic and International Studies, June 2, 2011.

2010 currency was clearly the dominant issue on the U.S. economic agenda with China.²⁷

Even with currency established as the preeminent object of U.S. efforts, there remains the difficult question of just what policy the United States was seeking. Somewhat surprisingly, this was rarely addressed in great detail.

Consider first the implicit idea that China might undertake a dramatic appreciation in a short period of time. Ardent recent critics, such as Paul Krugman and Fred Bergsten, have argued that a full revaluation of China's currency (perhaps by 25 to 40 percent) could boost demand for the rest of the world's exports, cut the U.S. trade deficit, and expand U.S. employment.²⁸

Krugman played out the tactical scenario:

"First, the United States declares that China is a currency manipulator, and demands that China stop its massive intervention. If China refuses, the United States imposes a countervailing duty on Chinese exports, say 25 percent. The EU quickly follows suit, arguing that if it doesn't, China's surplus will be diverted to Europe. I don't know what Japan does ...

[F]or those who counsel patience, arguing that China can eventually be brought around: the acute damage from China's currency policy is happening now, while the world is still in a liquidity trap. Getting China to rethink that policy years from now, when (one can hope) advanced economies have returned to more or less full employment, is worth very little."²⁹

There are several separate, relevant parts to this argument. First, there is the previously discussed argument that we are in a liquidity trap (stuck at zero interest rates with ineffective monetary policy). Second, there is the contention that Chinese appreciation would result in a rapid increase in demand for U.S. products. Finally, there

²⁷ As discussed below, in the fall of 2010, the U.S. Treasury pushed a process through the G-20 that tried to reorient the discussion to current account balances. That encountered opposition abroad, while domestically it was interpreted as a simple proxy for currency issues.

²⁸ Dickson, David M., "China's yuan value hits U.S. economy, two experts say," *Washington Times*, March 15, 2010.

²⁹ Krugman, Paul, "Capital Export, Elasticity Pessimism, and the Renminbi (Wonkish)," *The Conscience of a Liberal*, *New York Times*, March 16, 2010.

<http://krugman.blogs.nytimes.com/2010/03/16/capital-export-elasticity-pessimism-and-the-renminbi-wonkish/>

is the issue of how long the liquidity trap window will last, after which, as Krugman notes, the change would be worth very little.

Suppose, *arguendo*, that the first two premises (liquidity trap and job linkage) are granted. Then there would be a short window in which the United States would care about additional Chinese demand, followed by a much longer period in which the United States would return to welcoming other countries willing to lend us money and hold down our interest rates.

But what would happen if China were to adopt a 25 to 40 percent sudden currency revaluation? In all likelihood, large swathes of Chinese low-margin producers would fail and the weak Chinese financial system would be ill-equipped to reallocate the economy's resources quickly. Beijing University Professor Michael Pettis described the likely consequences of a rapid appreciation:

“... China cannot adjust too quickly. If Beijing removes the implicit subsidies, including those caused by the undervalued exchange rate, too rapidly, that could force large-scale bankruptcies as Chinese manufacturers found themselves unable to compete globally or at home. If these bankruptcies forced up unemployment, then ... household income would ... decline as unemployment soared. In that case Chinese manufacturers would find themselves becoming uncompetitive in international markets just as domestic markets are collapsing.

The conclusion? A rebalancing is necessary for China, as nearly everyone in the leadership knows. This will involve, among other things, a significant revaluing of the currency. But rebalancing cannot happen too quickly without risking throwing the economy into a tailspin. That cannot and should not be a part of the US or Chinese policy objective. By the way if China is forced to revalue the currency too quickly, it will have to enact countervailing policies — lower interest rates, suppress wages, increase credit and subsidies — to protect the economy from falling apart, and these will exacerbate other imbalances that may be even worse than the currency misalignment.”³⁰

Thus, if China were to try to revalue too quickly, the ensuing turmoil could prevent China from significantly boosting world demand. If China were to try to revalue slowly, then the policy would not have the near term impact that Krugman and Bergsten described. A sudden appreciation would seem to offer little to the United States.

A second possibility, one that ultimately prevailed in 2010, was that China could resume the pace of appreciation that it employed from 2005 to 2008. At that time, China was appreciating at an average rate of roughly 6 percent per year. Augmented by

³⁰ Pettis, (2010).

Chinese inflation, the effective rate of appreciation has been somewhat faster.³¹ While practical, this policy is unlikely to have a dramatic impact on the United States in the short term. As noted above, it also need not redress concerns about macroeconomic imbalances, since China's earlier appreciation was accompanied by continued current account surpluses and foreign exchange reserve accumulation.³²

A third possibility is that China could avoid the question of how quickly to appreciate by leaving it up to market forces. It could open its capital account and let the renminbi trade freely against other major currencies. While such an approach has a certain appeal to an advocate of market forces, it is worth noting at least two potential downsides. First, this could just add uncertainty to the problems of economic shock described above. Second, it is not obvious that China's currency would appreciate. China is full of avid savers who have been compelled to choose between limited investment choices offering low interest rates. If they were free to put their money anywhere in the world, there could be a large outflow of renminbi into other currencies that would cause it to depreciate.

For this reason, the Bush and Obama administrations have consistently advocated for a 'market-determined exchange rate,' rather than for a free float. That policy has sufficient ambiguity that it can claim even a very gradual appreciation as a success. Though this position may be a reasonable one, it is difficult to assert that it represents a consensus within the United States.

From a diplomatic perspective, the lack of consensus about U.S. negotiating objectives had an important implication for China. There was a significant discontinuity in U.S. reaction around the zero rate of currency appreciation. In those periods when China held the RMB-dollar rate essentially fixed, it managed to unite the different U.S. groups in dissatisfaction. Whether they favored a free float, sudden appreciation, gradual appreciation, or a "market-determined" exchange rate, they all knew they opposed stasis. One puzzle of the 2008-2010 period was why China was so slow to recognize

³¹ Treasury Secretary Tim Geithner made this point about the real exchange rate, sparking a debate about whether measured Chinese inflation, with a heavy weight on rapidly rising domestic food prices, was particularly relevant in discussions about tradables.

³² As a matter of economic policy, there is a significant downside for a country that attempts steady, predictable currency appreciation: It provides investors with a one-way bet. With a predictable 6 percent annual appreciation, any investor who could convert dollars into renminbi would achieve an additional 6 percent return beyond any interest rate differential. This creates great pressures for 'hot money' flows into China and complicates the task of tamping down Chinese inflation. Recent Chinese experience, with diminishing trade surpluses but rapid foreign reserve accumulation, seems to reinforce these concerns.

this. In terms of the impact on Chinese inflation or unemployment, there was little difference between a minimal appreciation and a fixed rate, whereas the minimal rate of appreciation would have required U.S. critics to delineate the difference between an acceptable and an unacceptable rate of appreciation. That was (and remains) a difficult line to draw.

What did China want?

There is an asymmetry in describing China's objectives, since they were largely defensive. China had goals such as access to U.S. high technology goods and market economy status, but these were only tangentially connected to issues of macroeconomic imbalances. As noted above, China was concerned about U.S. macroeconomic policies that could affect the value of its substantial holdings of U.S. government bonds, but this did not amount to much more than general admonitions to the United States to behave in a prudent fashion. For the most part, China was eager to stick to its principle of noninterference and argue that macroeconomic policies were not an appropriate subject for negotiation.

In the period before China's initial currency appreciation in 2005, there was an exception to this. At that time, China had specific concerns about how to mitigate the potentially adverse impacts of exchange rate volatility on its tradables sectors and was willing to seek, or at least accept, advice from the United States. This willingness to seek financial advice dissipated in the wake of the financial crisis.

How to persuade?

Whatever the ultimate goals of U.S. policy toward macroeconomic imbalances with China, there were three broad venues under which they could be pursued: unilateral, bilateral, and multilateral.

The unilateral approaches were largely congressionally mandated and consisted of deadlines, determinations, and retaliatory threats. The most prominent of these, one that was actually in effect, was the requirement that the United States Treasury issue a twice-yearly report declaring which countries among U.S. trade partners had manipulated their currencies. This regular reporting requirement was part of the 1988 Trade Act and is a regular source of contention. No administration has named a currency manipulator since China was cited in 1994 (GAO 2005). The Bush administration was regularly excoriated for its failure to name China. As a candidate for the presidency, then-Sen. Barack Obama pledged that he would find China to be a

currency manipulator, a pledge that was repeated by Tim Geithner at his Senate confirmation hearings to become Treasury Secretary (Calmes 2009). This was one reflection of the sensitivity and political pressure surrounding trade imbalances and exchange rate issues with China. Once in office, however, the Obama administration declined to name China a manipulator, frequently delaying the report beyond its mandated release date.

It is somewhat odd that the labeling (or failure to label) China as a currency manipulator has become so central to U.S. debates. The 1988 Trade Act requires only that when a currency manipulator is identified, the Treasury must “initiate negotiations with that country to ensure a foreign currency exchange rate adjustment that eliminates the unfair trade advantage” (GAO 2005, p. 6). Since the United States has steadily been engaged in such negotiations with China for most of the period under discussion, one might ask what difference it would make. Both the United States and Chinese governments treated the decision as significant, however. U.S. principals endured intense criticism from legislators and commentators for the failure to name China, while Chinese officials made clear that the label of currency manipulator would be distinctly unwelcome and intimated that, if anything, it would slow progress toward currency revaluation.

Congressional frustration with the relatively moderate stance of successive presidential administrations resulted in persistent threats to force a bolder stance through legislation. Among the legislative leaders in these pushes were Sen. Charles Schumer (D-NY), Rep. Tim Ryan (D-OH), and Rep. Duncan Hunter (R-CA). The threats embodied in the legislation evolved over time, from a 27.5 percent tariff to measures that refined Commerce Department practices in antidumping and countervailing duty investigations. Part of that evolution was intended to ensure that the retaliatory measures would not violate U.S. obligations at the World Trade Organization. Most such legislation never came to a vote, but in late September 2010 the House of Representatives passed H.R. 2378, the “Currency Reform for Fair Trade Act.” (Mantell 2010). Despite threats that it might, the Senate never took up the legislation and President Obama was never forced to decide whether he would sign it.

Although threatening China legislation never made its way through Congress, it still had a significant impact on economic diplomacy. It served as a persistent source of pressure on negotiators, who had to worry that if they expressed insufficient concern

about exchange rate undervaluation, their had could be forced by difficult and potentially damaging legislation.

This situation changed with the U.S. congressional election of November 2010 and Republican control of the House of Representatives, effective in January 2011. The new leaders of the critical House Ways and Means Committee, Chairman Dave Camp (R-MI) and Trade Subcommittee Chairman Kevin Brady (R-TX) said they would not pursue China currency legislation (Beattie and Politi, 2011).

The bilateral venues included a whole series of dialogues between the United States and China, including the Joint Commission on Commerce and Trade, the Strategic Economic Dialogue (under the Bush administration) the Strategic & Economic Dialogue (under the Obama administration), and presidential summitry. . These complemented routine diplomatic discussions by convening top-level policymakers to discuss matters of pressing concern. A persistent challenge of the dialogues was that they often aimed to engage in conceptual discussions but were nonetheless expected to result in “deliverables” – momentous movements toward policy goals. Given the legislative pressure described above, U.S. negotiators felt compelled to make currency movement a top demand. This generally resulted in unsatisfying conclusions to the meetings, since Chinese leaders were not about to rework their macroeconomic policy just to suit visiting U.S. cabinet secretaries.

The opportunity cost of this approach was demonstrated in a Washington summit between President Obama and President Hu Jintao in January 2011. With Congress under new House leadership no longer credibly threatening currency legislation, the Obama Administration was freed to emphasize issues such as China’s indigenous innovation policies. Currency issues were mentioned, but deemphasized. Rather than encountering the traditional impasse, the talks elicited significant commitments from the Chinese side (Levy 2011).

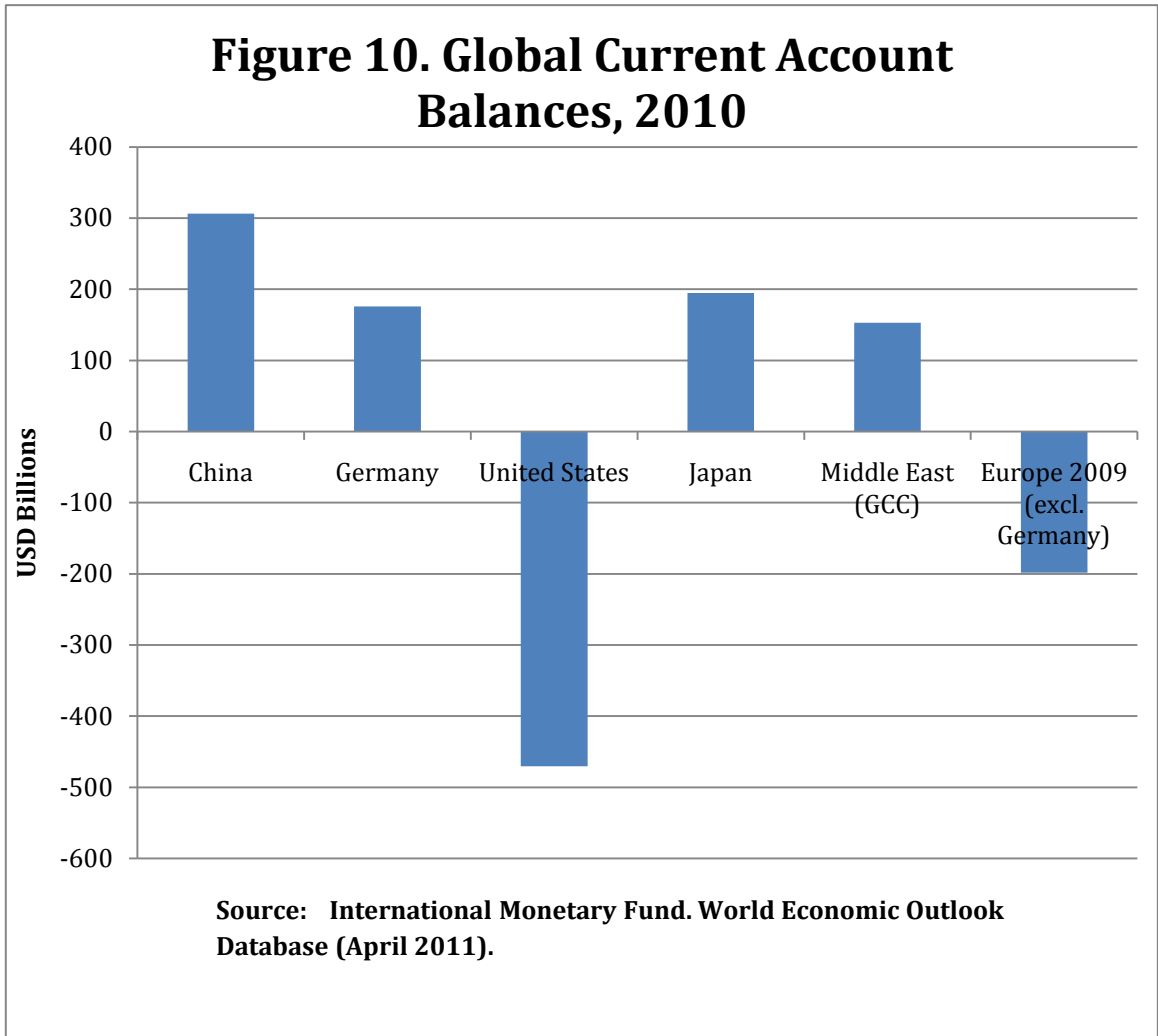
The final venue for addressing macroeconomic imbalance issues was multilateral. It is taken up in the next session.

IV. Repercussions for economic governance

With China and the United States occupying the top two spots in world GDP tables by the end of the decade, there was little useful distinction between bilateral macroeconomic imbalances and global imbalances. Figure 10 shows current account

balances for major players in the global economy in 2010. The United States and China stand out as featuring the two largest imbalances in absolute value.

This section will address four pillars of global economic governance that have been engaged in questions of macroeconomic imbalances between the United States and



China: the Group of 20, the status of the dollar as a global reserve currency, the International Monetary Fund, and the WTO.

Undermining of the G20

The first pillar is the G-20, which first met in crisis mode at the end of the Bush Administration in 2008 and then was elevated to the status of premier global economic negotiating forum under the Obama administration. The central justification for the elevation of the G-20 over predecessors such as the G-7 or the G-8 was that it brought

the right players to the table. Of these previously excluded players, China was easily the most prominent.³³

The London summit of April 2009 included a call in the leaders statement for “a new global consensus on the key values and principles that will promote sustainable economic activity.”³⁴ In the ensuing Pittsburgh summit later that year, the leaders pledged “to adopt the policies needed to lay the foundation for strong, sustained and balanced growth in the 21st century.”³⁵ The sustainability called for in London could be interpreted to include moderation in current account balances. If the meaning were unclear, the Pittsburgh declaration included “balanced” in the pledge. Such ambiguous language is very useful, in that it can allow countries with disparate interests to reach agreement on a declaration. Therein lies its weakness, however, as it need not compel any country to actually change.

There was a glimmer of hope for the G-20 process in June 2010 when China’s decision to resume allowing currency appreciation was announced within a week of the Toronto G-20 summit, though the Chinese disavowed any linkage between the two events.

That hope faded with a finance ministers meeting in Seoul in the fall of 2010 when a U.S. effort to make these pledges more concrete hit strong opposition. (Levy 2010b) The U.S. proposed having an accepted threshold beyond which persistent current account imbalances (surplus or deficit) would be considered problematic. This minimal step was opposed, most prominently by China and Germany. Though Figure 10 shows Germany as a prominent surplus country, German leaders would object vehemently to the depiction. They would argue that Europe should be treated as a whole, in which case the German surplus is counterbalanced by the deficit prevailing in the rest of the area.

One notable feature of the Seoul talks was the U.S. move away from exchange rate movement as a target toward the broader goal of current account balance. This was, in part, a recognition of the limited efficacy of exchange rate moves in China in the absence of complementary measures to bolster domestic consumption.

In light of the opposition, the G-20 was left muddling through an arduous definitional process, whereby it might be possible to identify countries who deserve heightened scrutiny to determine whether any untoward and unsustainable activity had

³³ A great deal of information on the G-20 is available at <http://www.g20.utoronto.ca/>.

³⁴ <http://www.g20.utoronto.ca/2009/2009communique0402.html>, point 21.

³⁵ <http://www.g20.utoronto.ca/2009/2009communique0925.html>, line 11.

taken place. The process seemed unlikely to produce any firm action in the foreseeable future. Nor did it seem to offer much hope for the institution as a means to address pressing imbalances.

IMF

The experience at the IMF paralleled that at the G-20. The IMF was officially tasked with policing misbehavior in international financial matters and rendering judgments on improper currency practices. At roughly the same time that the G-20 was replacing the G-8 to better reflect new economic power relationships, the IMF was renegotiating its voting shares for the same reason. In each case, China was prominently given a greater say.

In terms of addressing macroeconomic imbalances, while the Managing Director did pronounce the RMB undervalued (quoted above), there were no policies to prod China in that direction. Nor, for that matter, were there policies to compel the United States to address its chronic current account deficits. This laid bare a weakness of the institution. It has substantial influence when countries come seeking funds to address balance of payments difficulties. It has very little influence when dealing with donor countries such as the United States and China. Not only does the IMF lack levers over their behavior, but it is generally loath to take actions to offend its principle funders.

Impact on the WTO

The last decade marks not only a significant era in macroeconomic imbalances but also the epoch of the troubled Doha Development Agenda talks at the WTO. China was admitted to the organization just as the talks launched in 2001. While Doha's troubles largely revolve around disagreements over market access obligations and policies such as agricultural market supports, macroeconomic imbalances have played a non-trivial role, albeit one that has received little attention.

A core principle of the WTO is that of 'most favored nation,' whereby market access concessions that are granted to one WTO member are automatically extended to all others. With China's accession, this meant that any country offering new market access had to offer it to China as well. As China grew into an exporting powerhouse, this became a steadily more fearsome prospect. This mattered less to advanced developed countries such as the United States and Europe, who had already largely eliminated industrial tariffs in previous trade negotiating rounds and who often produced different, more capital-intensive goods than those produced by China. It potentially mattered much

more to advanced developing nations that had retained substantial tariffs and were more likely to be competing head-to-head with China in a range of markets.

The WTO is also threatened by moves to compel it to render judgment on China's currency practices. This has been one popular course of action in the U.S. Congress. On its face, it seems impartial and multilateral. The difficulty lies in the inability of the WTO to cope with such case. (Busch and Levy 2010). The relevant article in the trade agreement, Article XV:4, is exceedingly vague. It says members "shall not by exchange action frustrate the intent of the provisions of the GATT." It proceeds to refer anyone seeking greater detail to the IMF. The potential for a case on currency at the WTO would put the organization in an exceedingly difficult position. If it rejected the case on the grounds that it did not have sufficient guidance to rule on such matters, it would look impotent. If it accepted the case, it could only pass a judgment by creating new rules to govern macroeconomic conduct. Such rules would have only the most tenuous grounding in agreements among the organization's membership and would thus almost certainly have their legitimacy challenged.

The dollar as a reserve currency

The final institution of global economic governance to be challenged by U.S.-China macroeconomic imbalances has been the status of the U.S. dollar as a reserve currency, an institution in the figurative sense. With the U.S. economy in a persistent state of recession or slow recovery, with no real option for pursuing an expansive fiscal policy, and with key short-term interest rates hovering at or near zero, U.S. macroeconomic policymakers were left few choices to spur the economy. One option would be to boost the economy through increased external demand. That was certainly part of the motivation for seeking rebalancing under the G-20 process. With no prospect for such progress, the Federal Reserve pursued a policy of quantitative easing (known as "QE2," since it was the second such attempt).

This drew a sharp reaction from China and other creditor nations, who worried that the United States was failing to fulfill its duties as provider of the world's reserve currency. Given the troubles of the eurozone and Japan, critics of U.S. actions had few practical alternatives to the dollar as a reserve currency, but the episode served to undermine confidence in the institution and to prompt talk of currency wars and a search for options.

This section has argued that the macroeconomic imbalances between the United States and China have featured prominently on the agendas of the major institutions of global economic governance. In no case have those institutions demonstrated any significant success in moving toward balance and each seems to have been at least somewhat weakened in the process.

V. Conclusion

Over the last decade, macroeconomic imbalances between the United States and China have grown significantly. The policy instruments that could potentially bring about adjustment have been the subject of intense political debate in both the United States and China. Throughout the decade, concerns about Chinese currency undervaluation have dominated economic diplomacy between the two countries, often to the exclusion of other issues that may have been more amenable to negotiation. The bilateral negotiations were often as much an attempt to keep domestic forces from pursuing more damaging measures as they were realistic attempts to change policies abroad. The push for global macroeconomic rebalancing extended into multilateral negotiating bodies as well, though the institutions appeared largely impotent in the face of the problem.

Going forward, it will be vital to determine whether the United States can demonstrate the patience to allow the issues to be resolved without forcing the question. Although unilateral, bilateral, and multilateral pressures have all failed in dislodging China from its commitment to an undervalued currency and rapid reserve accumulation, China's own demographic and economic forces could succeed in effecting change. The advent of inflationary pressures within China have prompted calls for currency appreciation as an anti-inflationary measure. The potential costs of excessive exchange reserves have prompted calls for limiting holdings. An aging population has prompted calls for a shift from an economy focused on investment to one more oriented toward consumption.

Two factors loom as critical in determining whether the issue will flare into conflict or remain manageable. First, the upcoming government transitions in both the United States and China are likely to exacerbate tensions. In the United States, there is little political return to being tolerant of China; in China, there is little political return to appearing subservient to the United States. Second, the broader macroeconomic performance of the two countries will matter significantly. It was fear of a sharp downturn in 2008 that caused China to stop its policy of currency appreciation. It was the sharp

upturn in U.S. unemployment that led prominent economists to begin discussing winnable trade wars against China.

For years to come, questions of how to address the macroeconomic imbalance between the United States and China seem unlikely to lose their prominence in economic diplomacy and global governance.

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